**GOVERNANCE**

*Getting closer to hour X...* As we should have expected, this political autumn is hot, despite the cold weather outside. At the same time, the internal political life "is heating up" simultaneously with a clearer outlining of some external trends. Thus, it is extremely interesting to see what will result from the "synergy" of these developments.

**On the external arena, we still have an equation with two poles of attraction – the EU and Russia.** On the Western side Moldova is still a "success story", tarnished a bit by the patchiness of domestic reforms, as well as by the EU agenda overcrowded by other matters. The burden of sovereign debt crisis and the risk of Eurozone implosion will remain the biggest constraints for the EU foreign policy. On the Eastern side, the announcement of V. Putin’s candidature in the presidential elections of Russia and the launching of the Euro-Asian Union (EAU) concept reveal an even more assertive policy of Russia towards the former USSR countries for the near future. We discussed previously the different attractiveness of the EU integration versus accession to the Customs Union of Belarus, Kazakhstan and Russia (MEGA 3). From the economic development perspective, the arguments are perfectly valid for the EAU as well. In the short run, it is very likely for the EAU to be an attractive option. Theoretically, this would ensure access to cheaper energy resources (taking into account the perspective of increasing the tariffs) and would guarantee unhindered access to the market of this Union (taking into account the share of the Russian market in the Moldovan exports - about 27% of the total exports). But, all these will not bring Moldova to modernization, including by approving the acquis in a number of essential areas, such as competition, liberalization of internal markets, etc. Finally, even Russia is searching for the Western support to modernize its economy. And this is without speaking here about the commitments assumed by the Republic of Moldova towards the EU, WTO, etc. and about the fact that the relationships among the members of the Customs Union are not always clear, while the Russian customs policies have become the common denominator for the union agreements. Obviously, Moldova is deeply anchored on the European integration path, but the future will depend a lot on the settlement of the European sovereign debt crisis and on the political stability of Moldova.

**Internally, the current governance coalition is drawing quickly closer to its disintegration.** But what will come next? Ideally, the country would need a wide coalition that would step outside the vicious electoral circle and would be able to promote the reform agenda. Moreover, in the short run, such a coalition could implement much easier the unpopular fiscal and budgetary policy, but also survive the "high-tariff winter". In such a situation, the parties out of the coalition would "use" the period until the early elections for electoral purposes. However, the recent story leaves little space for ideal scenarios for Moldova ...
BUSINESS CLIMATE

After one year of discussions, the work on the draft Law on Competition was finished in August 2011, but unfortunately this first attempt of the National Agency on Protection of Competition (NAPC) is not successful. With the new draft of the Law on Competition, NAPC intends to overtake a wide range of rights and establish a set of exaggerated penalties that might compromise the activity of some entrepreneurs. These deficiencies are worsened by the fact that methodological norms, (that will be eventually drafted at a later stage) could aggravate the existing flaws of the legal act. Although the initially planned deadlines were exceeded by almost 2 months, both the draft Law on Competition and draft Law on State Aid have not been yet submitted to the Government, albeit the work on these draft laws started more than one year and a half ago.

The authorities have decided recently to keep the fiscal facilities introduced in 2005 for the IT companies for other 5 years (until 2016). The decision was influenced by the reaction of the representatives of this sector to the Government’s plan to eliminate some of these facilities. The leaders of the IT companies claim that the decision to launch their businesses in Moldova was influenced to a large extent by the facilities implemented in 2005 and their possible displacement could make the investors leave the sector. This particular case should be a lesson for the Government, showing that the fiscal facilities can lead to "severe addiction" syndrome among business entities and that attempts to eliminate them could result in a "delicate blackmailing" of the Government.

The business entities rush to take advantage of the last months when they still can apply 0% income tax on the reinvested profit. Thus, according to the balance of payments, during the first 6 months of the current year the equity capital investment increased by about 46% y-o-y, while the reinvested profit increased eightfold (!). The dynamics of this indicator can even further accelerate as we get closer to the end of the year.

The topic of the Free Economic Zones (FEZ) is again on the economic policy agenda. Prime-Minister Vlad Filat made a remark we cannot disagree with, namely that "we should create a Moldova FEZ". EXPERT-GRUP criticized long time ago the concept of economic development based on free economic zones or any other zones of exclusive character (see Real Economy no. 3, May 2008). Although two of the eight (6 classical + Giurgiulesti port + Marculesti airport) FEZ show a positive economic dynamic, their cumulated economic effect is more negative than positive, mainly because of the distorted free competition and high tax and customs evasion.

REAL SECTOR

August: a perfect month for industry. The explosive growth by 19.4% of the industrial production output in August y-o-y and, consequently, the 10% growth during January-August y-o-y confirm the positive trends in this sector. The recorded advance is a good precondition that will allow ending the year with over 10% growth. The following sectors have registered the highest growth rates during January-August: machine and equipment manufacturing (39.4%), electrical machinery and devices (33.9%) and medical devices and medical technologies.

2 Both draft laws were developed by NAPC.
instruments, of high precision - oriented mostly towards export, but also mining (16.7%) and production of other non-metallic mineral products (20%) influences by the demand in construction area. Taking into account that the food and beverages industry grew in January-August by only 2.7% y-o-y and its significant share in the industrial production (about 40%), it is obvious that the total increase achieved in industrial sector is due to the non agri-food sectors. At the same time, the steady increase of the food industry has an important role in the development of related sectors (glass and cardboard products), some of them having a good development during this period of time.

The substantial growth of the transport services is not enough to get back to the pre-crisis level. In August 2011 the amount of transported goods increased by 25% m-o-m and other 27% y-o-y. We would also like to emphasize a double rate of increase in the amount of transported goods, compared to the average rate recorded in April-July of the current year. In August the railway transport services were the key driving factor of the sector, where the amount of transported goods increased by 52% y-o-y. The recent evolution indicates that the rate of railway sector recovery is accelerating and could be explained by the return of the manufacturers and exporter to the local transport services. Despite these dynamics, the amount of goods transported in the first eight months of the current year accounts for only 40% compared to the same period of 2008, while the amount of road transported goods managed to recover 80% of the pre-crisis level (Chart 1).

The results of the agricultural sector are less remarkable, but here we also have sub-sectors that grew quicker than others. The global production increased by only 3.7% y-o-y during January-September 2011. Nevertheless, the increase of the average harvest of grapes per hectare by about 44% is noteworthy. During the upcoming years these results will have a favorable impact over the wine-making sector. Besides that, it is also worth mentioning the 7.4% growth in the production of livestock and poultry in all types of farms.

**Households**

The income increases, but so does the inequality... In Q2’11 the disposable income of the population returned to the relatively strong ascending, but disproportionate trend. The population’s welfare increases mainly in the urban area, where the revenues rose by 11.1%, while in the rural area the progress was lower - only 3.7%. Thus, the financial status of the rural population has remained almost unchanged after the crisis, its disposable income being under the cost of living and the co-relation has improved marginally (Chart 2). Hence, we can notice the positive change in the share of wage income, which is in line with the evolution of salaries in the economy. As well, in Q2’11 the revenues from individual agricultural activity and social benefits, particularly pensions, increased, the latter tending to cover a larger share in the income of the rural population.
Where do the remittances go? Although the remittances continue to grow quickly, we notice a very interesting redirection. Even though the largest share of migrant population comes from rural area, in Q2’11 the income from remittances increased only in the urban area (24.6% vs. -18.3% in the rural area). A possible explanation is that the parents who are abroad send money to their children who moved to towns. The important implication of this trend, if it continues, is that the contribution of remittances to the further reduction of rural poverty will diminish.

The growth rate of the population’s income exceeds that of the expenses. This is suggested by the data of the Household Budget Survey and by the evolution of individuals’ deposits in September 2011, which was the strongest during the entire year. The deposits in MDL increased by 34% and the ones in foreign currency increased by 11%, partially also encouraged by the increase of the interest rate provided by the commercial banks for deposits.

In September the number of new registered unemployed with the NEA increased after a slight decrease during the summer time. Nevertheless, this is a seasonal feature specific to the autumn months, when the demand for labor force in some occupations, particularly in agriculture, decreases. At the same time, in annual terms the number of the unemployed people registered with the NEA is falling (Chart 3).

PUBLIC FINANCE

A step towards balancing the budgetary revenues’ structure. The Government has recently approved and submitted to the Parliament the draft law on amendment and completion of some legal acts, which reflects the implementation of the new budgetary-fiscal policy. The most important amendment in the fiscal policy for the next years is the re-introduction of corporate income tax. We endorse the decision and the 12% rate seems acceptable, taking into account that the zero-rate did not meet the optimistic expectations that were behind this initiative. Similarly, the non-taxation of the dividends paid to the business entities is a suitable decision in order to avoid the decrease of liquidities available for business activities.

At the same time, the current draft contains neither policies for small business support, nor for the entrepreneurial initiatives facilitation and promotion. The 4% tax on the operating income of corporate business entities, VAT non-payers, is optional only on the MDL 100-600 thousand interval of taxable deliveries, being mandatory as effect for amounts up to MDL 100 thousand. This cannot be regarded as a real support because according to our calculations this rate is advantageous only for the enterprises with a profitability rate over 33%. Similarly, the 15% tax on the increase of the equity capital on the account of the corporate profit without changing the shares held by the shareholders will slow down the augmentation of the equity capital and the share of retained earnings. Even if this technical accounting difference will not decrease the companies’ resources, it will reduce the financing possibilities and will diminish the enterprises’ credibility.

Is the personal taxation system fair? The taxation of individuals in 2012 with 7% under the threshold of MDL 25,200 and 18% above that threshold, providing a personal exemption amounting to MDL 8,640 (it was MDL 6,300 in 2008) keeps the main structural elements introduced in 2008. The adjustment only of the personal exemption to the inflationary expectation for 2012 reveals that the MoF believes that the 2008 system is suitable. At the same time, this taxation system does not reflect adequately the use of public resources and the conditions for earning personal income, being excessively cumbersome for the people, whose income is under the cost of living. The system of personal exemptions is not efficient in this respect, as it is universal.
in nature. To increase the disposable income of these people, the personal taxation system should be adjusted.

**Financial Sector**

Paradoxically, the interest rates on bank deposits are still lower than the interest rates on state securities. In late August the difference accounted for about 5 p.p. - an unprecedented phenomenon in Moldova. The main reasons are the following: (i) higher interest rate on state securities, coupled with tighter monetary policy and lower interests among banks; and (ii) the abundance of liquidities that allow banks applying lower interest rates on deposits. Though the interest rates grew slightly in September, they are still net inferior to the interest rates on state securities.

Despite the growth of crediting, the level of liquidities in the banking system is still very high. Thus the banks benefit of a massive inflow of deposits on the background of higher disposable income of population and higher turnovers of the companies, but also due to the lack of a feasible alternative to the bank deposits on the financial market. Besides, the current discussions about the raider attacks on shareholders of several banks did not affect significantly the banking system: both the stock of deposits and the amount of new deposits in late August were by about 20% higher than the level recorded last year (Chart 4) and the annual increase rate has accelerated compared to July.

The most visible increase of deposits was recorded in case of deposits for more than one year, which could reveal higher uncertainties in the local business environment. Particularly, for legal entities the amount of new long term deposits in MDL almost tripled, while the deposits in foreign currency doubled as compared to August of the previous year. Consequently, business entities prefer to "park" their liquidities in commercial banks rather than invest them in the real sector, though the interest rates on deposits are under the inflation level.

The financial situation in the banking system continues to improve thanks to the higher crediting of the real sector. Most banks enhanced their credit portfolios, which already impacted positively the profitability and employment levels (Chart 5.). At the same time, there are several more "problematic" banks supervised closely by the NBM that have not yet recovered definitively after the economic crisis.

**Money and Prices**

In late September, the annual inflation rate decreased down to 8.8% on the background of a comparably higher basis than in the previous year. As in the previous months, this was mainly determined by the rise in the price of foodstuffs, which occurred simultaneously with the increase of all regional prices, less favorable climate conditions, and higher storage costs (Chart 6).

Unlike the annual inflation, the monthly inflation (+0.4%) was caused by the rise in the price of non-food products (+0.8%). The main inflation factors relate to the propagation of the second round effects as a result of previous rises in the prices of fuels and utilities, agricultural and industrial inputs, as well as of the regional trends that determined the increase of the price for liquefied gas. Besides the supply-driven inflation factors, the demand-pushed factors are continuously ascending due to the increase in the population’s disposable income, augmentation of commercial banks’ crediting activity and recovery of economic sectors.

After several stages of monetary policy tightening, in September the NBM decided to keep the main rates unchanged, focusing on the sterilization of excess liquidities. The reason is that the current inflationary expectations,
which are quite high, are not determined by monetary factors and, respectively, cannot be influenced by the NBM. Thus, the increase in the tariffs for gas, heating, and hot water will have an unavoidable impact on the level of prices in October, which will also involve second round effects in the upcoming period by means of production costs.

**FOREIGN TRADE**

*Foreign trade continues to expand spectacularly.* Commercial exchanges of the Republic of Moldova with the world have an unprecedented ascending trend. During the first eight months of the year both exports and imports have increased remarkably, by 61.9% and 39.5% y-o-y respectively. The advances in the trade in goods are also supported by the progress in the trade in services. In the second quarter of 2011 the exports of services increased by 31% and their import increased by 20.1% y-o-y. As a result, in Q2'11 Moldova had a positive balance of the trade in services, for the first time in the past years. At the same time, the export expansion rates are still high in regional comparison, but closer to the rates specific for the CIS countries.

*Between two poles.* At the same time, Russia and Romania are consolidating their roles as the main trade partners of the Republic of Moldova. As for exports, these two countries receive 45.8% of the total Moldovan exports of goods (27.6% and 18.2% respectively) and 24.6% of the total imports (14.9% and 11.5% respectively).

*The goods composition of exports is changing slightly.* As for the categories of goods, the exports are still dominated by the "in recovery" category such as agri-food products and textiles, as well as by a "supernova" category - machines and equipments for transportation. At the same time, the imports are dominated by fuels, machines and equipment for transportation, chemical and food products.

*The shadows on the horizon.* Despite these positive developments, the growth rate is already "cooling down". This trend could become even more obvious by the end of the year, taking into account the higher comparison basis in the second half of 2011 and the moderation of trade expansion rate at the global level. Thus the WTO reduced its forecast for the global trade growth rate from 6.5% to 5.8%. Moreover, if the risks related to the global economic growth and stability of world financial architecture magnify the Moldova’s foreign trade prospects could come to face devastating effects.

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4 [http://wto.org/english/news_e/pres11_e/pr641_e.htm](http://wto.org/english/news_e/pres11_e/pr641_e.htm)
TABLE 1. MOLDOVA: KEY SHORT-TERM ECONOMIC INDICATORS

<table>
<thead>
<tr>
<th>Feb’11</th>
<th>Mar’11</th>
<th>Apr’11</th>
<th>May’11</th>
<th>Jun’11</th>
<th>Jul’11</th>
<th>Aug’11</th>
<th>Sep’11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial production growth rate, y-o-y, %</td>
<td>9.1</td>
<td>3.7</td>
<td>11.4</td>
<td>4.9</td>
<td>11.6</td>
<td>7.8</td>
<td>19.4</td>
</tr>
<tr>
<td>Retail-trade growth rate, y-o-y, %</td>
<td>17.4</td>
<td>18.4</td>
<td>18.8</td>
<td>22.8</td>
<td>24.2</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Services to population growth rate, y-o-y, %</td>
<td>1.1</td>
<td>1.7</td>
<td>-6.5</td>
<td>-3.3</td>
<td>10.0</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Merchandise exports, million USD</td>
<td>161.2</td>
<td>182.9</td>
<td>175.9</td>
<td>173.6</td>
<td>172.5</td>
<td>181.0</td>
<td>186.0</td>
</tr>
<tr>
<td>Merchandise imports, million USD</td>
<td>356.9</td>
<td>457.5</td>
<td>421.1</td>
<td>437.6</td>
<td>417.5</td>
<td>414.8</td>
<td>420.6</td>
</tr>
<tr>
<td>Official reserve assets, million USD</td>
<td>1739.8</td>
<td>1793.4</td>
<td>1918.4</td>
<td>1909.4</td>
<td>1901.5</td>
<td>1988.1</td>
<td>1981.5</td>
</tr>
<tr>
<td>Registered unemployed, persons, end-period</td>
<td>50095</td>
<td>51204</td>
<td>48686</td>
<td>44719</td>
<td>41141</td>
<td>39146</td>
<td>37397</td>
</tr>
<tr>
<td>Real wage growth rate, y-o-y, %</td>
<td>5.4</td>
<td>2.2</td>
<td>6.8</td>
<td>5.5</td>
<td>11.4</td>
<td>2.5</td>
<td>9.3</td>
</tr>
<tr>
<td>Consumer prices growth rate, y-o-y, %</td>
<td>5.4</td>
<td>2.2</td>
<td>6.8</td>
<td>5.5</td>
<td>11.4</td>
<td>2.5</td>
<td>9.3</td>
</tr>
<tr>
<td>Budget revenues growth rate, cumul. y-o-y, %</td>
<td>7.7</td>
<td>7.7</td>
<td>7.7</td>
<td>8.3</td>
<td>9.2</td>
<td>8.8</td>
<td>8.8</td>
</tr>
<tr>
<td>Nominal exchange rate, end-period, MDL/USD</td>
<td>11.99</td>
<td>11.90</td>
<td>11.69</td>
<td>11.67</td>
<td>11.61</td>
<td>11.40</td>
<td>11.34</td>
</tr>
<tr>
<td>Broad money (M2) growth rate, y-o-y, %</td>
<td>19.97</td>
<td>17.38</td>
<td>20.51</td>
<td>22.1</td>
<td>16.75</td>
<td>16.30</td>
<td>16.37</td>
</tr>
<tr>
<td>Central bank refinancing rate, end-period, %</td>
<td>8.0</td>
<td>8.0</td>
<td>8.0</td>
<td>9.0</td>
<td>10.0</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Bank deposit rate, %</td>
<td>14.53</td>
<td>14.6</td>
<td>15.05</td>
<td>14.59</td>
<td>14.32</td>
<td>14.06</td>
<td>14.06</td>
</tr>
<tr>
<td>Banks unfavorable credits, % of total assets</td>
<td>n.a.</td>
<td>33.2</td>
<td>32.82</td>
<td>33.34</td>
<td>31.77</td>
<td>32.30</td>
<td>32.68</td>
</tr>
<tr>
<td>Currency deposits, % of total deposits</td>
<td>n.a.</td>
<td>47.98</td>
<td>48.30</td>
<td>47.20</td>
<td>47.64</td>
<td>46.84</td>
<td>46.84</td>
</tr>
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</table>

Source: NBS, NBM, and EG calculations and estimates.