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Moldovan Economic Growth Analysis

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Key Policy Messages

The strong economic growth recorded in 2013 should be regarded with caution, because it was mainly determined by context factors with a temporary effect (catch up growth in agriculture, ultra-relaxed monetary policy and national currency depreciation). However, if we leave out these critical elements that are irrelevant in assessing the quality of growth, the Moldovan economy would have shown a structural advance estimated at only 3%. Such a growth is twice slower than the minimum required to ensure a convergence towards the central-European average and is not enough for tapping the structural potential of the economy. Moreover, the growth was unevenly distributed: the sectors making up for half of the added value in industry have remained stuck in recession, which partially explained the decline in urban population employment rate.

The strong contribution of very short-termed factors coupled with a low structural growth of only 3% in 2013 reflect the multitude of deficiencies and systemic vulnerabilities of the national economy. Thus, in the upcoming years, the strong and inclusive growth of the Moldovan economy will depend on the quality of the business environment, the access to foreign markets (competitiveness), the stability of the financial sector and, crucially, on the quality of the human capital and success of the education reforms.

Given the high prices for and, accordingly, the deficit of economic capital, the main factor that can ensure the long-term development of the Moldovan economy is the human capital. However, for the past several years, from an unquestionable comparative advantage that ensured competitiveness, it became a major constraint for increasing the sophistication and modernization of the national economy. This is happening amid extensive expenditures for the education sector, in comparison to other states in the region. Thus, the education reforms should be directed towards three major objectives: (i) improving the efficiency of expenditures in the system by redirecting the money flows towards increasing the quality of education and schools' infrastructure; (ii) ensuring the relevance of education to the economic reality and increasing the system flexibility to adjust to the labour market dynamics; and (iii) facilitating the involvement of the private sector in the educational process. The long-term development of the Moldovan economy depends, specifically, on the successful implementation of these three objectives.

The economic growth for 2014-2015 will be undermined by a series of important domestic and foreign risks.

- ***Internal risks****:* the factors that fuelled most of the 2013 growth will dissipate over the next few years, and the structural factors (quality-wise) will not be able to support an optimal growth level. At the same time, many vulnerabilities that have been perpetuating for some time will undermine the economic growth in the near future. Among these are the deficient competitiveness framework on a number of important markets (the banking and non-banking market, the agricultural intermediaries market, the importer's market of fuels and other production factors), low protection of property rights, especially of shareholders, low level of trust from potential creditors in construction companies, low level of competitiveness of industrial and agricultural producers. These vulnerabilities are intensified by the electoral cycle, when prior to the parliamentary elections, the budgetary policy became more relaxed, and the authorities are tempted to favour policies with short-term effects and to postpone the systemic reforms with long-term effects. Moreover, the investment activity will be affected by a high level of uncertainty that is associated with both the parliamentary elections and the tensioned situation in Ukraine, as well as eventual economic and political repercussions on Moldova.
- ***External risks:*** The main risks arise from the CIS market, amid a visible deterioration of the situation in Ukraine, Russia and Belarus that attract over one third of all Moldovan exports. At the same time, the risks of tightening the restrictions applied by the Russian Federation on imports from Moldova are not trivial in the context of tension build up in Ukraine and signing the Association Agreement with the European Union. In the same context, the risk of more Moldovan migrants being expelled from the Russian Federation remains high, with major

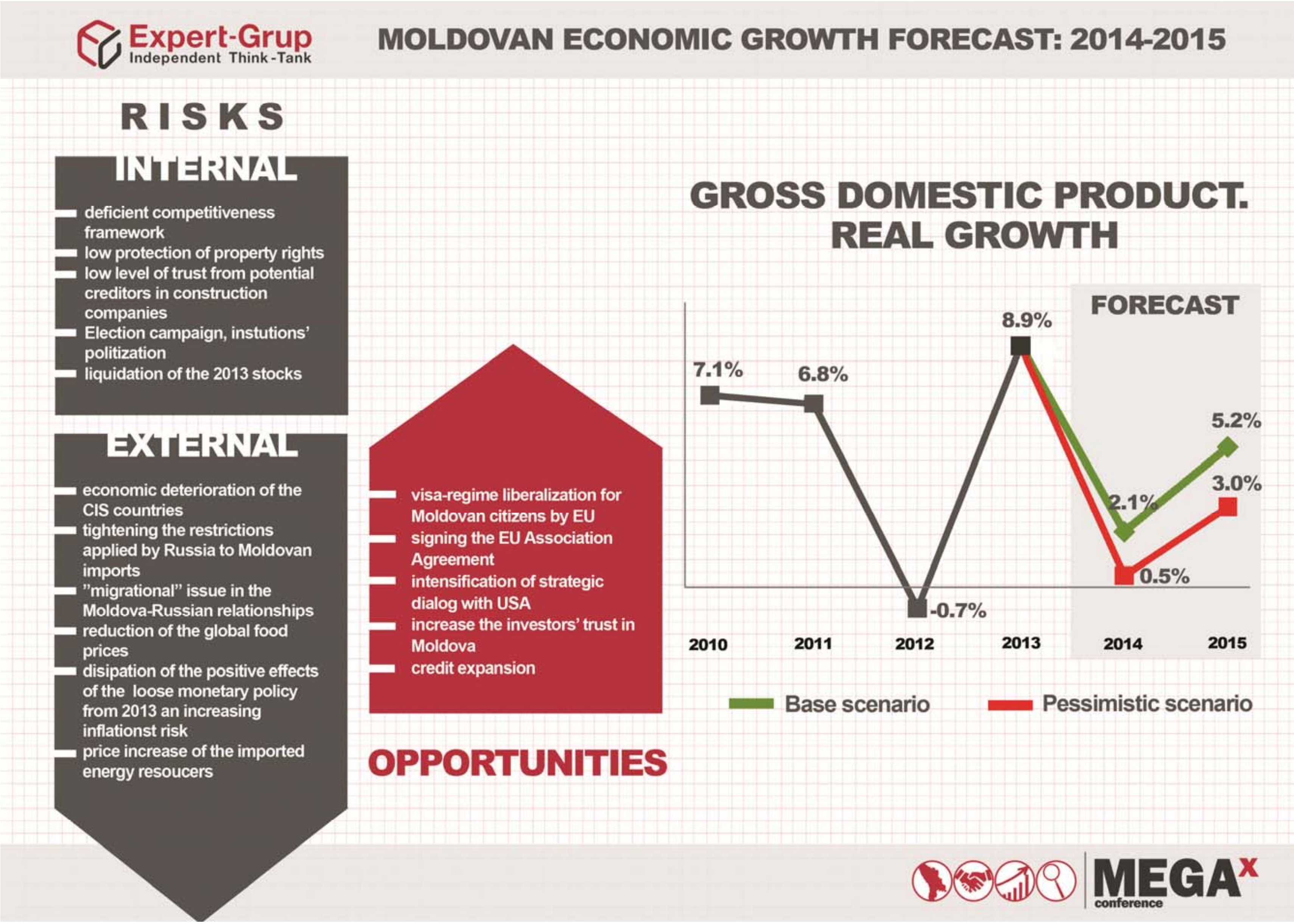
repercussions through remittances' channel and additional pressures on the domestic labour market. In this regard, the dynamic of remittances from and exports to the CIS over the past months has already started to raise some concerns. Another foreign risk for the agricultural producers is related to the anticipated reduction of the global food prices in the context that the strong agricultural production from 2013 has already contributed to an accumulation of important stocks. Thus, declining global food prices could serve a major blow on the profitability of agricultural activities, with the risk to undermine investments in this sector.

The above mentioned risks will be partly offset by the visa-regime liberalization for Moldovan citizens by EU, as well as by signing the EU Association Agreement and the intensification of strategic dialog with USA. This will and will ensure the preconditions necessary to facilitate institutional reforms. Still, the effects of these actions will be visible on medium- and long-term, whereas on short-term the risks will prevail, curbing the economic growth in 2014 and 2015.

Given the balance of domestic and foreign risks as well as the specifics of the 2013 economic growth, we forecast a substantial slowdown of the economic growth in 2014 and 2015. According to the baseline scenario, the GDP will grow by only 2.1% in 2014, the growth having to go back to its natural rate of 5.2% in 2015. For 2014, the growth will remain a function of the households' final consumption, fuelled by wages and remittances. The expansion of loans will also support the economic growth. At the same time, the diminishing demand from the East will curb the growth of exports, so that imports will growth faster than exports. Regarding the GDP resources, half of the growth will be determined by services and net taxes on goods. At the same time, the industry and constructions will have a more modest contribution in comparison with the previous years, while the agriculture, contrary to the situation in 2013, will have a negative impact on the 2014 growth.

Still, we must accept, with a certain probability, the pessimistic scenario as well, according to which the GDP could have a growth of only 0.5% in 2014 and 3.0% in 2015. This involves the materialization of the foreign risks mainly related to worsening of constraints applied by the Russian Federation on imports from Moldova, as well as an increase in the number of expelled Moldovan citizens from this country. This scenario implies a slowdown of the population consumption growth from 6.5% in 2013 to 2% in 2014 on the background of 5% decline in remittances and a slowdown in exports' growth from 11% in 2013 to 3% in 2014.

The economic recovery of 2013 took place amid a relative macro-financial stability, but certain risks persist. The inflation level remains within the limits targeted by the NBM, a certain fiscal consolidation was achieved and most of the banking sector indicators have improved. Still, the pro-cyclic and relaxed budgetary policy promoted in the early 2014, paralleled with a lack of sustainable and cheap sources to cover the budgetary deficit, creates certain medium-term risks for the stability of public finances. Moreover, this pro-cyclic budgetary policy is implemented amid an ultra-easy monetary policy promoted by the central bank. Even though, at the time being, both the current and forecasted inflation rate are kept within the targeted interval, a gradual adjustment of the accommodative stance of the monetary policy to the strong credit expansion and robust growth in monetary mass, is needed. Moreover, the medium-term inflationary impact of the national currency depreciation should not be underestimated.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MOLDOVAN ECONOMIC GROWTH FORECAST: 2014-2015
RISKS
INTERNAL
deficient competitiveness framework
low protection of property rights
low level of trust from potential creditors in construction companies
Election campaign, instutions' politization
liquidation of the 2013 stocks
EXTERNAL
economic deterioration of the CIS countries
tightening the restrictions applied by Russia to Moldovan imports
"migrational" issue in the Moldova-Russian relationships
reduction of the global food prices
disipation of the positive effects of the loose monetary policy from 2013 an increasing inflationst risk
price increase of the imported energy resoucers
visa-regime liberalization for Moldovan citizens by EU
signing the EU Association Agreement
intensification of strategic dialog with USA
increase the investors' trust in Moldova
credit expansion
OPPORTUNITIES
GROSS DOMESTIC PRODUCT. REAL GROWTH
FORECAST
7.1%
6.8%
-0.7%
8.9%
2.1%
0.5%
5.2%
3.0%
2010
2011
2012
2013
2014
2015
Base scenario
Pessimistic scenario
MEGA x
conference

Key Indicators

Table 1. Moldova: key long-term economic and socio-economic indicators

	2010	2011	2012	2013	2014 forecast	2015 forecast
Population, million (excludes Transnistria), beginning of the year	3,564	3,560	3,559	3,559	3,558	3,558
GDP, billion MDL, current prices	71,885	82,349	88,228	99,879	107,308	119,525
GDP, billion USD, current prices	5,813	7,016	7,284	7,933	8,068	8,854
GDP per capita, USD at PPP	3067	3347	3383	3722	3778,5	4149,2
Real GDP, y-o-y % change	7,1	6,8	-0,7	8,9	2,1	5,2
GDP deflator, y-o-y % change	11,1	7,2	7,9	4,5	5,1	4,5
Private consumption, y-o-y % change	9,2	9,4	1,8	6,5	4,1	5,1
Gross fixed capital formation, y-o-y % change	17,2	13	-0,8	3,3	9,9	8,5
Industrial production, y-o-y % change	9,3	9,5	-1,9	6,8	6,8	7,5
Agricultural production, y-o-y % change	7,9	5,0	-22,3	38,3	-0,1	4,7
Share of industry in GDP, %	13,3	14	13,9	13,8	14,0	14,3
Share of agriculture in GDP, %	11,0	12,2	11,2	12,2	10,8	11,0
Merchandise FOB exports, million USD	1541,5	2216,8	2161,9	2399,0	2555,6	2874,6
Merchandise CIF imports, million USD	3855,3	5191,3	5212,9	5492,7	6057,7	6752,5
Service exports, million USD	700,3	881,5	936,3	1028,7	1088,9	1197,0
Service imports, million USD	763,8	884,1	957,4	1031,2	1140,7	1265,5
Net foreign direct investment, million USD	193,9	242,6	155,4	215,1	228,9	254,6
Net work remittances, million USD	1243,7	1511,8	1712,1	1868,5	1860,9	1919,9
Current account/GDP, %	-7,9	-11,2	-6,8	-4,8	-7,5	-8,6
Official reserve assets, end-year, million USD	1717,7	1965,3	2515	2820,6	n.a.	n.a.
Total external debt stock, million USD	4711,1	5358,9	5983,8	6300,0	6652,0	7004,0
External debt/GDP, %	81,0	76,4	82,5	79,4	81,8	79,0
Employment rate, % of population aged above 15	38,5	39,4	38,4	39,0	38,7	38,7
Unemployment rate, % of economically active population	7,4	6,7	5,6	5	5,5	5,5
Real wage growth rate, y-o-y % change	0,7	-0,1	4,1	3,5	7,3	5,5
Consumer prices index, year end, y-o-y % change	8,1	7,8	4,1	5,2	5,1	4,5
General government balance, % of GDP	-2,5	-2,4	-2,1	-1,8	-2,6	n.a.
General government expenditure, % of GDP	40,8	39	40,3	38,7	41,1	41,5
Exchange rate, year average, MDL per USD	12,4	11,7	12,1	12,6	13,3	13,5
Broad money (M2), y-o-y % change	18,3	14,1	23,5	29,2	20,7	20,2
Central bank refinancing rate, end-year, %	7,0	9,5	4,5	3,5	n.a.	n.a.
Total commercial bank loans, % of GDP	35,4	36,2	39,6	42,2	42,5	43
Bank deposit rate, %, average per year	7,6	7,5	7,6	7,2	7	6,5
Bank lending rate, %, average per year	16,3	14,4	13,3	12,3	12	11,5

Source: NBS, NBM, Ministry of Finance and EXPERT-GRUP calculations, estimates and forecast;

Executive Summary

Domestic supply. In 2013 Moldova witnessed an unprecedented in its history, 8.9% economic growth. However, an analysis over the statistical data shows that only 3 percentage points of this growth rate can be considered "natural", the rest being determined by episodic or incidental factors, such as the recovery of agricultural production after a year 2012 marked by extreme climate conditions, depreciation of the national currency and an ultra-relaxed monetary policy. Due to the high base of comparison, 2014 will record a relatively modest expected increase of 2.0-2.2 % in the best scenario case. Most probably, agriculture sector will not be able to reproduce the 2013 performance and its added gross value will shrink by 7%. The industry sector will grow by about 3%, as well as construction industry. The services sector will remain the main driver of the economic growth and its added gross value is expected to grow by about 3-4%. Growth risks are rather downward, the most significant being the geopolitical ones followed by commercial risks.

Domestic demand. In 2013, final consumption of the households surged by 6.5% and kept their status as the main source of economic growth seen from the aggregate demand point of view. Gross fixed capital formation increased by 3.3%, exports of goods and services by 10.7%, while imports by 5.5%. Developments for the current year are highly uncertain and the source of this uncertainty is especially represented by unforeseeable external demand, at the moment, and the evolution of migrants' remittances. In the best case scenario, remittances from Moldovans abroad will increase in 2014 by 3.4% and exports will by about 5.5-6.0%. Therefore, external demand will be, in any case, lower than in 2013. These developments are consistent with the anticipated 2.0-2.2% GDP growth. Yet, in a negative scenario these two components could fall – exports by 1.0-2.0% and remittances by 5%. For such a negative evolution of these basic components, economic growth will stagnate.

Public finances. In 2013, public finances had a relatively optimal structure in terms of sustainability and fiscal consolidation; the final values of the budget deficit and spending as of GDP were -1.8% and 38.7% respectively. Also the economic growth beating the initial forecasts contributed to a faster Revenues' growth over the National Public Budget expenditures. Along with the execution of only 96.4% of the total planned expenditures, it allowed the budget deficit to go below 2% of GDP (revised and expected figures for the final NPB).

Being an election year, 2014 will mark a significant increase in budget spending and deficit, to 40.6% and 2.6% of GDP respectively, which is going to threaten the fiscal consolidation efforts undertaken so far. Another medium-term challenge is the significant share of foreign grants and loans as of GDP, reaching 2.2% in 2014 and representing an important source of income and budget deficit financing. Dependence of the external financing to the complicated local policies and sluggish payment procedures increase the risk of funding from these sources, in 2013 the grants were executed at a rate of only 91.2 %, whereas loans from international financial organizations – at just 80 %. Balancing public finances and increasing their effectiveness is only possible through continued reforms in the public sector, primarily in terms of managing public funds, combating the informal sector/grey economy, social security and pension reform and inclusive development of government securities market.

Labor market. As a result of the 2013 economic growth, labor market key indicators have improved, as unemployment rate fell to 4.1%, and the employment rate slightly increased to 38.7%. Minor increase in the employment rate, oscillating around 39 % in recent years and the significant share of the population in the informal sector and those working abroad attest a labor market that has reached suboptimal equilibrium of labor use in the medium term. Other worrying trends are related to a faster growth of real wages over the labor productivity and continuous increase of the skill gap (mismatch between the level of education obtained and current work place) of domestic labor force. In order to improve the performance of the labor market major structural reforms are needed, primarily focused on adjusting the education system to the functioning mechanisms of the market economy and stimulating investment in sectors with higher labor productivity, to increase the national economic competitiveness on the medium term.

Banking sector. The banking system ended 2013 with pleasing financial results, but on the verge of growing risks, both internal and external. Lending activity clearly increased, amid a relaxed monetary policy, reaching maximum values in the last quarter of the year. However, portfolio quality has not recorded noticeable improvements. Deposits' attraction was anaemic throughout the period and decisions regarding *Banca de Economii/Savings Banks (BEM)* and volatility of the exchange rate have had a negative impact on depositors' confidence in the local banking system – forcing them to focus on foreign currency deposits with short maturities. Institutional and corporate governance risks remained at high levels, with growing challenges coming from the external sector. In the short and medium run, a close monitoring of the risks associated with a loose monetary policy is necessary, especially the risk of accumulating vulnerabilities on asset-liability maturities mismatch. At the same time, it is imperative to achieve *de facto* political independence of the National Bank of Moldova and protection of the banking system from the chronic institutional ineffectiveness shocks and the reputational risks associated with it.

Prices and Monetary Policy. Although overall inflation level has remained within the NBM target, the past few months have seen some inflationary pressures caused by the depreciation of the national currency in the second half of last year, coupled with an ultra-relaxed monetary policy which allowed rapid expansion of the lending activity. However, these pressures will be mitigated by a number of disinflationary trends, including here the depreciation of the Ukrainian hryvnia , lower prices on global food markets , a worsening economic situation in the CIS countries (Russia, Ukraine, Belarus, Kazakhstan) and the accumulation of large agricultural & food stocks due to the bumper crop from 2013. Therefore, according to forecasts, inflation rate will stay within the NBM target, with possible small outruns in the coming months. However, the perpetuation of an ultra-relaxed monetary policy amidst the rapid growth of credit and money supply create certain medium and long term risks. Therefore, a gradual adjustment of the monetary policy to the new economic realities is necessary, in order to maintain a stable and sustainable macroeconomic framework.

External sector. The analyzed period was characterized by the emergence of important prerequisites for trade liberalization with the EU. The slow recovery of the European economy and timid growth of Moldova's key partners have had an impact, albeit small, on Moldova trade flows. Moldovan exports to CIS countries continued to decrease at an even higher pace, reaching 38.5% from the total exports in 2013, comparing to 47.6% for the EU. In part, this trend has been determined by the non-tariff pressures applied by Russia, which resulted in the exclusion of domestic wine products from the Russian market. The escalating situation in Ukraine, generated by Russia's intervention, involves economic risks that can bear serious consequences for the intra-regional trade flows. In the medium and long term, boosting trade with European partners will depend on the outcome of the reforms designed to promote quality infrastructure. Simultaneously, strong actions are required in order to restore trade with traditional markets (Russia and other CIS countries), while achieving the goal of economic integration with the EU.

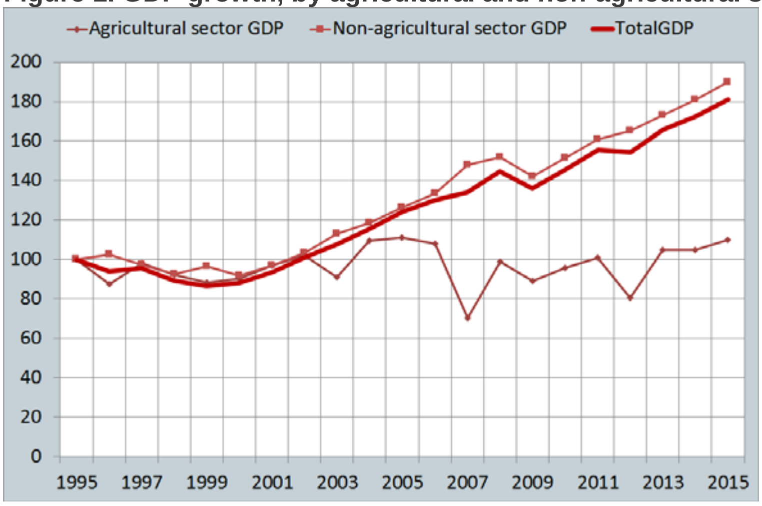
Chapter 1. Domestic Supply

A closer look at the statistical data on economic growth reveals the fact that the agricultural production had a key role, however the non-agricultural components account for 50% of the GDP, and the its growth accelerated comparing to 2012. Thus, the main weakness of this economic growth is not related to its high concentration, but rather to its strong reliance on cyclical (short-term) factors. For 2014, we anticipate a GDP growth of 2.0%-2.2%. The capacity to ensure a healthy growth rate in medium-term – at least 5.0%-6.0% - will depend on the quality of the business climate, the situation on the main foreign markets, the stability of the country's financial sector and, to a crucial extent, on the pace of reforms from the educational sector.

Healthy Economic Growth or Magic of Figures?

In 2013, the Moldovan economy registered a boost that has not been witnessed over the last two decades. The GDP grew at a rate of 8.9%, and the advance of 12.9% achieved in Q3:13 is an absolute quarterly record for the entire period of statistical observations. The last time when the economy showed such a quarterly growth was right before the crisis, in Q3:08. Though quantitatively impressive, this growth has raised certain doubts as to its quality and sustainability. The argument invoked by the critics is that agriculture, after a 23% recession one year earlier, "saved" the economy in 2013 based on a stronger recovery of about 41% of the production volume and that the economic growth would have been negative without the agriculture. Having omitted the agricultural component, we find out that the non-agricultural GDP grew by only 4.4% - a respectable indicator, but not as much as 8.9%. Thus, as revealed by statistics, the recovery of agriculture does not explain more than 50% of the addition to GDP in 2013. This is the part produced by the "magic of figures". The rest is a genuine economic growth, the non-agricultural component registering even a noticeable acceleration, from 2.6% in 2012 to 4.9% one year later (Figure 10). However, this "natural growth", as we could call it conventionally, is by no means sufficient to ensure a visible convergence of the income level towards the Central-European average.

Figure 1. GDP growth, by agricultural and non-agricultural sectors, 1995=100%



Source: NBS, Expert-GRUP forecasts for 2014-2015

After a deep recession in 2012, the growth of 41% reached by the ***agricultural sector*** in 2013 is just a new episode in the sinuous evolution of the sector over the past two decades. The vegetable production grew by 62%, reaching a level that is difficult to keep in 2014, while the animal production remained unchanged. During 1995-2013, the fluctuations of the sector have eroded the cumulative rate of GDP growth by 10 percentage points. The agriculture is a long way from becoming the engine of growth; for the time being, it is rather a burden for the Moldovan economy. In the short and medium term, there are two sources for the growth of agricultural production - higher investments and more skilled workforce. The investments in agriculture over the past 5 years have raised much faster than the overall investments in economy, their share having grown from an average of 5.2% in 2005-2008 to 9.2% in 2009-2012. However, taking into account the deep decapitalization of the sector over the past two decades, as well as the poor financial situation of the agricultural households, many years of investments are necessary to reach a good technological equipping. An obvious example: only 32% of the households afford to use plant protection products in their activity, only 1.3% use organic fertilizers (despite an obvious abundance of natural fertilizers) and only 21% use chemical fertilizers. A quarter of agricultural households does not use machines and equipment in their activity. Higher investments will contribute to bringing back abandoned lands into agricultural use, which account for 11%-12% of the total area of land available for agricultural purposes. The second source of growth - the quality of workforce - is discussed in the last section of this chapter, where the connection with the education sector is shown.

The ***industry,*** having recorded a noticeable recovery of the production volume (+6.8% compared with -3.1% in 2012) showed also the extension of the basis of growth. Towards the end of year the growth has slightly accelerated compared to the first six months, however the branches producing about a half of the GVA generated by the industry remained in a temporary of even structural decline. The positive outcome in industry was mainly due to the residents of two free economic zones, which manufacture electrical car equipment. The production of this segment has grown by over 30% and, after such good a growth in 2011-2012, it is currently the most important branch of the Moldovan heavy industry. The less gratifying outcome comes surprisingly from oil production branch, despite a good harvest of oil seed crops in 2013. The sector of alcoholic beverages has showed resistance to the new “technical barriers” set up by Russia for the exports of Moldovan alcoholic products: decrease by 9% of the wine production was highly compensated by the increase of volumes of distilled beverages.

Construction. The sector showed a modest growth of 2.8% in 2013, remaining, thus, in stagnation where it got in 2009. The total volume of contracted works accounts for only 71% of that achieved in 2008, which is greatly determined by the public projects of road rehabilitation. The residential construction sector is in deep crisis, the volume of works accounting for only 62% of the 2008 volumes, while the commercial constructions are in a worse situation (54%). The banks’ prudence in financing is the main reason of stagnation of this sector, coupled with the vigilance of investors who are not attracted anymore by the perspectives of the real estate sector. The confidence in the construction sector that was once dented would be difficult to regain.

Services. The market services showing a positive evolution over the last years gained stronger momentum in 2013. The volume of services provided to the population increased by a respectable rate of 10% after a weak evolution last year (+2%), while the volume of retail trade increased by 3% compared to 1% in 2012. The transport operators also had better times in 2013, the demand for their services having increased by almost 26% after a very modest performance in 2012 (-2.3%).

Political Economy Dilemmas of the Economic Growth

The GDP volume compared to 1994 is now bigger by 64%, while the households’ consumption expenditures are 2.6 times higher. With the risk of over-simplification, these figures show that the consumers want and can consume much more than offered by the national economy. The key question is why the manufacturers do not respond to the increasing consumption appetite and why does the gap increase? The answer consists of three components: one structural and two institutional.

Structurally, the Moldovan economy has entered in transition disadvantaged by the large proportion of rural population employed in agriculture that is less productive. Theoretically, during 20 years a reflux of excessive workforce from agriculture to industry and services should have been noticed. However, these processes occurred either in the opposite direction (the industrial companies, for example, hired in 2013 by 10% less persons than in 2000) or they occurred very slowly (the service sector compensated only one quarter of the job lost in agriculture). Should the Government support actively the workforce mobility or leave the process to run naturally? The Government has not yet given a clear answer to this dilemma. The first option involves an ambitious and costly urbanization policy, as well as a management plan for the situation in the rural depopulated regions and conversion of land. This option is accompanied by the risk of arising of “large landowners” and impoverishment of broad rural strata. The second option involves a focus upon the rural development and preservation policies in the hope that the electorate would appreciate this care and that the natural demographic processes would minimize the costs of demographic modernization of the country. Over the past two decades, the Moldovan governments, having used a rhetoric of economic and social modernization, did, in fact, very little in practice. At the same time, the resources provided to the village were largely squandered for suspicious “social and cultural” investment projects - culture houses in which no cultural activities are carried out, rehabilitated local roads, which were not finished, public bathrooms - which did not make the village more attractive as a destination for investments in the non-agricultural sector.

To elucidate the first institutional deficiency, we remind that in the issue No 2 MEGA of 2009 we appreciated the entry into politics of some people with business experience as being a favorable evolution for the reform of the business regulatory framework and for loosening the economy “straps”. These hopes have been fulfilled only partially. The “small” reforms implemented have been carefully outlined not to encroach on the large economic interests, but such subjects like competition, justice and integrity of public sector have hardly been considered. Many representatives of the political class do not yet separate politics from business. Their interests are so big and the instruments so influential that only a strong EU presence in the domestic processes and a definitive anchorage of the country to the European integration path may lead in the long term to the loosening of the oligarchic grasp in which the country is caught.

The second institutional deficiency is reflected by the exponents of some bureaucratic interests confluent with those of party. The party-related resistance and that of bureaucrats explains the failure of some key reforms, including in the field of business authorization, cross-border trade and fiscal decentralization. These interests can be ***addressed*** only by undermining the motivations of bureaucrats in terms of higher loyalty for national interest. Howevr, this is not possible without a deep reform of public sector and essential raise of salaries in this sector, the public budget being obviously not prepared for that. Unfortunately, as revealed by the experience of the past years, the optimization of the public service both at central and local level - absolutely sound financially and necessary economically - is a solution that is difficult to articulate and implement politically. How paradoxically it could seem, but a coalition governance in which the partners are tempted to place their “people” in the key positions, does not seem to be very favorable for a radical reforming of the public sector.

Short- and Medium-Term Forecasts and Challenges

- The 8.9% economic growth of 2013 set a basis of comparison that is not too easy to replicate in 2014. That is why, in the main scenario for this year we anticipate an economic growth of 2.0% to 2.2%.
- This forecast is based on an anticipated decline by 7% of the added value generated in agriculture, which will fail to maintain the level of 2013. The main correction will come from the plant-growing sector, while the livestock sector will record a slight increase of the production.
- As for the industry, we expect the worsening of the energy sector (-5% in the gross value added), as a result of the delay of the thermo-energy sector reform in Chisinau municipality. Due to processing branches (+4% in the gross value added), and mining industry (+15%), the

industry as a whole will grow by about 3%. In 2014, we might witness the entry of new major investors in electrical equipment and devices production.

- In the construction sector, we anticipate the same growth as in 2013 (+3%). This expectation is sustained by the road rehabilitation projects funded from foreign sources. Being deprived of bank financing, the private entrepreneurs will have to complete on their own the projects started in the residential sector. The commercial construction sector will remain frozen.
- The services sector will remain the main engine of the economy, expected to generate a 3%-4% growth in its gross value added. The trade will grow by about 6% in parallel with the volume of services in the hotel sector (+5%) and transport (+4%). The financial sector and real estate sector will be on a moderately positive slope of 3-4%.
- The risks that might affect this forecast have a top-down orientation. A worsening of the political and security situation in Ukraine will lead to the collapse of an important market and to blockages for Moldovan transporters. The range of geopolitical risks is supplemented by a possible tightening of the trade embargo by the Russian Federation. In this sense, the fruit exports are the most vulnerable, which targets the Russian market at the rate of 80%. This could be supplemented by the risk of a stagnating economic growth in the Russian Federation starting with the first half of this year, as well as the disappearance of the “Olympic effect”, which will entail a reduction of the demand of Moldovan goods and decrease of the earnings transferred by the Moldovan migrants. Neither in Italy - the second destination preferred by the Moldovan migrants - the economic situation is better. The instability of the financial sector is the source of some major systemic risks for the economic growth. The parliamentary elections scheduled for the end of 2014 are rather a “bonus” for the economy, their impact being estimated by us at 1 percentage point of the GDP growth, including due to the anticipated raise of salaries in the budgetary sector and of social payments.

Policy Recommendations

- The main mid-term challenge is to keep a 5.0%-6.0% annual growth rate of the non-agricultural GDP. Because of increased global warming and higher number of extreme weather events, the agriculture will undergo an increasing stress. For this reason, the subsidies in agriculture should be directed towards the protection infrastructure and technologies that are appropriate for the development level of the Moldovan agriculture.
- The industrial policy based on attracting large investors in the special economic zones (free economic zones, free ports and airports) should be reevaluated in terms of its sustainability. Though promising in the short run - with regard to job creation - this approach is ruinous for the long run. The liabilities for EU and more stringent fiscal constraints will anyway impose the gradual abandonment of some economic preferences and establishment of a uniform field of economic activity.
- The stabilization of the financial sector is an objective deserving all political costs, therefore the Government and independent regulators should promote more insistently the necessary measures. During 2013-2014, the sector was again the object of some hostile takeovers, and the political class, including Members of Parliament, proved to be insufficiently prepared and/or willing to take the necessary legislative measures to reverse and prevent such events.
- It is clear that the large privatization will not take place in 2014. The political, institutional and economical climate is not favorable for this process. At the same time, the objectives for recovering the public sector enterprises continue to be relevant. Therefore, the Government should choose, at least for the short term, to reform the management of public enterprises. In this regard, it is essential to establish a system for assessment of achievements and for motivation / imposition of sanctions, and a system for reviewing the previous decisions on the salaries of public enterprise managers.
- The trade shock caused by Russia in 2013 was relatively easily absorbed by identifying new sales markets. However, the pressures could continue in 2014. Therefore it is imperative for the Government to support through information and logistic campaigns the identification of

new markets for foodstuffs, agricultural products and alcoholic beverages. China, India, Norway, some Near East countries are promising markets in terms of the capacity to absorb the Moldovan products.

Economic Growth: Connection with the Educational Sector

The poor quality of workforce employed in the national economy represents a very different and complex problem. As a recent study, conducted by EXPERT-GRUP at the request of the National Confederation of Employers of Moldova, shows that over the past 3 years about 47% of the 205 interviewed firms encountered difficulties when hiring the staff with the skills and competences desired by the employer. The quality and relevance of formal training in the primary, secondary education and VET sector, as well as training at workplace were addressed in the reforms that have been already initiated by the Government. One of the most recent evolution is the adoption by Government Decision adopting more liberalized rules with respect to the establishment by the employer of the costs for employees' vocational education and their tax deduction.

The problem of workforce quality should be, firstly, addressed in the industrial sector, which has the chance to benefit of major investments in the near future, especially after signing the Association Agreement with EU. However, in terms of severity, agriculture is the sector where the situation is the most difficult: according to the Agricultural Census conducted in 2011, only 3.4% of the leaders of agricultural holdings have higher education in the agricultural field, while 4.8% graduated from colleges. Only 6.5% of the leaders participated in vocational training. Over 85% of the agricultural holdings produce in particular for their own consumption, which denotes the low level of innovation activity in the sector, despite the fact that eight agricultural colleges prepare yearly about 500 specialists, and the agricultural university - about 350. Where exactly all these graduates are getting employed after their graduation is one of the biggest mystery of the Moldovan transition.

Chapter 2. Domestic Demand

In 2013, foreign demand grew much stronger than the domestic demand. However, household consumption was the main driver of GDP. Capital investments showed a rather slow development, being largely driven by public infrastructure projects. Thus, the change of the growth model, to which the Government aspired, is still far from having a clear shape. In 2014, the consumer demand from the population will maintain a positive development, while exports could increase moderately, under favorable circumstances. Still, a negative scenario should not be excluded according to which the exports might even shrink, depending on political developments in the East.

Shaping a New Economic Growth Model?

Since 2009, the Governments of the Republic of Moldova, led by Vlad Filat and Iurie Leanca, have repeatedly reaffirmed their desire to "correct" the economic growth model, so that a higher share of the national income is used for investment, while decreasing the share of income allocated to final consumption and so that exports and innovation have a more prominent role in economic growth. In this development perspective, the government advocated to encourage imports of equipment, machinery and technology, while arguing that they will support technological convergence of the national economy to European standards. More than four years after the inauguration of the first government of the Alliance for European Integration, it is high time to assess to what extent macroeconomic performance in the years 2010-2012 and 2013 reflects the stated objectives for the improvement of the development model.

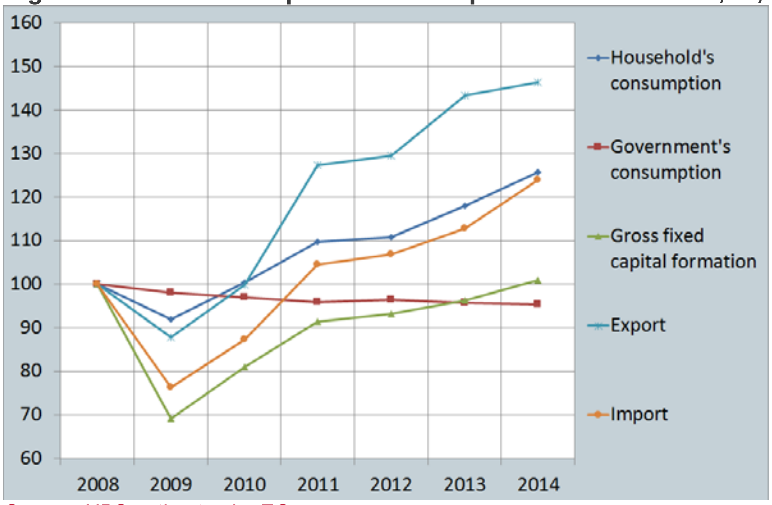
The year 2013 ended with a record growth, officially estimated at 8.9%. All the important elements of aggregate demand had a positive development. In particular, household final consumption increased by 6.5%, this being the main driver of the GDP growth. Gross fixed capital formation increased by 3.3%, exports of goods and services – by 10.7%, while imports – by 5.5%. During the last months of the year, exports grew even slightly faster, but the arithmetic effect of this increase on the GDP, combined with the evolution of imports, was virtually nil.

While corroborated with the data for the previous period, 2008-2012, the developments in 2013 cannot be interpreted unambiguously. On the one hand, the long-term trend of final consumption is rather an accelerated growth, while investment remains visibly behind (Figure 2). On the other hand, exports had the fastest growth in comparison with other components of GDP. Chapter 1 pointed out the issue of the growing gap between supply and domestic demand. Thus, we note that during the last years the following economic growth model was established: domestic demand for final consumption grows faster, while covered mostly with imported goods and services; a large part of imports cover exports of goods produced in active processing mode or re-exports (i.e., about one third of total exports). So far, we cannot refer to the country's accelerated technological development: industrial machinery and equipment that accounted for an average share of 21% of imports in 2005-2008, preserved the same share in 2009-2013. Thus, we cannot identify all the elements of a more sustainable growth model.

Household consumption. In 2013, the growth of household consumption was estimated at about the average value of the past decade, about 6.5%. This trend was largely driven by the increase in real wages (+3.5%), the increase in Moldovan emigrants' remittances (+7.7%) and the credit expansion for household consumption (+10%). Still, unlike other years, in 2013, a very important role in the growth of consumption (about 1.5 percentage points) has played a recurring factor - 10% increase in the consumption of goods and services in kind, due to a recovering increase in agriculture. Depreciation of the national currency had a net positive effect on consumption, taking into account the fact that many families receive remittances from abroad. Obviously, this is a short-term effect, which is likely to dissipate with the upward adjustment of prices.

Consumption of public administration and non-profit institutions serving households. Their consumption has declined steadily in 2009-2013, mainly due to the reduction of consumption expenditures by the public administration. In 2013, budget revenues have not been executed for about 150 million MDL (about 99.6 % of the total), while expenditures were executed at 96% of those planned.

Figure 2. Growth of expenditure components of the GDP, %, 2008=100%



Source: NBS estimates by EG

Gross fixed capital formation. This component of the aggregate demand had a modest increase in 2013 - with 3.3% - and consequently, the pre-crisis level of 2008 has not been yet recovered. However, even this modest increase was largely due to the implementation of investment projects financed by the public budget and external sources (especially in the road sector). Investment appetite in the private sector is still not very prominent; thus, the investment in machinery and equipment fell by 1.8%, while the most dramatic was the sharp decline in funds allocated in Q4:13 (-13.8%). Own incomes of economic operators and individuals remain the main source of funding for investment in long-term assets (almost 60% of the total). This is a sign that banks are still not able to fund growth in line with the companies' expectations.

Net exports. In 2013, foreign demand for Moldovan products increased sharply, while exports of goods and services recorded a growth of nearly 11%. Imports increased at a more moderate pace, +5.5%, thus continuing the trend observed since 2010. This lead to a slight increase in the level of coverage of imports by exports, from 52% in 2012 to 54% in 2013.

A more Qualitative Economic Growth: the Crucial Role of Justice

The desired change in the economic growth model – more investment, more advanced innovations, higher exports – has political economy implications. Materialization of these components requires essential changes in the functioning of the Moldovan political and economic system. Thus, to ensure that firms make higher investment, there is a need for a judiciary system able to enforce the universal compliance with the law and, what is most important, to protect ownership rights. If there is no protection of property rights, Moldovan and foreign companies will continue to invest as much as it is strictly necessary to ensure simple reproduction or as much as they are able to protect by themselves, through their personal connections with politicians and representatives of the justice system.

At the end of 2013, the government adopted an interesting document that was unfairly overlooked by the public – Innovation Strategy for 2013-2020 "Innovations for Competitiveness". The strategy provides for a number of financial, information and regulatory tools to encourage companies to become more innovative and advance the country's international competitiveness. Nevertheless, it is ridiculous to expect that companies will invest in innovative business, as long as investors are likely to be deprived at any time, through secret channels, of shares they hold in companies. Thus, in the past four years, we have witnessed a growing "insolence" of hostile corporate takeover schemes or those of elimination of market competitors. Corrupt judges played a crucial role in the implementation of such schemes by adopting a priori illegal decisions. Sensational cases, such as „Moldova-Agroindbank”, „Grawe”, „Registru” and many others, would not have been possible, if the Moldovan justice considered the protection of property rights in the first place.

The government initiated a judicial reform and its implementation will benefit from the generous financial support of EUR 60 million provided by the EU. However, the "carrot" announced by the Government – an essential increase of judges’ salaries – does not seem to be sufficiently attractive to the community of judges (not to mention the fact that the decision generated protests by some more vulnerable state employees, such as teachers and cultural workers). This measure did not provide for an appropriate "stick". The feeling of impunity of judges got so far that they attempted to „rip off” the government: a particularly eloquent example is the case of judges from Causeni, who ordered the seizure of accounts of the local mayor’s office in order to obtain private flats. As a result, 300 educators in Causeni kindergartens remained unpaid, which were paid with utmost generosity by the Government from the Reserve Fund.

Short- and Medium-Term Forecasts and Challenges

- The year 2014 brings many uncertainties regarding economic growth. Major uncertainties are related to foreign demand and the evolution of remittances. Under favourable circumstances, in 2014 remittances from Moldovans will grow by only 3.4% and exports - by 5.5-6.0%. Under negative circumstances, both components could decrease, exports - by about 1.0%-2.0% and remittances - by 5%. Such a scenario could materialize through an eventually stricter trade embargo imposed by the Russian Federation and the introduction of restrictions to the entry of Moldovans on the Russian labour market.
- Household consumption will have a positive development in any case. However, under favourable circumstances, it will increase by only 4.0%-4.3%, while under negative circumstances, it could post an inertial grow of only 2.0%-2.5%.
- In 2014 consumption of the public administration could expand, estimated at about 10%-12%, largely due to greater generosity demonstrated by the central and local public authorities on the eve of parliamentary elections scheduled for the end of 2014.
- Overall, final consumption will increase by about 6.0%-6.2% under positive circumstances, and by 5.2%-5.4% under unfavourable circumstances.
- Foreign demand will be lower in 2014 than in 2013. This will be reflected in a slower rate of growth of exports of goods and services (+6%). On the other hand, imports will increase slightly faster, the expected indicator will be +12.5%.
- Thus, viewed from the demand side, GDP will increase by about 2.0%-2.2% according to the baseline scenario and by 0.5% according to the pessimistic scenario.

Policy recommendations

- The government adopted in September 2013 the Roadmap for actions to remove critical constraints for business. The document provides for about 90 legislative and regulatory measures, and includes a series of actions in key areas: tax administration, cross-border trade and customs administration, competition, access to finance and effective and credible justice. Elimination or at least mitigation of such constraints would be an incentive for increased investment and implementation of structural changes in the growth model. Unfortunately, the two interim reports prepared by the Ministry of Economy on the implementation of the Roadmap do not leave much room for optimism. Many of the planned actions were not implemented, because of the institutional inertia and the way of thinking that prevails in public authorities involved in the implementation of the document. Some actions already undertaken

– such as simplified connection to the electricity grid – are likely to be reflected in the next Doing Business rating. However, overall progress will not be very high. Satisfactory implementation of the Roadmap (i.e., at a rate higher than 50%) is possible only if "resistance areas" from the public authorities are totally removed, including by replacing their leaders. It is unlikely that the government will follow this path on the eve of elections, therefore, there is a need at least for a larger public exposure of authorities that are not willing to cooperate in the implementation of the Roadmap.

- Exports may obtain a greater role in economic growth both by increasing physical quantities of traditional exports (more exports) and through technological advancement of exported products (more valuable exports). The first approach requires elimination of internal and external barriers in the way of exports, while the second one refers, in particular, to a higher level of maturity of Moldovan managers. A telling example is that of fruit exports. These are targeted at a rate of over 80% to the Russian market, which is likely to close at any time for “geopolitical” reasons. The access to the European market is barred by quota values, customs tariffs and the minimum entry price mechanism. Their complete removal is not possible in the short term, even after the entry into force of the Deep and Comprehensive Free Trade Area. However, in November and December, the EU will apply a more relaxed minimum entry price mechanism that will offer the opportunities for the Moldovan producers to achieve higher dividends. It is important for producers to work together in order to build controlled storage capacities (refrigerators) for the fruits and vegetables, using this "temporal window of opportunity". The government's role is to attract the available long-term resources to provide producers with the opportunity to make such investments.

Virtuous circle of education and innovation

Unexpectedly, for its level of income, Moldova ranks quite well in the rating of the Global Innovation Index 2013: out of 143 countries, Moldova ranks 45th. Among other advantages of the country, the rating highlights the high level of public and private expenditure for education and the small number of students per teacher. It may sound paradoxical, but the optimization of the school network might be followed, at least in the short-term, by a lower country's position in the innovation rating. However, resources released from optimization should be directed to remedy weaknesses reflected by the rating - very low quality of education, including university education, and the lack of links between the education sector and the real economy. Today in Moldova, where the share of GDP allocated to education is two times higher than the European average, the average tuition time is only 11.8 years compared to 14.2 years in the countries of Central and Eastern Europe and the average PISA score of a Moldovan student is 14% lower than the average in the countries of Central and Eastern Europe. Thus, the priorities set by the Government – more qualitative and more relevant education – are perfectly plausible. While the optimization of the network is absolutely necessary, it was not accompanied by a good communication campaign, to ensure the support of the key players – parents and students. Sociological surveys show that physical presence of a school in the community prevails over the quality of education provided to children. In other words, better public communication is essential to ensure the support required to implement the announced reforms.

Chapter 3. Public Finances

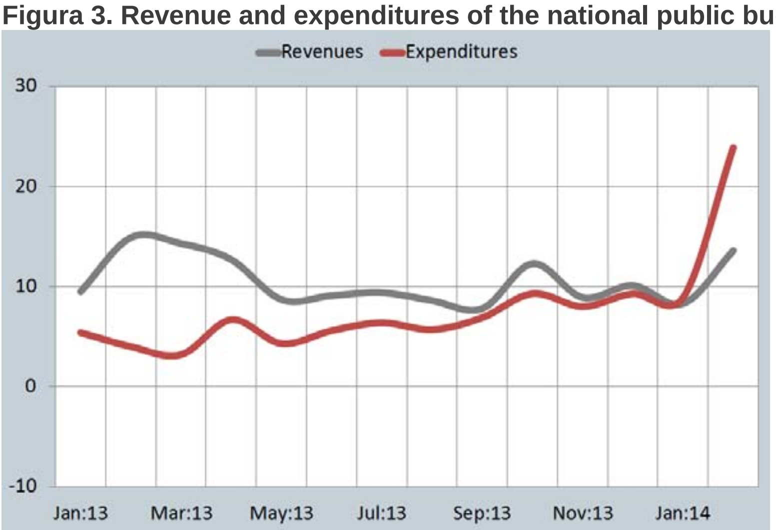
The year 2013 has been the best after the 2009 crisis from the perspective of the consolidation of Moldova's public finance system. However, the progress in reforming and improving the efficiency this year is sacrificed by electoral ambitions to the disadvantage of on medium-term sustainability.

The 2013 budget – the point of no return for the quality of public finances

According to aggregated indicators, the 2013 budget has reached optimal values of medium-term sustainability: the shares of expenditures and budget deficit have declined to 38.7% and -1.8%, being close to the levels initially planned (for 2013 the forecasted budget deficit was 1,14% and the expenditures - 38,4% of GDP). Contrary to this process of fiscal consolidation over the last years, the budgetary policy for 2014 is relaxed and pro-cyclic. Thus, despite the anticipated economic growth for this year, the increase of budget deficit is planned to increase up to 2.6% of GDP, while the expenditures - to 40,6% of GDP.

The expenditures and global revenue growth rate have had an insignificant volatility with a convergence towards the end of the year, the dynamic being reversed in feb:14 (Figura 3). The reversal of the growth rate tendencies is symptomatic and reflects a change of objectives in the fiscal and budgetary policy.

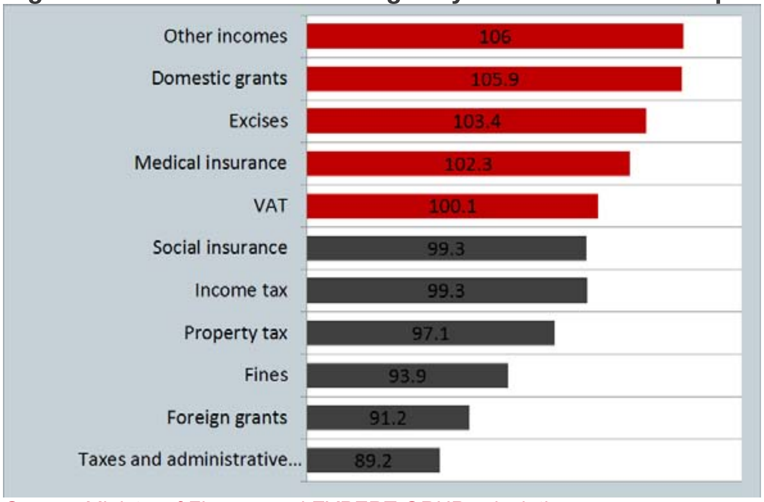
Figura 3. Revenue and expenditures of the national public budget, y-o-y growth, %



Source: Ministry of Finance and EXPERT-GRUP calculations.

Due to a favorable economic and political context, the fiscal revenue has mainly reached the expected numbers close to 100%. This level of achievement was, to the same extent, reached in the categories of direct and indirect taxes. The external grants have a level of execution of 91,2% compared to the foreseen level, this still being better than 2012 when the figure was of 87,3%. The fact that the objectives regarding external grants haven't been reached can be explained, firstly, by the political crisis, slow disbursement procedures for external grants, as well as limited absorption capacity for these grants. At the same time, increasing the amount from this source with 28% shows the will of external partners to promote reforms when Moldova agrees to takes some external commitments (Figura 4)

Figura 4. Execution of the budgetary revenue collection plan for 2013, %



Source: Ministry of Finance and EXPERT-GRUP calculations.

Importantly, the budgetary deficit financing priorities has shifted from the foreign sources to domestic ones. As shown in Table 2, the net share of domestic financing has been increasing rapidly over the last three years, overpassing the external financing in 2013. The reversal of the internal and external financing shares is due to receiving only 80% of the total planned amount for the “Loans from International Financial Institutions” component, which was compensated by the increase in the “Loans from other Financial Institutions”. The under-execution of the plan can also be explained by the political instability at the beginning of the year, as well as the revision of the financing terms for external projects

Table 2. Developments in the budgetary deficit financing sources 2011-2014.

	2011	2012	2013 expected	2013 executed	2014 project
Net internal financing	22,0	239,4	545,9	691,2	657,4
Net external financing	588,7	1215,3	825,4	516,3	1657,4

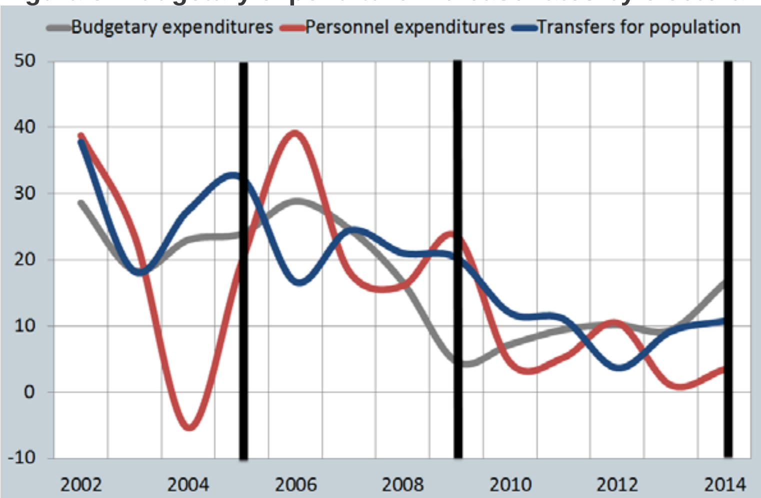
Source: *Ministry* of Finance

Political Economy Considerations: A New Political Budgetary Cycle?

The goal of incumbent politicians, regardless of their political doctrine, is to get reelected. At the same time, the electorate tends to prefer a government that could provide higher salaries and social benefits, better infrastructure and a faster economic growth. Thus, close to the elections, the political stakeholders are prone to use all the available means in order to maximize their chance of being reelected. An indispensable tool in this regard is the budgetary and fiscal policy. In Moldova’s case, this tool becomes even more relevant, considering the fact that about 22% of the employed population is working in public administration, education, public health and social assistance, which largely depend on the allocations from the budget. Thereby, it is not surprising that in the proximity of extremely important parliamentary elections, the budget was approved with a budgetary deficit of 2.6% of GDP, being much higher in comparison with the previous years (except for the 2009 economic crisis), despite the positive economic growth anticipated by the government. At the same time, the share of expenditures in the GDP was planned at 40.6% of the GDP, also higher compared to the previous years. Thus, contrary to the classical economic policy approaches, the budgetary policy for 2014 is pro-cyclical and not counter-cyclical, which does not augur well for fiscal consolidation.

Figura 5 perfectly shows that the interference of the political factor in economy in order to manipulate the macroeconomic indicators in electoral years has become very strongly rooted. This process is particular to all government parties, regardless of their place in the political specter. This cyclicality can be observed in all electoral years 2005, 2009 and 2014, with variation in the financing components.

Figura 5. Budgetary expenditure increase rates by electoral cycles.



Source: Ministry of Finance and EXPERT-GRUP calculations.

If we analyse only the dynamic of the public expenditure increase, we can have the impression that there was no electoral cycle between 2005 and 2009, as compared to 2014. However, if we consider the growth rates of the public sector salaries and social assistance payments (pensions first of all), their faster growth compared to the general dynamic of total budget expenditures is perfectly visible. This phenomenon was very marked in 2009, when on the background of the economic crisis and sudden drop of growth rates, the budget deficit has increased till 6.4% of GDP in order to ensure the planned growth in salaries and social transfers of over 20% f-a-p. The 2014 cycle is different from the previous ones, taking into account the structure of expenditures. Thus, the major growth is planned for "Goods and services" and "Capital expenditures" components, both of which will increase by 2 percentage points of the GDP. The main explanation is the different electoral base of the government parties, a significant part of the constituency of left ones being the population employed in the public sector and elderly people. Alternatively, the center-right parties have increased the capital expenditures, next to the intention of accelerating economic growth, to send symbolic messages related to the modernization and European integration agenda.

The electoral motive has dominated the formulation of the fiscal and budgetary policy this year as well. Besides the increase of expenditures, this phenomenon manifested itself in the formulation of the financing sources of the national public budget as well. The decision to go back to 8% VAT in the agricultural sector and not signing the cooperation agreement with IMF, as well as postponing the privatization program are just the most indicative examples of how the political opportunism dominates the economic reason.

Short- and Medium-Term Forecasts and Challenges

- The biggest challenge for the sustainability of the public finance system is the increase of expenditures and budgetary deficit in the electoral year, contrary to the consolidation and efficiency improvement efforts invested in it during the previous years;
- There is a risk that the planned disbursements of foreign grants will not be fulfilled in full amount, posing additional pressures on the budgetary deficit;
- The economic slowdown in key trading partner countries, the possible decrease of remittances and the growth slowdown of national economy could hamper the fiscal revenues;
- On medium and long term, the sustainability of social insurance budget financing will decrease due to negative demographic tendencies;

- The underground economy will undermine the efforts to increase tax collection and balance the revenue through direct and indirect taxes;
- The volume of foreign assistance will decline on medium-term and, hence, a key challenge would be to find a proper replacement from domestic sources.

Policy Recommendations

In order to achieve an economic growth that is sustainable on medium-term, the quality aspect of public finances needs to be improved, as well as a balanced structure of public expenditures and revenue must be built. The consolidation of the above mentioned framework can be accomplished through the following measures:

- Bringing the budgetary deficit back to sustainable financing terms around 1.0% of GDP, it's expansion being closely linked with stable financing sources;
- The minimization of the reliance on foreign grants and loans can be achieved by a qualitative development of the market of T-bills. Specifically, it is necessary to increase its specter and maturity. For example, an efficient tool for non-inflationary financing of capital expenditures are infrastructure bonds;
- Continuing and widening the public sector reforms in order to make expenditures more efficient and optimize the number of people employed in this field;
- Reforming and rationalizing the social assistance and pensions system in order to minimize the State Social Insurance Budget deficit on medium term.

Public Finances in Education

Since 2010, the share of public expenditures on education in GDP follows a downward trend, declining from 9% in 2010 to 7.2% in 2013, whereas for 2014 it is expected to be 7.1%. So does the share of education expenditures in the public budget, which shrank from 18.7% in 2013 to 17.6% in 2014. However, contrary to the conventional wisdom, the declining financial envelope for education does not tell anything about priorities. On the contrary, the education sector remains a key priority on the government's agenda and this trend in the sector financing is the result of a series of ambitious reforms aimed at optimization and increasing the financing efficiency, shifting the emphasis from quantitative to qualitative aspects. These measures, although unpopular, are aimed at ensuring a sustainable financing of the education sector and enhancing its quality, being motivated by the fact that while spending twice as much as the European average, the education sector performs worse. Particularly, this is related to the PISA 2009+ test results, as well as the rising gap between the labour force demand and the qualifications supplied by the Moldovan schools and universities (see the Chapter 4).

Chapter 4. Labour Market

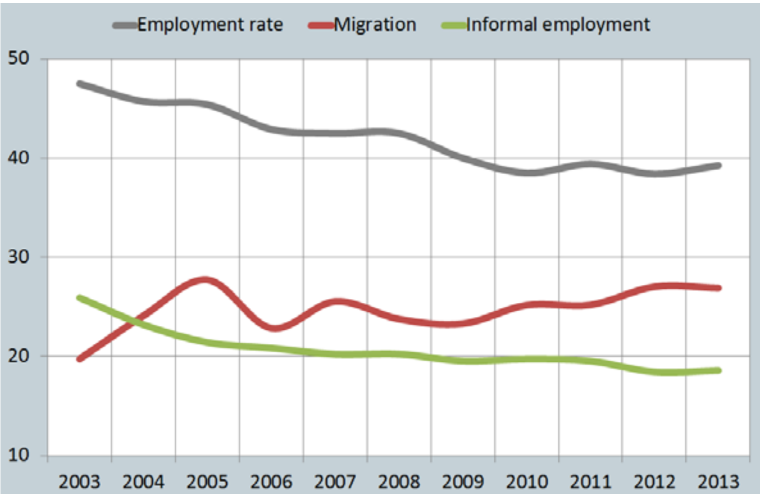
During 2013, we noticed some positive though modest dynamics of the main labour market indicators as a response to the recorded economic growth. Still, the structural analysis of the market, as well as the dynamics of labour productivity compared to the wage growth in the real sector highlight the inefficient use of the labour force in the Moldovan economy. Only the complex approach, addressing the structural and efficiency parameters combined can contribute to a sustainable and inclusive economic growth.

Is the Labour Market of the Republic of Moldova Efficient?

In 2013 the labour market followed the overall dynamics of the economy; the economic growth led to a decrease in the unemployment rate down to 4.1% in Q4:13 compared to 5.9% in Q4:12, while the employment rate stabilized at 38.7% in the same quarter, with 0.8% increase compared to the respective period of 2012. Hence, there is a decreasing development of the unemployment rate since 2010, when it accounted for 7.4%, and the employment rate stabilized at around 39%. The fact that the negative dynamics of the employment rate has is promising, taking into account the fact that, currently, this indicator is among the lowest in the region and reveals that the human resources are underutilized.

The Figure 6 reveals that the labor market of the Republic of Moldova reached a dynamic equilibrium in the past four years. The employment rate has also stabilized at about 39%, as well as the rate of the population working abroad - at about 26% and the population employed in the informal sector or having an unofficial workplace - at about 19%. This structure of the economically active population reveals the possible areas where action can be taken to maximize the employment rate in the formal national economy. This is possible, mainly, by decreasing the motivations for migration and downsizing the informal economy.

Figure 6. Dynamics and Share of the Main Components of the Employed Labor Force



Source: NBS

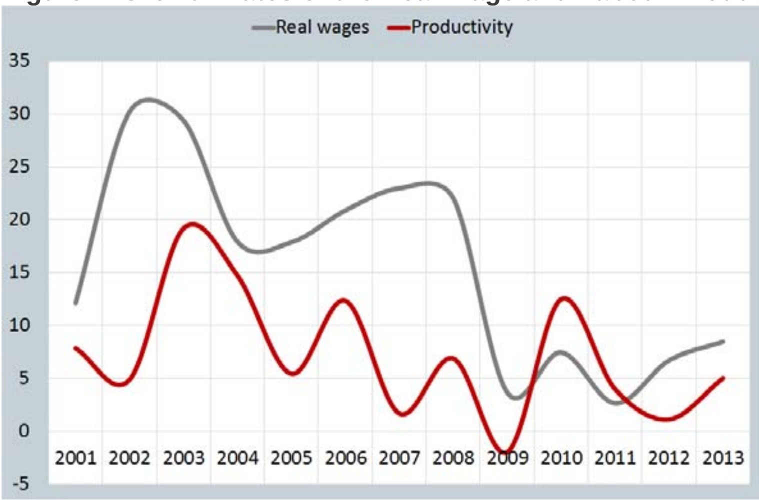
Though the rate of labor force migration slowed down, in 2013 the number of people working abroad continued to increase, reaching 332.5 thousand and, almost recovering the loss in absolute numbers after the 2008 crisis. Given this trends, amid rising constraints on migrants applied by the Russian

Federation, this variable will have an increasing impact on the further developments on the labor market, both from quantitative and structural perspective. The labor export model made our economy sensitive to the developments on the foreign markets and responsive to shocks, the migration dynamics having a pro-cyclical movement.

Another qualitative aspect of the labor market is the dynamics of labor productivity[1] compared to the increases of the salaries in the real sector. The Figure 7 reveals that the growth rate of the labor productivity, except for 2010 and 2011, has been lower than the average wage growth. These dynamics denotes a low competitiveness of the real sector, caused by limited access to capital and technologies, which actually is one of the biggest challenges in the medium and long run for the national economy.

The gap between the wage growth and overall productivity in the economy is higher when we take into account the public sector, due to its share in the total active population. In the past decade the active population decreased by about 25%, while the number of people employed in the public sector decreased by only 8% and currently this sector accounts for about 25% of the active labor, having increased by 5 p.p. in the past ten years. This indicator for the Republic of Moldova is one of the highest in Central and Eastern Europe, as well as in CIS.[2]

Figure 7. Growth Rates of the Real Wage and Labour Productivity, %



Source: NBS, Expert-Grup calculations

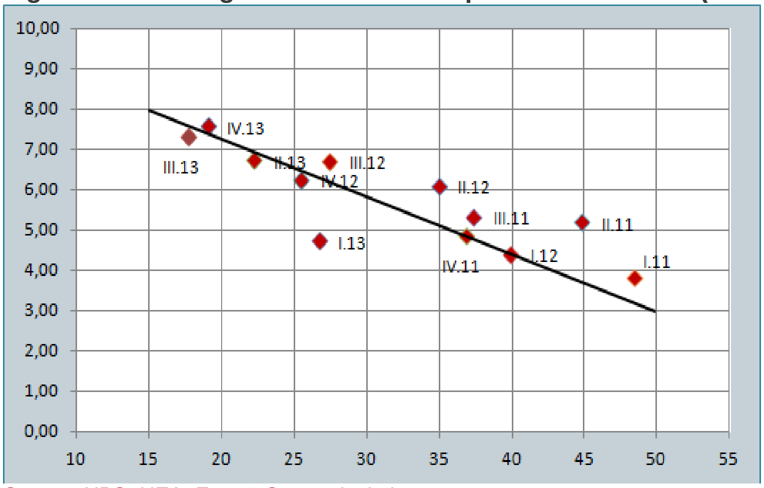
How Flexible Is the Moldovan Labor Market?

Analyzing the structure of supply and demand on the labor market in terms of quality of vacancies and structure of the labor force by education level, we would expect a misbalance between demand and supply with a negative impact on the structural unemployment. However, this hypothesis is partially infirmed by the analysis of Beveridge curve[3] for the Republic of Moldova (Figure 8). This reveals the dynamics between the number of created vacancies and unemployment level. At the first glance, this seems to be a paradox on the local labor market, as there is perfect indirect relation between these mentioned indicators, showing a well-adjusted labor market. If the structural unemployment increased, as it was expected, the curve should have got an inverse bending - due to mismatch between the qualification of job seekers and the quality of the new vacancies. Such developments took place in

[1] Labor productivity was calculated reporting the gross added value to the employed labor force. The reference year for the calculation of productivity and real salary was chosen to be 2000.
[2] *Republic of Moldova:Selected Issues*, IMF Country Report No. 12/289, October 2012
[3] Beveridge curve is drawn only for 2011-2013, because older statistics about the number of created vacancies is missing.

most EU countries after the current crisis, where the curve moved to the right, towards a higher balance between the indicators in the chart.[4]

Figure 8. Beveridge Curve for the Republic of Moldova (2011-2013)



Source: NBS, NEA, Expert-Grup calculation

Short- and Medium-Term Forecasts and Challenges

- Given the forecasts of moderate growth in 2014, no spontaneous changes in the main labor force indicators are anticipated. The main indicators will oscillate around the balance set for the medium term - specifically the employment rate will be around 39%; unemployment rate - around 5% and the share of migration with a slight increase over 27% of the active population.
- The developments of the structure of employment by branches will continue the trend of the past years. Given the forecasts of a slower growth rate in the agricultural sector, the number of employees in this sector will decrease, being compensated by an increase in the number of employees in the service sector.
- The gap between the real salaries growth and productivity growth will be maintained, due to the sub-optimal balance established on the labor market. The delayed effect of the reforms in the educational system, insufficient investments and constantly high shares of migration and informal sector will maintain the disequilibrium between labor demand and supply, perpetuating the aforementioned gap.
- There are external risks related to the economic slowdown in the main countries of destination of Moldovan migrants, as well as geopolitical risks. The major risk in this respect is a potential worsening of the bilateral Moldovan-Russian relations. Besides the mid-term deceleration of the Russian economy, which impacts the demand for labor, there is a probability that a high number of Moldovan migrants will be expelled from this country. This “pessimistic” scenario can cause a shock to the local labor market.

Labor Market from the Perspective of Political Economy

So far the main concerns and policies regarding the labor market were the unemployment level and job creation at any cost. Perpetuation of these public policy goals has led to underused labor force and in order to maximize its use it is necessary to change the priorities. Moldova cannot afford promoting a policy of enlarging the number of employment opportunities at any cost, regardless of their quality. Since we already have significant “buffers”, such as migration and informal sector, which absorb the surplus of the labor market and reduce the relative importance of unemployment rate, it is important to focus the policies on creating workplaces in the sectors with the slowest dynamics of labor

[4] *"Skills Mismatches and Labour Mobility"*, EU Commission Report 2013, http://ec.europa.eu/europe2020/pdf/themes/27_skills_gaps_and_labour_mobility.pdf

productivity, emphasizing the qualitative aspect of workplaces. As proved by the productivity dynamics in the past decades in most developed and transition countries, industry and service sector are the most dynamic. This leads to the biggest dilemma for every Government of the Republic of Moldova, how much time and resources are worth investing in the agricultural sector, which cannot be the main driver of the economic growth?

Policy Recommendations

The labor market of the Republic of Moldova is in a dynamic disbalance, with a suboptimal use of the labor force. To maximize the efficiency of labor force use, a set of comprehensive policies is needed in this area, tackling the redistribution of labor force among sectors, its quality and productivity. We could list the following as some of main and most urgent measures:

- Informal employment should be diminished by improving the quality of the public institutional framework, the business climate and finding an optimal distribution of social insurance contributions between the employer and employees. Consistency of the relevant public programs and policies to generate the necessary stimuli for diminishing the informal component of the labor market;
- Pro-active approach to migration by adjusting the institutional and legal frameworks for an efficient management of the labor migration process;
- Continuation and expansion of reforms in the educational system to diminish the structural disbalance on the labor market; strengthen the human capital; and enhance the labor productivity through penetration of modern technologies;

Role of the Educational Sector in the Operation of the Labor Market

The educational system plays an extremely important role in the efficient operation of labor market in the medium and long run. Coordination of policies in these areas, related to the macroeconomic development context, is essential for achievement of some efficiency and sustainability objectives. However, currently, the supply of qualifications of the educational system does not match the demand from the labour market. Particularly, a significant part of those with higher education works in sectors that need a lower level of education (over-qualification effect). This phenomenon has expanded in the past years - from 2007 to 2013 the average gap increased from 22% to 36%, being particularly specific for the population with mid-level specialized and secondary vocational education (Figure 9). The major reason is the unsatisfactory quality of the educational system and its poor correlation with the needs of the economy.

Figure 9. Share of People, Employed in Jobs under their Educational Profile, %

Source: authors' calculations based on NBS data

Hence, it is necessary to build an optimal educational system, both in qualitative and quantitative terms, able to adjust timely to the structural changes in the economy. System flexibility can be achieved by more active involvement of companies in the educational process and structural optimization of the overall system according to the long-term goals.

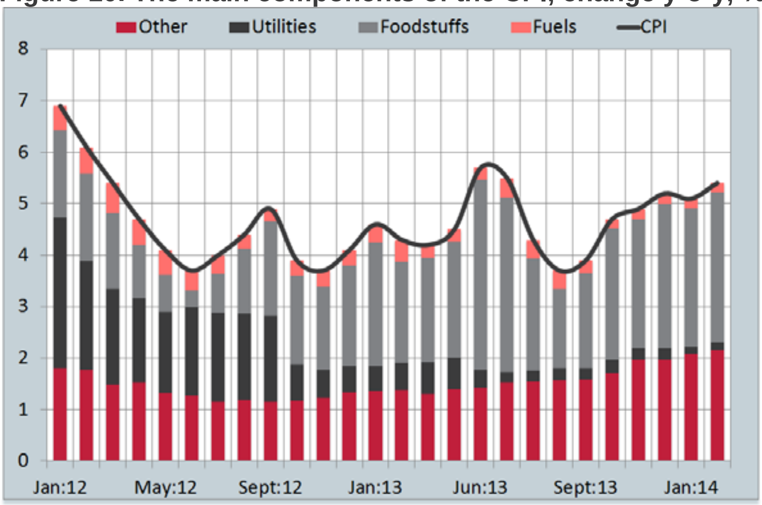
Chapter 5. Prices and Monetary Policy

During the last months, inflation followed an upward trend, determined by supply-side (rising foodstuff prices) and demand-side (currency depreciation and credit expansion) inflationary pressures. Nevertheless, the current and expected headline inflation rate remained within the targeted interval, which motivated the central bank to maintain a broadly accommodative stance of its monetary policy. Still, in order to keep the inflationary pressures under control, a gradual adjustment of the monetary policy is recommended, as a response to rising core inflation, credit expansion and monetary mass.

Understanding the Inflationary Pressures?

Over the last two years, the annual rate of inflation measured by the Consumer Price Index had a sinuous trend, while resting at the bottom of the central bank's target range (5%, +/-1,5 pps). However, since Aug:13 there has been a steady upward trend, while the CPI increased from 3.7% to 5.4% in Feb:13. This trend was mainly due to higher food prices, which accounted for more than one half of the inflationary pressures, as a result of higher prices of fresh vegetables (Figure 10).

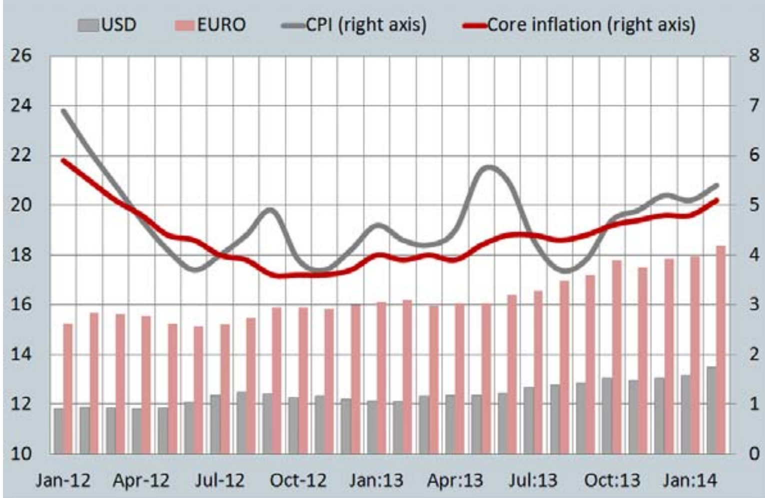
Figure 10. The main components of the CPI, change y-o-y, %



Source: Estimates by EXPERT-GRUP based on NBS data

Another major driver of the headline inflation was the core inflation: total CPI excluding food and beverages, fuels, products and services with regulated prices. Since jun:13 it has had a steady upward trend coupled with the national currency depreciation (Figure 11). At the same time, the robust economic growth driven by final household consumption emphasized demand-side inflationary pressures, but to a lower extent.

Figure 11. Trends in the Consumer Price Index (CPI) and core inflation, %, compared to the average official foreign exchange rates of the national currency against the U.S. dollar and Euro



Source: NBM

Specifics of an Ultra-Relaxed Monetary Policy

Despite the upward trend in the Consumer Price Index, it rested within the central bank's target range (5%, +/-1.5 pps). This allowed the NBM to promote a stimulative monetary policy to create conditions for a robust economic recovery[5]. In this regard, NBM used two main tools: purchases of foreign currency in the interbank market during 2013 and the promotion of a monetary policy of negative real interest rate.

Foreign exchange market interventions

The net purchases of foreign currency made by NBM during 2013 amounted to approximately USD 304 million, most of which were made in the second half of the year. This caused a steady depreciation of the national currency: on Dec:13, the Moldovan leu depreciated by 7% y-o-y to U.S. dollar and by 13.6 % y-o-y to Euro. These measures were determined by at least three purposes:

(i) mitigating deflationary trends (it contributed with about 1.5 pps to the annual CPI in 2013);

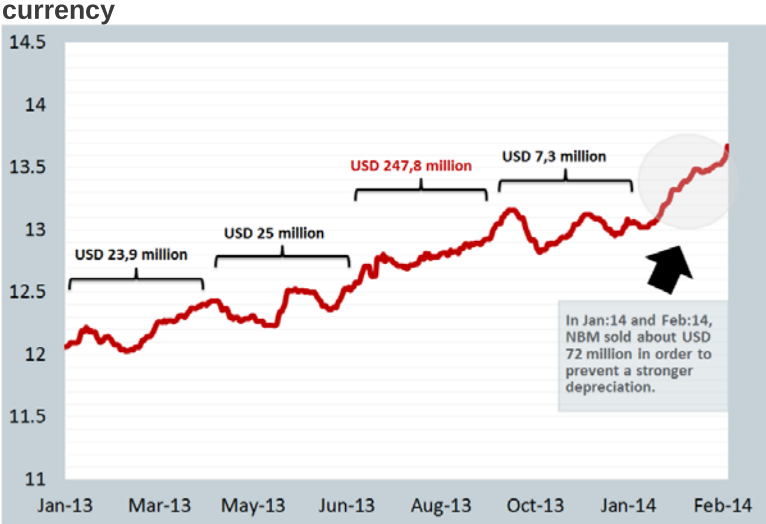
(ii) encouraging exports, consumption and, consequently, the economic growth (it contributed with about 1 pp to economic growth in 2013);

(iii) consolidating official reserve assets, which in 2013 increased with 12.2% y-o-y.

However, the risks of such foreign exchange policy increased since the beginning of 2014, together with the accelerated depreciation of the national currency. This was due to the unusual increase, in this period, of the demand for foreign currency, accounted for by certain speculative attacks or by some anxiety firms and individuals. Thus, in Feb:14, as compared to Dec:13, Moldovan leu depreciated, on average, by 3.5% against the U.S. dollar and by 3.1% against the Euro. However, to address the higher demand for currency and alleviate pressures on the national currency, the NBM sold in Jan-Feb:14 about 72 million US dollars from its official reserve assets (Figure 12).

[5] Conform art. 4, al. (2) din Legea cu privire la Banca Națională a Moldovei, „fără prejudicierea obiectivului său fundamental, Banca Naţională promovează şi menţine un sistem financiar bazat pe principiile pieţei şi sprijină politica economică generală a statului”

Figure 12. Trends in the MDL/USD exchange rate and net purchases of foreign currency

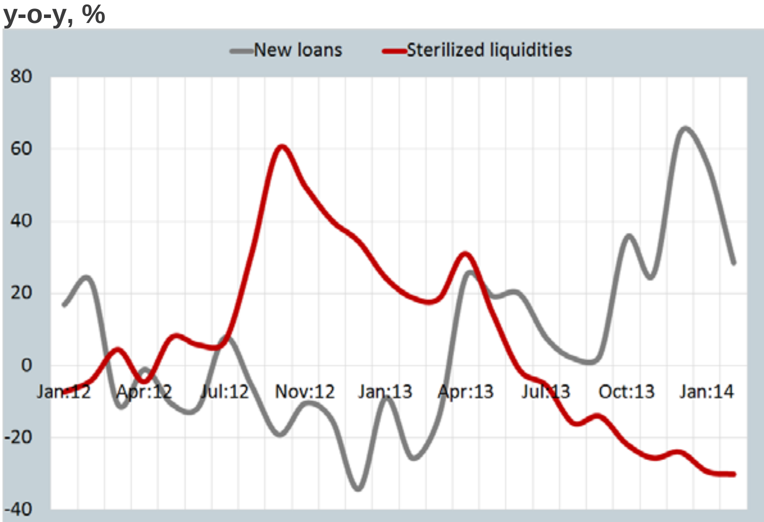


Source: NBM

Monetary policy of negative real interest rates

NBM kept its base rate at a historically low of 3.5%. Although, conventionally, it must be greater with about 2-3 pps than the inflation rate, it was actually lower than the CPI and the inflation rate forecasts for the end of 2014 (4.8%) and 2015 (4.5%). Such a policy of negative real interest rates aims to motivate banks to redirect resources from lending to government to lending the private consumption and real sector, in order to boost the economic growth. To further catalyze this process, NBM reduced in Apr:13 the remuneration rate of required reserves from 1.5% to 0.5% and enhanced the banks' motivations to boost the lending activity. As a result, from Apr:13 to Feb:14, the volume of new loans grew with a respectable average rate of 26% y-o-y, thus improving the banking system indicators and the overall economic performance (Figure 13).

Figure 13. Sales of NBM Certificates (sterilized liquidity) and new loans, growth y-o-y, %



Source: Estimates by EXPERT-GRUP based on NBM data

Political economy considerations

Normally, this sub-chapter should be irrelevant to the monetary policy, given the conventional principle of personal, institutional, operational and financial independence of the central bank. The central bank independence is a good international practice that enables the monetary authorities to fulfil their responsibilities effectively, while empirical evidence shows a close correlation between the independence of the central bank and price stability[6]. However, the National Bank of Moldova is not fully immunized against any pressures from politicians. According to a recent study conducted by EXPERT-GRUP[7], the independence of the NBM is estimated at 64%, while the largest gaps relate to institutional independence (45%), allowing interference by other public authorities in the operation of the bank[8]. Additionally, the personal independence of the monetary authority is not sufficiently fortified and a proof to that is the recent parliamentary initiative to dismiss the NBM Governor. In light of the insufficient independence of the central bank, is it a mere coincidence that, on the eve of elections, the objectives of the monetary policy correlate with the objective of economic growth pursued by the Government?

Short- and Medium-Term Forecasts and Challenges

- In the short- and medium-term, inflation is expected to remain within the central bank's target range, while the annual CPI will hover around the level of 5.3% at the end of 2014 and 5.1% at the end of 2015. Thus, the forecast made by EXPERT-GRUP is slightly higher compared to that of the NBM (4.8% in 2014 and 4.5% in 2015). However, inflation will most likely remain at a comfortable level for the economy and the monetary policy. This forecast is a result of the fact that the growth of domestic inflationary pressures will be mitigated by certain regional disinflationary pressures:
    - The main domestic inflationary pressures relate to the expected robust growth in lending (about 10% in 2014 and 7% in 2015), which will feed aggregate demand. However, the depreciation of the national currency and the ultra-relaxed monetary policy generates certain inflationary risks in the short and medium term.
    - The main foreign disinflationary pressures relate to: (i) the expected reduction in world food prices in the context of favourable climate conditions; (ii) the economic slowdown in the Russian Federation and Ukraine, accompanied by some disinflationary trends in these countries; (iii) the expected depreciation of Ukrainian hryvnia against MDL, which will lead to cheaper imports from this country; (iv) the expected reduction in world energy prices.
- NBM will balance between the need to ensure the national currency stability and maintaining an optimal level of foreign exchange reserves. The main challenges in this respect are the reduction of exports to and remittances from the Russian Federation. Those pressures could be exacerbated in the context of uncertainty about this year's parliamentary elections and developments in Ukraine, coupled with the erosion of trust in the national currency over the last months (the share of foreign currency deposits in total deposits in Jan:14 amounted to 46.1%, 1.4 pps higher y-o-y).

Policy recommendations

- In order to avoid endangering the confidence in the national currency, the NBM's interventions on the domestic FOREX market must aim exclusively at mitigating excessive fluctuations, without inducing exchange rate adjustments (similar to the controlled depreciation in 2013). Although the national currency depreciation may entail several advantages (lower current account deficit based on stimulation of exports and substitution of imported products with local products; stimulation of consumption based on the MDL income growth in migrant families; higher budget revenues etc.). In the case of the Republic of Moldova, this involves a number of costs that, in the long run, outweigh the benefits. First, the vast majority of households'

[6] Crowe C., Meade E.E. (2008): „Central Bank Independence and Transparency: Evolution and Effectiveness", IMF Working Papers, WP/08/119
[7] A. Lupușor (2013): „Independența Băncii Naționale a Moldovei în pericol?", EXPERT-GRUP
[8] Spre exemplu: Actele normative adoptate de BNM sunt supuse procedurii de expertiză juridică și înregistrare în Registrul actelor departamentale, efectuată de Ministerul Justiției, procedură de care este condiționată intrarea în vigoare a actului normativ adoptat de BNM.

incomes (about 80%) is expressed in MDL, over one half of which is used for food, most of which being imported. Additionally, about 20% of the average per capita expenditures are allocated for housing maintenance, which depend on energy imports. Therefore, the depreciation of the national currency exposes most of the Moldovan population to a high poverty risk. However, people with incomes expressed in foreign currency are in a better position, as they usually enjoy higher living standards compared to the rest. Therefore, the depreciation of the national currency in Moldova contributes to higher income inequality, which is detrimental to the majority of population. Other repercussions relate to higher production costs as a result of higher prices of imported raw materials and, respectively, erosion of competitiveness of domestic enterprises.

- A major long-term priority for the NBM should be related to increasing the efficiency of the transmission mechanisms of classical monetary policy instruments (base rate, required reserves, open market operations). This can be achieved through two sets of policies that need to be implemented in parallel. The first set relates to creating conditions for the development of lending, which will allow channelling of structural abundant liquidities from the banking system, which currently impedes the transmission of monetary policy decisions, in the operational activities of banks. To this effect, priority should be given to the strengthening of lenders' rights, increasing the efficiency of restructuring the non-performing loans, improvement of the business climate and country risk mitigation. The second set aims at strengthening the confidence in monetary policy by increasing the independence of the NBM, enhancing the communication between the monetary authority and businesses and civil society, as well as increasing the overall transparency of the institution.

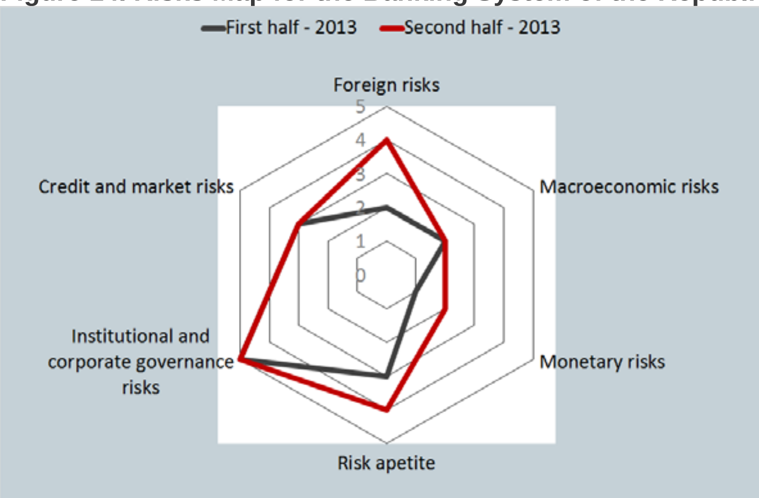
Chapter 6. Banking System

Despite the satisfactory financial results, the banking system of the Republic of Moldova will face in 2014 institutional vulnerabilities and corporate governance issues that have haunted the sector during the previous years. The system's stability and resilience will be also tested by the unpredictable macroeconomic environment: a still weak economic recovery in the European Union, the risk of default and the escalation of the conflict in Ukraine, as well as a possible new recession in the Russian Federation.

Balance of Risks in the Banking System

During the period under review, Jun:13 to Mar:14, the foreign risks, and the monetary and currency risks have intensified[9] (Figure 14). At the same time, the institutional and corporate governance risks remained at the highest level and did not change significantly, compared to the previous period. The banks' risk appetite increased visibly during the same period, the increasing supply of loans being matched by a similar demand. The macroeconomic and credit risks did not suffer any significant changes y-o-y, which reflect an enhanced economic activity, supported by the lengthy accommodative monetary policy promoted by the National Bank.

Figure 14. Risks Map for the Banking System of the Republic of Moldova



Source: developed by EXPERT-GRUP;

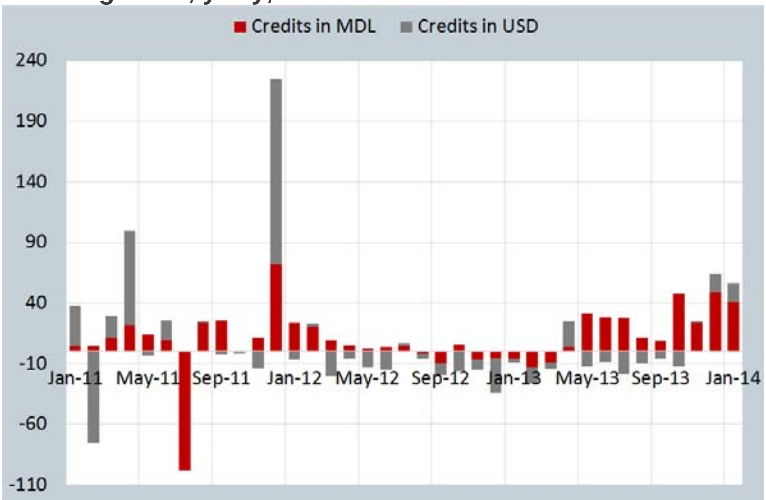
The ***foreign risks*** for the local banking system have intensified mainly on the CIS dimension. Thus, the political and economic crisis from Ukraine has a destabilizing potential for the entire region. Its contagious potential was reflected through the depreciation of the national currencies of Russia, Ukraine, Kazakhstan and Kyrgyzstan, but also of the Moldovan Leu - although fundamentally the economy of the Republic of Moldova does not pose any risks of depreciation. The EU's economic growth remained weak (an advance of only 0.52% in Q4:13). The short-term developments are characterized by an inflation much lower than the targeted 2% (0.7% for February 2014), increasingly

[9]This chapter presents a map consisting of 5 risks affecting the banking activity in the Republic of Moldova and their risk appetite. Thus, external risks refer mainly to the economic, financial and political developments of the main trade partners of Moldova. The credit and market risk encompass the evolution of loans quality, the speed of extending new loans, as well as issues related to financing of banks. The institutional and corporate governance risks are mainly generated by the evolutions of institutions and major decisions with a direct impact on the banking activity. At the same time this category includes risks derived from the internal organization of banks, which can degenerate into reputational risks, either for individual institutions or for the entire system. Monetary and currency risks measure the impact of the monetary and currency policy on the banking activity. Macroeconomic risks relate to the level of economic growth, inflation and unemployment rate, indicators that indicate the level of real economic activity. Finally, we estimate the banks' risk appetite – this indicator shows the banks' willingness to increase their exposure by extending new credit lines and expanding the non-credit investment portfolio.

limited options for intervention, but also a threat of commercial confrontation with the Russian Federation.

The banks' **risk appetite** has increased against the background of accelerating economic growth in the last quarter of the year and gradual decrease of the share of non-performing loans in the banks' portfolio. Credit expansion intensified especially in Q4:2013, culminating with an impressing increase of 64.5% in Dec:13 y-o-y (Figure 15). It was caused partially by the growth of lending in MDL (by 71.7% y-o-y) and in foreign currency (by 49% y-o-y). The same trend was maintained in Jan:14, although at a slightly lower pace - the total credit expansion amounted to 56.2% y-o-y.

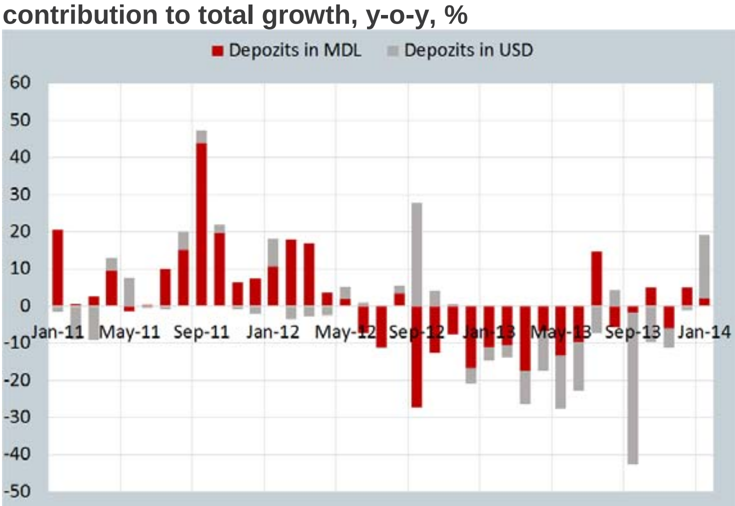
Figure 15. Evolution of new loans provided by commercial banks, contribution to total growth, y-o-y, %



Source: NBM, EXPERT-GRUP;

Deposits followed a volatile dynamics, particularly in the second half of 2013 (Figure 16). Thus, though in Jul:13 and Aug:13 deposits increased unsubstantially by 7.4% and then decreased by 1.4% y-o-y, already in Sep:13, in the context of the Government giving up on Banca de Economii, the new deposits decreased by 42.6%. A similar dynamics, although less intense, continued during the next two months. Deposits returned on the growth path in Dec:13 only, with +3.9% y-o-y. In Jan:14 deposits grew at a higher rate, 19.1% y-o-y, which was mainly driven by an increase in foreign currency deposits with a maturity of up to 6 months (+164% y-o-y). This dynamics led to an increase in the share of foreign currency deposits in total deposits from 44.7% in Dec:13 to 46.1% in late Jan:14, reflecting a general feeling of distrust in the national currency.

Figure 16. Evolution of new deposits opened with commercial banks, contribution to total growth, y-o-y, %



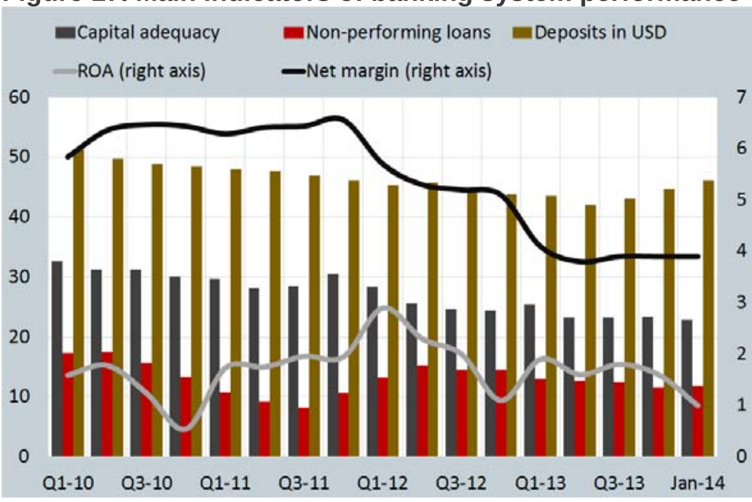
Source: NBM, developed by EXPERT-GRUP;

The ***macroeconomic risks*** were moderate – inflation level hovering within the interval targeted by NBM, and the real economic activity witnessing an accentuated pace in the last quarter.

The ***monetary and currency risks*** increased slightly. The monetary policy maintained the accommodative stance; however some shocks propagated through the depreciation of the national currency against the US dollar and Euro. Although this depreciation did not affect lending, it impacted mainly the balance sheet liabilities by an increase in foreign currency deposits, in particular the ones on a very short term.

The ***credit and market risks*** remain anchored in terms of indicators on financial stability of the banking system (Figure 17). Thus, in Jan:14 the risk weighted capital adequacy of 22.8% exceeded the minimum of 16%. The decrease of the indicator during the last months under review was mainly caused by the rapid expansion of credit portfolio. As of the end of the year Return on Assets remained at a level of 1.6%, recording a slight increase compared with the 1.1% registered for 2012. Except for "Eximbank", all banks ended 2013 with profits. However, the net interest margin declined in 2013, if compared with the previous year, reaching 3.8-3.9%, while the share of non-performing loans in total bank loans recorded a slight decrease on the average per system. Banca de Economii still remains under the pressure of a high rate of non-performing loans (58.4%), but nevertheless succeeding to strengthen risk weighted capital adequacy from 5.9 % in 2012 to 26.03% in Q4:2013.

Figure 17. Main indicators of banking system performance



Source: NBM, developed by EXPERT-GRUP;

The highest risk to the domestic banking system is, however, generated by ***the functioning of institutions and corporate culture*** of the still weak domestic banking system. Year 2013 brought back into discussion the ability of policy-makers and authorized institutions to deal with crises in the banking system but also of the effectiveness of the instruments available to them.

Political Economy Considerations

With a price tag of MDL 320-526,8 million – a conservative estimate – the crisis of Banca de Economii represented the classical example of dysfunctional state, and from this point of view the solution found by the Government is not a surprise. Apart from the faulty management of the Bank, the BEM crisis revealed the so-called "triangle" of institutional inefficiency (or a self-maintained vicious circle) – when none of the state institutions involved in this case acted at the maximum potential conferred by the law. Thus, the National Bank did not have the "courage" to use the same approaches as in the case of "Investprivatbank" or "Universalbank" - indicating that a powerful banking supervisor in a weak institutional environment is a dangerous solution to financial stability, competitive banking environment and the long-term viability of the sector. The Government has basically gave up on the Bank, forgetting in the meantime about the public interest and ignoring the viable solutions for the recovery of the situation. The judicial system has only amplified the vicious cycle of institutional failure. If at least one of these three institutions fulfilled its institutional obligations following the public interest, the crisis of Banca de Economii would have been resolved without affecting the image of the banking system, Government, National Bank, and the investment attractiveness of the country in general.

Short- and Medium-Term Forecasts and Challenges

- The cycle of a relaxed monetary policy seems to end. Its inappropriate extension could lead to accumulation of vulnerabilities in the banking system, mainly through exposure to the risk of maturities gap, taking into account the robust expansion of lending on the background of low confidence in the banking system. In this context, the National Bank shall improve its communication policy and monitor carefully the position of each bank.
- The low quality and institutional functionality will remain a major risk for the domestic banking system. Moreover, during the electoral year the institutional inefficiency may exceed the limits of the previous years. In the short term, banks should intensify and improve the communication with stakeholders in order to prevent any possible deterioration of image.
- The banks' risk appetite will continue to be fueled by the easy monetary policy, but it can be curbed by the acute regional instability. The interaction between these two factors poses high risks of accumulation of additional vulnerabilities for financial stability of the banking system.
- The level of non-performing loans will remain high – particularly because of certain banking institutions have restructured their non-performing loans. To be solved, this issue requires a more active response from the National Bank, as well as from the management teams of the banks concerned by strengthening the departments in charge of collecting the overdue loans, developing early warning systems, revising the conditions for transferring the loan files to the enforcement departments, way of loans restructuring etc.

Policy Recommendations

- During the next period the institutions responsible for financial stability of the banking system should be more alert than ever, and the situation should be monitored on four dimensions: (i) evolution of the quality of loans portfolio and taking additional measures to resolve the problems of the banks with the highest exposures; (ii) enhanced monitoring of the gap between assets and liabilities and foreign currency position; (iii) closed monitoring of the changes in the ownership of the banks; timely blocking of suspicious transactions, and (iv) developing a package of legislative proposals to reform the corporate governance framework of banks of the Republic of Moldova;
- In the short term, it is necessary to insure the safety of investments in the financial sector. In this respect, it is necessary to increase the transparency of banks' shareholders, and it is crucially important to protect the property rights. This would exclude any speculations about interest groups and would minimize the incentives for pseudo-legal or even illegal takeovers of important packages of shares of the existing banking institutions.

Chapter 7. Foreign Sector

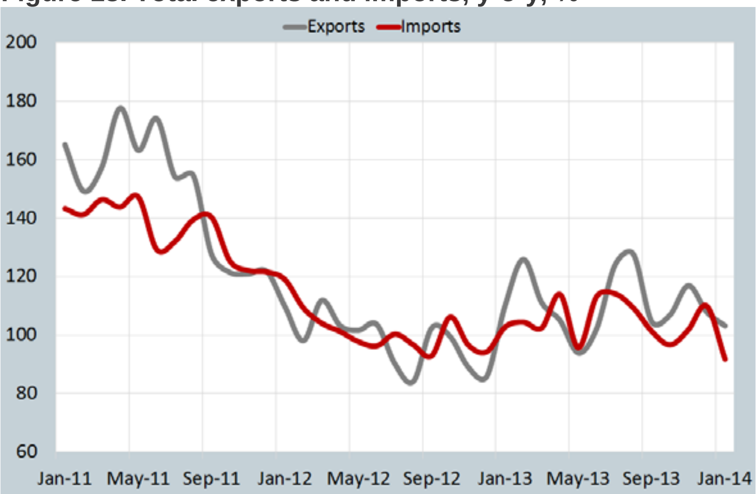
The share of EU as a sales market strengthened, while the exports to Russia decreased again. Partially, this is determined by more intensive trade relations with European partners, but also by the preparations for DCFTA. At the same time, this trend is one of the consequences of Russia using trade leverages for political and geopolitical purposes.

Higher Exports to the West and Increasing Trade Deficit

In 2013, both exports and imports increased, in spite of the restricted access to certain markets. The exports remained dominated by agro-food products, which accounted for about 41% of all trade flows in 2013, recording a timid growth of 0.5% y-o-y. This was conditioned in particular by the foreign constraints, characterized by the restricted access of Moldovan wine producers to the Russian market.

The European market has an increasing role for the local producers, given the continuous decline of the Russian share as a sales market. Thus, during 2013 the European market (UE-28) attracted a large share of the Moldovan products. Exports to EU accounted for 47.6% of all exports (by 0.7 pps. more than in 2012 - 46.9%). The CIS countries accounted for 38.5% of exports (by about 4 pps. less than in 2012 - 42.9%). This regress was mainly caused by decreasing exports to Russia (-3.5%). We underline that the slow recovery of the European economy, as well as the internal domestic crises decreased the exports to some important European markets: Italy (-8.4%), Hungary (-45.3%). The imports volume increased y-o-y (+5.4%), but did not exceed the exports growth (+11%) (Figure 18).

Figure 18. Total exports and imports, y-o-y, %



Source: NBS, EXPERT-GRUP estimation;

The diversity of the sales markets for local products has increased. Thus, the share of other countries (except for EU and CIS) in the total exports increased from 10.2% in 2012 to 13.9% in 2013. This evolution is partially determined by some producers reorienting to some markets that are still non-traditional, but with a high potential. The most impressive developments were noticed in the trade with Turkey (fifth most important sales market): the exports to this destination increased 2.3 times in 2013 compared to 2012.

Overall, 2013 was a positive year for the main world economies - USA and EU-28; it also revealed visible slowdown signs in the Chinese economy, as well as a minor growth in other regions of the world, including in CIS. Recovery of the European economy has been fragile and manifested particularly outside the Eurozone (GDP for 2013: EU-28 +0.1%; Eurozone -0.5%). The modest economic growth was associated with a slight recovery of the Consumer Confidence Index, up to the level of 2004-2005.[10]

The economic developments in the EU Member States reflected accordingly on the commercial relations with Moldova. ***Germany*** recorded only a 0.5% GDP growth. However, this modest progress did not affect the Moldovan exports (+61% y-o-y). On the contrary, improved indicators supporting the acceleration of German economy (investments, consumption, and unemployment rate) could ensure stabilization and even gradual improvement of export flows to Germany. The trade with ***Romania*** has been ascending, with exports growing by 15.8%. This rate improved its position in the foreign trade of Moldova. As a result, the role of the European market increased and the dependence of Moldovan exports on Russia diminished. Internal political uncertainty and short life of Governments endanger the efforts to revive ***Italy***'s economy, which goes through a recession second year in a row.[11] The low level of domestic consumption and anemic situation in the banking sector influenced the industrial output and the imports. The decline of these indicators also had a negative impact on the Moldovan exports (-8.4%).

The ***Russian*** economy had a low performance in 2013, registering a growth under the forecasts (1.5% compared to 3.4% in 2012).[12] The low competitiveness of the Russian production on the international markets, the unfavourable business environment, strong dependence on the exports of hydrocarbons associated with the completion of major infrastructure projects (preparations for Sochi Olympics and Nord Stream gas pipeline) led to the gradual stagnation of the Russian economy. These factors had a minor impact on the trade with Moldova, as opposite to the non-tariff measures applied to Russia that ended up with the ceasing of alcoholic beverage imports. As a result, the exports to this destination decreased by 3.5% y-o-y, having affected indirectly the imports (-3.5% y-o-y). The commercial dynamics of the relationship with **Ukraine** had a positive trend (export +15.3%, import +10.9%). This reinvigoration could be determined by the worsening of the trade relationships with Russia and by Ukraine's need to make use of other sales markets in its proximity.

Political Economy Considerations

The critical moment for the foreign trade, noticed during the analysed period, is the materialization of DCFTA as a logical consequence of initialling the Association Agreement with EU. Besides the technical and purely diplomatic aspects, the following elements are necessary in order to make use of the DCFTA: efficient, sustainable and transparent administrative capacity; feasible financial support in the reform process; and the most important one - a political climate needed to ensure irreversibility of reforms. The first two depend on the robust involvement of European partners - a commitment they assumed for the immediate period. The last one refers to maintaining the external vector by the Moldovan authorities, which could oscillate significantly after the elections of this year. Other important aspects result from the feasibility of the local business environment, which is directly influenced by the quality of governance and efficiency of justice. That is why, justice reform completion and governance improvement should be viewed together with the sector reforms (particularly in product quality management), rather than separately.

An important event related to the (geo)political economy consisted of selective restrictions applied by the Russian quality surveillance authority (Rospotrebnadzor) on imports of Moldovan wine products.13. These pressures, though generated by issued related to quality management14, are

[10] Flash Consumer Confidence Indicator for EU and Euro area, Accessible here: http://ec.europa.eu/economy_finance/db_indicators/surveys/documents/2013/fcci_2013_12_en.pdf
[11] Eurostat data, available here: http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00115
[12] Russia Overview, Available here: http://www.worldbank.org/en/country/russia/overview
[13] "О поставках продукции из Республики Молдова и закавказских государств" of 8.07.2013 and "О поставках продукции из Республики Молдова и закавказских государств" of 23.07.2013. Press releases that are omitted from the official website of Rospotrebnadzor.
[14] Роспотребнадзор: Молдавия не восприняла предупреждения по алкоголю, Available here: http://www.rbc.ru/rbcfreenews/20130903064507.shtml

most likely conditioned by political considerations, taking into account at least three main factors. First, the restrictions were set on the eve of initialling the Association Agreement between the European Union and the Republic of Moldova, which contradicts the integration processes in the Eurasiatic area, promoted by the Russian Federation. Second, the restrictions were not applied to wineries from the Eastern rayons of the Republic of Moldova. Third, the generated constraints did not influence the behaviour of other regional markets, including the other members of the Customs Union (Belarus and Kazakhstan), which apply similar quality standards as the Russian Federation.

At the same time, the trade relations with the West have improved thanks to the more advanced liberalization of the trade with EU. This trend manifested in initialing of Association Agreement (AA), which envisages the establishment of DCFTA (during 2014). Moreover, this process was accelerated in the context of the pressure put by Russia and developments in Ukraine. Thus, while the conclusions of the Vilnius Summit stated a vague date for signing the Association Agreement - "by autumn 2014"[15], subsequently this objective was set for August 2014[16]and recently was moved to June 2014[17]. Additionally, in order to support Moldova, the EU started the unilateral liberalization of the Community market for Moldovan wine products, anticipating the actual launching of the DCFTA.[18] However, this initiative is rather symbolic, at least in the short run, taking into account the limited capacity of local producers to use the quota for Moldovan wines which was already provided in the Autonomous Trade Preferences (starting with 2008).

Short- and Medium-Term Forecasts and Challenges

- The recovery rate of the European economy from 2013 will continue in 2014. According to the forecasts of the European Commission, the EU-28 GDP will grow by 1.5% in 2014 and respectively by 2% in 2015. Compared to this, the economic growth in the Eurozone will be slower (1.2% in 2014 and respectively 1.8% in 2015)[19]. ***Germany*** shows signs of economy acceleration (GDP, 2014 - 1.7%) accompanied by a raise in the domestic consumption. Mitigation of the recession effects is expected for ***Italy*** (GDP, 2014-2015 - over 1%). The intensification of economic activity will be based on the activities in the trade sector, where the demand for Italian products on foreign markets is expected to grow. These circumstances will favour the trade flows (primary industrial products, textiles and raw materials) towards Germany and Italy, which together account for 12.6% of the total exports (2013). ***Romania's*** economy will continue to be stable. Despite the slowing of the economic growth (+2.3% in 2014 compared to 3.5% in 2013), an increase of real salaries is expected (+3%)[20], which will stimulate the consumption, as well as the interest to import. The position of ***Turkey*** as a sales market for Moldovan products (in 2013 ranked the 5th) will most likely strengthen. This might be a result of the anticipated GDP growth (3.8-4.1% for 2014-2015) and steady domestic demand (3.9-4.9% for 2014-2015).[21] Prior to the crisis in Ukraine, the economic growth of ***Russia*** was expected at 3%. The poor performance of the Russian economy, dependent on hydrocarbons and with an unfavourable business environment, determined the IMF to review downwards the country's forecast (2% for 2014).[22] Because of external constraints and major fiscal issues, the risk of a deeper recession with hover above the economy of ***Ukraine***. EBRD

[15] Joint Declaration of the Eastern Partnership Summit,Vilnius, 28-29 November 2013, Eastern Partnership: the way ahead, Available here: http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/139765.pdf
[16] Conclusions of European Council of 19-20 December 2013, Available here: http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/140245.pdf
[17] Conclusions on Ukraine approved by the European Council, 20 March 2014, Available here: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/141707.pdf
[18] European Union to open fully its market to Moldovan wine, Brussels, 25 September 2013, http://europa.eu/rapid/press-release_IP-13-872_en.htm
[19] Winter forecast 2014 - EU economy: recovery gaining ground, Available here: http://ec.europa.eu/economy_finance/eu/forecasts/2014_winter/overview_en.pdf
[20] Romania, Available here: http://ec.europa.eu/economy_finance/eu/forecasts/2014_winter/ro_en.pdf
[21] OECD Economic Outlook, Turkey, Available here: http://www.keepeek.com/Digital-Asset-Management/oecd/economics/oecd-economic-outlook-volume-2013-issue-2/turkey_eco_outlook-v2013-2-37-en#page4
[22] Russian 2014 Growth Forecast Cut by IMF as Inflation Persists, Available here: http://www.bloomberg.com/news/2013-12-10/russian-2014-growth-forecast-cut-by-imf-as-inflation-persists.html

forecast for 2014 estimated its recovery from the recession (GDP, +1.8%)23; but according to a recent review done by IMF, GDP growth is estimated at only 1%24.

- The decrease in the share of traditional sales markets (CIS countries) will continue. According to some sources, the foreign trade of ***CU R-B-K*** decreased by 0.4% in 201325. Despite an increase of imports to the CU (+1.4%), the tariff and non-tariff barriers could hinder the imports from third countries. This could affect the re-exports in the first place, which accounted for 32.6% (2013) of the total exports of Moldova. The interference of politics in the trade relations will grow considerably, also given the launching the Eurasian Union (2014-2015). The latter could increase the incompatibilities with the free-trade agreement within the CIS, leading to its amendment or even termination.
- In order to stabilize the Ukrainian economy, the EU will allocate financial support amounting to EUR 11 billion. The support to be provided will also include trade facilities (Autonomous Trade Preferences) functional for the period of May - November 2014, its extension not being excluded. The partial liberalization of the community market for the Ukrainian goods comprises a number of challenges for the Moldovan exports. As a result, competition will rise, particularly in the agri-food sector, taking into account the constraints Moldova and Ukraine face on the Russian market.
- When establishing the DCFTA, the capacities and preparedness of authorities and local businesses should be taken into account, particularly in the sensitive sectors. Hence, a forcedly rushed process could impair its quality and consequences.
- Crimea attachment to Russia and potential military conflict with Ukraine will have poor effects on both countries (depreciation of the national currency, outflow of capital, burdening of the banking system etc.). The negative effect will amplify in case of economic sanctions for Russia in case of a possible armed conflict with Ukraine. This will diminish the internal demand in these countries, having repercussions on the Moldovan exports.

Policy Recommendations

- Development of quality infrastructure and adoption of European requirements and standards (at least 6000 standards to the existing over 20,000 European standards) are imperative in order to raise the competitiveness of Moldovan products on the European market. The authorities involved in ensuring the quality infrastructure (particularly in the area of accreditation and certification) need to be strengthened and recognized by the European institutions (adhering to the EA Multilateral Agreement - EA MLA). Implementation of policies in the sanitary and phytosanitary areas is critical for the improvement of agricultural and foodstuff products, which account for about 20% of the domestic exports.
- Though joining the CU is not on the political agenda, the trade relations with this block are important for Moldova (Russia, Belarus and Kazakhstan together account for 36% of total exports). It is necessary to establish an efficient communication platform in the area of technical and customs procedures of the CU, in order to prevent any barriers to the Moldovan exports. The cooperation dimension should not contradict the effective economic integration with the EU. Its role is to complement and not to substitute the information mechanisms existing in the WTO (TBT, SPS notification procedure).
- It is necessary to keep depoliticizing the commercial relationships with Russia, attention being focused on delivery of qualitative products and decrease of commercial dependence (by enhancing product quality management and diversifying the sales markets).

[23] Regional Economic Prospects in EBRD Countries of Operations: January 2014, Available here: http://www.ebrd.com/downloads/research/REP/rep-1401.pdf
[24] IMF cuts Ukraine's economic growth forecast to 1 percent in 2014, Available here: http://news.xinhuanet.com/english/business/2013-12/20/c_132984923.htm
[25] Об итогах внешней и взаимной торговли товарами Таможенного союза и Единого экономического пространства за январь-декабрь 2013 г., http://www.eurasiancommission.org/ru/nae/news/Pages/14-02-2014-2.aspx

Appendix A. Forecasting Framework

The forecasts were made based on a structural model. The model consists of 17 regressions and an identity relation that reflect the GDP structure (utilization approach). The following indicators entered the model as exogenous variables: export of goods, export of services, foreign direct investments (*FDI*), remittances, credits in MDL, stocks variation, agriculture, index of unit value of imports (*UVI*) and the real exchange rate MDL/USD (*RER*).

The main data sources serves the National Bureau of Statistics, Ministry of Finances and the National Bank of Moldova.

For most observations, the time span was Q1:2000 to Q4:2013. However, due to some data limitations, several variables have a shorter time span. All variables have been expressed in average prices of 2005 and were deflated with CPI, except for industrial production which have been deflated with the IPPI. The variables have been seasonally adjusted using Census X12.

Table 3. Summary of model regression results

Regressions	R^2
ln(*households_consumption*) = 19.55 + 0.15*ln*(*remittances*) + 0.01*TREND* - 0.14*DUM T*1:2009 + 0.1*DUM T*1:2011***	0.95
ln(Import) = - 4.9 + 0.83*ln(households_consumption)* + 0.07*ln*(*FDI* $_{t-1}$) + 0.32*ln*(*goods_export*) + +0.19*DUM T*1:2009 - 0.19*DUM T*4:2009	0.9
ln(Trade) = 1.77 + 0.74*ln*(*households_consumption*) + 0.1*ln*(*investments*) + 0.008*TREND* - 0.3*DUM T*4:2013	0.93
ln(investments) = 8.98+ 0.23*ln*(*FDI* $_{t-1}$) + 0.28*ln*(*credits_MDL*) +0.66*TREND*^{0,33}	0.77
ln(*constructions*) = -2.15+ 1.07*ln*(*investments*) - 0.2 *DUMT*1:2009 - 1.64e-08**TREND*^{4} + 0.26 *DUM T*4:2013	0.92
ln(*industry*) = 3.72+ 0.44ln(*goods_export*) + 0.17ln(*credits_MDL*) + 4.94*TREND*$^{0.01}$ - 0.08*DUM T*4:2008 - - 0.09*DUM T*4:2012	0.91
ln(*transport*)= -7.74 + 0.5*ln*(*goods_export*) + 0.76*ln*(*Transport* $_{t-1}$) - 0.004*TREND**** + 0.34*DUM T*2:2011	0.88
ln(*wages*)= 1.01 + 0.14ln(*investments* $_{t-1}$) + 17.17*TREND*^$^{0.02}$ - 0.1*DUM T*3:2009 - 0.09*DUM T*4:2009	0.96
ln(*fiscal_revenues*) = -3.35+ 0.59*ln*(*import*) + 0.51*ln*(*wages*) + 0.42*DUM T*2:2010	0.79
dln(*CPI*) = 0.087+ 0.3*dln(UVI*$_{-1}$) + 0.24*dln*(*UVI* $_{-2}$) + 0.2*dln*(*RER*$_{t-2}$)- 6.95e-06*TREND*^2 – 0.04*DUM T*3:2007 - 0.03*DUM T*3:2012 + 0.95*e*$_{t-2}$	0.61

Source: EXPERT-GRUP estimations, based on NBS, NBM and Ministry of Finances data
Note: most variables are significant on a 95% confidence interval
**** - variables are significant on a 99% confidence interval;*
ln – natural logarithm; dln – first difference of natural logarithms; DUM - dummy variables.

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

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- Political economy;
- Public finance;
- Human development and poverty reduction;
- Labor market and consumers' behavior;
- Foreign trade;
- Financial markets;
- Economics of European integration;
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