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Moldova Economic Growth Analysis

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Key Policy Messages

- The recurrence of some tendencies similar to those during 2008-2009 crisis points out the vulnerability of Moldovan economy to external shocks and its incapacity to tackle the challenges from inside the country. We cannot expect an open economy to be immune to external shocks, but at the same time in a healthy economy the dependence of domestic demand on the situation abroad should be lower and may save the economy from recession. In case of Moldova, narrow interventions in the system proved to be inefficient in medium- and long-term, therefore, there is clear need for more consistent reforms and radical change in the institutional settings. The economic activity cannot grow in an unhealthy business environment and Moldova failed to provide such an environment due to still persistent unfair competition, trade barriers and administrative burden. Higher economic activity ultimately determines higher employment opportunities and incomes generated inside the country, making the economy less dependent on external factors. These are essential elements to ensure the economy develops, not only grows.
- As Moldovan agriculture continues its lethargic development, the Moldovan food industry increasingly relies on imported raw materials. With the agriculture-industry supply chains weakening, the Moldovan farmers will find it more difficult to maintain their market shares and a predictable flow of cash. The Moldovan agricultural policy therefore requires urgent reform, combining a more predictable and transparent subsidies policy, reviewed educational system for agriculture and research and development investments targeting solution of the real problems the sector encounters. Equally important to understand, the extreme weather should not anymore be treated as something exceptional, but rather as a constant likely to influence the development in the future.
- We expect that in 2012 the strongest decline in employment will take place in agriculture, the sector which saw the most dramatic fall in employment in the recent decade. Combined with the stronger decline of income from migrants' remittances in the budgets of rural households as compared with urban ones, and with the negative short-term outlook for agriculture output, we believe that 2012 will be one of the most difficult years for the rural inhabitants in the recent Moldovan history. This makes the improved business climate in agriculture and related industries employing rural inhabitants and investments in infrastructure connecting villages to the rest of the country an immediate and imperative priority for the Moldovan government, both central and local.
- Reduction of informal employment is an imperative issue to ensure a more sustainable fiscal and budgetary system and a more fair distribution of the state social aid. However, it should be clear that informal employment and informal salaries are only derivatives of a more fundamental phenomenon: the informal financial inflows into the private companies. Acknowledging this fact requires a change in the approach to fighting informal economy: the central role should belong to the State Tax Office, not to the Ministry of Labour, Social Protection and Family or to Labour Inspection.
- The fact that FDI in Moldova in 2012 have declined while in other countries in the region – including Belarus, Ukraine, Georgia - have increased, is a testimony of the fact that the financial crisis is not the only culprit for the decline in FDI inflows into the Moldovan economy. There is also certainly a result of what foreign investors think of the Moldova's investment climate. Redressing these perceptions require both regulations really addressing the problems of the business and investment climate, and also a more effective investment promotion agency.
- Our past expectations regarding the decline in the external support for the state budget and official development assistance confirmed; these trends will persist in the future. Privatization of the state-owned assets is a source for covering the financing gap only in

short- to medium-term. Moldova needs to invest more in tax collection capacities and to ensure an efficient management of expenditures. Addressing the existing shortcoming is really worthwhile, as suggested by the fact that in 2011 the total amount of public resources found by the Court of Accounts as being misspent was equivalent to one third of the budget deficit for the same year.

- A clear political decision regarding the trade policy in Moldova has to be taken and followed by corresponding organizational and institutional measures. Currently, the most detrimental impact on the foreign trade derives not from the trade policy decided at governmental level (e.g. level of customs tariffs), but rather from the arbitrary regulations adopted by implementing agencies, such as Customs Service. It is necessary to find a way of increasing the political and public control over such bodies, while not undermining their institutional independence.
- The reduction in the economic growth rates and the short-term pessimistic perspectives of the Moldovan economy underlines the importance and urgency of adopting an innovation based economic growth model. An important remark is that an innovation-driven economy has the entrepreneur – not universities, academia or inventors – playing the key role. A scientific result, an invention or a new technology is not an innovation as long as it is not applied in the economy and not widely accepted by the society. Adopting this new policy philosophy requires a completely different approach to the innovation support policy, with a more central role to be played by the Organization for Development of SMEs and by a reformed Agency for Investment and Exports Promotion.
- The National Bank of Moldova should not deviate from its inflation targeting strategy despite the presence of deflationary pressures. Even though the current situation seems appropriate for interventions on the foreign exchange market and increase the level of international reserves the central bank should take into account the current depreciation pressures on the Moldovan Leu as, remittances, exports and FDI are on a downward trend. This might develop into lower consumption and stagnation of the economy. Therefore, the interventions on the foreign exchange market should be minimal and only for correction of some short-term shocks.
- Also, NBM should consolidate its supervision capacities. The fact that the banks' portfolios are worsening and among the problematic banks is present the state owned one should be taken into consideration, given its impact on the whole society. Recently, NBM has done some progress by stricter supervision and implementation of new international standards for financial reporting. However, the banks should be monitored properly in order to avoid major risks and to increase credibility of NBM.
- The Government should pay more attention to increasing the capacities for macroeconomic forecasts. This implies consolidation of the forecast capacities in the institutions responsible (especially, Ministry of Finance, Ministry of Economy), a better understanding and coordination of the forecast done and assurance of a proper channel for using of the forecasts. A proper analysis of the budget-sensitiveness to various macroeconomic scenarios should be done. This is important in order to avoid the multiple changes in the state budget during the year and high uncertainties in the activity of many institutions dependent on public funding.
- At the same time, it is important that national statistical data ensure a consistent format of presenting the quarterly GDP and sectors' output figures. At the same time, changes are necessary to better reflect the evolution of the economic sectors. *Inter alia*, the indicators for telecommunications and the transport sector should be presented in disaggregate form, as in the recent years these sectors have followed completely different trends.

Statistical Indicators

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

		2009	2010	2011	2012 forecast
Population, million (excludes Transnistria), beginning of the year	3.573	3.568	3.564	3560.4	3553
GDP, billion MDL, current prices	62.840	60.429	71.849	82.174	87.318
GDP, billion USD, current prices	6.047	5.409	5.810	7.003	6.985
GDP per capita, USD at PPP	2986	2843	3088	3373.0	3495.0
Real GDP, y-o-y % change	7.2	-6.5	6.9	6.4	1.2
GDP deflator, y-o-y % change	9.7	2.0	11.2	7.4	5.0
Private consumption, y-o-y % change	4.5	-7.9	9.0	8.5	2.8
Gross fixed capital formation, y-o-y % change	2.2	-30.9	17.2	10.7	0.0
Industrial production, y-o-y % change	0.7	-22.2	7.0	7.4	-2.5
Agricultural production, y-o-y % change	32.1	-9.9	7.9	5.8	-15
Share of industry in GDP, %	13.9	13.0	13.3	13.7	13.2
Share of agriculture in GDP, %	8.8	8.5	12.0	12.3	10.3
Merchandise FOB exports, million USD	1646.0	1331.6	1541.5	2221.6	2243.3
Merchandise CIF imports, million USD	4866.3	3275.8	3855.3	5191.6	5322.9
Service exports, million USD	843.9	673.1	701.2	868.8	920.0
Service imports, million USD	837.1	712.9	770.9	894.7	960.0
Net foreign direct investment, million USD	695.4	138.6	193.9	253.4	n.a.
Net work remittances, million USD	1888.0	1198.6	1351.4	1600.4	1645
Current account/GDP, %	-16.7	-8.6	-7.9	-11.5	n.a.
Official reserve assets, end-year, million USD	1672.4	1480.3	1717.7	1965.3	2100
Total external debt stock, million USD	4093.8	4364.1	4778.7	5452.3	n.a.
External debt/GDP, %	67.9	80.8	82.2	77.9	n.a.
Employment rate, % of population aged above 15	42.5	40.0	38.5	39.4	38.5-39.0
Unemployment rate, % of economically active population	4.0	6.4	7.4	6.2	6.7
Real wage growth rate, y-o-y % change	10.2	9.0	0.7		0.0
Consumer prices index, year end, y-o-y % change	7.3	0.4	8.1	7.8	4.1
General government balance, % of GDP	-1.0	-6.8	-2.5	-2.4	-2.0
General government expenditure, % of GDP	41.6	45.3	40.8	39.1	38.0
Exchange rate, year average, MDL per USD	10.4	11.1	12.4	11.7	12.5
Broad money (M2), y-o-y % change	18.3	-3.8	18.3	14.4	8.0
Central bank refinancing rate, end-year, %	14.0	5.0	7.0	9.5	4.0
Total commercial bank loans, % of GDP	37.5	35.0	32.6	36	33.0
Bank deposit rate, %, average per year	18.1	14.7	7.6	7.54	7.0
Bank lending rate, %, average per year	21.0	20.3	16.3	14.4	14.0

Source: NBS, IMF, NBM and EXPERT-GRUP calculations, estimates and forecast;

Summary

Domestic Supply

In the first quarter of 2012 Moldovan GDP grew 1.0% y-o-y, which is quite a poor performance considering the bright expectations that rapid recovery of Moldova's economy in 2010-2011 has given rise to. The decline in the industrial output and tepid growth in agricultural output have been the main causes of such a sluggish growth. We expect the situation to remain very fragile over 2012. After two years of draught, Moldovan agriculture is set to experience a negative growth in gross value-added in 2012, at a rate we expect to vary between 15 and 20%. Short-term prospects for the industry are equally bleak: the weakened supply from the part of agriculture and more modest demand on domestic and foreign market may result in a 2.5% contraction of the sector. The growth in constructions sector will remain positive this year (+5%), however this is mainly on the account of public investment in roads. The services sector will remain the main source of the economic growth in 2012, with an expected growth in value-added of 2.25%. Telecommunications, retail trade and services rendered to the population will support this growth. Overall, we expect the GDP to rise by 1.2% in the basic scenario, however this forecast is subject to revisions as situation in the euro may change significantly.

Domestic Demand

While too early to define the economic situation in Europe as a crisis per se, the way it spreads on the Moldovan economy is quite similar to the 2008-2009 crisis. Thus, the private demand responded fast to the external risks with both households' and business' demand slowing down. On the one hand, households' consumption is seriously affected by the slowdown of remittances, which explains more than half of variation in consumption, but also by uncertain situation on the labour market with layoffs and/or forced unpaid leaves. We expect a 2.8% rise in households' consumption by the end of the year, caused by a significant slowdown of increase in remittances. On the other hand, domestic businesses that confront daily in their activity many administrative barriers face a lower demand that undermine their profits and investments. In this context, the role of public investment is crucial, as it can compensate for part of the losses in the private sector. Even though recent evolutions impose significant constraints on budgetary revenues, there is sufficient fiscal space to keep investments at the current level if the inefficiencies and irregularities in public spending are excluded.

Public Finance

The economic activity slowdown primarily hit the indirect tax collections which pose the highest burden on the state budget. In order to keep the budgetary deficit under control the Government committed to a series of important spending cuts after a recent budgetary revision. However, public finances' stability will continue to be threatened as the updated forecasts which served as a basis for the planned budgetary incomes and expenditures remain too optimistic. Hence, the execution of the state budget within the targeted levels will be a major challenge for this year and failure to do so will inevitably result in a new budget revision until the end of the current year.

Labour Market

Higher awareness about the potential impact of the crisis and more pessimistic expectations on their ability to tackle it determine employers to act faster than in the previous crisis. Thus, employment already decreased in the first quarter, though not fully due to external situation. While in service sector the decline in employment may be attributed to the lower demand, the downward trend of employment in agricultural sector is a decade-long natural trend of contraction. Additionally, the evolution of wages in some sectors point out to the difficulties faced by employers that look for ways reduce the costs. Following these trends we expect employment rate to decrease to 38.5-39% in 2012. Meanwhile, the unemployment felt by 2.2 p.p. showing once again the low correlation between unemployment and general economic conditions in Moldova, partly due to migration opportunities. Thus, the number of emigrants was on a strong positive path despite the slowdown

global economy, but only due to a one-time event: construction works in Sochi for the Olympics in 2014.

Prices and Monetary Policy

The fading impact of cost-push price shocks, decreasing world energy prices, strengthening of the national currency and slowing down of economic activity are the main culprits of the disinflationary process which started at the end of 2011. Moreover, our estimation revealed that the impact of the latter factors has been the most important during the current year. As a result, it prompted the central bank to ease its monetary policy in order to anchor, on the medium-term, the inflationary expectations and, on the short-term, foster the domestic demand and economic growth. We forecast a 4.1% annual CPI at the end of 2012 – lower in comparison with the central bank's forecast. Hence, upon materialization of Expert-Grup scenario, the central bank might continue cutting its REPO rates in order to keep the accommodative policy stance.

Banking Sector

The worsening of economic conditions since the last quarter of 2011 translated into a constant lending slowdown on the grounds of banks' credit rationing, stronger risk aversion and higher real lending rates. Fewer new loans, especially in foreign currency, paralleled with weaker financial conditions of banks' borrowers, led to gradual increase in the share of bad loans in total banking assets. This is likely to be the main contagion channel and the main challenge for the Moldovan banks in the short and medium term if the domestic and regional economic conditions continue to deteriorate. We expect lending to remain on the tough side, decreasing by about 5% while the nominal credit rates to hover at around 14% until the end of 2012.

Foreign Sector

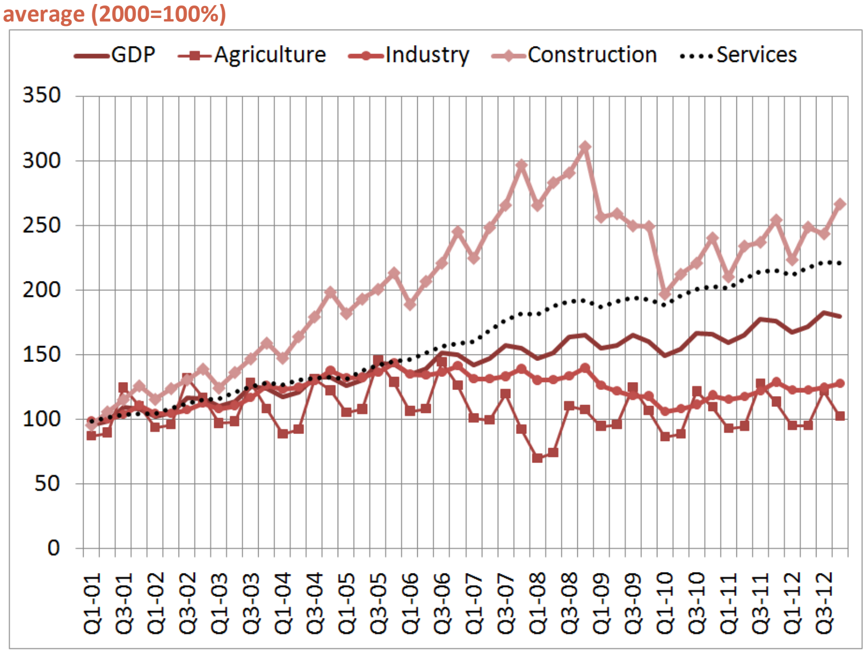
Evolution of the Moldovan trade in the first half of the year perfectly reflects the worsening economic optimism both in the global economy and in Moldova. The year began with relatively high growth rates both in exports and imports, but growth moderated remarkably by mid-2012. The particularly rapid deterioration of the exports growth comes mainly on the account of the EU markets; so far, the exports to the CIS have not felt such a dramatic reduction in growth, but this can swiftly change, as growth in Russia depends significantly on the economic situation in the EU. The relatively good global economic indicators in Q1-12 have recently subsided, and the developments in the second quarter worsened in most of the countries which are major destinations for Moldovan exports. The more tepid than expected global economic growth in 2012 (3.5% versus 3.7% expected by IMF previously) will exert a negative impact on the Moldovan exports. We expect that in 2012 the growth of Moldovan exports will be marginally positive (+1.0%). As the same time, we expect that domestic demand for import products will register a 2.5% growth in 2012. The evolution in services will not differ too much from what we have seen in 2011. Combined, all these evolutions will open a bit higher trade deficit (42% of GDP) than in 2011 (40%).

1. Domestic Supply

Major evolutions: expected slowdown, unexpected rate

According to official statistical data, in Q1-12 the Moldovan GDP grew 1.0% y-o-y, which is quite a poor performance considering the bright expectations that rapid recovery of Moldova's economy in 2010-2011 has given rise to. With a 2.1% decline in gross value-added (GVA), the Moldovan industry has served as the key source dragging on the economic growth in early 2012. Market services (+4.6% in GVA) have been the main factors compensating the receding industrial and sluggish agricultural outputs (+1.6%), while the constructions sector posted the biggest surprise, with the GVA reported to rise 9.8%. Whether or not Moldovan economy is set to follow a double-dip recession pattern, as the recent evolutions may suggest (Chart 1), is a question which can be addressed only after looking deeper into the key economic sectors.

Chart 1. Evolution and forecast of the quarterly GDP and its main components, 2002-2011, 5-period moving average (2000=100%)



Source: NBS, forecast for Q2-Q4 2012 by Expert-Grup;

The 0.6% y-o-y growth of the ***agricultural output*** in Q1-12 (compared with +8.3% in Q1-11) was determined by growth in the livestock subsector, which due to seasonal factors is the main contributor to the total agricultural output in first half of the year, while the crops production registered a negligible growth. A deeper look into the data shows a persisting structural pattern of the animal production: as in 2011, the poultry and cattle sold for meat was the key source of growth (+1.7%), whereas production of milk increased by a negligible 0.8%, and production of eggs declined by 5%. Meat is the only product whose production has sustainably grown after the 2009 recession; production of eggs has followed a more erratic growth, while milk producers seem to confront systematic hurdles lowering their level of production. In the second quarter the growth in the livestock sector seems to continue the trends set in the first quarter. However, the further evolution will very much worsen due to the severe impact of the two consecutive drought years on the crops sector. The 2011 has been an arid year, but the 2012 has been even more so up to mid-July: the quantity of precipitations fallen in the first half of the year was 20% below the average for the corresponding period in 1994-2011, while the average air temperature in the critical April-July period was from 3 to 5 Celsius degrees above the average. In early July the Government assessed the impact of the extreme climate conditions (-5.5% in the value of agricultural products expected for 2012), but we believe this assessment significantly undershoots the drought's fallout.

Industrial sector experienced a shock-induced recession in 2005-2007, which was further compounded by the generalized economic decline in 2009. However, between January 2010 and September 2011 Moldovan industry was entering a growth path. The reality turned much sober, however, with industrial sector experiencing a steady decline between October 2011 and April 2012. The situation is not uniform across industrial sectors though. In striking contrast with the lethargy of the domestic producers of meat and milk, the meat processing industry and the dairy industry are currently growing steadily (an estimated production growth of 22% and 10% accordingly in the first half of 2012), suggesting that these industries are substituting domestically-supplied raw materials with imported ones. After a relatively weak start of the year, the alcoholic beverages industry has somewhat improved its situation towards mid-2012 but the industry's prospects are far from rosy; problems related to accessing external markets and problems with grapes' quality control are the main culprits. The level of production of the key cluster of "textiles, clothes, footwear" industries has also lowered (-7%) reflecting the cooling demand on the EU markets and Moldovan producers' inability to escape the lohn-based processing schemes. However the situation is even much worse in case of industries targeting mainly the domestic market – wood products (a 12% estimated decline in level of production in first half of 2012), paper and paperboard (-12%), printing materials (-5%), chemical industry (-10%), and, the most important, production of products from non-metal minerals, i.e. construction materials (-15%). The champions of growth are the 'newly discovered' industries – including electrical equipment, machines, medical tools and equipment, that double the level of production in first half of 2012 – supplying to the external markets, mainly targeting Russia and other CIS. While the growth of this industry will remain positive during 2012, such growth rates are obviously unsustainable.

In the ***constructions sector***, the 9% y-o-y growth in Q1-12 and the estimated 7% growth in Q2-12 have been accompanied by significant structural shifts. The share of works undertaken on new constructions sites has increased significantly, reaching an estimate share of 65% of total (in comparison with only 53% in 2011). Two key sources of growth has been residential sector (+20%) and, more importantly, the engineering works (+35%, mainly consisting of roads rehabilitation). However, the demand for constructions work from the part of the companies has declined significantly in Q1-12 (-33% y-o-y), and in Q2-12 (estimated decline of 37%), reflecting the lower economic confidence of the producers and their unwillingness to expand the productive capacities in the context of escalating worries regarding the evolution of the demand.

The ***services sector*** has remained the main driver of economic growth in first half of 2012. Retail trade (+4.4% in Q1-12 y-o-y) and consumers' services (+3.7%) remained the most important sources of the growth in the services sector, followed by hotel and restaurants (+2.9% in sales). The business-oriented services, such as cargo transport services, have shown less resilience in the context of declining industrial output in Q1-12 (-27% in freights, mainly on the account of railroad transportation), but has somewhat improved in Q2-12 (estimated growth of 15% y-o-y). Even though (mistakenly) aggregated by official statistics in a single mega-sector with the transport services, the telecommunications services followed a completely different evolution: +16% y-o-y in number mobile communications users, and + 28% y-o-y in number of the broadband users (with broadband penetration rate exceeding the psychologically and structurally significant 10% level). Even the tiny tourism sector has registered a significant growth (+14.4% in sales in Q1-12), although the structural imbalances persist: the demand for outgoing tourism has grown more rapidly (+17.5%), than in case of the incoming (+8.9%) or domestic (+10%). However, the latter figure significantly undershoots the real number of internal tourism, a phenomenon which remains largely in the 'grey' economic zone.

Short-term forecast and challenges

- Due to lack of spectacular improvements in agricultural technologies used, the evolution of the crops output in Moldova in the recent two decades is best described by a simple linear model incorporating areas under annual and multiannual crops and weather conditions[1]. Based on this model and the observed areas under agricultural crops and weather conditions, we expect that in 2012 the value-added in agriculture will decline by 15% in the base scenario. This will have a detrimental impact on the income of the rural inhabitants and significantly alter the consumption patterns.

- The prospects of the industrial sector remain bleak for the whole year. The lowered agricultural output will make food producing companies to resort to imports of the raw materials. The lower domestic demand, both for final consumption and for investment goods, will inhibit growth of such industries as wood processing, metal processing, furniture production, building materials. All in all, we expect the Moldovan industry to end the year with a 2.5% decline in value-added[2].

- The growth in the constructions sector will remain on the positive side, even though the growth rate of the value-added is expected to reduce from the 10% in early 2012 to the level of 5%, mainly on the account of slashed public investment.

- The services sector will remain the main source of the economic growth in 2012, with an expected growth in value-added of 2.25%. Telecommunications, retail trade and services rendered to the population will support this growth. The evolution of the transport sector will marginally improve compared to early 2012, but not enough to get a strongly positive growth. At the same time, high risks persist that additional cuts in expenditures in administration, education, social protection and health sector may arithmetically depress the GDP growth.

- On the assumption that taxes on imports and production will grow by about 8%, the total GDP at market prices is expected to rise by 1.2%, which is consistent with the forecasted GDP growth based on the expenditures elements[3].

Policy recommendations

- The key recommendation we are addressing to the government and farmers alike is to adequately learn from the recent past. The extreme weather conditions are increasingly becoming a norm rather than an exception. Making high value of the fertile soils the country requires an upgrade of the farmers' skills and knowledge, adoption of the protective technologies, redesign of the innovation-support policy for agriculture, including a corresponding reform of the education and R&D sector.

- The expected worsening of the economic situation on the main markets targeted by the Moldovan industry makes the recovery of the industrial sector a particularly daunting task. As international evidence suggests, the promotion and active support of innovation, particularly among the SMEs, is a key policy that a good-willing government can adopt in order to boost the competitiveness of the industrial companies both on domestic and foreign

[1] GVA = 339.888*Areas _Crops – 388292*Aridity_Index, where Areas _Crops is the total surface of areas occupied by annual and multiannual crops, and the Aridity_Index is the ratio between the sum of monthly average air temperatures in the period April-July and the sum of the monthly averages of precipitations in the period November previous year – June current year;
[2] The forecasts for growth of the GVA in industry, constructions and services are based on a set of SARIMA models;
[3] GDP by expenditure approach was forecasted by SVAR model with 10 variables and 2 endogenous lags on a time series of 45 observations (2000:1 to 2012:1)

markets. For a proper reform of the innovation policy, it is key for the Government to understand that ultimate source of innovation is the entrepreneur. All other policies – such as industrial parks, free economic zones – will attain limited effect unless innovation is promoted as key factor supporting Moldova's success in international competition.

- The constructions sector is expected to grow in 2012 mainly due to infrastructure projects funded by the Government and less to private funds. Three key elements featuring the constructions sector in Moldova are high level of corruption, low level of investors' protection and unfair competition, all serving as main culprits limiting the privately-funded constructions projects. While apparently too generic recommendation, dealing with these hurdles is strategically the key priority to pursue in order to get the sector back to the growth.

- We maintain our key recommendation for how to make the growth in services sector more resilient: a more forceful protection of the fair competition combined with better protected consumers' rights. This will help getting the companies out of shadow, give impulse to the companies operating fairly with a corresponding impact on the consumers' utility.

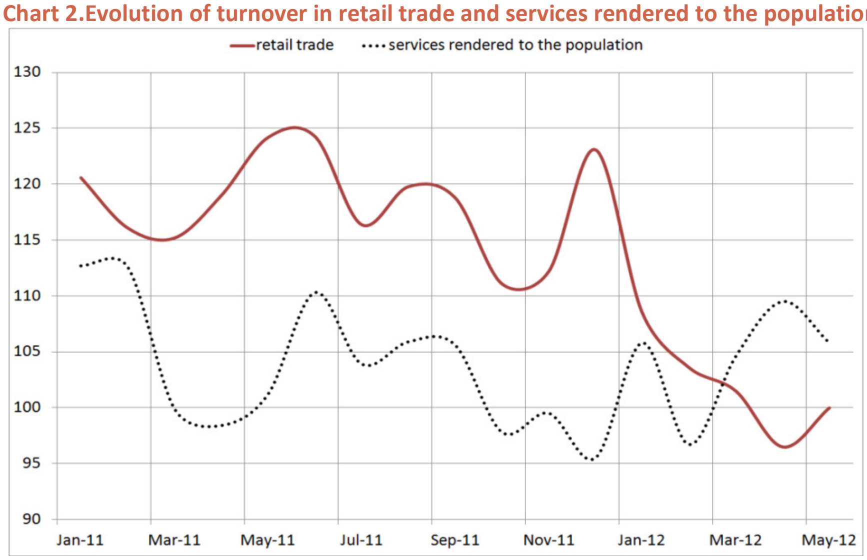
2. Domestic Demand

Is there a way to compensate for the decline in private demand?

Although it is early to talk about an economic crisis per se, the repercussions of the euro area debt crisis are fully perceptible not only in the European countries, but also outside EU. Thus, the domestic demand in Moldova has already encountered evolutions similar to those of 2008-2009. While private consumption slowed down the first, public consumption could still compensate for part of the losses through higher planned investment in 2012. However, the task is not easy at all, as the budgetary constraints have become more severe and the persistent uncertainties in the European economies may result in higher budgetary pressure by the end of the year.

Households' private consumption, which is still the main determinant of economic growth, slowed down in late 2011 and in the first quarter of 2012 registered only 2.7% growth; compare this with the growth rates in the range of 10% in 2010-2011. The immediate perspectives are even worse, as the data on turnover in retail trade show already a negative growth rate in the second quarter (Chart 2).

Chart 2.Evolution of turnover in retail trade and services rendered to the population, % y-o-y



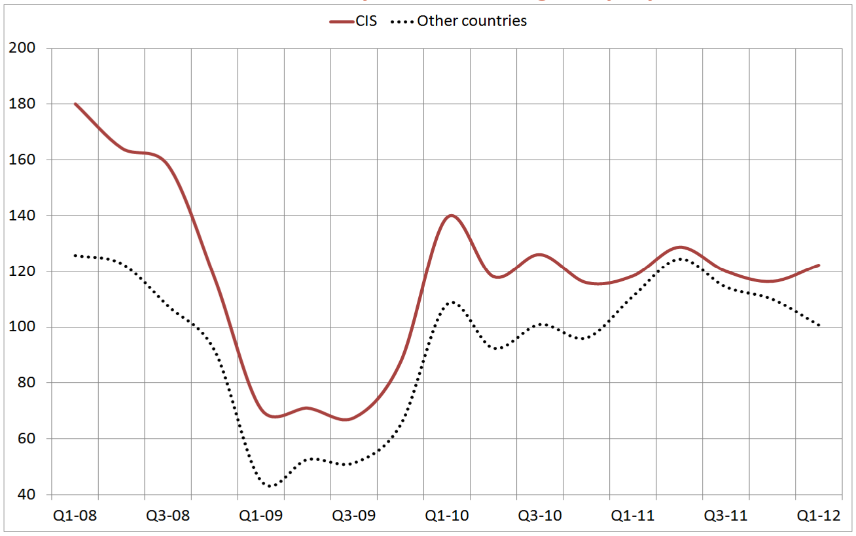
Source: NBS;

The tempering of consumption was due to stagnation of the disposable income of the population in early 2012. This refers to two main sources of income: salaries and remittances. While average wages have been still on a slightly positive path, the declining employment and the possibly forced unpaid leaves decreased the revenues from salaried work in the first quarter by almost 10% y-o-y.

Remittances also tempered their advance. The growth of remittances in the first quarter, based on Balance of Payments data, was 13.3% after 18.4% increase in 2011. Even though the overall remittances still rose, the impact of European debt crisis is not absent. While the remittances from CIS countries increased by 22% in Q1-12, the remittances from other countries, where EU member-states have the largest share, increased only by 0.7% (Chart 3).

Monthly data on money transfers from abroad in favour of natural persons show a decline for the period February - April 2012, indicating over the magnitude of implications of the European crisis on overall remittances sent to Moldova. Moreover, a trend which could be seen in 2011 was back in the first quarter this year: remittances growing in urban areas and decreasing in rural areas. Thus, those who are more dependent on transfers from abroad, due to lower participation on the labour market, are going to be more affected by an eventual crisis. The consequences are not related only to the loss

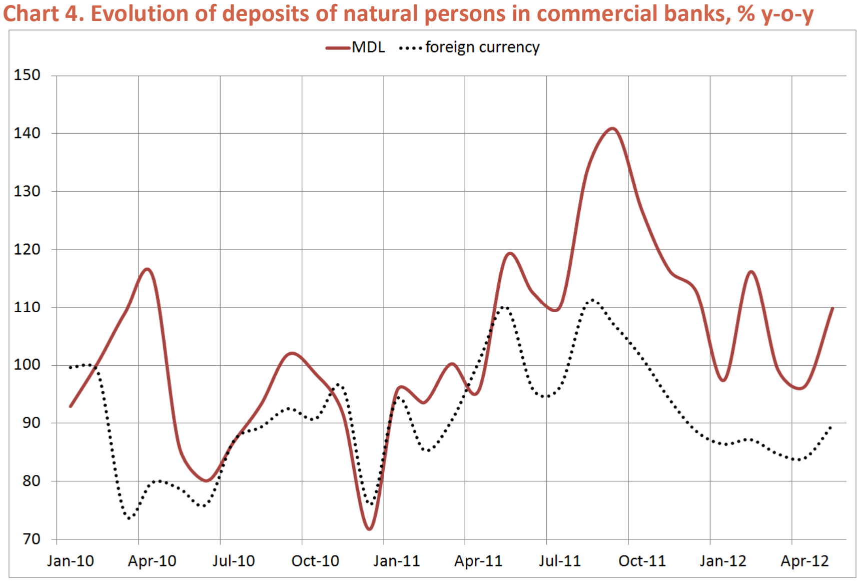
Chart 3. Evolution of remittances by countries of origin, % y-o-y



Source: NBM;

of income, but also to the more limited opportunities for the development in rural areas. In fact, after several quarters of convergence between the incomes of the rural and urban population, the gap increased again in 2012, which may have serious implications on poverty and inequality.

Chart 4. Evolution of deposits of natural persons in commercial banks, % y-o-y



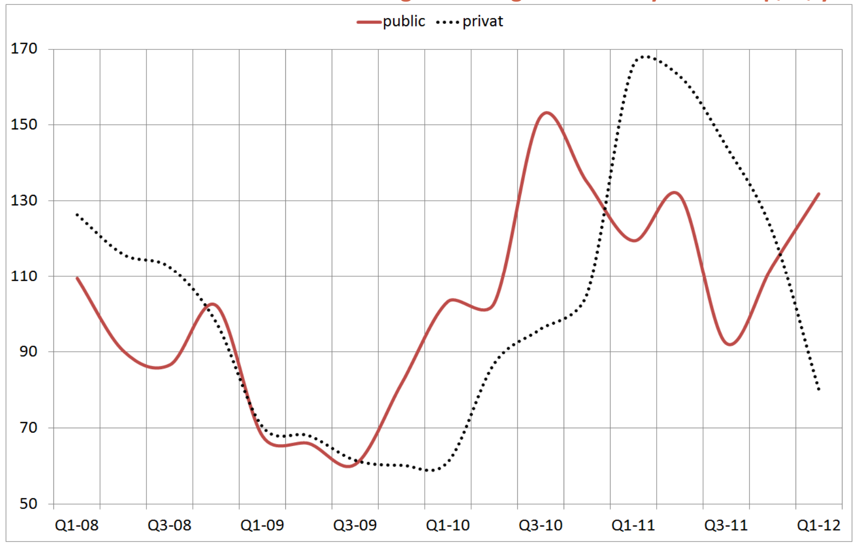
Source: NBM;

The impact immediately translated into the savings of the population. The deposits of natural persons have decreased since December 2011, with a more pronounced decrease in deposits in foreign currency, determined by the mistrust in European currency (Chart 4).

The private business sector is also seriously hit by the decline in domestic and foreign demand. Thus, due to the lack of financial resources, but also to the more pessimistic short-term expectations the firms reduced their investment activity in 2012. While, the total investment in long-term tangible assets decreased in the first quarter of the year by 4.6% y-o-y, those in private ownership decreased the most - by 20% (Chart 5). The cooling down of the demand coincided with a tighter fiscal policy in 2012, making companies confront more serious constraints. Moreover, the FDI almost halved in the

January - March compared to the same period of 2011. This does not necessarily reflect only the worsening situation in the global economy, but also the fragility of Moldovan economy to external shocks, as FDI grew in some of the countries in the region in early 2012 (e.g. Ukraine, Georgia, Belarus). The decrease in FDI is determined by lower reinvested profits and payback of the credits or even lending to mother-companies.

Chart 5. Evolution of investment in long-term tangible assets by ownership, %, y-o-y



Source: NBS;

In this context the role of the Government is imperative in compensating for the decline in private demand, but the budgetary resources make it difficult to accomplish this task. The initial intentions were positive, for 2012 the current budget being based on the idea of higher share of investment in GDP and lower share of current expenditures. Indeed, the investments financed from the state budget increased by 63% in the first quarter y-o-y, making it possible to rich a positive growth in gross capital formation, but only of 1.4%. However, already after the first quarter it was clear that the initial plans were too optimistic and cuts in the budgetary expenditures were proposed, including for investment projects. Nevertheless, in the case of public investment, there is place for growth only through the improved efficiency in budgetary expenditures. Firstly, the capacity of state institutions to assimilate the funds is limited and in January - May the execution of expenditures for investment project was very low - about 50%. Secondly, there are many irregularities and inefficiencies in spending of public funds and capital investment activity is the most often issue tracked down for such irregularities. Thus, according to the audit reports of the Court of Accounts, only in the first half of the year the deflection form the legal procedures for capital investment in the audited local budgets caused irregular and inefficient expenditures of 32 mil. MDL[4]. The total amounts are much higher, making it imperative to increase the efficiency of public spending in such challenging economic times, in order to support the economic growth.

Short-term forecast and challenges

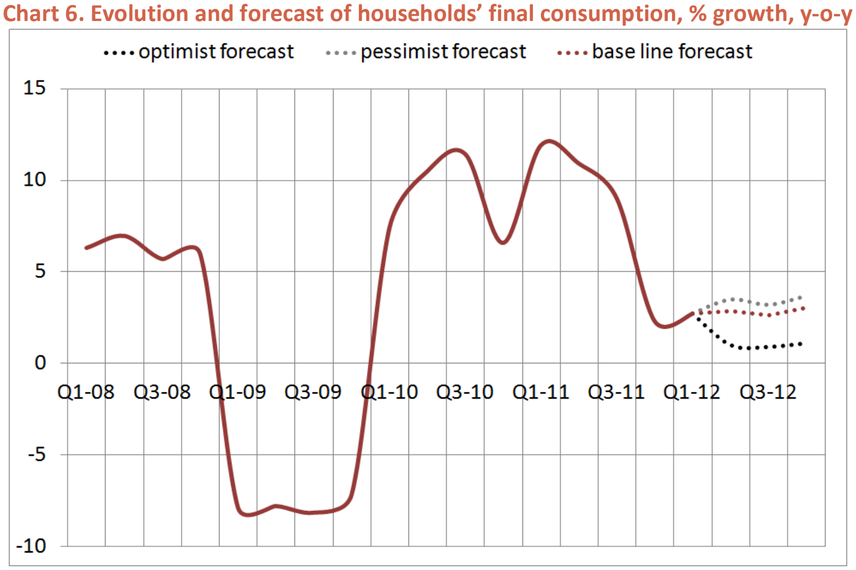
- The incomes of the population will be at the level of previous year in the best case scenario in 2012 taking into consideration already declining transfers in favour of natural persons. However, the magnitude of the impact depends very much on the general evolution in euro-

[4] How the public money are being lost: Synthesis of Court of Accounts reports in the first semester of 2012, Expert-Grup, 2012;

zone and the way the crisis impacts other CIS countries. Our estimations[5] show an increase in remittances between 2.8% - 8% in 2012. However, if the GDP of EU and CIS are taken into account[6] the forecast becomes even less positive, with a possible decline in remittances up to 1.5%.

- Thus, households' consumption will follow the trend of remittances, these explaining over 50% of the variance of consumption since 2000[7]. Based on the above forecast for remittances the growth rate of the individual consumption will most probably be in the range of 1.4% – 3.2%, with our baseline forecast for 2012 set at 2.8% (Chart 6). Such low advance of consumption was not registered since the economic growth was launched in 2000 (except for 2009 when it declined). Thus, the contribution of consumption to the GDP growth will be minimal this year.

Chart 6. Evolution and forecast of households' final consumption, % growth, y-o-y



Source: Expert-Grup calculations based on NBS data;

- The decline in incomes will erode the savings of the population that, coupled with the low trust in European currency, will lower the deposits of natural persons in the commercial banks. However, currently this will not have serious implications on the banking system, due to relatively high liquidity.

- As for the capital investment, the short-term evolutions are highly dependent on the further developments in the euro area and it might take some time for the private companies to invest. Thus, private business investment may be at best stable in 2012, but with a high risk of decrease. At the same time, the budgetary allocations for the current year leave some space for greater public investment, which are even more important currently for the development of the country and might ensure the stability of gross capital formation in 2012. However, as high uncertainties persist and the budgetary constraints have tightened, new cuts in public expenditures, including investment, are possible by the end of the year.

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[5] The forecast is given by the results of ARIMA model for remittances (from Balance of Payments) and transfers from abroad in favor of natural persons (NBM data) on a time series of 45 quarters (2001:1 to 2012:1). Each variable was expressed in logarithmic terms. Hence, the transfers were modeled with seasonal ARIMA model (0,1,4)x(0,1,0), while the remittances with seasonal ARIMA model (1,1,0)x(0,1,1);

[6] ARIMA model with 2 exogenous variables: growth rate of EU and CIS GDP;

[7] We used a structural vector autoregressive model to forecast final consumption of the households with three endogenous variable (y-o-y growth of final consumption, real y-o-y growth of wages and real interest mrates for deposits on deposits) and one exogenous variable (remittances). The forecast error variance decomposition (FEVD) reveals that remittances explain most of variance in consumption, followed by lagged consumption, wages and interest rates;

Policy recommendations

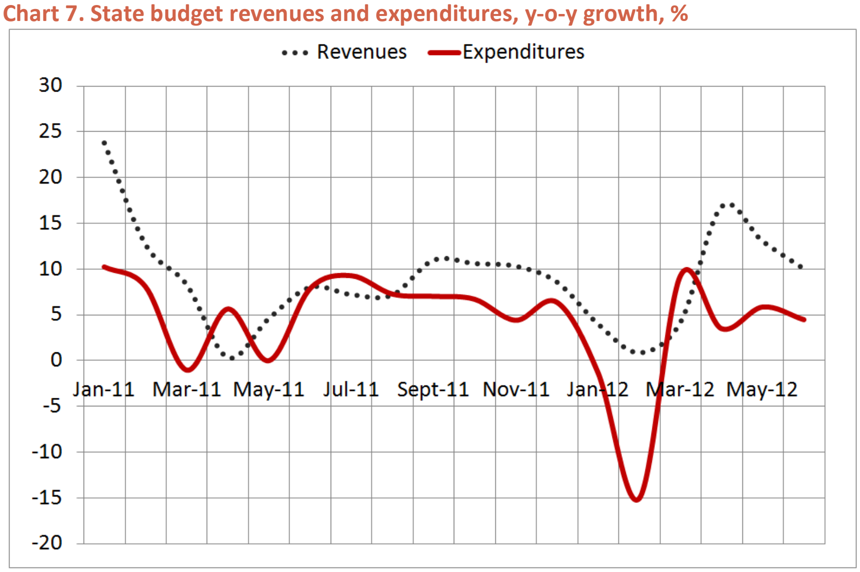
- It is not easy at all to increase the domestic individual demand in an economy dependent on remittances when external situation worsens. The only way to avoid or to mild the effects of such types of crisis is to create a healthy economy, where the domestic demand would be less dependent of foreign evolutions. This generally implies creating a more friendly investment climate with honest competition, reduction of transaction costs and removal of informal payments. This would ensure more employment opportunities and consequently higher share of incomes generated in the country and increase in consumer utility by getting higher quality goods and services at lower prices. Consequently, the domestic demand will increase and will be less responsive to external shocks. But these measures will not have an immediate effect and are rather oriented to avoid other similar crisis.
- The necessity of social protection mechanism might increase by the end of 2012, taking into account the decreasing incomes, especially in rural areas where these are under the cost of living level. Thus, the social policy should aim to reach the most vulnerable, but also to ensure their full integration in the society, not only take a functional approach aiming to cover the physiologic needs. The Government has approved a draft law on the cost of living in June 2012, aiming to give the "cost of living" a legal framework, so that it could be used in socio-economic policy tools. Currently there are too many redundant concepts used that, although having more or less similar aims, differ significantly ('cost of living', 'poverty line', 'minimal income guaranteed by the state', 'minimum wage'). The use of a single concept is recommendable, though budgetary constrains may not allow the inclusion of cost of living in every socio-economic aspect (pensions, social benefits, unemployment benefits).
- Insurance of the efficiency of public spending. The reports of Court of Accounts show regular breaches in spending at public institutions level. Though an increase in transparency in public spending and application of sanctions for all tracked irregularities is needed in any settings, the immediate application might prevent the investment from falling in a period where the budgetary revenues are shrinking.

3. Public Finance

Stability of public finances under economic storm: mission possible?

The slowdown in economic growth brought major challenges for domestic public finances. Cooling down of domestic demand posed a significant burden on the state budget through lower-than-expected public revenues, which cannot entirely cover the planned expenditure programs. Thus, the Government embarked on an austere budgetary policy accompanied by tighter fiscal control and rougher sanctions: after the first half of 2012 the revenues from fines and administrative sanctions were 17.6% above the planned level and 34% higher compared to the same period of the previous year. As a result of these measures and following the introduction of the corporate income tax of 12% since the beginning of 2012, the y-o-y growth rate of budgetary revenues is still positive and even above the growth rate of expenditures (Chart 7).

Chart 7. State budget revenues and expenditures, y-o-y growth, %



Source: Expert-Grup calculations based on Ministry of Finance data;

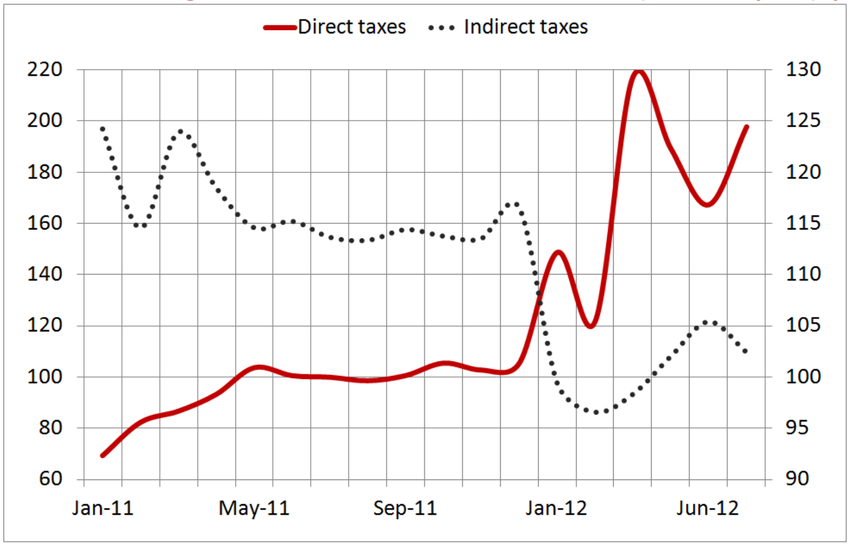
Chart 8 confirms the fact that the main contribution to the growth in pubic revenues belongs primarily to direct taxes. Particularly, it owes to income tax collections which during the first half of 2012 exceeded by 7.6% the planned level. On the downside, we can notice a very tepid growth in indirect taxes. Accounting for over 70% of total state budget revenues and over 90% of total fiscal revenues, the persistence of this downward trend since January might jeopardize the entire system of public finances in the near future. Most worrisome signs come from VAT collections which during the first six months of 2012 decreased in y-o-y terms by 1.4%.

The increasing pressures on the state budget led mainly by indirect taxes have caused the public revenues to constantly underperform in comparison with the planned level for 2012. Hence, after the first half of 2012 the total public revenues were by 5.7% below the planned level, mainly owing to under-collection of VAT - by 6.8% - and excises – by 11%. Significant gaps from the planed revenues are attested for the collection of road taxes, international grants, as well as foreign budget assistance which underperformed by 4.4%, 1.8% and 3.4%, respectively. The main reasons are:

i. Revenue effect of moderating economic activity and cooling down the domestic demand;
ii. Collection problems due to tax evasion and inefficient fiscal management. It has been uncovered during the previous year when the public revenues laid below the plan despite the robust economic growth;

iii. More lengthy than expected procedures from the part of the donors related to disbursement of the grants and credits;
iv. Overconfidence bias of public officials. The initial budget, as well as the recent revision of the state budget law has been based on very optimistic forecast for economic growth, contrary to the visible worsening of the world and domestic economic situation.

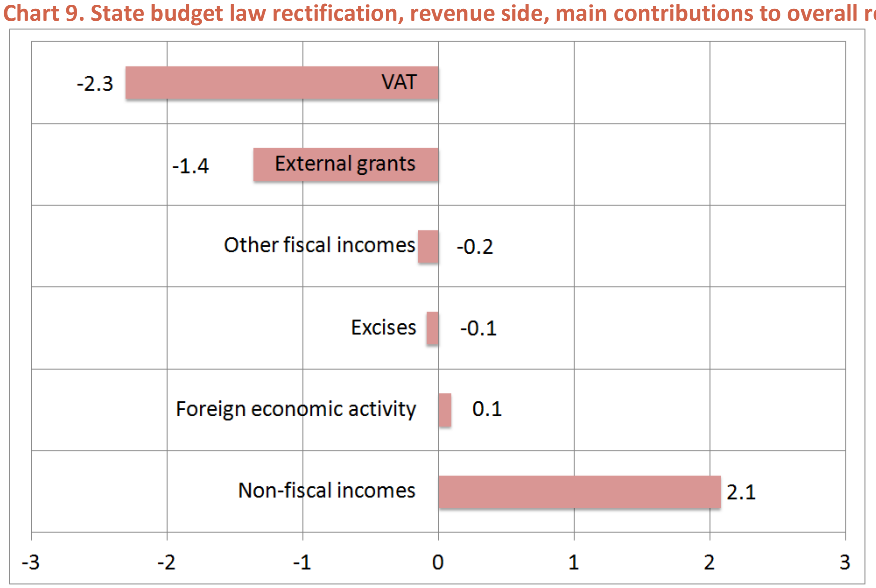
Chart 8. State budget revenues from direct and indirect taxes (seco0ndary axis), y-o-y growth, %



Source: Expert-Grup calculations based on Ministry of Finance data;

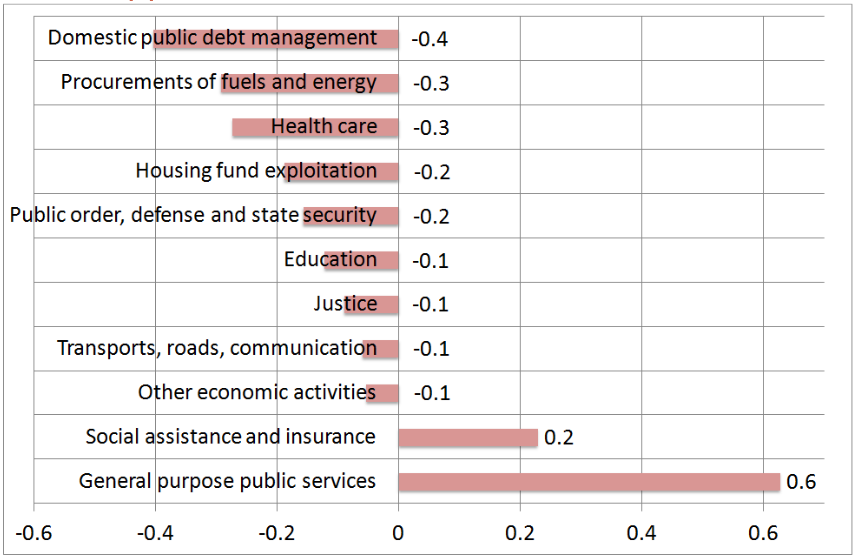
Consequently, in order to minimize the budget gap and keep the public finances under control, after the first half of 2012, the Government reviewed downwards the expected revenues (-1.6%) and expenditures (-0.9%) sides of the state budget for the current year. The main contribution to public incomes' slowdown belongs to VAT and external grants (Chart 9) which generated corresponding adjustment on the expenditures side (Chart 10).

Chart 9. State budget law rectification, revenue side, main contributions to overall revenue revaluation, p.p.



Source: Expert-Grup calculations based on Ministry of Finance data;

Chart 10. State budget law rectification, expenditures side, main contributions to overall expenditure revaluation, p.p.



Source: Expert-Grup calculations based on Ministry of Finance data;

As a result, the level of state budget deficit expected for the end of 2012 increased by 13.7% as compared to the original estimates. An important change brought by the recent state budget revision is related to the financing sources of the fiscal gap. Unlike the previous years, it is expected to be financed almost equally through domestic and foreign sources (37.5% and, respectively, 33.8% of total deficit), the rest being covered by privatization. Particularly, the Government intends to expand domestic borrowing through T-bills by about nine times more than it has originally planned. At the same time, external financing is by 18.3% lower than the original level.

Short-term forecast and challenges

- Despite the recent revision of the state budget for 2012, its execution within the targeted levels remains a major challenge for this year as it has been based on too optimistic forecasts, which could add to the burden if the economic conditions continue to deteriorate. Particularly, these are related to the real GDP growth forecast which is more than twice higher than our baseline forecast, as well as few other important macroeconomic indicators (Table 2).

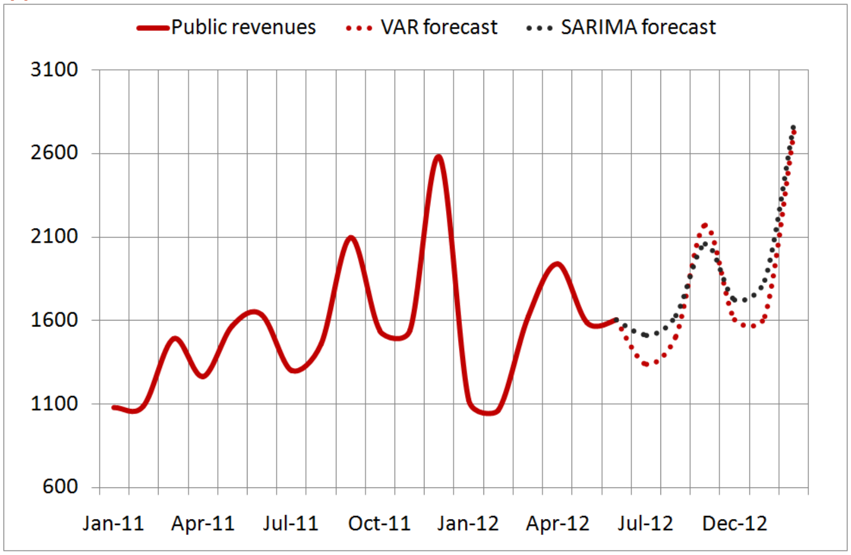
Table 2. Comparison between the Government forecast and Expert-Grup baseline forecast for the main macroeconomic indicators for the end of 2012

	Government Forecast	Expert-Grup Forecast
Gross Domestic Product, y-o-y growth, %	3.0%	1.2 - 1.5%
Consumer Price Index, y-o-y growth, end-year, %	5%	4.1%
Industrial Production, y-o-y growth, %	4%	-2.5%
Agricultural Production, y-o-y growth, %	0.5%	-15%
Nominal average wage, MDL	3550	3325

Source: EG calculations;

- As a result, it can further erode the budgetary revenues calling for additional spending cuts and/or new financing sources to close the budget gap. It corroborates with our forecast for y-o-y growth of state budget revenues which for the end of 2012 is expected to hover around 7%-9%, depending on the econometric model used (Chart 11). This is much lower than the official Government estimates (+12.9%), which could create an additional gap of about MDL 900 mil. - the equivalent of currently planned budget deficit for 2012.

Chart 11. Current and forecasted levels of state budget revenues based on two different econometric approaches[8], mil. MDL



Source: Expert-Grup calculation based on Ministry of Finance data;

- The objective to scale the budget deficit down to 1.2% of GDP until the end of 2012 is too ambitious, given the worsening of domestic and regional economic conditions. Thus, without additional budget cuts aimed at compensating the decelerating growth in public revenues, it will be impossible to downsize the budget deficit to the targeted level which could easily top to 2% of GDP. However, a more fundamental question is whether the Government has to be lured by scaling down the deficit with any cost in times of worsening of economic conditions and high uncertainty.

Policy recommendations

- The authorities have to take into account a more conservative outlook when elaborating future state budget laws in order to ensure that the planned expenditures are matched by the necessary amount of revenues. The overconfidence bias which guided the initial state budget law for 2012 and its recent revision should serve as a good lesson for further budgetary cycles. Hence, if the Government estimates will prove to be too optimistic for the current year, a new revision will be necessary to accommodate the fiscal stance to the current macroeconomic constraints.

- In case the de facto situation for the next months will approach the Expert-Grup baseline scenario, the Government will have to undertake decisive steps to ensure that the budgetary deficit will not spiral out of control. In this regard, it should find the optimum balance between scaling down the fiscal gap through spending cuts and financing the remainder by debt. Although, Expert-Grup has warned many times about the necessity to downsize the domestic debt, the current macroeconomic circumstances look appropriate for using this instrument to mitigate the pressures on the state budget. Hence, the Government could tap for banks' resources which are currently idle due to their reluctance about lending to the real sector. Therefore, issuing more T-bills over the current year will help closing the short-term

[8] The forecast is based on a structural VAR Model with 4 endogenous lags and a SARIMA model (1,1,0)x(2,1,0);

budget gaps without crowding out private investments. Moreover, the currently accommodative monetary policy stance and low level of indebtedness (7% of GDP for domestic public debt and 16% of GDP for foreign public debt) creates room for contracting additional debt at relatively low costs. Still, the Government should use this money only for covering the short-term fiscal gaps and once the business cycle will enter the recovery phase the debt should be immediately paid back. Failure to do so will result in pyramidal financing of domestic public debt, as the interest rates will start rising, as well as in crowing out of private investments due to the competition for bank resources between the Government and private sector.

- Nevertheless, the main emphasis should be on ensuring the medium-term stability of public finances through improving the efficiency of tax and custom administration and fighting tax evasion. Thus, the fiscal policy should be clear, transparent and non-discriminatory. Particularly, it refers to the agricultural sector, which serves as a major pool of unexplored public resources. These should gradually be tapped by the Government by closing various fiscal policy loopholes and elimination of preferential tax rates. At the same time, the fiscal policy should create incentives for tax-payers to refrain from tax-evasion. It should imply higher quality of public services, better transparency in utilization of public resources and eradication of corruption in public institutions.

- Increasing efficiency of administration of public finances by the state institutions should be another key medium-term policy objective. For example, in 2011, the Court of Accounts depicted frauds amounting for about MDL 375 mil. only for the audited institutions, which could cover about one third of budgetary deficit planned for this year. Hence, the poor utilization of public money implies significant opportunity costs which translates into a major burden on the state budget.

- The National Decentralization Strategy, approved by the Parliament in April 2012, adequately addresses the issues of poor local tax base and excessive dependence of local governments to the central power. However, it suffers from lack of clearly specified financial resources necessary for the actions' plan and excessive generality. Consequently, it steers the uncertainty about its efficient implementation.

- The medium and long-term fiscal consolidation should not limit to keeping the budgetary deficit within the level of 1% as a share of GDP, as it is officially planned for 2013-2015. The fiscal policy should rather be fully countercyclical, implying running into surpluses in times of good economic weather. Consequently, it could ensure the Government with enough resources to mitigate the effects of potential recessions when the time for deficits will come again. Therefore, a good indicator of fiscal sustainability should be conditional on the business cycle's phase, meaning that if the Government anticipates the economy to recover or even prosper during 2013-2015 it should aim for budget surplus of about 1% of GDP.

4. Labour Market

Poor performance of the labour market: external impact or a systemic problem?

While it has been known that social indicators follow the economic evolutions with a lag, the experience of a recent crisis in 2008-2009 makes employers more cautious in their actions and short-term strategies. Higher awareness about the potential impact of the crisis and more pessimistic expectations on their ability to tackle it may determine employers to respond faster to the economic challenges compared to the 2008 crisis. In fact, the employment rate already felt by 1.2 p.p. y-o-y in the first quarter, being close to the lowest value set in late 2010 (Chart 12).

Chart 12. Seasonal adjusted employment and unemployment rate (secondary axis), %

Source: Expert-Grup calculations based in NBS data;

The number of employees reduced only slightly (less than 1%) and was determined mainly by factors not directly related to the current uncertainties in the European economies. Firstly, the employment in agricultural sector continued its natural decline, with a rate of 1.7% y-o-y. Secondly, the employment in public sector decreased by 5.5% y-o-y; this is one of the most significant reduction since 2000 though the reasons are not very clear. While some progress with the central public administration reform and the optimization of schools' network can explain the decline in employment in these two sectors it is more difficult to understand the reasons for a 12% decline in employment in the health system. Therefore, we can also assume a high error margin and a conclusion might be formulated only if the trend persists during the following quarters. As for the contraction of employment in the market services sector, this is certainly a reaction to the external and internal economic evolutions. Retail and wholesale trade and hotels and restaurants lost 6.8% of the workforce. Meanwhile, employment in industrial and construction sectors increased by 4.5% and 9.6% respectively, given the lag of up to four quarters of GVA changes on employment.

The evolution of wages also points out over the potential situation in specific sectors. The real wages have slightly increased since the beginning of the year, but with few sectors showing a negative evolution, especially in industrial branches: production of leather articles and shoes, production of paper and boardpaper, printing industry, chemical industry, metal industry, production of non-metal minerals, machinery and equipment, radio, TV and communication equipment. Most, but not all, of these sectors also face decrease in GVA, indicating over a possible contraction of employment by the end of the year. Moreover, the decrease in real wages in banking sector might be viewed as a sign of worsening of general economic conditions as the banking sector is one of the first taking the rhythm of the entire economy.

It is important to mention that informal employment declined faster than formal employment, which is mainly explained by the shrinking of employment in agricultural sector. Nevertheless, the number of informal wage earners also decreased. Given the current concern about undeclared work and recent steps undertaken to reduce the phenomenon this evolution disserves more attention. In fact, the LFS data show a declining trend in number of informal wage-earners during the last decade, with only small deviations. Thus, even prior to the adoption of the Action Plan for fighting undeclared work, this was on a downward trend, meaning that some of the incentives for shadow employment were eliminated. Nevertheless, there is no evidence of decrease in total undeclared work, e.g. undeclared salaries. However, as the determinant factors of undeclared work have changed over time the strategies applied by the Government should also address a wider series of actions. The current Governmental approach look at the undeclared work as a purely negative phenomenon with employers and employees being seen as the only guilty parts and ignoring the fact that the state is also culpable for bending the social contract by not providing the public goods and services of quality and imposing high burden over business sector. Therefore the measures proposed for fighting undeclared work mainly refer to sanctions and increase of control, with no change in behavior of the state in fulfilling its responsibilities.

Meanwhile, in Q1-12 unemployment rate has surprisingly decreased by 2.2 p.p. and the number of unemployed felt by 25%. The number of unemployed registered at NEA also declined by more than 20% annually each month of this year. Although the number of unemployed placed on the labour market also increased, this level is by far lower than the fall in number of unemployed, making this evolution difficult to explain. Or, the amendments to the law on employment and social protection of individuals looking for a job implemented in 2011 aiming to reduce the access to unemployment benefits already had an impact. The expenditures for unemployment benefits payment decreased in the first semester of the year by 23% compared to the same period of 2011. However, this does not explain the low unemployment rate based on ILO standards, even though the increase in the number of inactive population may be partly determined by emigration for workers abroad. In the first quarter of 2012 the number of persons working abroad increased by 15.6%, bringing the level of migration very close to pre-crisis level. While it may seem surprising that during an external crisis more people migrate abroad, the disaggregated data on migration explains partially this evolution. The number of men who migrated increased by 23.9%, while the number of women increased only by 3.9%. This suggests that migration takes place mostly to CIS countries, given higher share of men working in CIS and still growing economies and construction sector, especially in Russia, Sochi. However, if the situation in the euro area aggravates, it will have an impact on CIS countries and would cut the work opportunities in Russia too, especially that the high growth in Sochi is a one-time event.

At the same time, the rise in emigration was characterized by higher increase of young emigrants (15-24 year old) and better educated individuals (tertiary education graduates). This imposes higher risks for our country and undermines its competitiveness, taking into account the role of human capital for a healthy economic development. Also, this throws the seeds for the future risks as the need of human capital may increase when DCFTA with EU enters into force. The human capital is one of the main preconditions that makes possible the valorization of potential benefits of deeper relations with EU.

Short-term forecast and challenges

- Employment in agriculture will most probably continue its natural descending trend. Our estimation based on the already set trend and the effects of the drought is that employment in agriculture will decrease by around 8% by the end of 2012. Employment in industrial sector follows the GVA evolution with a lag up to four quarters. Thus, the decrease in GVA in industry will be accompanied by a slight decrease of about 1% in employment in the sector[9]. Employment in construction sector will be on the upward trend due to expected growth in the sector. However, we do not expect a rise in employment of more than 4%. Our estimates vary between 3.5% and 4%. According to our estimates employment in service sector will slightly increase by about 2%.
- Given the above sectoral forecasts and the hypothesis that employment in public sector will remain stable, the employment rate may drop to 38.5% - 39% in 2012. It is difficult to predict the unemployment rate as there is no real correlation between the employment and unemployment rate registered by now and it depends mostly on the situation in the main destination countries for migration. Therefore, we expect an increase in unemployment rate if the situation in the Euro area aggravates.

Policy recommendations

- Generally, higher employment is the result of a more intense business activity which may increase only when the business climate is appropriate. Thus, even though it is a very general statement, a friendly investment climate, implying many other recommendations mentioned in the report regarding fair competition, protection of investment, reduction of administrative burden, is essential for job creation.
- As the Government is very much concerned about informal employment it should adopt a comprehensive action plan for fighting informal economy, with all line ministries involved for promoting sectoral reforms. One minister alone (i.e. Ministry of Labour, Social Protection and Family) cannot solve the problems of the whole system. Also, the approach should be changed by addressing both sides of the social contract: the state and taxpayers. Without some concession from the part of the state, which has actually violated this contract by neglecting its own responsibilities, the impact of the sanctions may be only moderate and short-term. Also, the authorities should consider that fighting undeclared work will generate new costs as this may cause the exit from employment to unemployment of some individuals and lower incomes of other individuals.
- It is necessary to implement a correct and documented approach for the human capital development in Moldova. The deficit of human capital and mismatch of demand and supply on the labour market in Moldova have widened. Meanwhile, it is clear that the European vector pursued by Moldova will result in higher demand for human capital in medium and long-term. Therefore, Moldovan government should not be concerned by the fact that the investment in education may be meaningless if the people migrate. More competitive jobs may attract back at least some of the migrants. And this is very possible in the medium term if the DCFTA with EU is set up. Moldova will not fully benefit from closer relations with EU if the lack of human capital and labour force persist or aggravates.

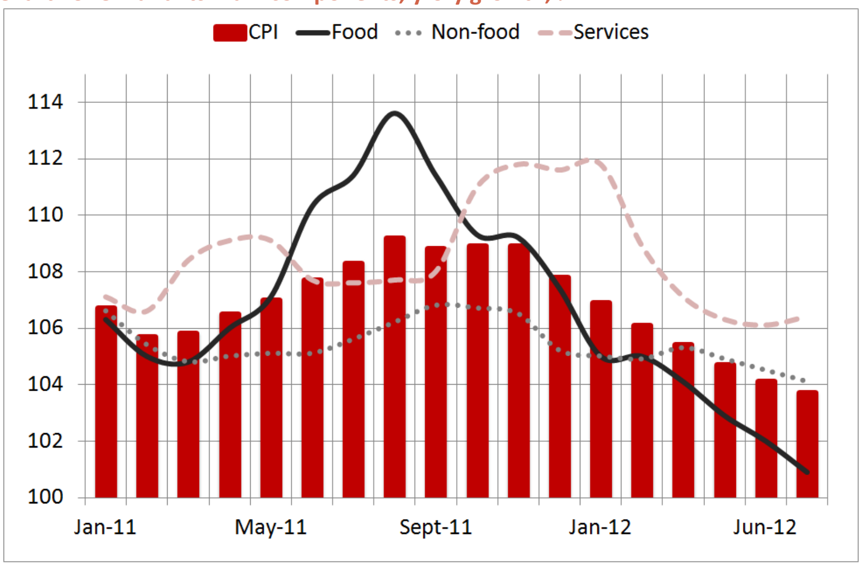
[9] Employment in industrial, construction and service sectors was forecasted using two models: (i) VAR model with the following endogenous variables: employment, GVA and wages in the sector and (ii) SARIMA model. All variables were expressed in y-o-y growth;

5. Prices and Monetary Policy

Economic slowdown matched by a fall in inflation

The contraction of economic growth, which started in the fourth quarter of 2011, fuelled a strong disinflationary process with consumer prices falling to the lows of 2009. This downward trend was triggered by all components of the CPI basket. Still, the most prominent drop was registered by foodstuffs, which by the end of June almost approached the zero level of price growth y-o-y (Chart 13).

Chart 13. CPI and its main components, y-o-y growth, %



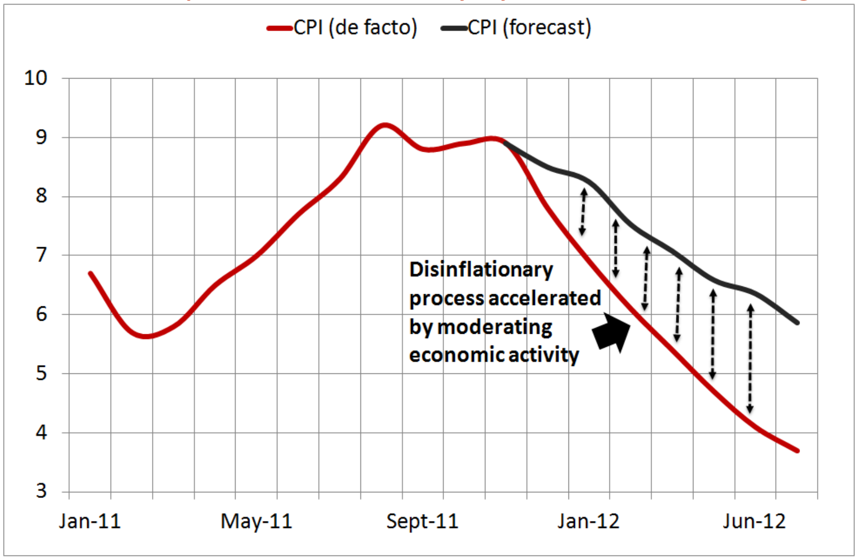
Source: NBS;

The main factors explaining the downward trend are:

- *Fading impact of cost-push price shocks.* The hikes in regional energy prices over the previous year have caused corresponding adjustments on the domestic market, boosting the CPI close to the two-digit level. Hence, a higher comparison basis made annual CPI to subside during 2012-2013;
- *Decreasing world energy prices.* The disinflationary process accelerated due to decreasing world energy prices from the beginning of the current year, on the grounds of tough economic conditions in the world. Consequently, it made the fuel prices to decline by 0.1% and 2.5% over May and, respectively, June and had a mitigating impact on the cost-push inflation;
- *Appreciation of the national currency.* In June 2012 the Moldovan Leu strengthened in comparison to Romanian currency, Russian Ruble and Euro by 3.3%, 2% and respectively 0.6%, since the beginning of the current year. Consequently, it contributed to the disinflationary process for the imported products, particularly from Russia, Euro area and Romania;
- *Slowing down of economic activity.* Weak regional and economic conditions primarily hit remittances' inflows and exports, which dented the companies' financial resources and households' disposable income. Consequently, it made final consumption and bank's credit activity to cool down;

The net impact of the mentioned factors is relatively significant, being revealed by the consistent deviation of the de facto y-o-y headline inflation from the forecasted one[10]. Thus, the expected disinflationary process due to maturing growth and high comparison base, proved to be milder in comparison with the actual one (Chart 14).

Chart 14. The comparison between de facto y-o-y CPI and the forecast starting from December 2011, %



Source: Expert-Grup calculations;

Among all disinflationary factors, the main culprit belongs to the worsening of domestic economic conditions, as a direct consequence of Eurozone sovereign debt crisis. As a result, it caused significant changes in the structure of (dis)inflationary risks: in 2012 the importance of demand-driven (monetary) factors visibly increased, in comparison with the cost-push ones. Therefore, we may conclude that most of disinflationary pressures stem from cooling down of final consumption and credit activity. This is attested by the increasing gap between the headline and core inflation, being corroborated by the recursive OLS estimators[11] (Chart 15).

Consequently, it created additional room for maneuvers for the central bank. NBM embarked on a monetary policy easing in order to compensate for the tempering demand and keep the economy away from the deflationary slump (Chart 16). Thus, over the first quarter of 2012, NBM cut the policy interest rate to the historically low of 4.5%, which is, in fact, a negative real rate, taking into account the bank's forecast of 4.9% of annual CPI at the end of the current year. Such an accommodative policy stance is driven by the necessity to fine-tune the economy in a short-run. Particularly, it is motivated by the following key factors:

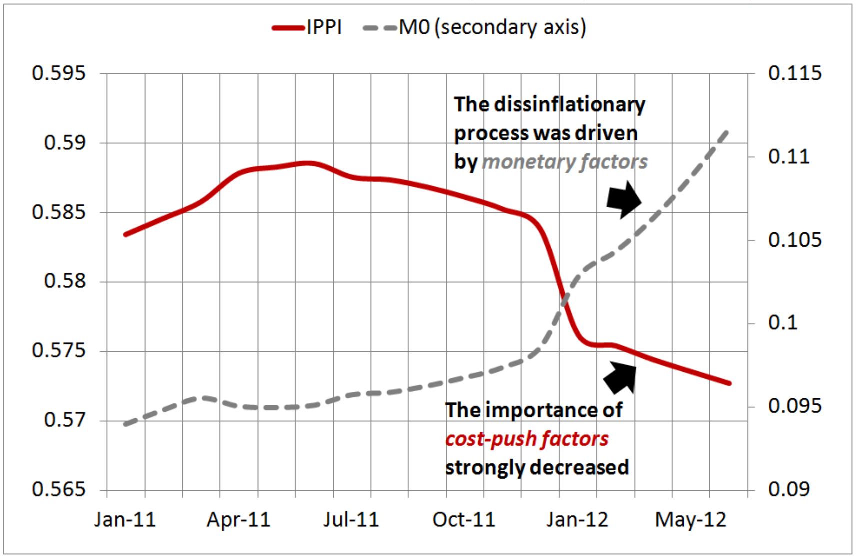
- Necessity to mitigate liquidity constraints faced by many Moldovan firms which aggravated during the current year. Thus, monetary expansion might spur lending and, though on a short-run, fuel the economic growth. This objective does not conflict with the central bank's inflation targeting strategy due to the expected disinflationary process, as well as moderate demand and declining energy prices;
- Appreciation of the national currency, which might be counterbalanced by an easy monetary policy and, thus, prevent Moldovan firms from eroding their foreign competitiveness;

[10] The in sample forecast was derived from SARIMA model (1,1,[7])x(0,0,2)

[11] $CPI_t = \beta_0 + \beta_1 IPPI_{t-5} + M0_t + \mu$

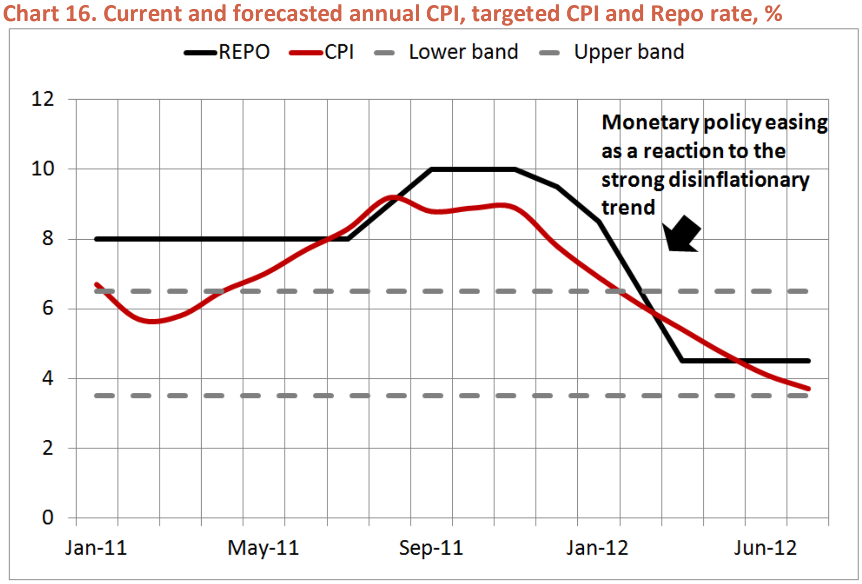
- High current account deficit: during the first quarter of 2012 it peaked to the worrisome level of 13.4% of GDP. Thus, it could be financed, to some extent, by a moderate monetary easing and its pass through the exchange rate of the national currency.

Chart 15. Econometric estimation of monetary and cost-push inflationary factors[12]



Source: Expert-Grup calculations;

Chart 16. Current and forecasted annual CPI, targeted CPI and Repo rate, %



Source: Expert-Grup calculations;

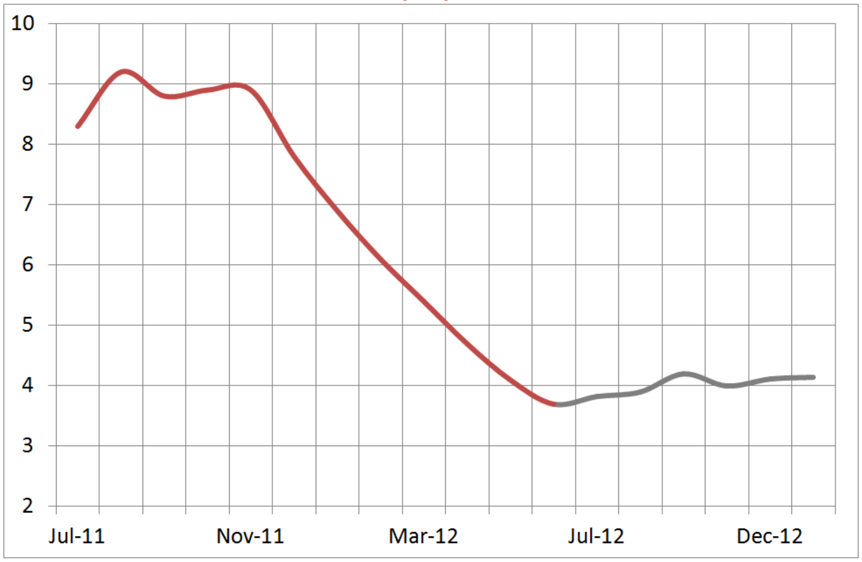
Short-term forecast and challenges

- As long as the outlook does not paint a bright future for regional and domestic economies, the inflationary expectations for the end of 2012 remain low. Given the tepid foreign and domestic demand, as well as the plunge in world energy prices, the disinflationary process will continue, at least, on a short-run. Hence, our baseline forecast for the annual headline

[12] Recursive OLS time varying coefficients of the econometric model describing the cost-push (industrial production price index – IPPI) and monetary inflationary factors (money in circulation – M0);

inflation is 4.1% (± 0.5 p.p) for the end of 2012[13] (Chart 17). Still, due to high level of uncertainty regarding the prospects of national and world economy, we consider two additional scenarios which might arise, on the one hand, due to acceleration of disinflationary pressures and, on the other hand, due to some supply-side inflationary shocks.

Chart 17. Baseline forecast for 2012 of y-o-y CPI, %



Sources: NBS and Expert-Grup calculations;

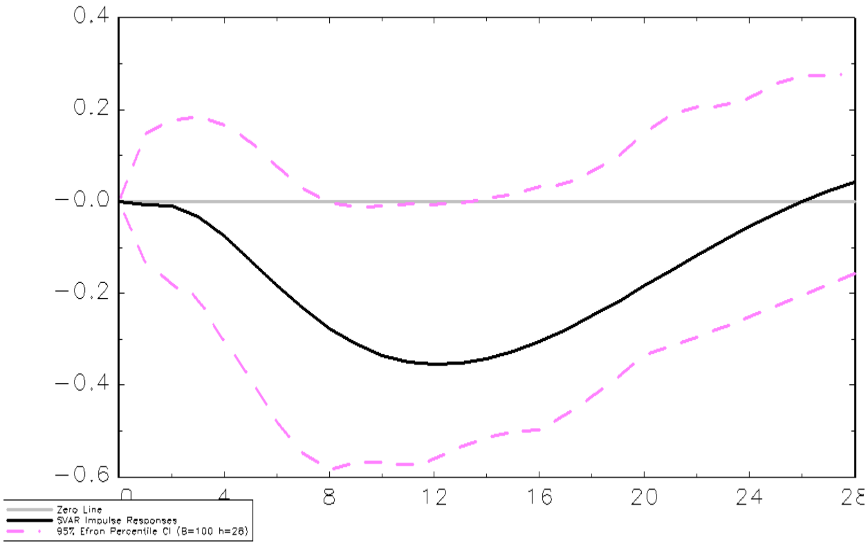
- In case the inflation in EU will dip below the 2% level and the energy and food prices will remain on their downward trend, the annual CPI could even approach 3.0% - 3.5%. Cooling down of foreign demand due to more severe economic conditions in euro area will add to the burden, creating visible deflationary risks. Consequently, it might increase the burden on the indebted firms, worsening further the banks' loan portfolios and increasing tensions on the labor market. The resulting decline in population's disposable income could further accelerate the deflationary pressures with even worse repercussions on the economic activity.
- At the same time, the current year's drought, at national and regional level will partly counterbalance this disinflationary trend. Hence, the decreasing supply of many agricultural products could inflate the prices for cereals, vegetables and other prepared foodstuffs. In case these supply-side shocks prevail over the demand-side ones, the annual CPI might reach the 4.5% level by the end of 2012.
- Additional risks stem from raising current account deficit which becomes even more pressing as the main sources used for its financing are gradually draining away: remittances and investments are declining, while the exports and overall economic activity are tempering. Hence, the central bank might increase its interventions on the domestic foreign-exchange market in order to augment the level of international reserves and, in this way, to weather eventual shocks in external inflows. Moreover, these actions could be motivated by the disinflationary process that would be mitigated by increasing the supply of national currency.

[13] The forecast has been derived from a structural VAR model with 3 endogenous lags and 8 variables.

Policy recommendations

- Given our baseline inflation forecast of 4.1% for the end of 2012, the current monetary policy stance is less accommodative in comparison with NBM's perception which expects the CPI to hover at around 4.9%. Hence, in case the annual inflation for July and August tends to approach the Expert-Grup forecasted level we recommend the central bank to cut its policy rate, at least, by 50 basis points during the next months. According to our estimation (Chart 18) a hike in policy rate reaches its highest impact on inflation with a lag of about four quarters. Therefore, NBM should be very prompt and flexible to efficiently mitigate the disinflationary process and properly anchor the inflationary expectations within its targeted interval. The necessity to further ease the monetary policy is confirmed by our forecasts for GDP real growth, which is well below the official estimate (see Chapter 1); Moreover, the current decrease in the dollarization rate (see Chapter 6) might improve to certain extend the efficiency of the monetary policy decisions, which could make the central bank to handle more efficiently the current deflationary risks.

Chart 18. The impact of a 100 basis points hike in REPO rate on the annual CPI level, SVAR impulse response



Source: Expert-Grup calculations;

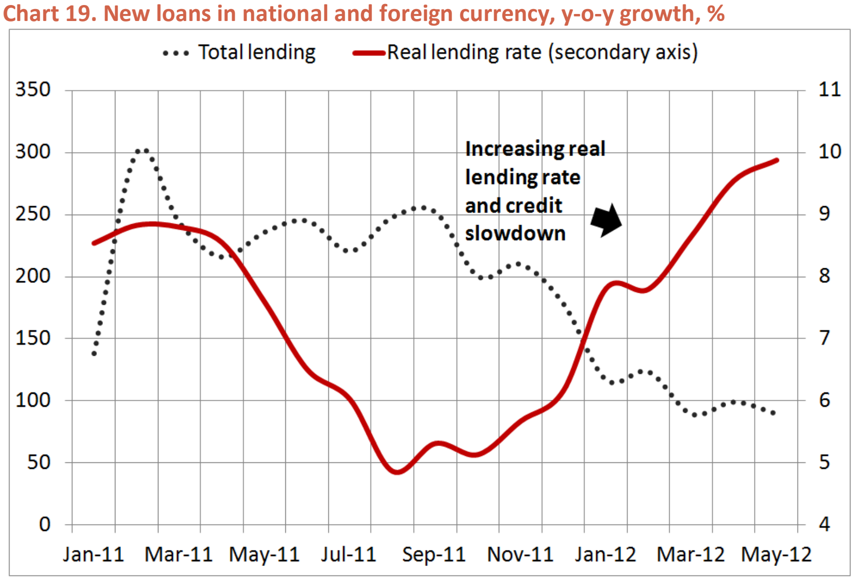
- Although, NBM has a more efficient monetary policy tool for controlling inflation – Required Reserves (RR) Rate – we recommend using it only in case of maximal urgency. The reason is that the shocks it generates imply harsh effects on the banking sector. Hence, nurturing the economy back to its healthy growth could become a very challenging task especially in the recovery period when NBM will have to hike its rates back. Moreover, Moldovan banks are sufficiently capitalized and solvent, which makes cutting the RR rate redundant.
- Moderate nominal depreciation of the national currency could be allowed as an additional source for financing the current account deficit and stimulation of price competitiveness of Moldovan exports. H Importantly, the central bank should not be lured by increasing its purchases of foreign currency as a means to combat the disinflationary process. The reason is that such interventions could make the national currency spiral out of control.

6. Banking Sector

Credit slowdown and increase in bad loans amid tough economic conditions

After an ample credit expansion which lasted until the second half of the previous year, lending started to gradually slowdown (Chart 19). It owes both to maturing growth due to higher comparison base, as well as to the repercussion of the regional economic crisis. Thus, banks increased their risk aversion and credit rationing in order to minimize their exposure to the current tough economic conditions and, particularly, to exchange rate risk. As a result, since March 2012 total credits declined in y-o-y terms mostly due to the lending squeeze in foreign currency, which in May 2012 dropped by 19.5% y-o-y. At the same time, the banks' reluctance is milder to lending in national currency which remained relatively robust with 18.4% y-o-y increase in the same period.

Chart 19. New loans in national and foreign currency, y-o-y growth, %



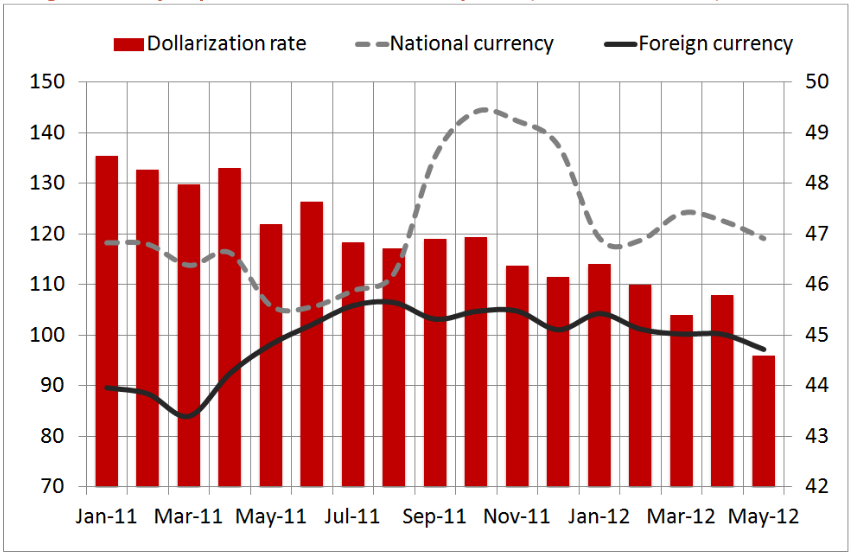
Source: Expert-Grup calculations based on NBM data;

Besides the supply-side factors explaining the credit slowdown, it has demand-side culprits as well, determined by:

- the strong increase in real lending rates owing to expected correction of the inflationary trend, as well as to the fact that most of Moldovan banks inflated their risk premiums as part of new conservative risk management strategy;
- many firms postponed their investment projects which might be financed from bank credits;
- high uncertainty about potential returns and cash-flow due to very volatile economic conditions at national and regional level.

Additionally, the sovereign debt crisis in the EU countries has motivated the firms and households to immunize their holdings against the exchange rate risk. As a result, new bank deposits in foreign currency grew much slower in comparison with those in national currency, while in May they even decreased in y-o-y terms. As a result, the dollarization rate followed a clear downside trend over the previous and current year, which bodes well for ensuring the stability of the banking sector and improving the monetary policy efficiency (Chart 20).

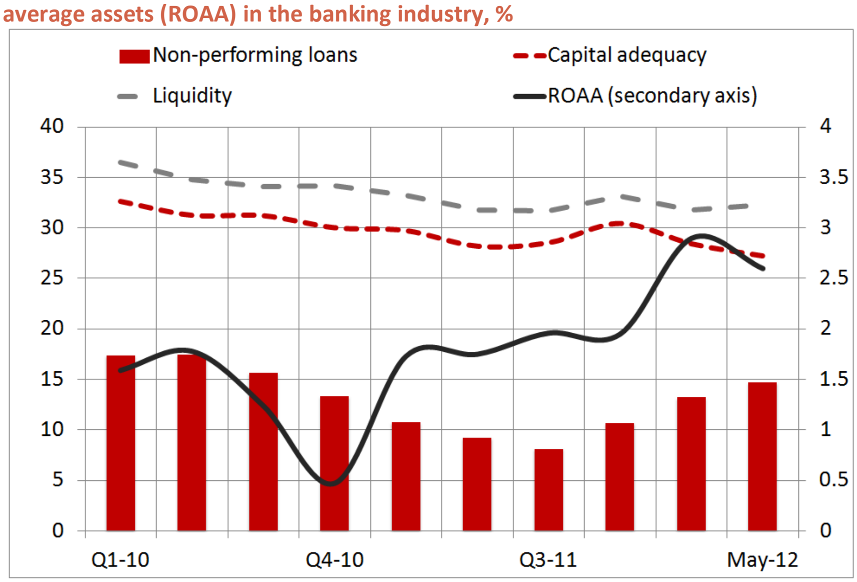
Chart 20. New deposits in national and foreign currency, y-o-y growth (secondary axis), and the share of foreign currency deposits in total stock of deposits (dollarization rate), %



Source: Expert-Grup calculations based on NBM data;

Overall, the y-o-y growth of new deposits cooled down from 18.2% at the beginning of the current year to 5.2% in May 2012. Since this trend has been matched by a squeeze in lending activity, the Moldovan banks remained highly capitalized and abundant in liquidities. The biggest issue faced by the banking sector is the consistent worsening of banks' balance sheets. Thus, the share of non-performing loans in total credits surged from 8.13% after the third quarter of 2011 – before the first signs of economic slowdown appeared – to 14.7% in May 2012. Although part of this increase owes to a methodological change since January 2012, which added about 2 p.p. to the figures, the worrisome signs already appeared in the fourth quarter of 2011, while the dynamics is still upward (Chart 21).

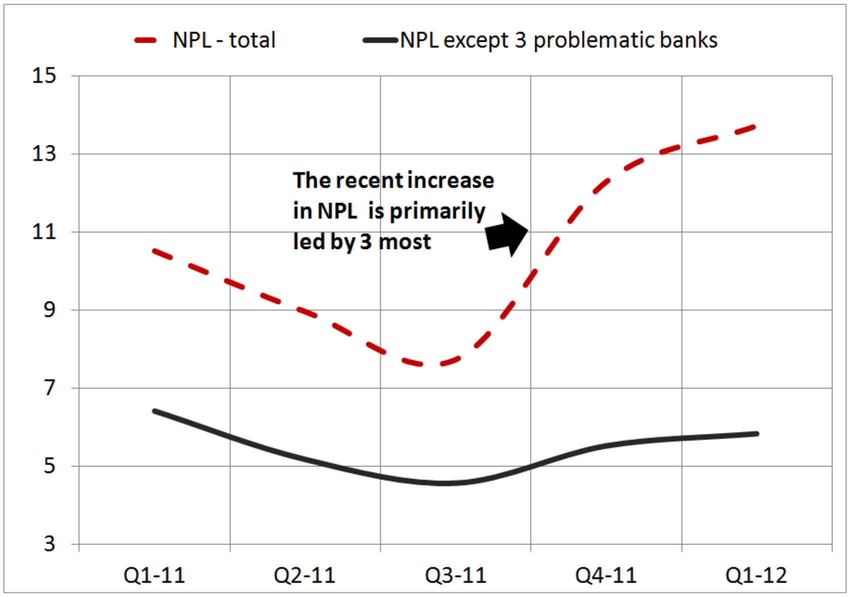
Chart 21. Non-performing loans as a share in total loans, short-term liquidity, capital adequacy and return on average assets (ROAA) in the banking industry, %



Source: NBM;

It is worth mentioning that the share of NPL varies significantly among banks from 1.1% up to 37.5%, at the end of the first quarter of 2012. Thus, an important contribution to the overall increase in NPL belongs to three most problematic banks which owe over one half of the entire pool of bad loans. This is also confirmed by the increasing gap between weighted average of NPL of the whole banking system and the industry except the mentioned banks. Nevertheless, we would like to point out that even controlling for this effect, the loan portfolios started to worsen, though at lower pace, since last quarter of 2011 for most of Moldovan banks (Chart 22). This is one of the most important repercussions of the current regional economic crisis, as borrowers face liquidity shortages and banks are becoming increasingly reluctant in their lending activity.

Chart 22. NPL share in total credits, comparison between the weighted average according to assets' value of Banks15 and Banks12[14], %



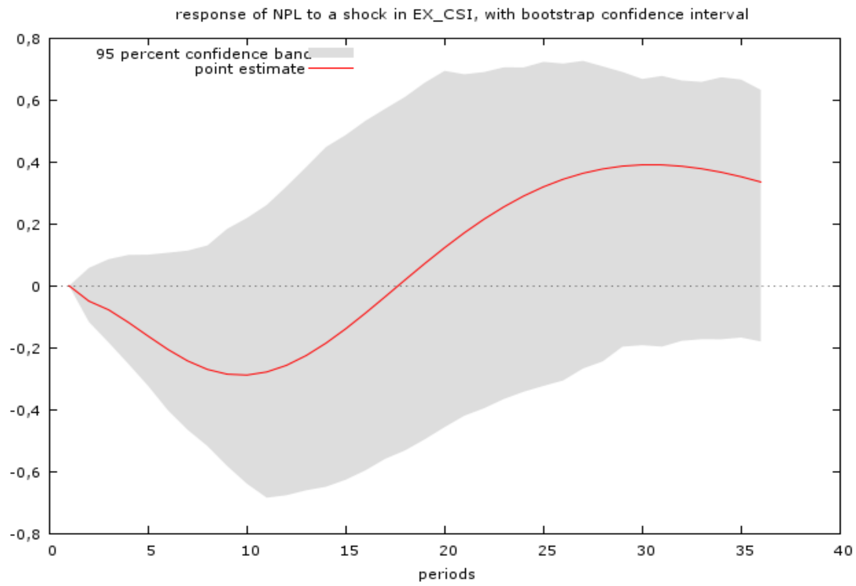
Source: Expert-Grup calculations based on NBM data;

Short-term forecast and challenges

- Currently, the main risks stem from the Eurozone sovereign debt crisis and its ramifications across regional economies. The high uncertainty coupled with contracting growth, which in some EU countries turned into a recession, fuels credit rationing, cools down the demand for loans and worsens banks' portfolios. The main problem is that this trend can easily fall over into a self-fulfilling process, given banks' cyclical behaviour which might aggravate the issues of liquidity constraints and high credit costs and, consequently, poor demand and slow economic growth. Additionally, this might accelerate the disinflationary process, turning into a deflationary spiral.
- The main contamination channel of the banking sector as a result of an eventual foreign economic crisis is the share of non-performing loans in total credits. Our empirical estimations denote that the exposure of the Moldovan banking sector to an eventual shock in foreign demand from EU is several times bigger than the shock from CIS countries. This is confirmed by the VAR impulse-response analysis which denotes the fact that the quality of banks' portfolios – share of NPL in total credits – is much more sensitive to potential shocks in EU (Chart 23 and Chart 24). It reveals the strong repercussions of the current sovereign debt crisis from the Euro area and the general economic conditions in EU.

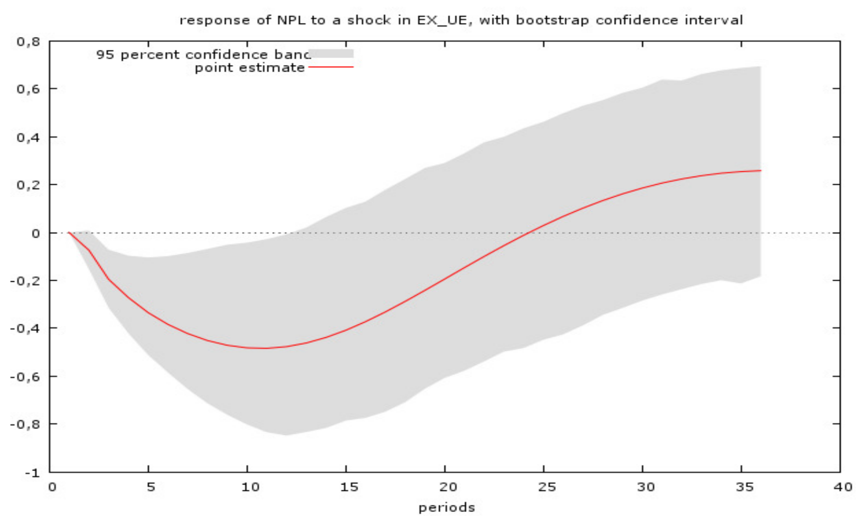
[14] Except three most problematic banks;

Chart 23. The impact of 1 p.p. acceleration in exports' annual growth to CIS countries on the banking portfolios



Source: Expert-Grup calculations;

Chart 24. The impact of 1 p.p. acceleration in exports' annual growth to EU countries on the banking portfolios



Source: Expert-Grup calculations;

- The evolution of nominal lending rates will be determined primarily by three key factors: (i) expected correction of the disinflationary process, mainly due to poor weather conditions and slight depreciation of the national currency; (ii) risk premiums which might be further inflated by the commercial banks on the grounds of high uncertainty and expected worsening of the overall economic situation; (iii) additional easing steps which might be undertaken by the central bank in case the de facto inflation will lay below the baseline NBM's outlook. The first two factors will contribute to the reversion of the downward trend in lending rates which will be partly counterbalanced by the third factor. Hence, we expect the nominal lending rates to increase slightly at about 14.3% at the end of 2012. However, if we admit that the annual headline inflation will continue approaching the deflation zone which will call for more aggressive monetary policy easing, the lending rates could hover at around 12.5% at the end of the current year[15].

- Given banks' pro-cyclical behavior, lending will remain on the tough side on the grounds of poor demand, credit rationing and high uncertainty. According to our baseline scenario, till the end of 2012, total new loans will decrease by about 5%. However, under a more pessimistic scenario, according to which the debt crisis in the euro zone will worsen, making the regional and domestic conditions even more complicated, lending could subside even by 20%-30%[16].

Policy recommendations

- An important macroeconomic risk associated with the current and expected credit squeeze is related to the possibility that is could switch from being the effect of the economic moderation to its cause. Hence, the monetary authority should undertake a very resilient approach in order to adequately tackle the current slowdown and prevent the economy from sinking into a deflationary spiral. Therefore, NBM should commit to an accommodative monetary policy for 2012-2013, with eventual possibility of easing in case the deflationary risks will remain prominent.
- The central bank should revaluate its supervisory framework in order to spot early the risky lending practices and potential data manipulation by commercial banks and, in this, way to have a more timely intervention. The fact that the most problematic bank which is currently under the close supervision by NBM has previously been constantly reporting healthy financial situation which suddenly proved to be untrue undermine the credibility about the reports of all other banks. Hence, a more efficient and transparent control is required in order to restore confidence and allow for more prompt interventions.
- The harsh financial situation of the state-owned commercial bank "Banca de Economii" S.A. is the classical result of the principle-agent problem: the manager (agent), benefited from the information asymmetry and embarked on risky lending projects. Coupled with the transfer of the bad loans from the failed Investprivatbank, it made the share of NPL in total credits to catapult to the highest level in the banking sector (31.25%). Despite its sufficient capitalization and liquid balance-sheet, it proved once again the existing deficient management which, on its turn, highlights the necessity for the bank's privatization. However, it should be conducted only after the balance sheet will be cleaned, while the tender and acquisition procedure should be in line with the best international practices.

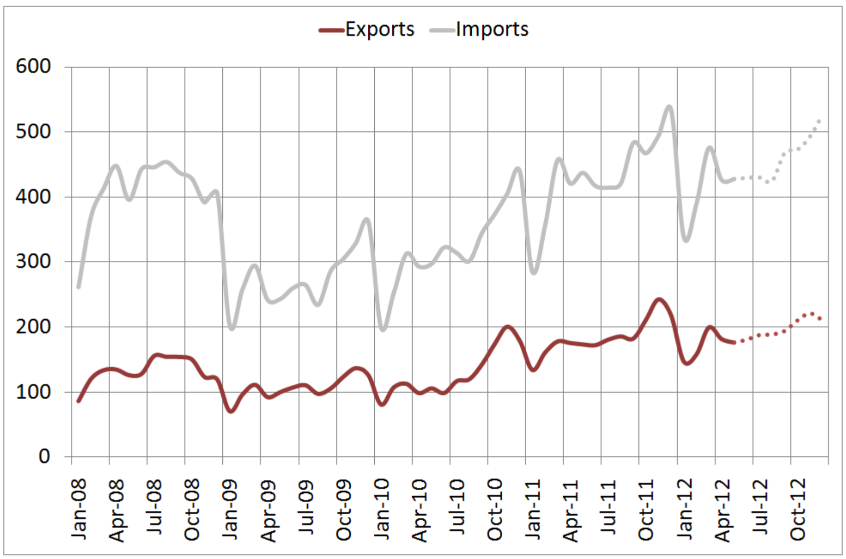
[15] The forecast is derived from a structural VAR model with 3 endogenous lags.
[16] Ibid

7. Foreign Sector

EU gets flu, Moldova sneezes

The evolution of the Moldovan trade in the first half of the year perfectly reflects the worsening economic optimism both in the global economy and in Moldova. According to official statistical data on trade with goods, in Q1-12 the Moldovan exports posted a 6.7% y-o-y, while imports grew 9.6% y-o-y. However, our estimates show that in second quarter the exports have only grown 3.3% y-o-y, while the growth of imports was 4.7%. This rapid deterioration of the exports growth comes mainly on the account of the EU markets; so far, the exports to the CIS have not felt such a dramatic reduction in growth, but this can swiftly change. Quite interesting, the exports to other destinations have actually increased in Q2-12 compared to Q1-12, reflecting partly the efforts of some Moldovan producers to diversify their market outlets. In result of the more rapid growth of imports, the trade deficit has significantly widened (Chart 25), and we actually expect this trend to continue till the end of the year.

Chart 25. Evolution and forecast of the monthly exports and imports of goods, million USD, January 2005 – December 2012



Source: NBS, forecast for June-December 2012 by Expert-Grup;

In fact, the evolution of the 'real' exports has been even less impressive when controlling for the growth in export prices. The physical quantity of the exports in Q1-12 has actually declined by 2%, a shift which was compensated only by higher export prices. This reduction in physical quantities exported could be better explained by faltering domestic supply rather than by falling demand. At the same time, the imports have grown in the first quarter both in terms of unitary value and quantity.

A positive, even though still feeble, trend which we would like to mention is the reduction in level of concentration of the Moldovan exports around the 'traditional' products (agriculture, textiles, clothes). In Q1-12 the Hirshman-Herfindal Index of Moldovan exports equalled 0.0482, compared with 0.0507 in the previous quarter. This positive structural shift is the result of the more dynamically growing exports of machines, equipment, electric components and other products incorporating a higher value-added compared with the traditional Moldovan products. Some products registered really impressive exports growth rate: ethereal oils (6-fold increase in exports y-o-y), sugar and sugar products (3.3-fold), vehicles spare parts (1.95-fold).

Whether or not this beneficial diversification of the Moldovan exports continues will be a factor of how innovative Moldovan industrial companies will be, which partly will be determined by the state policy on innovation. A new strategy on innovation is currently being drafted by the Moldovan ministry of economy, which is supposed to incorporate a new vision on how the innovation potential should be harnessed.

The trade in services followed a more dynamic evolution, even though equally misbalanced: the services exports in Q1-12 grew 11%, while that of imports – 15%. According to our estimates, in Q2-12 the deficit of the trade in services widened further due to higher demand for tourist services abroad from the part of Moldovan consumers.

In short term the evolution of the Moldovan exports will also depend on the economic growth registered by the countries of Moldova's main trading partners. In this regard, the relatively good global economic indicators in Q1-12 have subsided, and the developments in the second quarter worsened in most of the countries which are major destinations for Moldovan exports. Also, the unemployment in peripheral EU countries – Portugal, Greece, Italy and Spain - has been on the rise, and these are the countries hosting approximately 25% of the Moldovan migrants. Obviously, problems in the real economy are partly enrooted in the financial stress these countries undergo in result of escalating sovereign debt. However, the problems created by fiscal disorder are significantly amplified by the problems related to the Southern countries low competitiveness and structural problems. Tackling these shortfalls will take a lot of time and readjustment of consumers' behaviour, which may ultimately reverberate on the final consumption demand, including for Moldovan products. Data available also suggest a less robust economic growth in mid-2012 in US, Brazil, China, India, and Russia.

The lower rates of global growth reflected on the prices for global commodities. Crude oil in mid July 2012 was about 20% cheaper than during times of high prices in February-March this year. Metals' prices have also declined about 10% compared to early 2012. These trends serve as downside pressures on the prices for Moldovan imports. However, the global food prices have also displayed a negative trend so far: in June 2012 the meat was 3% cheaper y-o-y, dairy prices declined 25%, cereals – 15%, oils and fats – 15%, sugar - 19%. These changes obviously impact negatively the revenues of the Moldovan farmers exporting their products. Because of the adverse weather conditions in many parts of the world, these trends can reverse to such a magnitude that growth in farmers' income will not offset the negative impact on the growing prices on consumption patterns.

Short-term forecast and challenges

- IMF has recently revised downwards its global forecast for 2012-2013. Among Moldova's key trade partners, Ukraine is expected to grow slower than previously expected. We believe that Romanian economy may also suffer because of the on-going political crisis. Forecasts for Russia and EU did not change for 2012 (4.0% and -0.3% accordingly).
- The more tepid than expected global economic growth in 2012 (3.5%) will exert a negative impact on the Moldovan exports. We expect that in 2012 the growth of Moldovan exports will be marginally positive (+1.0%); however, this forecast is highly sensitive to the financial and economic developments in the EU. In fact, the lower threshold of our forecast is a -0.2% growth rate[17].
- As the same time, we expect that domestic demand for import products will register positive growth in 2012: the basic scenario is a +2.5% growth in imports. The smaller yields of cereals

[17] Forecast of Moldova's imports and exports has been done using a SARIMA model.

output is likely to result in higher demand for imported cereals. This may add about 0.2 percentage points to the figure above.

- Combined, these evolutions will open a bit higher trade deficit (42% of GDP) than in 2011 (40%). The expected evolution of trade in services will not change dramatically this outcome. The growing trade deficit combined with smaller revenues and transfers from abroad may result in high depreciation pressures on the national currency.

Policy recommendations

- Moldovan small and open economy is set to incorporate fully the fallout from the more timid economic growth on the global and regional scale and to suffer of the smaller growth in income levels in the EU countries. However, Moldovan government can significantly ease the pain suffered by Moldovan exporters by alleviating the behind-the-borders barriers to trade.

- In spite of the declared liberalization of the trade in the recent years, these barriers remain high and difficult. What is interesting, however, is that these barriers take their origin not as much in the trade policy decided at the high political level, but more in the arbitrary decisions of the Customs Services, and various state agencies which have control functions. These authorities often adopt regulations which do not correspond to minimal standards of decision transparency and impose new rules on ad-hoc basis. It is necessary to adopt a political decision on how to ensure proper political control on such bodies, in order to make them facilitate rather than inhibit the trade, while at the same time not affecting their institutional independence.

- Moldovan policy authorities may be tempted to 'contribute' to the depreciation of the Moldovan currency in order to stimulate exports and insure higher budget revenues. However, across the globe such policy tools have shown their limited use and ambivalent impact. In any case, the positive impact will be short-living. A growing level of competitiveness should come from more innovation at the enterprise level, which, on its turn requires policies stimulating on-job training of the labour force, marketing and management innovations, investments in relevant research and technological development.

- Contrary to what common wisdom would suggest, Moldova needs also to liberalize more the import of services and goods. Obviously, these are those imports which serve as inputs into the production technologies. More than customs tariffs, imports of equipment and professional services often fall victim of Moldovan policy of over-regulating the technical parameters, immigration policy, unfinished reform of the VAT and other policies alike.

About the Expert-Grup

Who we are

EXPERT-GRUP is a leading economic think-tank in Republic of Moldova. It is member of the PASOS (Policy Association for an Open Society) network comprising 50 policy think-tanks in 27 countries from Central and Eastern Europe and Central Asia.

Our mission

The institutional mission of the Expert-Grup is to contribute to the economic, democratic and social development of Republic of Moldova, as well as to promote its international competitiveness. We tend to accomplish this mission by delivering top quality services and promoting efficient, transparent and innovative policy models.

Main activities

- Provide the public with relevant and most up-to-date analysis on economic trends;
- Offer assistance and consultancy in the decision-making and policy-making processes;
- Promote innovative development solutions and policy models.

Areas of expertise

- Development strategies;
- Macroeconomics and economic systems;
- Global economy and international economic relations;
- Economy of the European integration;
- Monetary and fiscal policies;
- Labour economy, management and business culture;
- Consumer behaviour;
- Industrial and agricultural economics;
- Economy of health and education.

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