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MOLDOVA ECONOMIC GROWTH ANALYSIS

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Contents

Key policy messages in MEGA #2.....	7
Summary.....	8
Economic governance.....	8
GDP decline.....	8
Agriculture.....	9
Industry and infrastructure.....	9
Investments and constructions.....	10
Services.....	10
Labour market.....	10
Households' income.....	11
Households' consumption and savings.....	11
Prices.....	11
Monetary policy.....	12
Budgetary and fiscal policy.....	12
Financial sector.....	12
Foreign trade.....	12
Global markets.....	13
1. Economic governance.....	14
Analysis of the key aspects of the governmental program.....	14
From anti-crisis mismanagement to post-crisis management.....	15
Dialogue with IMF.....	16
Learning from Doing Business 2010.....	17
Outlook for 2010.....	18
Challenges ahead.....	18
2. Gross Domestic Product.....	19
Visible versus real decline of the GDP.....	19
Sources of GDP decline by expenditure and production sectors.....	20
Outlook for 2009 and 2010.....	22
Challenges ahead.....	22
3. Agriculture.....	23
Analysis of crops subsector developments in 2009.....	23
Evolution of the livestock subsector.....	24
New Government – new agricultural policy.....	25
Outlook for 2010.....	27
Challenges ahead.....	27

4. Industry and infrastructure.....	29
Industry and financial crisis.....	29
Towards a new philosophy of industrial policy.....	32
Outlook for 2010.....	33
Challenges ahead.....	33
5. Investments and constructions	34
Overview of investments and constructions in 2009.....	34
Outlook for 2010.....	35
Challenges ahead.....	35
6. Services.....	36
Main evolutions in the sector	36
Main policy issues.....	38
Outlook for 2010.....	39
Challenges ahead.....	39
7. Labour market	40
Main evolutions in the context of the global financial crisis.....	40
Outlook for 2010.....	42
Challenges ahead.....	42
8. Households' income.....	43
Changing structure of households income	43
The paradox of remittances.....	44
Wages and social payments – the most important sources of income.....	45
Outlook for 2009 and 2010.....	46
Challenges ahead.....	47
9. Households' consumption and savings	48
Decreasing consumption – instant response to crisis	48
Saving for the “worse day”	49
Outlook for 2009 and 2010.....	51
Challenges ahead.....	51
10. Prices	52
Deflation: an outcome of economic crisis.....	52
Outlook	53
Challenges ahead.....	54
11. Monetary policy	55
From an illusionary tight policy to an illusionary loose policy	55
Switching from money sterilisation to liquidity provision.....	57
Foreign exchange market – looking for the “right” exchange rate	57
Outlook for 2010.....	58
Main challenges.....	59

12. Budgetary policy	60
General overview.....	60
Consumers as main source of budgetary revenues.....	61
Public expenditures: who will pay for the Government's myopia?.....	62
Bankers' patriotism as a source for financing budgetary deficit	63
Outlook for 2010	64
Challenges ahead.....	65
13. Financial markets	66
Structural changes and trends in the banking system	66
Outlook for 2010	70
Challenges ahead.....	70
14. Foreign trade.....	71
The foreign trade in crisis... ..	71
Exports have remained euro-bound.....	72
Policy issues	72
Shrinking imports: the suddenly frugal consumers... ..	73
Outlook for 2010	74
Challenges ahead.....	74
15. Global markets	76
Main commodities: on a firmer ground.....	76
Outlook for 2009	78
Challenges ahead.....	78
About the Expert-Grup	80

List of charts:

Chart 1 Changes in the Doing Business rating 2010/2009 for Moldova and for the region, positions in the rating	17
Chart 2 GDP decline in some countries of the region in Q1-Q2'2009, %, y-o-y	19
Chart 3 GDP evolution and forecast for 2009 (thou. MDL)	20
Chart 4 GDP growth by expenditures in Q1 and Q2'2009 (% , y-o-y).....	21
Chart 5 GDP growth by production sectors in Q1 and Q2'2009, %, y-o-y	21
Chart 6 Evolution of agricultural production in 1990-2008, and forecast for 2009-2010, 1990=100%.....	23
Chart 7 Evolution of the cereals yields 1995-2008 and forecast 2009-2010, 100 kg/ha	26
Chart 8 Evolution of high-value added crops yields 1995-2008 and forecast 2009-2010, 100 kg/ha	26
Chart 9 Evolution of the Moldovan industry in 2008-2009, y-o-y,%.....	29
Chart 10 Growth of industrial output in CIS countries in Q1-Q3'2009, y-o-y, %.....	30
Chart 11 Growth of industrial output in European countries in August 2009, y-o-y, %.....	31
Chart 12 Evolution of construction works, y-o-y % of the previous period	35
Chart 13 Evolution and forecast of the transported goods and persons, 2006-2009	36

Chart 14 Evolution and forecast of the tourism flows in Moldova, 2006-2009, thousand persons.....	37
Chart 15 Evolution of the retail trade and services rendered to population, y-o-y, %.....	38
Chart 16 Evolution of the employed population in Q1'02-09 and Q2'02-09, thousand people	41
Chart 17 Evolution and forecast of unemployment rate, %.....	41
Chart 18 Evolution of different sources of households' income in Q1' and Q2'09, %.....	43
Chart 19 Structure of households' income (%).....	44
Chart 20 Value of remittances according to BoP and HBS (million USD).....	44
Chart 21 Evolution of money transfers from abroad (%).....	45
Chart 22 Growth rate of the real wage in some sectors in Q1-Q3'09, y-o-y, %.....	46
Chart 23 Collected revenues as % of planned revenues from the taxation of salaries	46
Chart 24 Trends in households' consumption and remittances (by Balance of Payments), y-on-y, %.....	48
Chart 25 Evolution of remittances and natural persons' deposits, y-o-y, %.....	50
Chart 26 Evolution of consumer credit and interest rate for consumer credit	50
Chart 27 Annual inflation rate (%).....	52
Chart 28 Evolution of the monetary aggregate M3 and CPI (M/M-12) and NBM refinancing rate, %.....	55
Chart 29 NBM refinancing rate and average annual CPI index, %.....	56
Chart 30 Evolution of real monetary policy rate, real interest rate and annual growth rate for credits in national currency, %.....	56
Chart 31 Evolution of annual indicators of monetary aggregates, seasonally adjusted, %.....	57
Chart 32 Evolution of the ratio official reserve assets/imports for 3 consecutive months.....	58
Chart 33 Annual indicators of budgetary revenues and expenditures, %.....	60
Chart 34 Budgetary revenues structure, % of total.....	61
Chart 35 Annual growth of direct and indirect taxes, %.....	62
Chart 36 Structure of budgetary expenditures, %.....	62
Chart 37 Evolution of budgetary social and economic expenditures, real terms, mil. MDL	63
Chart 38 Evolution of budgetary deficit and sources of financing Sep'08-Sep'09, MDL million.....	64
Chart 39 Share of non-performing loans and assets in the banking system, %	67
Chart 40 Evolution of the profitability ratio of the banking system, % (Q1-Q3'08 and Q1-Q3'09).....	67
Chart 41 Share of foreign currency loans in total loans in % (Q1-Q3'08 and Q1-Q3'09)	68
Chart 42 Liquidity trends in % (first three quarters of 2009).....	69
Chart 43 Evolution of the interest rates	69
Chart 44 Monthly evolution of Moldovan exports and imports, %, y-o-y.....	71
Chart 45 Geographical distribution of Moldovan exports, Jan-Aug 2008-2009	73
Chart 46 Composition of Moldovan exports, Jan-Aug 2008-2009	73
Chart 47 Oil price (Brent), Jan-Oct 2009, USD/barrel.....	76
Chart 48 . Evolution of main commodity indexes, Jan-Oct, 2009.....	77

List of tables:

Table 1 Productivity indicators for some agricultural products, 2008.....	27
Table 2 Moldova main banking system indicators, Q1-Q3'09, %.....	66

Key policy messages in MEGA#2

With a string of domestic and external crises the year 2009 has clearly shown how fragile and illusory have the economic growth and modernisation been in Moldova in the last decade. The expected GDP decline will get Moldova three years back; capital investments have fallen at path not seen since early 1990s; economic confidence is at historical lows, while the public finance has been fundamentally undermined. Although global financial crisis has its part of blame, Moldova is also a victim of the blundering political irresponsibility.

The Governmental change in September 2009 brings new hopes, but it should be clear that these expectations should not be overblown. Although the reshuffle of the ministers was necessary it is not sufficient to change the modus operandi of the ministries. The administrative system is subject to its own logic and inertia. The real challenge for the new Government will be to push forward a new logical framework under which policy is being developed and implemented. Political uncertainty and difficult negotiations within the governing coalition compounds this task still more.

New Governmental program emphasizes the idea of economic competitiveness and attractiveness. Moreover, the Government is very well position to start an ambitious set of reforms since many of its members have an extensive business experience. Republic of Moldova is poised to remain a small and open economy for the foreseeable future, save some dramatic shifts in the regional geopolitical landscape. Therefore, in order to thrive in good times and weather out better the bad ones, Moldovan economy should be competitive abroad and attractive inside. For this purpose, the new Government should forcefully push forward a comprehensive institutional reform agenda. The barriers for business development should be dismantled, while public administration trimmed and modernized. We believe that this Government should aim at establishing the best business environment in Central and Eastern Europe. There is a lot of good international experience to learn from in this respect. Such a task is ambitious but feasible provided that the Government remains politically stable and accountable.

This reform process should pave the wave for negotiation of the new political agreement with EU as well as starting the talks on conclusion of Deep and Comprehensive Free Trade Agreement between EU and Moldova. For the new Government the consistency should become the key word; it was missing from the activity of the previous government and this very fact made the promises of reforms, both in and out of Moldova, sound empty. Thus, the new Government has to show that it is different both to external and local partners (business, civil society, general public).

The new Government should also strategically approach impacts the global markets have on economic and social development in Moldova. As a net commodity importer Moldova should rationalize its dependencies through becoming more efficient user of those. At the same time opportunities emerging from new development trends should be carefully analyzed with respect to country's ability to benefit from them. In this context, the policy action should aim at making domestic economy to be among the first to benefit from such "flashes" of things to come.

S u m m a r y

Economic governance

The previous Government has, to put it simply, mismanaged the impact of the global financial crisis. Guided only by its narrow electoral interests, the previous Government postponed a number of vital reforms and necessary adjustments to the public budget. Because of this, the new Government will have to demonstrate double efficiency when dealing with the consequences of the crisis in 2009 and beyond. Among the first actions undertaken by the current Government was the development of the Program for Economic Stabilization and Revival of the Republic of Moldova for 2009-2011. The document expresses a clear analysis of the economic situation and is focused on three priorities: public finance stabilization, resumption of economic growth and ensuring an efficient and fair social protection. Gathering the necessary resources for its implementation is the real problem yet to be solved. Agreeing on a preliminary memorandum with the IMF with quite advantageous conditions has been a real success for the Government as it paves the way for additional and more targeted support from other donors. But it has to be clear that no money will be transferred to Moldova before the domestic political instability is settled. The key challenge for the Government is to ensure an efficient use (read investment) of the external resources that agreement with IMF can unlock rather than to use them for current expenditures. Unfortunately, temptations can be high unless political crisis is overcome and the current Government has a clear long-term mandate and political support for action.

GDP decline

Although Moldova has not been the most severely hit country in the region by the global economic crisis with a decline of 7.8% in the first semester 2009, the real impact was much stronger taking into consideration the potential growth if no crisis had occurred. Because of the crisis, the real (as opposed to the visible) GDP decline from the forecasted potential GDP is 15.1% in the first semester. The main drivers of decline are decreasing consumption that reacted already in 2008 to the global evolutions; decreasing capital investments due to the economic, but also political crisis in Moldova that affected the most foreign investments; and decrease in foreign demand that resulted in a severe industrial recession which had the most major contribution to the GDP decline as compared with other production sectors. As these trends will not change by the end of the year we expect an economic decline between 8 and 11% in 2009 and a slight recovery of up to 1% in 2010. However it will not be an immediate reaction to the recovery of Moldovan trade partners as the contracts between many partner-companies have been voided and many companies in Moldova have been or are being liquidated. Thus, the major role of the Government in reaching economic growth will be to support consumption, among others through decreasing artificially high prices resulted from anti-market arrangements, and to increase the country's attractiveness after the too long period of political instability.

Agriculture

The crops output in 2009 will decline by about 18-19% while livestock production is likely to put an 8% growth. Neither the first one nor the second indicators are anything of special. Crops production declined so much after a spectacular growth in 2008, while the livestock is only recovering from the 2007 drought blow. We expect a rather bleak growth of the agricultural output of 1.7-2.5% for 2010. Small quantities of harvested cereals are the main reason of falling agricultural production, which was to some extent moderated by improved yields of some high-value crops (vegetables, fruits, grapes). Falling prices has been the main concern for the farmers, even though it should be added that to some extent farmers are victims of their own price myopia and lack of investment coordination. Improved quality of cereals has not compensated enough the quantitative losses. Meat producers have been fortunate in 2009 by stable or even increasing prices, but this has not been the case of milk producers, with the prices collapsing by 1/3 in some instances. New Government has completely changed the agricultural policy philosophy by abandoning “land consolidation” mantra and adopting more relevant goals of enhancing sector’s competitiveness and making full use of country’s agricultural resources. However, we believe that a key precondition for the new policy implementation is a radical institutional restructuring of the Ministry of Agriculture and Food Industry which in past 7-8 years has acted as an agency implementing political orders from the Presidency rather than designing meaningful policy. The reformed Ministry will have to put a lot of resources to ensure adequate training of the farmers in order to reduce the yields volatility. It will also have to contribute to reducing price volatility by market interventions, price forecasts and other tools, but here clearly the producers associations will have a bigger role in horizontal coordination.

Industry and infrastructure

Moldovan industrial sector entered the year 2009 already being shackled by a series of shocks. With some positive yet rather feeble signs of emerging in October-November, we believe that the most optimistic scenario for 2009 is a 20% decline in industrial output and this will be one the deepest decline of industrial production in Europe and CIS. For 2010 we expect a positive 5-6% growth, not enough to speak even of a recovery. Change in government has brought also some changes in industrial policy rhetoric and practice. The new Government puts more emphasis on technological competitiveness of the Moldovan companies and on more competent human resources and managers. The issue of quality of corporate management in industrial sector is a special one. As Doing Business 2010 prove, the legislation in Moldova does not held executive directors responsible to their shareholders, be they private or public, which results in extreme managerial inefficiency and assets funnelling. The dramatic involution of the Moldovan industrial sector is ultimately explained by the managers’ incapacity in adapting their companies to new market realities posed by the crisis and their exaggerate expectations regarding state support. As preliminary financial results for 2009 show, state-owned enterprises have been particularly inefficient during the crisis. For the state-owned property to be efficiently used in the economy, it is highly necessary that the Government either adopts more severe standards of management of state owned enterprises or restructures/privatizes these companies. Another issue of real concern is inefficiency of market regulatory agencies. Many of them have been prisoners of political or vested interests in the last years. As the Ministry of Economy is not able to “pilot” indefinitely long economic sectors, it is necessary that these agencies are effectively empowered and trusted by the Government and better controlled by the Parliament.

Investments and constructions

In 2009 the capital investment has collapsed by 45% as compared with 2008. Such rates of investment decline can be found only in Moldovan statistical yearbooks of the turbulent early 1990s. Financial crisis has certainly had the main contribution to this, but many companies were also frightened by the political violence in April and subsequent political turmoil. The foreign direct investment shrunk around 9-fold in the first half of 2009. As for the domestic investment, it ultimately has contracted because of the high interest rates for the long-term banking loans, shallow domestic capital market and lack of companies' own financial resources; and all these combined with general economic pessimism. The 40% contraction of the construction-assembly works – representing more than half of total capital during the last years – has been the main structural factor of the investment decline. At first sight, with the real estate market overblown in the recent years, such a contraction would not be seen as anything more than a necessary cold shower. However, the real risk is related to the fact that the domestic banks have buried a lot of money in the constructions sector (15% of total loans) and presently this market is in a systemic crisis. Falling real estate prices serves as a rude awakening for construction companies, developers and banks.

Services

Services sector has proven to be the most resilient under the current economic recession. Even though the current year began with a significant contraction of many services sub-sectors, in the second part of the year the situation improved. After a moderate decline of 2-3% that is likely to be registered in 2009, we expect that in 2010 volume of services will rise 3%. In 2009 the transport sector has been the most heavily hit by the global financial crisis, with freighted goods contracting 3 times in a only couple of months. Positive development in the tourism sector came as a positive surprise, and despite the crisis Moldovans continued to prefer Turkish, Bulgarian and Romanian resorts to the domestic ones. This is a positive sign in the context of the on-going financial crisis; another one is the rising volume of services rendered to population. However for the consumers to buy more services it is imperative to ensure a fair, market-set, level of prices and a good protection of consumers' rights. The new Government's business-friendly tone has not been matched by a similar attitude regarding the consumers' rights. As EU practices suggest, an Agency for Consumers Protection is just as important as the Agency for Competition Promotion.

Labour market

The global financial crisis has exerted a significant impact on domestic labour market in Moldova. Diminishing demand resulted in a reduced supplied of goods and services and therefore in worsening of the labourers' situation. While the reported average wage has increased by 7-8% in real times in 2009, this does not reflect an improved situation of the employees, because of rising wage arrears and decreasing employment. According to our estimates in 2009 about 80 thousand of the people lost their jobs because of the crisis. Employment rate has reached record low levels of 39%, which is seems be the lowest in the region. It is also historically the lowest level ever achieved in Moldova in the last 20 years. Worsening pessimism is reflected also by the growing number of discouraged people, i.e. those that do not even look for jobs because they are afraid will not find in any case. Under normal conditions, we should expect about 8-9 thousand people per year to enter this category; because of the crisis their number is likely to exceed 25 thousand in 2009. The global financial crisis has also taken many Moldovan migrants back to Moldova where jobs are missing as well; this inflow of human resource only worsens even more the difficult situation on the domestic labour market. We have seen this inflow in the first quarter of the year, but afterwards people this effect was not so visible: people came back home, did not find any jobs and get back abroad, eventually with changed destination country.

Households' income

The overall income of the population has decreased in 2009, with a deeper decline in the second quarter: 2% compared to 0.2% in the first quarter. However, different sources of income followed different paths. Remittances has decline the most, with a huge difference in data reported in Balance of Payments and in Household Budget Survey, not only in values but also in trends. This reflects the problem of reporting of remittances in the Balance of Payments, where also investments and payments for goods and service provided from Moldova are included, which actually decreased prior to the decrease in real remittances used by households for consumption. Also, despite the increase in the average wage reported by the NBS, household real revenues from salaries have decreased. The budgetary revenues collected from taxation of salaries decreased and are much lower than in the previous period, denoting the delays in the wage payments and/or the forced unpaid leaves. Only social payments have increased, mainly due to the increase in pensions in the beginning of April in the context of upcoming elections. As the recovery of most of the countries is expected in 2010 a slight increase in remittance of about 5% may be also expected. At the same time, the wages will remain stable except the wages of the teaching staff in the budgetary sector and in the service and industrial sectors where salaries are strongly correlated with the labour productivity.

Households' consumption and savings

Consumption was the first macroeconomic indicator testifying the presence of the economic crisis in Moldova. It has decreased even before the decrease in remittance and other incomes of the population, and this was shortly after the first signs of global economic crisis emerged in September 2008. This proves that, as opposed to the previous Government, population was aware of the upcoming crisis and expected a decrease in income. Mirroring the consumers' frugality, population savings in form of deposits in the commercial banks continued to increase until April 2009 despite the decrease in remittances. Since April the rate of growth has decreased significantly and the bankruptcy of a Moldovan commercial bank in June 2009 made population more cautious in storing up money in banks for a while. However, already in August, a slight increase in deposits of natural persons there was registered again. Still, decreasing consumption and significant negative growth rates for retail trade and of services provided to the population in October, despite the second year of crisis point to a decrease in consumption of over 10% by the end of the year. As consumption is one of the main elements of GDP it is very important to support it by fiscal measures that the Government avoided so far (a decrease of VAT for some goods and services, such as deduction from taxes of investments in durable goods of natural persons).

Prices

After many years of high inflation for the first time since independence Moldova has registered a significant -2.3% annual deflation in January-August 2009. However, in September the deflation trend reversed and the next two months Moldova registered high rates of monthly inflation. The new price surge was determined the growing production costs as revealed by the Industrial Prices Index that has been growing since March. Also, reversal of deflation trend in most of the European countries made the imported goods more expensive again. An administrative increase in tariffs for transport services and some utilities in Chisinau in October fuelled the inflation spike. 2009 will probably end with an annual inflation between 0% and 1%. For 2010 our expectations are more negative, with an end-year annual inflation of 4-5% to come as result of increased oil prices and economic recovery.

Monetary policy

Since September 2008 the central bank's monetary policy became more focused on stimulation the economic growth. However, despite the central bank's attempts to lose its monetary policy, the gap between its policy rate and annual inflation increased. Surprisingly, the deflation undermined the efficiency of the monetary policy, leading to a decrease in economy monetization and credits volume offered by commercial banks. Following the same objective, stimulation of the economic growth, the central bank started to rely more intensively on liquidity providing operations and since April 2009 sterilisation operations have not been used any more. Two monetary policy instruments were used in this direction: REPO operations and direct loans to commercial banks. The depreciation of national currency since beginning of 2009 was caused both by objective factors (decrease in foreign currency inflows as a result of the decrease in exports, remittances and FDIs), as well as by downwards anticipations of investors. Increased demand for foreign currency made the central bank to conduct massive interventions on the foreign exchange market in order to prevent the national currency from a steep depreciation.

Budgetary and fiscal policy

The public budget in Moldova felt the first crisis repercussions of the global crisis back in October 2008, when the annual indicators of budgetary revenues registered a sluggish decline. A sharper deterioration of the budgetary position followed in 2009. As indirect taxes form the main source of budgetary revenues, the decrease in domestic consumption and, respectively, in imports represented the main cause of budgetary contraction. Besides the economic constraints affecting the state budget, the Governmental electoral myopia served as another major factor which deepened the budgetary deficit. It led to a critical situation which made the previous and current Government to rely intensively on internal borrowings by issuing state treasury bills. Due to the fact that the maturities of these loans are short, such form of financing can be used only for covering some temporary cash deficits. The current budgetary deficit determines the necessity for an austere budgetary policy which will be promoted until the end of the current year and during 2010 and even beyond. A major policy challenge will be therefore to ensure a synergy between the tight budgetary policy and economic growth.

Financial sector

In 2009 all financial markets- including capital and insurance markets - have suffered because of the global financial crisis. However, main concerns are related to the evolution of the commercial banks which form the main pillar of the domestic financial system. Even though domestic commercial banks were not highly entrenched in loans agreement with Western financial institutions, Moldovan banks have suffered because of the declining inflows of currency from migrants, investors and exporters. They have been also victims of lower public trust, and the ordered liquidation of a commercial bank has only added to the public anxiety.

Foreign trade

The global financial meltdown had some serious impacts on the Moldovan foreign trade in 2009, as both exports and imports dramatically fell in the aftermath of the crisis. This fall underscored the high degree of exposure of domestic economy to the external risks, magnified by the lack of an adequate response on the policy level. These dramatic effects, however, did not change the course Moldovan exports were following: their drift towards EU market continued. This re-orientation occurred at the surprising background of slumping Russia at the top of destinations for Moldovan exports. The oft-cited culprit is political animosity ensued in the wake of the April elections; although, an attentive glance at the structure of Moldovan exports to Romania might

offer more sound explanation. The imports spiralled downwards as well, as both consumers and companies started scaling back their expenses. Besides the newly found frugality of consumers, the cheapening petrol imports also added to the overall decline in imports.

Global markets

After the steep decline in the end of 2008 and the beginning of 2009, main commodities found themselves on a firmer ground further in the year. Starting March-February, oil, metals and food commodities set on the rebound of different degrees. The rebound was helped by significant monetary stimuli applied by the governments of leading economies as well as by some supply-side policies of commodity producers, as in the case of OPEC or big western metal producers. If the current economic recovery does not prove a false dawn the global economy is set for a lasting rebound in commodity prices that might aim at reaching again the peaks of 2008. The more expensive commodities do not bode well for Moldovan economy as these inputs will most probably translate into more expensive and less competitive end-products.

1. Economic governance

This chapter discusses the main reforms included in the new Government's agenda, and evaluates its crisis management program. It also includes a brief analysis on Moldova's evolution in the World Bank's Ease of Doing Business rating, highlighting the main positive and negative trends in the business climate. The 2009 year has brought about a new beginning in Moldova's relations with IMF, which is also described in this chapter. Finally, the chapter states our anticipation regarding the 2010 year and the main economic challenges for this period.

Analysis of the key aspects of the governmental program

Since mid 2008 the economic governance in Moldova was influenced by three types of constraints:

- ❑ **Electoral constraints**, which made the Government to postpone some painful reforms and to emphasize its populist stance in order to gain more political dividends for the April 2009 elections;
- ❑ **Economic constraints**, which undermined the Government's financial ability to sustain its promises made before April 2009 elections; and
- ❑ **Political constraints**, which affected the Government's institutional capacity to implement the necessary reforms aimed at mitigating the economic crisis effects.

A number of economic and political constraints continue to influence the activity of the new Government sworn in on 25 of September 2009. The new governmental agenda (its title is "European Integration: Freedom, Democracy and Wellbeing") includes many of the reforms started by the previous Government; however it contains also conceptually new approaches to their implementation. Additionally it emphasizes the administrative decentralization reform which was not considered as a real priority by the previous Government. The main barriers impeding this reform are the low financial autonomy of the local governments and the poor quality of local institutions. Therefore, the administrative decentralization reform should be part of a bigger package including fiscal decentralization reform, local public administration reform and a territorial-administrative rationalization of the country.

The Governmental program also identifies the social assistance and social insurance reform among its main priorities. The actions planned in this respect do not differ conceptually from those in the previous Government's agenda. For instance, both refer to the necessity to switch the social protection system from nominative compensations to means-tested system. A fundamental challenge related to the social insurance system is that the current public pensions system is financially not sustainable. The new Government, as the previous one, plans to reform the public pillar of the pension system (PAYG), by unifying the pensions system, eliminating unwarranted benefits for some categories of employees and developing a multi-pillar pensions system. The new Government seems to be more determined than the previous one to introduce the 2nd mandatory pillar in the pension system. However, the current Government may commit the same mistake as the previous one: it is inclined to increase the replacement rate while maintaining the current pensions' indexation procedure (with pensions indexation coefficient calculated as average of the Consumer Price Index and the growth rate of the average wage). In such circumstances, the replacement rate will continue to decrease since the wage growth rate, usually, exceeds the inflation level which, by default, makes the pensions growing slower than the wages. Thus, a

sustainable increase in replacement rate can be achieved only after a reformation of the actual PAYG system and the development of the multi-pillar pensions system.

The new Government is very well positioned to start more aggressively elimination of bureaucratic barriers for companies and to ensure fair competition on the market. In this respect, the Governmental program stresses the importance of diminishing the number of economic activities subject to licensing, elimination of foreign trade restrictions and other administrative barriers. It also includes the Government's commitment to diminish the state's abusive intervention in the activity of enterprises. A distinct priority is promise of supporting the development of Small and Medium Enterprises which conveys a positive message to the country's business community.

From anti-crisis mismanagement to post-crisis management

As of end of September 2009 the industrial production index registered 75.9% in comparison with the previous year, fixed capital investments – 57.5%, while those financed from foreign resources – 35.5%, construction works – 63.6%, volume of goods transported – 40.8%. Additionally, in the first semester 2009 the GDP dropped by 7.8% and the budgetary deficit increased to 7.2% of GDP. The dramatic economic situation that these indicators reveal is not just an effect of the world economic crisis, but also a result of the lack of any anti-crisis management from the part of the previous Government. Its reluctance to undertake unpopular anti-crisis measures was determined by electoral objectives. At this stage, lack of anti-crisis management program on behalf of the previous Government should be compensated by a more efficient post-crisis management program on behalf of the current one.

Developing a Program for Economic Stabilization and Revival of the Republic of Moldova for 2009-2011 has been among the first actions undertaken by the current Government. The Program is based on three fundamental priorities: public finance stabilization, consolidation of economic activity and promoting an efficient and fair social protection system. It contains a series of unpopular measures requiring an austere budgetary policy to be promoted by the Government in the next 2-3 years.

The most painful measures aimed at stabilization of public finances are focused on diversification of public revenues financing sources (with increases in excises for some goods, such as luxury cars, tobacco, cosmetics, alcoholic beverages, and fuels) and decrease in non-priority public expenditures with the purpose to decrease the budgetary deficit. Among these there is the optimization of the number of public servants in central public authorities, elimination of unfulfilled vacancies from public institutions, increase in the dormitory accommodation fees paid by students, elimination of many facilities for distinct categories of employees (especially those in police, customs, and military).

These unpopular actions are somewhat counterbalanced by more popular reforms, such as the liberalization of export and import operations for economic agents, elimination of many bureaucratic barriers in obtaining licenses and permits, decrease or elimination the VAT for construction services, facilitation of the access to crediting resources, reduction of state controls on economic activity, simplification of the fiscal reporting procedures and many others.

Generally, the current Government's post-crisis management is liberal in its approach, but at the same time it promotes orientation of more public resources from social to economic areas. Its assumption is that the consolidation of the positive economic growth will be mainly based on stimulation of aggregate supply, rather than aggregate demand. This new approach to crisis management is determined by increasing budgetary constraints and inefficient social protection policy. These constraints have made the current Government's to rely more on external financing sources. Thus, a part of the budgetary deficit is planned to be financed from an IMF credit, while most of the infrastructural projects are supposed to be financed with the foreign creditors' and donors' support.

However, there are two weak aspects of this program that have to be further worked:

1) Unclear sources of financing. The Government announced that the overall cost of this program is 10 billion MDL. It is clear that these funds will be not possible to be channelled from domestic resources. For this reason, the Government will have to be very persuasive during its forthcoming meeting with international donors (scheduled to take place in Brussels in early 2010).

2) Lack of an action plan and of a clear division of responsibilities among relevant public authorities. The program does neither specify who will be responsible for the implementation of its measures, nor how will they be implemented. As a result, it is not clear how some of the most costly measures will be achieved (e.g. stimulation of mortgage crediting, governmental acquisition of unfinished real estate).

Dialogue with IMF

Because of the deep crisis impact, in the next 2-3 years external economic support will play a fundamental role for the economic, social and even political stabilization of Moldova. Therefore, consolidation of the relations with IMF, World Bank and European financing organizations should be a priority for the recently invested Government.

In October 2009 Moldova has agreed with the IFM on a new policy memorandum. The importance of the new memorandum was determined more by the necessity to finance the budgetary deficit rather than by consolidation of the Central Bank's official reserve assets (which is the usual destination of IMF funds). Additionally, the memorandum with IMF is important because it enhances Moldova's credibility for other Western and Eastern potential investors, creditors and donors which may provide funds for many infrastructural projects.

The Moldovan Government entered the negotiations with IMF facing a series of major constraints as revealed, foremost, by the increasing budgetary deficit spiking from 1% of GDP at the end of 2008 to 7.4% in the first semester of 2009, whereas for the IMF the maximum acceptable limit is 3%. These constraints generated negative expectations in the civil society, fuelled by political declarations of some representatives of the previous Government, related to the conditions they asserted the IMF would insist on to be incorporated in the new memorandum (increase in VAT, depreciation of national currency, cut in wages and pensions etc).

However, the new Government proved to be quite efficient in negotiations with IMF and, as a result, a preliminary agreement regarding a new financing program was reached for a period of three years (2010-2012). The total credit amount will range between USD 580-600 million, however the final decision will be made in January, 2010. Part of the credit will be based on the Extended Credit Facility (ECF), with an annual interest rate of 0.25% and another part is based on Stand-by Arrangement (SBA) which implies a higher interest rate, depending on the IMF policy rate. The credit duration for ECF is 10 years, while for SBA - 5 years. With IMF not insisting on tough conditionalities and committed to disburse an additional allocation of USD 180 million until the end of the current year for financing the budgetary deficit, the deal with IMF can be considered as an important success for Moldova. The next tranches will be disbursed provided that the Moldovan Government maintains the budget deficit below 9% for 2009 and decreases it to 5% in 2010 and 3% in 2011. It is clear as well that if the political instability spirals up, no funds will be disbursed from any creditor or donor.

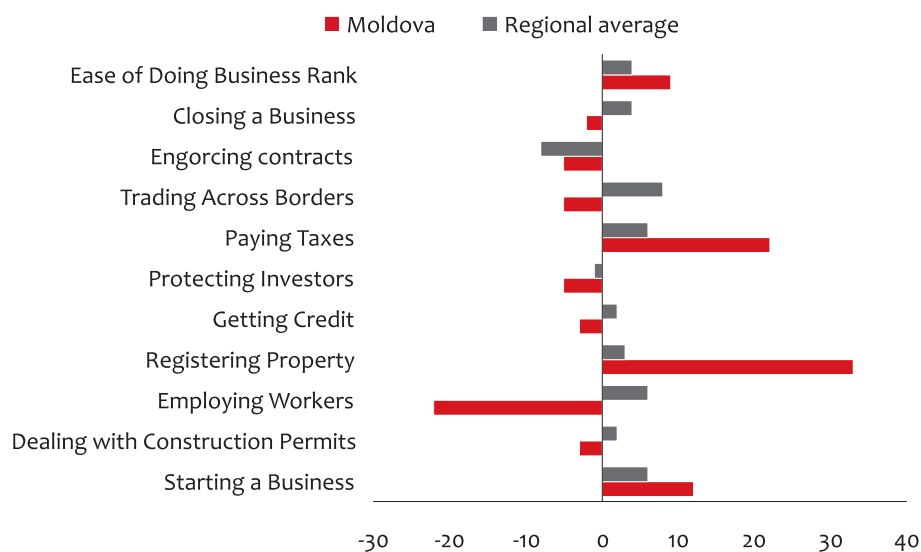
In any case, the Government will have to gather more domestic resources, and in this respect a number of excises are set to increase in 2010: excises for fuels by 7.5%, tobacco – 10%, luxury cars – 20%, alcoholic beverages – 4%, cosmetics – 15%. Also, it has to continue optimizing the public service, including decreasing the number of staff positions by 4000 units. The Government managed to avoid politically unacceptable conditions, related to the increase in VAT, decrease in pensions and wages for public workers and reintroduction of the corporate income tax in 2010. However, we believe that some necessary measures cannot be postponed for long, such as increase in pensions' age and setting a fairer income tax for corporate and personal income.

Learning from Doing Business 2010

The World Bank report “Doing Business 2010” published in September 2009 revealed an important progress that Moldova achieved: it advanced from 103rd place in 2008 to 94th place in 2009 in the ranking of 183 countries. This has narrowed somewhat the gap between Moldova and the regional average¹ that has increased only 4 positions, from 76 to 72. As shown in Chart 1, Moldova scored the most significant progresses in registering property (from 50th place in 2008 to 17th in 2009), mainly due to the reduction of the time necessary to perform the procedures (from 48 days to 5 days) as result of the State Land Register reform. Another positive change is related to paying taxes (from 123rd to 101st), due to reduction of the number of procedures and time necessary for fiscal administration, as well as due to the lessening fiscal pressure. Additionally, Moldova went up 12 positions in starting a business, due to the decrease in duration of necessary procedures (from 15 days to 10 days), their number and costs. These positive evolutions were determined mainly by the (partial) implementation of the second phase of “guillotine” regulatory reform.

At the same time a significant regress was registered in employing workers (from 119 in 2008 to 141 in 2010), dealing with construction permits (from 158 to 161), trading across borders (from 135 to 140), protecting investors (from 104 to 109), closing the business (from 88 to 90), getting credit (from 84 to 87) and enforcing contracts (from 17 to 22). These evolutions reveal the chronic institutional problems affecting Moldova’s business climate: corruption, excessive bureaucratization, and high cost of capital, which should be of priority for the current Government.

Chart 1 Changes in the Doing Business rating 2010/2009 for Moldova and for the region, positions in the rating



Source: www.doingbusiness.org

¹We define this region as composed of Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Estonia, Georgia, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lithuania, Macedonia FYR, Moldova, Montenegro, Poland, Romania, Russian Federation, Serbia, Slovenia, Tajikistan, Turkey, Ukraine, and Uzbekistan.

Outlook for 2010

- ❑ The year 2010 is likely to mark the end of the economic recession in Moldova and to come with a nil-to-moderately positive economic growth. However, this will directly depend on the political situation in the country and the ability of the current Government to implement its post-crisis management program.
- ❑ Despite the planned increase in excises for alcohol, tobacco, luxury cars, perfumes and other products, this measure will not have dramatic effects on the internal demand. First of all, these products have low price elasticity and their consumption will not go down significantly. Secondly, the main factor affecting the domestic demand during the current economic crisis is remittances. We believe that the increase in excises should have been accompanied by a reduction in VAT for selected products which would stimulate households' consumption – the key for resumption of the economic growth in Moldova in short term.
- ❑ In 2009 the Moldovan economy has been hit not only by financial crisis but also by the domestic political turmoil. Political stabilization and more friendly business environment are necessary to unblock many investment projects postponed for the reasons of political uncertainty. In this respect, the improvement of relations with Romania is very positive sign coming at the right time. Despite economic difficulties that the two countries face, this will significantly strengthen their investment and trade relations in 2010.
- ❑ We expect that a number of amendments and new laws will be adopted in 2010 to reduce the bureaucratic pressure on the constructions sector. This will make the activity in this sector more profitable, but also it will improve significantly Moldova's position in the international business and competitiveness ratings. This is important not only as formal prestige, but also as important public communication tool to attract more international investors and transnational companies in Moldova.

Challenges ahead

- ❑ The more austere budgetary policy in 2010 bears the risk of social exclusion of some vulnerable segments of the population. In order to avoid this, **the social protection reform should be finished as soon as possible**, so that it gets better targeted and less cumbersome for the state budget. So far, we have not seen a clear exit strategy from the previous system.
- ❑ Given the Government's commitment to cut 4000 units of public servants, this politically painful measure can be easier accepted and understood socially if accompanied by a decrease in bureaucratization and improvement in public services supplied. Therefore, **this reform must be implemented in line with the public service reform. Also, further implementation of regulatory reform should remain a priority for the Government**, to ensure an efficient relocation of redundant human resources from the public to the private sector.
- ❑ Because the next IMF tranches will be based on the more severe SBA terms, **the Government has to ensure the budgetary deficit and other macroeconomic indicators within the limits agreed with IMF**. Keeping the budget deficit in 2010 below 5% without further optimization in public sectors (education and health) seems very problematic.
- ❑ The agreed memorandum with IMF opens to Moldova many opportunities regarding the attraction of foreign assistance for many infrastructural projects. Even though the Government is short of money for current expenditures (for paying wages, utilities and others) **it is important that money coming from external donors is invested in projects with maximum economic effect in long-run and not consumed**. We believe that capital repair of national roads can render the maximal benefit for the economy in long-term.

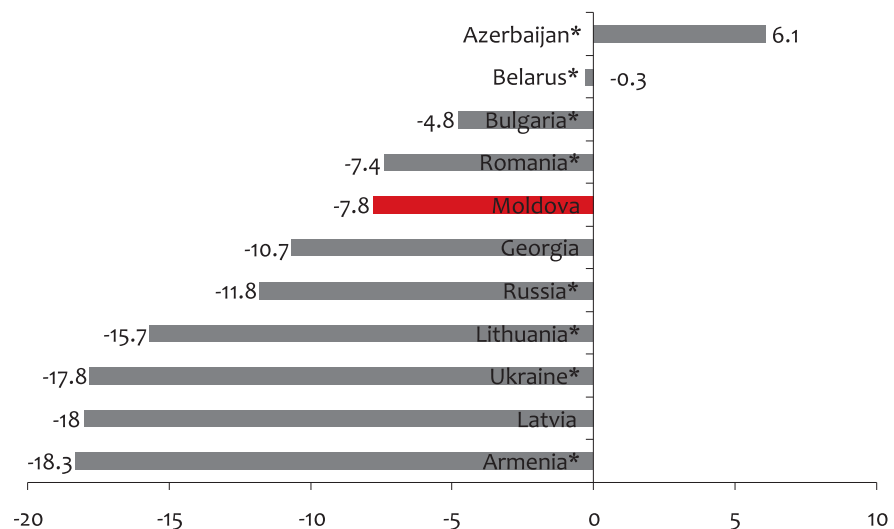
2. Gross Domestic Product

This chapter analyzes the GDP evolution over the first two quarters of 2009, not only compared to the same periods of 2008, but also to the potential GDP forecasted using a SARIMA dynamic model. The sources of GDP decline both by expenditures and production sectors are identified in detail. The chapter finalizes with a basic forecast regarding the evolution and structure of GDP in 2009 and 2010.

Visible versus real decline of the GDP

The decrease in domestic and foreign demand has had a tremendous effect on the Moldovan GDP, which has declined in the first semester of 2009 by 7.8%. Although the decline was lower than in many of the countries in the region (Chart 2), it has affected all categories of economic agents through all possible channels. Moreover, the 7.8% decline in the first semester does not reflect the real losses that Moldovan economy has suffered and the overall impact of the global crisis. This is explained by the fact that, if no crisis had occurred, the GDP would have continued to grow strongly in 2009. I.e. the 7.8% GDP decline is only the visible not the entire effect of the financial crisis.

Chart 2 GDP decline in some countries of the region in Q1-Q2'2009, %, y-o-y

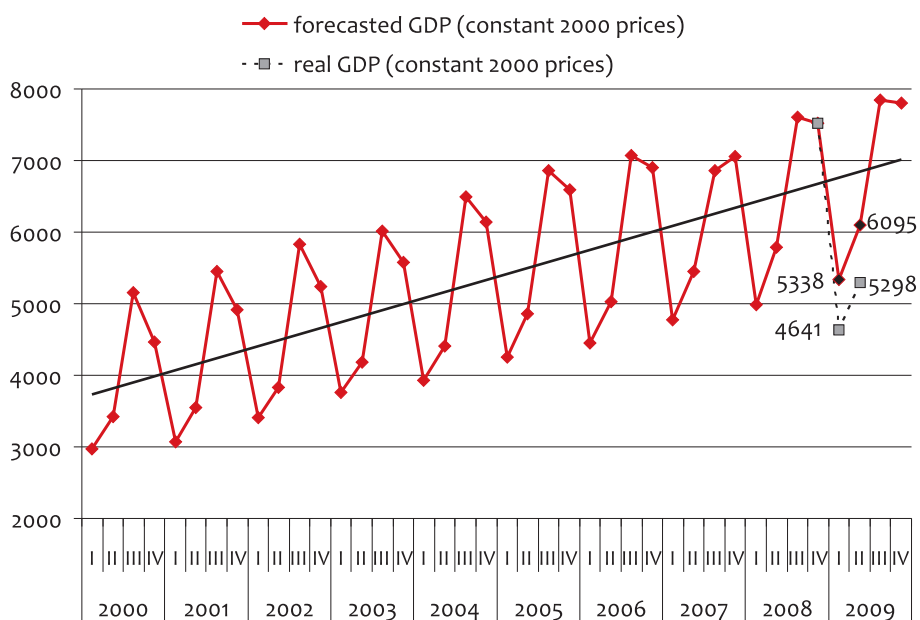


Note: *Q1-Q3'2009/Q1-Q3'2008;
Source: National bureaus of statistics;

In order to assess the real decline of the GDP we have forecasted the potential GDP in 2009 using a dynamic model (SARIMA) that decomposes dynamic series in three components: the trend, seasonality and random factor. Combining these three factors we can get the potential GDP that would have been registered in “ordinary” conditions. According to the model, the real GDP decline was much higher – 15.1% - both in the first and second quarter, compared to the values

of 6.9% and 8.6% on yearly base (Chart 3). Therefore, even after the resumption the economic growth, which most probably will take place in 2011, the Moldovan GDP will be much lower than its potential.

Chart 3 GDP evolution and forecast for 2009 (thou. MDL)



Source: EG calculations based on NBS national accounts data;

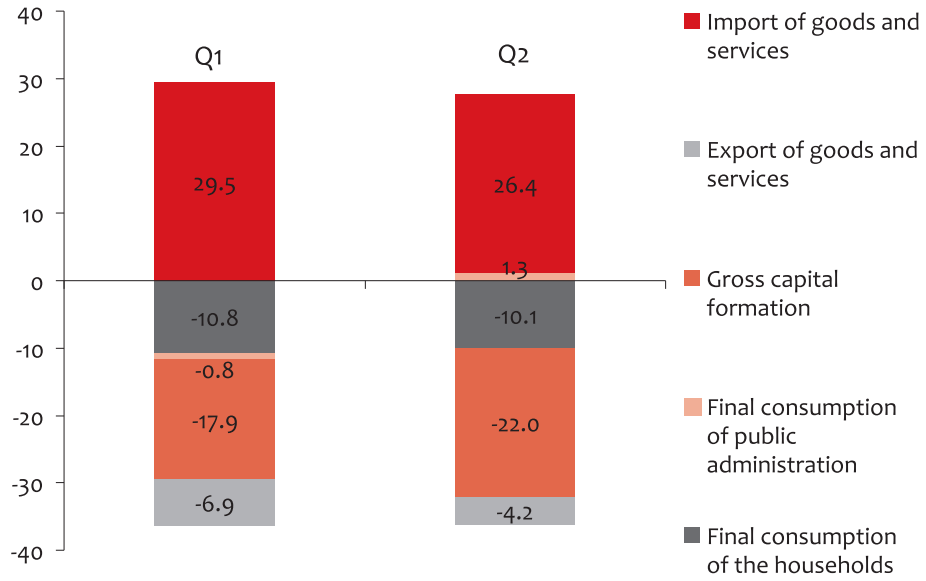
Sources of GDP decline by expenditure and production sectors

After a 4-year long period of significant growth in investment, a 59% decrease of gross capital formation contributed with 20.2% to the decline of Moldova's GDP in the first semester of 2009. In the second quarter impact was even bigger (Chart 4). This dramatic fall in investment is the consequence of the global crisis that had mostly influenced the decrease of FDI, but also the result of political instability that had scared both domestic and foreign investors. The fall in FDI inflows was more than impressive: on annual basis they declined 6 times in the first quarter and 14 times in the second quarter.

Final households' consumption also had a major contribution to the economic decline due to its high share in GDP. An interesting fact is that households' consumption started decreasing before the income started, and even before the fall in remittances which in Moldova are highly correlated with consumption. This evolution was determined by the public's awareness of the crisis and by its increasing propensity for savings, as it is explained in more details in Chapter 8.

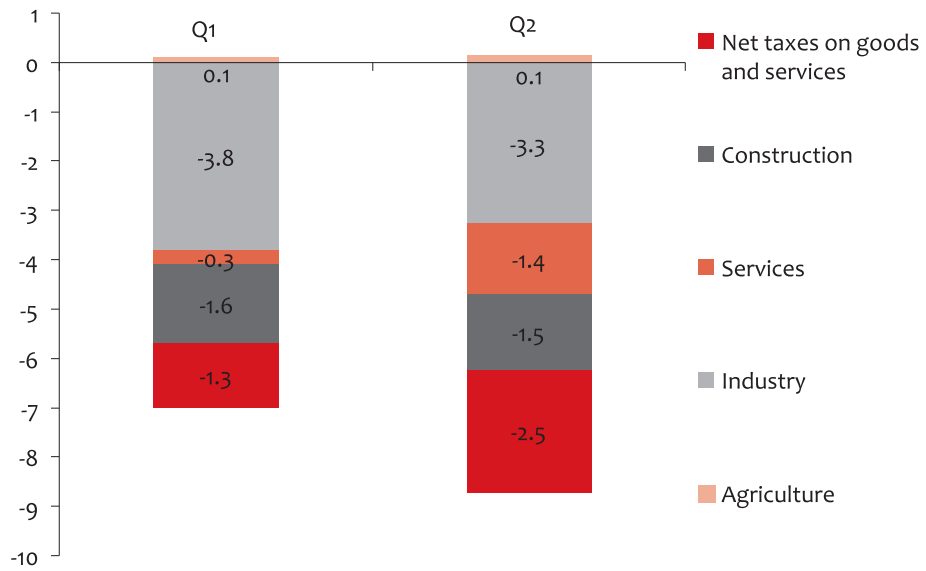
As for the evolution of the GDP by production sectors, almost all of them contributed to the economy's decline (Chart 5). In the agriculture the gross value added (GVA) has increased, but with almost negligible effect on the GDP growth and the positive growth turned to negative in the third quarter 2009. All other sectors had contributed negatively to the economic growth, with the most significant impact coming from the industrial sector that suffered from reduced demand both domestic, but especially foreign. GVA in service sector decreased the least; however, with worsening trend over the second quarter.

Chart 4 GDP growth by expenditures in Q1 and Q2'2009 (% y-o-y)



Source: EG calculations based on NBS national accounts data

Chart 5 GDP growth by production sectors in Q1 and Q2'2009, % y-o-y



Source: EG calculations based on National Accounts data

Outlook for 2009 and 2010

- Based on the forecasts of expenditure and production components of the GDP (see chapters 3-9) for the end of 2009, we expect a GDP decline of 8-11% for the current year, which is in line with the IMF forecast of 9% decline¹ and with our previous economic forecasts indicating a decline between 6% and 12%². In 2010, due to the expected recovery of the main trade partners of the Republic of Moldova and also of the countries where most of Moldovan migrants work, we forecast a moderate economic growth of about 1%.
- Due to the higher impact of crisis on industrial and service sectors, the structure of GDP will slightly change, with an increase of agricultural sector share to about 9-10%, despite the overall decline of the agricultural sector. However, it is not expected that this will be a long term evolution and already in 2010 its share will decline again, mainly due to the expected growth in service sector and low growth of the agricultural sector.
- Capital investments have already decreased by 40% in nine months of the year and most probably this rate of decline will persist by the end of the year. It is difficult to assess the evolutions for 2010 as they will depend not only on the economic recovery and a possible increase in FDI, but also on the political situation in the Republic of Moldova. However, a slight increase in investments, both domestic and foreign is expected in 2010.

Challenges ahead

- As final consumption forms the main share of Moldovan GDP, even a slight variation in consumption will have a sizable impact on the economic growth. Due to the decrease of households' income in 2009, which will continue to the end of the year, but also because of the general concerns of the population regarding future economic developments, the propensity to consume is decreasing, while propensity to save is strengthening. Therefore, without Governmental intervention, we do not expect a significant increase in consumption in short term. One of the main roles of the Government should be the stimulation of consumption, which consequently will influence domestic production and imports. So far the Government has avoided the **decrease in VAT for some goods and services (constructions, computers) as an instrument of consumption stimulation**. However, we believe that this is an important measure that should be taken into consideration as it can increase consumption, without a negative impact on the budgetary revenues.
- Another important source of GDP decline is the investments collapse. Although the economic recovery should theoretically contribute to the increase in investments in 2010, **the Government of Moldova should take more efforts to improve the image of the Republic of Moldova on the international arena and increase the investors' confidence in the new Government**. So far, these investors have remained reluctant to investing in Moldova, taking into consideration the long-lasting political turmoil in 2009.
- The recovery of main trade partners in 2010 (not expected to be very significant) will not necessarily generate a proportional increase in exports as many Moldovan companies have cancelled the contracts with their partners. Thus, for many of them it would be a challenge to renew the relations with the old partners, but also to set contacts with new trade partners. **The main role of the Government is to eliminate all barriers in the trade operations, as there are no other governmental tools (including financial and fiscal) to help the companies recover.**

¹World Economic Outlook, IMF, October 2009

²MEGA, issues 1, May 2009.

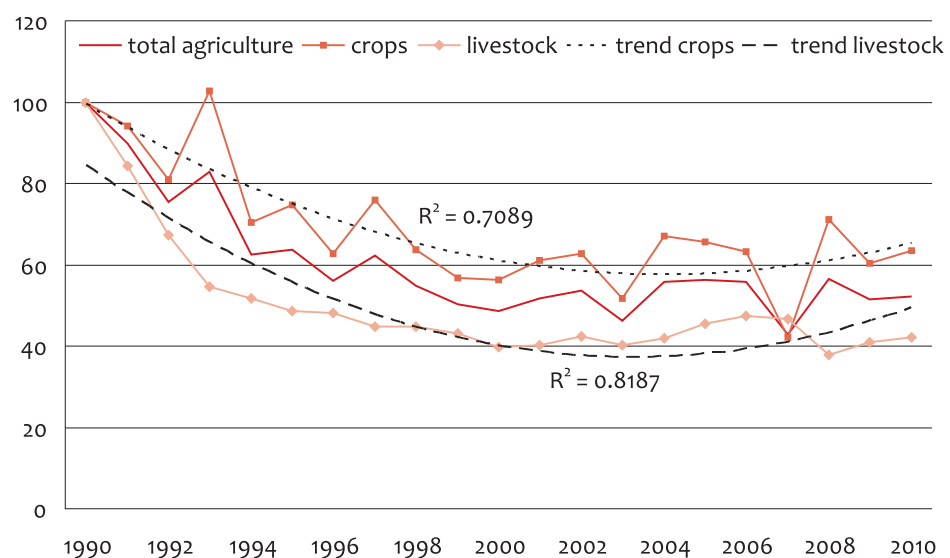
3. Agriculture

This chapter deals with the recent evolutions in the agricultural sector. It shows that the decline in the crops subsector registered in 2009 will not be a dramatic one and in fact it does not diverge from the long-term trend. Further on main evolutions in the livestock subsector are assessed, with an emphasis on the impact of the prices trends. New agricultural policy which is being formulated by the new Government is also subject of this chapter. It ends with the general outlook for 2010 of the agricultural sector and the main challenges that producers and government will have to face.

Analysis of crops subsector developments in 2009

The agricultural output in Q1-Q3'2009 has declined 10.2% y-o-y in real terms and the decline was totally due to falling crops production (-17%). Should the Moldovan government and agricultural producers treat this figure as a dramatic decline? No, and this is because the baseline year 2008 was an abnormally positive one for the crops production, following the abnormally negative year 2007 when a catastrophic drought stroke. As shown in the Chart 6, with an overall decline of 18-19% the total value of the crops production in 2009 is expected to be slightly below the long-term trend line. However, the production value could have been much higher in real terms. Smaller quantity of harvested cereals is the main reason of falling agricultural production. On the other hand, improved yields of some high-value crops (vegetables, fruits, grapes) have prevented a deeper decline of the crops production value.

Chart 6 Evolution of agricultural production in 1990-2008, and forecast for 2009-2010, 1990=100%



Source: NBS, forecast for 2009 and 2010 by EG.

While the general picture of the crops sector would not be much worrying, a deeper structural analysis shows some negative trends. Moldovan crops producers apparently have not yet learnt how agricultural market is functioning and are acting short-sighted by the prices in the previous period when they take decisions regarding the allocation of the land plots for different crops. As result, overinvestment for plantations of cereals and sunflower usually associates with low price levels in the harvesting period which hits severely the producers. And the 2009 was such a year with a dramatic fall in crops prices across the board, except a few crops such as tobacco and tomatoes. To make things even worse, in 2009 the cereals yields have been much lower than on average for 1995-2008: the wheat yields by 10%, for barley – by 5% and for corn – 15%, which further dented the farmers' income. Because of falling prices and yields, the better quality of the wheat harvested in 2009 did not compensate the farmers their big quantitative losses.

Evolution of the livestock subsector

With swine and sheep stocks on rise in 2009, the livestock sector production increased by 8.6% y-o-y in Q1-Q3'2009 and we expect that the annual growth will reach 8.1% in 2009. The level of production in 2009 will be slightly higher than the trend suggests (Chart 6), but this is not an especially impressive performance.

The meat producers have been fortunate in 2009 by stable or even increasing prices. As result, production of meat will likely increase by 15% in 2009 to reach 125.2 thousand tone. In Q1-Q3'2009 the farmers sold the bovine meat at prices exceeding 4.2% the level of Q1-Q3'2008; sheep and goat meat was 7.6% more expensive. However, with high production costs, the profitability for both bovine meat and sheep/goat meat producers remained negative in 2009 and no positive changes are expected for 2010 in this regard. The pork price did not change significantly, but we estimate that it has grown in the last quarter so that by the end of the year it will be 2.5% more expensive than in December 2008. The poultry price decreased by 10% in Q1-Q3'2009 and will not change much by the end of the year. Both pork and poultry production provide high level of profitability and we expect that an increasing number of small farmers in Moldova will turn from cattle to pork meat production, while the number of poultry will increase mostly in the mid- to large farms, where economies of scale are easier to be achieved than in the households sector or small farms sector. Despite a recent decline in eggs price, the production volume increased in 2009 (+9.5%) and we expect that the production growing trend will persist in the future, mainly due to growing number of poultry and high levels of profits that this branch provides to producers.

The milk production is presently having a difficult time. With dramatically falling prices (-29% expected for the entire year 2009), the farmers have limited if any incentives to increase their production in the short term and the total milk output for 2009 is expected barely to match the level of 2008 (about 540 thousand tone). However, it is interesting to note that average productivity of cows has been on constant rise (from 2.14 tone/cow in 2001 to 3.45 tone/cow in 2009) while the number of cattle reduced drastically (153 thousand in Q1-Q3'2009 as opposed to 269 thousand in 2001). This suggests that milk producers are becoming more efficient; because of this we believe that that production of milk will remain stable in 2010.

An interesting market twist has been the recent surge in the wool prices (10.7 thousand MDL/tone expected for end-2009 as compared with 4.3 thousand MDL/tone in 2008). Moldova is not an important wool producer (on average 2000 tone/year in 2000-2009), but with wool prices going up at such a rate as in 2009, many small farmers will probably consider increasing their sheep and goat stocks. The livestock has already increased by 2% in 2009 but raising it further rapidly may be a mistake taken into account that the profitability of this activity is among the lowest in Moldovan agricultural sector (estimated at -70% in 2009).

New Government – new agricultural policy

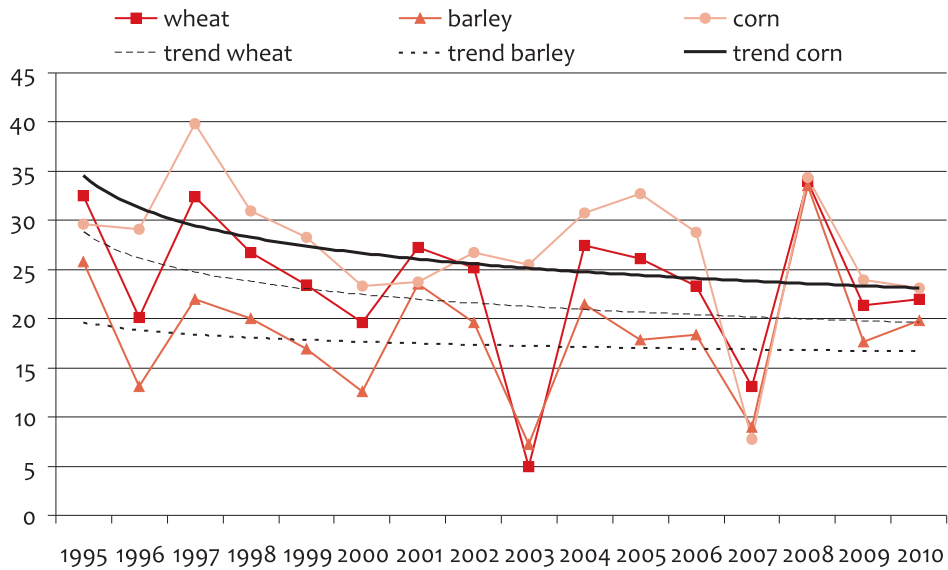
We expect that with the Moldovan Government changing in September 2009, significant changes in the agricultural policy will happen too. The current Government departs from the “land consolidation” mantra that communist Government professed in the last 8 years and tries to concentrate on issues related to rational use of land resources, on elimination of critical constraints to agricultural development and on provision of critical governmental inputs and services. As regards the agricultural sector, the new governmental agenda includes 6 ambitious key goals:

- ❑ Ensuring country food security and increasing competitiveness of the Moldovan agricultural products and exports;
- ❑ Harmonizing the national system of standards and technical regulation with the EU system;
- ❑ Increasing efficiency of the agricultural subsidy program;
- ❑ Integrating agricultural assets in the general economic circuit and increasing investors’ access to these assets;
- ❑ Improving human resources for agriculture through agricultural extension institutions;
- ❑ Stopping the degradation of the soil resources.

However, reaching or at least moving closer to these goals requires not only a clear agenda for reforms and strong political support, but also significant institutional changes. This is why we believe that the new minister of agriculture (Mr. Valeriu Cosarciuc) will probably have first to reshuffle and downsize the behemoth Ministry of Agriculture and Food Industry and its subsidiary institutions before he starts implementing any ambitious reform. (Such downsize would be also in line with the governmental commitments to reduce the number of public employees by 4000 units in 2010). In the last decade, the Ministry of Agriculture and Food Industry has lost its former prestige and it was perceived more as a secondary player in formulating agricultural policy. There is no secret that the Ministry often acted as promoter of obscure industrial interests or as executor of the indications given from above (Presidency). Equally important, District Agricultural Directions have to be restructured. While most of their staff is well trained in agro-techniques they lack even the basic capacity for designing and promoting agricultural policy at regional level and are only serving as information collectors/dispatchers and organizers of Ministry staff visits “in the territory”.

Right policy is important but farmers change of mind and better training is more important for a sustainable agricultural development. Presently, most of the key productivity indicators related to agriculture in Moldova are very low both in a historical perspective and in an international comparison. Even the strong growth of crops production in 2008 and of animal products in 2009 was just a post-drought recovery and not a significant breakthrough. After surging in 2008, in 2009 the yields for the crops providing basic food security (wheat, corn, and barley) continued to decline and the expected growth in 2010 is minor (Chart 7). With such a high volatility of the yields, the Ministry of Agriculture may consider ensuring the population food security by liberalizing imports of these crops rather than by counting exclusively on domestic production capacities. In this context, it is clear that Moldova will not be able to outperform Ukraine and Romania which are better endowed with large areas of land to produce grains.

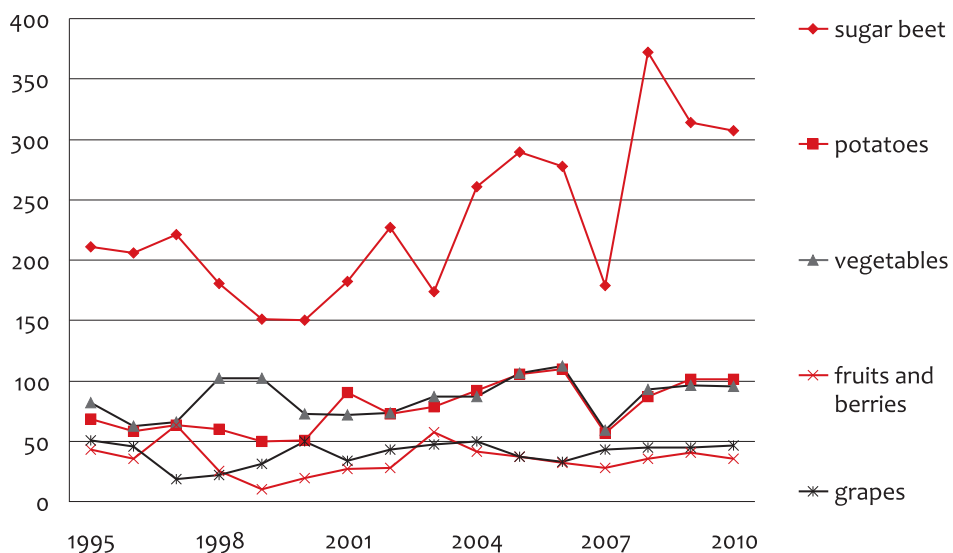
Chart 7 Evolution of the cereals yields 1995-2008 and forecast 2009-2010, 100 kg/ha



Source: NBS, forecast by EG;

From another hand, productivity of other important agricultural products has increased, especially of the sugar beet, vegetables, potatoes, fruits and grapes (shown in the Chart 8). This supports the idea that Moldova should use its outstanding natural resources (climate and soil) for producing more high-value agricultural products and fewer cereals.

Chart 8 Evolution of high-value added crops yields 1995-2008 and forecast 2009-2010, 100 kg/ha



Source: NBS, forecast by EG;

Reversing the negative trends and encouraging the positive ones is a key challenge for the new policymakers. However they will have to take into account that even those crops that performed well in the last years return yields which are far from EU or CEE average. While having higher quality soils, Moldova has wheat yields 25% below the CEE level, almost 50% below for corn, 1/3 below for sugar beet and more than 50% for the potatoes (Table 1).

Table 1 Productivity indicators for some agricultural products, 2008

	wheat yield, 100 kg/ ha	corn yield, 100 kg/ ha	sugar beet yield, 100 kg/ ha	potatoes yield, 100 kg/ ha	sunflower yield, 100 kg/ ha	collected milk, tone/dairy cow/ year
European Union-15	59.5	95.7	640.5	336.0	18.0	6.6
CEE countries	43.3	60.0	508.4	183.0	19.7	4.0
Bulgaria	41.7	41.6		162.7	18.0	2.1
Romania	34.0	32.4	346.4	142.9	14.3	0.7
Moldova	33.9	34.4	372.2	86.5	16.3	3.3
Ukraine	30.9	-	356	139	15.3	4.1

Source: NBS, Eurostat, CISstat and EG calculations.

Outlook for 2010

- ❑ The outlook of the Moldovan agricultural sector for 2010 is quite bleak, with only a 1.7-2.5% growth of production in real terms. The trend of small farmers leaving the sector will continue, mainly because of the severe financial constraints that they have presently.
- ❑ We expect that as a result of the falling prices in 2009 the areas sown with wheat for the 2010 harvest will decrease by 20%. At the same time, areas under corn will increase by about 9-10% because farmers will prefer to have their own (even though low quality) fodder for the increasing number of cattle.
- ❑ No significant improvement in cereals productivity is expected because of the financial constraints impeding farmers to buy high quality fertilizers and other necessary inputs. We expect that total crops production in 2010 will increase by 5-6% in real terms and that will be again a recovery growth after the decline in 2009.
- ❑ The livestock is expected to register a positive but rather feeble growth on 3-4%. This growth will be driven by pork and poultry meat production and by eggs production. We do not believe that a significant growth of the produced milk is possible, even though there has been a strong growth of dairy cows productivity lately.

Challenges ahead

- ❑ Moldova has a bigger productivity potential in production of vegetables and fruits than most of the countries in the region, but this potential is not fully used. The productivity indicators both in crops and livestock subsectors are very low and some positive trends registered in the recent years are not yet very convincing. **Making use of the unexploited potential remains main challenge for Moldovan agricultural producers and policymakers.**

- ❑ Implementing the new agricultural policy that the current Government has adopted will be difficult. For instance, provision of the food security requires two key preconditions: 1) stabilization of prices and 2) constant increase in productivity indicators of the agricultural producers. **We believe that these two goals should be on the top of priorities list of the new agricultural policy in Moldova.**
- ❑ For prices stabilization, the government will have to use some tools of market intervention (intervention reserves, forecasted prices), but their expected impact is quite small because of the limited resources the government has. **With external prices for agricultural products constantly bigger than domestic ones, the government has also to ensure free access of the Moldovan producers to foreign markets.** But for farmers to count exclusively on governmental support would be totally unwise. **Producers themselves have a big role to play in setting market prices by coordinating horizontally their investment plans.** Producers associations, unions and product councils have a key role in this.
- ❑ Reaching sustainable productivity increases will probably take longer time than stabilizing prices. Productivity is linked to fundamental factors, such as competent and trained human resources, good seeds and genes, rational use of fertilizers and developed agricultural infrastructure (irrigation, agro-technical consultancy, competent veterinary service providers and so on). **Providing these inputs/facilitating their provision/eliminating constraints that impede private providers, this is the range of issues that practical agricultural policy should target in 2010 and beyond.**

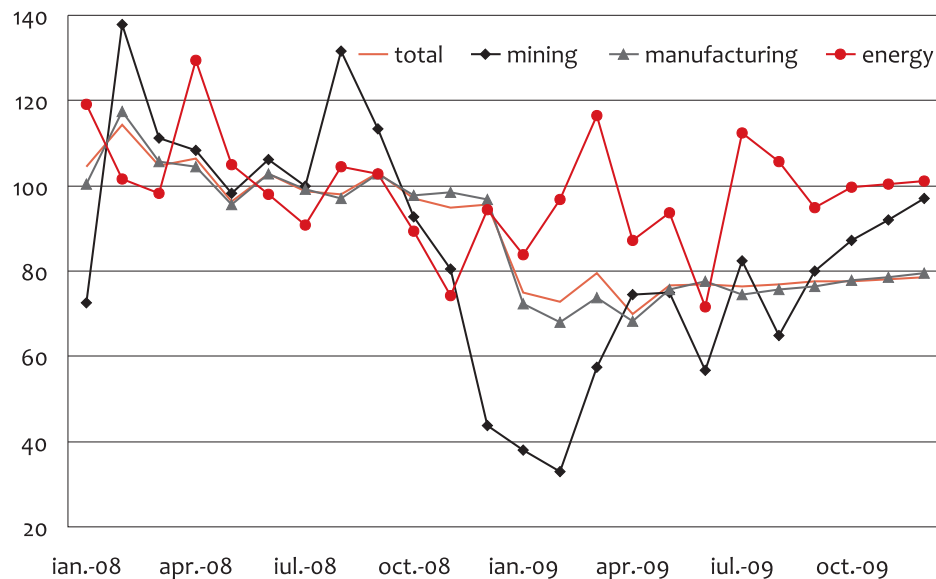
4. Industry and infrastructure

This chapter tries to assess the impact of the financial crisis on Moldovan industrial sector in 2009 and shows that almost all of its subsectors have been severely hit. The chapter makes a geographical comparison of the industrial growth in CIS and CEE region and shows that Moldova is likely to experience one of the deepest declines in this region. We are looking at the new industrial policy formulated in the new governmental agenda and stress that improving corporate management should be among the top priorities. This part of the MEGA #2 ends with a brief outlook of the industrial sector for 2010 and with a summary of main challenges that the sector will confront with.

Industry and financial crisis

Following a series of external shocks, the Moldovan industrial sector stagnated in January-September 2008 and contracted 5% in the last quarter of 2008. As result, the Moldova's industry entered the year 2009 already in very bad shape. The global financial crisis and falling external demand resulted in an even more severe 25% recession of the industrial output in January-April 2009. In the second and third quarters 2009 the industrial output stabilized at 75% of the production level for 2008, with some positive yet rather feeble trends emerging in October-November (Chart 9).

Chart 9 Evolution of the Moldovan industry in 2008-2009, y-o-y, %

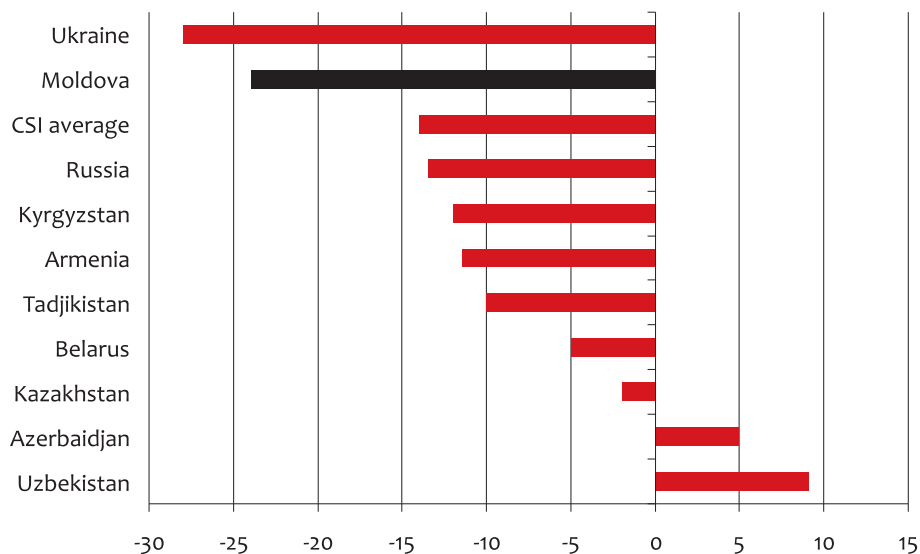


Source: NBS and EG estimates

We expect that for the whole year 2009 the recession will be -20% in best case and this will be probably one of the worst performances both among the European and CIS countries (see Chart 10 and Chart 11). One of the conclusions that can be derived from such a dramatic evolution is that Moldovan companies are very inefficient in adapting to new market requirements and to serve their customers under more difficult conditions. With poor anti-crisis management skills and with doubtful willingness to learn them, many Moldovan producers are only inclined to ask the Government for introducing “protection” measures (higher customs tariffs, lower tax rates, continuation of the zero-rate tax on the reinvested income etc.) and are not looking at how they can overcome the companies’ internal weaknesses.

We have not heard of any Moldova company adopting active programs to deal with the new conditions set up by the financial crisis. Indeed, in 2009 there has been no spectacular restructure of any middle or large company; and very few strategic mergers/acquisitions. Such measures would be obvious for an economy caught by a severe crisis. Instead, the Moldovan companies are passively waiting for better times, with rising stocks of unsold goods, unfinished constructions, fired labour and so on.

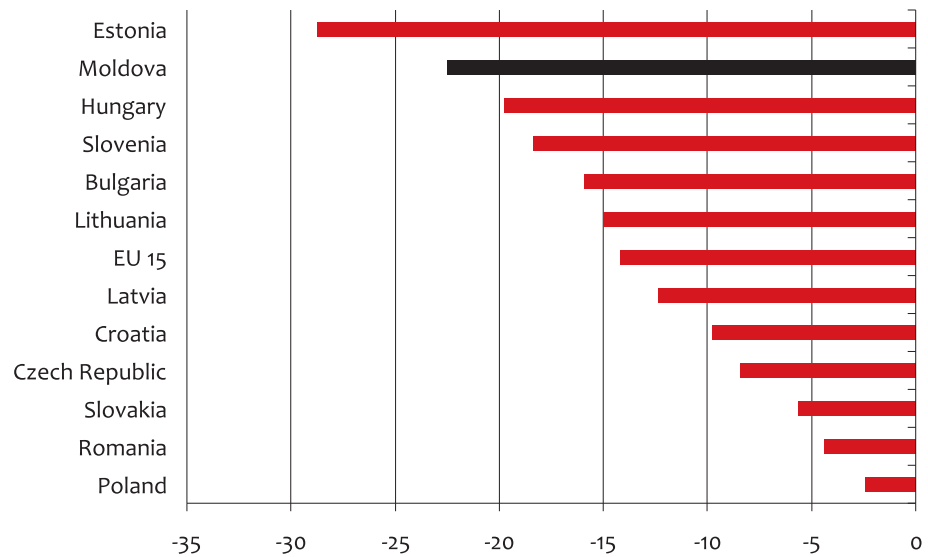
Chart 10 Growth of industrial output in CIS countries in Q1-Q3'2009, y-o-y, %



Source: CIS Stat;

The evolution of the textiles, apparel and shoes production sectors is the most telling example of the negative impact of lack of strategic management skills. Most of the companies in these sectors got used in the last decade to work under lohn arrangements for external customers (mainly from Italy, Germany and Romania) and few of them bothered to develop own brands. As result, these important sectors of the Moldovan industry (with a share of 15% of total industrial production in 2008) are presently suffering one of the deepest recessions. This is not to say that managers of these companies are technically incompetent. They have a lot of technical expertise, but these skills are necessary for engineers overseeing the technological process, while managers would be expected to be first of all leaders with more strategic visions.

Chart 11 Growth of industrial output in European countries in August 2009, y-o-y, %



Source: Eurostat, NBS

It is interesting to note that not all industrial sub-sectors are currently declining, as probably most of the policymakers and public believe. For instance, in Q1-Q3'2009 the production of tobacco products has grown by 2.6%, production of animals' fodder – by 70% and of sugar – by 10%. However, except tobacco industries, the other two performances have little to do with management improvement. The growth of the tobacco products comes after a long period of economic decline, and partly has been determined by a recent change in management staff. The growth of the animals' fodder consumption comes as result of a good harvest of fodder crops and increased demand from the part of the livestock growers. As for the sugar, its production has been lately supported by high customs tariffs protecting domestic sugar market, an effect which is likely to vanish in 2010-2011.

There are some more positive signs in the mining industry, where the collapse from the late 2008-early 2009 (about -70%-80%) is over, with a “milder” -20% y-o-y decline registered in September 2009. As the constructions sector does not show any sign of recovery we expect the growth of the mining industry to remain negative in the fourth quarter 2009.

Winemaking sector is presently the main sector hanging on the growth of domestic industry. Its situation was particularly difficult in Q1'2009, when the production fell by 27%, and it marginally improved in the next two quarters (with a -20% growth rate in Q3'2009). A big number of companies in the sector face existential challenges and many have already bankrupted, are firing their staff and closing down production. A number of large companies are not yet in bankruptcy but are very close to it, including many state-owned companies. Some businessmen from the sector call this situation as “catastrophe”. At the same time, those producers who were able to timely restructure the production and started targeting new markets (including the domestic one) or are selling wine stocks for brandy production will probably get through these difficult times easier than others.

In the vegetables and fruits canning industry, the steep production decline is related to the accumulation of large production stocks (about USD 25 million in September 2009). Again, we see this situation as a problem resulting from improper marketing strategies. Most of the companies in the sector continue operating under traditional management schemes and are very slow in improving their quality standards. In 2009 the meat processing and meat products sub-sector has declined in real terms by more than 20%, and this is despite stable domestic demand and growing domestic production of the raw material. This is just another example of deficient management skills. On the other hand, a number of companies that have adopted quality management schemes are exporting successfully their products to EU and have not been so dramatically affected by the crisis.

Towards a new philosophy of industrial policy

A number of new policy issues related to industry have emerged after instalment of a new Government in September 2009. The governmental program promotes a new vision of the industrial policy. According to this program, the industrial policy should aim at promotion of technological development of the companies, provision of technically competent human resources, development of a business-support infrastructure and of a knowledge-based economy. We believe that this competitiveness approach is right. Because decisions affecting companies' competitiveness are taken at governmental and corporate levels, the government should target two strategic directions: provision of effective governmental services enhancing competitiveness and promoting corporate management efficiency.

The government has started on its part of the field with elimination of some key constraints affecting the domestic industrial producers. The effect of such actions can be immediate, as shown by the example of the winemaking sector. Winemaking and vinery industry is suffering because of two interrelated problems: lack of short-term financial resources and lack of access to external markets. After Russia introduced its trade embargo in 2006, the Moldovan government has only worsened the situation by introducing its own "embargo" against Moldovan winemakers through unwarranted barriers to trade (state marks, certifications, interdiction of exporting raw wine, cross-controls and others). Officially, these barriers to trade were set to ensure high quality of exported Moldovan wines. As a matter of fact, they only created market distortions, enabled installing political control on the sector and set conditions for hostile taking over. The September 2009 abolishment of barriers to exports of raw wine and grapes has been a significant boost for unlocking the industry. According to recent information, in October 2009 the exports increased three-fold, however big losses and companies' closures are yet unavoidable.

Abolishment of unwarranted interdictions will probably continue provided that the Government remains stable. However, the Government should also impose better corporate governance standards in order to increase the companies' competitiveness. Few governmental officials and economic journalists in Moldova have noticed that in the Doing Business 2010 report Moldova is very bad positioned in terms of investors' protection rights and it fell in the new rating (from position 104 in 2009 to position 109 in 2010). Basically, this means that executive directors of companies are not held responsible by the shareholders (be them private or public) and the rights of the shareholders are not properly enforced and defended. This relates both to private and public companies, and the most telling example of decisions affecting interests of minority shareholders is how Moldtelecom and Banca de Economii management adopted decisions of providing funds for reconstruction of the Parliament and Presidency buildings destroyed as result of April 7 riots.

However, the companies themselves have much to do in order to become more competitive. Learning new management skills is a precondition for this and the government can little do in this respect if the managers do not want to learn. Obviously, the government can swiftly change management incentives in the state-owned companies and thus to increase efficiency of these companies.

Outlook for 2010

- ❑ We believe that in 2010 the Moldovan industry will stop declining and a positive growth of 5-6% of the production volume will be registered. Obviously, this growth rate will not be enough to recover to the pre-crisis levels.
- ❑ Main drivers of the industry growth will be the winemaking sector (with an expected production growth rate of 12%) and production of non-metaliferous products, mainly construction materials (+15%). Such sectors as textiles, clothes and shoes production will stagnate or even fall further, because most of the companies lost their Lohn-processing contracts and it will take longer time to find new customers or to put in place own products.
- ❑ We think also that mining and quarrying industry will register positive growth of about 10%, but its impact on the total industrial output will be negligible. Also, this growth will be mainly determined by the demand coming from the informal constructions sector rather than formal one.
- ❑ Energy sector will register a positive growth as well, driven by the growing demand from the part of the households and industry, but the growth is most likely to remain below 3%.

Challenges ahead

- ❑ The new government already confronts with a significant challenge which can worsen further. **After it came to power the new Government “discovered” that most of the market regulatory agencies are not functional.** As result of this, many economic sectors are functioning inefficiently, while unrealistically high or unrealistically low levels of prices lead to unfair distribution of the income in the society. Government has started some activities to rid some markets of trust agreements (meat, fish) with some other markets subject to similar actions in the future.
- ❑ However, a sustainable progress is difficult to be achieved by the Ministry of Economy manually piloting the economy, and this is because market inquires and anti-trust supervisions will have to remain permanent in the foreseeable future. Such activities have to be performed not by the Ministry of Economy (which is a policy development center and not a regulatory body), but rather by the National Agency for Competition Protection which has such a legal mandate. **The Agency has to be effectively empowered (with human resources and a clear regulatory backup) in order to undertake effective market inquiries and enforce anti-trust rules. Obviously, this means that the Agency should remain independent from the government, even though a stronger political control from the Parliament is necessary.**
- ❑ Management malpractices in the state-owned enterprises form a separate chapter in the Moldovan management tradition. Most of these companies are poorly run and are only a drain on budget resources. With a new government ruling the country and the economy, **time has come to investigate objectively the performance of the corporate and financial management of the state-owned companies in times of crisis and to make necessary decisions regarding restructuring or privatization.**

5. Investments and constructions

In this part of the analysis we are looking briefly at a phenomenon which has not been seen since early transition – the collapse of the investment and constructions activity. We try to estimate where the investment activity and constructions sector will head in 2010 and to shed some light on two most critical constraints.

Overview of investments and constructions in 2009

Capital investment collapsed in 2009, and we expect that by the end of the year the volume of investment will barely exceed 55% of the 2008 level. The investment in technological equipment and machines is expected to contract by 50%, in production buildings and offices – by 55%, and in transport units – by 69%. High interest rates for long-term banking loans, shallow capital markets and lack of own financial resources combined with general economic pessimism of the companies and represent the ultimate causes of such a dramatic decline in investment activity.

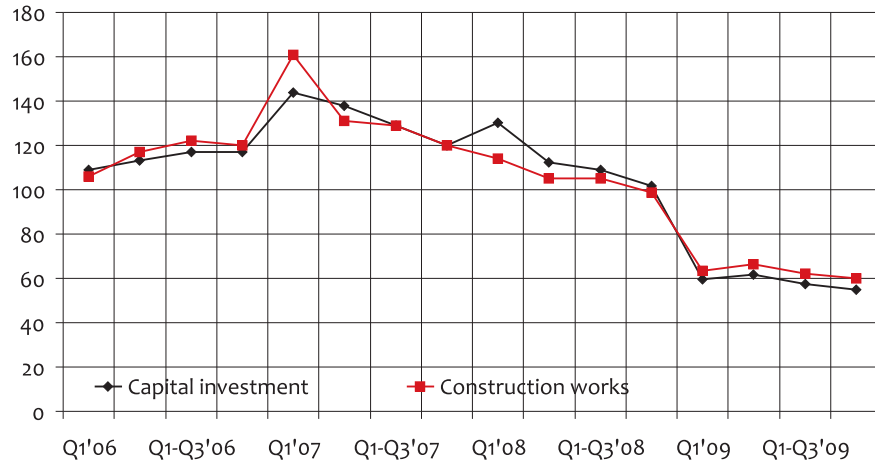
Important to say, such rates of decline of the investment activity as in 2009 Moldova has seen only in its early transition period: in 1992-1994 the investment rate fell on average by 53% per year and has set the stage for a long and difficult economic recommencement. However, we do not expect that this time economic resumption will take so long, because companies have invested significantly in their productive capacities in the last 3-4 years and presently most of them operate at only half or even less of their capacities. However, it is clear that such kind of growth will be only a recovery growth and will not represent any qualitative shifts.

In this context, it is particularly worrying that foreign direct investment in Moldovan economy fell at fastest rate in 2009; according to the balance of payments, in the first half of 2009 the FDI inflow contracted almost 9-fold (from USD 309.4 million in H1'2008 to USD 34.6 million in H1'2009). We believe that by the end of 2009 the FDI inflows will further contract and the end figure will not get above USD 60 million (as compared with USD 707 million in 2008). If the new Government fails to convey more trust and optimism regarding country's economic perspectives, Moldova will be deemed to undergo a more difficult and longer exit from its present crisis.

In 2000s the construction-assembly works has been the most essential type of investments in Moldova, going from 46% of total capital investment in 2001 to 56% in 2008. Residential constructions represented in 2008 about 1/3 of the total construction-assembly works. As mentioned in the MEGA #1, the first-round effects of the world financial crisis on the Moldovan construction sector became visible back in mid-2008, with the volume of construction works declining by 1.6% in 2008. The recession of the constructions sector worsened even more in 2009, with some more encouraging trends emerging in Q2'2009 but reversing again in Q3'2009. We expect that situation will worsen a bit more by the end of the year and that the overall figure for the year will be -40% (Chart 12).

Residential segment suffered particularly much, as result in Q1-Q3'2009 it shrunk to less than ¼ of the total constructions sector. As expected in MEGA #1, the demand-side shock continued throughout 2009 and forced a gradual reduction of the prices for housing (about 15% as compared with end 2008). However, this decline was not enough to entice buyers to buy actively on the residential housing market.

Chart 12 Evolution of construction works, y-o-y % of the previous period



Source: NBS and estimates by EG;

Outlook for 2010

- We expect that in 2010 the investment activity will resume but the growth will be modestly positive, with a 5-7% growth rate of the capital investment. This can improve significantly if the country remains politically stable and becomes more attractive as location of foreign direct investment.
- Prices for residential and productive real estate will probably stabilize in 2010 and will thus provide more certainty to both sellers and buyers.
- Constructions sector as a whole will start growing again, but we expect a modest recovery rate of 3-5%. We believe that in 2010 a consolidation of the sector will start, with the number of operating companies set to decrease drastically.

Challenges ahead

- Restarting investment activity in general and constructions sector in particular is of key importance for a sustainable economic recovery of the country. These objectives are part of the governmental program and of the economic recovery plan. The program provides for many reforms that are supposed to make life easier for the investors (such as streamlining of construction authorizing procedures and easier rezoning). **However, there are some thorny issues that remain. The most important one is the danger that constructions sector poses for the banking sector.**
- In 2008 commercial banks provided about 15% of their total loans to construction and development companies. Because of the market fall these money are now partially lost. Banks are not interested to take over the collateral because of the liquidity problems. From another hand construction companies do not want to further reduce the prices and are expecting the market price to bend up again soon in the future. However, we do not believe that prices will start growing soon. The government has included in the economic recovery program two important measures concerning the constructions sector: 1) developing mortgage system and 2) providing credits to construction companies to finish residential projects. Neither of the proposed solution is able to unlock the constructions market which overheated during the last years. Indeed, the constructions will likely use the money to reimburse their banking loans and not to finish the construction projects. **The losses have to be internalized by speculative investors, banks and construction companies, and not by end investors (families and individuals buying apartments and houses for living).**

6. Services

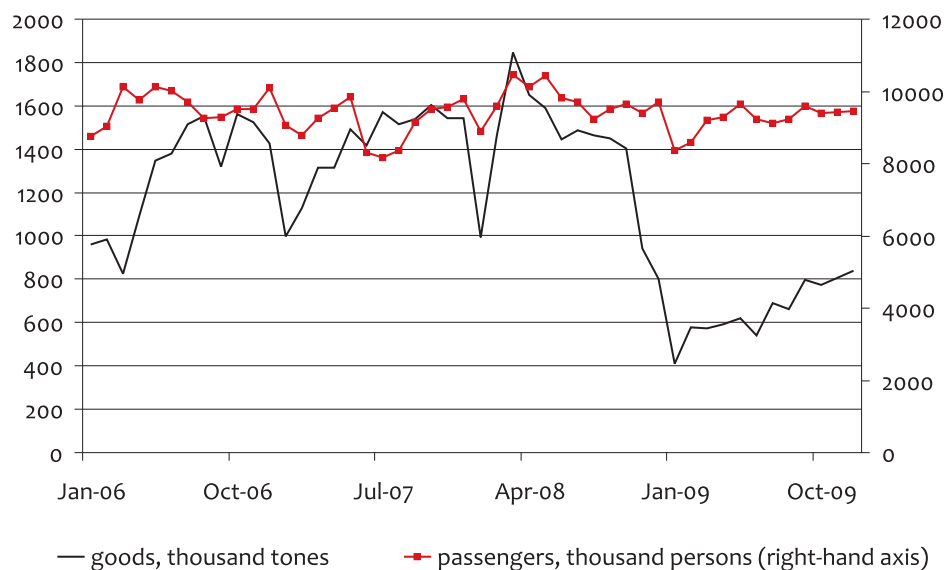
This section deals with the most important sector of the Moldovan economy – services. It analyses how the sector performed under the crisis conditions, based on tourism, transport and retail trade and service sub-sectors. Further on we assert the idea that institutional measures – such as streamlining regulatory environment, empowering market regulatory agencies - are those that can help the sector develop sustainably in the future. The chapter ends by enlisting main sector's trends for 2010 and identifying some thorny issues challenging services growth.

Main evolutions in the sector

Services sector has proven to be the most resilient under the current economic recession. Even though the current year began with a significant contraction of many services sub-sectors, in the second part of the year the situation improved. According to our estimates, the production volume and gross valued added generated by services sector will decline only 2-3% in 2009.

However, in the cargo transportation sector, one of the most important service sectors, situation is much worse. As seen from the Chart 13 the transport of passengers segment suffered very little as compared with the transport of goods segment, where the volume of transported cargo collapsed more than 3 times. Reduced demand on the CIS markets has hit particularly hard the railroad transportation of goods. The road transportation of goods suffered most of all because of the falling domestic demand.

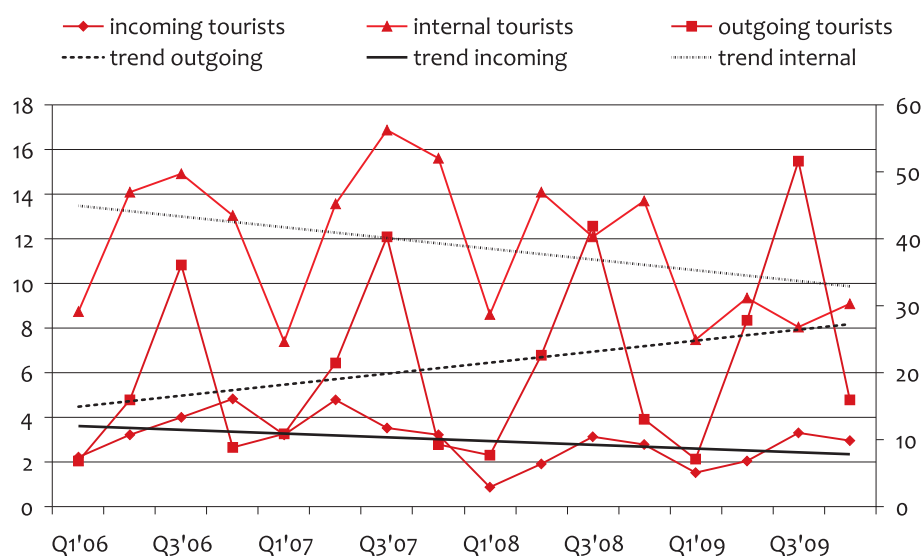
Chart 13 Evolution and forecast of the transported goods and persons, 2006-2009



Source: NBS, forecast by EG

Tourism sector has also suffered to some extent because of the financial crisis, but the situation is a bit more nuanced. Financial crisis reflected first of all in declining demand for hotel services in Chisinau, which were not able to adapt their price-schedules to new financial constraints. At the same time, the number of incoming tourists has grown in annual terms (+28%) even though this is not enough to make a credible reversal of the negative trend that started in 2007 (Chart 14). Another interesting remark is that during these difficult financial times the number of internal tourists (Moldovans going to Moldovan destinations) has continued its decreasing trend (about 25%) while that of outgoing tourists has increased (+28%)! When financial crisis stroke in late 2008 we expected that many Moldovans in 2009 would prefer domestic tourist destinations to the external ones. But these figures clearly show that Moldova is not attractive as tourist destination even for its own citizens not to speak about the foreigners. Plans of the Government and of some of the sector operators about developing tourist routes to Moldova should be reviewed and correlated with the economic reality. The only way to go to make use of the (rather low) domestic tourist potential is to get Moldova integrated in international tourism routes involving Romania and/or Ukraine. Such routes have not been developed yet, and this is the task of the tourist operators and not of the government. Many “rural tourism” projects implemented in the years 2000s with donors’ support proved to be completely unsustainable so far.

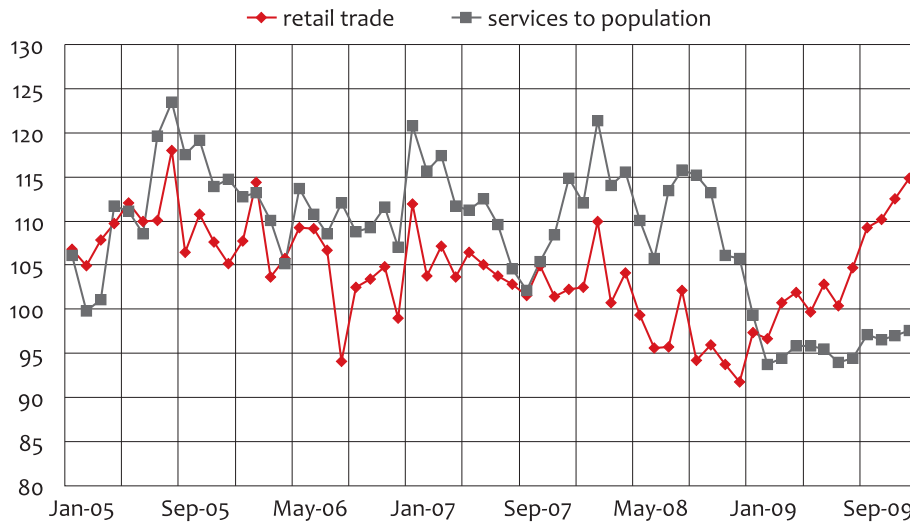
Chart 14 Evolution and forecast of the tourism flows in Moldova, 2006-2009, thousand persons



Source: NBS, forecast by EG

Another interesting evolution is that of services rendered to population. The year 2009 started with a declining trend but this rapidly corrected in the second quarter and in fact the total growth for 2009 is expected to be positive, about 4-5% (Chart 15). Retail trade displayed a different, negative pattern, and despite some positive trends in the second part of the year, we expect that total volume of retail trade in 2009 will be 5% less than in 2008. However, one important remark should be added with respect to services to population and retail trade: their real growth is apparently higher than officially reported. A number of cases have been reported to us that many services companies and traders are trying to hide a part of their turnover for “fiscal optimization” reasons.

Chart 15 Evolution of the retail trade and services rendered to population, y-o-y, %



Source: NBS, forecast by EG

Main policy issues

Governmental program for economic recovery provides for the implementation of a number of measures that will directly or indirectly reduce the costs of doing business in services sectors, as well as in other sectors.

A significant provision of this program is integration of all state bodies participating to business registration procedures in an integral informational system to reduce the costs and time for business registration. Equally important, the program provides for the reduction of the number of economic activities subject to licensing. Reduction and streamlining of the procedures for getting sanitary permit and sanitary-veterinary permit is likely to positively surprise many companies in the food retail and catering sectors. However, a significant issue will probably emerge here: many companies in Moldova are known to care little about the customers' safety and health and the customers' choice is not quite diverse. The government will have to consider how to better protect consumers' rights and not only to make easier the companies' life.

The prices for urban housing services and other public services dominated the policy discussions in 2009. The issue of the tariff for centrally supplied heating in the Chisinau municipality was a heavily politicized one, which has not yet reached a sound solution. The Government decided to intervene and to empower the National Agency for Energy Regulation (NAER) to set the tariffs level. This is a move in the right direction, and this is the practice in many European countries too. However, this is not enough for setting up tariffs which would be less contested by the public and politicians. The core problem is that NAER, as Chisinau municipal authorities, does not have a clear understanding on the financial situation of the energy companies and its economic costs. The companies in the energy sector (Termocom, power-generation plants, Moldova-Gaz) have to be exposed to an independent financial and performance audit in order for the policymakers and the public to be confident regarding any tariffs policy decision.

The transport services have suffered a particularly severe recession in 2009 and the Government has declared that it will try to alleviate the situation. The problem is that the Government can little do for this sector immediately, except streamlining licensing and authorization procedures (including for international carriers). These measures have been included already in economic recovery program. However, in the long run the transporters will be right to demand higher quality roads and a more transparent collection road taxes and use of the Road Fund.

Outlook for 2010

- ❑ We believe that in 2010 the service sector will see a rebound of up to 3%. This growth will be led by retail trade sector (+6%) and by the services rendered to population sector (+8%).
- ❑ Transport sector will continue stagnating at the level of 2009, while other services provided mainly to businesses (such as IT) will probably register a moderate growth.
- ❑ Tourism sector will remain largely where it was in 2009, without any significant breakthrough in developing national routes and attracting more tourists to Moldova.

Challenges ahead

- ❑ New Government has introduced some quite ambitious measures in its governing program and in the recent economic recovery plan. Among the most ambitious are those related to the restructure of the public services and infrastructure. For instance, it is planned to increase the access of alternative operators (private, foreign, mixed) to railroad, air transportation, communications, and to further liberalize these sectors. However, some of these sectors have grown in recent years in hard-to-blow political-economic conglomerates that spread their influence across many economic sectors and public administration layers. ***We believe that in some cases reaching the established goals will require a complete reshuffle of the current management and of the regulatory environment. A fierce bureaucratic and institutional opposition is to be expected against implementation of these plans.***
- ❑ Consumers' rights in Moldova are not adequately enforced and this subject is not present in the current policy debate. Moldova needs a strong National Agency for Protection of Consumers, which should be just as important as the National Agency for Competition Promotion. Consumers' rights are a constant issue of policy and public debates in all European countries and we expect that it will become an important issue in Moldova – EU negotiations of the future agreement. ***Therefore, it is really important for the Government to consider creation of powerful National Agency for Protection of Consumers.***

7. Labour market

This part of the analysis deals with main effects of the global financial crisis that manifested on the domestic labour market. It analyzes two key aspects of this market - employment and unemployment – by decomposing evolution in 2009 in trend-component and crisis-component. This chapter suggests that declining employment rate rather than unemployment rate should be the main concern for the government in 2010 and, probably, beyond.

Main evolutions in the context of the global financial crisis

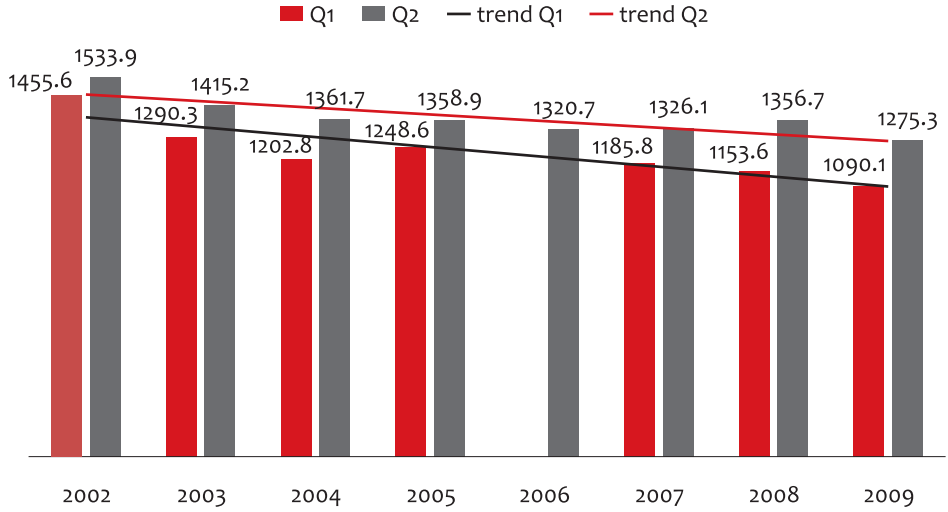
The global financial crisis has exerted a significant impact on domestic labour market in Moldova. Diminishing demand resulted in a reduced supply of goods and services and therefore in worsening of the labourers' situation. The global financial crisis has also taken many Moldovan migrants back to Moldova where jobs are missing as well; this inflow of human resource only worsens even more the difficult situation on the domestic labour market.

The global financial crisis impacted the labour market in many ways. It is apparently surprising that in conditions of the crisis the average wage per economy keeps on growing as reported by the NBS. Even though the nominal wages are not rising as fast as in 2008, because of the deflation, the real wage in Moldova has grown in Q1-Q3'09 by 9.7%. Such an evolution is difficult to explain if one does not take into account the methodology of NBS. In fact, this growth is only the result of the arithmetic and not an economic trend. NBS calculates the average wage by dividing the overall wage bill reported by companies to the number of employees who worked during the reference period. Because the number of employees decreases faster than the wage bill reported by companies, their ratio grows modestly or even remains stable. This is exactly what happened in 2009. An additional fact is that companies with number of employees below 20 do not report their wages to NBS and it is very likely that in these smaller companies the wages registered a higher rate of decline.

Therefore, the effective wages have reduced in a number of sectors, even though in some of them not only as result of global financial crisis. For instance, in the winemaking and other related sectors wages are declining because of the long-lasting effects crisis enacted by the Russian trade embargo back in 2006. Others, such as mining industry and construction sector are victims of the crisis, with the real wages expected to decline more than 10% in 2009.

Jobs shedding, either because of the “technical unemployment” or because of the effective closure of the job is another effect of the global crisis. The magnitude of this effect is conveyed by the fact that in Q1-Q2'09 the number of employed has drastically decreased, by 145 thousand people. While the general trend of employed population was negative in Moldova in the last ten years, it improved somewhat in 2007-2008. In 2009 the negative trend reversed again (Chart 16) and we estimate that about 80 thousand of the people lost their jobs because of the crisis. Employment rate in the first half of the year has reached record low levels of 39%, the lowest not only in the group of transition countries but also the lowest in Moldova's recent history.

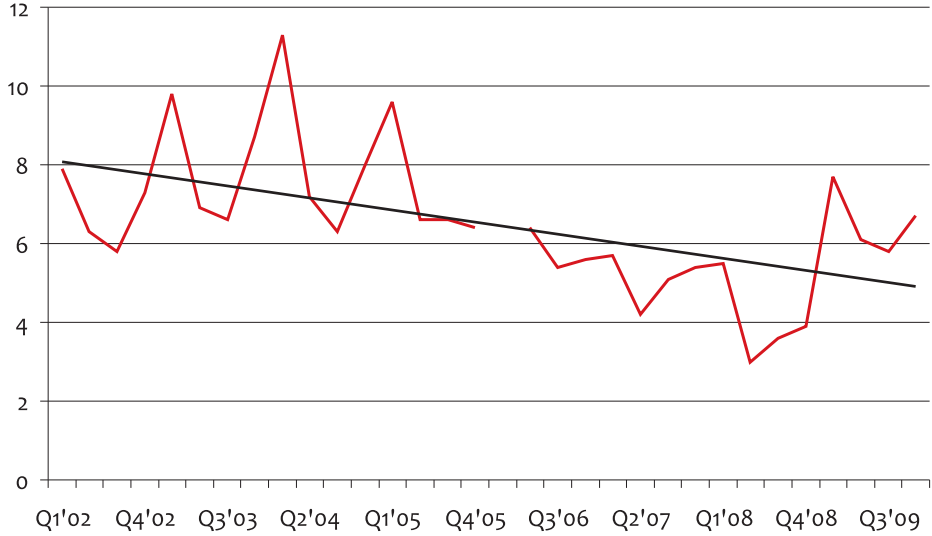
Chart 16 Evolution of the employed population in Q1'02-09 and Q2'02-09, thousand people



Source: NBS and EG

Rising unemployment and under-employment due to lay-offs, shorter working schedules and returning of migrants home is another very significant impact of the crisis. The positive trend of declining unemployment that persisted in the last 7 years has definitely reversed in 2009 (Chart 17). According to our estimates, about 80 thousand people in 2009 will be unemployed and between 35 and 40 thousand because of the crisis.

Chart 17 Evolution and forecast of unemployment rate, %



Source: NBS, forecast by EG;

It has to be added that financial crisis has resulted also in an increasing number of discouraged people. This means that the number of those avoiding searching for jobs because they believe that employment opportunities are scarce in times of crisis is on rise. Under normal conditions, about 8-9 thousand people in 2009 would be discouraged, but because of the crisis their number is likely to exceed 25 thousand.

Because of the crisis, we have expected a big number of returning labour migrants to Moldova. Indeed, in the first quarter of 2009 we have estimated a rather big number of 50 thousand migrants coming back to Moldova because of losing their jobs in the host country. However, we have not seen such an impact in the second quarter. This most probably means that migrants came back and after discovering that there are no jobs available in Moldova either, they decided to go back even to lower paid jobs than then had in the past. Political violence in April – May 2009 probably has added to citizens' pessimism regarding opportunities in Moldova.

Outlook for 2010

- ❑ Employment rate is likely to continue declining in 2010 because many enterprises have adopted restructuring plans for 2010. Employment will also decline because of many public employees will be fired or are expected to leave the public sector.
- ❑ On the other hand, that in 2010 the unemployment rate will remain as high as in 2009 (around 6-7%), at least in the first part of the year. Despite declining employment, unemployment rate will not rise because people will prefer to migrate or stay inactive rather than accept low wages.

Challenges ahead

- ❑ With a relatively low unemployment rate, the Government will have pay attention to active labour policy targeting creation of the well-paid jobs. Main challenge for the government in 2010 remains thus creating proper conditions for private entrepreneurship because this is the ultimate panacea for the labour market problems.

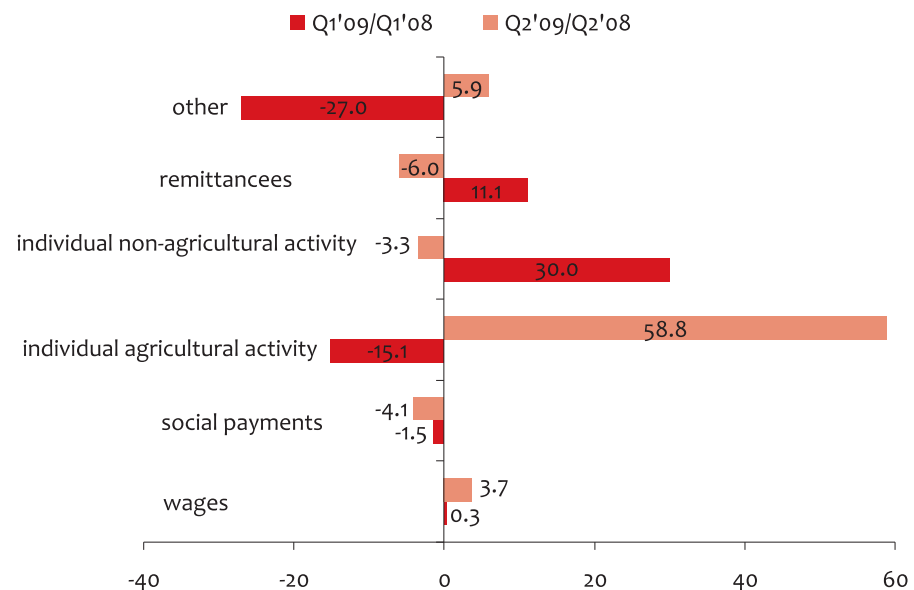
8. Households' income

This chapter reflects the evolution of households' income in 2009, with a number of controversial developments, such as the decrease in remittances and wages in real sector and increase of social payments and wages in budgetary sector. It also identifies the problems related to the difference in data from different sources that create difficulties in formulating clear conclusions about the evolution of remittances. This is one of the challenges presented in a separate section at the end of the chapter.

Changing structure of households income

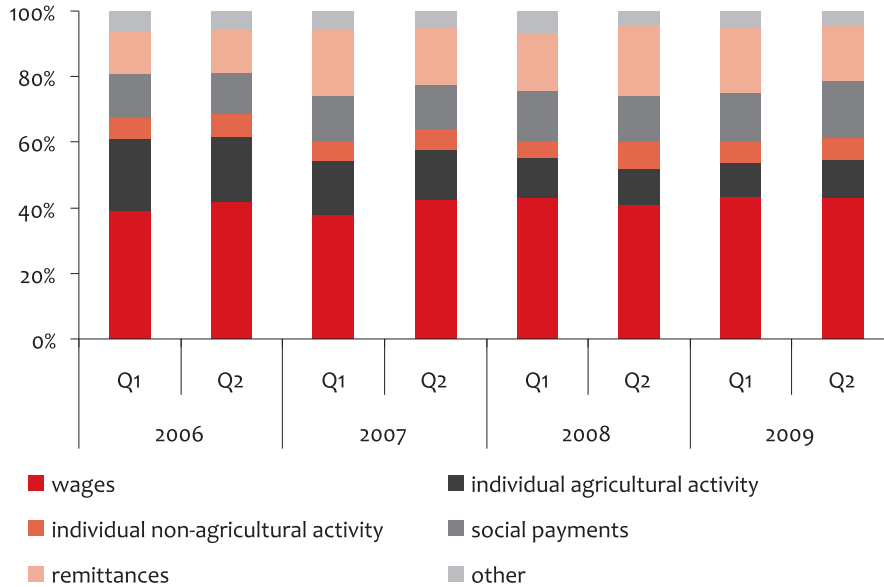
Domestic and international economic developments in 2009 have influenced the income of the Moldova population that followed a decreasing trend over the whole year. According to the Household Budget Survey (HBS) data the decline of households' income in the second quarter (2%) was even deeper as compared to the first quarter (0.2%), which is also in line with the GDP developments in these periods. The decline in remittances in the second quarter (Chart 18) was the main factor contributing to the overall decline in the households' income as it was expected at the incipient stage of the global crisis. This has been also reflected in the structure of income, with remittances falling from the second position, where they have been placed since 2nd quarter of 2006 (Chart 19) to the third position being replaced by social payments.

Chart 18 Evolution of different sources of households' income in Q1' and Q2'09, %



Source: EG calculations based on Household Budget Survey data;

Chart 19 Structure of households' income (%)

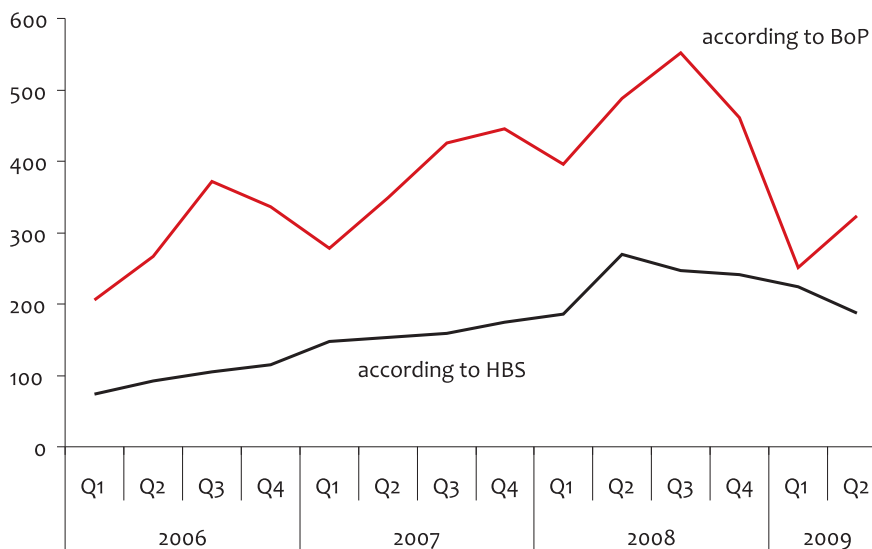


Source: Household Budget Survey;

The paradox of remittances

The evolution of remittances over 2009 is not very clear due to the significant discrepancies in data sources. Firstly, there were always important differences between remittances reported in the Balance of Payments and those calculated based on HBS data. On average, remittances reported in the Balance of Payments were twice higher than remittances according to HBS, suggesting that some of the remittances reported in the Balance of Payments are actually payments for goods and services delivered from Moldova or even some investments transfer, but paid as remittances due to lower administrative and transactional costs. In the first quarter of 2009, these two sources have shown almost identical values for the first time (Chart 20).

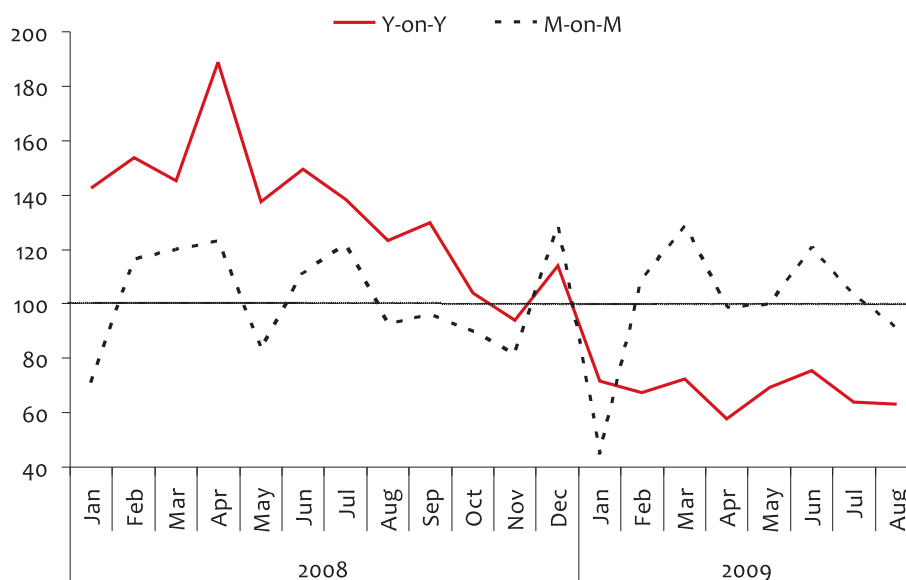
Chart 20 Value of remittances according to BoP and HBS (million USD)



Source: Balance of Payments and EG calculations based on HBS data

At the same time, despite the decrease in remittances in the first quarter according to the Balance of Payments data source, the data from the HBS showed a slight increase in the remittances year-on-year. These contradictory data suggest that, in the first quarter, the remittances inflows decreased because of those types of payments mentioned above (which actually do not represent remittances). However, in the second quarter the remittances have decreased according to both sources, indicating that the negative impact of crisis on migrants revenues aggravated. According to the data on the money transfers from abroad, they continued to decrease even more in July and August (Chart 21), therefore we may suspect that they further decreased in the 3rd quarter of 2009.

Chart 21 Evolution of money transfers from abroad (%)



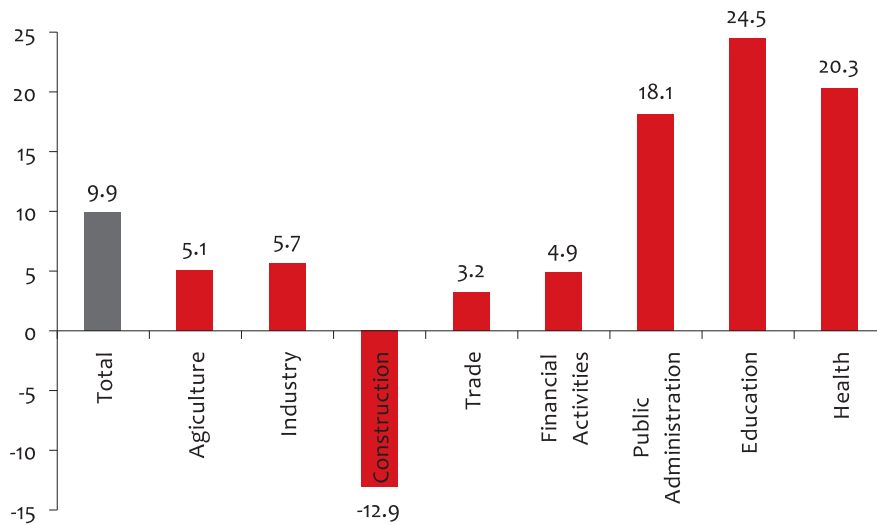
Source: NBM;

Wages and social payments – the most important sources of income

In 2009 there were registered some controversial evolutions of other sources of income of the population. The value of social payments paid to the population has increased during the crisis period. There is no doubt that the share of economically vulnerable population is going up during crisis and the need in social payments is also more pressing. However, this evolution is mainly related to the April increase in pensions. Although pensions are still low in Moldova and do not cover the minimum living cost, the decision to increase them right before the Parliamentary elections gives a political flavour to this act, taking into consideration the increasing budgetary deficit and no certainty (at that moment) of any external credit or grant for covering the deficit.

This also refers to the salaries in the budgetary sector. Thus, despite the increase in the average monthly salary in economy by 9.9% in three quarters of the year, the increase was not proportional by private and public sectors. It has mainly increased in the budgetary sector, and remained stable or even decreased in some economic sectors affected by crisis (Chart 22). But statistical data on wages reported by the NBS, which identify an increase in average monthly salary, does not reflect the real situation in the economy because it does not take into consideration the delays in the wage payments and/or the forced unpaid leaves that were common during the year. And there are some indicators showing that this has happened indeed. Firstly, according to the HBS, the income from salaries has increased less than 9% (0.3% in the 1st quarter and 3.7% in the 2nd quarter).

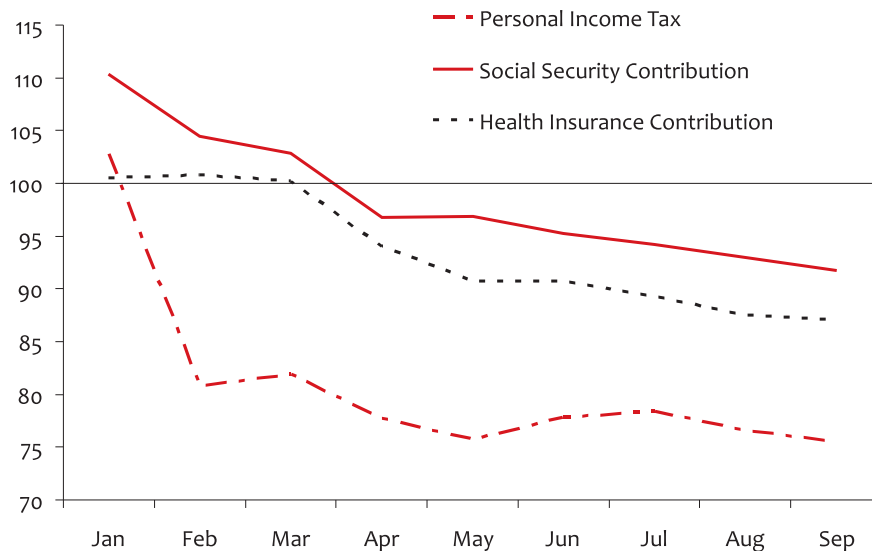
Chart 22 Growth rate of the real wage in some sectors in Q1-Q3'09, y-o-y, %



Source: NBS;

Another source of evidence is reflected in the incomes collected from the taxation of the salaries (personal income tax, social security contribution and health insurance contribution), which are much lower than the planned incomes and the gap is constantly increasing. Together these sources show a real and significant decline in households' income that had worsened in the second quarter, and thus indicating a lasting impact of crisis on Moldova (Chart 23).

Chart 23 Collected revenues as % of planned revenues from the taxation of salaries



Source: Ministry of Finance

Outlook for 2009 and 2010

- Remittances represent an important source of income for the households; therefore, their further evolution will influence the general trend of households' income. As they are highly dependent on the economic situation in the countries where most of the Moldovan migrants work, the economic recovery in these countries is the key for

the reversal of the negative trend of remittances to Moldova. Based on the current IMF forecasts on the economic growth for 2009 and 2010 in the countries where most remittances come from (Russia, Ukraine, Italy, Spain, Portugal and Greece) we expect a decrease between 35% and 40% in remittances volume by the end of 2009. As for 2010 an economic growth is expected for both CIS countries (including Russia and Ukraine where Moldovan migrants work) and for EU (including Italy and Portugal hosting big numbers of working Moldovans), the remittances are also expected to increase based on previous trends, approximately by 5%. Thus, despite the expected end of decline in most of the countries where Moldovan citizen will work in 2010, Moldovan recovery will be painful and not immediate.

- As regards the other sources of income, in 2010 social payments and wages in budgetary sector will remain stable due to lack of financial resources for further increases, except wages for the teaching staff, which has been accepted by the MF. The wages in the real sector of the economy are expected to increase slightly in industrial, agricultural and service sectors (excluding construction sector) where there is a positive correlation between the evolution of labour productivity and evolution of wages.

Challenges ahead

- Large gaps between data on remittances from different data sources points to the **necessity to revise the methodology of reflecting remittances in the Balance of Payments** as they presently also include investments and other payments which are not remittances per se. It creates difficulties in data analysis and generates enormously high number for the share of remittances in GDP. This was reflected in many IMF reports, but a solution has not been found yet.
- **Moldovan social protection system does not reflect the real needs of the population and, therefore, has to be reformed in the nearest future.** On the one hand, the abolishment of nominal compensations and full transit to means-tested social allowance is discussed for a long time, but has not been fully implemented due to the political reasons. Currently, the Program for Economic Stabilisation and Revival of the Republic of Moldova for 2009-2011¹ stipulates a gradual abolishment of nominal compensation system by not increasing further the value of compensation and not allowing for registration of new beneficiaries. We believe that the Government should fully abandon the nominal compensation as soon as possible. These resources can be better used for other urgent needs during crisis as, for example, the payment of unemployment benefits, which have increased due to the continuous increase of registered unemployed. The unemployment benefits themselves are also very low and should be revised.
- The new Government may be exposed to growing pressures from different categories of public employees to increase their salaries and which are likely to use the example of increase of salaries for the teaching staff. Obviously, this will be impossible next year; however, **in mid-term, the productivity and quality of public services will depend on the level of wages in the sector and they need to be increased.**
- In short-term it is very difficult to apply any measures that would immediately stimulate individual entrepreneurship as the crisis still hinders the economic developments. However, creating fair business environment and eliminating “monopolies” are necessary to protect small and micro business that may serve as important sources of income for some households. Also, **it is very important to eliminate the intermediary agents thriving currently on the trade of agricultural goods** and reducing the income from agricultural activities of the households.

¹ Draft Program for Economic Stabilisation and Revival of the Republic of Moldova for 2009-2011, <http://mec.gov.md/node/1766>

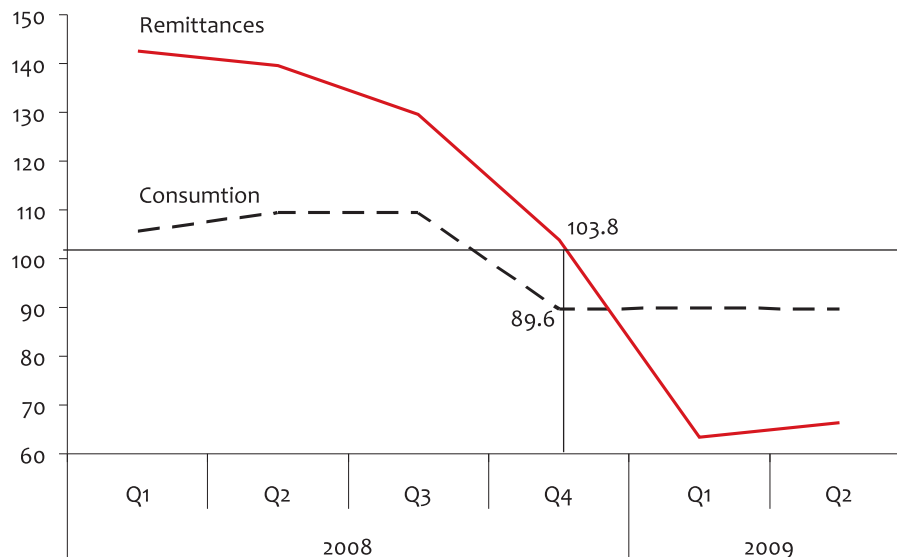
9. Households' consumption

In this chapter we analyze evolution of consumption, which reversed its long-term increasing trend even before the income started to decrease. This might reflect the imperfection of data collection, but more probably it is the outcome of the generalised perception of the population about upcoming crisis with subsequent decrease in income. These perceptions are also proven by the trend in natural persons' deposits at commercial banks that continue to increase at the beginning of the year. The chapter ends with an outlook for 2009 and 2010 and some challenges that need to be solved in order to stimulate consumption that in short term will be the main engine of economic growth.

Decreasing consumption – instant response to crisis

Households' consumption which was the engine of the Moldovan economic growth for a long period reacted immediately to the first signs of the global crisis and started decreasing already in the last quarter of 2008. This had a major impact on the GDP in 2009, contributing to its decline by 10.8% in the first quarter and 9.3% in the second. It is very interesting that household consumption started to decline both according to National accounts and HBS data before the decline in the income of the population. Also, according to both of these data sources, the decrease in consumption started before the decrease in remittance (Chart 24).

Chart 24 Trends in households' consumption and remittances (by Balance of Payments), y-on-y, %



Source: National Accounts, Balance of Payments

These might suggest two things. *Either there was an actual fall in real remittances and not only in the part of investments in the first quarter, as it may be argued from the difference in data from Balance of Payments and HBS. Or, there was a general awareness of the population about crisis, and especially of the families of migrants, who expected a fall in their salaries already in the end of 2008 and reacted with a preventive contraction in consumption and increased propensity to save, as suggested by the fall of consumption one quarter prior to the decline in remittances.*

Both data from HBS and evolution of retail trade show a decrease in non-food products consumption, while the expenditures for food continued growing slightly in 2009. This is mirrored by the significant decrease in imports of some categories of non-food goods (such as household appliances), the decrease of production and collected taxes. Therefore, we believe that it is necessary to analyze the possibility to stimulate the consumption of some of these goods through VAT decrease on some goods and services with elastic demand (such as computers, constructions). So far, the new Government has decided only to increase excises for some products. As the demand for the products considered for an increase in excises (fuel, tobacco, alcohol, cosmetics, luxury car) is inelastic, this should not reduce consumption significantly.

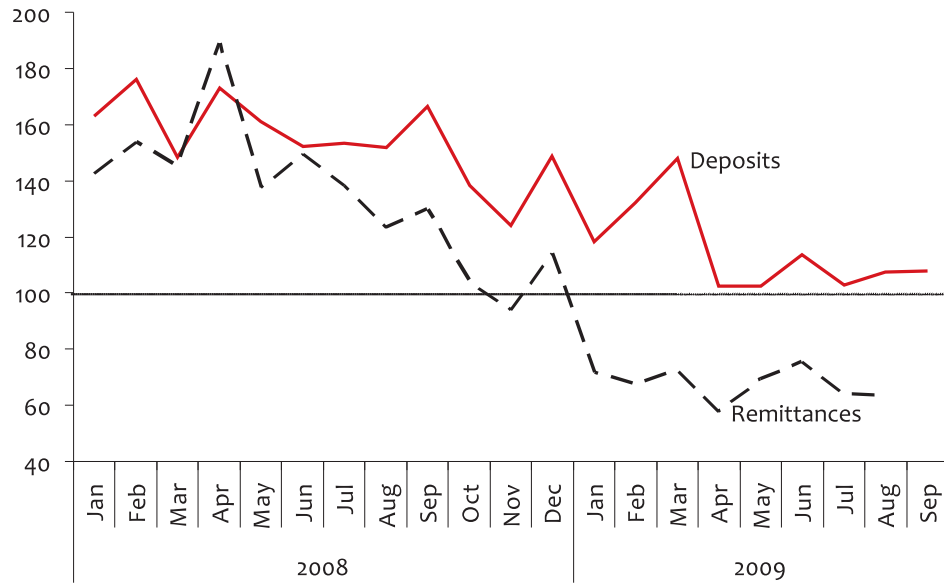
In September 2009 a slowdown of the decline rate of retail trade was registered on annual basis. Taking in consideration that the base period was already affected by the crisis and that in September Moldova actually entered the second year of crisis, this seemed to be a normal evolution. However, October data show a further and much deeper decrease in retail trade and services provided to the population, in line with the trends of main sources of income of the population. These trends have not been paralleled by the evolution of services rendered to population which has kept growing both in September and October.

Saving for the “worse day”

Awareness of the population about crisis effects before the actual decrease in income is confirmed by data on evolution of the bank deposits of natural persons that were still on rise at the beginning of the year, although their rate of growth slowed down. Further, the trend of the deposits followed the general trend of remittances with the most significant fall in April that perfectly correlates with the drop in remittances (Chart 25). The stagnation of the rate of growth is explained both by the declining trend of remittances, but also by the political instability in the country that made population more worrisome and decreased the confidence in banks, especially after the June bankruptcy of the Investprivatbank. However, over August and September, the confidence in the banking system have been re-established and the deposits of the population continued to increase despite the further decrease in money transfers from abroad and the decline in the interest rate for deposits.

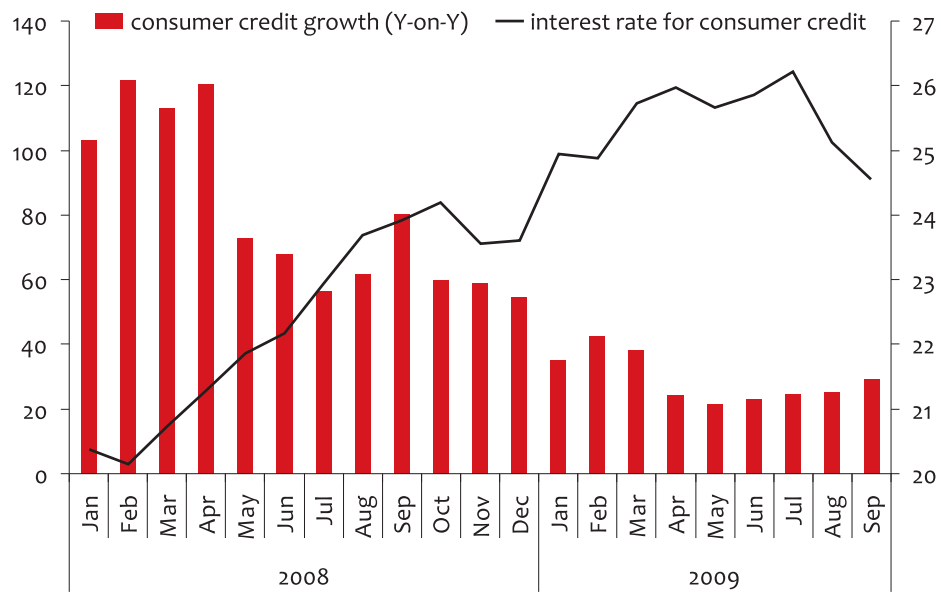
At the same time, in the context of decreasing and volatile income of the population, the consumer credit has decreased this year on average by 70% monthly y-o-y. The increase in consumer credit until April 2008 was a normal evolution in the context of increasing salaries and economic growth. However, the commercial banks reacted somewhat contradictory to the deflation and NBM looser monetary policy measures and increased the interest rates during the first semester (Chart 26). Only in July an opposite trend of the interest rates started to materialise.

Chart 25 Evolution of remittances and natural persons' deposits, y-o-y, %



Source: NBM

Chart 26 Evolution of consumer credit and interest rate for consumer credit



Source: NBM

Outlook for 2009 and 2010

- As there is strong positive correlation between consumption and remittances, the forecasted decline in remittances by 35-40% in 2009 can result in a decrease of household consumption by around 16-17% in 2009. Taking into consideration the increase in social payments and increase in salaries in the budgetary sector at the beginning of this year, but also the increased propensity of not declaring the revenues from sales in crisis period, the net decrease in consumption may register values between 10% and 12% by the end of 2009. The slight increase in remittances expected for 2010 (around 5% based on IMF forecast for economic growth in 2010) may keep consumption stable in 2010 if no other measures will be undertaken by the Government in order to stimulate consumption.
- The savings of the population, in the forms of deposits in commercial banks, most probably will continue to grow at a low positive rate this year, which might increase slightly in 2010 as a result of increase in remittances.

Challenges ahead

- Continuous decrease in consumption in 2009, especially for non-food goods (trade of non-foods has decreased by 10.4% in January – September) should be a major Governmental concern. In short run, the Government should act to stimulate consumption. Although, the decrease in budgetary revenues puts more pressure on the Government to look for additional revenues and brought forth the idea of increasing the VAT, this would only decrease consumption. On contrary, **the decrease of VAT for some goods may stimulate consumption** and should be considered by the new Government.
- Also, **the deduction of investments in durable goods of natural persons** may increase consumption not only of these specific goods, but also complementary goods and services.
- The weak channels of transmission of the monetary policy keep interest rates high and make credits unaffordable for most of the population. **The National Bank of Moldova should further orient its monetary policy to increase the crediting of the economy and consumers**, but at reasonable interest rates, keeping track of inflationary pressures.

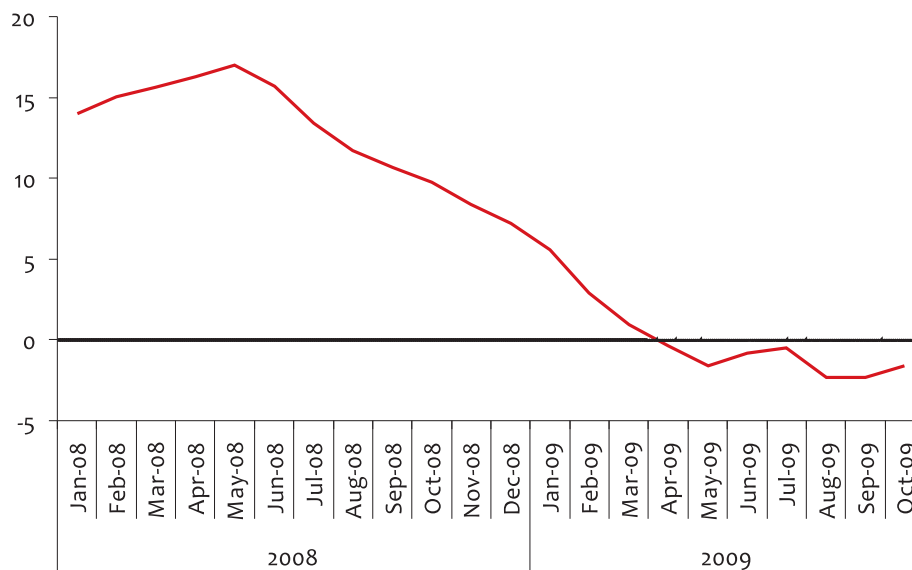
10. Prices

This chapter is on the evolution of prices during 2009 and factors that contributed to different trends in January-August and September-October. The decrease in prices in the first period was a short-term effect of the crisis, which has reversed and in mid-term Moldova will have inflation rising again. However, as the inflationary pressures are not so strong, the NBM should continue with a policy oriented towards the crediting of the economy, which it has failed to implement in 2009, despite monetary tools used actively in July.

Deflation: an outcome of economic crisis

After many years of high inflation (constantly exceeding the limits set by the NBM and agreed with IMF), for the first time since independence Moldova has registered a significant annual deflation in 2009. The CPI started to decrease already by the end of 2008 at the early stage of economic crisis and led to an annual deflation rate in April 2009 (Chart 27).

Chart 27 Annual inflation rate (%)



Source: NBS

However, the prices' trend was not homogenous during the year and two main stages in the evolution of prices may be identified in 2009. During the first stage, January-August, the prices were constantly decreasing due to:

- **Decrease in oil and oil derivatives prices.** These prices have a sizable impact on the Consumers Price Index both directly (fuel has a significant share in CPI) and through their impact on production costs. The price per barrel of oil in January-August 2009 was twice lower than the price in 2008. Consequently, this made possible a general decrease of prices per economy.

- ❑ **Deflation in many of the European countries.** That made a number of goods imported to Moldova much cheaper.
- ❑ **Significant decrease in prices for agricultural products and foodstuff.** In the first semester of the year the wholesale prices for agricultural production decreased by 46%. This was still an effect of the serious drought of 2007 that contributed to an increase in prices in the first semester of 2008 by over 50%. However, this is the most significant drop in wholesale prices for agricultural products since 2000 pointing to the difficulties and uncertain framework which farmers operate in. Consequently, the CPI for foodstuff products has decreased by 6.8% in ten months of the year, much more as compared to non-food and services. As result, the Industrial Price Index in the food industry decreased more than on average this year.
- ❑ The **decrease in monetary mass** paralleled the shrinking domestic demand and had its own major contribution to the decrease in prices over the whole period as the producers and retailers tried to get rid of their stocks through more attractive prices.

However, in September the deflation trend reversed and the next two months Moldova registered high rates of monthly inflation. The reasons are:

- ❑ **Industrial Prices Index that started increasing again in March.** This obviously should have reflected in the CPI for foodstuff and non-foodstuff products with a certain lag.
- ❑ **The reversal of deflation trend in most of the European countries** that made the imported goods more expensive again. In September 2009 inflation was registered in 17 out of 27 EU member countries.
- ❑ **Administrative increase in tariffs for transport services and some utilities in Chisinau in October.** This measure was adopted due to the losses suffered by the companies operating in the sectors, which resulted in an overall increase of prices due to the large share of the population based in Chisinau.

Deflation is not an economically healthy phenomenon, but in case of Moldova it provided some opportunities for the Government this year. After many years of unsuccessful inflation fighting by tightening monetary policy, in 2009 the NBM had the opportunity of applying a looser policy by decreasing the base interest rate and mandatory reserves maintained by commercial banks in national and foreign currency. However, the reaction was quite late. Despite continuous deflation in the first semester, NBM operated really significant changes of the two monetary tools only in July (see more next chapter).

Outlook

- ❑ Deflation trend seems to have suffered a relentless reversal and Moldova is likely to close the year with an annual inflation of about 0-1%. Prices for foodstuff products will bring about the main contribution to the low inflation but this mainly due to the evolutions in the beginning of the year. As regards 2010, expectations of increasing oil price and slight economic recovery in many EU and CIS countries will tend to push the prices upward. For 2010 we expect an end-year annual inflation rate of 4-5%.

Challenges ahead

- Increasing prices may direct the NBM towards tightening the monetary policy. However, this should not be the case as it is already too tight in the current context. In 2010, inflation still will be under control, so, ***the main task of the NBM should be to support further the real sector of the economy and ensure necessary conditions for crediting the economy at reasonable interest rates.***
- ***An important task for the new Government is to shorten the long value-chains in the trade with agricultural goods*** that is the cause of high prices of foodstuff products and a constant reason for complaints of the agricultural producers; sometimes they are even forced to sell their production at prices below the cost of production.

11. Monetary policy

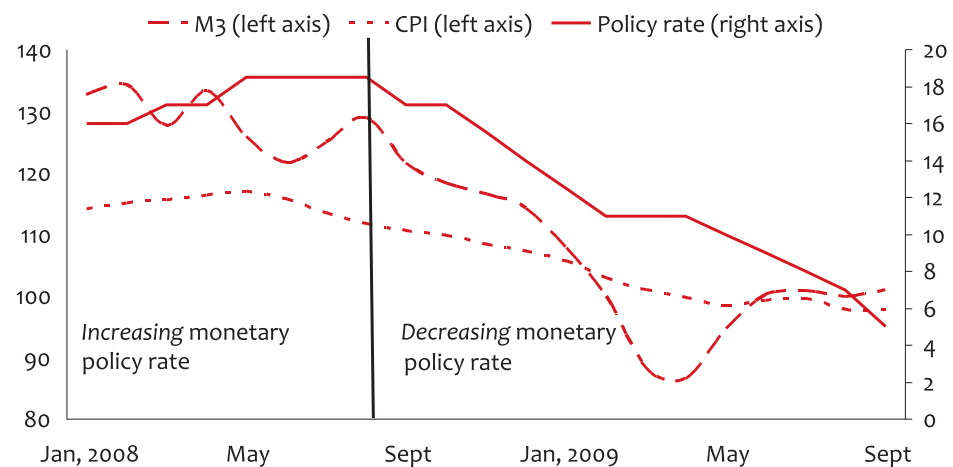
This chapter discusses the main actions undertaken by the National Bank of Moldova in 2009 in order to mitigate the repercussions of the world financial and economic crisis and how the monetary policy radically changed from tight to a loose one. The chapter explains why these actions did not bring the expected results and what are the main constraints affecting the central bank's monetary policy.

From an illusionary tight policy to an illusionary loose policy

The monetary and foreign exchange policy of the National Bank of Moldova (NBM) for 2009 was focused on keeping the end-year annual inflation rate at 9.0%, with a possible deviation of +/- 1.0 percentage point. It is clear that when designing its policy in late 2008 the NBM did not expect the world financial crisis to have a domestic impact of such a magnitude as it had in 2009. The deflation registered in April-August 2009 and the decrease in economy monetization since September 2009 made the NBM to change its focus to the stabilization of the economy. After gradually tightening its anti-inflation policy in September 2007-May 2008, in 2009 the NBM gradually decreased its policy interest rate.

But does the current level of NBM policy rates correlate with the inflation trends? An optimal monetary policy rate should be 4 p.p. above the annual inflation, according to the central bank's officials¹. However, since September 2008 the gap between the annual CPI index and policy rate has only increased. This means that although NBM attempted to relax its monetary policy (as Chart 28 illustrates), in real terms the monetary policy became much tighter (Chart 29).

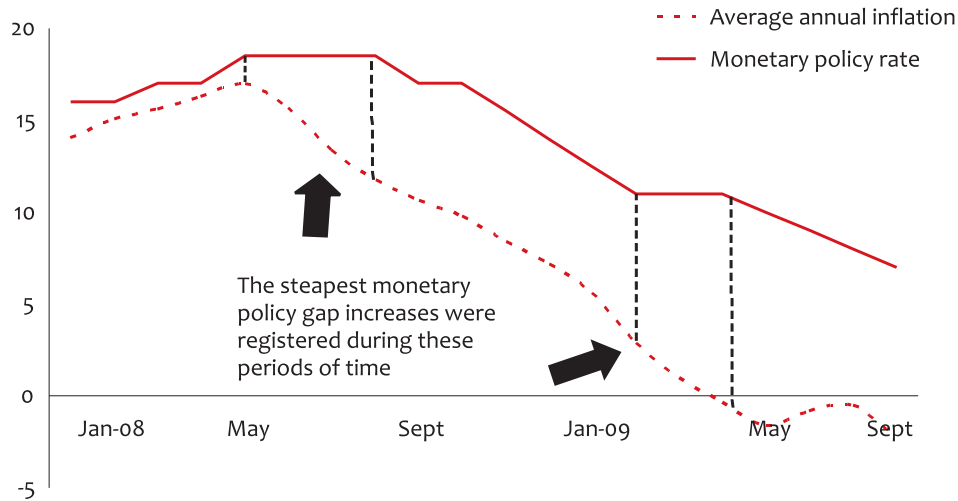
Chart 28 Evolution of the monetary aggregate M3 and CPI (M/M-12) and NBM refinancing rate, %



Source: NBM, NBS, EG calculations

¹<http://logos.press.md/Weekly/Main.asp?IssueNum=817&IssueDate=11.09.2009&YearNum=33&Theme=3&Topic=25834>.

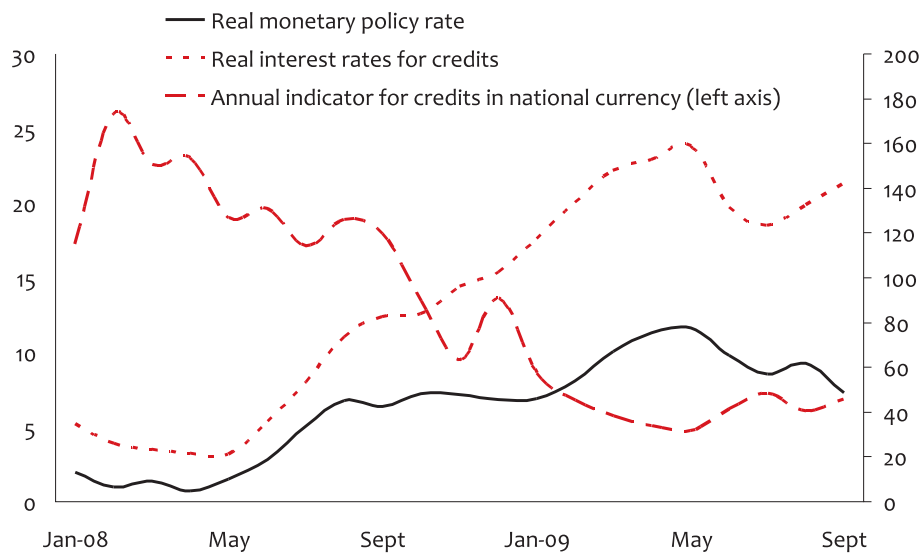
Chart 29 NBM refinancing rate and average annual CPI index, %



Source: NBM, NBS, EG calculations

NBM's attempts to effectively relax its monetary policy were undermined by the deflationary trends. We believe that in 2008-2009 NBM took a too conservative approach regarding its monetary policy. NBM needed four months in 2009 to be completely sure that inflation is subdued and during this period it kept the policy rate unchanged despite the decreasing CPI index. Its reluctance can be explained to some extent by the speculative attacks on national currency in February-March 2009 and by the elections campaign. A consequence of the NBM exaggerate prudence was the decrease in economy monetization which undermined even more the economic growth by restraining crediting activity. Chart 30 illustrates the positive correlation between the real policy rate and real interest rate on credits in national currency and the negative correlation with the credits growth.

Chart 30 Evolution of real monetary policy rate, real interest rate and annual growth rate for credits in national currency, %

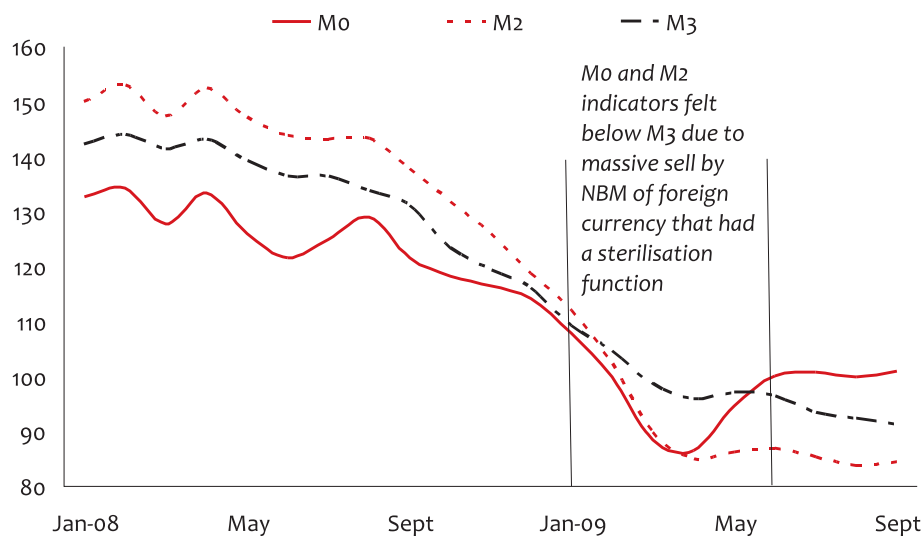


Source: NBM, NBS, EG calculations

Switching from money sterilisation to liquidity provision

When the global financial crisis set on in September 2008 the decrease in monetary mass in Moldova accelerated (Chart 31). Refuelling the economic system with additional liquidities became a priority for the NBM only gradually during 2009. Unlike other countries in the region, only the economy's real sector felt a shortage of liquidities, whereas the banking system in Moldova fared well in terms of liquidity indicators.

Chart 31 Evolution of annual indicators of monetary aggregates, seasonally adjusted, %



Source: NBM

Since April 2009 the NBM has not used its certificates as sterilization tool anymore and has only provided liquidity through REPO operations and direct loans to commercial banks. The first instrument has been used mainly from May to July and helped injecting MDL 346 million in the banking system. In March-September 2009 the NBM has provided also MDL 1389.1 million direct credits to commercial banks at its refinancing rate. The main condition was for the banks to further channel these resources into the real sector with a maximum margin of 5 p.p.

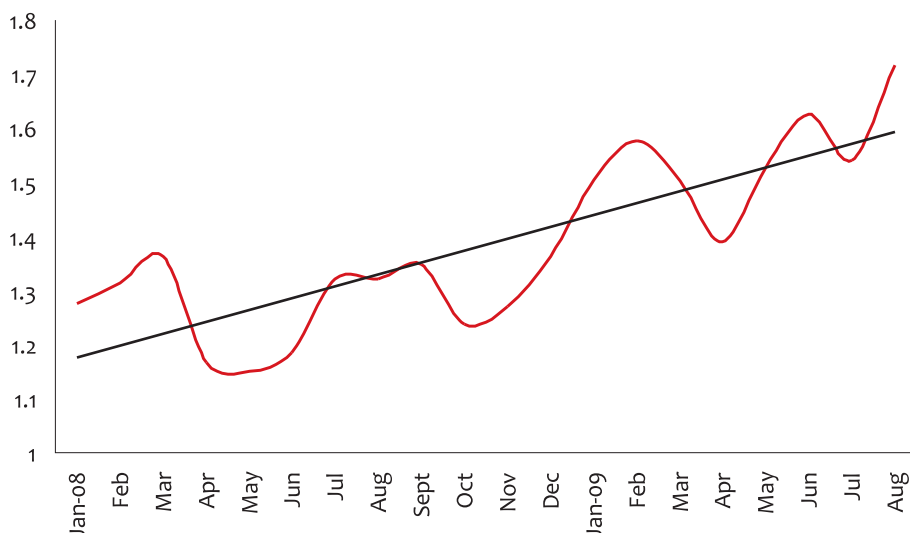
Additionally, NBM decreased the obligatory reserves rate which offered commercial banks the possibility to free up more resources for crediting activities. The obligatory reserve rate for attracted resources decreased from 22.0% in September 2008 to a record low level of 8.0%, both for national currency, fully convertible and non-convertible currencies.

Foreign exchange market – looking for the “right” exchange rate

Since the beginning of 2009 until September 2009 the national currency depreciated against USD by 8.3% and against EURO by 16.8%. During this period of time the internal foreign exchange market faced many challenges which created depreciation pressures on the Moldovan Leu. Besides objective factors which led to the decrease in foreign currency inflows and, respectively, decrease in demand for national currency (decrease in remittances, exports and FDIs), there were factors related to investors' and consumers' downwards anticipations. They had a dramatic impact during the electoral fever, when a massive speculation fuelled the negative anticipations against national currency.

These depreciation trends are, also, revealed by the evolution of the real effective exchange rate (REER). During the first semester of 2009, REER depreciated by 15.2 p.p., from 133.1% to 117.9%, which denotes the depreciation of the Moldovan national currency in comparison with its main trading partners¹.

Chart 32 Evolution of the ratio official reserve assets/imports for 3 consecutive months



Source: NBM, NBS, EG calculations

Given the NBM commitment to keep the national currency stable, during the first months of 2009 it made historically high interventions on the foreign exchange market by selling its official reserve assets in order to meet the increased demand for foreign currency. During January-April 2009 the total amount of foreign currency sold was equivalent USD 513.7 million. These massive interventions were not welcomed by a major part of the economic analysts for two main reasons: first, sterilization of these currency interventions had negative effects on the economy monetization (Chart 31); second, keeping the national currency stable was made at the expense of the central bank's official reserve assets, which decreased in volume by 34.1% from January to April 2009. While the first reason for concern was fully justified, the second one was not. According to an internationally accepted and IFM-backed norm, the optimal level of official reserve assets should not be lower than the imports volume for three consecutive months. As Chart 32 clearly shows, the central bank's interventions did not affect negatively the optimal level of its international reserves.

Outlook for 2010

- ❑ It is likely that NBM will continue to relax prudently its monetary policy, by decreasing the refinancing and obligatory reserves rates. This will contribute to the increase in economy monetization.
- ❑ As a result of anticipated increase in exports, remittances and FDIs for 2010, the official reserve assets will also go up, which will strengthen the NBM's position to keep the national currency stable.

- We expect that the real interest rates for credits in 2010 will decrease which will contribute to the increase in crediting the economy's real sector.

Main challenges

- Despite the fact that the NBM's refinancing rate was set in September 2009 at the minimal historical level of 5%, it remains quite high in real terms. Taking into account that the interest rates applied to the central bank's loans to commercial banks equals its policy rate, it will continue to create constraints for the crediting the economy's real sector. **Respectively, NBM have to continue relaxing its monetary policy given the deflation trends and the necessity to stimulate the real sector's crediting.** However, this measure should not only lead to the increase in the liquidity indicators within the banking system. **It is crucial that commercial banks invest their resources in programs for financing the economy.** Otherwise, the continuous decrease in the monetary policy rates with almost no immediate impact on the economy, can lead to a boomerang effect in the near future. For instance, it can result in massively flooding the economy with liquidities and such a sharp increase in the monetary mass could immediately boost the inflation to dangerous levels.
- **The lack of population' and investors' confidence in the national currency serves as another key policy issue and challenge which the NBM's foreign exchange policy should deal with.** Chart 31 denotes that since April 2009 the annual indicator for monetary aggregate M0 constantly exceeds M2 which is associated with the decrease in the amount of time deposits denominated in national currency. This phenomenon makes the issue related to the shortage of long money in the Moldovan economy even more acute.

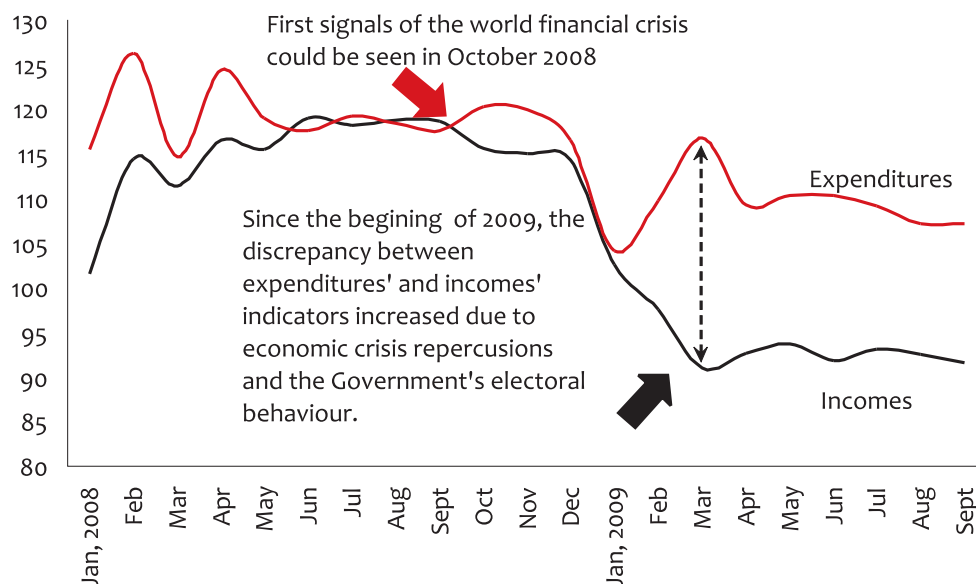
12. Budgetary policy

This chapter describes the main trends related to public finances which were influenced by economic crisis, as well as by the political situation in 2009. It analyzes the budgetary policy which on the revenues side was influenced by the shrinking internal and external demand and on the expenditures side by the electoral behavior of the Government. There is also a discussion of the methods used to finance the increased budgetary deficit and of the possible effects of an austere budgetary policy. This chapter highlights the challenges which the Government will face in short-term.

General overview

Our statement in MEGA #1 that public finances are a mirror of the country's economic and political situation remains valid. The data on national public budget execution perfectly reveals the first signals of the world financial crisis and the inappropriate reaction of the previous Government (Chart 33).

Chart 33 Annual indicators of budgetary revenues and expenditures, %



Source: Ministry of Finance, EG calculations;

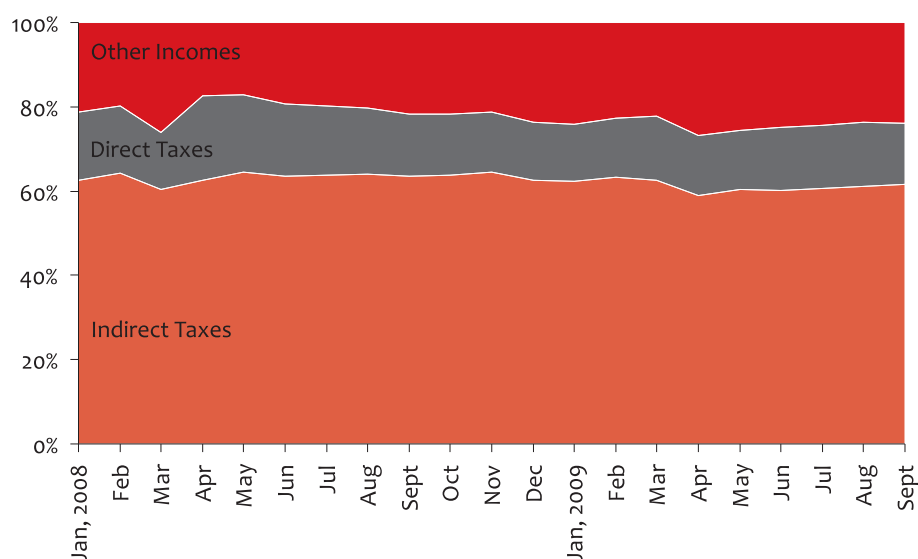
Starting with October 2008 the budgetary indicators registered a sluggish decline, followed by a sharp collapse starting with January 2009. Taking into account that public revenues in Moldova depend mainly on household's final consumption, the shrink in internal demand had dramatic effects on the national public budget. At the same time, the Government driven by electoral interests did not renounce to its pre-electoral promises and even made more promises. As a result of the increase in pensions and wages in the public sector, the public

expenditures also increased from the beginning of 2009. The discrepancy between public revenues and expenditures led to an uncontrolled budgetary deficit which in the 1st semester 2009 accounted for 7.5% of GDP.

Consumers as main source of budgetary revenues

During the past several years the reliance of the budget on households' consumption continually increased as revealed by the increasing share of indirect taxes (VAT, excises and custom duties) in total public revenues. Their share increased more prominently after the introduction of zero corporate income tax since January 2008. While in 2007 the share of indirect taxes in budgetary revenues was 57.5% and of direct taxes – 20.9%, in 2008 indirect taxes made already 62.5% of total revenues and direct taxes only 13%¹. This model of budgetary revenues formation preserved in 2009 (Chart 34) and with a recent Governmental decision to keep the zero rate on CIT until 2012, it is unlikely that this model will change in the near future.

Chart 34 Budgetary revenues structure, % of total

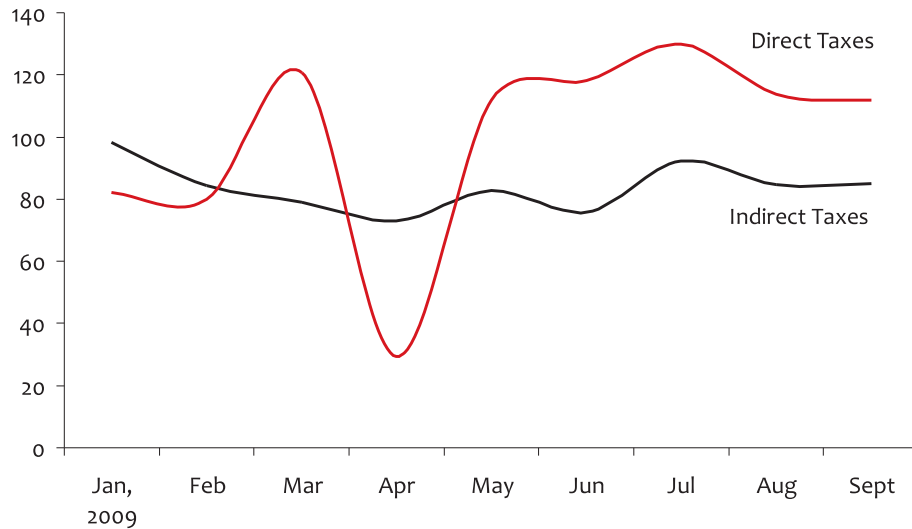


Source: MinFin, EG calculations

The share of fiscal revenues in GDP decreased during the 1st semester 2009 until 32.6%, which was mainly caused by the shrink in final consumption. As Chart 35 illustrates, the revenues generated by indirect taxes were much more affected by the world economic crisis which had a dramatic influence on total budgetary revenues and budgetary deficit.

¹The calculations were based on the Public National Budget, except social and medical insurance contributions.

Chart 35 Annual growth of direct and indirect taxes, %

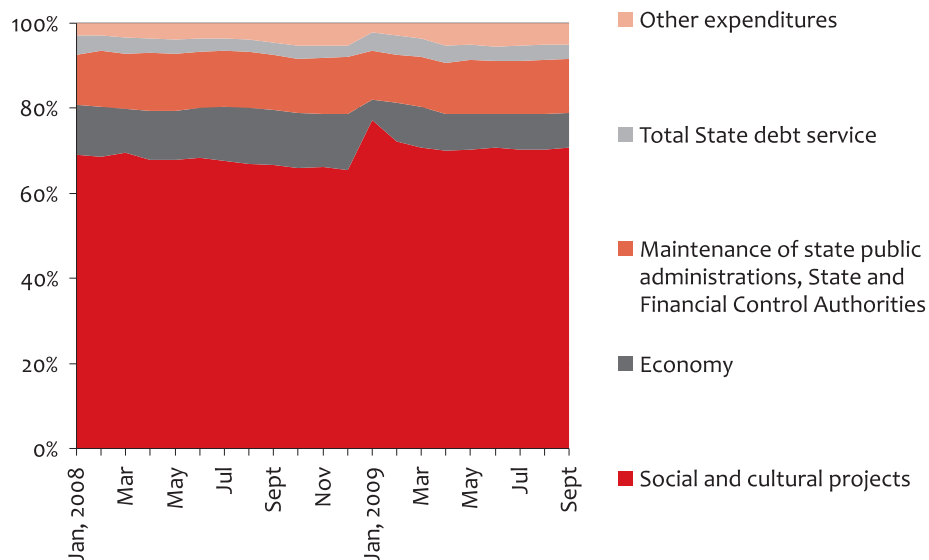


Source: MinFin, EG calculations

Public expenditures: who will pay for the Government's myopia?

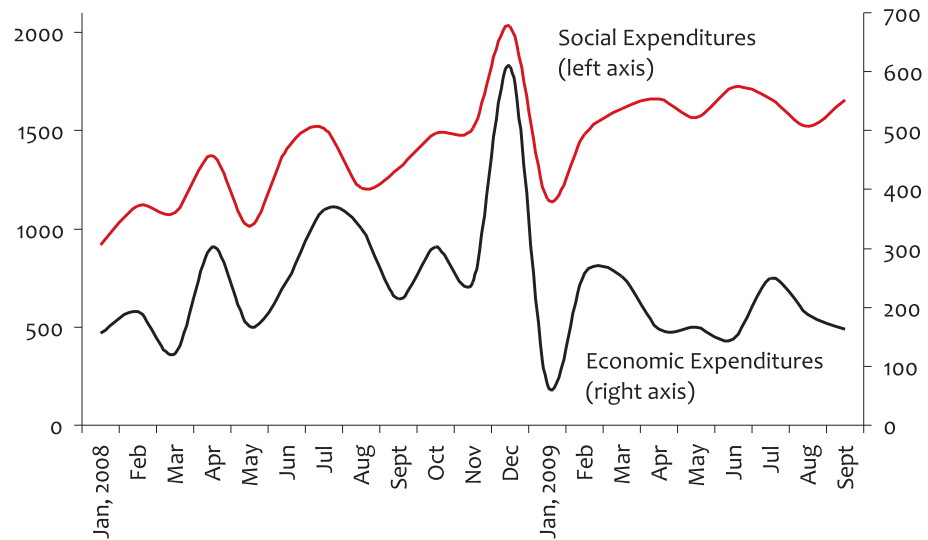
Given the continuously decreasing public revenues, the first measure which should have been immediately undertaken by the Government in order to mitigate the increase in budgetary deficit was to reassess its expenditures policy. First of all it concerns public expenditures on social and cultural projects which traditionally form the major part of total budgetary expenditures (Chart 36). However, the Government did not cut its social expenditures but rather decreased its economic expenditures (Chart 37).

Chart 36 Structure of budgetary expenditures, %



Source: MinFin, EG calculations

Chart 37 Evolution of budgetary social and economic expenditures, real terms, mil. MDL



Source: Ministry of Finance and EG calculations;

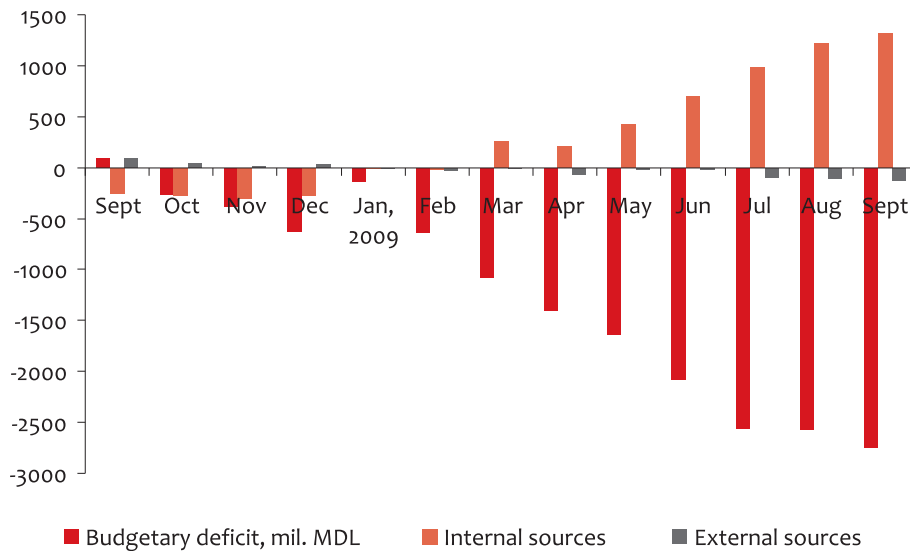
Moreover, in light of the approaching April 2009 parliamentary elections, the Government increased even more its social expenditures despite decreasing its revenues. It increased the pensions by 20% instead of the legally required 15 indexation¹ and promised wage increases for public employees. With this budgetary myopia, the Government spent the budgeted resources for several months ahead. Covering these “budgetary black holes” was possible only by issuing state treasury bills, which intensified since May. Obviously, the bill for such a charity, sooner or later, should be paid and that is the point where the real problems begin. As of the end of September 2009 the budgetary deficit reached MDL 2750.2 million and the deficit could double by the end of 2009. This makes difficult to keep the budgetary deficit at the level of 9% of GDP as new Government promised. Even more, it is practically impossible unless external sources of financing budgetary deficit are identified.

Bankers’ patriotism as a source for financing budgetary deficit

Main investors in state securities in Moldova are the commercial banks, and in 2009 they became the main creditors of the Government for financing the increasing budgetary deficit. Chart 38 reveals that since March 2009 internal sources of financing started to be intensively used for covering a part of budgetary deficit. However, the most prominent increase in revenues from issuing state treasury bills was registered since May 2009, with the total volume of transactions increasing from MDL 154.3 million (April 2009) to MDL 418.5 million.

¹ According to the Law on state socially insured pensions, the pensions are indexed annually on the date of 1 April. The indexation coefficient is determined based on the average between annual CPI and average wage growth rate.

Chart 38 Evolution of budgetary deficit and sources of financing Sep'08-Sep'09, MDL million



Source: MinFin

Taking into account the cost of domestic capital, much higher than in other countries, as well as shortage of long-term investment resources in the economy, we consider such a form of financing as quite dangerous for Moldova. Most of the treasury bills are issued with a 91 and 182-days maturity, which means that the revenues earned from such securities can be used only for financing some temporary cash deficits. On the one hand, the Government cannot use these resources for financing some long-term infrastructural projects and used this type of borrowing for financing part of its social protection policy and paying wages to public workers. On the other hand, the Government has permanently to seek for funds in order to repay these debts. The increase in domestic public debt with so short repayment periods and contracting public revenues will create soon significant pressures on the budget.

This policy of using internal sources for financing budgetary deficit was supported by the NBM monetary policy. The refinancing rate and required reserves rates decreased from 10.0% and 17.5% in June 2009 until 5.0% and 8.0% in September 2009 and this made possible for commercial banks to use more resources for crediting the Government. Because of the high risks in almost all economic sectors, banks believed that the state is the most secure debtor and they did not hurry to provide loans to private companies or consumers.

Outlook for 2010

- It is certain that in 2010 the Government will implement a more austere budgetary policy. The only measure to maximize the budgetary revenues will be the increase in excises for several commodities (for fuel by 7.5%, tobacco - 10%, alcoholic beverages - 4%, cosmetics - 15% and luxury cars - 20%). With the budgetary base not likely to widen significantly, this will create significant pressures on the budgetary expenditures policy which will be less expansive during 2010.
- The recently agreed memorandum with IMF will make much easier to attract external resources from many creditors and donors and this will mitigate the pressures on the national public budget. It will make the Government to rely more intensively on external sources instead of internal ones for financing the budgetary deficit.

Challenges ahead

- The fundamental challenge for the end of 2009 and during 2010 will be keeping the budgetary deficit within the limits agreed with IMF (9% of GDP in 2009 and 7% of GDP in 2010). **The main function of the austere budgetary policy will be taking the budgetary deficit under control.**
- The increasing sales of state treasury bills during May-September 2009 will create significant pressures on the state budget already at the end of current year, due to their short repayment period. Therefore, a major challenge for the Government will consist in **identifying external sources for financing the state budget.**
- The Government committed to cut 4000 staff units of employees in the public sector. This creates two problems: **a spike in unemployment rate and political costs.** It is extremely important that this optimization is a fair one (targeting increased efficiency and professionalism rather than political loyalty) and accompanied by **streamlined business environment so that human resources redundant in public sector are channeled in the private one and not migrate.**
- As a result of the expected increase in the state external debt, a major challenge for the Government will be **to avoid any shocks related to the exchange rate which would increase the burden of external debt on the economy.**
- In 2010 Government will have to combine its economic policy focused on economic growth with better social protection. In this context better means socially fair (i.e. targeting the poorest and the most vulnerable). **The Government will have to strike the right balance between social and economic expenditures, while keeping the budgetary deficit under control.**
- With the CIT planned to be reintroduced only in 2012, the narrow tax base at local level and high fiscal centralization will remain important issues unless more consequent actions are undertaken by the Government. For instance, it can reintroduce the practice of VAT sharing with local governments. Additionally, it can increase the property tax which could become a more important own source for local budgets¹. It is also necessary to improve the regulatory framework that will offer local governments clear possibilities to borrow long-term loans on the capital market.

¹ According to the situation from September 2009, the share of property tax revenues in total local public revenues except transfers from the central government represented 8.9%

13. Financial markets

The current chapter is focused on the analysis of the last evolutions in the banking system. Main issues are studied based on the available statistical data, national and regional research reports and comparative analysis for the current trends. What needs to be stressed is that all three markets were affected by the current economic crisis and are in the process of overcoming the difficulties. The analysis provided the necessary understanding of the challenges ahead on all three markets.

Structural changes and trends in the banking system

The global financial crisis has indirectly affected the banking system in Moldova. Moldovan banks have had limited access to international capital markets and thus limited possibility to raise cheap funds in the previous years. As result, Moldovan banks were not subject to large outflows like other countries' in the region. However, the significant reduction of remittances and the corresponding economic stagnation could not go by without a negative impact on the domestic banking system. Domestic currency deposits declined by around 25% in nominal terms between December 2008 and June 2009, while foreign currency deposits have remained relatively stable, reflecting concerns about the prospects of the domestic currency and declining remittances. Main indicators of the banking sector also register a lower performance and a higher concentration of the sector (Table 2).

Table 2 Moldova main banking system indicators, Q1-Q3'09, %

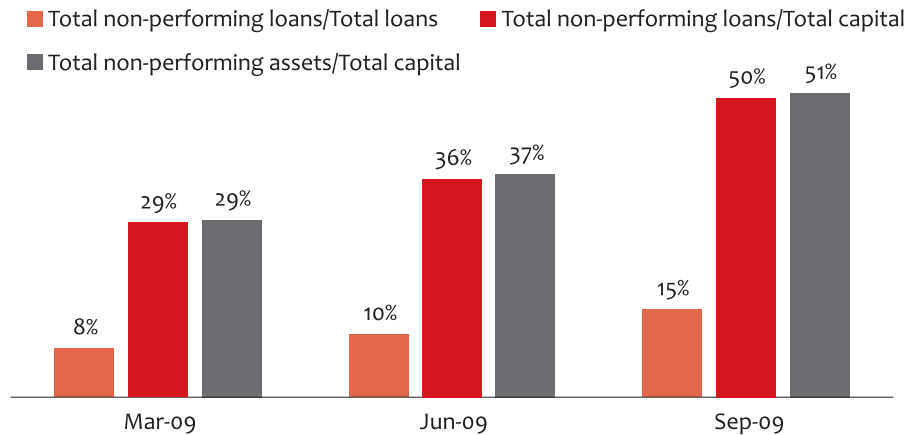
	Q1	Q2	Q3
Depth of the banking system			
Total banking assets/GDP	29	12	N/A
Lending/GDP	19	8	N/A
Deposits/GDP	20	9	N/A
Concentration			
Equity/Total banking system	63	65	64
Total assets/Total banking system	64	67	68
Ownership as a ratio of assets			
Subsidiaries of foreign banks	21	22	22
Capital adequacy ratio	31	33	32
Dollarization			
Foreign currency loans/Total loans	41	45	45
Foreign currency deposits/Total deposits	53	57	55

Source: NBM and EG calculations

The stability of the banking system is affected by the current economic situation of the country. A number of risks influence the banking system and in particular the credit risk, also known as the risk of deterioration of the banking assets. According to the NBM data the quality of the loans portfolio of the banking system has worsened during the first three quarters of 2009, with the

weight of the non-performing loans (NPL) in the total capital increasing from 29% in March up to 50% in September. Same negative trends registered the weight of the non-performing assets in the total capital and the weight of total NPL in the total loans (Chart 39). Similar evolutions have been remarked in most countries in the region, although the share of NPL in total loans did not overpass 5%.

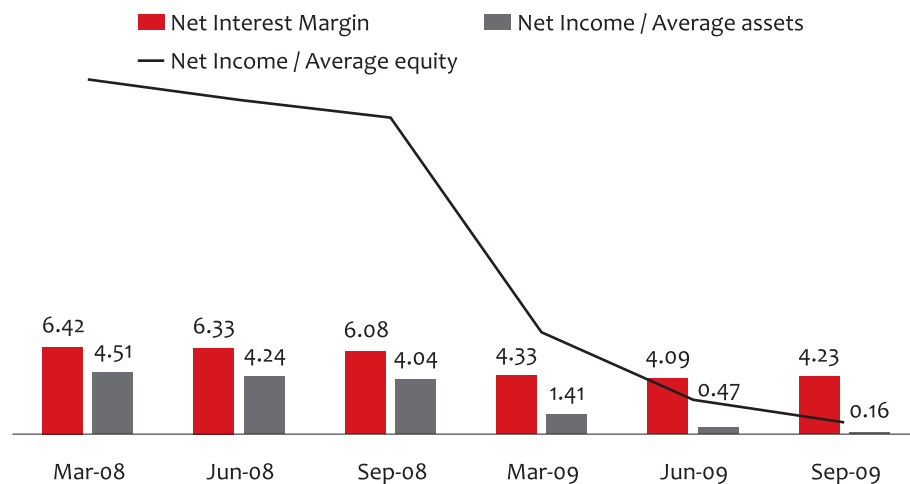
Chart 39 Share of non-performing loans and assets in the banking system, %



Source: NBM and EG calculations

As a result of accumulating non-performing loans the profitability ratios also registered significant negative trends (Chart 40). Just by looking at the evolution of such a key indicator as Net Interest Margin, it can be noticed the significant decrease from 6.08% in September 2008 to 4.23 in the same month this year. Both ROA and ROE have collapsed in 2009. As a result the banks became much more restrictive and cautious when extending loans.

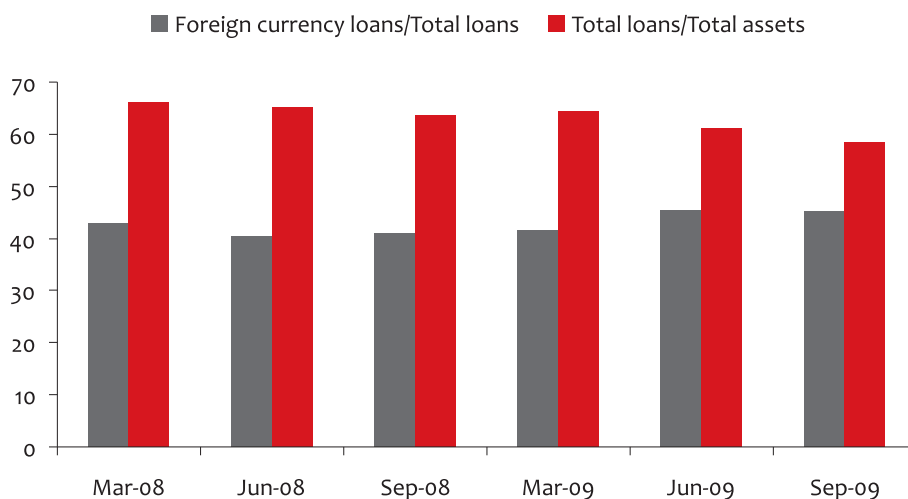
Chart 40 Evolution of the profitability ratio of the banking system, % (Q1-Q3'08 and Q1-Q3'09)



Source: NBM and EG calculations

Thus the share of total loans in the total assets continued a decreasing trend from 66% in March 2008 to 58% in September 2009, while the share of the foreign currency loans in the total loans increased from 40% in September 2008 to 45% in the same period this year (Chart 41).

Chart 41 Share of foreign currency loans in total loans in % (Q1-Q3'08 and Q1-Q3'09)



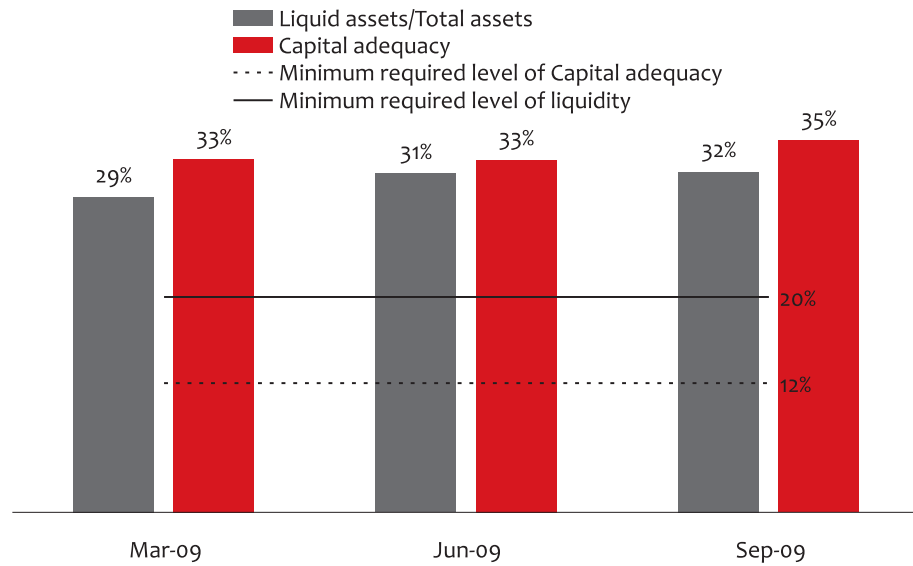
Source: NBM and EG calculations

Many companies, mainly from constructions, industry and trade suffered important losses during the current economic crisis and became incapable to reimburse the contracted loans, thus placing a significant strain on the banks' lending activity. In order to promote the lending activity the NBM took a number of actions, including the reduction in September this year of the obligatory reserve requirements from 20% of capital to 8% and of the interest rates from 20% to 7%. In May 2009 the NBM announced a program of funding to Moldovan banks for terms up to 12 months at the base rate to provide liquidity and support lending to the real economy. At the same time the NBM effected important amendments to a number of prudent regulations and standard acts, while the Banking Association of Moldova developed and proposed a draft law on amending certain legislative acts, in particular the Execution Code of the Republic of Moldova, the Insolvency Law, the Penal Code of the Republic of Moldova and the Law on financial institutions.

Banks hold the necessary sources for covering the potential future requirements. In 2009 Moldovan banks have been very prudent and ran capital adequacy ratios of over 30%, although the minimum required level is 12%; and maintained the liquidity level of more than 20% which is required by the prudent standards (Chart 42). The black spot on this rosy picture is the InvestprivatBank commercial bank, which entered an orderly liquidation procedure in June 2009 and all its deposits were transferred to the state-owned Banca de Economii commercial bank. The NBM pulled InvestprivatBank's license not because it ran out of money, but because its owners had been using the bank's assets for real estate investment funds and were fried when the market collapsed.

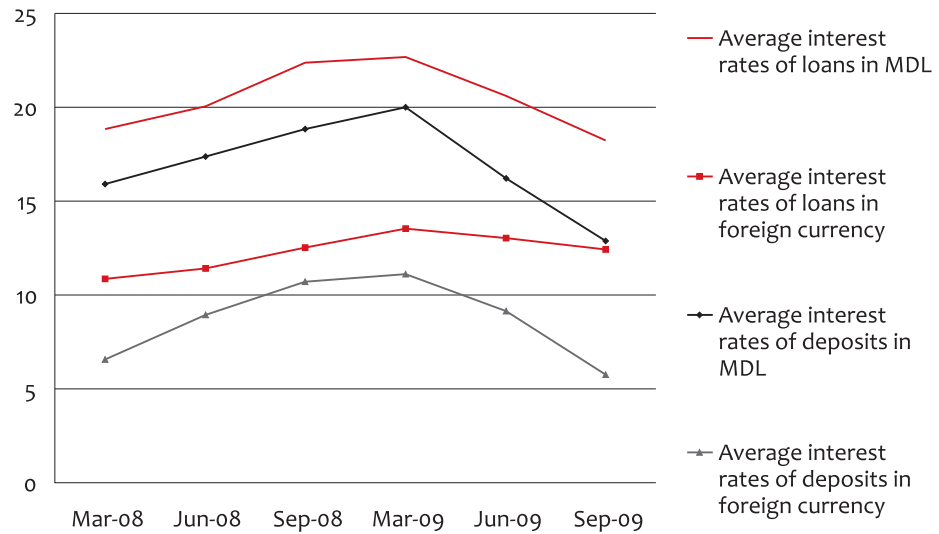
Total bank deposits amounted to MDL 24.9 billion as of September 30, 2009 registering a 8.5% decrease as compared with December 31, 2008. The weight of natural person's deposits in total deposits also followed a decreasing trend amounting, with 62.6% in September this year compared to 64% during the same period last year. The interest rates followed a decreasing trend as well beginning with the second quarter of this year after reaching a peak in March (Chart 43).

Chart 42 Liquidity trends in % (first three quarters of 2009)



Source: NBM and EG calculations

Chart 43 Evolution of the interest rates



Source: NBM and EG calculations

It can be noticed that the loans weight in total assets also was higher during the first quarter of this year and continued a slowdown after March, although it should have been vice-versa: as the interest rates decrease the loans volume should increase. The current situation is due to the slowdown of the overall real economy and as a result of the decrease of the number of extended loans, in particular due to the more restrictive requirements for the extension of loans.

Outlook for 2010

- In 2010 financial markets are expected to begin the process of recovering from the current economic crisis. The named recovery depends to a large extent on the political situation given the confidence of both national and international investors. Actors of the banking sector will look for new opportunities to augment their services portfolio in order to achieve higher levels of profitability and mitigate the potential risks.

Challenges ahead

- *The world financial crisis and the current economic crisis equally affected* the Moldovan financial system. The decreasing trends of all main indicators, including of lending and profitability ratios of the banking system is a direct result of the named impact. It is necessary for Moldova to have in place a financial early warning system, which would allow taking preventive actions before the new eventual crisis occurs in the future.

14. Foreign trade

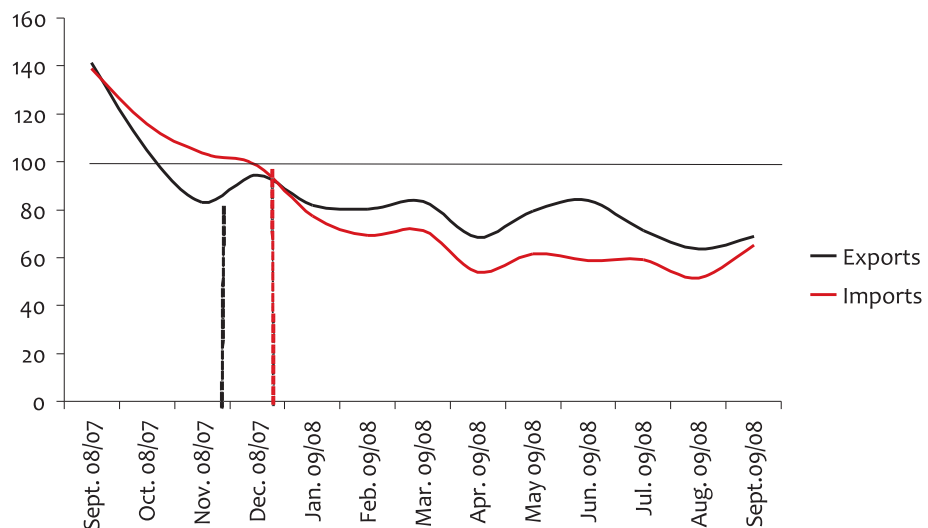
This chapter looks at how Moldova's foreign trade evolved in 2009 and how global financial crisis impacted it. It also attempts to see if and how the fundamental trends observed in the preceding decade have changed as the response to the crisis and where the future challenges may lie.

The foreign trade in crisis...

As the global financial and economic turmoil started to unfold, a certain number of Moldovan economic analysts and observers anticipated (despite the former Government's "no-crisis-in-sight" stance) the crisis to affect Moldovan economy not via financial contagion, but via down-to-earth real economy mechanisms. Specifically, slump in foreign demand for Moldovan goods would bring down Moldovan exports resulting in less profit (if any) for local companies and less work and income for local workers, which coupled with dwindling remittances would result in contraction of the domestic demand pushing Moldovan economy still deeper under water. The developments that followed gave credence to this view.

The almost freefall in exports and imports (see Chart 44) outlined the exposure of Moldovan economy to the external risks and pressures as well as offered better understanding of what the famous phrase "small and open economy" means. It is worthwhile to mention that exports felt the brunt of the crisis before the imports. Initially the internal demand held up better and decline in imports was not as steep as that of exports. The resilience of the imports is even more surprising if we take into account the plunge in exports. However, further on the speed of fall in imports became much stronger with signs of tentative recovery shaping up only in September.

Chart 44 Monthly evolution of Moldovan exports and imports, %, y-o-y



Source: NBS.

Exports have remained euro-bound...

The effects of the crisis translated swiftly in the fall in external demand resulting in a considerable slide in Moldovan exports in January-September of 25.1% y-o-y. The crisis, nonetheless, has not affected the recent trend of the geographical reorientation of Moldovan exports towards the European market. Thus, in January-September, 2009, the share of exports going to the EU market increased while that of CIS markets declined (Chart 45). In a way, crisis spurred the “reorientation” trend since it had hit the economies of the CIS countries much harder. The use of ATPs granted by the EU has further supported this trend. During the first three quarters of 2009 Moldovan exporters fully used the quotas provided by EU for wine and wheat, while the sugar quotas were used by almost 90% and quotas for maize by 98.5%. Given that the second year in a row since ATPs were granted Moldovan exporters managed to fully use the quotas well before the end of the year Moldovan authorities should try to promote the idea of more considerable annual increases in the quotas than initially envisaged.

At the same time composition of the exports changed as the result of the crisis: the balance significantly tilted towards agri-food exports. Non-agricultural exports, especially metals, appeared main victims as the demand and prices plunged in the wake of the global financial crisis. The Chart 46 may conceal part of the picture, though. Even most of the categories that expanded its share decreased in absolute terms (with notable exception of vegetal products), including such major exports as textiles and foodstuffs.

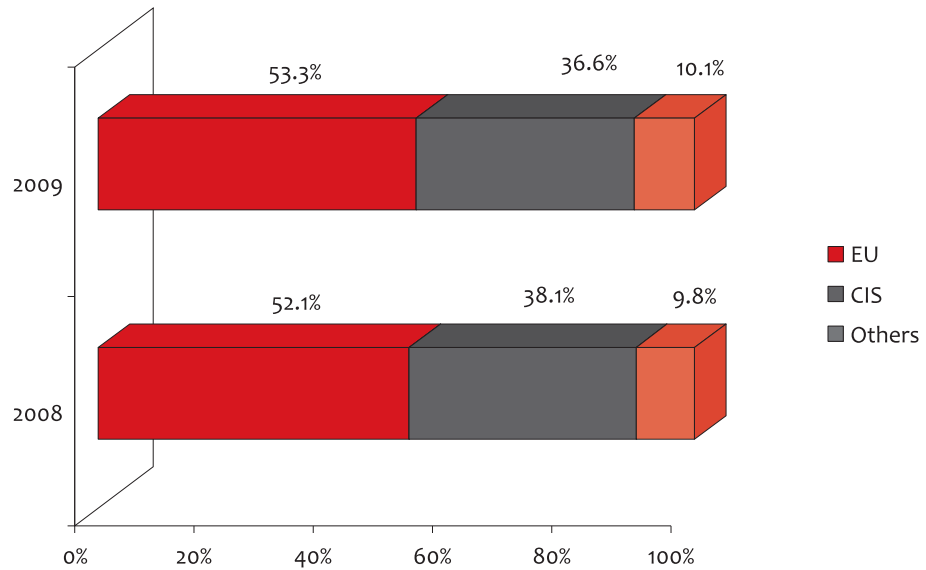
Policy issues

Although EU market as a whole has entrenched its position, Romania - a top destination for Moldovan exports - in recent times lost some ground in the face of Russian market. Thus, in the first eight months of the year Moldovan exports to Romania declined by 30.3%, the slide that was exceeded only by exports to Ukraine (-48.4%) and Poland (-48.9%). The shrinking share of Romanian market was swiftly explained by the political reasons since former Moldovan authorities introduced visa regime for Romanian citizens in the aftermath of the civil unrest that followed general election from April this year.

However, this was not the first time when Russia’s share superseded that of Romania. On the quarterly basis the similar development was observed in the last quarter of last year (visas not yet introduced) and the second quarter of the current year (visas just introduced). Thus we have two instances, where “visa” factor had no influence and another one when it hypothetically could influence bilateral trade, however, it remains quite doubtful whether these effects could kick in so fast as to suspend the export contracts between Romanian and Moldovan companies.

Perhaps, the political tensions indeed created quite an unfavourable environment for trade between these two countries; nonetheless, there are more reasons to this development than meets the eye. The structure of exports to Romania turned out to be major weakness in the time of crisis. The textiles, footwear and metals held major shares in the Moldovan exports to Romania (the very exports that suffered considerably on the aggregate level), and they declined by 23.5%, 47.7% and 79.5% respectively in case of Romania. On the contrary, such exports as machinery and equipment, oilseeds and sugar exports going to Romanian market increased at the background of the overall decline in exports. The exports to Russian Federation are mostly composed of agricultural exports, which as we saw proved to be more resilient in the crisis’ aftermath and this also helped Russia to overcome Romania on the top of the export destinations for Moldovan goods.

Chart 45 Geographical distribution of Moldovan exports, Jan–Aug 2008-2009



Source: NBS

Chart 46 Composition of Moldovan exports, Jan-Aug 2008-2009



Source: NBS

Shrinking imports: the suddenly frugal consumers...

Apparently, the impact of crisis on imports was much more severe. As it was mentioned initially the imports resisted better the crisis pressures, so more spectacular was their further fall. In the first nine months of 2009 the imports dwindled by 37.8% on annual basis (with strong signs of recovery in September: monthly expansion of 22.3%), being massively pulled down by falling internal demand as both companies and citizens' incomes (remittances) stumbled. The fall in imports was determined not only by frugality of Moldovan companies and households, but also

by cheapening of such imports as petrol and derivative products (which translated in lower import volume figures). The fall in imports was wide-spread with all categories taking the hit, however, mostly affected appeared mineral products, machinery and equipment, transport vehicles and metals, showing that both corporate and personal demand remarkably sagged in the aftermath of the crisis.

As opposite to the exports, the decline in imports was slightly stronger with respect to EU producers than with those from the CIS. Nonetheless, it should be noticed that geographical distribution of imports remained largely balanced despite the crisis, with notable exception of Kazakhstan, whose ascendance is easily explained by the fact that natural gas imported in Moldova this year originated from this country (in previous years it originated from Russian Federation). It is also noticeable that imports from Romania reduced considerably, but this mostly goes down to the fact that petrol and its derivative products are mostly imported in Moldova from this country.

The precipitous decline of imports also led to an improbable evolution in the balance of Moldovan trade: the shrinking trade deficit. Indeed, imports fell much stronger than exports and that led to almost halving trade deficit in January-August on yearly basis.

Outlook for 2010

- ❑ The recovery of foreign trade flows will most likely remain sluggish and highly dependent on speed of convalescence of global economy. The outlook for main Moldovan trade partners remains rather unpromising: it is highly improbable the main CIS economies and Romania will boast again high growth rates in the near-term future meaning that demand for Moldovan goods will remain subdued. Overall, we can expect that exports will shrink this year by 20-25% range, with some improvements by the end of the year. If the current external economic environment persists Moldovan exports are set for a rather slow recovery in 2010;
- ❑ The imports continue its decline because of falling demand (sagging remittances, worsened credit conditions, less business investment). Nonetheless, in the forthcoming months this tendency may be somewhat corrected due to reversals in pricing trend for some imported commodities. The eventual pick-up in private consumption and business investment may see a surprising turn-around in imports. At the moment our expectations regarding consumption remain quite conservative so the imports are poised to climb up at a slow pace.

Challenges ahead

- ❑ With global economy setting more or less firmly on the recovery path **the outlook for the sector looks increasingly brighter in comparison with the beginning of the year**. It is quite reasonable to expect the external demand to get more robust with the eventual turnaround in remittances inflow helping heal the domestic demand. Nonetheless, this recovery will perhaps be quite sluggish, save the 'double-dip' recession is avoided. Hence, expect only modest upturn in Moldovan foreign trade;
- ❑ These conservative estimates should not dishearten, though. They simply **put more emphasis on the arduous tasks in front of the new government to promote institutional reform and 'free' the foreign trade**. The Doing Business 2010 report released this year outline once more the lack of progress in the "trading across borders" area in Moldova. The indicators gauging the financial and time costs for export-imports operation have been still for a couple of years in the row;

- The hurdles for exports and imports are not however limited to customs area. They also abound beyond borders. Both exporters and importers are subject to a series of official and less official payments which ultimately either diminishes international competitiveness of Moldovan goods or simply digs too deep into consumer's pocket. Therefore, ***institutional reforms in this area will be critical for magnifying effects of global economic recovery for Moldovan economy through enhanced international competitiveness and stronger domestic demand;***
- On the external policy front ***the task is to come well prepared at the negotiations of the eventual free trade agreement with the EU.*** At the same time, the possibility of enhancing ATP quotas for some goods should not be put aside in the short-term;
- On domestic front, the institutional reform should not focus exclusively on the import 'monopolies'. It should put ***a special emphasis on preparing Moldovan economy for convergence with the European "one"***. In trade this means foremost ***the capacity to withstand competitive pressures of common market.*** The long and difficult road starts with some trivial (albeit still unaccomplished) stuff like sanitary standards and finishes with more sophisticated one as competition policy and state aid. In order to plead for deep and comprehensive convergence, Moldova has to show will and capacity to implement simpler things ... and this is the place to start.

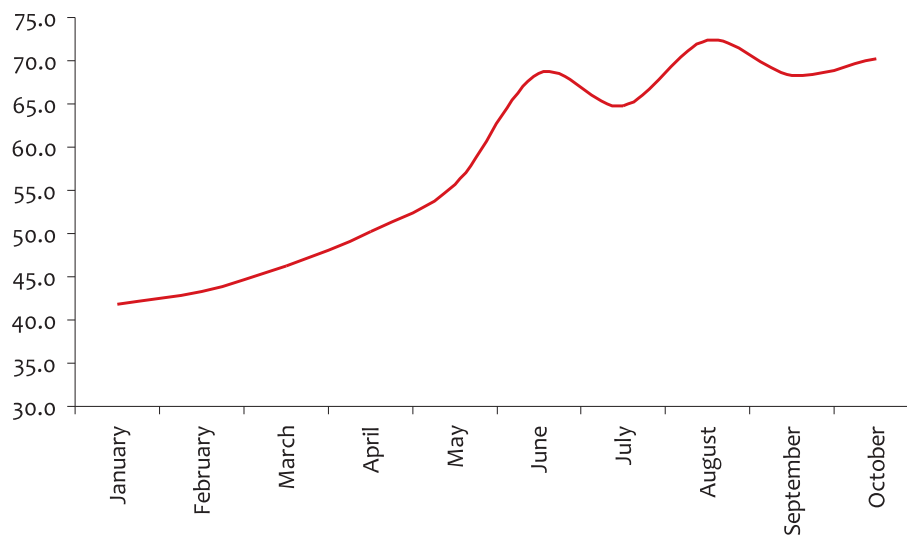
15. Global markets

This final chapter tries to assess the main evolutions on the main global commodity markets in the aftermath of the global financial turmoil. It also tries to dissect main fundamental and speculative factors that determined these evolutions. Finally, it looks how the situation on the market will evolve as economic recovery starts taking hold.

Main commodities: on a firmer ground

In the beginning of 2009 the jitters throughout the main commodity markets continued. The global economic slowdown coupled with debacle on the financial market led to overall slide on the commodity markets as demand shrank and investors fled the markets. At the same time by February-March the upward trend became obvious as signs of an eventual recovery supported by fiscal and monetary stimuli worldwide started emerging (Chart 47, Chart 48). Furthermore, the recovery of demand was coupled with the supply-side policies put forward by main producers aimed at maintaining (such as OPEC in oil sector) or scaling back current production levels (metal producers).

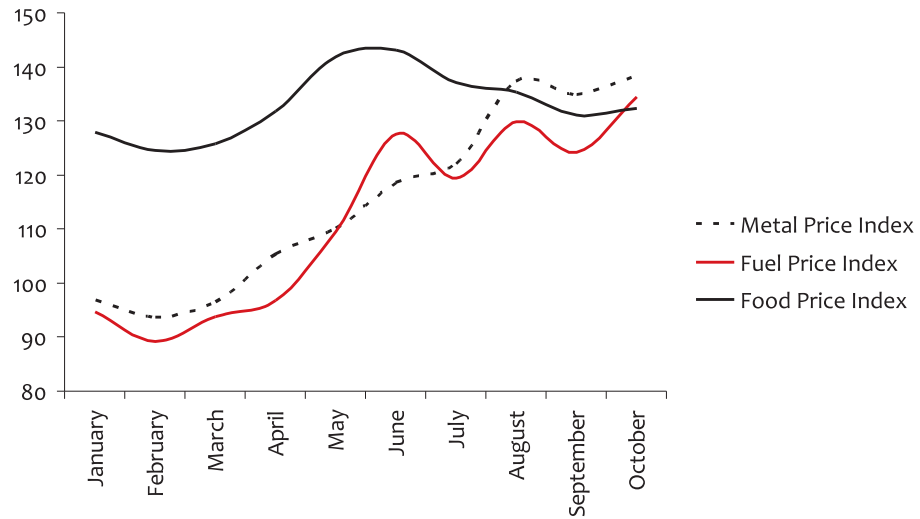
Chart 47 Oil price (Brent), Jan-Oct 2009, USD/barrel



Source: US Energy Information Administration.

Therefore, the fluctuations of the commodity prices were determined both by the fundamental and speculative factors and thus remained inherently volatile throughout the period.

Chart 48 . Evolution of main commodity indexes, Jan–Oct, 2009



Note: Commodity Metals Price Index includes Copper, Aluminium, Iron Ore, Tin, Nickel, Zinc, Lead, and Uranium Price Indices; Commodity Fuel (energy) Index includes Crude oil (petroleum), Natural Gas, and Coal Price Indices; Commodity Food Price Index includes Cereals, Vegetable Oils, Meat, Seafood, Sugar, Bananas, and Oranges Price Indices; 2005 = 100. Source: IMF.

The **oil** prices after a significant upward leap of 40% in May-June, have then apparently stabilized at the level of 65-75 USD per barrel (Brent). However, these price increases are strongly supported by wide-spread expectation of the approaching economic recovery, while the demand remained quite sluggish throughout the period at the background of expanding supply (mostly non-OPEC driven). At the same time the OPEC producers repeatedly demonstrated their will to resist pressures aimed at spurring **oil** production and opined that prices of 70-80 USD per barrel would not imperil the economic recovery. Furthermore, the advances in **oil** prices were helped by weakening US dollar.

The higher prices at the global **oil** market swiftly translated into price hikes for petrol on Moldovan markets in 2009. After two consecutive reductions in February and March the price for 1 litre of petrol (A95) reached level of 8.80 MDL. However, as the **oil** prices rebounded on the global market, the domestic petrol prices rose three times in a row reaching 11.85 MDL per litre by August-September.

The evolution on the **metal** markets closely resembled that on oil market, though with a slower recovery (Chart 48). Demand remained feeble throughout the period on the most markets, while drop on most major markets being partly offset by the growing demand in China (+19%) and India (+8.9%). The global demand in 2009 is estimated to be down by 8.6% on yearly basis, with the fall in EU and Romania (main markets for Moldovan metals) of 32.6% and 43.2%, respectively. The CIS demand has also been in freefall (-30.8%).

The fall in **food** and **agricultural** commodities was much milder than on other markets and conversely the recovery started in the beginning of the year was less buoyant. As with the other commodity markets the price developments were determined by both fundamental and speculative factors. Fundamental factors at play are: strong global demand for food, high level of supply of majority of cereals and more or less favourable weather conditions in many producing countries. All these factors keep the prices higher than in pre-boom 2007-2008 years, however

lower than peaks of 2008. Furthermore, the high food prices are supported by rebounding oil prices due to oil inputs (such as fuel and fertilizers) as well as use of corn for bio-ethanol production. Thus, cheaper oil (in comparison with peaks of 2008) also added to downward pressure on the food prices as well as on the bio-ethanol producers.

Speculative factors, as in the commodity markets, have also contributed to the increased volatility in the agri-food commodities' prices. The expectations of the global economic recovery as well as US dollar depreciation have helped prices rebound.

Outlook for 2009

- The trend of more expensive oil will hold up through the end of this year and the next year. Recently, International Energy Agency revised up its estimates for oil demand in 2009 and 2010, by 200 kb/d for and 350 kb/d, respectively. As a result, price forecasts were also revised upwards. Thus, the International Monetary Fund expects the oil price for 2010 of 76.5 USD comparing to 61.53 USD in 2009 (assumed price based on future markets).
- As global demand started picking up in the second half of the year, the World Steel Association expects brighter outlook for the next year on the **metal** markets. The global demand is expected to rebound by 9.2% in 2010.
- For the rest of 2009 and 2010 the trends on the **agrifood** markets will more or less be the same as in the middle of this year. Thus, Food and Agriculture Organization expects prices to stay above pre-2006 years or even a new surge in prices like the one seen in 2007-08 appears to be a “realistic possibility”. There are significant unknowns or upward risks, such as weather condition, oil prices, US dollar exchange rate, biofuel demand, etc. Another important risk is decision by many farmers to reduce the wheat sowings as result of the lower wheat prices this year, the trend easy to observe in Moldova too. Combined with the steadily growing demand it is reasonable to expect that most of the agrifood commodities will remain at least at the 2009 second half price level.

Challenges ahead

- ***The recovery of fuel prices bodes no well for import-bound Moldovan economy since it will lead to more expensive products in Moldova*** because of more costly energy product inputs (e.g. agricultural products, etc.) as well as bigger indirect costs (transportation, heating production facilities, labour due to high living expenses, etc.). As a result the overall competitiveness of Moldovan goods will be put under stress. The strategy for the newly-elected Government should be two-pronged: it should focus on diversification of the energy supply and domestic production with special focus on renewable sources of energy; it should revive the efforts at increasing energy efficiency in order to modernize existing buildings and equipment and set more rigorous standards for the future ones;
- As it was mentioned in the previous MEGA issue the orderly gas supply may again be imperilled this winter as “gas tussle” between Russia and Ukraine may re-emerge, while election environment in Ukraine in that period may prove fertile ground for the conflicts of this sort. ***The new Government should put forward an “emergency plan” for such a situation*** or risk facing up the consequences;

- The more expensive food is about to stay with us for some more time, at least. Due to the fact that Moldova became a net importer of food some time ago only magnifies the dangers stemming from more expensive food especially when the incomes of households are severely hit by the economic crisis. However, **given important agricultural potential of Moldova our country has chances to transform these risks in awesome opportunities**. In this sense the new Government should turn to important sector reforms which are long overdue. Speeding up the implementation of the sanitary safety standards required by the EU-Moldova action plan will be the first important test in this respect. While another important venue for efforts should be de-monopolisation of local agricultural market, cutting red tape, streamlining the intermediary structures and allowing domestic producers to earn fairer profits.

About the Expert-Grup

Who we are

EXPERT-GRUP is a leading economic and social research centre in Republic of Moldova and a member of the PASOS (Policy Association for an Open Society) network comprising 39 policy think-tanks in 27 countries of 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 as well as support the international competitive enhancement of the Republic of Moldova. We tend to accomplish this mission by employing skilful researchers, delivering top quality services and promoting efficient, transparent and innovative models for economic and social policies.

Main institutional objectives

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