MEGA

Moldova Economic Growth Analysis

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About the MEGA

The title of this new economic review edited by the Expert-Grup think-tank is **MEGA**, which stands as acronym for "**M**oldova **E**conomic **G**rowth **A**nalysis". **MEGA** has the purpose to explain the economic evolutions in Moldova, to update economic policy analysis and to provide policy recommendations for advancing country's economic development. **MEGA** is conceived as a bi-annual review to be issued each spring and autumn.

MEGA will combine sound analysis, academic rigour, realistic forecast and feasible policy recommendations. This review targets the readers who in their professional duties have to take strategic decisions affecting large number of people, such as Government policymakers, banks' directors, managers of domestic and international companies, investors, heads of international organizations and others.

Economic recovery in Moldova in 2000 has generated new opportunities as well as new challenges for the Moldovan government, private companies and citizens. The economic growth has been mainly supported by migrants' remittances that have kept the country afloat. However, as consumption-led economic growth has reached its limits, the economic policymakers have to ensure the transition of the economy from the economic growth model based on migrants' remittances towards an investment-based and innovation-based growth model. Because of the international financial crisis, this transition is unlikely to be smooth, but still it is necessary to be pursued.

Changing the economic growth model requires the accountability, efficiency and anticipatory capacity of the Government to increase correspondingly. If the Government achieves better policy performance, this will encourage domestic and international investors to channel more capital in the reviving Moldovan economy and will consolidate the public confidence in economic policy. However, for the economic policy to respond to the changing needs of the producers and consumers and to the new challenges of the globalization it has to be constantly monitored and assessed and whenever necessary updated.

Presently in Moldova there is quite limited independent and professional analysis of the economic policy, while public discussions often take the form of ideological rather than policy debates. More consistent, independent, forward-looking and professional feedback from the civil society organizations regarding the economic governance may help the Moldovan Government to fine-tune the economic policy and adapt it to new realities. The international financial crisis has made the need for a new economic thinking even more pressing.

The first issue of the **MEGA** is dedicated to a review of the megatrends that have shaped Moldovan economy since its independence. It covers 15 distinct areas which basically represent core parts and sectors of any economy. As macro-econometric model is still being tested and fine-tuned to respond to the new economic conditions imposed by the ongoing economic and financial crisis, no comprehensive quantitative forecasts are made at this stage. Only qualitative outlook for 2009 in each sector and a general scenario for 2009 is presented, with key policy recommendations. Next issues will update the economic analysis, identify risks and opportunities and make sound mid-term forecasts (1-3 years) regarding the basic economic indicators.

MEGA, spring 2009: key messages

The economic transition was a quite difficult and protracted process for Moldova. Although, it may be hard to make a univocal statement on whether transition is over or not, the megatrends of this transition can be traced and most important lessons can indeed be learnt:

- The economic transformation has been both radical and, at the same time, underachieving by regional standards. True, Moldovan economy have passed through deep macroeconomic structural changes throughout the last 15 years: shedding its over-reliance on agriculture; becoming deeply intertwined in regional trade in goods and services; development on the national banking system and attraction of foreign banks; growing incomes of population and gradually contained inflation; attracting robust FDI inflows in the most recent years. Finally, national economy has survived several significant shocks: 1998-1999 regional financial crisis, trade embargos and numerous nature calamities.
- However, there is another side to the coin: labour migration has become emblematic to Moldova's image abroad while effecting negatively social fabric back home. Corruption has become rampant and red tape pervasive. Significant parts of the energy and transport infrastructure are in shambles. State enterprises are still kept afloat by questionable government support; and public money is often spent in a non-transparent manner.
- Furthermore, the reform efforts have been unsteady and half-hearted at best. The issues of economic governance remain no less relevant as they have been throughout the last decade, despite some tentative progress being made. Some eloquent examples of unenthusiastic reforms would be the regulatory reform, central public administration reform, social care system reform, education (especially vocational) sector reform, competition policy and state aid reform. These reforms have been enshrined into the main policy documents and have been widely supported by international donor community and it is still more unfortunate that the progress has been so uneven despite this external support.
- However, the most regretful thing is the fact that such an uneven progress, both on the policy and ground levels, took place at the background of the very favourable economic conditions in Moldova's near and distant neighbourhood. As the global financial crisis unfolds, past are the times when foreign investors were looking to Moldova to relocate their investments as EU expanded, when Moldovans lacking economic opportunities home were migrating in droves to Russia and EU countries in order to make money that sent back home would not only lift from poverty their families but also indirectly support the national budget, when growing demand allowed Moldovan companies to sell their goods and services more or less easily. Apparently, the most favourable times for reforms are over. Now, the reforms if they are to be sustained are to be undertaken in a much more inauspicious environment. But at the same time, the more necessary are these reforms.
- Ultimately, our first issue of MEGA launched in spring 2009 seeks to show in more detail what was achieved and what was not, although should have been, achieved in 15 years of transition. With the benefit of the hindsight, it may be not that difficult task. Nevertheless, we do not stop here. Besides, giving a well-documented overview of transition past, we attempt to offer some possible scenarios of immediate future as well as a set of policy recommendations of "do's" and "do not's" in this crisis-year … and we hope it will help.

Expert-Grup

Executive summary

Economic governance

Although the transitional transformations have resulted in some significant achievements of institutional or legislative nature, the overall progress has been hampered by the corruption and excessive state involvement in the real sector of the economy. Optimization in the use of public funds through division of the Social Assistance and Protection was complemented with reforms aimed at better targeting of Social Assistance only in 2008 and these reforms are yet far from being complete. Regulatory reforms encountered progress through the laws of “Guillotine I” and “Guillotine II”, although they are still in a developing phase in the area of competition policy, issuance of construction permits, business authorisations and some other areas. Despite two decades of transition the reforms process is still far from the end with major efforts needed both in the area of economic and institutional development. The former refers to the process of recovery of economic output to the pre-1994 levels while the latter to the establishment of effective free-market institutions. The unfolding international financial crisis and expected domestic economic downturn make the reforms in the area of the economic governance even more urgent. Lagging institutional reforms may worsen the consequences of the economic recession expected in 2009 and to set Moldova 3-4 years back in terms of GDP/capita.

Gross Domestic Product

The recovery of the Moldovan economy from one of the longest and deepest declines among the transition countries started in 2000. Constantly increasing consumption has been the main engine of the economic growth. Final consumption, mainly fuelled by the inflows of remittances, has increased to 113% of GDP in 2008, being the highest in relative terms in the group of transition countries. However, since 2005 investments also moved upwards, contributing positively to the GDP growth. Unfortunately, this tendency stopped as first symptoms of contagion from the international financial crisis emerged in Moldovan economy. Increasing domestic demand influenced different economic sectors in different ways. The sharp increase in demand for services has brought the sector’s share in total Gross Value-Added (GVA) to present 65%, similar to the CEE countries and to some of the core EU members. Due to constant underinvestment, difficult climate conditions and protracted reforms in agriculture, its share in GVA has constantly declined and reached 10% in 2008 (similar with the GDP share of the information and communication technology). In a way, “thanks” to these evolutions, Moldova can no longer be considered a country with agriculture-based economy. This was offset by the increase in service and construction sectors, while industrial production is still at its 1994 level. Although consumption-based economic model has generated a high GDP growth over the past 8 years, it is unsustainable in long-run as recent evolutions have clearly shown. Government has failed to benefit from the rising budgetary revenues in order to put more public investment in the infrastructure and education and thus to consolidate the growth in the private sector. As result, amid international financial turmoil and economic decline, Moldova seems to be one of the most vulnerable transition economies.

Agriculture

During transition the Moldovan agriculture moved from being a high value-added sector to a low-performing and subsistence-oriented one. Even though critical reforms such as land privatisation, prices and trade liberalization have been implemented, in some aspects these important reforms are not finished yet. For instance, many landowners cannot sell or rent regularly their land because they lack the ownership titles. Weak investment and difficult climate conditions have undermined agricultural output, even though experts believe that the weather impact could have been mitigated with proper agricultural works and an effective agricultural insurance system in place. Ineffective companies restructuring and persisting governmental policy distortions are other interconnected factors undermining the development of the sector. Current policies of land consolidation and agricultural subsidies are favouring big corporate farms, but at the same time most of these companies are forced by local and central public authorities to preserve "social responsibility" programs in their communities (just as many private companies in other sectors of the economy). As for the family and peasant farms, their agricultural techniques are often close to archaic, and are used to provide only subsistence means. An important element which is almost missing in the Moldovan agricultural landscape is the medium-sized agricultural entities representing the backbone of agricultural sectors in most of the EU countries. In 2009-2010 agricultural output will probably be less affected directly by the ongoing global economic recession, but a number of other associated risks are looming ahead for Moldova (biotechnologies progress, likely increases in non-tariff barriers to international trade with agricultural products, incapacity of processing companies to buy agricultural row materials etc.). Despite growing production, these risks will cut from the farmers income.

Industry and infrastructure

High level of initial integration of the Moldova's industrial sector into the soviet economy and technological difficulties of military-to-civil conversion explains the dramatic and long decline of the sector at initial stage of transition. Slow progress in industrial restructuring and privatisation is another set of constraining factors. However the industrial sector rebounded in 2000 and cumulated a 66% growth by 2005. The restructuring of the industrial sector is far from being complete and many enterprises are still in state's hands, nonetheless, in the last decade the industrial sector has changed in a good way and many companies were able to adapt to the market system. New competitive advantages are being discovered by Moldovan companies (like production of rubber and plastics, cement and gypsum, mechanic tools-machines). Emergence of a mining industry is one of the most interesting developments in the last decade. However some of the traditional industries are collapsing and a few seem even being lost for good (production of fodder, tobacco processing), which makes even more urgent to complete the privatisation of the big industrial companies. Lack of progress in privatisation of the energy sector in the last 8 years has undermined the performance of the whole industrial sector, while in the sphere of industrial policy the Government has followed an incoherent path with many strategies being written but very few if any implemented. Other pillars of the industrial development policy such as "free economic areas" concept and governmentally-controlled R&D have proven their inconsistency as well. The new trade crisis set in motion by Russia in 2006 has sent Moldovan industry in a 10% decline in 2006-2007. Some positive but rather feeble trends emerged in 2008 but with the global economic downturn the industrial sector will yet again immerse in a deep recession in 2009-2010.

Constructions sector

During the transition period the constructions sector passed through two stages of development: the first one was characterized by the liberalization shock after the Soviet Union collapse; during the second one the construction sector has been mainly influenced by the economic revival after the regional crisis of 1998-1999 and the increase in inflow of remittances. Favourable endowment with production factors (cheap labour, available construction materials) caused an almost exponential growth in the number of private construction enterprises, volume of entrepreneurial works and capital investments, as well as the prominent increase in the share of the private capital in this sector. Equally important, in 1995-2008 the number of employed labour force doubled. Taking into consideration the recent repercussions of the world economic crisis, we can assume that presently the Moldovan constructions sector enters the third phase as both falling demand for construction works and interruption of financing construction projects by the commercial banks show.

Services

Since beginning of transition the Moldovan services sector evolved from an "unproductive" one (as considered by soviet-type economists) to the most important one in terms of share in total employment and contribution to the country's GDP. Its share in total value-added grew from about 32% in 1994 to 68% in 2008, while the share in total employed population rose from 35% to 49%. Such a fast expansion of the services sector is unique for the group of the transition countries. Market-based services have grown at higher rate as compared with public services. The evolution of production and exports of some services reveal strong competitive advantages that Moldovan producers are discovering (such as software and computer-related services). Even though the role of the privately-owned companies in the services sector has increased rapidly in the past decade, a significant part of the market-based services are still being provided by public companies (state, municipal) or mixed private-public companies. The growth of "production" in the public sector has been quite uneven. On one hand, the two public services sectors that are the most important for sustainable economic development – education and health – have had their production declining in real terms in 1995-2008. This decline was associated with a constant outflow of specialists from both sectors. On another hand, since 1995 until present the public administration has grown 50% in real terms, but with doubtful positive results for the rest of the economy. The Moldovan Government acknowledges that the public administration sector is excessively large and in 2004 has started a reform of the central public administration. So far, this reform brought no palpable economic results. Because of the domestic consequences of the international financial crisis, in 2009 the services sector in Moldova is expected to in a decline of at least 5%. While smaller than expected recession in industry and constructions, the decline of services sector will affect very much the GDP as it is the main economic sector.

Labour market

Since 1999 the situation on labour market has been characterized by an almost constant decrease in both employment and unemployment rate. Shrinking employment in agricultural sector has not been offset by a similar job creation rate in other sectors of the economic activity, determining people to leave abroad for work. Thus, migration of labour force is the main explanation of the two seemingly contradictory phenomena: decreasing employment and decreasing unemployment rates. Nowadays, migration does not necessarily represent an option to escape poverty. At the same time it rose to the levels that define it as a feature of Moldovans life and a well-known image of the country abroad. The structural and quality mismatch between supply of skills by the educational sector and the labour market demand represents another important constraint for the increase in productivity and wages. Therefore, business climate and education should be the policy priorities for the government in dealing with low employment rate, rather than labour legislation which does not create jobs by its own. This is the even more important in 2009-2010 when Moldovan economy will suffer because of the economic recession in Europe and CIS and when migrants are expected to return home.

Households income

After the decrease of households' income during the economic recession, it started to grow in 2000. Although wages still represent the main source of income for the population, the major change in the trend of income has been generated by the constantly increasing transfers from Moldovan citizens working abroad. Thus, early transition attempts to open small businesses as natural persons were overshadowed later on by the possibility to migrate. This negative trade-off denotes clearly the weaknesses and risks of the Moldovan business climate. At the same time, remittances provided a permanent and growing source of income for the population, placing Moldova on the second place in the world in 2006-2007 as much as ratio of remittances to GDP is considered. This had also boosted wages by raising the equilibrium and reservation wages in the country. However, the increase is not attractive enough for Moldovans working abroad as the average wage in Moldova is still significantly lower than in all neighbour countries. Moreover, wages in important sectors as education and health remain lower than the average wage in economy and consequently result in high turnover of employees, corruption and low quality of public services. Migration of the medical personnel and teachers is the area of particular concern given the big public resources invested in their training and importance of the two sectors for social and economic development. Still, the public wages, including in education and health, will come under even higher pressures in 2009 and 2010 as result of expected lower budget revenues. All in all, in 2009 the poverty is expected to rise again.

Households consumption

Household consumption has increased significantly since 2000 becoming the engine of economic recovery. Neither wages that have increased slower than consumption, nor consumer credits that have grown but still are at low levels in regional comparisons were able to support such an important growth of consumption. Remittances were the most important source of consumption, almost perfectly correlating with consumption growth since 2000. The significant increase in remittances contributed not only to the increase in consumption but also to savings of the population that turned from net consumers to net savers in 2002. The main developments of rising savings in the past years were in the banking and construction sectors. Therefore, contrary to the public belief, the migrants' remittances have contributed significantly to the growing investment, even though not directly but via the financial sector as any economist would expect. (For more direct investment better general business climate is necessary rather than any remittances-tailored policy solutions). The deposits of natural persons increased rapidly, providing additional finances to the banking system. The construction sector responded to the increase in demand for housing and flats through a boom in housing construction and galloping rise in prices. As the GDP is still strongly dependent on consumption, the latter should be stimulated by the Government as a major anti-crisis and recovery measure in 2009-2010.

Inflation

High inflation has been a constant feature of Moldovan economy even in the period of economic stabilization. Food prices vulnerable to climate conditions and high import prices for energy resources kept inflation above 10% since 2003 until 2007. The role of remittances is also significant as the increase in the monetary mass is highly correlated with the increases in prices over this period. The NBM, whose main policy objective since 2006 has been to maintain the stability of prices, was not very effective in fighting inflation as it was looking for a optimum between stability of prices and stability of exchange rates (in the context of almost free international circulation of capital) and because of weak channels of transmission of monetary policy (such as interest rates). Only in the first half of 2008, the National Bank of Moldova managed to implement a tighter monetary policy, which together with the later developments on the international markets helped bringing inflation to one-digit number. The absence of inflationary pressures creates a favourable environment for the NBM that should take advantage of the current situation and act in order to promote the credit supply to the economy and to give it a new growth momentum which will be vitally important in 2009-2010.

Monetary policy

Since the introduction of Moldovan national currency (November 1993) the monetary policy of the National Bank of Moldova has undergone two main evolution phases. During the first phase (1994-1998) the NBM actively credited the commercial banks in order to foster the monetization of economy, which made it the major creditor of the banking sector. During the second phase (1999-2008) the central bank concentrated its efforts on sterilization of the monetary mass mainly through open-market operations. Thus, the NBM switched from being the major creditor, to being the major debtor of the banking system. An essential dilemma of the central bank during the whole period has been either to maintain the national currency exchange-rate stability or to keep control over the prices level. The NBM walked this tightrope having on one hand monetary policy instruments as weapons for fighting the inflation (obligatory reserves rate, refinancing rate, open-market operations) and on the other hand – the possibility to interfere on the currency exchange-market for ensuring its stability. Taking into consideration the slow monetary policy transmission in the early transition period the NBM switched to the intensive use of the obligatory reserves as a tool for direct control over the monetary mass. However, after the economy started reviving in 2000, increasing inflows of foreign currency and the development of capital markets, the central bank's monetary policy became more focused on open-market operations and interventions on the currency exchange market. Still, high inflationary pressures in late 2007 – early 2008 determined NBM to use again intensively obligatory reserves rates as a tool to control the monetary mass. As inflationary pressures are expected to ease in 2009-2010 the NBM will have to revise its monetary policy again and reduce policy interest rates across the board in order to pump necessary liquidity in commercial banks and to reset the crediting mechanisms.

Budgetary-fiscal policy

During the beginning of transition the budgetary-fiscal policy was influenced on the one hand by the economic collapse which undermined the national tax base and revenue rising capacity of the Government. On the other hand structural reforms aimed at optimization of public expenditures (mainly for education, social protection and health sectors) also were lagging behind. This situation caused the increase of budgetary deficit up to historical maximums in late 1990s and forced the Government to resort to unpopular forms of deficit financing, such as increasing social payments arrears and direct crediting from the National Bank of Moldova. However, after the economy bottomed up in 2000 and due to optimization reforms the budgetary deficit was lowered to more controllable limits. It made possible for the Government to gradually decrease the corporate and personal income taxes from relatively high levels in the first years of transition to the current low levels (and zero-rate for reinvested corporate income). However, there is a rising concern of continuous increase in dependence of public incomes on indirect taxation (consumer taxation). It could have negative repercussions in a mid-term perspective as a result of increasing budgetary propensity towards social public expenditures and insufficiency of public capital investments.

Financial markets

Even though present through an increasing number of operators, the insurance and capital markets are much less developed than the main pillar of the financial sector in Moldova – the banking sector. The banking system in Moldova has considerably developed in legislative, systemic and structural terms since the declared independence. The share of banking assets in country's GDP has grown from less than 20% in 1995 to almost 70% in 2008. Despite this growth, Moldovan banking sector remains very small in comparison with other countries in the region. For a long period the banking sector was effectively closed from foreign participation. However, as result of the effected amendments to the regulatory framework, the foreign participation in the banking sector's assets increased from 49% in 2004 to 72.5% in 2008, even though a large part of non-residents own only minority shares in banks and in many instances the origin of the capital is obscure. Since 2000 there was steady growth of loans and deposits suggesting that the overall confidence in the banking system has improved. In early 2009 the average capital adequacy rate has been 2.5 times above the minimum required level. Although high capital adequacy and liquidity serve as reliable cushions in cases of possible distress, they also indicate weaknesses in operations and low risk management capacity. According to some IMF evaluations of the Moldovan banking system, only 10% of rural households have access to bank accounts, i.e. the market seems to remain attractive for investment in retail banking.

Foreign trade

The path followed by Moldovan foreign trade in goods is quite revealing of the overall evolution of Moldovan economy. At the background of transformational crisis both exports and imports grew quite slowly in the first half of the 90s. The tentative economic recovery was aborted by the Russian financial crisis of 1998, which resulted in plunging exports and imports. The new dawn that followed was marked by diverging trends in exports and imports. The former were propped up by regional economic recovery and effects of economic restructuring in Moldova, while the latter was mainly driven by soaring remittances sent home by Moldovan labour migrants. In the meanwhile, the Moldovan trade environment was significantly liberalized. Furthermore, the geographical orientation of trade as well as its goods' composition changed to great extent. The trade with EU countries grew most strongly and EU became the main trade partner of Moldova. The exports composition also changed significantly as such new goods as apparel grew significantly thanks to closer integration of Moldovan companies in European production chains, while agri-food and wine exports took the hit as the result of both trade shocks and inability to ensure implementation of the standards in the food sector. The trade in services evolved quite differently from the trade in goods as it followed a much more balanced path. However, one feature is proper both to trade in services and goods: a liberal trade regime. In contrast with the trade in goods, exports and imports had quite a close evolution, trade balance remained quite stable, even becoming positive in 2006 and afterwards. The CIS countries have remained main Moldovan trade partners throughout the period, while geography of trades plays only limited role over the composition of trade. However, it should me mentioned that telecommunications services play a stronger role in the trade with EU, than in the case of the CIS countries. Other important exported services are transports and travel. Moldova mostly exports and imports the same categories of service. Moldova's foreign trade flows will remain under pressure in 2009 as global financial and economic crisis brings havoc to the global trade. Therefore, in the forthcoming months the foreign trade flows will contract significantly.

Global markets

The evolution of the global commodity markets can be best described in the 'from boost to bust' fashion. The rally in the commodity prices (oil, metal, etc.) was mostly driven by soaring demand, especially in fast industrializing China, India and other South-East Asian economies, weakening dollar and speculative binge on the futures' markets. Indeed, as the global economy growth and trade boasted breath-taking expansion rates the supply remained tight the investors were eager to bet on rising prices. The bubble eventually burst and this resulted in plunging commodity prices worldwide. The commodity exporting countries were particularly severely hit, the development that can be easily observed in the case of metal exports from Moldova and its Transnistrian region. Moldova was, however, on the receiving end in the case of petrol and gas, which are overly imported in the country. In the case of natural gas, the negative effects of the soaring commodity prices were amplified by the shifts in Russian price policy towards the so-called 'near-abroad'. In couple of years Moldova saw the gas prices rising more than three-fold. The rise of petrol prices was also severe, although much higher degree of liberalization ensured that domestic prices followed the global trends in due time. The market of food was also part of over-heating commodity markets, however, the fall in the prices was less steep and much shorter. This is quite understandable, given the fact that demands remains strong as crisis could dent it only to limited extent. The prices for the main commodities seem to have stabilised after their collapse in the second half of last year. However, they will remain largely dependent on whether and when the recovery sets on.

Key policy recommendations

We expect the Moldovan GDP to decline by 12% in 2009. This indicator is likely to be among the worst economic performances in the group of transition countries. International financial crisis has exerted the most significant impact on the economic situation in 2009, but there are many factors affecting growth inside the country. In the context of the unfolding international financial crisis and ensued economic recession in Europe and the CIS a number of urgent measures are necessary to be adopted by Moldovan Government to rebuild economic confidence, stimulate consumption and domestic supply:

- Corruption and governmental interference with private businesses should be addressed as being among the most significant internal barriers to economic growth, with administrative bodies monitoring/controlling foreign trade being a particular area of attention.
- It is necessary to speed up the business regulatory reform which, with a special attention paid to issuance of the construction permits, issuance of market authorization by local authorities, and issuance of sanitary clearances and land rezoning.
- With the budget deficit looming large, the Moldovan Government has to look for additional budget revenue that would not dry up the investment resources in the economy (thus, these revenue should come mainly from privatization and foreign debt rather than domestic debt) and to optimize the expenditures side (by pushing forcefully for public administration reform).
- Social protection policy has to be streamlined and made more socially fair and economically efficient. In this context it is necessary to review the governmental price policy by reducing the basket of goods and services with governmentally controlled prices and trade margins and to protect the economically vulnerable people by direct subsidies rather than by keeping prices below production costs.
- Some fiscal tools should be considered as means of stimulating demand. For instance, the VAT for the goods and services creating additional demand in the economy can be reduced (computers, constructions, cars), while the VAT and excises for other goods can be increased (luxury, alcoholic beverages, tobacco).
- As inflation risks are downside, it is necessary for the National Bank of Moldova to relax its monetary policy in order to reset the economic mechanism through more investment and consumption loans. At the same time, the National Bank has to gradually let national currency depreciate to a more competitive level.
- Even though immediate risks for agriculture are not larger than in general for economy, agricultural sector may suffer the hardest blow in mid- and long-term. Gradually allowing foreign companies to buy agricultural land for investment purposes represents the only solution to attract investment in the sector, increase the rural labour productivity and reduce the rural poverty.
- Exports of Moldova are expected to decline dramatically as result of falling global and regional demand. In order to remove internal barriers for exports' growth, Moldovan Government has to abolish all prohibitive or restrictive regulations limiting the exports, speed up the VAT reimbursement procedure and refrain from erecting trade tariff barriers.
- The relatively low-skilled migrants returning from Russia represent a potential workforce for implementing big infrastructure projects and other public works. At the same time it is necessary to increase the scope of the active labour policy to channel the high-skilled labour force that is presently fired by some private companies to alternative occupations, including in individually-owned businesses.
- Even though financial contagion from international financial markets was very limited, the Moldova's banking sector has to be carefully monitored and stabilized. Maintaining the public confidence in commercial banks is of vital importance for Moldovan economy at this stage.

1. Economic governance

Present chapter presents a broad view of major areas of economic governance. Situation in areas of privatization, corruption fighting, social protection and regulatory reform are introduced through most important episodes occurred along the transition period of the country. Interplay of events of institutional or legislative nature, along with resulted changes in the ease of doing business are supported with the assessment of corruption and of role of the state. The section ends with an evaluation of progresses achieved during the 20 years of transition and challenges ahead in discussed areas. The text is accompanied by relevant data from TI, WB and EBRD with possibility of comparison among neighbouring countries, CEE, CIS and EU.

Privatization protracted for more than one decade

First round of privatization in Moldova through a voucher privatization program took place in the early years of independence with most of the small-to-medium enterprises being successfully privatized. However, most of the large-scale privatizations were held back by opposition from the part of vested interests. As result, the privatization program planned for 1997-1998 was rolled-over until the end of 2006. Most politically sensitive were the initiatives of selling the key state-owned enterprises in the wine and tobacco companies (and tobacco sector so far remains almost completely state-owned). Major privatizations in wine industry started only in 2002 and mainly to Russian investors. Among the biggest privatization deal was the sale of three electricity distributors to a Spanish firm in 2000, with failed sales of the remaining two. Through these two rounds of privatizations the national market entered Union Fenosa, Lafarge, Mabanaft, Knauf and other foreign investors. The most significant setbacks include annulments in the period 2001-2006 of some earlier sales and blocked progress on agricultural land privatization to non-residents. Several big objects as “Banca de Economii”, “Moldtelecom”, and “Tutun” CTC formally are still in the process of privatization[1]. A new round of privatization started in 2007[2] with many major objects privatized in 2007-2008 but also with many enterprises excluded from the privatization process. The reasons for prohibiting privatization of such companies as the thermal energy plants, the two electricity distribution networks, a roads building company are not clear.

Corruption hindering economic development

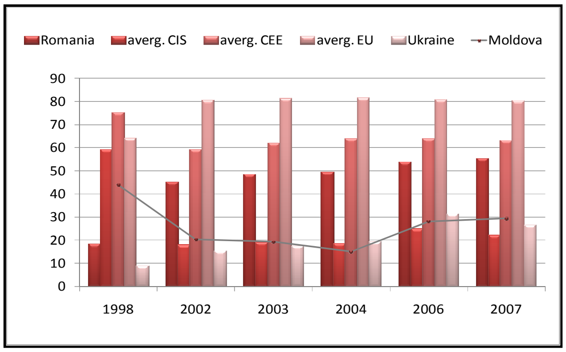
Businesses in Moldova still have to contend with less favourable conditions than companies in other countries in the region. Most obstacles arise from Government interference in the economy. Corruption is a serious problem, partly due to this state’s continued involvement. The World Bank’s Governance Indicator “Control of Corruption” as well as the Transparency International’s “Corruption Perception” Index show the worsening of the situation along the transition (Chart 1 and Chart 2). On average, Moldova is doing worse than EU and CEE as well as Romania and fares at comparative level with CIS on average and Ukraine. The main developments over the last decade in this area also do not convey too much optimism. Many civil society organizations and political parties claim an absence of independence, public accountability and transparency in the work of the Centre for Combating Economic Crimes and Corruption (CCECC). Indeed, so far most of the revealed “corruption deals” relate to the so-called petty corruption (in schools, hospitals, etc.). Another issue is the alleged tendency to use the CCECC as a tool of governing party against political opposition or economic opponents. Despite the donors involvement and internationally supported efforts the progress in this

[1]According to the Memorandum between IMF and Republic of Moldova, Banca de Economii privatization tender had to start on March, 31 2008 at latest. New consultant to assess the ways of privatizing eventually the Moldtelecom should have been selected by late September 2008 on the basis of an open contest. Both commitments have been blocked recently by the on-going financial crisis.

[2] Law no. 121-XVI of 04.05.2007 on administration and deetatization of public propriety, Official Gazette, nr.90-93/401 din 29.06.2007.

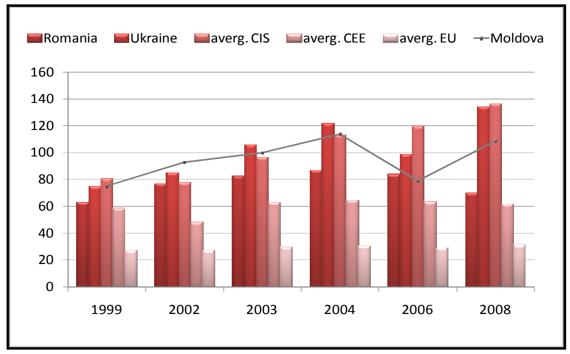
area seems to be trivial although one has to admit that the methodology of corruption measurement is mostly related to its perception in the society rather than hard-data measurements.

Chart 1. World Bank Worldwide Governance Indicators: Control of Corruption



Note: the higher the bar, the better control on corruption; Source: WB Control of Corruption Worldwide Governance indicator and EG calculations

Chart 2. TI Corruption Perception Index (CPI)



Note: the higher the bar, the lower perceived level of corruption;
Source: TI Corruption Perception Index and EG calculations

A research conducted by Transparency International assessed as modest the impact of Country Threshold Program[3] (CTP), launched by late 2006. According to the study, households most often give unofficial payments to customs officers, to register cars or get driver licenses, to the police and doctors. Business activity is most affected by need of making unofficial payments to customs officers and the police. Public health and education remain problematic areas for both categories[4].

Towards a more efficient and fair social protection

The heritage of soviet type of social assistance left Moldova with no clear distinction between Social Insurance and Social Assistance. From the early 90's reforms in this area were concentrated on two goals. First goal was to separate the social insurance from social assistance with main purpose of making social insurance sustainable and extra-budgetary. Second, in the area of social assistance the goal has been to ensure the transition from categories-based system towards means-tested one. The latter achieved some progress only in 2008 through approval of the Law on social aid (into force from October 1, 2008) [5]. One of the major benefits expected from the new system is of better targeting the scarce resources on the most vulnerable groups of people. Despite clear schedule of inclusion for three distinct categories of population in the newly elaborated system, no phase-out schedule for old, category-based system was yet adopted to present day. This will result in additional costs in short-term.

Social assistance benefits are designed to alleviate poverty. As such they might be used to evaluate Government pro-poor policies. Until the new system will prove its effect, the currently existing categories-based scheme is mainly targeted to the war veterans, disabled and children. These three categories increased in size and in 2004 reached 90% of all beneficiaries and total expenditures[6]. The practice of social assistance is biased in favour of selected categories of beneficiaries irrespective to the wealth status and to date none of the benefits are really means tested[7]. As data for the period of

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[3] The Millennium Challenge Corporation (MCC) Threshold Country Program (TCP) is a $24.7 million, two year initiative implemented by USAID to support Moldovan Government to reduce corruption and improve transparency in five major public domains: judiciary, health care, tax, customs and police agencies and Centre for Combating Economic Crimes and Corruption (CCECC).

[4] 2009, "Fifth Consolidated Monitoring Report of the Implementation of the Threshold Country Plan by the Government of the Republic of Moldova" January 1, 2009 – March 31, 2009, Transparency International-Moldova, Anticorruption Alliance (ACC) http://www.alianta.md/index.php?module=stiri_int&news_id=44&news_cid=10

[5] Law no. 133 from 13.06.2008 on social aid

[6] Paolo Verme, Policy Research Working Paper 46508. Social Assistance and Poverty Reduction in Moldova, 2001–2004. An Impact Evaluation, World Bank, 2008

[7] Ibid. Benefits for children in age 0-3 and material assistance are supposed to be accompanied by means-tests but in reality the system preselects categories of beneficiaries making the means-test an almost redundant exercise.

2001-2004 show, such a system addresses the political constituencies of Moldovan Government rather than the stated intention of improving citizen's welfare. The Government opted to increase expenditure and coverage rather than focus on proper targeting based on means tests and fine-tuning of individual transfers. Recent WB report concludes that "the real engine of poverty reduction in Moldova between 2001 and 2004 has been the country economic growth rather than social assistance transfers"[8].

The separation of social assistance and social insurance was complemented with specific reforms in two areas of labour protection. One relates to the protection from risk of complete or partial (or even temporary) loss of working capacity (old age, disability, work injury, unemployment, and maternity) of former or present workers. Another regulates the worker protection at the workplace and decent working conditions with direct influence on labour costs. Major changes started in 1998-1999 when Moldova's long-term pension strategy was approved[9] and a new law on state social insurance pensions was adopted[10], establishing a correlation between social contributions and pension size. These changes were initiated in parallel with several other reforms and measures undertaken to reform the solidarity pension system based on standard and best-practices. However, in 2002 and 2003 the pension reform in Moldova was paused. Among frozen issues are the move from 62 and 57 years of retirement to the 65 and 60 for men and women respectively and the reform of pensions in agricultural sector. Still more needs to be done to strengthen the link between pension benefits and pension contributions. To date only about 75% of the individual pension records entered into the contributors' database. [11] Another issue is the reversal of declining replacement rate that in long term has undergone a declining trend, from 44.9 in 1995 to 26.7 in 2006. [12] Another policy issue is the unification of the pension system for all types of pensioners (non-agricultural, agricultural and privileged), developing multi-pillar pension system with a mandatory fully-funded second pillar and avoidance of creation of new privileged categories of pensioners. One more policy issue is the system of benefits for the privileged pensioners that currently continue to increase. [13]

Regulatory framework reform

February 17, 2004 is considered as date of the formal start of the reforms towards simplification of regulatory framework with a Governmental decision issued on reforms in the area of state regulation of entrepreneur activity. The major goal was to eliminate ambiguous, repetitive and ineffective business regulations that create obstacles for investment and enterprise development.

The three stage process of regulatory simplification culminated with the approval on 16th of December 2004 of the so-called First Guillotine Law[14] (818 normative acts revised, 184 abrogated and 496 introduced in a Register of official regulatory acts of entrepreneur activity). A little more than half of the acts relevant to the Nomenclature of authorizations for different types of enterprise activity remained in place with 82 out of total 125 issued free of charge and 7 with extended terms of use up to 5 years. Furthermore, the new law encouraged development of public-private relationships

[8] Paolo Verme, Policy Research Working Paper 46508. Social Assistance and Poverty Reduction in Moldova, 2001–2004. An Impact Evaluation, World Bank, 2008

[9] The Strategy for reform of the pension system approved by the Government Decision No 141, on 23.09.1998.Designed with the assistance of the World Bank and European Union the Strategy replaced the Social Fund with National Fund for Social Insurance in 1999.

[10] Law no. 156 from 01.011998 on state social insurance pensions

[11] MONITORING CAS RESULTS Country Assistance Strategy, WORLD BANK. December, 2006 http://siteresources.worldbank.org/INTMOLDOVA/Resources/ResultsReportAnn.pdf

[12] The old-age pension replacement rate is a measure of how effectively a pension system provides income during retirement to replace earnings which were the main source of income prior to retirement. Society at a Glance: OECD Social Indicators, 2006 edition, OECD, 2007.

[13] Ibid 6

[14] Law No 424-XV of 16December 2004 on optimisation of the legislative framework governing the entrepreneurship activity was adopted and implemented, which was the legal basis for the application of the guillotine mechanism and principle.

by creating private sector and Government collaboration in order to review business regulations and help drive new law implementation.

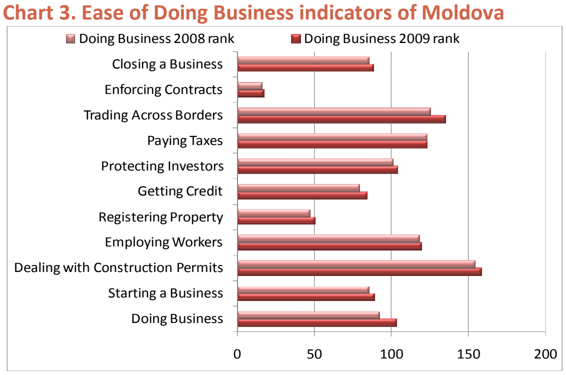
Second Guillotine Law (Law on basic principles and mechanism of regulation of entrepreneurial activity approved on 20 of July 2006) had the purpose to extent the reform beyond the revision of the normative acts by starting the revision of laws and entered into force on 1 of January 2008. It establishes Regulatory Impact Assessment governance (RIA) standards for all law drafts ensuring that all future business regulations will be based on law, effectively blocking Government bodies from issuing unnecessary business restrictions. It holds the Government accountable for making decisions in a transparent manner, restricts the Government from conducting unnecessary or intrusive state controls in the private sector. However, currently implementation of RIA is limited to the elaborated guidebook of ex-ante impact analysis and several pilot projects with some ministries. There is no RIA introduced as integral part of the legislative routine.

The three-fold "liberalization" initiative advanced by the Moldovan President in April 2007 is the most telling example of initiatives introduced without proper preparation and cost benefits analysis. This package provided for:

- capital legalization through benevolent declaration of all money means and other tangible and intangible assets owned by both natural and legal persons;
- fiscal amnesty by forgiving all fiscal debts of the economic agents to public budgets (except local budgets) accumulated before January 1, 2007;
- setting out a "zero rate corporate income tax" for reinvested profit (since January 2008).

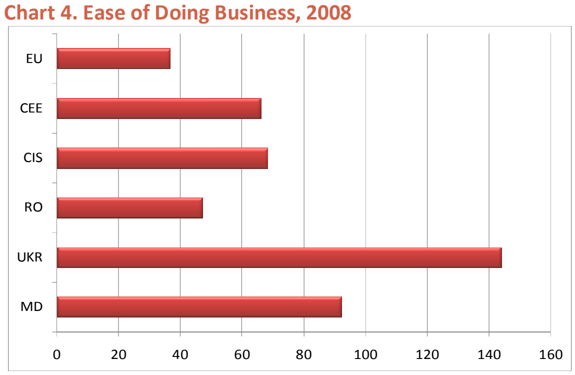
One of the problems immediately induced by this reforms package was the discrimination among companies that fulfilled their fiscal duties for the period up to 2007 and those that incurred debts or were active in the grey sector of the economy. Apart from creating wrong incentives for economic agents, the fiscal amnesty cost around 4 billion lei of annulled debts mostly to the state budget and social insurance fund. In such way the final outcome of this reform is a strong incentive for "soft budget constraints" and for continuing debts accumulation. The capital legalization also did not bring a spectacular net effect despite the degree of grey economy estimated at the level of 30% to 70%[15].

Chart 3. Ease of Doing Business indicators of Moldova



Source: World Bank

Chart 4. Ease of Doing Business, 2008



Source: World Bank and Expert-Grup calculations

The "one stop shop" principle was introduced in the functioning of the state chamber of registration (2005), license chamber (2008) and customs (2008) as an attempt to reduce costs and time for businesses dealing with official requests. Several elements of this principle are used in local public administration of the Chisinau municipality and other 15 district centres. However until the acknowledged reforms will take effect, the national indicators of ease of doing business show major obstacles in trading across border and dealing with construction permits, apart from taxes and rigid employment policy (Chart 3). Also, although doing comparatively better on average than Ukraine, in

[15] Interview with the Minster of Economy Igor Dodon by Vlad Bercu
http://www.allmoldova.com/index.php?action=interviu&id=539&lng=rom

terms of easiness of doing business Moldova is far from both CEE & Balkans and EU simple averages (Chart 4).

A possible improvement in above mentioned indicators might take place through the adoption and implementation of two important pieces of legislation: the new Law on Protection of Competition and the Law on State Aid. The old law regarding competition was adopted in June 2000 and formally is still in force. However the National Agency for Protection of Competition has not been created until the February 2007 when the head of the Agency was officially appointed by the Parliament. The new draft Law on Competition was approved by the Parliament but rejected by the President in 2008. The adoption has been postponed because of the lengthy process of additional examination by relevant Parliamentary Committee. Major discussions referred to the degree of competition in both transition context and harmonization with the EU's acquis context. In particular one of the unsolved issues is the specific ways of ensuring an effective interplay between independence and accountability of NAPC. Although the new draft Law on Competition is declared by the Government as fully in line with the EU acquis, the Association of Foreign Investors (AFI) indicates that NAPC selected only those EU regulations that contribute to the increase of agency competencies and size of the imposed fines[16]. Also AFI considers several NAPC decision based on an arbitrary methodology and without legal basis for applied fines[17].

20 years of transition: is it over?

As country moves towards its 20th year of transition the assessments of successes and failures become essential in order to determine further steps in the country's development. Each of the dimensions in institutional and economic shifts towards a functioning of a market economy must be evaluated under a proper benchmarking against regional and world economic leaders. Indeed, our country competes for pockets of foreign investors that seem to be interested in the whole region and not in individual countries, especially in a very small one as Moldova.

Despite successes in the area of liberalization of foreign exchange system and price liberalization on most of the goods and services, there is still need for change in the sphere of privatization, non-banking financial institutions and infrastructures. These should be accompanied by lessened implication of the Government in the economy and increased efficiency and transparency in use of budgetary resources. No surprise, because of all these shortfalls, so far the US and EU have not yet recognised Moldova as having a market economy.

At the same time, development of alternative macroeconomic methods of economic stabilization should be coupled with the strengthening of the institutions of democratic participation and citizens' control as a warranty of an equal wealth distribution, equilibrated development benefiting to all groups of citizens and avoidance of state capture by different interest groups. Hence, apart from EBRD transition indicators[18], the indicator of citizen participation and control is an important part of transition measurement e.g. WB Voice and Accountability Indicator.

There are no doubts that Moldova is still in the process of the transition both in terms of economic output and institutional building. The latter refers as to the institutions necessary for a proper functioning market economy, so to mechanism of citizen control and participation. World Bank's

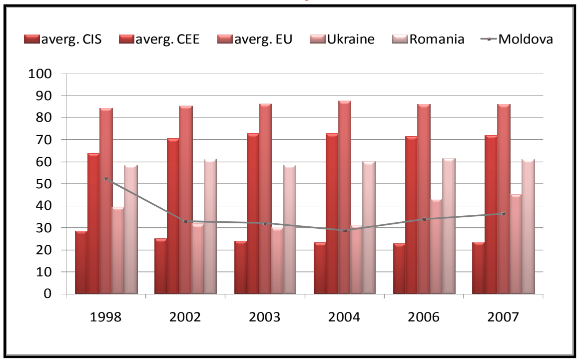
[16] 2008 Foreign Investors Association "The Foreign Investors Association expresses its concern with the abuses committed by the National agency for competition protection" 30.10.07 http://www.fia.md/index.php?option=com_content&view=article&id=72:301007-asociaia-investitorilor-strini-atenioneaz-asupra-abuzurilor-comise-de-agenia-naional-pentru-protecia-concurenei-&catid=3:presa&Itemid=33 http://www.dejure.md/index.php?go=news&n=1525

[17] ibid

[18] Large-scale privatisation, Small-scale privatisation, Governance and enterprise restructuring, Price liberalisation, Trade and foreign exchange system, Competition policy, Banking reform and interest rate liberalisation, Securities markets and non-bank financial institutions, Infrastructure reforms.

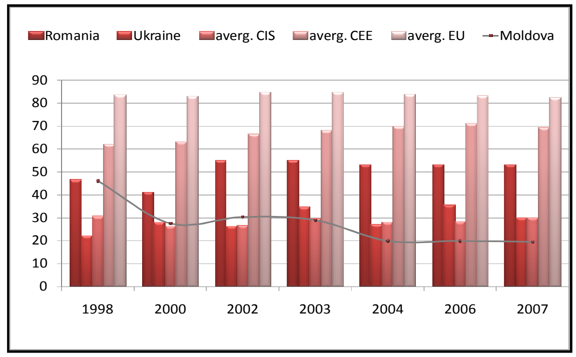
Voice and Accountability Indicator[19] and Governance Effectiveness Indicators[20] show an absence of progress in these areas (Chart 5**Error! Reference source not found.** and Chart 6). Moldova lags below all control groups doing better on Voice and Accountability indicators only as compared to the CIS average.

Chart 5. Voice and Accountability Indicator



Source: WB and EG calculations.

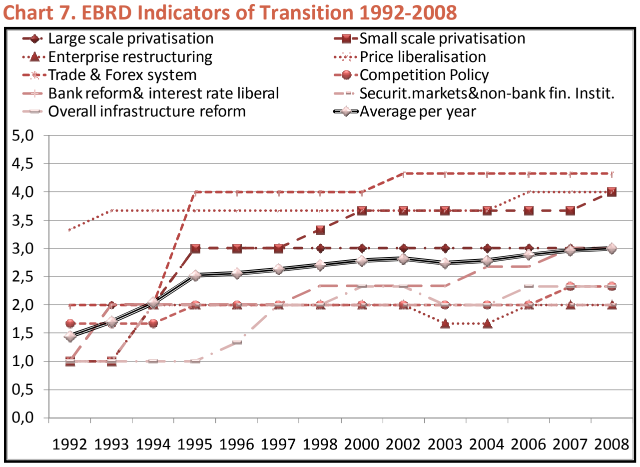
Chart 6. Government Effectiveness Indicator



Source: WB and EG calculations.

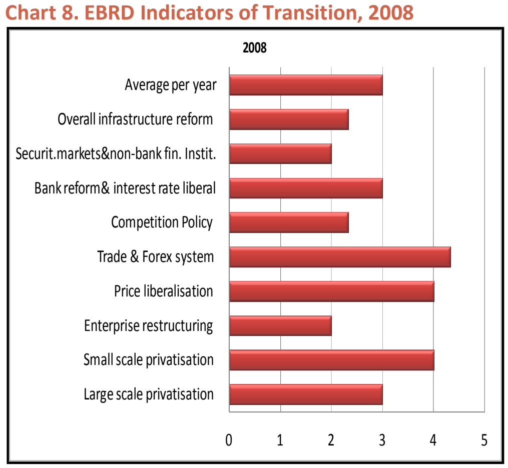
Moldova has maintained a rather poor performance in the area of enterprises restructuring, competition policy and non-bank financial institutions (Chart 7and Chart 8). There are still actions needed to strengthen the legislation related to the bankruptcy as well as corporate governance. The 2007 fiscal amnesty might one more time hinder the efforts to harden the budget constraints that are essential for the finalization of enterprises restructuring. The overall assessment by EBRD indicators of transition[21] shows that the country is still half way through the transition. On average, Moldova's aggregated score achieved in 2007 and maintained in 2008 was 3 out of 5 compared to the level 1 for most of the dimensions in 1989.

Chart 7. EBRD Indicators of Transition 1992-2008



Source: EBRD, EG calculations.

Chart 8. EBRD Indicators of Transition, 2008



Source: EBRD, EG calculations.

Challenges ahead

- ***Corruption remains one of the most stringent problems in the society***. The activity of the CCECC should be further strengthened in terms of transparency and independence from political factors of influence. ***Special attention has to be paid to the systemic corruption rather than petty***

[19] Voice and Accountability measures the extent to which country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
[20] Government Effectiveness measures the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
[21] The transition indicator scores (min 0 max 5) reflect the judgment of the EBRD's Office of the Chief Economist about country-specific progress in transition, developed first in 1995.

corruption[22]. In this flows of ideas mechanisms of transparency along with parliamentary and civil society controls should be further implemented in functioning of all key institution regarding fighting and preventing of the corruption e.g. judiciary, public finances and institutions with the function of inspections. ***It is worthwhile to emphasize that civil control on the public security institutions, the citizens' participation in public affairs and the governmental accountability are basic ingredients of a successful campaign against systemic corruption.***

- ***The continuation of reforms in the pension system*** is still a challenge for a Government that prefer serving its political constituencies rather than addressing stringent problems of shrinking population, emigration and poor economic performance. Among most stringent issues are privileged pensions for different groups of citizens, absence of multi-pillar pension system, market distortion of working pensioners, diminishing replacement rate and establishment of an adequate relation between contribution and pension.
- ***In the area of social assistance the efforts should further be concentrated to improve its function of poverty reduction***. The finalisation of reforms towards a means tested system should be based on rational of optimisation of public budget rather than political constituencies' preferences. A clear phase-out agenda has to be set up for leaving the old system based on principle of compensations paid to broad social categories and introducing the means-tested system of social payments.
- ***Institutional reforms for a functioning free market still remain among tasks to complete despite twenty years of transition***. Reforms in the area of Competition Protection should be finalised through the assurance of the independence and transparency of NAPC's decisions and the adoption of the Law on Competition and Law on State Aid, as well as clear established rules and methodology of work. The process of enterprises restructuring should combine an efficient privatization program and hard budget constraints. The former should include the remaining subjects excluded from privatization according to the law[23]. The later should stimulate the process of redistribution of economical assets from ineffective economic agents through a sound bankruptcy procedure and avoidance of measures that stimulate accumulation of the arrears to the state budget or debt collection e.g. fiscal amnesty.

Outlook for 2009

- It is highly unlikely in the next 1-1.5 years a significant progress to be achieved in reduction of the systemic corruption because of the extremely polarized society after the events in April 2009, domestic political turmoil, strong political control over the judicial system and lack of effective access of the civil society and mass media to sensitive information.
- Progress of the privatization will depend to some extent on the situation of the public finance. However, the new Government most probably will prefer to rely more on external borrowing in order to cover the budget deficits in 2009-2010. Restructuring with subsequent privatization of the "Moldtelecom" and privatization of the "Banca de Economii" are necessary in order to give the markets a new impetus, but their privatization is not likely because the new Government will be afraid of the bids to reveal low market prices of these entities.
- The pensions system is under big strains and the situation may even get worse as migrants are returning home and pensioners will rely less on remittances from abroad. As the ruling party seems to be willing in the future to rely less on the pensioners as its traditional constituency and to turn more to the youth, moving to high retirement-age may start again. Some marginal progress is possible with streamlining of the pensions preferences, but the reform of the pension system in agriculture most probably will not advance in short term.

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[22] Systemic corruption is not a special category of corrupt practice, but rather a situation in which the major institutions and processes of the state are routinely dominated and used by corrupt individuals and groups, and in which many people have few practical alternatives to dealing with corrupt officials.

[23] Law nr. 121-XVI from 04.05.2007 regarding administration and privatization of public property.

- Some progress is expected with further simplification of the companies' registration (especially in regions) and with licensing but the progress will be limited in such areas as issuance of constructions permits and introduction of the RIA in legislative process.

2. GDP as pulse of the economy

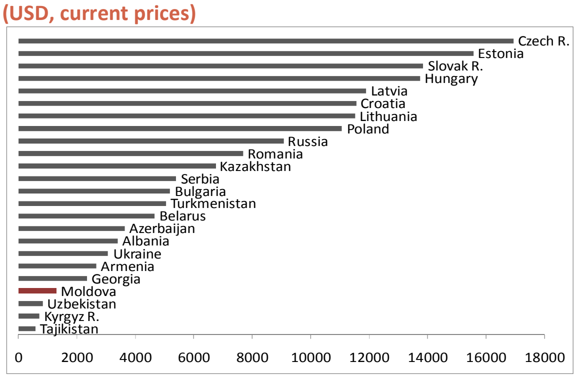
This chapter contains an analysis of GDP trends since 1994 based on the two statistical approaches: expenditures- and production-side. It identifies the main factors that contributed to the economic growth resumption in 2000 and important changes in the structure of GDP in this period, related mainly to the transformation of the consumption patterns of the population and to the contraction of the agricultural sector. At the end of the chapter some challenges are reviewed in the context of the global crisis, which already affected Moldova in the last quarter on 2008.

From deep recession to economic growth

After the soviet collapse, Moldova has suffered one of the deepest and longest economic declines among the transition countries. After almost one decade of transition, in 1999 its GDP was about 33.8% of its pre-transition level. The rebound of Moldovan economy started in 2000 due to the increase in domestic and external demand. Despite the constant economic growth after 2000, Moldova's GDP is still under its pre-transition level and its GDP per capita is one of the lowest among CEE and CIS countries (Chart 9). During 1994-2009 the economic growth of Moldova followed four phases:

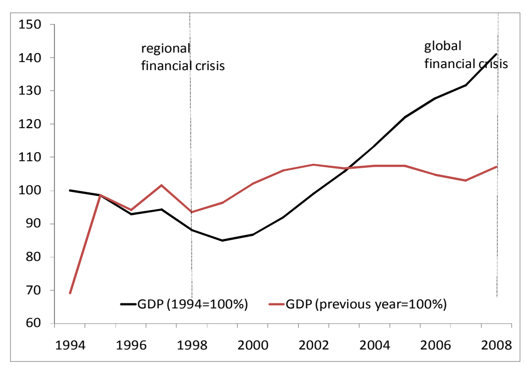
- 1994 – 1999: economic collapse. The only year with positive (minor) economic growth was 1997, followed by the regional financial crisis that has thrown Moldova into an even deeper economic decline (Chart 10).
- 2000 – 2005: economic recovery. The average annual GDP growth in this period was 6.25% and a certain degree of convergence to CIS and CEE average occurred.
- 2006 – 2008: external shocks. Although the economic growth remained positive, the growth rate slumped to 4.1% in 2006 and 3.0% in 2007. Despite the impressive economic growth in 2008 (7.2%), this was mainly a recovery growth after a very severe drought.
- 2009: economic decline. Short-term perspectives for Moldova are not good because the country was heavily hit by the second round effects of the global financial crisis. Its first consequences were visible already in the last quarter of 2008 and were confirmed by bad statistical indicators in the first quarter 2009.

Chart 9. GDP per capita in CEE and CIS countries in 2007 (USD, current prices)



Source: World Economic Outlook Database

Chart 10. GDP growth in Moldova (%)



Source: NBS

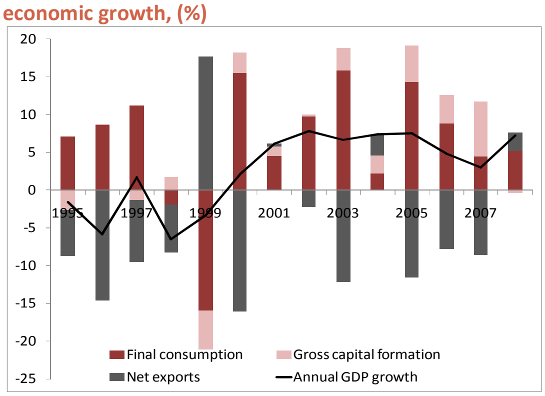
Replacing consumption-based with investment-led economic growth

In the initial stage of transition, Moldova's GDP structure by expenditure components was more or less similar to other CIS and CEE countries. Consumption accounting for 83% of GDP in 1995 was lower than the CIS average but it increased rapidly reaching 113% of GDP in 2008. A comparable "performance" was achieved only by two other transition countries: Kyrgyz Republic and Tajikistan (as Moldova, both countries depend very much on migrants' remittances). At the same time the production followed a decreasing trend until 1999 due to restructuring of industrial enterprises and collective agricultural enterprises. These developments, accompanied by the change in trade relations with some strategic partners from among the former Soviet Union countries, generated the fall in exports, while still increasing consumption fuelled the imports until 1998. Only in 1998 and 1999, the regional financial crisis had a negative impact on the domestic demand generating a fall in imports but also a further decline in GDP.

The rebound of economic growth since 2000 was primarily the consequence of increased domestic and regional consumption. Domestic demand played a particularly important role in the revival of Moldovan economy (Chart 11). Final consumption increased from 90% of GDP in 1999 and to 113.5% of GDP in 2008; households had the main contribution with an average annual growth of consumption of 9.7% since 2000, as compared to 4.6% for the public administration consumption. The growth in household consumption was fuelled primarily by increasing transfers from Moldovan citizens working abroad and to a lower extent by wage growth in the economy. Indirectly, growing private consumption propped the public administration one via indirect taxes on consumption. Since 2000, the remittances' annual growth rate was 37% on average, while the annual real growth of the average monthly wage in the economy was 11.8% on average. The domestic supply did not respond proportionally to the explosion of consumption, which was consequently fuelled by the galloping growth of imports. Therefore, despite the positive economic growth since 2000, it was lower than the average growth in CIS countries.

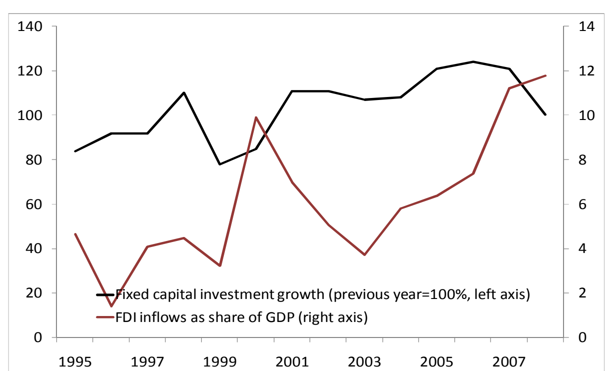
The consumption-based economic growth has been always criticized as being unsustainable and vulnerable to external shocks. However, capital investment also followed a healthy evolution since 2005 and in 2007 economic growth in Moldova was very much an investment-led growth. Capital investment growth in recent years was possible due to higher FDI inflows into the Moldovan economy that in 2005-2007 was stronger than in CEE-CIS region. Thus, in 2007 FDI/GDP ratio was 10.4%, placing Moldova on the fourth position among the transition countries according to this indicator. In 2008 the share of FDI inflows to GDP increased more to 11.8% (Chart 12). The increase of FDI inflows may be attributed to some extent to the improvement of the domestic business climate, but it seems that the FDI have increased in the whole Eastern Europe in 2008. Nonetheless, it is clear that for the capital investments to grow sustainably rather than episodically it is critically important that Moldova continues the business regulatory and investment climate reforms in order to become more attractive for the investors and not to lag behind the countries in the regions in international business climate rankings. This is even more important as global financial crisis and economic recession reveals strong negative impact on Moldovan economy.

Chart 11. The contribution of expenditure factors to economic growth, (%)



Source: NBS and EG calculations

Chart 12. Capital investment and FDI inflow trends, (%)



Source: NBS, NBM and EG calculations

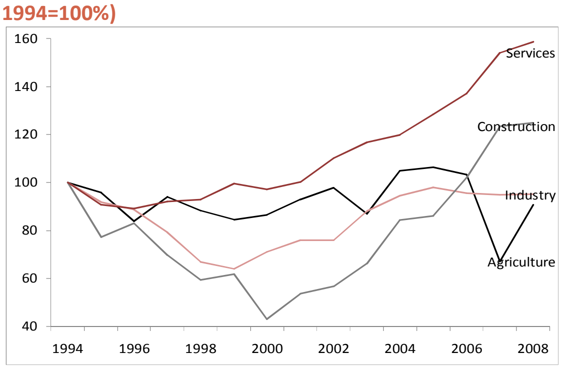
Moving from agrarian to modern economy

A close analysis of the trends in the structure of GDP by production should eliminate the stereotype of Moldova being a country extremely dependent on the agricultural sector. Moldova still relies more than other European countries on agriculture and related industrial sectors as winemaking, food industry and tobacco processing. But a look at the statistical series shows a shrinking role of agriculture and a constant expansion of services. The share of the Gross Value Added (GVA) produced in agricultural sector in GDP has decreased from about 30% in 1994 to 8.9% in 2008, a comparable decline being observed only in Caucasus and Central Asia, countries which historically also relied largely on agricultural sectors. Unfortunately this "economic modernisation" was a consequence of the sluggish structural reforms and underinvestment in the agricultural sector.

The agriculture is not the only sector with such a sharp decline; the share of the GVA produced in industrial sector in total GDP has also decreased from about 30% in 1994 to 14.4% in 2008, placing Moldova bellow other CIS and CEE countries. However, after 2000 all economic sectors but agriculture followed a positive growth. The growth in agricultural sector was almost intangible since 1994, partly because of three major shocks in 2000, 2003 and 2007, when serious droughts affected or destroyed the harvest (Chart 13). The decrease in the above mentioned sectors was partly compensated by the increase in service sector, where the produced GVA reached 53.9% from the GDP in 2008, this being higher than in CIS and some CEE countries. Even in the service sector the growth was uneven; it was mainly determined by the growth in transport and communication, real estate transactions, IT and recreation activities, while education, health and public administration services showed a very modest growth in the analyzed period.

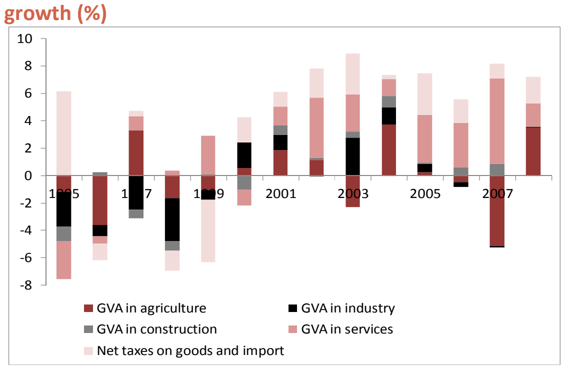
In the context of increasing consumption and a fiscal policy of heavily taxation of consumption, it is not surprising that the net taxes on goods and imports followed a positive path, reaching 17% of GDP in 2008 and thus adding some percentage points to the real economic growth (Chart 14).

Chart 13. GVA growth by sector of economic activity (%, 1994=100%)



Source: NBS and EG calculations

Chart 14. The contribution of output factors to economic growth (%)



Source: NBS and EG calculations

Challenges ahead

- ***Despite the positive and impressive economic growth in 2008, recent global trends will not give Moldova a wide breath***. Some effects of the contagion were already tangible in the last quarter of 2008: the decline of remittances, moderation of domestic consumption, and the decline in the external demand and negative trends in foreign trade, which consequently resulted in the slow-down of GDP growth in the fourth quarter of 2008. The forecast for economic growth are not optimistic at all. In April 2009, the IMF published the new World Economic Outlook Report, where it revises the earlier-predicted positive economic growth in Moldova to -3.4% in 2009.[24] There are no signs for reversal of trends and IMF forecasts may still be revised.

- ***As Moldova's export markets have plummeted and the resumption is going to take at least 1.5-2 years, the Government has to remove internal barriers limiting the economic growth and domestic demand***. The main areas where Government should concentrate its efforts through tools and policies, as specified in previous and next chapters are improvement of business climate, promoting a monetary policy which would stimulate easier access to credit both for consumers and producers, promoting a sustainable fiscal policy through the optimization of the expenditures that would maintain public investments in key infrastructure projects (roads) and public services (education) as these have both short-term and long-term positive effects on the economic growth.
- ***After one decade of severe recession, since 2000 the economic growth in Moldova has been very a much a recovery growth driven by consumption and supported by better use of existing capital and improved total factor productivity, rather than additional investment and labour***. In fact, the disaggregation of the GDP by production factors shows that because of the migration, after 2003 labour had a constantly negative contribution to the GDP growth. As for the capital, it has had a minor contribution to the economic growth. This suggests that more investment and more human capital would certainly consolidate the country's economic growth in the future.

Outlook for 2009

- In 2009 a severe decline of the GDP will be registered. Depending on external factors, this decline may vary between -3% to double-digit recession rates. Reduction of domestic private and external consumption is expected to be the key factor of recession.
- After a long period of contraction, the share of the agricultural sector in country's GDP is expected to rise again and marginally to compensate for the shrinking industrial and construction sectors. The share of services, main contributor to the country's GDP will remain unchanged.
- Even though Moldovan migrants are returning home, there are no jobs available to put this labour force at work. Even more, most of the Moldovan companies face severe budget constraints and have to implement short-day working plans or/and to reduce the wages. We expect a negative contribution of the labour factor to the total GDP growth in 2009-2010.
- Investment resources will remain scarce in 2009-2010. Under these harsh economic conditions companies are expected to make better use of existing capital and labour and to achieve higher Total Factor Productivity. Contrary to conventional wisdom, in this difficult period more marketing and product innovations are expected to come out from the Moldovan companies.

[24] World Economic Outlook: Crisis and Recovery, IMF, 2009

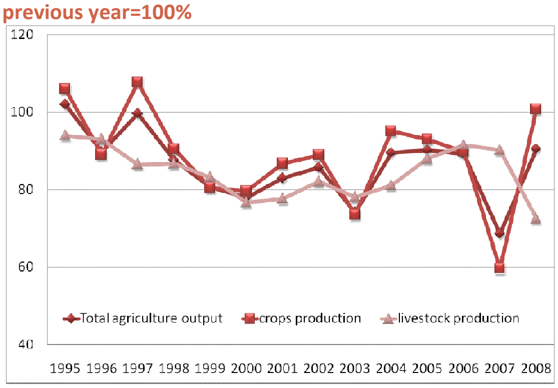
3. Agriculture: from centralized planning to underdevelopment

This chapter highlights the most significant changes featuring Moldova's agricultural evolutions in the past 15 years. It identifies "tectonic" shifts that have fundamentally altered the outlook of the sector, such as changing ownership patterns and the evolving structure of crops and animals productions. Main issues of agricultural policy are assessed in terms of their relevance for the real situation of the Moldova's agriculture. Chapter ends with an analysis of main risks looming ahead and most urgent priorities for the sector's development.

Big structural changes

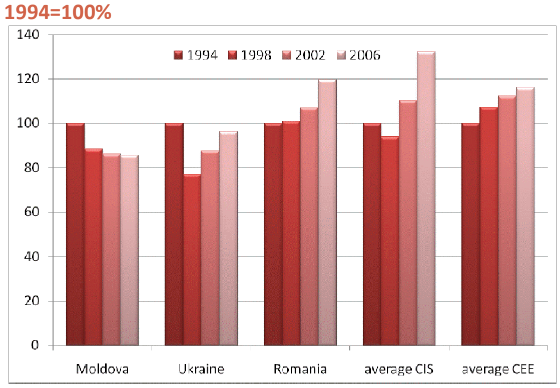
In the soviet period the economic role of agriculture in Moldova was overemphasized, while its competitive advantages were largely due to subsidized inputs and guaranteed access to the markets. Dismantlement of the USSR resulted in losing previous advantages which in 1991-1994 reflected in a collapsing production of its main high value-added products - apples, tomatoes, grapes and meat. Even though with big delays, by the end of 1990s Moldova has almost accomplished basic reforms necessary for a market-oriented agriculture to function well, such as land privatization, abolishing control for most domestic prices and liberalization of foreign trade. However, even though necessary, these structural reforms were not sufficient (and some are far from being complete). The agricultural sector has continued stagnating mainly because of chronic shortage of investment: in 2000 investments in agriculture equalled only 15% of the 1994 level (62% in general per economy) and in 2007 have reached 72% of the 1994 level (160% per economy). Ineffective companies restructuring and persisting governmental policy distortions are other two interconnected factors undermining the development of the sector. Difficult climate conditions caused additional losses but their impact could have been reduced with proper agricultural works in place[25]. According to recent estimates, in 2008 the total agricultural output equalled 90% of the 1994 level, with crops production exceeding the level of 1994 but with the livestock sub-sector much behind (Chart 15). In comparison with the 25 countries in the CIS and CEE regions for which data are available, in 1994-2006 Moldova has experienced the most dramatic decline of agriculture (Chart 16 shows Moldova's evolution as compared with its two neighbours, and with the CIS and CEE average agricultural growth).

Chart 15. Growth of the Moldova's agricultural output, previous year=100%



Source: NBS; EG estimates

Chart 16. Comparative growth of the agricultural output, 1994=100%



Source: CIS Statistics Committee and EBRD; EG calculations

The fundamental evolution featuring the Moldovan agriculture in the transition period has been the ownership reform. The share of privately-owned agricultural land increased from 0% in early 1990s to about 90% in 2007-2008. Changing ownership has lead to production shifting from big to small agricultural entities: while in 1992-93 about 70% of the agricultural output originated from the big

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[25] Rural productivity in Moldova – Managing Natural Vulnerability, WB, 2007.

collective enterprises (kolhozes) and only 30% from the small family farms, in 2007-2008 the small entities (individual companies and peasant farms) produced more than 70% of the agricultural output using only 40% of the agricultural land. Quite interesting is that despite the land privatization the shares of two agricultural subsectors (crops and livestock) in total agricultural output has remained practically the same, with crops production balancing between 60-70% in the transition period. However, inside the two main sub-sectors important long-term changes are in motion, as shown in the section below.

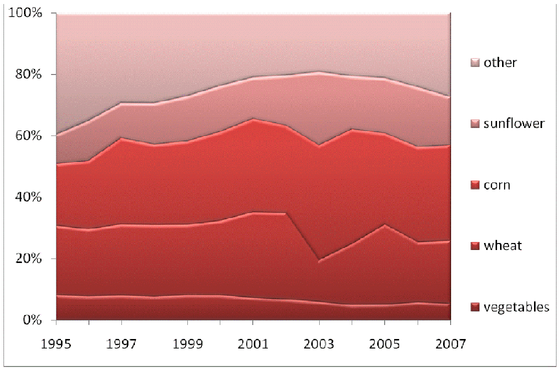
A big number of new agricultural entities emerged as result of the land privatization. However, most of them are new only in name and are using outdated management practices and production technologies. Most of the big corporate farms are still forced to keep some forms of “social responsibility” in the communities they are operating in. Even though this is not efficient in economic terms, it is a socially appraised practice. As for the family and peasant farms, their agricultural techniques are often close to archaic, and are used to provide only households subsistence means. An important element which is almost missing in the Moldovan agricultural landscape is the medium-sized agricultural entities representing the backbone of agricultural sectors in most of the EU countries. Skewed sector structure, deficient farm management, inappropriate technologies, weak vertical integration and feeble horizontal coordination corroborates with deficient agricultural policies and explain why Moldovan agriculture is such in a poor situation. Obviously, there are still many external barriers to trade, such as protectionist policies in the high-income countries, but they only marginally explain the dare state of the Moldovan agriculture. Main barriers lying across Moldova’s agricultural development path are inside the country. With current level and speed of trade globalization, the costs of these barriers are getting higher and in long-run may put an end to agriculture as important sector of Moldovan economy.

Crops and livestock production trends

One of the most important trends featuring the crops sub-sector in the transition period has been the growing share of the agricultural land sown with cereals and sunflower at the expense of vegetables, fruits, grapes and other higher value-added crops. It reflects the declining income of the farmers which were not able to finance investment necessary to plant or maintain higher-value crops requiring more expensive inputs and better protection against extreme weather events (Chart 17). In 1995-2007 the area occupied with orchards decreased by 30%, while that with grapes by 20%. It is noteworthy to say that expansion of areas with cereals (from 50% of total sown areas in 1994 to 65% in 2004, with a subsequent decline to 62% in 2008) combined with declining yields for these crops (while yields of vegetables and potatoes tended to increase). This structure of crops aggravates the erosion processes of the soil, exhausts its organic components and undermines the perspectives of developing ecological agriculture in the country.

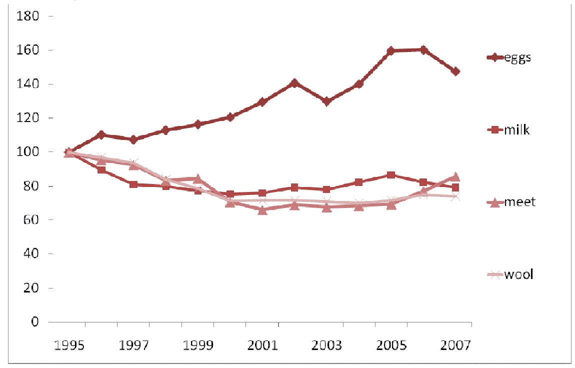
What key lessons can be drawn from the evolution of the Moldova’s crops sub-sector over the last decade? First, Moldova has been under-investing in those horticulture crops for which it has strongest competitive advantages and which can provide highest income to farmers (especially vegetables, fruits). Second, output of some “marginal” crops which were not subject to any governmental strategies and have been cultivated mainly by small farms has registered almost constant growth in the last decade (such as onions, pop-corn maize, and soya). This shows that Moldovan farmers are able to discover new opportunities and advantages even without governmental support. Another conclusion is that tobacco – formerly “strategic” - is presently a “lost case” for Moldova, with production decreasing almost 10-fold since 1994. Besides not meeting economy of scale conditions that an efficient tobacco processing sector would require, it would be strategically wrong to invest in a product facing growing public constraints in Europe and elsewhere. This implies that maintaining tobacco processing facilities under state control is wrong as well. Finally, areas sown with fodder crops have declined almost 7 times after 1994 and this has undermined even more the economic situation of the livestock sub-sector unable to pay for imported inputs.

Chart 17. Structure of growth of the agricultural output, 1994=100%



Source: NBS and EG calculations;

Chart 18. Growth of main livestock outputs, physical volume, 1995=100%



Source: NBS and EG calculations;

The livestock sub-sector is more capital intensive as compared with the crops sub-sector. No surprise, in the transition period it has collapsed more drastically than the crops sector. In 1995-2006 the cattle livestock decreased by 56%, pigs - by 41%, sheep and goats by 32%, with some more encouraging trends since 2004. The production of cattle and pigs moved almost entirely from agricultural enterprises to farms and households that practice it mainly for subsistence purposes. As for the large agricultural companies, most of them have abandoned completely the livestock sub-sector (they are producing currently 13% of meat, 3% of milk and wool, and 34% of eggs). Another suggestive trend is growing livestock of horses in farms and households, with their number increasing more than two times in 1996-2004. Obviously, this evolution shows how outdated are the agricultural techniques used by small farms. Poultry is the only important output that has grown constantly in 1996-2006 - more than 80% - and the number of birds has grown both in large and small farms (Chart 18). As a matter of fact, poultry may be presently the only branch in the livestock sub-sector for which Moldovan companies do have strong competitive advantages. For other livestock branches, the main disadvantages of the Moldovan farms are in the relatively small areas available for pasture, scarce investment resources, decreasing areas sown with fodder crops and inability to ensure necessary economies of scale. However, the most important disadvantage of the Moldovan livestock sector is that its products are not able to meet EU standards of animal and human safety.

Main policy issues

Land consolidation. In late 90s - early 2000s the agricultural land reform was formally accomplished. However, after a new Government came to power in 2001, the reform focus changed completely. Its permanent policy-mantra has been the "consolidation" of the agricultural land in order to increase the efficiency of the small corporate farms. However, available evidence shows that small farms in Moldova are more efficient than the bigger ones[26], including in production of the high value-added vegetables and fruits. In an unconstrained market economy company of any size may find its own niche. With an unconstrained land market, the land would consolidate by itself in a decade or so as rural population decreases and finds alternative non-agricultural occupations. Despite evident flaws of the consolidation policy, it received a wide support in the agricultural academic and education community. Adopting such a policy objective has impeded the governance to concentrate on the real problems of Moldovan agricultural: un-restructured big agricultural enterprises, lack of basic economic and technologic knowledge of farmers and deficient agricultural infrastructure.

[26] World Bank, "Moldova Agricultural Policy Notes: Agricultural Land", December 2005.

Strategic sectors. Occasionally Moldovan Government and Ministry of Agriculture and Food Industry (MAFI) produce new strategies and programs to rehabilitate some priority sectors. Presently the MAFI is implementing 14 own strategies and programs while being responsible for implementation of at least 3 national strategies in its areas of competence. Criteria for choosing the priority sectors subject to governmental development impulses are most often obscure, while strategies and programs are most often shelved. Normally, sectors associations are those expected to elaborate strategies of development which would closely correlate with their business plans while the MAFI and Ministry of Economy and Trade would be expected to response to these strategies as a policy coordinator. Contrary to this, the MAFI pretty much acts as a soviet-type planning body and pays little attention to the real priorities of rural development. As mentioned above, a number of agricultural crops have progressed in the last decade without any support from the part of MAFI. This experience suggests that the Government has to refrain from designing development strategies for "strategic sectors" but rather remove systematic constraints to agricultural and rural development.

Agricultural subsidies. An efficient system of agricultural subsidies is indispensable for development of Moldova's agriculture, especially considering the high level of subsidization and protection in other countries. However the current system of agricultural subsidies used in Moldova is not only inefficient, opaque and complex, but also socially unfair as it is clearly penalizing individual companies and peasant farms and is favouring big companies. While dominant in terms of number, processed land and produced output, the share of these small farmers in total agricultural subsidies has decreased from 23% in 2006 to 13% in 2007-2008. The subsidies program is in fact used as an additional tool to promote land consolidation.

Hidden taxation. This is a general problem that manifests in many ways. For instance, in order to implement its social protection goals, the Government closely monitors wheat and flour prices in order to maintain low bread prices. This generates distortions in distribution of the value-added along production chain with farmers receiving the smallest part of the value-added. In fact, farmers are forced to sell products at low prices in order to subsidize the consumption of the urban dwellers. In 2004-2005 the producers have been forced to export cereals and sunflower only through Universal Stock Exchange or to use exclusively the railroad transport. Monopoly in providing critical inputs to the agriculture (such as seeds, which are provided only by a state seeds institute) also raises the production costs and reduces the competitiveness of the products. Due to ill-advised market regulations and trade barriers, domestic agricultural prices in Moldova in the last decade have been constantly below the international prices.

Poor statistical system. Statistics are not a secondary policy issue at all. Agricultural statistical system in Moldova is as outdated as the agricultural sector itself. A number of terms, definitions and indicators are inherited from the soviet system (while other important indicators are missing, such as distribution of agricultural entities by economic size, distribution of the land used by different types of agricultural entities). For instance, agricultural farms are not considered "agricultural enterprises", the latter representing a separate category in statistics. Economic performance indicators (net financial results, profitability indicators, labour productivity) are not computed for small farms but only for agricultural enterprises. With such a statistics system, it is not possible to design and implement efficient policy.

Challenges ahead

- Organizational and management issues are much more important determinants for the competitiveness of an agricultural sector than the economic size of the farms or the average area of the land plots. For Moldovan agriculture to succeed it is necessary to change the main policy focus from the dubious objective of land consolidation to the much more necessary farmers training, and management and marketing supporting activities. In the foreseeable future Moldova will maintain a sizeable rural population and a significant part of it will have no real economic alternatives to the agriculture. ***Continuing "land consolidation" will result in labour***

shedding and an even higher rural emigration. Poor education and poor access to market information are the critical barriers to increase farmers' income and not the small size of their plots.

- The land reform is not yet 100% complete and a number of unresolved juridical issues remain. The most significant is that many land-owners (according to some estimates about ¼ of total) do not possess the ownership titles. Without these documents, they cannot sell the land or dispose in other ways of their assets. ***In order to eliminate one of the main constraints impeding good functioning of the land market it is necessary to update the cadastre registers and to complete the distribution of ownership titles to all land owners.***
- Moldovan agriculture will not survive without investing in better technologies and in labour education. Domestic resources are scarce and will remain so in the future. ***The only way to channel the necessary investment to agriculture is to allow foreign companies buying agricultural land for productive purposes.***
- Moldova has the necessary natural endowment to produce an agricultural output by far exceeding its domestic needs. However, Moldovan agricultural producers do not seem to understand the needs of foreign consumers, especially those from EU. Guaranteed quality, certified safety and attractive packing – these are the missing elements that hinder exports of the Moldovan agricultural products to West. Agricultural products risk becoming uncompetitive even on the Eastern markets where consumers get more sophisticated and retailers and governments move to international standards. Because of the current global financial crisis, the public and private standards in EU, Russia and Ukraine will only get more complex and be applied as non-tariff barriers to trade with Moldova being unable to observe them in the short future. ***Adopting complete set of international standards, elaborating necessary technical regulations for incorporating them and channelling financial and consultancy resources to implement them at company's level – these are the most urgent needs from the part of the Government in order to boost Moldovan agricultural exports.***
- Biotechnology revolution is another risk looming ahead. Only countries adopting early the new techniques will benefit from this revolution while others will lose. If state monopoly in providing seeds and other critical inputs stays unchanged and the current seeds homologation procedures are not streamlined, Moldova will not be able to adapt to the new technologies. ***It is also highly necessary to reflect on how to position globally Moldova as a country with ecological agriculture and to occupy "green niches" in global retail chains***.
- Agriculture remains highly vulnerable to natural hazards. The frequency of extreme weather impacting agriculture has increased constantly in the last two decades. One study suggests that annual losses caused by natural sum up to 3.5-7% of Moldova's annual GDP[27]. Droughts remain the most dangerous, with irrigation being a feasible solution on less than 5% of the agricultural land and should not be considered an efficient protection against droughts. ***Mitigation of the damage requires better choice of crop rotation, observing recommended production technologies, forestation and water-harvesting and water-keeping techniques. Also, current insurance system in agriculture is not yet an efficient mean of risk transfer, being complex and costly. This system is not sustainable in long run unless it narrows the focus only to the most important two risks (drought and frosts).***

Outlook for 2009

- After a spectacular recovery growth in 2008, in 2009-2010 the Moldovan agriculture is expected to post a rather modest growth below 5%. Both crops and livestock sub-sectors are expected to grow positively, but the share of individual sector in total agricultural output is likely to increase.

[27] World Bank, "Rural Productivity in Moldova – Managing Natural Vulnerability", 2007.

- Because of lack of investment in protecting infrastructure, the agricultural producers will remain very vulnerable to volatile weather conditions. As shown in previous years, difficult climate conditions can emerge suddenly and undermine the sector fundamentally.
- At least in the short- to medium-term the MAFI will remain guided by wrong policy objectives and continue implement policies biased in favour of the big agricultural entities. The precondition to change the policy philosophy is implementation of the central public reform and review of the line ministries competences and areas of interventions.
- No significant progress is expected in implementation of the EU compatible SPS standards. Implementing them at sectors' and companies level is quite expensive. Facing hard financial constraints the companies and the Government are expected to invest few resources in the harmonization of the quality standards infrastructure.

4. Industry and infrastructure

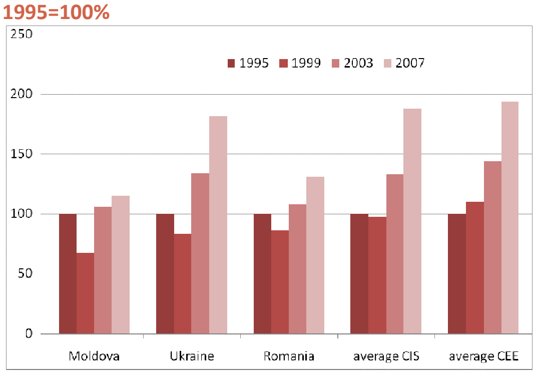
This chapter explains why Moldovan industrial growth resumed so late as compared to other transition countries. It shows that during the last decade the structure of the industry changed very much and that currently Moldova discovers new sets of competitive advantages. Authors highlight the most important policy issues that have marked the industrial policy. Most important challenges of this sector in short – to medium-term are identified. Outlook for 2009 finishes this section.

Why so difficult a start?

Transition of the Moldovan industry to market economy relations started from a very high level of integration of industrial enterprises into the soviet industrial and military complexes. Machines and equipment industry and food industry were the most export-oriented, with respectively 90% and 70% of the outputs sold to the Eastern market. Disintegration of the soviet systems in 1990-1991 inevitably led to industrial collapse. Conversion of the big enterprises from military to civil production was not successful because of the brain drain and difficulties in adapting technology to civil purposes. More important, in the post-socialist area there were no successful conversion stories without management restructuring and / or privatization of enterprises. Despite the bold reform rhetoric, the Moldovan governments in 1990s were reluctant to privatize / restructure its industrial "pearls". As result, the former high-tech "Mezon", "Semnal", "Sigma", and many others started to produce metal gates, fences and safes and are still producing these assortments. Disruption of industrial ties with enterprises located in Transnistria apparently played a significant role as well.

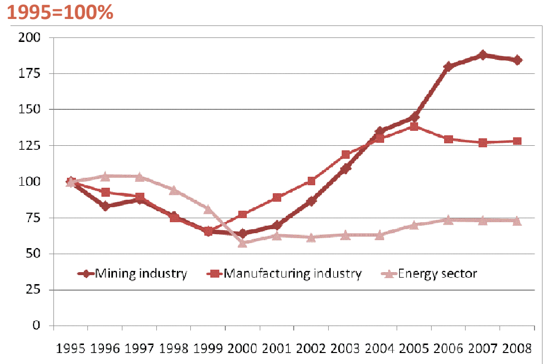
Under such circumstances, the transformational collapse of the industrial sector in Moldova was 4-5 years longer than in most Central European countries; it lasted as long as in most of the CIS countries but was much deeper (Chart 19). In 1997 the bottom was thought to be touched but the Russian financial crisis extended with 2 more years the industrial recession. With key industries being oriented to foreign markets the biggest policy mistake in the 1990s was to halt the restructuring of the industrial enterprise which undermined in long term their competitiveness.

Chart 19. Comparative growth of the industrial output, 1995=100%



Source: EBRD, CIS Statistical Committee and EG calculations

Chart 20. Growth of the Moldovan industrial sectors, 1995=100%



Source: NBS and EG calculations

Changing industrial structure

The most dramatic decline of the industrial sector happened in 1992-1994 (estimate -60%) but because of the poor statistics and because of the country disintegration it is difficult to include those years in consistent time-series. The years 1995-1997 were a period of moderate recession (-3.5% on average) followed in 1998-1999 by a severe decline of 30% due to Russian financial crisis. Industrial sector rebounded soundly only in 2000 and grew 66% until 2005 (Chart 20). A new trade crisis emanating from Russia has sent Moldovan industry in a 10% decline in 2006-2007. Some positive but rather feeble trends emerged in 2008 but with the global economic downturn it is likely that industrial growth will be negative in 2009.

With rapidly changing industry's structure, it is clear that Moldovan companies are discovering new competitive advantages. The restructuring of the industrial sector is far from being complete and many enterprises are still in state's hands, but one can affirm that in the last decade the industrial sector has changed for the good and many companies were able to adapt to the market system. New industrial branches are emerging; however some of the traditional ones are collapsing and a few even seem to be lost for good. As Table 1 shows, the most dynamic branches have grown from 5 to 7 times (such as production of rubber and plastic articles, production of shoes, or production of cement) and some of them are brand new for Moldova. From another hand, the most laggard industries reduced production from 3 to 10 times in real terms. It is interesting that three of the bottom 5 branches are either upstream or downstream connected to the agricultural sector (fodder production, flour-milling, tobacco processing; even the water reception sub-sector to some extent shrunk as result of declining demand for irrigation).

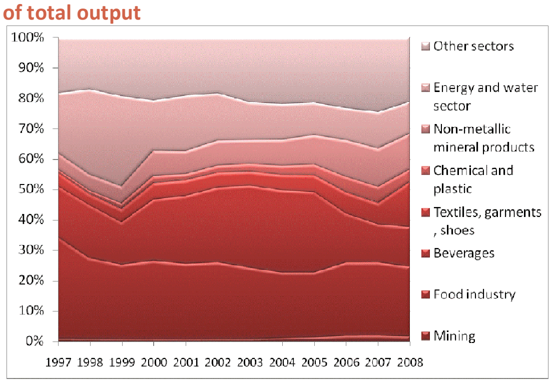
Table 1. Top 5 versus bottom 5 industrial branches by production level in 2007

Top 5		Bottom 5	
Branch	Production growth rate, 1996=100%	Branch	Production growth rate, 1996=100%
Production of cement and gypsum	690,6	Production of animals fodder	7,5
Production of shoes	682,4	Radio, television and telecommunications equipment	13,9
Mechanic tools-machines	622,0	Flour-milling industry and starch products	21,3
Beer brewing	547,5	Water reception and distribution	25,4
Rubber and plastic articles	502,3	Tobacco processing	37,1

Source: EG calculations based on NBS

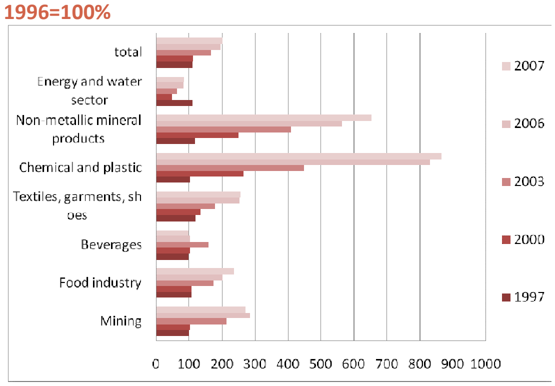
Emergence of a mining industry is one of the most interesting developments in the last decade. While remaining small, the share of mining industry in total industrial output expanded 2.5 times (from 0.8% in 1995 to 2.1% in 2007, Chart 21Chart 21.). This expansion associated with a larger than average growth of the labour productivity (Chart 22). In 2008 the share of the mining sub-sector declined to 1.7% due to stagnating constructions activity in the second part of the year. However, we expect that the growth of demand for constructions works will resume in mid-term, especially for transport infrastructure and for productive facilities. This will spur the growth of the mining industry, which has large potential of growth due to large available stocks of necessary mineral resources.

Chart 21. Evolving structure of the Moldovan industry, % of total output



Source: NBS

Chart 22. Growth of the industrial labour productivity, 1996=100%



Source: NBS

Food industry has suffered very much during the transition period, with its share in total production declining from 34% in 1995 to 21.3% in 2005 and then reaching 27% in 2008. Flour-milling industry reduced its share from more than 5% in mid-90s to less than 1% in 2007-2008. There was also a drastic contraction of the vegetables and fruits processing industry, with the share going from about 8% in mid-90s to 3% in 2002-2004 and then with a strong rebound of production. Production of vegetable oils has increased more than two times its share in 1995-2008, helped by the oilseeds' domestic prices maintained below the world average. With a declining corporate livestock sector the fodder production evolved from a relatively important sector (1.5% in 1995) to almost nil presently. In case of beverages industry, in the entire period there was a clear overinvestment in production of the wine and brandy without diversifying their market outlets away from Russia. The result of this miscalculation was the collapse of the sector in 2006-2008. In the beverages industry the main winner is industry of mineral water and freshener beverages whose share went from almost zero in early 1990s to an important 1.3% in 2008. The same goes for the beer-brewing industry whose share expanded more than 3 times in 1995-2007.

Decline of the manufacturing industry in 1990s let the energy sector increase two-fold its share in total output (from 15% in 1995 to 30% in 1999). Presently, this sector is less significant, representing around 10% of total output. Its further reduction may be the main risks for the industrial growth in Moldova, which may stop due to shortage of electric power. Construction of new power plants and improving energy efficiency of the economy are necessary to ensure sustainable industrial growth.

Main policy issues

Privatization. After conducting the first round of mass privatization in mid-90s, for more than a decade the Moldovan Government did not have a clear position regarding the privatization of the large industrial enterprises. The privatization program adopted for 1997-1999 was simply rolled-over for about a decade without any palpable progress. As result, by the end of 2007 about 500 economic entities were functioning as being subordinated to different ministries. Most of them were economically inefficient and represented a burden on public budget. The five tobacco processing companies subordinated to Ministry of Agriculture and Food Industry are a clear example of what happened to un-restructured industrial enterprises. In 1995-2007 their production decreased by about 70%, while the labour productivity by -6%. Presently there are about 300 state-owned and municipal enterprises in the industrial sector, including 50 industrial enterprises subordinated to Ministry of Agriculture and Food Industry and 52 – to the Ministry of Economy and Trade (formerly subordinated to the Ministry of Industry and Infrastructure). The law on administration of the public propriety passed in December 2007 provides for many forms of restructuring of public enterprises, including by privatization. However, the law incorporates a big annex with 179 commercial companies and state-owned enterprises which are not subject to privatization. Privatization in the energy sector is a distinct issue. The few enterprises from the energy sector that were privatized show presently better efficiency indicators as compared with the state-owned enterprises (this is the case of the power distribution networks privatized by a Spanish company in 2000). However, the policy decision is not to privatize further any facilities in the energy sector. This decision will undermine the National Energy Strategy for 2007-2020 and worsen the country energy insecurity.

Industrial policy. Industrial sector "benefited" of a big number of governmental strategies and programs without any clear development impact. The main problem behind the industrial policy is lack of any clearly expressed understanding why this policy has to be promoted at all: either for the infant industry growth argument, or for coordination and information reasons, or for solving any other market inefficiency. Contrary to that, the Government only tried constantly to address all issues simultaneously: be it the lack of investment capital, difficult access to external markets, poor labour training, the low technological inputs etc. Former Ministry of Industry and Infrastructure was particularly productive in dreaming about various forms of direct support to industry. In one analytical note regarding the situation of the "light industry"[28] the Ministry was proposing to provide companies state support in form of 100% subsidy for interest rate on bank loans attracted for technological renovation and for buying raw material, and to set zero rate VAT tax on import of technological equipment with no domestic substitutes[29]. In 2007 the Ministry of Industry and Infrastructure ordered elaboration of long-term development strategies (2015) of four priority industries: light industry, electronics, construction of machines and equipment and "glass and paperboard industry" (sic!). The criteria of adopting those four branches as priorities are not evident. Most of the strategies are disconnected from the real business plans in the sector. It is not wrong to elaborate development strategies but these documents have to be grounded in the reality and not represent belletrist work. All industrial strategies designed in the last decade explicitly set as priority the increasing of the industry share in GDP. This is a completely wrong priority going against the economy that tends to be based more on services rather than on industry and agriculture. Relatively low labour productivity rather than low share of industry in GDP is the real problem of Moldovan industry.

Free Economic Areas. Ministry of Industry and Infrastructure at par with Ministry of Economy and Trade have been the key promoters of the Free Economic Areas (FEAs). So far, 6 FEAs have been created, plus one free international airport (Marculesti) plus one free international river port (Giurgiulesti), the latter two enjoying benefits similar to FEAs. Apparently, in both ministries there were many believers that the FEAs would attract more FDI and promote territorial development of Moldova. This argument is flawed simply because these areas are not part of the customs territory and in a way are separated from the rest of the economy (with high security fences as provided by the law). In 2007 the FEAs accounted for less than 2% of the capital investments in the country, less than 8% of its total exports and 0.6% of the employed population. About 30% of the production created in FEAs was delivered to the rest of Moldova, which undermines honest competition and goes against the main purpose of FEAs which is stimulating exports.

Innovation and technological transfer. As some studies suggest, for the level of income it has Moldova is relatively advanced in terms of sophistication of its industrial products and exports[30]. However, it is clear that much is yet to be done in order to narrow the technological gap with the advanced countries. Technological development can be sourced either from internal or external resources (or from both indeed). Moldovan Government has chosen to stimulate domestic technological research and innovation by setting up a bureaucratic body (National Council for Accreditation and Attestation) which "accredits" the innovation and research entities willing to benefit from budget support. This approach is limiting the access to public money only to some institutes doing fundamental research with relatively limited economic impact. In order to stimulate the innovation and technological development across the economy, the R&D entities should be as close to universities and companies as possible.

Challenges ahead

- ***Poor labour training***. A large number of educational institutions of all levels provide education based on poorly defined and outdated curricula. Plus, the set of qualifications that the education sector provides does not match the real demand on the market. This is one of the most detrimental factors affecting industrial labour productivity and exports. ***Reforms of the***

[28] „Light industry" is a term inherited from the soviet industrial classification that includes textiles, garment, apparel, shoes and other leather products.
[29] The four Strategies for development of light industry, electronics, construction of machines and equipment and glass and paperboard industry have been downloaded from the website of the former Ministry of Industry and Infrastructure, http://www.mii.gov.md/libview.php?l=ro&idc=98&id=207.
[30] Alexander Culiuc, *Economic security through the prism of export diversification and productivity growth*, downloaded at http://www.culiuc.com/papers/aculiuc_2008_competitiveness_en.pdf

education sector (especially vocational education) cannot be postponed anymore, but it should be born in mind that effects of the reforms will manifest only in long run.

- ***Weak corporate management.*** The private industrial companies tend to move very slowly from the management schemes characteristic for a socialist economy to modern approaches. In case of state-controlled enterprises, most of them are still operating based on old practices and are maintained by direct or indirect budget support. ***Facilitation of transferring management know-how and implementation of the internationally recognized management standards should be among the main priorities of the Moldova government***.
- ***Poorly defined industrial policy***. The Government does not have enough information and expertise in order to select and promote distinct industrial branches. It should rather support industrial innovation across all industries, and by innovation we do not necessarily mean only high-tech solutions but any solution increasing labour productivity and with immediate economic application. ***The main criterion for receiving governmental support being clearly stated business plans with demonstrated innovation elements***.

Outlook for 2009

- In 2009 the industrial output is expected to fall by another 15-20% and then to grow marginally in 2010. In 2009 all three big sub-sectors are expected to decline: mining industry will register a decline because of difficult situation in construction sector; production of the processing industry which is oriented towards foreign markets will continue plummeting; with economic system in recession the demand for electric energy and gas is expected to decline as well.
- While many industrial strategies have been adopted by the Government and several others are in the pipeline, their effective impact will be negligible. In most of the cases, the strategies are not relevant for the real business development priorities, with most of the financial resources for implementation expected to be provided by private companies and donors and only with limited resources from the public budget. Under new financial constraints in 2009 it is realistic to expect companies and donors to focus on current priorities rather than on strategic outcomes.

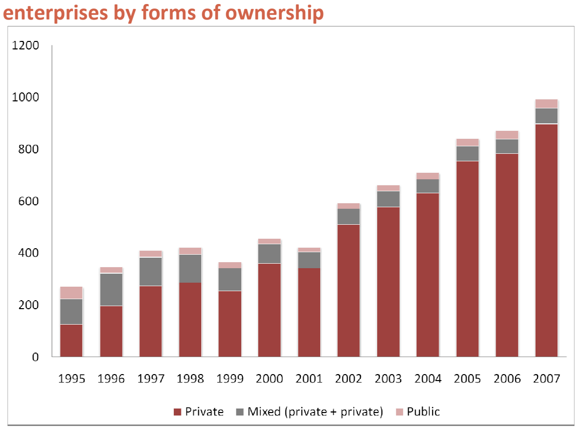
5. Sinuous evolution of the constructions sector

This chapter reveals the evolution of the construction sector through two main stages: the contraction stage (1994 – 1999) when it was affected by the liberalisation shock in the early transition period; and the development stage (2000–2008) when the increasing disposable income and growing savings of the population fuelled the demand for construction services. It, also, comprises main policy issues, as well as the actual challenges appeared as a result of the recent repercussions of the world economic and financial crisis.

Overview

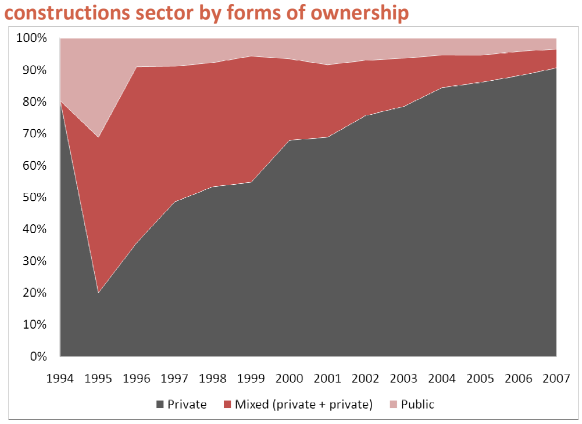
During the analyzed period (1994-2008) the construction sector followed an outstanding development revealed by a 7 times increase in the number of private construction enterprises and an average annual growth of 25% in the volume of entrepreneurial works and capital investments. The advantageous endowment with production factors represented a favourable precondition for this development. Constructions companies have seized the opportunity to operate with based on available and cheap local raw materials (limestone, lime-sand, gypsum, granite, natural stone etc.) and labour force (except the recent years when due to massive emigration the demand for labour force has been increasingly higher than the supply, which respectively raised the price for this production factor). Another major driving factor has been the accelerated increase in population's disposable income and savings as a result of the remittances' boom since 2001.

Chart 23. Evolution of the number of construction enterprises by forms of ownership



Source: NBS

Chart 24. Structure of entrepreneurial works in constructions sector by forms of ownership



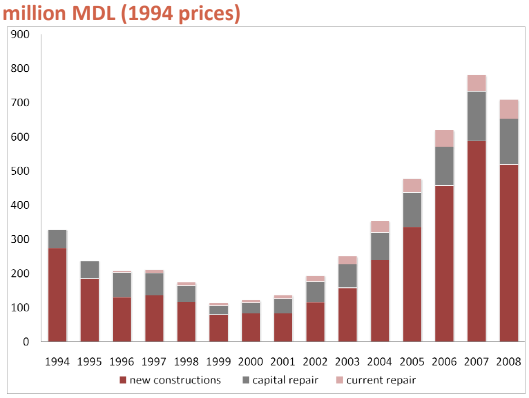
Source: NBS

Besides the progressive growth of the number of construction enterprises, Chart 23 also reveals the increasing share of private capital in this sector during the transition period. Thus, if in 1995 the share of private enterprises was 46.7% from total number, then in 2007 it increased up to 90.4%. A similar trend followed the structure of entrepreneurial works executed by construction enterprises (Chart 24), where the share of private capital increased from 20.1% in 1995 up to 90.6% in 2007. These trends denoted the increasing attractiveness of this sector for private capital as a result of the mentioned favourable market conditions and endowment with production factors.

1994-1999: the contraction stage

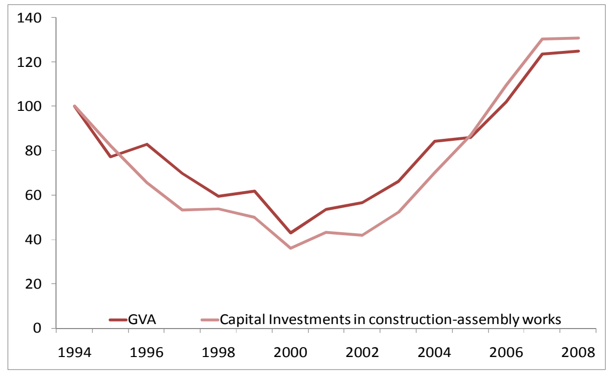
Closing down the large-scale enterprises after the Soviet Union collapse, as well as the decline in population's income and savings rate became the fundamental factors negatively affecting the constructions sector in this period. No surprises, the involution of entrepreneurial works in this sector during the early transition period had been mostly determined by the decline in new constructions which decreased by almost 3 times since 1994 until 1999, followed by capital repair works which declined almost twice during the same period (Chart 25).

Chart 25. Volume and structure of entrepreneurial works executed by construction-assembly enterprises, million MDL (1994 prices)



Source: NBS

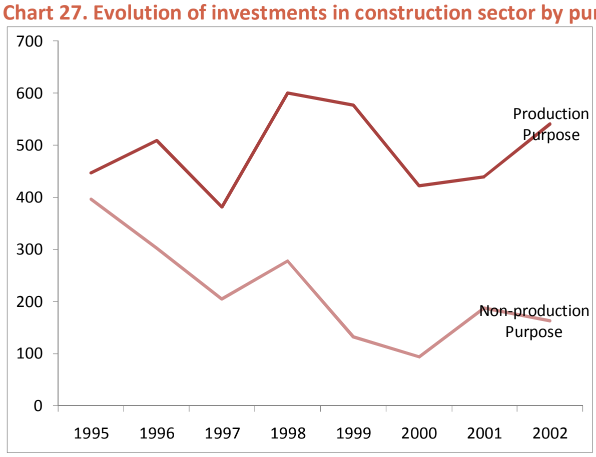
Chart 26. Evolution of capital investment and GVA in constructions sector, million MDL (1994 prices)



Source: NBS

As the Chart 26 reveals, the evolution of capital investments in the constructions sector also followed a decreasing path which had an impact on gross value-added formation. To some extent this decrease was mitigated by the implementation of the 2nd stage mass privatization according to the Privatization Program of the Government for the period 1997-1999. Although it served as a modest impulse for real sector development, it marginally stimulated the productive investment activity in the construction sector. Moreover, the availability of local raw materials and even the exporting potential of construction inputs, made this sector highly attractive for private investments[31]. Chart 27 illustrates the positive growth of capital investments with production purpose despite the recession of 1998-1999, which, by contrast, affected the non-productive capital investments.

Chart 27. Evolution of investments in construction sector by purpose, million MDL (1994 prices)



Source: NBS

[31] From 11 objects finished in 1997-1998, 5 belonged to the construction complex and were supported by foreign capital. *Republic of Moldova: Strategy for Development,* Center for Strategic Studies and Reforms, January, 1998

2000-2008: development stage

During this stage the construction sector got a second breath due to the economy revival. The positive economic growth fuelled the demand for construction services as revealed by the constant increase in the volume of entrepreneurial works made by construction companies.

In 2001-2008 the construction sector had a large positive contribution to the GDP growth. Thus, the positive market circumstances generated by the increase in disposable income, mainly as a result of the remittances' boom, had stimulated the investment activity leading to a constant increase in GVA in this sector. The average annual increase in fixed capital investments in construction-assembly works during 2001-2008 constituted +25.4% and caused an average growth of +15.7% in GVA in the same period.

The increase in remittances, as a major fuel of Moldovan economy, has mostly stimulated the development of new constructions, which registered an average increase of +33.4% during 2001-2007, followed by capital repair works with an average increase of +24.9%. It is explained by the boom in collective housing units as a result of increasing population's propensity to real estate acquisition and bank's ability to finance constructions projects. Another explanation of such a prominent development of residential sector consists in population's perception of real estate as a secure and even profitable investment, given the prices growth rate similar with the annual interest rates for time deposits.

The first effects of the world financial crisis on the construction sector became visible in 2009 and were revealed by a decrease in volume of entrepreneurial works by -9.2% expressed in real terms. Also, in 2008 this sector had no contribution to GDP growth and it is expected that in the next year this contribution will turn to negative. The constructions sector has currently entered into the third stage – the stage of recession.

Main policy issues

Introduction of Value-Added Tax on construction works. Since 1 January 2008 the 20% VAT on construction works was introduced which put significant pressures on the prices for real-estate. Apparently, in conditions when the prices are driven at a high extent by demand side factors, the introduction of VAT is reasonable and feasible. However, it was implemented in the year when the entrepreneurial works of construction enterprises declined in real terms, the demand stagnated and the financing of construction projects by commercial banks interrupted. Therefore, the introduction of VAT for this sector will multiply the crisis repercussions and will deepen the recession in this sector as a result of an accelerated decrease in demand for construction works.

Interruption of construction projects financing by commercial banks. Uncertain financial situation and shrinking demand has paused many constructions sites, especially the new constructions. The problem is aggravated by the fact that most of these projects are partly finances (usually 30%-35%) by the clients of construction firms. Therefore, the interruption of their activity and the impossibility to meet the contract terms leads to another major problem related to returning back the money invested by their clients. This situation is worsened again by the pyramidal pattern of financing construction projects used by many enterprises. This scheme supposes that the start-up contribution of the future inhabitants are reinvested into another construction projects while the banking credits were counterbalancing the cash-flow necessities. It made the construction enterprises running out of enough liquidity negatively affecting their possibility to eventually return the initial contributions to their clients.

Lack of attractive mortgage programs. The fact that mortgage loans require the availability of "long money" makes more difficult for commercial banks to offer advantageous mortgage conditions under the constraints generated by the world financial-economic crisis. Another significant impediment for the population's access to mortgages consists in low official wages.

Prohibition to sell unfinished apartments and houses to the final consumer ("grey variant"). This decision created additional costs for construction enterprises which have to channel more money to finishing the apartment/house before being sold. Taking into consideration that in recent years the dominant share of real-estate was sold in "grey variant", this creates significant pressures on the financial situation of the constructions companies and reduce their profit margin.

Excessive bureaucratization of construction permits issuance. According to the Doing Business 2009 rank, elaborated by the World Bank Group, Moldova is situated on the 158 place of 181 analyzed countries according to the ease in obtaining the construction permits. Thus, in order to build a warehouse it is necessary to complete 30 procedures which take 292 days, much higher than the regional average. This excessive red-tape stimulates corruption and illegal constructions which do not meet the security and other standard requirements.

Challenges ahead

Taking into consideration the economic crisis repercussions mainly revealed by the decrease in remittances and interruption of construction projects financing by the commercial banks, the construction sector is presently affected by both supply-side and demand-side shocks.

- The demand-side shock is caused by the recent shrink in remittances' volume, as well as the deflationary expectations after a sharp increase in housing prices during recent years. Additionally, several policy decisions implemented during 2008 created significant constraints for the construction sector development and has put pressures on the financial situation of the construction companies. Therefore, a major way for mitigating the demand-side shock could be the ***reduction of value added tax for construction works and creation of better conditions for a wider access of households to mortgage credits. The last one can be achieved through a more intensive cooperation between commercial banks and construction enterprises which should be regulated by an adequate legal framework.***
- The supply-side shock refers mostly to the banks' reluctance in financing construction projects which led to stagnation of a number of construction works which were co-financed by the future apartment owners. ***Therefore, the Governmental implication would be necessary to unblock the financing by commercial banks at least for the main construction projects, selected according to the degree of accomplishment and other relevant confidence criteria.***
- Taking into consideration the excessive bureaucratization and its impact on expanding illegal constructions and on corruption it is necessary ***to simplify the process related to construction permits according to the regional experience.***
- Since the prohibition to sell unfinished apartment and houses supposes additional costs for enterprises, which can have destructive effects under the economic crisis repercussions, it is necessary ***to cancel this policy initiative as an inappropriate one for a crisis year.***

Outlook for 2009

- The demand-side shock will continue to force the entrepreneurs to decrease gradually the prices for housing during 2009. Thus, it is expected that the prices will decline by almost 20%-25% during this year in comparison with 2008.
- In the same time, the supply-side shock will mitigate the decline in housing prices which after a decrease during the 2009 year will probably remain relatively stable in 2010.
- The capital investments and entrepreneurial works can register in 2009 a decrease by almost -50% in comparison with the previous year, caused by high dependence of construction sector on the overall economic situation.

- The decrease in capital investments and entrepreneurial works in construction sector will lead to the decrease in gross value added in this sector by almost 15%-20% which will influence the decrease in GDP during 2009 by approximately 1% - 1.5%.

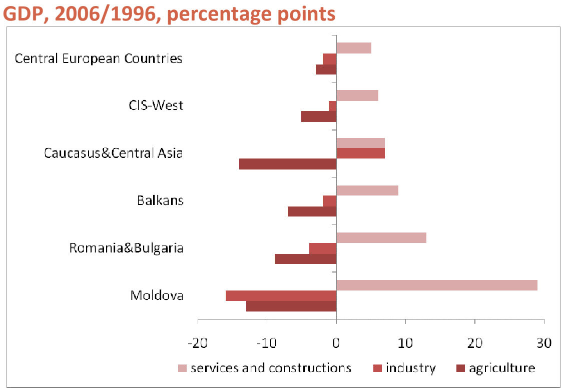
6. Moving to a services-based economy

This chapter deals with the issues related to the emergence of the services sector in Moldovan economy – from an ideologically neglected one in late 1980s to a sector representing nowadays the backbone of the economy. It analyzes the tremendous emergence of the market-based services as opposed to the rather slow evolution of the public services. Main policy issues that have affected the development of the sector in the recent decade are analysed – such as regulation, competition, trade organisation. This part ends with highlights of the most pressing challenges that Moldovan Government faces in short- to –medium-term as related to the development of the sector.

Emergence of the market-based services

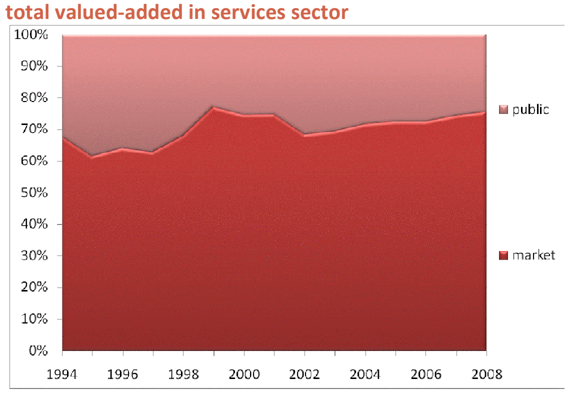
Under the soviet economic system the services sector was not counted as a "productive" one even though it was very important both in terms of the created value-added and of the employed labour force. (It is quite interesting that this misperception is still widely shared by many citizens in Moldova). After starting the economic reforms, the evolution of the services sector in Moldova was the fastest as compared with all other major economic sectors. Its share in total value added has grown from about 32% in 1994 to 68% in 2008, while the share in total employed population has risen from 35% to 49%. Such a dramatic change of the economic base from traditional sectors to services seems to be quite unique in the group of transition countries (Chart 28). At the same time, one has to acknowledge that this expansion of services was also the result of stagnating primary and secondary sectors.

Chart 28 Changes in the share of main economic sectors in GDP, 2006/1996, percentage points



Source: EG calculations based on WB World Development Indicators

Chart 29 Share of market-based and public services, % of total valued-added in services sector



Source: EG calculations based on NBS

This rapid evolution was driven mainly the by the market-based services whose share in total value-added created by the sector has grown in long term, even though not constantly (Chart 29). Apparently, market-based services provided to businesses have grown more rapidly than those rendered to the population. In 1995-2007 the value-added created by "software and computer-related services" has grown 14.6 times in real terms, "other services rendered mainly to companies" – 7.7 times and "rent of machines and equipment" – 4.6 times. Constant real growth of the value-added in the software and computer-related services sub-sector and the rapid growth of its exports services since yearly transition suggest that Moldovan companies may have quite strong competitive advantages in this sub-sector.

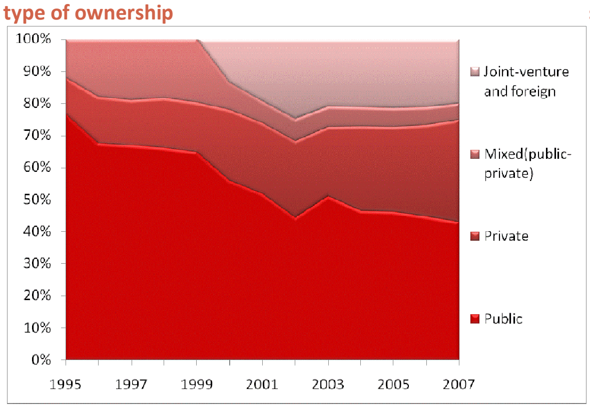
The structure of the market-based services has changed significantly since late 1990s. While wholesale and retail trade remain an import sector (with about 30% of total value-added in 2007), it has almost constantly decreased from the 40% held in 1999-2000. Trade has been practically matched by the transport&telecommunications sector which in late 1990s was two times smaller. Inside the latter, important changes have happened as well. While in mid and late 1990s the transport sub-sector was two times larger than the telecommunications one in terms of volume of sales and value-added, presently the telecommunications are more important. This change was driven by tremendous expansion of mobile telecommunications, while the fixed-line telephony market seems to have reached its apex in 2005-2006. Financial activities had more than 20% of total value-added per services sector in late 1990s, but its share has decreased to 12% in 2006. The constant expansion of the real estate-related services (from less than 2% in 1994 to 10% in 2008) reflects the growing domestic demand for real estate and for constructions services.

Even though the role of the privately-owned companies in the services sector has increased rapidly in the past decade, a significant part of the market-based services are still being provided by public companies (state, municipal) or mixed private-public companies. By all means, the role of the private sector in services is still very low for a country which has been in transition to the market economy for almost 20 years. For instance, the share of publicly-owned and mixed (public-private) companies in total volume of services provided to population has decreased twice, from 77% in 1995 to 43% in 2007 (Chart 30Chart 30), while the share of private companies in retail trade is about 70%. Increasing efficiency of trade will make the role of private sector more central in the services sector. The high potential for better economic efficiency that could be achieved by private traders is suggested by big discrepancy between performance indicators of the domestic companies as compared with foreign companies trading in Moldova: the volume of annual sales per 1 m^2 in foreign companies is two times bigger than of the domestic ones[32].

Stagnant public services

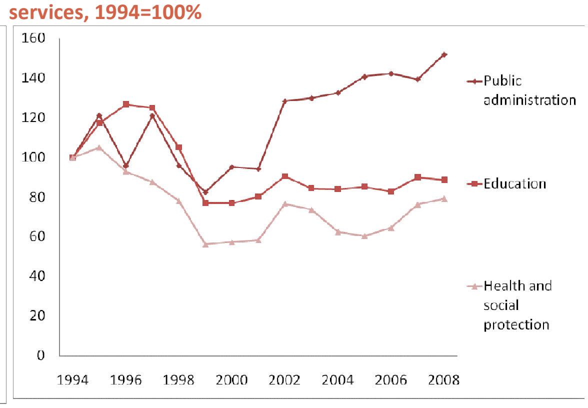
In case of the public services it is more difficult to measure the created value-added than in case of the marketable services. In the National Accounts System the value of output in public sectors is measured based either on market prices for similar services/products (if existing, such as in case of health and education) or based on expenditures (in case of public administration). With this feature in mind, one can observe that the public services in Moldova displayed a completely different development path as compared with the market-based services (Chart 31).

Chart 30 Structure of services rendered to population, by type of ownership



Source: EG calculations based on NBS

Chart 31 Evolution of the value-added created by public services, 1994=100%



Source: EG calculations based on NBS

It is rather surprising that the two public services sectors that are the most important for long-term economic development – education and health – have had their production declining in real terms. This decline was associated with a constant outflow of specialists from both sectors. As for the public

[32] Strategy for supporting the development of the domestic trade, Adopted by Governmental Decision no.111 of February 1, 2007.

administration, its "production" is presently 50% higher than in 1995, partly because the number of employed in public administration has increased from 30 thousand to 57 thousand. This positive growth is rather doubtful from the point of view of its impact on total productivity in the economy. The Moldovan Government acknowledges that the public administration sector is excessively large and in 2004 has started a reform of the central public administration. So far, this reform brought no palpable economic results.

Main policy issues

Market regulation. The development of the services sector in Moldova is hindered significantly by the excessive state regulation and oppressive state controls on the businesses. The services sector is more vulnerable to state interferences as compared with manufacture and agriculture because it is subject to a more intricate regulatory environment and risk of unintended mistakes is very high. State control bodies have extensive and often overlapping competencies resulting in constant and multilateral pressure on the companies. Even the municipal police can exert in many forms controls on the economic activities of the businesses. Among the most telling examples in this regard were the economic controls in 2003 and in 2007 ordered by the central Government and executed by the police with the purpose of controlling whether the prices for bread of the private sellers were or not "economically reasonable" (in both years Moldova suffered because of droughts and domestic prices for wheat and flour grew which normally should have reflected in the bread price as well). As in case of control of the bread price, the price policy is often driven by political or electoral reasons resulting in inefficient market regulations. E.g. it is clear that providing direct money support to the neediest persons to enable them affording bread and other basic food products would reduce more effectively the poverty and have less market distortions than keeping administratively the bread price at levels below production costs.

Disorganised trade and rural-urban divide. According to the official methodology in Moldova, "disorganised trade" is the trade realised through public markets, while "organised trade" flows through legally registered commercial entities. Related to this, the Government considers that the rising gap between retail trade volumes in urban and rural communities as a significant policy issue to be addressed directly. In its Strategy for supporting the development of the domestic trade the Moldovan Government has mentioned expressly "increasing the share of the organised trade and steady legalisation of the illicit trade" as one of the main tasks of the Strategy. This is a right objective to pursue. However, the Government is willing to achieve them in a rather strange way by promoting supermarkets chains in rural communities. That would be a completely wrong start for the Government towards achieving these goals. Inhabitants of the rural communities in any case will continue buying durables and semi-durables in district centres or big cities as they are looking for goods diversity and lower prices which cannot be found in rural stores. Slow growth of rural retail as compared with the urban one is partly explained by the fact that supermarkets in towns and cities serve not only urban dwellers but also people coming to shopping from nearby or remote villages. As disposable monetary income of the rural dwellers will grow, some retailers may consider extending their chains to some bigger villages. However, it is clear that the best for Government is to leave the market to address this issue rather than to spending public resources to solve a secondary problem.

Competition policy. Moldovan Governments have not had a clear understanding on how important is the protection of the competition, control of monopolistic powers and preventing/abolishing trust agreements. Because of this lack of understanding and because of vested interested the anti-trust law was adopted only in 2000 i.e. almost ten years after starting economic reforms. After adopting the law, Moldova did not have a functional regulatory agency for other 7 years: the National Agency for Competition Protection was established only in 2007 and only as result of pressures from the part of domestic companies and the European bodies. Even though the Agency was created, its activity has been negatively affected by unclear mandate, lack of proper methodology, conflict of interests and lack of policy coordination with sectoral regulatory agencies (e.g. National Agency for Energy Regulation, National Agency for Electronic Communications and Information Technology). Among the most detrimental results of the incoherent competition policy one can mention the low broadband Internet penetration rate (because of the Moldtelecom playing with prices and exerting monopolistic power of providing access to its infrastructure), low quality of housing services, and poor urban transport services.

Reform of the public administration. From economic point of view, the public administration should be treated as a latent production factor entering with positive or negative sign the production function of the economic agents. It enters with positive sign only provided that the public administration is able to address the market failures, to coordinate companies strategies and to share information whenever necessary. Apparently, Moldovan Government is most often worsening market failures by its direct interventions instead of solving them. This happens because ministries and other governmental agencies execute functions improper for the market economy. Coordinating business strategies and sharing information would require the degree of transparency and public accountability which has not been matched by Moldovan Government since beginning of transition. A reform of the central public administration started in 2004 with the purpose to streamline the system and increase its efficiency. But these tasks would be incompatible with the high degree of political dependency of the public servants and high concentration of political power which is presently the case. Political dependency and political polarisation are fundamental causes explaining the lack of progress in implementation of the central public administration.

Challenges ahead

- Since 2000 the consumption of services was the main driver of the economic growth. Declining consumption of services is the basic risk that may reverse the progress achieved by Moldovan economy. While the Government does not have enough resources to stimulate directly the private demand, it still can address this issue by removing institutional and regulatory barriers affecting services suppliers and thus to reduce the price of the final services. Lower prices may still reverse the declining demand and thus restart the economic mechanism. ***For this, the Government has to abolish all unwarranted state controls except only the fiscal controls, ensure independency of the market regulators and refrain from direct interventions in the private businesses***. Among others, this will improve the business efficiency of the rural trade companies, as intended by the Government.
- ***It is necessary for Moldovan Government to refrain from using the housing and other public services for political purposes***. Maintaining with administrative tools the tariffs for public services below production costs may by the end of the day result in destroying the market. Besides having distortive market impacts, these practices also have detrimental development impact as low tariffs for housing services in the capital area are compensated by rest of the country's citizens either directly by taxes paid to the budget or by higher tariffs paid for similar services.
- A number of services markets are underserved because of the improper regulatory policy. For instance, the broadband Internet penetration rate in Moldova is the lowest in the region (less than 2%, which is ten times lower than in CEE countries). While being a market in itself, international evidence suggests that increased broadband internet penetration (at least 20%) gives rise to systemic positive changes and to improving business efficiency across the economy. ***In order to increase the broadband penetration rate the Moldtelecom has either to be restructured and divided in separate entities or its infrastructure to be shared under clear conditions by all market players***.
- In times of crisis it is necessary to speed up and not to postpone critical reforms. In Moldova this is the case of the public administration reform which was protracted for several years without any clear outcome. ***In order for the public administration system to respond to the social and market needs it has to be professionalized, freed of any political interferences, endowed with computers and internet, while the labour productivity be assessed on clear and measurable***

performance indicators. This would permit reducing the number of unwarranted personnel and increase the wages in the system. Ex-ante Regulatory Impact Assessment has to be in-built as underlying principle of the new public administration.

Outlook for 2009

- In 2009 we expect a 6-8% decline in retail trade that will be caused by reduction of expenditures for non-food items, whereas those for food will increase. This structure of demand will be supported by declining or stable prices for food, whereas in case of the non-food items marginal price inflation is more likely.
- A marginal 2-3% of volume of services consumed by the population is expected as well. This reduction will come mainly as result of reduced spending for services of secondary importance (leisure, tourism, real estate repair and others alike).
- In case of the market services rendered to the businesses the negative growth will be much more significant and likely to post a 15-20% declining rate. Companies will spend less on information services, logistics, and others.
- The public services sector is expected to decline significantly as well. Taking into account the methodology of computing the value-added in this sector (based mostly on expenditures), it is likely that a negative growth of 20% will be registered in 2009.

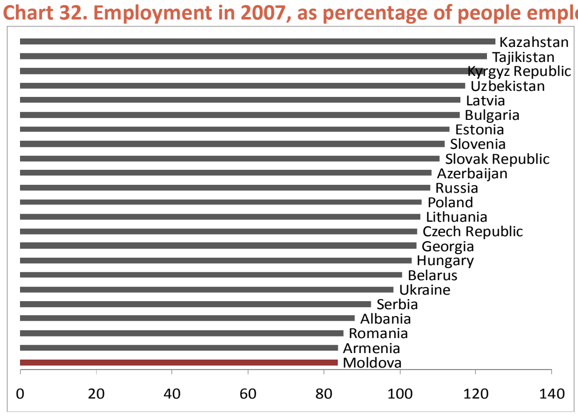
7. Labour market: still a country of cheap and skilled labour force?

This chapter presents the main developments of the labour market since 1999. Employment trends in Moldova have been negative due to the significant contraction of the agricultural sector, which in the mid '90s employed more than 50% of labour force, and due to insufficient compensation of labour shedding in traditional sector with jobs created in other sectors of economy. Emigration came into sight as a silent reaction of the population to the inability of the economy to create jobs and offer attractive remuneration. It is also the main cause explaining the relatively low unemployment rates in Moldova that were common since mid-2000s. While the migration consequences may be dangerous in long run, the Government has not paid enough attention to this issue.

Employment and unemployment trends

The labour market outcomes in the transition period were closely linked to the macroeconomic and social situation in the country. Thus, the economic decline in Moldova was accompanied by a constant decrease in the employment rate, which continued even after the resumption of the economic growth in 2000. Since 1999, when Labour Force Survey was carried out for the first time in Moldova, employment rate decreased from 54.5% to 42.5% in 2008; this has been the steepest decline among CEE and CIS countries (Chart 32).

Chart 32. Employment in 2007, as percentage of people employed in 1999 in some transition countries



Source: EBRD and EG calculations

The employment rates declined for all age groups, for both rural and urban population and both male and female (Table 2). Urban-biased economic growth inverted the early-transition situation characterized by higher employment in rural areas and resulted in higher employment rates in urban areas.

Table 2. Employment rates in Moldova (%)

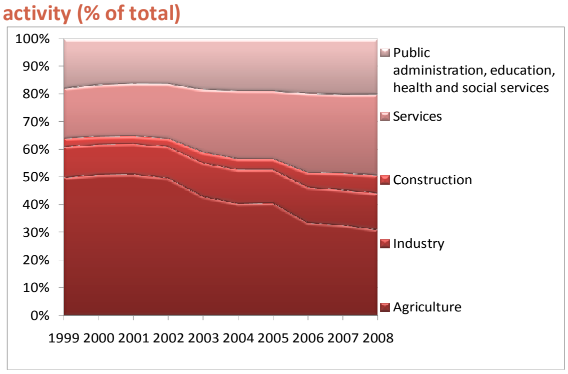
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total	54.5	54.8	53.7	53.3	47.5	45.7	45.4	42.9	42.5	42.5
Males	57.6	57.7	56.2	55.1	49.3	46.6	46	45.5	44.8	45.2
Females	51.8	52.2	51.4	51.7	46	44.9	44.8	40.5	40.5	40.1
Urban	48.3	48.6	48.2	49.4	48.1	46.5	46.6	45.2	43.8	44.5
Rural	59.2	59.4	57.7	56.2	47.1	45	44.5	41.2	41.6	41

Source: NBS

At the same time, unsuccessful outcomes of land privatization resulted in low productivity in the agricultural sector, which made people leave gradually for other jobs or migrate in order to survive. The agricultural sector lost the most jobs in the transition period and is no longer the most important sector of employment, falling behind service sector, which in 2008 had a 49.2% of total employment. Employment in industrial sector has not changed significantly since 1999, while its share in total employment increased from 11% in 1999 to 13% in 2008. The share of construction sector rose from 3.2% in 1999 to 6.6% in 2008, which was an expected response to the increasing demand for housing and other constructions since 2003 (Chart 33). Employment in public administration is high compared to other middle-income countries[33] resulting in low efficiency and impossibility to increase wages in the sector. Although, the Government acknowledged that the public administration sector is oversized and should be restructured, the reform that started in 2004 has not yet produced any palpable results.

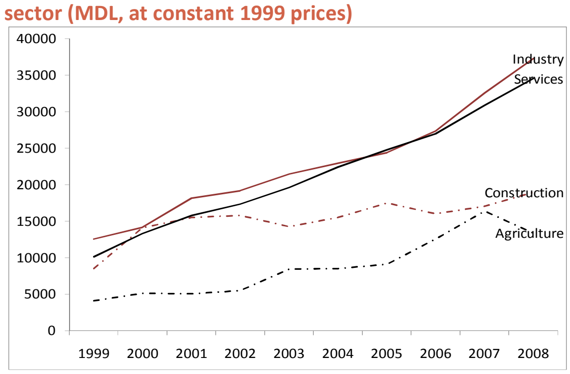
Changes in employment were not necessarily correlated with the economic growth registered in the sector. There is an almost perfect positive correlation between the growth of employment and growth of GVA in construction and service sectors. On average, a growth of 1% in employment in construction in the period 2001–2007 was associated with a 2.5% increase in GVA in the sector; in services such a growth was associated with a 6.6% increase in GVA.[34] On the contrary, in agricultural and industrial sectors there is no correlation between the changes in employment and production trends. This is explained by the increase in capital-intensity and labour productivity in industrial sector, while the reduction of employment in agriculture has not fundamentally affected agricultural output due to high over-employment levels. Despite the increase in productivity in agricultural sector, it is still the lowest in the economy due to outdated technology used (Chart 34).

Chart 33. Structure of employment by sector of economic activity (% of total)



Source: NBS

Chart 34. Labour productivity per employee by economic sector (MDL, at constant 1999 prices)



Source: NBS and EG calculations

Paradoxically as it may seem at first glance, the constantly worsening employment did not give rise to high unemployment rates. On the contrary, the unemployment rate has constantly declined and reached historical and geographical minimum of 4% in 2008 (Table 3). The major explanation of these seemingly “contradictory” trends is migration of labour force. The out-migration has significantly hit the employment rate through reduction of the number of people working in the country and by increasing the reservation wages of those remaining in the country.

Table 3. Unemployment rates (%)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total	11.1	8.5	7.3	6.8	7.9	8.1	7.3	7.4	5.1	4.0
Males	13.3	9.7	8.7	8.1	9.6	10.0	8.7	8.9	6.3	4.6
Females	8.9	7.2	5.9	5.5	6.4	6.3	6.0	5.7	3.9	3.4
Urban	19.1	15.7	13.8	12.1	12.2	11.9	11.2	9.2	6.9	5.5
Rural	5.4	3.4	2.7	3.0	4.5	5.0	4.0	5.8	3.6	2.7

Source: NBS

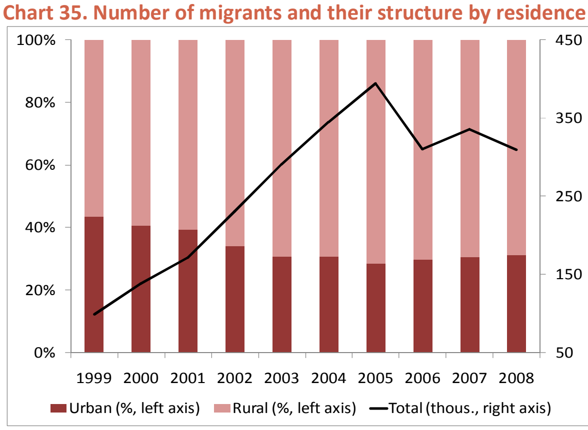
Migration: the saviour of the economy

Migration came into sight as a silent reaction of the population to the inability of the domestic economy to provide jobs and offer competitive wages. Over time it has intensified so much that it

[33] IMF Country Report No. 08/139, IMF, 2008
[34] Black Sea Labour Market Reviews - Moldova Country Report, ETF, 2009

became a defining feature of Moldovan economic and social life and a well-known external image of the country. The various estimates of the current emigration stock range from 150,000 to 1 million persons[35], and the most credible data lay probably close to the official estimates from the LFS (Chart 35) conducted by the NBS (309.7 thousand people in 2008), and the IOM's 'Pattern and Trends of Migration and Remittances Survey', conducted by the CBS AXA sociological research company (325 thousand in Q3 2008). The observed decline in 2006 is more a consequence of change in methodology and sampling rather than returning of migrants. However, the number of migrants tends to stabilize by most surveys since 2007. The much higher share of rural migrants compared to urban migrants is quite obvious in the conditions of low productivity in the agricultural sector and lack of alternative job opportunities in rural areas.

Chart 35. Number of migrants and their structure by residence area



Source: NBS

In the early 2000s in its initial forms migration was adopted as a strategy to escape poverty. While this might be still true in case of migrants leaving for CIS countries, this is not the case for migrants going to the EU countries. Almost 40% of migrants to the CIS gave as their reason for leaving the country the lack of a job and around 25% cited poverty as the main factor. In contrast, the share of migrants going to EU citing these reasons was significantly lower (26.4% and 12.7% respectively). Also, the poverty incidence rate in the households with CIS migrants tended to be almost twice as high as in households with EU migrants[36].

Although migration was a driving factor of the economic growth by providing financial resources for consumption it has negative implications on the employment rate and fiscal sustainability of the social insurance fund. It raised the equilibrium wage and led to labour shortages in some sectors of economy. Furthermore, high levels of remittances provide fewer incentives for other members of households to enter the labour market, since their reservation wages increase to levels the economy cannot support. Rising dependency ratio is a serious constraint of the fiscal system and a barrier for business development; migration aggravates the situation but no significant initiatives were launched by the Government to deal with the problem.

Main policy issues

- ***The National Strategy for Labour Employment Policy for 2007–2015 is not in line with other strategic documents.*** Since its independence Moldova has formulated plenty of labour employment laws, strategies and plans, although very few being implemented and evaluated; therefore their impact on labour market is undistinguishable. The current National Strategy for Labour Employment Policy for 2007–2015 was developed in line with the revised European Employment Strategy and based on the general development objectives stated in the Economic

[35] Black Sea Labour Market Reviews - Moldova Country Report, ETF, 2009
[36] Patterns and Trends of Migration and Remittances in the Republic of Moldova, IOM, 2007

Growth and Poverty Reduction Strategy for 2004–2006, the EU–Moldova Action Plan, the Millennium Development Goals, the Moldovan Village National Programme and other branch documents. As this reference base is outdated. an update of the Strategy is necessary in order to ensure its effective linkage with national development priorities specified in the National Development Strategy for 2008 - 2011.

- ***Inefficient reforms in education system.*** The education system of Moldova has been in continuous reform since the country's independence. However, the reforms did not manage to create equilibrium on the labour market: there is still a mismatch between labour demand and labour supply. Changing preferences of high-school graduates and enrolment based on tuition fees resulted in the increasing number of students in higher education institutions (concentrated mainly in three fields: economics, law and social sciences) and decreasing number of students in vocational schools. The negative effects on the quality of education were not enough handled by the government.
- ***Poor outcomes of labour market policies***. The new law on labour employment and social protection of unemployed stipulates the promotion of employment through active and passive labour market policies. However, the number of beneficiaries of active labour market policies is rather small and the impacts (net efficiency, cost-benefit ratio and side effects of the measures) have never been evaluated. As regards passive labour market policies, the number of people receiving unemployment benefit has increased constantly during the past few years. However, the share of people receiving benefit is only 10.2% of the total number of jobless registered with the NEA and 7.4% of the total number of unemployed people calculated by the NBS; the level of unemployment benefit is still less than a third of the average salary in the national economy[37].
- ***Lack of tools in managing migration***. Policies in labour migration field are almost missing in Moldova, some policy initiatives being launched by IOM, ILO and SIDA, but the effects are not remarkable and with minor implication for the labour market. In mid 2008 the Government passed the Plan of actions on fostering return of Moldovan labour migrants from abroad. However, the Government did not proceed with the implementation of the document. Nowadays, as jobs in EU and CIS are being closed, the Government should not be really kin to stimulate even more the return of the migrants.
- ***Low wages in the budgetary sector***. Low wages in the budgetary sector explain to some extent the poor quality of public services. Despite the few increases in wages for education, health and social assistance employees, these were insignificant and not a priority of the Government except pre-election periods and they are still lower than the average monthly wage in economy. The wages in public administration sector is higher on average, but not for the new entrants in the system. Therefore, it generates high fluctuations of young specialists, who prefer to accumulate some basic experience and then leave for jobs offered by the private sector.

Challenges ahead

The situation on labour market in Moldova had been worsening even before the global crisis started; and current developments only put more pressure on the Government to intervene in the fields where the reforms are lagging.

- Although labour regulations and policies facilitate the path from unemployment and inactivity to employment, they do not create jobs. Therefore they are not responsible for the situation on labour market in Moldova. Furthermore, the current crisis puts more pressure on the Government as a result of forced return of migrants from some destination countries lately. ***The only way to go beyond is to take the necessary measures to improve the business climate.***

[37] Black Sea Labour Market Reviews - Moldova Country Report, ETF, 2009

- The continuous mismatch between the demand and supply of labour force, disproportionate wages between economic sectors, low productivity in some sectors, the impossibility of Moldovan citizens to be hired according to the graduating field of study abroad are the outcomes of poor reforms in the education system. The investments in education should remain a priority even during the crisis period as it is a pillar for a long-run sustainable development***. Follow-up of reforms in educational system at each level is necessary in order to increase the quality of education and to match the labour supply with labour demand.*** This implies the creation of a non-governmental Agency for Academic Accreditation of educational institutions; creation of councils composed of employers or associations of employers and Government representatives for the administration of vocational schools; motivation of employers to collaborate with vocational and professional schools; optimisation of intra-sectorial expenditures[38].
- Taking into account the scarce public resources for more active foreign policy and the ongoing financial crisis, there are relatively few things that the Moldovan Government can, and must, do for its citizens while they are abroad. ***The most important the Government has to do is to ensure the protection of the social and economic rights of the country's citizens abroad by signing mutual agreements on the treatment of migrants in order to facilitate the legalization of their presence abroad.***
- Despite the negative outcomes of migration, it reduced the pressure on the Government by keeping unemployment rates low. ***The return of migrants as a consequence of the magnitude of crisis in some destination countries (mostly Russia, but also Spain and Portugal) will increase unemployment; therefore, the Government may be bound to amend its passive labour market policies.***

Outlook for 2009

- The forced return of emigrants from countries affected mostly by the financial and economic crisis will lead to an increase in unemployment rate given the lack of employment opportunities in the country. Therefore, the unemployment rate can reach 10% in 2009.
- Also, due to the declining demand, already noticeable in most of the economic sectors in the first quarter of 2009, the employment may shrink. In construction sector it may decrease significantly and moderately in service and industrial sector. Most probably, the employment in agricultural sector will be stable this year after a continuous decrease since 1999.
- Despite their importance, the reforms in the educational system in 2009 will cover only the matching of the supply and demand of labour force by setting limits for enrolment. The quality of education will not be addressed by the Government in short-run due to limited resources and time required for the establishment of an independent agency responsible for accreditation and monitoring of the quality of studies in educational institutions.

[38] More specific recommendations on the reforms in educational system may be found in *Black Sea Labour Market Reviews - Moldova Country Report,* ETF, 2009

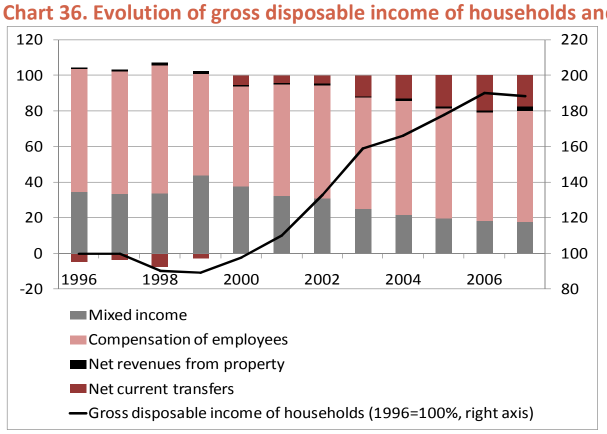
8. Households income

This chapter describes the major sources of disposable income of population from 1996 to 2007. Although there was a significant increase of the compensation of the employees since 1996 that still accounts for the largest part of households' income, the structure of disposable income has changed in line with the increase in remittances since 2000. Initially remittances had a contribution to the falling poverty rate, but since mid-2000s this impact has been modest. The chapter ends with challenges Moldova may face in the nearest future due to the decrease in households' income and some recommendations for the Government in this context.

Structure of disposable income

The trend of gross disposable income of the population was more or less similar to the evolution of GDP during the period of 1996-2007. Gross disposable income decreased in real terms until 2000 due to high inflation and begun to grow after the resumption of economic growth in 2000. In 2000-2003 the average annual growth of income was over 10%, but starting with 2004 the growth slowed down and even got negative in 2007 (Chart 36). As it is easily observed, the main evolution is marked by the heightening of current transfers to population since 2000, whose contribution to disposable income followed the most impressive increase. These consist of social payments to the population, but more important by the transfers from the Moldovan citizens working abroad.

Chart 36. Evolution of gross disposable income of households and its structure



Source: NBS and EG calculations

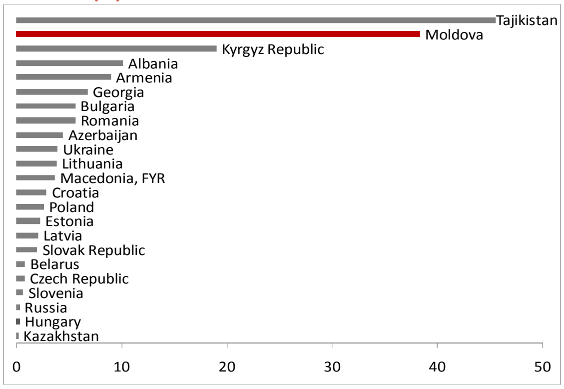
Remittances: fuelling domestic economy

As mentioned above, remittances became an important source of income for the population following a positive trend since 2000. Their impressive growth placed Moldova among the leaders according to remittances' share in GDP. In 2007, Moldova was on the second place according to this indicator, preceded only by Tajikistan and much afore other countries from the region (Chart 37 and Chart 38).

The impressive growth of remittances is a consequence of the increase in absolute number of migrants, the change in destinations of migration (EU vs. CIS countries) and consequently better-paid jobs and the fact that a greater share of remittances is transferred through official channels as a result of the growing credibility in banking system. Thus, both the number of households receiving remittances and their degree of dependence on remittances has increased. The number of individuals relying on remittances is impressive; according to some estimates in 2006 approximately

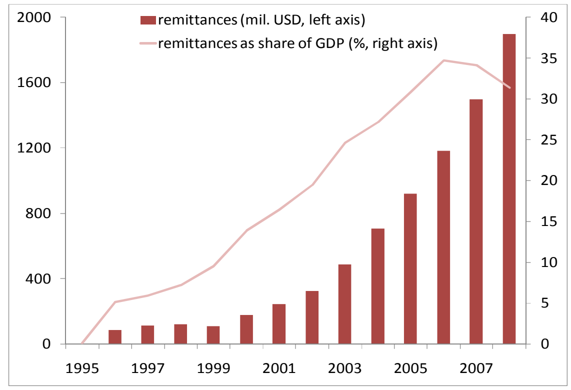
1.4 million people were members of households that received remittances[39]. CBS AXA survey suggests that remittances received per household per year increased from USD 700 in 2004 to USD 937 or so in 2006[40].

Chart 37. Remittances as share of GDP in some transition countries (%)



Source: World Bank, Migration and Remittances Factbook

Chart 38. Remittances in Moldova



Source: NBM and EG calculations

Remittances definitely played the major role in the increase of domestic demand; however, the high level of remittances and the low level of investment in Moldova are disappointing as any external shock and decrease in transfers from abroad will immediately affect consumption and GDP growth (already observed in the last quarter of 2008 – early 2009). There are also serious implications in some fields generated by the high level of remittances:

- Implication on the labour market by increasing the equilibrium and reservation wages in the economy and contributing to labour force shortages in some fields. The employment rate in Moldova decreased by 12 p.p. since 1999.
- Implications on balance of payments. Remittances are financing the major part of trade deficit, which increased from 27% of GDP in 2000 to 51% of GDP in 2008.
- Implications on the exchange rate through additional pressure for the appreciation of the Moldovan currency, which kept Moldovan production expensive on external markets. At the same time, the first signs of decline in remittances generated the depreciation of the national currency.
- Implications on monetary policy as a result of growth of monetary mass, increase in demand and warm-up of inflationary pressures.
- Implications on fiscal policy. While the Government was under less pressure relying on constant budget revenues from indirect taxation of goods and imports, the increase in dependency ratio and the return of emigrants at the retirement age hamper the viability of the social insurance fund.

Serious concern raises the decrease in remittances in the last quarter of 2008. It is for the first time since 1999 when such a significant decrease of remittances quarter-on-quarter basis (-21%) and a moderate increase year-on-year (+5.9%) has been observed. Although the initial expectations of the Government regarding the fall in remittances were not so pessimistic, data on international transfers to Moldova for January-February 2009 confirmed the trends of the late 2008 and apparently neither the population, nor the Government is ready for such a slew.

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[39] Migration and Remittances in Moldova, CBS AXA, 2005; Patterns and Trends of Migration and Remittances in the Republic of Moldova, IOM, 2007.

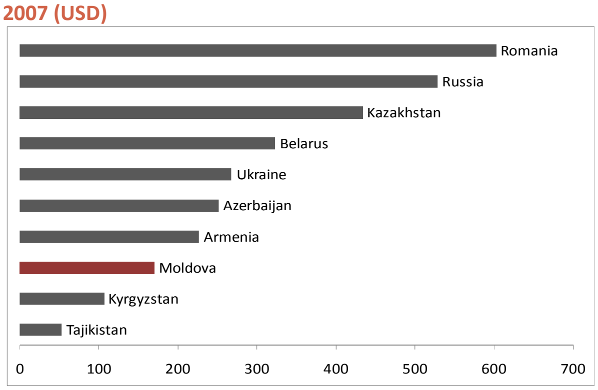
[40] Migration and Remittances in Moldova, CBS AXA, 2005; Patterns and Trends of Migration and Remittances in the Republic of Moldova, IOM, 2007.

Wages: still in transition

Low wages were characteristic to all transition economies that passed through a period of economic decline and decrease of public revenues. However, this period lasted much longer in Moldova as compared with other countries and in 2007 the average monthly wage in Moldova was one of the lowest in the region (Chart 39).

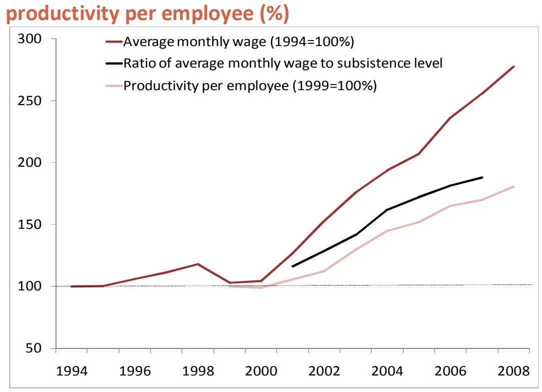
The resumption of the economic growth, the increase in the reservation wage due to migration opportunity, the FDI inflows in local enterprises were the main factors that contributed to the significant increase in wages since 2001. Actually the increase in wages was superior to the increase in productivity. Moreover, the ratio of nominal wage to subsistence minimum has also increased (Chart 40). Consequently, remuneration of employees became a more important source of income for the population and has increased as share of disposable income of the population from 56% in 2000 to 62% in 2007. Data on household income collected through HBS, although differ from data in national accounts, confirm this positive trend.

Chart 39. Average monthly wage in some transition countries, 2007 (USD)



Source: www.azstat.org

Chart 40. Average monthly wage and labour productivity per employee (%)



Source: EG calculations based on NBS data

While significant differences remain between wages across sectors of economic activities, these have diminished since 1999 and there has been a moderate degree of convergence in wages. Wages in the agricultural and education sectors are notable exceptions, where major reforms are needed. The highest wages are registered in financial activities, mining and quarrying, electrical and thermal energy, gas and water, construction, and transport and communication. Nevertheless, the highest increase in wages since 2003 has been in the construction sector, which has developed tremendously over the past few years as a reaction to increasing demand for dwellings.

An important issue in the Republic of Moldova is the underreporting of the wages and labour force. Data from BEEPS reports[41] show that the percentage of labour force reported for tax purposes is 92% and the percentage of wage bill reported for tax purposes is 90%, which is higher than in CIS countries, but still unsatisfactory. Instead of keeping a relatively high level of inspections to deal with the problem, the Government should eliminate the causes of "informal economy", one of the main issues being the high social contribution (29% in 2009) rather than personal income tax, which is lower than in most countries in the region.

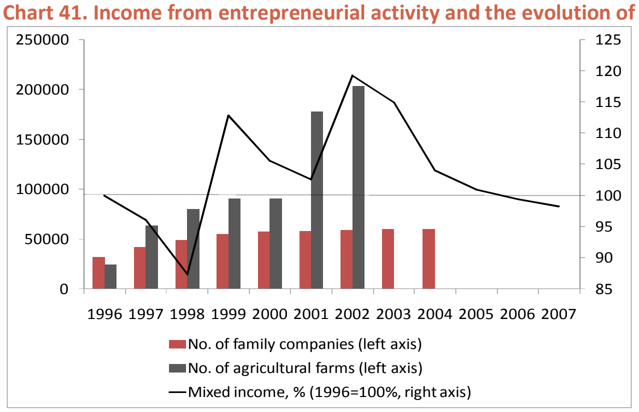
Incomes from entrepreneurial activity

The income from entrepreneurial activity of individuals is around 20% of the disposable income of the population and its share has decreased since 1999. Also, since 2002 there was a decrease in real

[41] *BEEPS Surveys*, World Bank and European Bank for Reconstruction and Development, 2002 and 2005

terms of these revenues (Chart 41). The attempts to start a business in order to compensate for the erosion of wage income in the first decade of transition were later replaced by the possibility to emigrate. Although the official statistics show an increase of privately owned corporations and unincorporated enterprises, these are mainly agricultural unincorporated enterprises, where usually subsistence agriculture is practiced or low value-added crops are produced which determine the low profits generated by entrepreneurial activity. Otherwise, the firm creation rate has always been low in Moldova (6-8%) as compared with that in other transition countries of Central Europe, where the rate was on average 16–18%[42]. The creation rate for firms registered as natural persons is particularly low. Sectors containing these entities have exploded in some transition economies, while in Moldova the increase has been rather modest.[43]

Chart 41. Income from entrepreneurial activity and the evolution of unincorporated enterprises

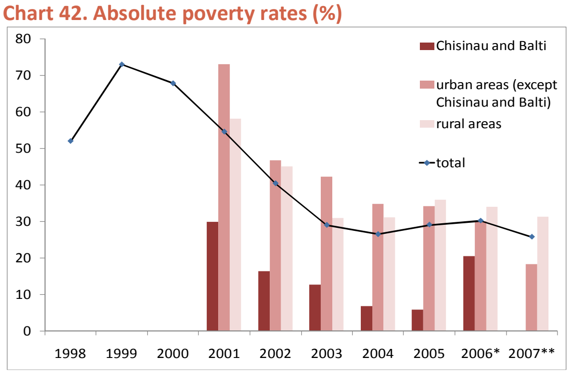


Source: NBS and EG own calculations

Poverty and inequality

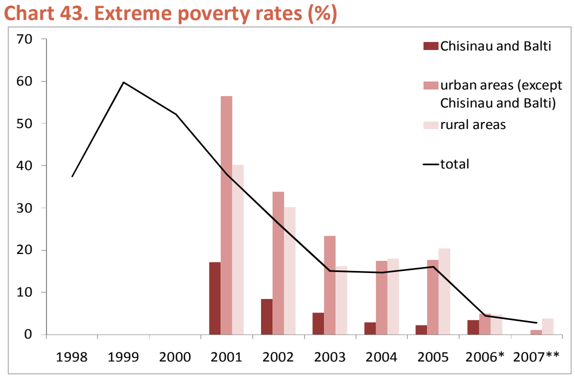
The increase in disposable income of households reflected also in the decrease of poverty rates (Chart 42 and Chart 43). However, poverty incidence is still very high in rural areas due to low productivity in agricultural sector and limited employment opportunities outside the agriculture. If during the first years of massive migration remittances had a significant contribution to the reduction of poverty, since 2005 this is not the case anymore. Only 3.1% of remittances are channelled to the poorest quintile of the population[44]. Besides, the current system where peasants are imposed to sell the agricultural products at low prices creates a system where rural population subsidizes the consumption of urban households, deepening in this way the inequality.

Chart 42. Absolute poverty rates (%)



Due to changes in methodology data from 2006 and 2007 is not comparable to data before 2005
***In 2007 the poverty rates are calculated only for rural and*

Chart 43. Extreme poverty rates (%)



Due to changes in methodology data from 2006 and 2007 is not comparable to data before 2005
***In 2007 the poverty rates are calculated only for rural and*

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42 Black Sea Labour Market Reviews - Moldova Country Report, ETF, 2009
43 Jan Rutkowski, Firms, Jobs and Employment in Moldova, World Bank, 2000
44 Moldova Poverty Update, World Bank, 2006

urban areas (including Chisinau and Balti)
Source: National Development Strategy

urban areas (including Chisinau and Balti)
Source: National Development Strategy

The inequality in incomes has not decreased significantly in recent years. Although there was a progress until 2003, the decrease in Gini coefficient stopped. Further it has increased and the decrease in 2006 to 0.371 level seems to be more a result of a change of methodology and sampling of the HBS.

Challenges ahead

- The level of remittances is definitely high in Moldova. However, existing data are misleading. Some payments for goods and services enter Moldova as personal transfers due to lower transactional and administrative costs. The 2006 HBS estimates that overall remittances (including compensation of employees) were less than half of those recorded in the balance of payments, implying that other transfers may be intended for investment[45]***. It is important to revise the reporting system and to dissociate investments from remittances in order to get a clear picture of the situation.***
- The need to increase wages in the budgetary sector cannot be contested; however, limited budgetary resources impede the reforms. Earlier attempts to increase the wages in education may be delayed considering the impact of the crisis on the economic growth and the budgetary deficit. However***, ensuring competitive wages in the budgetary sector should be a priority for the Government in order to promote quality services, fight corruption and avoid high fluctuations.*** The optimization of other budgetary expenditures, including intra-sectorial expenditures in education and health system, may free financial resources for this purpose.
- ***The worsening budget deficit should foster the reforms in the social assistance sector.*** The social benefits should be rationalized as the budgetary revenues are jeopardized. The amount of benefits should be raised and channelled to the most vulnerable categories of population.
- There is no way the Government can contribute to the further increase of remittances that are an important source of revenues for many households. However, one area of intervention should be ***improvement of business climate in order to promote investments both from local population and from the migrants that send remittances that would consequently increase the revenues of the households.***

Outlook for 2009

- Based on the trend of remittances since October 2009 and forecasts for the economic growth for countries with most Moldovan emigrants we can predict a decrease in remittances of about 30% in 2009. Consequently, this will have negative implications on the consumption, budgetary incomes, exchange rate and quality of life.
- The return of emigrants will lead to the decrease of the equilibrium and reservation wage (mostly valid for private sector). Also, as a result of increasing budgetary deficit, the increase in wages in public sector will most probably be postponed. Thus, we can expect a stagnation of wage increase in the economy or even a decrease up to 3% in 2009.
- Moreover, the difficulty of collecting the budgetary revenues may generate delays in the payment of wages in the budgetary sector, pensions and other social payments, which may result in the increase of poverty rates.

[45] IMF Country Report No. 08/139, IMF, 2008

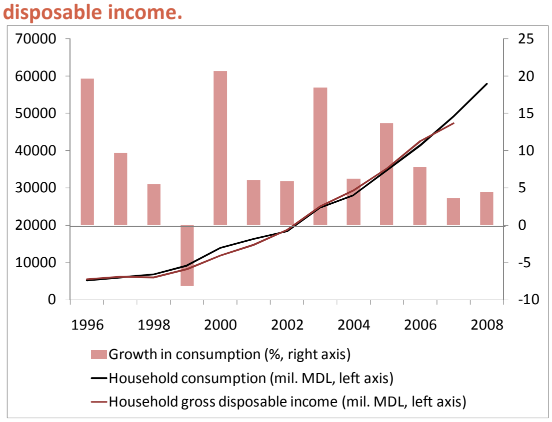
9. Households consumption and savings

The role of this chapter is to highlight the sources of increasing consumption and changes in the structure of final consumption of the households. Since 2000 not only have been remittances the most important generator of consumption, but their impressive growth ensured positive savings of the population. This may be easily seen at a review of the trends in amount of individuals' deposits in the commercial banks and the evolutions on the housing market. However, the high dependence on remittances is very vulnerable as already proven by statistics for the last quarter of 2008 and should be addressed by the governmental policies as recommended at the end of the chapter.

Consumption: the engine of growth

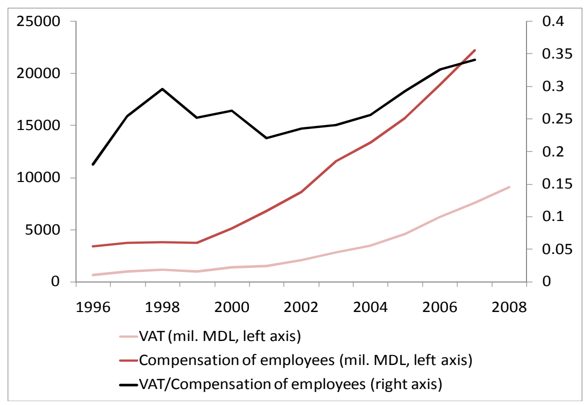
As mentioned in the previous chapters, household consumption increased tremendously since 2000 contributing the most to the GDP growth. But due to a higher increase in the disposable income since 2002 the population turned from net consumers to net savers (Chart 44).

Chart 44. Trends in household consumption and disposable income.



Source: NBS

Chart 45. Wage trends and VAT revenues



Source: NBS, State Fiscal Inspectorate and EG calculation

Statistics on imports of goods typical to household consumption, the revenues to the budget from the VAT and wage statistics confirms the fact that household consumption has not increased just because of the wage increase (Chart 45). It may be easily observed that the increase in consumption cut out the increase in wages since 2001. This provided a stable source of revenues for the government, but also made the state budget very dependent on indirect taxation. Revenues from VAT collection made up 56.7% of state budget revenues in 2008, which is quite high by international comparisons.

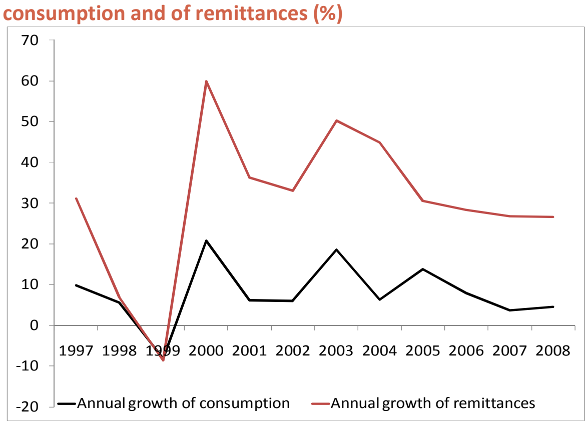
Although there might be more sources for the increase in consumption as higher borrowing or drawning on the savings, in the case of Moldova transfers form workers abroad have played the major role. There is an almost perfect positive correlation between the growth of remittances and the growth of consumption in Moldova (Chart 46). According to some studies, every USD 1 that comes from remittances and enters the local economy generates as much as USD 4 in demand for goods and services[46].

The developments of the banking system as a result of increased competition in the sector also contributed, but to a lower extent, to the increase in consumption. Chart 47 indicates that consumption was partly financed by the financial institutions. Almost constant increase in the financing of the households is a normal but late evolution and stopped in early 2008. This was not linked to the global financial crisis, but rather to the decrease of liquidity in the banking system as a

[46] Migration and Remittances: Eastern Europe and former Soviet Union, World Bank, 2006.

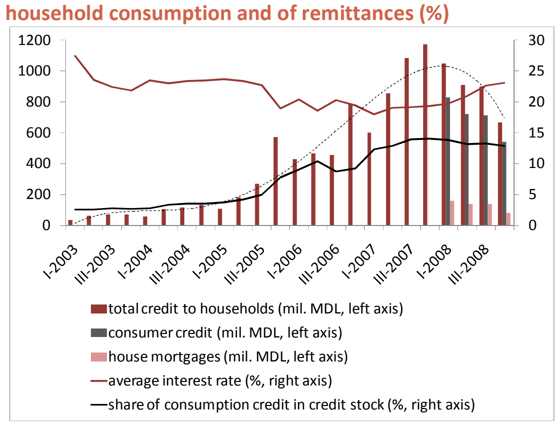
consequence of late 2007 and early 2008 interventions of the NBM, actively fighting inflation and increasing the obligatory reserves rate for the deposits held by commercial banks. Thus, the share of consumer credits in the total stock of credit stagnated around 13% since 2008, being much lower than in other countries in the region. It is quite clear that despite the intensified competition in the sector, this was not enough to promote consumer credit and lower interest rates to levels comparable to other neighbouring countries. As a response to the current international situation characterized by non-reimbursements or delays in reimbursement of consumer credits, Moldovan banks became very precautious. But the propensity to consume of the population is decreasing as well and probably in the short-term no significant progress will be registered.

Chart 46. Correlation between annual growth of household consumption and of remittances (%)



Source: NBS, NBM and EG calculations

Chart 47. Correlation between annual growth of household consumption and of remittances (%)



Source: NBM

The increase in consumption has gone together with changing structure of household expenditure. According to the HBS data, the share of food and drinks in household expenditures decreased from 70% in 1998 to 46% in 2007, being replaced by the increase in articles of apparel and clothing accessories, footwear and dwelling equipment and services. This also reflected in the trade balance as higher imports of goods for final consumption.

Households savings and implications

As mentioned above, the population of Moldova moved from net consumers to net savers in 2002, although the 2007 data show a new reversal of the situation (Chart 48). The main contribution to the growth in savings has been the increased remittances which initially were spent exclusively on consumption, but since 2002 rose enough for being invested and saved.

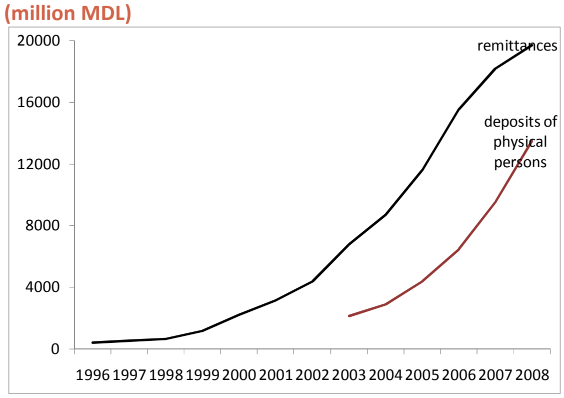
The main palpable outcome of positive savings generated by remittances is the evolution of individuals' deposits in financial institutions and investment in housing sector. A small proportion of savings is invested in businesses. For example, only 7% of remittances were used as investment in business activity in 2006[47]. This is explained by the insufficient level of remittances received by the households for starting a business, unfriendly business environment and the risk-averseness of the citizens. However, the increasing confidence in the banking system contributed to the deposition of population's savings in commercial banks providing additional resources for financing the economy. Thus, the individuals' deposits at commercial banks grew hand in hand with remittances (Chart 49). The deposited income may be very important and serve as a "life vest" for many possible returning migrants with no immediate prospects of finding a job or getting pensions which could cover basic needs. Obviously, this is not a solution in a long period.

[47] The contribution of human resources development to migration policy in Moldova, ETF, 2008.

Chart 48. Household saving rate (%)

Source: NBS and EG calculations

Chart 49. Trends in remittances and deposits of individuals (million MDL)



Source: NBM and EG calculations

The increase in savings also resulted in massive increase in housing prices as a result of the boom in demand. Since 1999 the number of buying/selling transactions of apartments has more than doubled and more than half of them are registered in Chisinau. However, since the beginning of the global financial crisis major implications may be observed on the housing market. After 10 years of constant growth the volume of entrepreneurial works in construction decreased in 2008 and so did prices for the apartments in the beginning of 2009. This will also have serious implications on the construction sector that became an important sector of employment lately.

Challenges ahead

Consumption has been the engine of Moldovan economy since 2000, and the Government did not take advantage of the financial resources entering the country and the state budget to promote capital investments. This model of economic growth cannot be significantly changed in short-time. The deceleration of the consumption growth that started in the last quarter of 2008 as a result of decline in incomes and in the propensity to consume of the population that prefer to save for the "bad day" and its implications on the budget revenues and on business sector is striking. In this context, the main role of the Government is to stimulate consumption through different means:

- ***The Government should consider the possibility of decreasing the VAT***. The effects of the reduction of the VAT should not necessary be the decrease in budgetary revenues as this would stimulate consumption. Furthermore, the Government should reconsider its decision of "zero corporate income tax". Moldovan fiscal system relies primarily on the taxation of consumers, while legal entities are almost excluded from the process of budgetary formation, which should be gradually changed.
- The share of consumer credit in the total credit in Moldova is lower than in other countries in the region. It is still difficult and expensive to get a credit despite the improvements and increased competition in the banking sector. ***The monetary policy of the NBM should be oriented to stimulate the crediting of the economy and consumer credit,*** especially that the inflationary pressures have diminished since mid 2008 and the IMF forecasts zero inflation rate for 2009[48].
- ***The fiscal legislation should allow natural persons to deduct from their tax-imposable income investments in durable goods***. Not only might this contribute to the consumption of durable goods, but also to the consumption of complementary goods and services.
- ***Investments in infrastructure and public services (mainly in education) should continue in the crisis period.*** These are beneficial both in short-term and long-term. In short-term they provide jobs for the population and consequently stimulate consumption. In long-run they create the necessary conditions for a more healthy economic development.

[48] World Economic Outlook: Crisis and Recovery, IMF, 2009

Outlook for 2009

- An expected decrease in remittances by 30% may result in a decrease of consumption by almost 20%, due to the high correlation between the two variables. Taking into consideration the possible decrease of other sources of households' income we can expect a decrease of consumption up to 25% at the end of the year.
- This will consequently result in a decrease of budgetary revenues, mostly due to an approximate 15-20% drop in VAT. As fiscal legislation cannot be easily changed during the fiscal year, probably no significant actions will be considered this year in order to stimulate consumption. However, in 2010 it is possible to reconsider some VAT rates and to amend the fiscal legislation in order to stimulate consumption.
- The decrease in remittances will also have an impact on the banking system. The deposits of natural persons will decrease as a result of lower inflows of transfers from abroad and withdrawal of deposits by returning migrants who are not able to find a job. Therefore, the NBM will probably relax the monetary policy and it should do so in order to avoid a potential significant decrease of crediting activity.

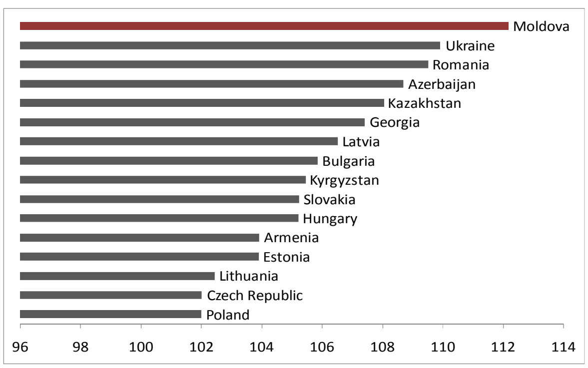
10. Inflation: the worst of the worst?

This chapter analyses inflation as an important phenomenon that had major implications on the macroeconomic policies over the last years. As monetary policy is analyzed below, the role of the present chapter is to outline the structure of inflation by analyzing consumer price index, producer price index and price index of agricultural producers. Persistent high inflation even after the achievement of some degree of macroeconomic stability reflects some weaknesses of the domestic economy and of the monetary and fiscal policies applied in this period. Some important actions to be considered in the process of fighting inflation conclude the chapter.

Consumer Price Index

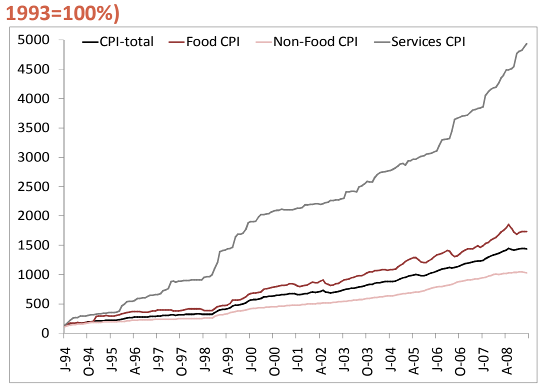
Since the introduction of the Moldovan currency in 1993, inflation had followed a decreasing trend until the regional crisis in 1998. During the Russian financial crisis the strong pressures on the exchange market determined investors to pull out of the Treasury bills and the Central Bank was obliged to step in with emergency liquidity for the Government[49]. After a short period of stabilization (2001-2002) inflation rose again above the 10% level and until 2008 governmental efforts could not get down inflation to one-digit number. As the macroeconomic situation has stabilized in the region, inflation decreased to acceptable levels in most of the countries, with Moldova remaining a leader in the average annual inflation (Chart 50).

Chart 50. Annual average inflation, 2003-2007 (%)



Source: EBRD and EG calculations

Chart 51. Consumer Price Indexes (December 1993=100%)



Source: NBS

However, the components of Consumption Prices Index (CPI) evolved quite differently (Chart 51). The most significant increase was in prices of services and two distinguished inflation rounds can be identified in this regard. The first increase in 1998-1999 reflects the adjustment in tariffs for energy, telecom and other utilities to the near cost-covering levels. The second round of accelerated inflation for services started in 2006 and corresponds to the changes of import prices of the energy resources and new adjustments of tariffs for gas and electrical energy, which had not been modified since 2003 despite serious pressures in this respect.

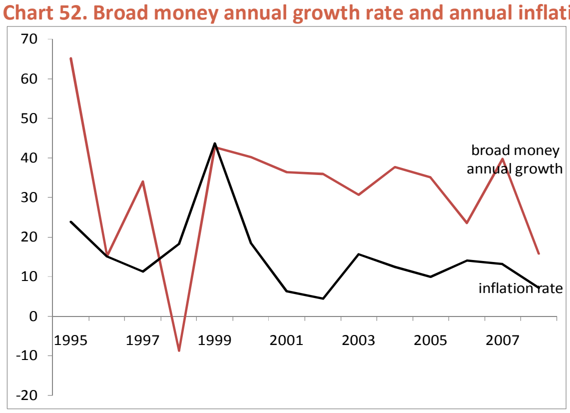
Food inflation has also been high, but the peaks are mainly linked to the volume of agricultural output; therefore, after 1999, growth rates in prices of food component exceeding 10% are observed only in years when droughts occurred. Sometimes, the Government actions against high inflation for some basic foods evolved in administrative setting of the prices (e.g. setting ceiling price for bread). However, the agflation on international markets also contributed significantly to food inflation given the fact that Moldova is a net importer of food products since 2006. The rising demand for food products, especially on China's and India's markets, and the evolution of oil price - as base factors for

[49] Republic of Moldova: Recent Economic Development, IMF 1999

global food inflation – have reversed by mid 2008, but food prices managed to keep at high levels until the beginning of 2009.

Non-food inflation has been the most moderate over the period, partly being imported inflation (following the trends of prices in trade partners of the Republic of Moldova or being associated with periods of national currency depreciation), and partly a consequence of increased costs of production across all domestic industries. However, the growth of the monetary mass had its own and non-negligible effect on inflation. Chart 52 shows the patterns of money growth and inflation, where a positive correlation may be easily identified. The link is stronger after 2000, associated with higher inflows of remittances.

Chart 52. Broad money annual growth rate and annual inflation rate (%)



Source: NBS, NBM

Thus, since 2003, high inflation was a consequence of robust domestic consumption fuelled primarily by remittances, but also increases in wages. It has been proven to be difficult to keep inflation low, while at the same time achieving other monetary policies goals in the presence of strong inflows of foreign exchange. As until 2006 the main objective of the NBM was not quite clearly stated, the NBM acted in order to maintain a equilibrium between keeping inflation low, preventing appreciation of the national currency and building international reserves. However, the monetary policy was not sufficiently tight to ensure a rate of inflation below 10% and it was not always supported by adequate governmental policies.

The high inflation pressures and the Memorandum for Economic and Financial Policies that Moldovan Government and National Bank signed with IMF in 2006, determined the Parliament to pass the amendments to the law on National Bank of Moldova and to set expressly the price stability as the main policy objective for the central bank. However, not immediately had the NBM given up other intermediary objectives. Only in late 2007 it started acting correspondingly and even stated its willingness to adopt direct inflation targeting in a three years time-span. This is an ambitious goal and requires efforts from both the Government and NBM; but during the current crisis featured by low inflation the economic growth becomes a more important macroeconomic goal and a revision of monetary policies might be needed very soon.

Producer Price Index

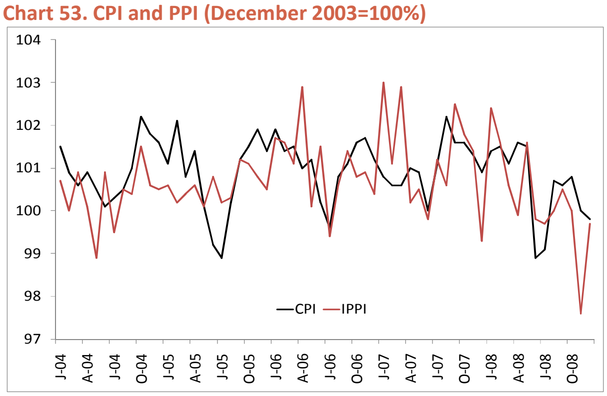
Producer price index (PPI) provides information on the inflationary pressures arising in the domestic industrial sectors. Its correlation with the CPI is strong and positive, but manifests with a lag of up to six months (Chart 53). However, the authorities disregarded sometimes this fact by loosing monetary policy in spite of the warning increases in the PPI.

The PPI evolution also was uneven in different industries (Chart 54). The steepest increase in PPI in recent years was in energy, gas and water subsector and was caused by the increase in import prices of electrical energy from Ukraine since 2006 (5% in 2006, 17% in 2007) of which Moldova was dependent in the proportion of 75% in 2008[50].

At the same time, the PPI increased constantly since 2003 in the mining and quarrying industry and the primary reason is that it is one of the most fuel-intensive industries. As oil prices on global markets continued increasing until mid 2008 with an average annual growth rate of 26%, the import prices raised in line with the international prices. Thus, the prices for energy resources affect significantly CPI directly and indirectly through their high contribution to the PPI. IMF estimates that an oil price increase of USD 10 per barrel would raise Moldova's consumer prices by 2–2.5 percent[51]. Another important contribution comes from the increase in wages in the sector, which grew faster than wages in other industrial branches and industry per total.

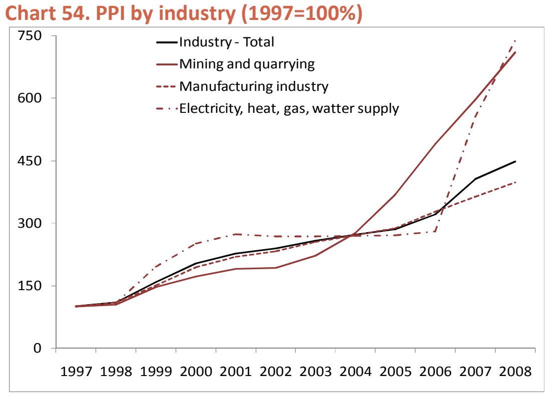
The most moderate change in PPI was in manufacturing industry, the industrial sector characterized by the smallest increases in wages. However, there are some significant exceptions in industries of with intense energy consumption such as sugar production and metallurgical industry.

Chart 53. CPI and PPI (December 2003=100%)



Source: NBS and EG calculations

Chart 54. PPI by industry (1997=100%)



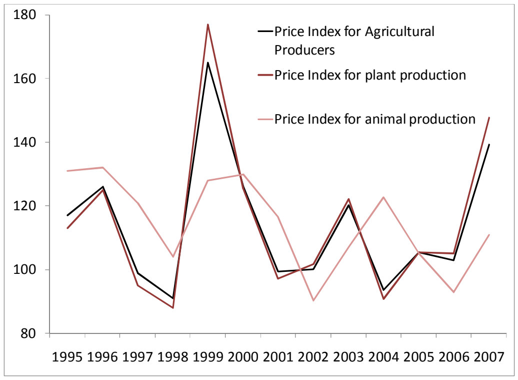
Source: NBS

Price Index for Agricultural Producers

The evolution of price index for agricultural producers is mostly linked to the weather conditions. On Chart 55 some significant leaps may be observed in the years affected by droughts (2000, 2003 and 2007). The outdated agricultural technologies negatively influence the productivity in the sectors and competitiveness of agricultural products. The governmental control over wheat and flour prices moderated the increase in CPI but it contributes to unfair distribution of value-added among producers. Price Index for animal production obviously follows the trend of plant production, marked with a one year lag.

Chart 55. Price Index of Agricultural Products (previous year=100%)

[50] Activity Report, ANRE, 2009
[51] IMF Country Report No.04/39, IMF, 2004



Source: NBS

Challenges ahead

- Constantly high inflation was an element of the model of economic growth of the Republic of Moldova. The favourable developments of 2008 – decrease in oil prices on global market and a good agricultural harvest – sustained by tight monetary policy decreased inflation to 7.2%. The new economic conditions, with lower inflationary pressures should determine ***the NBM to act differently and opt for looser monetary policy in order to stimulate consumption and production in the country.***
- Price statistics in Moldova has important gaps. Price collection for the CPI and PPI is limited geographically and new observations are not imputed. The weights of the CPI basket, underestimate the share of durable goods. The PPI is not a transaction price index, and covers a small population of industrial establishments. The industrial production index is compiled from data in constant prices adjusted to price changes by establishments themselves.[52] ***It is important to call into play a revised and correct methodology in order to get effective price indexes, which would provide better forecasts for CPI*** and consequently will have a positive impact on the inflation monitoring process.
- ***The practice of administrative ceilings of prices should be abolished*** because usually it acts as anti-competitive measure acting against the small private producers.

Outlook for 2009

- The deflation from the beginning of 2009 will probably not last long. However, there are no significant inflationary pressures and Moldova can end the 2009 year with a below 4% inflation rate.
- As 2008 seems to be a favourable agricultural year, we expect mainly non-food inflation. Given the expected depreciation of the national currency, the prices for the imported production may increase by the end of the year. Also, depending on the evolution of oil prices on the international markets, which have already stabilized and may moderately increase, we can predict a temperate rise in services prices.
- PPI will not increase significantly in most industrial sectors due to stable or even decreasing prices for input factors and due to the decrease of labour force costs, which in some sectors represents an important share of production cost.
- Taking into consideration the moderate inflationary pressures, the NBM will most probably act in favour of more relaxed monetary policy and continue decreasing the base interest rate by the end of 2009.

[52] IMF Country Report No. 08/320

11. Monetary policy: internal versus external stability

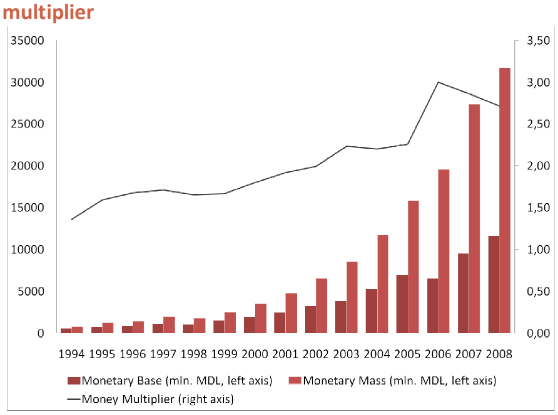
This chapter describes how the National Bank switched from being the major creditor to being a major debtor of the banking system. It will also reveal which central bank's monetary policy tools purport the most significant risks and which are the most expensive. The main challengers of the monetary policy during the entire transition period are identified, as well as the new risks that National Bank of Moldova faces under the unfolding world economic crisis.

Overview

During the transition period the chronic problem of our economy has been the high inflation. Therefore, the National Bank's monetary policy was mainly oriented on setting a rigorous control over the monetary mass. This objective became more prominent after the inflows of foreign currency started to grow rapidly at par with economy's growth. For achieving this objective, the National Bank used several instruments of monetary policy which influenced the monetary mass: open-market operations, obligatory reserves, crediting the banking system, operations with treasury bills.

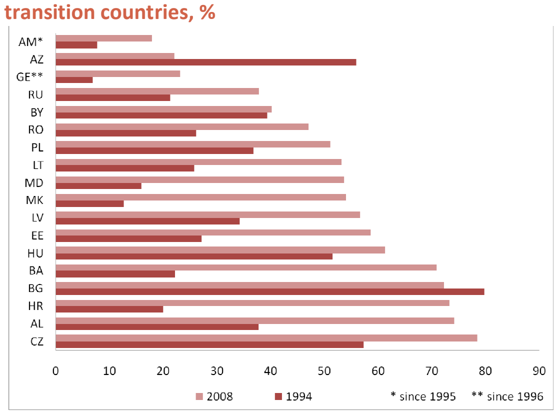
As illustrated in the Chart 56, since 1994 the monetary mass followed an increasing trend, which accelerated after the economy started recovering from the regional crisis from 1998-1998. The money multiplier indicator followed almost the same trend, except the last two years. It revealed the qualitative results of decreasing reserves requirements for commercial banks, which improved their lending capacity and assets management. However, during the last two years, 2007 and 2008, the money multiplier started to decrease as a result of more restrictive measures applied by the National Bank: increase in the volume of sterilization operations in 2007 and a strong increase in obligatory reserves rate for commercial banks and refinancing rate since the end 2007 and during the first half 2008. Continuation of this trend in the next years could negatively affect the capacity of commercial banks for crediting the real sector of the economy.

Chart 56. Monetary base, money mass and money multiplier



Source: NBM

Chart 57. Evolution of economy monetization in some transition countries, %



Source: IMF, International Financial Statistics, NBM

During the analyzed period Moldova registered a relative progress in monetization of the economy which reflected the increase in population and investors' confidence in banking system and national currency. Chart 57 illustrates the monetization level of Moldova's economy which nowadays is similar to that of Baltic countries and even higher in comparison with Romania or Russian Federation.

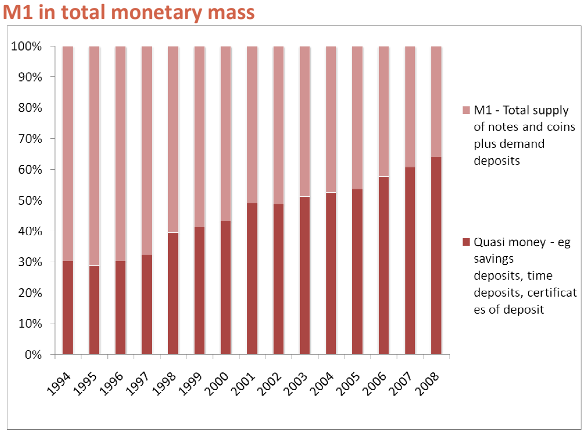
A structural analysis of the monetary mass reveals positive tendencies as well (illustrated in Chart 58). While before 2002 the main component of the monetary mass was the money in circulation and demand deposits (M1), afterwards it has been replaced by quasi-money[53]. This denotes increasing

[53] Assets with properties resembling that of M1 money (eg savings deposits, time deposits, certificates of deposit).

attractiveness of banking products and the development of intermediation on the financial market. It was a result of restrictive monetary policy promoted by the National Bank, increasing inflow of foreign currencies and confidence in Moldovan “leu”.

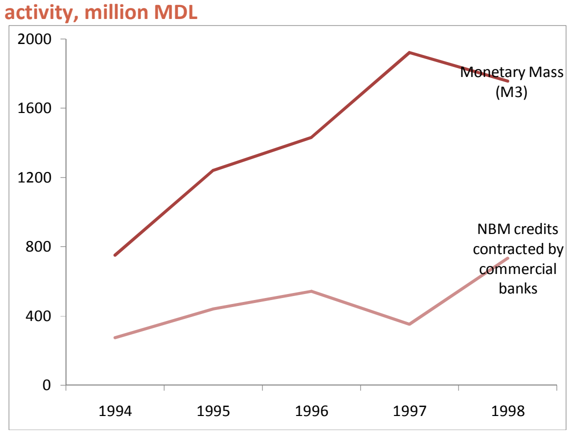
During the period of analysis we can identify two major stages of the monetary policy evolution. The first one (1994 – 1998) is characteristic for the yearly transition period when the National Bank anti-inflationary policy was undermined by an expansionary fiscal policy which required direct financing by NBM of budgetary deficit, as well as by the necessity to stimulate the commercial banks to credit the real sector of the economy (Chart 59). During the second stage (1998 – 2008) the National Bank concentrated its efforts on controlling the monetary mass while being major debtor of the financial-banking system.

Chart 58. Share of quasi-money and monetary aggregate M1 in total monetary mass



Source: NBM and IMF

Chart 59. Monetary mass (M3) and Central Bank crediting activity, million MDL



Source: NBM

1994-1998: National Bank as major creditor

During this period the National Bank of Moldova indirectly influenced the monetary mass through crediting the Government for covering the budgetary deficit and to commercial banks for fostering real sector crediting. The most significant issue faced by the National Bank in formulating its monetary policy was to manage two contradictory challenges. On the one hand it had as the main objective the decrease in inflation rate by regulating the monetary mass; on the other hand, the National Bank was a major creditor of commercial banks stimulating them to mobilize their resources for crediting the real sector of the economy. Therefore, before the regional crisis from 1998 the NBM monetary policy can be characterized as quite relaxed.

The credits offered by the National Bank to the Government for financing the budgetary deficit undermined the anti-inflationary monetary policy. In 1998 the Government decided not to rely any more on central bank’s credits for financing the budgetary deficit. This decision was an important milestone which marked better coordination between monetary and fiscal policies. Thus, the Government started to use more intensively as a source of deficit financing the operations with state-owned treasury bills which represents a non-inflationary measure of financing.

The decrease in monetary mass from 1998 is explained by the negative repercussions of the regional crisis which led to the outflow of foreign currency from the economy and decrease in credits’ volume offered by commercial banks. It was also caused by the National Bank interventions on the foreign exchange market for covering the increased demand for foreign currency through massive purchases (sterilization) of national currency on the international reserves account.

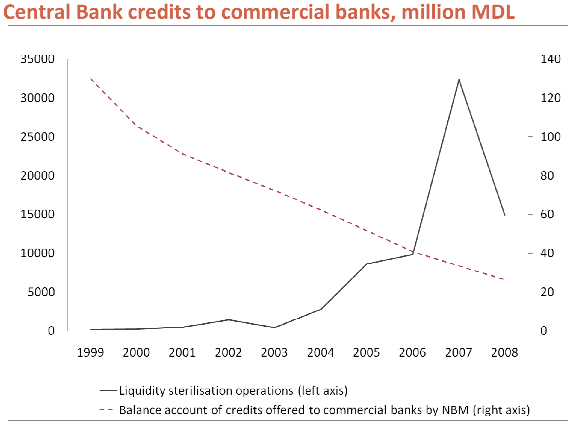
During the yearly transition period the open-market operations were not used intensively by the National Bank for influencing the monetary mass, due to the underdevelopment of capital markets and limited trust of potential investors for state treasury bills. The volume of open-market operations increased significantly in 1998 up to 217.7 million MDL from 49.7 million MDL in 1997. During this period, the mostly used type of REPO operations was the purchasing of state treasury bills. It was caused by the decrease in the volume of money in circulation due to the massive purchases of national currency by the National Bank and negative anticipations of investors regarding the stability of the Moldovan "leu" in 1998. The share of these operations in total open-market operations in 1998 constituted 73.6%, suggesting an inflow of additional liquidities by the central bank and its position of the major creditor of the banking system.

Since 1999: National Bank as major debtor of the banking system

This period is characterized by a constant sterilization of the monetary mass as a consequence of increasing flows of liquidities in the banking sector. The economic recovery after the regional crisis from 1998-1999 led to an increase of inflows of foreign currencies as a result of increase in exports, foreign direct investments and migrant's remittances. It fuelled the demand for national currency, which immediately reflected in increasing monetary mass. The reaction of the central bank to the increase in monetary mass was to sterilize it through open-market operations given the increasing inflationary pressures. Thus, whereas in the previous period the National Bank used the open-market operations mainly for injecting additional liquidities in the banking system, during this period the entire open-market operations were used for massive sterilization of liquidities through REPO operations with state treasury bills.

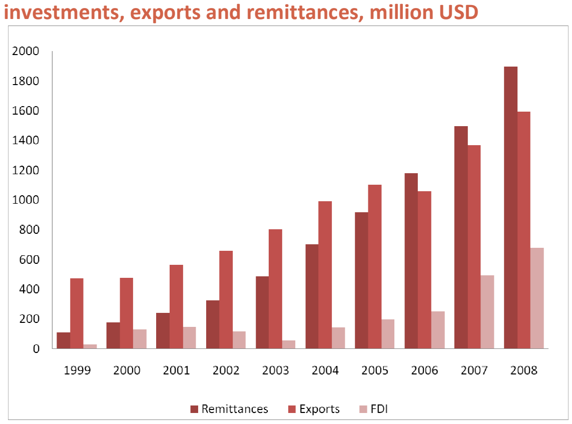
During this period the National Bank winded down the banking system crediting and this tool of monetary policy was not used any more. It was in line with the continuous increase in credits volume offered by commercial banks and, therefore, the decrease in necessity to stimulate their lending programs. Chart 60 reveals the increasing volume of liquidity sterilisation over the analyzed period in comparison with the diminishing trend of balance accounts of credits offered by the central bank to commercial banks during the first stage.

Chart 60. Sterilization operations and balance account of Central Bank credits to commercial banks, million MDL



Source: NBM

Chart 61. Inflows of foreign currency through foreign direct investments, exports and remittances, million USD



Source: NBM

Since the economic recovery, the increasing inflows of foreign currency determined the National Bank to intervene by purchasing foreign currency, which led to a constant increase in the monetization of the economy. As a result, it increased the necessity to control the monetary mass through liquidity sterilization operations. Chart 61 shows the evolution of exports, foreign direct investments and remittances which were the most important channels of foreign currency inflow into the economy. Thus, whereas FDIs started to increase more rapidly since 2005, the exports and remittances volume registered an almost continuous increase since 1999 (except 2006 – Russian trade embargo on imports of wine). The sharp increase in liquidity sterilization volume in 2005 (over

3 times as compared with 2004) was generated, on the one hand by an accelerated inflow of remittances (+62% than in 2005) and on the other hand by the introduction of a new sterilization instrument – NBM Certificates – which replaced the REPO operations of selling state assets.

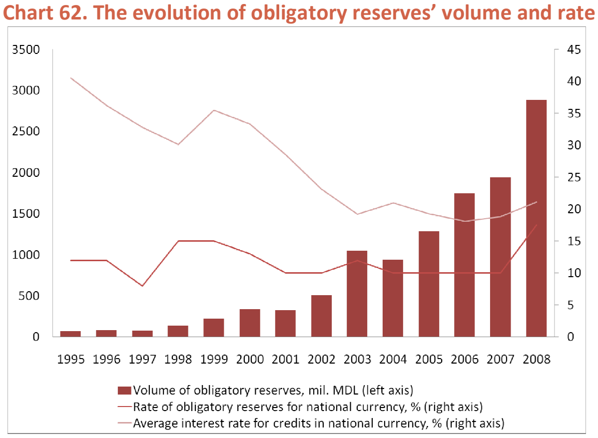
Obligatory Reserves Rate – cheap BUT risky

Although open-market operations are considered to be one of the most efficient mechanisms of sterilization the liquidity surplus, this monetary policy instrument generates additional costs for the National Bank because it acts as a debtor to the monetary market and, thus, it has to pay interest related to the treasury bills or certificates sold. However, the National Bank uses another monetary policy tool which does not bear any interest rate and can directly influence the monetary mass – obligatory reserves rate established for commercial banks on held deposits.

The National Bank of Moldova uses the obligatory reserves rate as a last resort monetary policy instrument since it can negatively affect the capacity of commercial banks of crediting the real sector of the economy. Thus, it was used only in situations of significant inflationary pressures as a result of an accelerated increase in monetary mass. Additionally, taking into consideration the slow monetary policy transmission mechanism in Moldova, the obligatory reserves rate was used as the most efficient and rapid monetary policy tool of the central bank.

During the period 1994-1997 the obligatory reserves rate decreased from 20% to 8% with the aim to foster the crediting activity of commercial banks despite that one of the main objectives of the central bank's monetary policy was the decrease in inflation rate. As it is shown in Chart 62, the evolution of obligatory reserves rate is directly correlated with the credits' interest rate. Thus, a more relaxed monetary policy has led to a decrease in the average interest rate for credits in national currency from 40.5% in 1995 to 30.1% in 1998. The regional crisis of 1998 determined the National Bank to sharply increase the rate for obligatory reserves from 8% in 1997 to 15% in 1998 in order to build a security shield in form of commercial banks' obligatory reserves and National Bank's international reserves. Once the economic recovery begun, the rate of obligatory reserves decreased and remained relatively constant between 10% and 12%. It was in line with the decrease in average interest rate for credits (from 35.5% in 1999 till 18.8% in 2007).

Chart 62. The evolution of obligatory reserves' volume and rate and the average interest rate for credits



Source: NBM

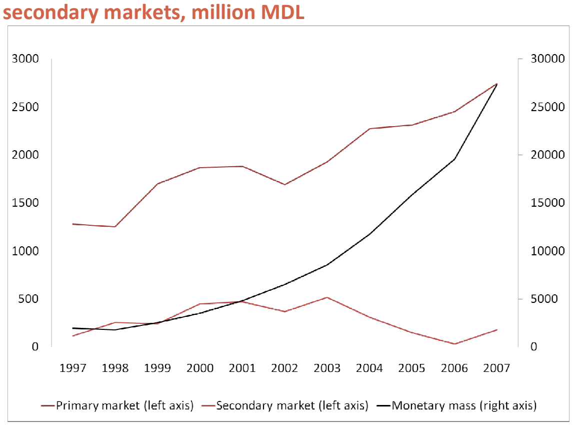
However, the NMB has been using again the obligatory reserves intensively since November 2007 replacing to some extent the open-market operations. The extremely high inflationary pressures during the first semester of 2008 made the NBM to increase the obligatory reserves rate gradually from 10% to 22% in July 2008. This decision has been supported by IMF which, after signing the Memorandum of Economic and Financial Policies with NBM, has been intensively recommending the tightening of the monetary policy.

National Bank as fiscal agent of the government

The constant increase in monetary mass after the regional crisis from 1998-1999, the NBM anti-inflationary monetary policy and gradual improvement of the confidence in Moldovan currency has led to the development of the primary market for treasury bills and state bonds. Additionally, Government's treasury bills proved to be an efficient non-inflationary revenue rising instrument for financing the budgetary deficit. Chart 63 shows an increasing discrepancy between the developments of primary and secondary market. The latter was negatively affected by the increase in liquidity indexes in commercial banks and crowding out of private investments from these assets due to a higher profitability for banking deposits.

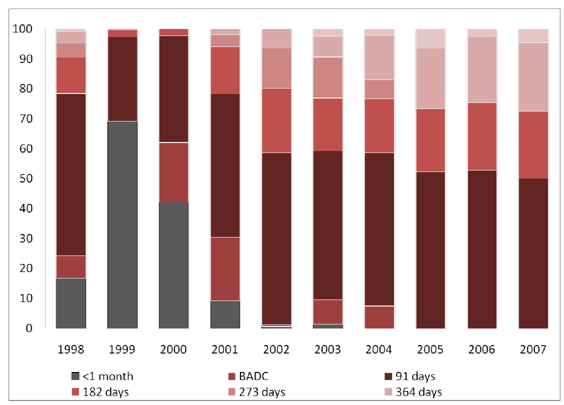
During the analyzed period, the shares of treasury bills with a longer maturity period increased, which indicates a growing confidence in the national currency from the part of investors as well as increasing availability of long-term liquidities at commercial banks. While in 1999 the treasury bills with less than one month maturity had the major share in total emissions, already in 2001 it has been replaced by those with 91 days maturity. Another positive milestone was the emission of state bonds with repayment after 1, 2 and 3 years which opened a window for the state budget for attracting long money and created a leverage for medium-term budgetary planning. However, the share of such assets in total emissions did not significantly increase, remaining at 4.5% in 2007.

Chart 63. Evolution of states assets on the primary and secondary markets, million MDL



Source: NBM

Chart 64. The structure of emissions of state assets, %



Source: NBM

National Bank interventions on the FOREX: walking a tightrope

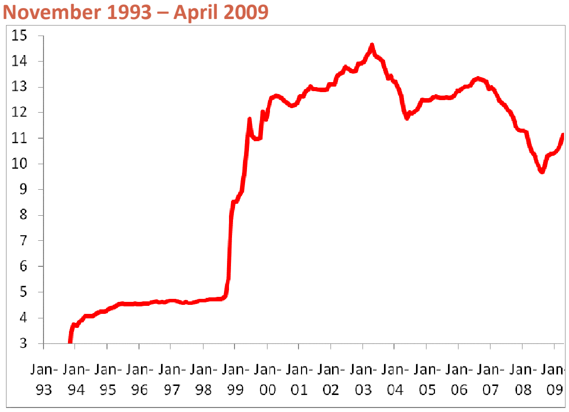
Given the importance of the national currency stability for attracting foreign direct investments, the main objective of the NBM foreign exchange policy as a component of its monetary policy has been to maintain the national currency exchange rate stability. However, the interventions on the foreign-exchange market made the central bank to walk a tightrope between two main perils: inflationary pressures on the one side and high fluctuations of the national currency exchange rate on the other.

National Moldovan currency – the Leu - was introduced in late 1993 after three years of hyperinflation with the initial exchange rate set at 3.43 MDL/USD. While the exchange regime was declared floating, in fact it was a controlled floating regime because Moldova did not have any hard currency reserves to protect itself against external currency and financial shocks. Despite feeble domestic currency reserves at initial stage, the nominal exchange rate of the national currency against US dollar remained quite stable for about 5 years floating between 4.50 and 4.70 MDL/USD (Chart 65). Even the 2.5 times real depreciation of the Leu that cumulated in 1994-1997 can still be judged as success taken into account the sharp decline in the real economy. That element of macroeconomic stability was mainly due to active monetary policy of the NBM supported by the IMF loans. The IMF alone has provided about 300 USD for macro-financial stability, but indirect effect on the national currency had the growing inflows from bilateral and multilateral official assistance. Thanks to the growing external support and rising exports, it was possible for the NBM to consolidate its currency reserves (from USD 180 million in 1994 to USD 380 million in August 1998) and to use the exchange rate quite freely as additional anchor for stabilisation of the inflation. The situation changed dramatically as result of the Russian financial crisis in August-September 1998. Moldova's exports to Russia collapsed and the economy went again in recession. Under growing external pressures the NBM wanted to keep the currency stable and wasted its currency reserves. The currency depreciated two times from mid-October to mid December 1998 (Chart 65). That was a memorable milestone which imprinted deep in the memory of local investors and citizens.

Since 2000, after the economic revival, the foreign currency inflows started to increase fuelling the demand for national currency. Thus, the increasing monetary mass volume created monetary inflationary pressures which determined the National Bank to rely on buying foreign currency which permitted the consolidation of international reserves volume. The most interesting point is that the buying operations of foreign currency and, respectively, selling of national currency creates additional inflationary pressures which National Bank has to deal with. Therefore, in order to counter-balance its anti-inflationary policy, the National Bank intensified the sterilization operations of monetary mass.

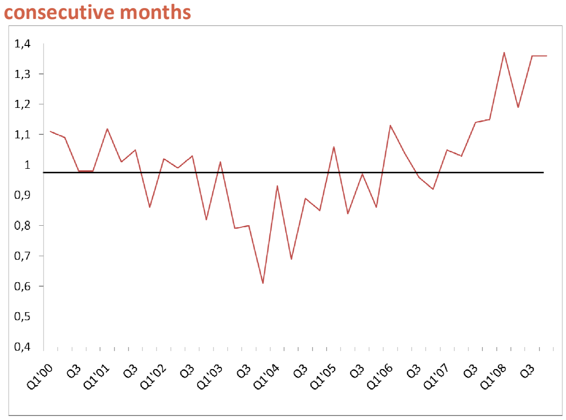
Another major driving factor which determined the central bank to rely intensively on foreign currency buying operations is the vital necessity for consolidation the international reserves level. According to the accepted norms, the optimal level of international reserves should not be lower than the volume of imports made during 3 consecutive months. Based on this criterion, Chart 66 denotes that during 2002-2007 this level was below the norm line which definitely justified the National Bank foreign exchange policy to focus on buying foreign currency. Since 2007 we see a positive evolution of the level of international reserves sufficiency which reveals the increasing capacity of the National Bank in managing various shocks and mitigating depreciation pressures on the national currency.

Chart 65. Moldovan leu exchange rate, MDL/USD, November 1993 – April 2009



Source: NBM

Chart 66. Ratio of International reserves to imports for 3 consecutive months



Source: NBM

The increasing discrepancy between monetary and foreign-exchange policies became more visible since the amendment to the Law on the National Bank of Moldova[54] in June, 2006 according to which the fundamental objective of the central bank became ensuring and maintaining the price stability. Despite the new legislative stipulation, the central bank continued to massively purchase the surplus of foreign currency creating additional monetary inflationary pressures.

[54] Modification in the art. 4 of the Law regarding the National Bank of Moldova no. 191-XVI of 30.06.2006

The 1998 financial crisis revealed the macrofinancial fragility of the country stemming from laggard structural reforms and depressed real sector. The financial crisis engendered deep economic and social consequences and has triggered the emigration of the Moldova labour force as a mass phenomenon. Moldovan currency continued to depreciate until January 2003, with the historical maximum of the official rate reaching 14.7838 on January 14. After that the leu started more sinuous evolutions, but following a generally declining trend. Remittances from the Moldovan labour migrants have been the main causes for this appreciation in 2003-2004, but in 2007-2008 other currency sources became more prominent: exports gains, FID inflows, and the official development assistance. The global financial crisis has triggered a reduction of the remittances which probably will remain on a downward trend at least the whole year 2009.

Challenges ahead

- The recent shrink in demand for national currency created pressures of depreciation of the Moldovan national currency. In order to mitigate it, since September 2008 the National Bank of Moldova has promoted an active policy of selling foreign currency which caused a gradual decrease in international reserves. Despite the fact that this tendency appears to be in line with imports' reduction and, therefore, the sufficiency level of international reserves was not significantly affected, the continuation of this trend due to the aggravation of the economic crisis could have negative repercussions on the national currency stability. Usually, the National Bank interventions on the foreign exchange currency market are justified by the necessity to attenuate some temporary fluctuations of the official exchange rate. This mechanism cannot be used for a long period of time simply because the international reserves are limited and a permanent decrease in their volume can significantly undermine the NBM capacity to manage other potential shocks. ***The depreciation pressures on the national currency and the decreasing international reserves serve as the major challenges for National Bank of Moldova for the next period of time.***
- The situation from 1998 should not be repeated. It served as an awakening lesson for Moldovan policymakers proving that keeping stable exchange rate of the national currency at the expense of international reserves is not a viable solution if it is caused by structural tendencies and not by temporary evolutions or seasonal factors. So far the National Bank of Moldova managed to form a strong "security shield" of international reserves offering the possibility to keep for a longer period of time the relative stability of the national currency. However, taking into consideration the current pace of diminishing international reserves, as well as the depreciation of currencies in our main trade partners' countries***, it is necessary to reorient the NBM efforts from maintaining the stability of the national currency to ensuring its gradual depreciation so that the internal situation on the foreign exchange market would be in line with the regional one.***
- As a result of intensification of sterilization operations by NBM in 2007 and tightening the monetary policy by raising the obligatory reserves and refinancing rates the crediting activity of commercial banks was undermined. Therefore, the money multiplier indicator has shown a decrease in 2007 and 2008 which made the banks more reluctant in crediting the real sector of the economy. The money multiplier can also be negatively affected by the massive sale of foreign currency which began in September 2008 and accelerated in the first months of 2009. Thus, ***a decrease in lending capacity of commercial banks revealed by the decreasing the money multiplier indicator represents a major challenge for the NBM monetary policy.*** Taking into consideration the recent decrease in inflationary pressures, the National Bank of Moldova can sequentially continue the relaxation of its monetary policy aimed at mobilization of long-term crediting resources of commercial banks and stimulation the real sector crediting.

Outlook for 2009

- As a result of the decrease in foreign currency inflows, caused by the decrease in volumes of remittances, foreign direct investments and exports in 2009 in comparison with 2008, it is expected that the national currency will depreciate by almost 20% until the end of 2009.

However, the NBM keeps the exchange rate under control and it is expected that it will ensure a gradual depreciation of the national currency on the account of its international reserves.

- A major warning for the monetary policy for 2009 is the anticipated increase in budgetary deficit which could lead to the decrease in confidence for national currency resulting in increasing additional depreciation pressures on the Moldovan "Leu".
- However, the depreciation pressures will be mitigated by the expected shrink in monetary mass (M3) by almost 25% during 2009, caused by NBM interventions on the foreign-exchange market, as well as by the decrease in current and time deposits and inflows of foreign currency.
- Consequently, the decrease in foreign currency inflows and NBM interventions for the sake of a relative stability of the national currency will cause the decrease in international reserves until the end of 2009 which could fall below the psychological level of 1 mlrd. USD. However, taking into account the decrease in imports, the volume of international reserves could remain at acceptable level, covering the imports volume for at least 3 consecutive months.
- It is likely that the NBM will continue the liberalisation of its monetary policy by reduction of refinancing rate and obligatory reserves rate. These actions appear to be logical taking into account the historically low inflationary pressures and the necessity to mitigate the effects of decreasing economy monetization.

12. Budgetary and fiscal policy

This chapter reveals the paradox of Moldova's fiscal-budgetary policy during the entire transition period: high tax burden and out of control budgetary deficit during the early transition period and, by contrast, low tax burden and controlled budgetary equilibrium until 2008. The chapter will review the causes of this paradox contradicting classical features of the fiscal-budgetary policy. A structural analysis denotes the increasing discrepancy between direct and indirect taxation, as well as the risks of excessive resorting to taxation of consumption. The chapter also includes an analysis of local public finances which became more centralized despite the already launched decentralization reform. There will be identified the main challenges which would negatively affect the budgetary equilibrium in the near future and the main policy recommendations in order to manage these challenges.

From budgetary instability to controlled deficit

Public finance has served as a mirror of the social and economic situation of our country during the entire transition period. Underdevelopment of the economy's real sector, high poverty rate and increasing social tensions, combined with a lack of expenditures' optimization and led to an explosion of budgetary deficits. Despite the fact that starting with the economic revival in 2000 there has been achieved a relative stability in the public finances, a deeper insight into the structure of public revenues and expenditures reveals major contradictions between fiscal and budgetary policies. E.g. in line with an increasing budgetary propensity to social expenditures we see a constant increase in the share of indirect tax revenues in total budget. It denotes the increasing dependence of public finances on taxation of consumption while proving the Government incompetence to sustain a direct taxation system of enterprises. Given the chronic insufficiency in public capital investments which could become a sustainable multiplier of public revenues on a medium perspective, the increasing discrepancy between direct and indirect tax revenues is a major factor undermining the principle of social justice in social protection policy. At the same time, the consumption based pattern of budgetary formation mitigated the first effects of the world financial and economic crisis on the public finances equilibrium during 2008.

During the first years of transition and until the end of the regional crisis from 1998-1999 the increasing budgetary deficit had been caused by the following set of major factors:

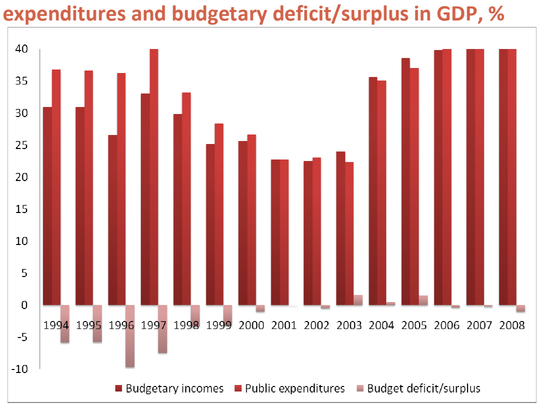
- ***Collapse in industrial and agricultural production***. The liberalization reforms implemented after the dismantlement of the Soviet Union caused a strong macroeconomic shock which negatively influenced the economic growth during the first years of transition.
- ***Tax exemptions, debt amnesties and tax avoidance.*** The ad-hoc decisions on tax exemptions and debt amnesties for many enterprises, made according to political or personal interests, eroded significantly the tax base. Additionally, the revenue rising capacity of the Government was undermined since the tax avoidance became widespread mainly due to high fiscal burden and deficiencies in fiscal legislation. The most relevant example was the VAT established in 1992, which, until the introduction of a new concept on value added tax in 1998, created wide opportunities for tax evasion[55].
- ***Lagging structural reforms.*** The policymakers did not ensure a continuation of liberalization reforms implemented in the first years of transition by rationalization of public spending. By 1999 the lack of structural reforms, excessive fiscal and administrative centralization, and inefficient public administration led to irrational social and public expenditures policies.

[55] The VAT principle in force during the period 1992-1998 offered many opportunities for tax evasion by speculating with the origin and destination of the goods imported or exported. It was possible due to a discriminatory principle of VAT assessment according to which imports from several countries were exempted from VAT, while the exports to several countries were subject to VAT.

- ***Government expenditure arrears.*** Under the constraints mentioned above, the Government failed to meet its payment obligations to employees, pensioners, other allowances earners, Government suppliers (energy companies). In fact, it meant the bankruptcy situation with investors pulling out of the Treasury bill market which made the Government to unilaterally borrow from employees, pensioners, energy companies. Although the increase in stock of Government's arrears was common for most of the former Soviet Union countries, in 1996 Moldova was on the top according to their share in GDP.[56]
- ***Increase in the public debt.*** The increasing budgetary deficit forced the Government to resort both on external and internal sources of financing which had its negative repercussions on the budgetary equilibrium since it implied costs related to interest rates payments on these debts. Thus, in 1999 Moldova's public debt share in GDP was among the highest in the region which determined the increase in the share of public expenditures for interest rate and principal payments in total public expenditures from 5.8% in 1996 up to 24.8% in 1999.

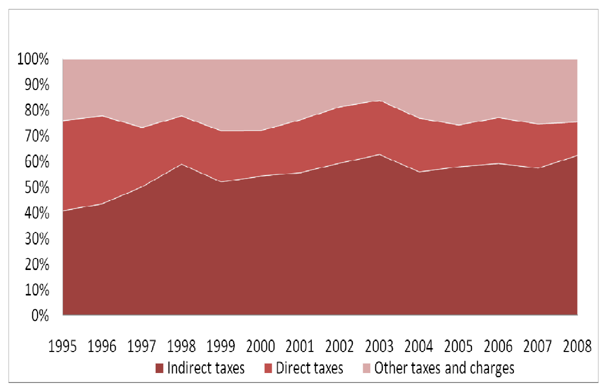
Chart 67 illustrates how the budgetary deficit switched from non-controllable values, reaching the maximum level of almost 10% of GDP in 1996, to acceptable limits. Thus, since 2000 the budget deficit has been under control and did not exceed the maximum level of 1% of GDP and during 2003-2006 there was registered even a budgetary surplus. This equilibrium was caused both by *market driving factors* – such as increasing the domestic demand and GDP growth - and by *policy driving factors* – such as the rationalization of public spending and authorities' commitment to clear the stock of arrears (in 1999 and 2000).

Chart 67. Shares of budgetary revenue, public expenditures and budgetary deficit/surplus in GDP, %



Source: NBS

Chart 68. Structure of budgetary revenues (% of total)



Source: NBS

Budgetary revenues: taxation of the consumption

The corporate income tax rate of 32% established in 1995 and the three-level progressive taxation (15%, 20% and 32%) of personal income were justified by the necessity to cover the extensive social programs, paying public debts and clearing up the Government's arrears. Due to the narrow tax base and low revenue raising power, undermined by the real sector collapse and inefficient tax administration, the Government did not succeed in sustaining a feasible direct taxation system. Thus, as the structure of budgetary incomes shows (Chart 68), the budgetary revenue policy became mainly focused on indirect taxation, VAT and excise duties serving as the major income sources. Since indirect taxes, by definition, are paid by consumers, their share in total budget increased in line with the remittances boom since 2000 reflected in increasing aggregate demand. Thus, despite the

[56] According to IMF data the share of consolidated general Government's stock of arrears (including only arrears for Social Protection Fund) in GDP was 11%, whereas this share in Kazakhstan was 5.4%, in Tajikistan – 5%, Ukraine – 4,6%, Uzbekistan – 3,6%, Russia – 3%. "Government Expenditure Arrears – Securitization and Other Solutions", Ramos, Alberto M., Working Paper No. 96/70

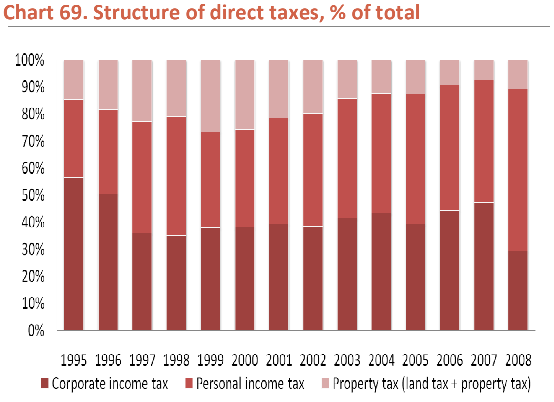
economic revival after the crisis from 1998-1999 the paradigm of public revenues collection based on indirect taxes has not change and the budget became even more dependent on VAT and excise duties.

During the transition period the importance of direct taxation decreased, its share in total budgetary incomes falling from 35.2% in 1995 to 13% in 2008. On the one hand this was caused by the relaxation of fiscal direct taxation policy with the main reasons to eliminate the tax evasion and stimulate the entrepreneurship. On the other hand it can be interpreted as Government giving up its efforts to sustain a direct taxation system and resorting more intensively to indirect taxes as a tool for benefiting from the increasing consumption.

As illustrated in Chart 69, before the regional crisis from 1998 the share of corporate income tax in total structure of direct taxes decreased due to the vicious practice of tax exemptions and debt amnesties applied to many enterprises based on political interests and personal connections which fundamentally undermined the tax base. It could be remarked especially in 1996 when the budget deficit as a share in GDP registered the highest historical value of -9.6%, mostly caused by a decrease in corporate income tax revenues by -3.9%, while other components of the budgetary revenue grew.

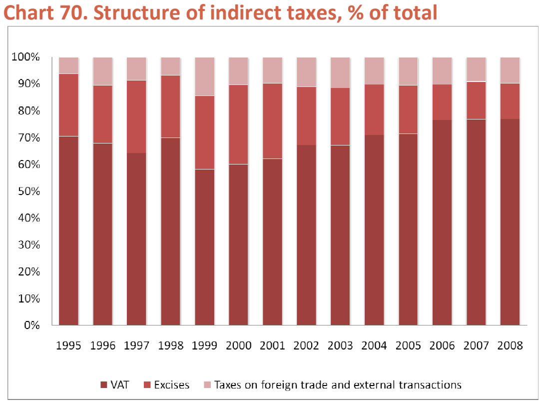
During the analyzed period the taxation of consumption has been the main pillar in collecting budgetary revenues. While in the first years of transition it was rather a necessity due to the collapse of the real sector, it seems that nowadays the Government aims at exploring the opportunities generated by an increasing aggregate demand as a result of the remittances' boom since 2000. Apparently, it is an obvious option of the Government which resorted to the simplest model of public revenues collection. However, the increasing share of indirect tax incomes in total budgetary revenues combined with the insufficiency of public capital investments can undermine the budgetary stability in a middle-term perspective. Finally, there is a contradiction between public revenues policy and public expenditures policy. Thus, while the first one is mostly based on taxation of the aggregate demand, the second one aims at stimulation of aggregate demand through extensive social programs.

Chart 69. Structure of direct taxes, % of total



Source: NBS

Chart 70. Structure of indirect taxes, % of total



Source: NBS

Chart 70 reveals that the most important component in the structure of indirect incomes is the VAT and it is applied both on goods and services produced within the economy and those imported. During the entire transition period the VAT share registered a permanent increase except the year of 1999 when the revenues generated by this tax decreased by -35.3% in real terms in comparison with 1998 as a result of the economic recession. Due to the economic revival and the increase in consumption, since 2000 the VAT has increased its share in total public revenues[57], rising from 28.8%

[57] The total public revenues were calculated taking into consideration the National Public Budget excluding the incomes of social and medical insurance funds.

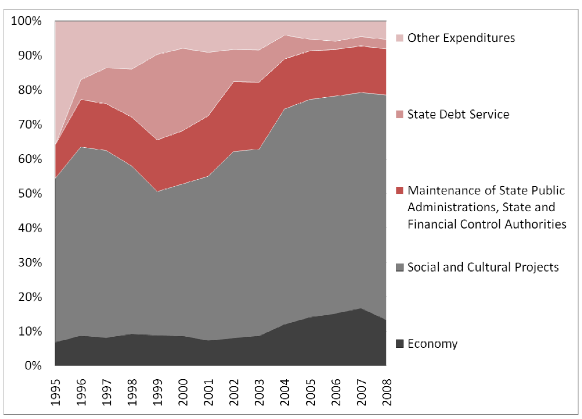
in 1995 up to 48% in 2008. This denotes a risky level which could distort the budgetary equilibrium after a potential decrease in consumption.

Public expenditures: choosing between social and capital investments

During the entire transition period the national budget preserved its social propensity as revealed by the high share of social expenditures in total public expenditures (Chart 71). However, the pattern and circumstances which influenced the extensive social programs changed during this period. Thus, in the first years of transition it was justified by the acute necessity to mitigate the social shock of economic liberalization and to attenuate the social tensions. As a result, in 1997 – the first year of positive economic growth since the independence – the share of expenditures for social assistance in total public expenditures increased up to 12.6% from 1.9% in 1996.[58]

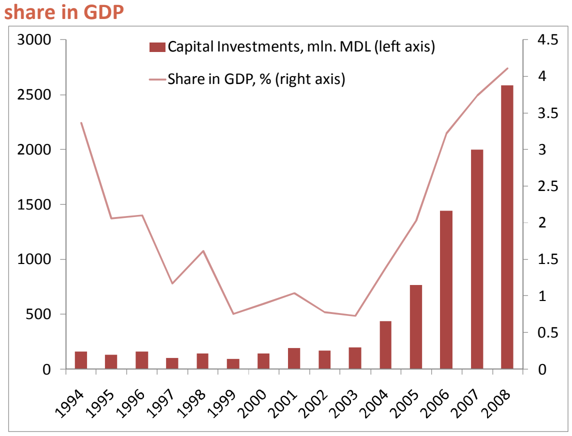
However, another major factor which caused the increase in social expenditures was lagging of structural reforms aimed at rationalization of public sector activity. Thus, the share of public expenditures for health and education sphere in 1996 reached 17% of GDP, among the highest in the region[59]. Not surprisingly, the share of budgetary deficit in GDP in this year reached its historical record. Therefore, given the budgetary constraints, the Government was forced to rely on unpopular reforms aimed at rationalizing public expenditures through freezing public wages, optimization in the education and health care system. These reforms decreased significantly the budget deficit share in GDP until -3.2% in 1999 despite the effects of the recession of 1998-1999. Chart 71 also illustrates the decrease in the share of public expenditures for social and cultural projects since 1996 until 1999.

Chart 71. Structure of public expenditures, % of total



Source: NBS

Chart 72. Evolution of capital investments as volume and share in GDP



Source: NBS

Resumption o f the economic growth offered the possibility to increase social public expenditures and to clear up the stock of Government arrears, especially for wages and pensions. Therefore, after 2000 we see an increasing budgetary propensity to social programs and as a result, since 2002, the social expenditures formed more than a half of total public expenditures.

Although the increase in social expenditures seems to be a rational one, given the positive economic growth and increase in total public revenues, the Government's passive investment policy in contrast with an active social policy could negatively affect the budgetary equilibrium in the mid-term. The main cause consists in the Government's reluctance to promote unpopular reforms switching its public expenditures propensity from social to an investment one, which supposes the increase in

[58] Total public expenditures on social assistance increased from 53.7 million MDL in 1996 up to 455.6 million MDL in 1997, *Ministry of Finances of the Republic of Moldova.*
[59] Republic of Moldova: Recent Economic Developments, IMF Country Report, 2001.

investments in economic activities. The active supply side policy would serve as a durable multiplier of public finances on a mid-term perspective by broadening the national tax base and increasing the Government revenue rising power after the consolidation of direct taxation system of enterprises. However, as Chart 72 shows, with a low share of public capital investments in GDP the Government is more passively contemplating the capital investment.

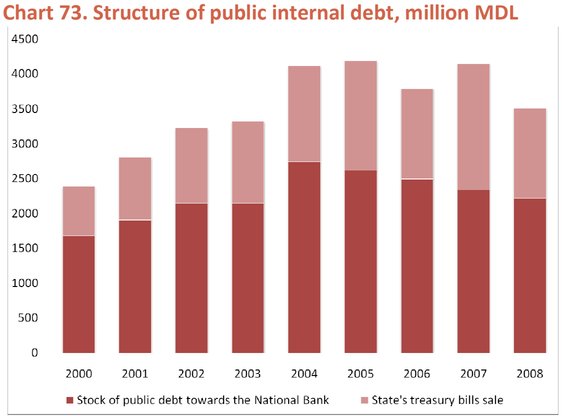
Financing the budget deficit

Given the low development of local capital market during the yearly transition period the main source of financing were the World Bank external credits, while the central bank internal credits had a lower share.[60] However, during this period there were other sources of financing, such as privatization receipts which in 1997 reached the level of 2.4% of GDP, or Government arrears on wages, pensions and energy suppliers which led to an unprecedented budgetary deficit reduction[61].

Since 2000 the pattern of budgetary deficit financing has fundamentally changed by replacing external source of financing with the internal one and inflationary financing with non-inflationary one. Chart 73 reveals the increase in the stock of public debt towards the central bank since 2000 until 2004. It was caused by the fact that during the period 2000-2002 the budgetary deficit was financed mainly by National Bank credits aimed at supporting the Government in external public debt payment. Afterwards, the Government did not resort to central bank crediting and was focused on clearing up its debt towards National Bank, except the 2004 year when a 50 million USD credit was contracted from the central bank for paying external public debt.

From 2005 until 2008 the public debt stock towards NBM had constantly diminished. The deficit had been financing exclusively through the State's Treasury Bills which represents an efficient non-inflationary means of financing. It culminated in 2008 when the entire Government's debt for National Bank was converted into treasury bills.

Chart 73. Structure of public internal debt, million MDL



Source: NBM

Illusory local fiscal autonomy

The importance of administrative and fiscal decentralization was firstly stipulated in the country's supreme Law – the Constitution[62]. However, the recent Law on Administrative Decentralization and the Law on Local Public Administration (2006), as well as the Law on Local Public Finances (2003) did

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[60] In 1999 the share of central bank credits in total budgetary deficit financing was 30%, which was 1,6% in GDP, according to the IMF Country Report No. 01/22, 2001.

[61] The stock of arrears increased from 7.9% of GDP in 1995 to 10.6% of GDP in 1998 according to the IMF Country Report No. 01/22, 2001.

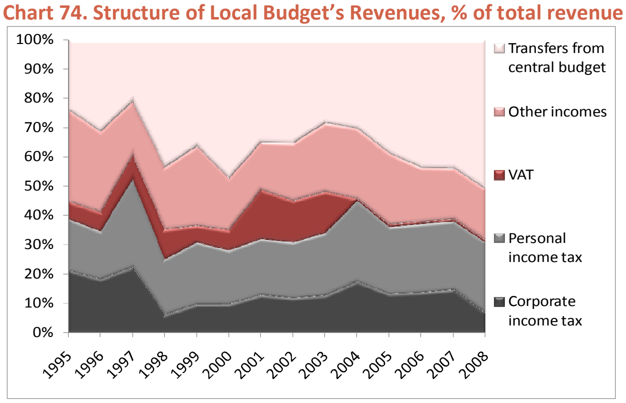
[62] The article 109 from the Constitution of the Republic of Moldova stipulates the necessity for administrative decentralisation and introduced the concept of local autonomy, inclusively in local expenditure assignments.

not facilitate the fiscal decentralization process, keeping local governments highly dependent on the Government. Thus, despite the express stipulation of expenditures commitments of local public administrations and delegation of responsibilities to local governments, the main deficiency of this legal framework remained the high centralization of public finances.

The increasing centralization of public finances is revealed by the share of local public revenues in GDP that has constantly decreased from 23% in 1994 to 9.8% in 2008. It was mainly caused by the gradual relaxation of the direct taxation policy and elimination of VAT (since 2004)[63] incomes from the revenue sharing system, which accounted for a half of local public incomes until 2004 (Chart 74). Consequently, the transfers from the central budget increased as a share of local revenues, which led to a decrease in local budget revenues without transfers from central budgets by 4% in comparison with 2003.

Thus, the narrow tax base and poor revenue raising power at local level became a chronic problem for local governments during the entire transition period; they were unable to manage the expenditure responsibilities delegated from the centre thus giving rise to unfunded mandate.[64] As a result, local budgets became highly dependent on transfers from the central budgets which form the major share in local budgets' revenues and are intended mainly for paying administrative costs for education and health services. Therefore, local governments mostly act as disconcentrated institutions of the central Government aimed at a banal redistribution of central public finances.

Chart 74. Structure of Local Budget's Revenues, % of total revenue



Source: NBS and Ministry of Finances

Social and health insurance funds

Despite the reform of the pay-as-you-go pension system which formed a better targeted scheme of social assistance and separated the social protection from social insurance, it couldn't ensure decent pensions which would cover even the minimum living level. Besides high social contributions, which stimulated the tax evasions, the social fund, during the entire transition period proved its inability to meet its payment obligations and, therefore, it permanently resorted to allocations from the central budget. Additionally, the worsening of the demographic situation and population aging has increased the pressures on the fund, undermining the efficiency of social assistance programs. The medical compulsory insurance has also some similarities with the social protection system being formed on the basis of medical premiums collected from those employed. The introduction of the medical

[63] According to the art. 38 of the Law on Local Public Finances, the VAT incomes were shared with local budgets of 2nd tier only until 2004, while the 1st tier local budgets were forming directly from VAT collected from local administrative units.

[64] The phenomenon of unfunded mandate appears when local governments are delegated with a bulk of responsibilities without ensuring an adequate financing.

insurance fund (2004) eliminated the responsibility of local governments for covering the expenditures related to health care services. Thus, the share of these expenditures in total local budgets' spending decreased from 22.6% in 2003 to 1.8% in 2004.

Challenges ahead

- The current pattern of budgetary formation, excessively based on indirect taxes, and the low budgetary propensity towards capital investments as a multiplier for budgetary revenues on a mid-term perspective, can negatively affect the budgetary equilibrium on a mid-term perspective. Taking into consideration the world economic crisis repercussions, in short-run consumption-based budgetary revenues are more secure then a budget highly relying on direct taxation. The main reason is that consumption is less sensitive to the economic crisis constraints than the enterprises and, therefore, it mitigated the reduction in budgetary revenues during the first world economic crisis effects. However, the recent trend of decrease in remittances and the possibility of freezing wages and pensions negatively affecting the domestic demand will have negative repercussions on the budgetary incomes in the near future. Therefore, in the short-run it is necessary ***to consolidate the direct taxation system as an important pillar for budgetary formation which would diversify the public income sources and broaden the national tax base. It could be achieved by implementing a 15% corporate income tax and improving the administration capacity for tax collection. Additionally, the economic crisis repercussions will be mitigated by the reanimation of consumption in the short-run by decreasing the VAT. On the mid-term a more consequent budgetary-fiscal policy it is necessary aimed at promoting an active investment policy gradually switching the budgetary propensity from social to capital investment and would increase the employment rate.***
- The relaxation of direct taxation fiscal policy for economic agents and establishing a zero corporate income tax in 2008 has diminished the participation of the economy's real sector in the redistribution channel of public incomes directed towards social assistance programs. Therefore, the consumers and wage-earners become the main sponsors of the Government social protection system which undermined the social justice principle of the social policy. ***Given the high social taxes and the social fund's impossibility to become self-sustainable without resorting to transfers from the central budget a reorganization of the social protection system is necessary. Its efficiency will be ensured by a gradual decrease in social contribution which would minimize the tax evasion and ensure a more active participation of the real sector in the redistribution schemes. The pressures on the social fund would be significantly diminished with a gradual implementation of the 2nd and 3rd pillars of the pensions system.***
- Given the increasing fiscal centralization, eroding the local tax base after elimination of VAT from public incomes sharing system and establishing a zero corporate income tax which fundamentally deteriorated the revenue rising power of local governments ***a more consequent reform aimed at ensuring the decentralization of public finances is necessary. Therefore, it is necessary to complete the Law on Local Public finances with additional local income sources, such as: sharing 20% from the central budget of VAT collected locally; consolidation of the 15% corporate income tax; improving the Law on Capital Markets by a clear stipulation of conditions for borrowing through treasury bills by local governments.***

Outlook for 2009

- Decrease in consumption and the shrinking economy's real sector will cause a dramatic decline in public revenues. Thus, the main income sources for the state budget, VAT and excises, will decrease by approximately 20% and 15% respectively which, along with the diminishing of other sources of income will cause a decrease in total public incomes by almost 25%-30% at the end of 2009. It will undermine the Government's capacity to meet its expenditures responsibilities, and thus should motivate the optimisation of public expenditures during 2009.

- However, the political crisis will cause the lagging of implementation of measures aimed at public revenues reduction, which means that the aggravation of political crisis will multiply the economic crisis repercussions on the public finances system.
- We expect that anti-crisis measures which will be implemented by the newly created Government will imply several unpopular reforms, among which would be the reintroduction of 15% corporate income tax, increase in excises for several products with inelastic demand (tobacco, alcoholic beverages), reduction of expenditures for many infrastructural projects, as well as diminishing transfers to local governments and other state institutions.
- One of the most unpopular measures which the Government could implement is financing the budgetary deficit through unilateral crediting on the account of payments due to pensioners, public servants, employees in education, health and social spheres and energy companies. It would imply the increase in arrears for paying wages, pensions and bills for the above mentioned persons which will obviously lead to intensification of social tensions within the country.
- It is unlikely that the Government will resort to the budgetary deficit financing from NBM credits. Generally, the Government is balancing between two contradictory forms of deficit financing: on the one side it could be a sharp reduction of public expenditures, inclusively for those related to social assistance and wages (unpopular reforms), and on the other side – direct financing from NBM credits which would permit the Government to meet its expenditure responsibilities which, despite the inflationary pressures created within the economy, implies less political costs. However, the political costs resulted after the implementation of unpopular measures by the Government at the beginning of its mandate (first two years) are, by definition, not so dramatic than it would be for a Government in the last years of activity. Other reasons for not resorting to NBM direct crediting are as follows: 1) it is prohibited by the new Law on NBM adopted in 2006; 2) it goes in contradiction with the IMF principles of deficit financing which have to be followed by the Government in its relations with this international organisation.

13. Financial markets

The current chapter is focused on the analysis of the following three main financial markets: the banking system, the capital market and the insurance system. Main issues that are studied based on the official statistical data, national and regional research reports and comparative analysis refer to the evolution of the named markets beginning with the early transition of Moldova to the current trends. What needs to be stressed is that all three markets evolved and have registered important developments, although the banking system has developed the most and currently holds 80% of the financial markets as a whole.

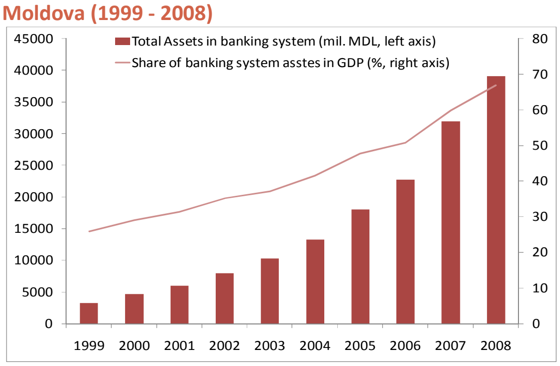
Banking system

The banking system in Moldova has considerably developed since the declared independence. The main areas of evolution were related to: the creation of the legislative framework for the functioning of the entire system; systemic development, meaning the development of the whole banking system, the regional and international impacts; structural evolution, by diversification of services, capital and the liaison with the domestic economy.

From the legislative point of view during the analyzed period was created the foundation of the entire system and its structure, as well as established the main empowerments of the National Bank of Moldova as banks supervisory authority. Even though with considerable delay, in 2007 the law on National Commission for Financial Markets was adopted. Thus, a number of very important laws and standard acts were developed and adopted for the efficient development and activity of the banking system, as well as important amendments to the existent acts were passed to harmonize the domestic legislation with the directives of the European Union and the international standards.

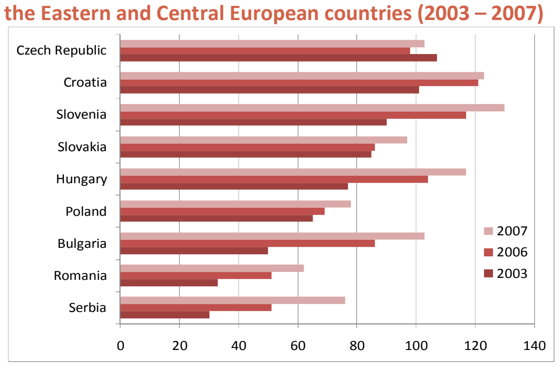
From the systemic perspective, the banking sector has progressively evolved since the 1999 to present (Chart 75), with the banks penetration ratio increasing from 26% to 67%.

Chart 75. Evolution of the banking sector penetration in Moldova (1999 - 2008)



Source: NBM and EG calculations

Chart 76. Evolution of the banking sector penetration in the Eastern and Central European countries (2003 – 2007)



Source: Deloitte and EBRD

Other countries of the region have known similar evolutions, according to the data provided by Deloitte and EBRD (Chart 77), although the growth of the penetration level of the banking system, shown by the ratio of the total banking assets to the GDP, had different trends. While the banking sector in Moldova has the greatest share in the financial sector of the country, it is still very small compared to other countries. Total assets and credit to the private sector have doubled since 2001, however it still remains modest (Table 4).

Table 4. Moldova main banking system indicators, 2004 – 2008, %

	2004	2005	2006	2007	2008

Depth of the banking system					
Total banking assets/GDP	42	48	52	54	67
Lending/GDP	23	27	31	33	44
Deposits/GDP	30	37	39	40	49
Concentration					
Equity/Total banking system	42	42	40	40	61
Total assets/Total banking system	52	52	48	48	64
Total loans/Total banking system	50	48	46	46	47
Deposits/Total banking system	57	55	51	52	67
Ownership as a ratio of assets					
State ownership	18	19	15	15	15
Majority foreign owned, *out of which*	34	20	23	23	23
Subsidiaries of foreign banks	4	4	12	22	22
Capital adequacy ratio	31	27	28	27	29
Dollarization					
Foreign currency loans/Total loans	42	37	38	40	40
Foreign currency deposits/Total deposits	42	39	49	48	46

Source: NBM and EG calculations

It is worth mentioning that as a result of the effected amendments to the regulatory framework, the foreign participation in the banking sector's assets increased from 49% in 2004 to 72.5% in 2008, however a large part of non-residents own only minority shares in banks. Majority foreign owned banks represent only 23% of the sector's total assets and according to the recent IMF assessment of the banking sector of Moldova, „the majority of foreign holdings belong to investors that are not internationally highly-rated financial institutions, with a significant percentage of the owners being residents in offshore centres"[65].

Structural changes and trends

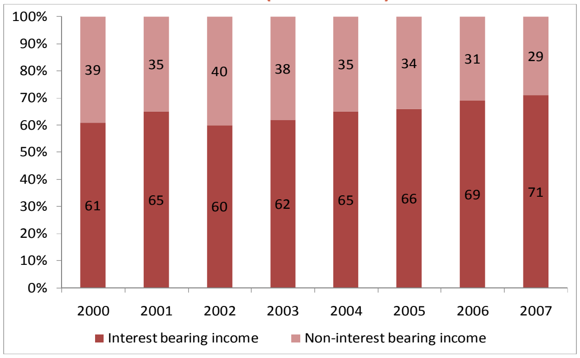
From the structural point of view the evolution of the banking system in Moldova may be characterized by a number of representative indicators some of which are presented further on. The total income of the commercial banks has registered an annual growth of 25.5% on average since 2001 to the present.

According to the data provided by the National Bank of Moldova the interest and the non-interest bearing income had different trends. The interest bearing income registered a growth during 2002 – 2007 from 60% to 71% of the total income and the non-interest income decreased from 40% to 29%, (Chart 77). The increase of the bank lending has been accompanied by the promotion of an ever restrictive policy of the National Bank which has shifted in 2006, through the Law no.191-XVI as of 30.06.2006, its policy targets from maintaining the stability of the national currency towards the insurance and maintenance of the prices' stability.

At the same time the deposit growth has been higher than the loan growth, lowering the loan/deposit ratios bellow the 100% barrier (Chart 78). The main drivers for the loan growth for 2008 according to the data provided by the National Bank of Moldova were the loans for trade and industry - 49%, followed by the construction, roads and real estate loans – 15%, the loans for agriculture and food industry – 13% and the consumer loans – 12.9%. Partly, the increase of lending has been determined by the increased commitment of the external partners, as for instance the EBRD, to lend for the financing of regional development projects, rural infrastructure, SMEs, road construction, etc.

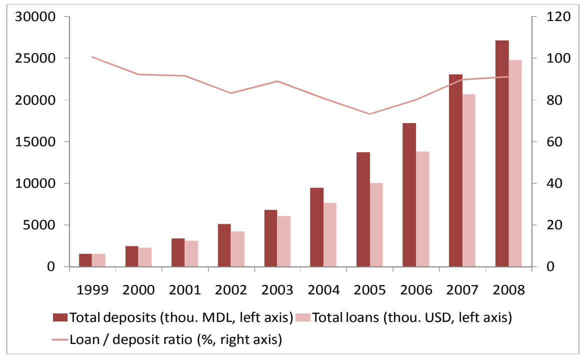
[65] Republic of Moldova: Financial System Stability Assessment—Update, IMF Country Report No. 08/274, August 2008.

Chart 77. Share of the interest and non-interest bearing income in total income in % (2000 – 2007)



Source: NBM and EG calculations

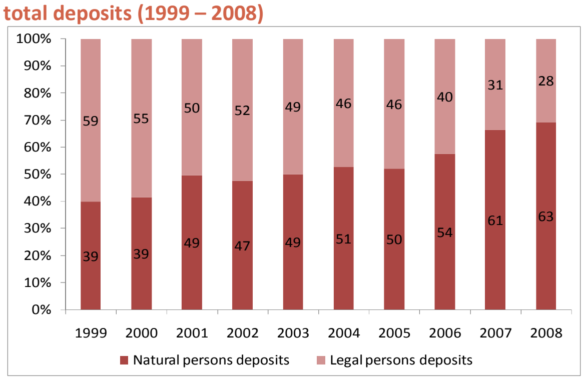
Chart 78. Loan to deposit ratio (1999 – 2008)



Source: NBM and EG calculations

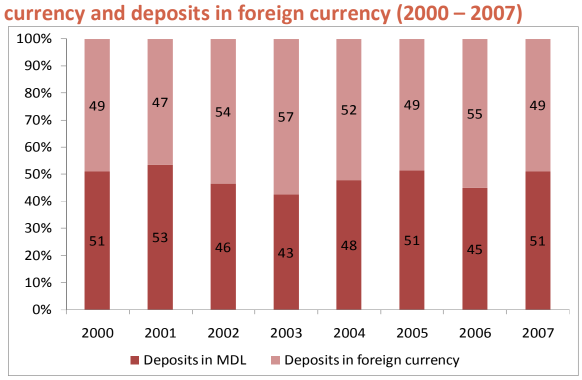
Both previous charts show a steady growth of loans and deposits meaning that the overall confidence in the banking system has improved over the analyzed period. This tendency is confirmed by evolution of the natural and legal persons' deposits in the total deposits (Chart 79). According to the data of the National Bank of Moldova, the share of natural persons' deposits in the total deposits of the banking system augmented from 39% to 63% during 1999 – 2008 as a result of the significant increase of remittances, as for the legal persons the same indicator has decreased from 59% to 28%, mainly as a result of reinvestment in their activity. During the analyzed period it has been observed a relatively steady trend in the currency in which the natural persons' deposits are made (**Error! Reference source not found.**).

Chart 79. Share of natural and legal person's deposits in total deposits (1999 – 2008)



Source: NBM and EG calculations

Chart 80. Share of natural persons' deposits in domestic currency and deposits in foreign currency (2000 – 2007)



Source: NBM and EG calculations

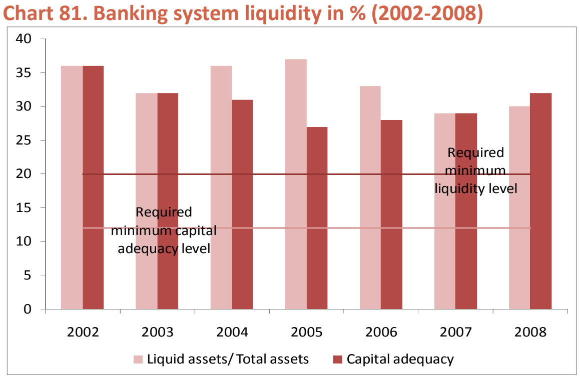
Analysis of the banking system liquidity and the capital adequacy ratios for the period of 2002 – 2008 shows that both indicators are high above the required minimum level (Chart 81). Although high capital adequacy and liquidity serve as reliable cushions in cases of possible distress, they also indicate weaknesses in operating and risk management capacity. The average capital adequacy rate continues to be high – 29.2%[66], although the minimum required level is 12%. According to the IMF evaluation of the banking system, only some 10% of rural households have access to bank accounts.

The capitalization level of banks registered a positive growth by 12.7% and reached 5890 million lei in the first semester of 2008 compared to the previous year. This shows a positive trend towards the consolidation of the banking system and therefore a higher ability to cover potential losses. The current liquidity level on the banking system represents 28.8%, which is in line with the NBM requirements (liquid assets/total assets × 100% ≥ 20%).

[66] Situation of the banking system for the first semester of 2008, NBM, July 2008

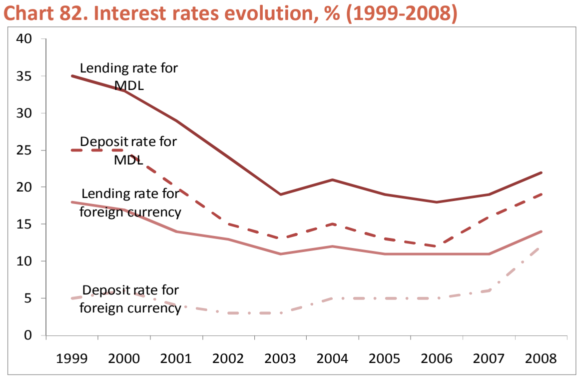
The following tendencies have been noticed as it regards the lending and deposit rates in MDL and foreign currency for the period of 1999-2008: stable decrease of the lending and deposit rates for MDL, slow decrease of the rates while lending in foreign currency and relatively stable rate for deposits in foreign currency (Chart 82). One important issue though is that the interest rates for deposits in foreign currency practically doubled in 2008 compared to 2007, as the banks were interested to attract more deposits in foreign currency.

Chart 81. Banking system liquidity in % (2002-2008)



Source: NBM and EG calculations

Chart 82. Interest rates evolution, % (1999-2008)



Source: NBM and EG calculations

A positive development is the fact that in recent years, banks have introduced more advanced payment instruments, such as internet banking and payment card schemes. Currently, 12 commercial banks issue payment cards of international brands (VISA and MasterCard), which are used mostly for cash withdrawals from automated teller machines.

The access to financing is dominated by banking loans holding 80%, while the non-banking financial market holds only 20%[67]. This reflects a higher development of the banking market although there is still place for improvement and further development.

Capital market

The level to which the capital market evolved represents an important proxy of the overall economic condition of the economy and its sustainability. The capital market in the Republic of Moldova appeared as a result of a rapid process of privatization and institutional development in the period 1992-1996. The evolution of the capital market since 1992 until present witnessed a general growth and development tendency both as it regards the evolution of the constituent segments, as well as it regards the main actors. The main three segments of the market analyzed are corporative shares, stock issued by banks and state securities.

As many as 1,726 sets of shares with a total value of over 10 billion MDL, issued by joint stock companies, were registered in the State Securities Register of the CNPF during the period 1998-2008, according to the data of the NCFM. During the mentioned period, there had been registered 11 sets of bonds with a total value of 36.7 million MDL. In 2007, the value of transactions reached the highest level in the history of the national capital market. There were traded 193.3 million shares worth 1.863 billion MDL. In 2008 fifteen companies have been quoted on the Moldova Stock Exchange. The largest volume of transactions during the past ten years was recorded in 2007 - 1233.4 billion MDL, mainly due to the direct transactions conducted on the Stock Exchange (1025.4 billion MDL).

[67] Report on the implementation of the Strategy on the Economic Growth and Poverty Reduction, Government of the Republic of Moldova, 2007

The foreign investments attracted through the issuance of shares in the second quarter of 2008 totalled 212.85 million MDL, an increase of over 15 times as compared with the same period of 2007. Foreign investors have been more active as it regards the investments attracted, namely they accounted for 75.33% of the investment attracted through corporate share issues, compared with the national investors – with 24.67%. Foreign investments grew and diversified in geographical terms. The shares of the commercial banks continuously attracted increased attention of the foreign investors over the last ten years.

Until the end of 2007 the trading continued to be quite intensive (for the local standards, of course) reaching at the end of the year the total sum of 1.23 billion lei (109 million US$). This can be considered a historical achievement for the Moldovan Stock Exchange, considering that, from the start of the trading activities on the exchange in 1995 until now, the entire trading value had only reached the sum of 4.37 billion lei, the equivalent of USD 407 million. The trading value reached such a peak in 2007 because of a number of important transactions with stocks of three important commercial banks. The shares of the banks traded on the exchange made up to 60 percent of the total trade volume o the exchange. The general overview of the transactions on the stock market is presented below and describes the general growth tendency (Table 5).

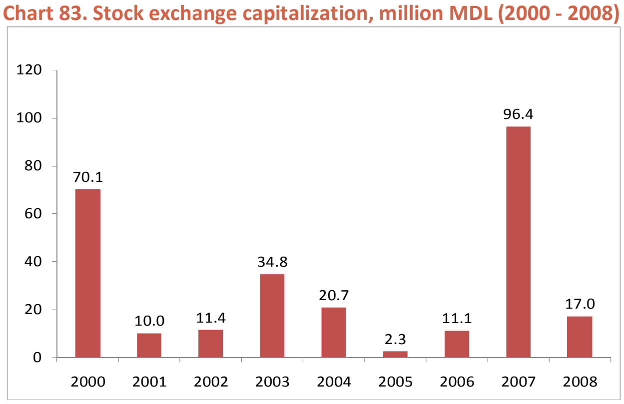
Table 5. Evolution of the number and volume of transactions on the stock market (2000-2008)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
No. of transactions, thousand	87378	71783	59462	54490	60917	34633	23216	42699	50774
Volume of transactions, million MDL	288.5	275.5	252.6	480.3	281.9	216.3	342.9	1233.3	996.7
Volume of transactions, million USD	23.9	21.4	18.3	36.4	21.7	16.6	30.3	109.1	93.33

Source: Annual Statistics of the Moldova Stock Exchange

The number of brokerage companies registered with the stock exchange in 2008 constituted 25 companies, out of which 13 commercial banks. On the core exchange segment, the total turnover for the 2008 constituted 136 million MDL in comparison with the 208 million MDL for 2007. The stock exchange capitalization for the period 2000-2008 has fluctuated considerably, but increased significantly in 2007 due to the accession of Romania and Bulgaria to the European Union, as reflected in Chart 83.

Chart 83. Stock exchange capitalization, million MDL (2000 - 2008)



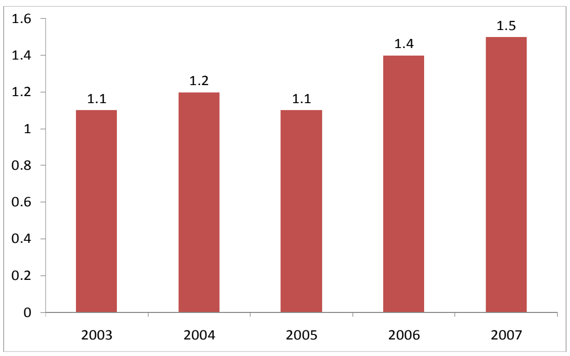
Source: NCFM and EG calculations

The global economic and financial crisis has already affected the national capital market. The value of transactions decreased considerably at the beginning of 2009, bottoming at 9.94 million MDL. The key indicators, as for instance the market capitalization, the EVM-Composite index, number of transactions, number of companies on the stock exchange, decreased significantly in February 2009. The price of the shares of several national banks has decreased significantly.

Insurance market

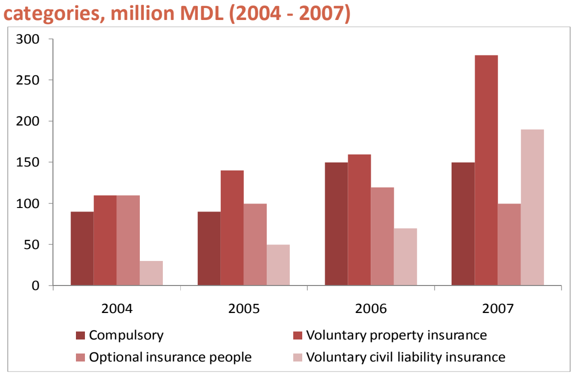
The analysis of the official statistical data shows an ascendant evolution of the insurance market in the Republic of Moldova. In the period 2003-2007 the weight of insurances in the GDP, in %, increased on average by 6.25% per year, which is relatively modest compared to the regional tendencies. The level of penetration of the insurance products in the GDP in 2006 has been lower than the same indicator for Romania, and constituted 2% - which is much lower than the EU level. According to the Roland Berger estimates, the insurance premiums per capita for 2008 in Romania represent one third of the value in Slovakia or Hungary, leaders being Germany and Poland. Nonetheless, there can be noticed a slow upward tendency, as shown in Chart 84.

Chart 84. Share of insurances in the GDP (2003 - 2007)



Source: NBS and EG calculations

Chart 85. Evolution of the insurance premiums for main categories, million MDL (2004 - 2007)



Source: NBS and EG calculations

The most important evolution in the period 2004-2007 has been registered by the optional insurance of goods, which grew in the same period by 2.3 times (Chart 85).

Insurance companies subscribed in 2008 premiums valued at 833.3 million MDL, which is with 13.1% more compared to the 724.2 million MDL subscribed in the previous year. Injuries were settled valued at 269.4 million MDL, 12.7% increase compared to 235.3 million MDL in 2007. The highest ratio of inflows of premiums is attributed to mandatory auto insurance, AUTO-CASCO insurance, voluntary insurance of persons and property insurance. The named insurance products represent 87% from the total amount of subscribed premiums. The diversification of the insurance products represents an important target for the national insurance market. The diversification shall go hand-in-hand with the development and implementation of the legal framework of insurance. New mandatory insurance products have rather important potential, as evaluated by foreign experts, as for instance insurances in agricultural sector which have been made mandatory for the countries accessing the EU. Some other products are welcomed, including insurance in case of floods.

The number of insurance companies decreased in time due to increased competition and legislative reforms affecting the minimum statutory capital. The analysis of the core indicators on the activity of insurance companies demonstrates a continuous increase of the statutory capital by approximately 63% for the period 2003-2006. In the named period two companies gained the most important share of the market and the highest evaluation in terms of sustainability – e.g. Moldasig and ASITO.

Challenges ahead

- ***Impact of the world financial and economic crisis,*** which according to the experts in the field and the effected analysis by the World Bank and the International Monetary Fund in 2008, already affected the Moldovan banking system. The decreasing trend of lending is a direct result of the named impact. The extent to which the banking system will be affected by the economic crisis remains to be largely discussed and the specialists' opinions are diverse.

Although the capital market in Moldova is at its early stage of development, the global economic crisis and slowdown is to influence the national conditions, especially as it regards the foreign investments which proved to be an important element in the development of the market.

- ***Banking opportunities are scarce***, which prompts most banks to avoid specialization. Corporate banking is the main source of revenues, whereas retail banking plays primarily a funding role. The involvement of banks in financial service such as capital markets, leasing, factoring, or insurance is low. Cash is still the major payment instrument in Moldova, particularly for payments among individuals. Credit transfers are the major payment instruments among legal entities. However, the named payment instruments are still underdeveloped and far behind the services offered by the banks of the EU member states.
- ***Weak diversification of the financial instruments*** creates new possibilities for investors, national and foreign. At present only shares are traded on the securities market and diversification is needed in order to attract new investors. Important actors, as for instance, commercial banks and leasing companies, are waiting for the emergence of bonds. The bonds represent a product which is wanted by the institutional investors (including private pension funds) and their introduction is part of the national strategy for the development of the non-banking financial market for 2009-2012.
- ***Insufficient transparency of the national capital market****, informational asymmetries* and *information of the public*, these are important challenges that need special attention and correspondingly an important step would be to implement a joint informational system with the territorial agencies and the main supervisory authorities.
- ***Weak promotion of the insurance sector is a serious problem*** which should be solved both through the effort of public and private entities, popularization of the main categories of insurances, so that to gain the confidence and raise the awareness of the population; as a result of the conducted analysis only the life insurances in Moldova are rapidly gaining weight in the last 5 years (by over 54% on an annual basis), other categories shall be further promoted.
- ***The impact of the new Law on insurances***, entered in force on April 6, 2007, has radically changed the national regulatory system. The provisions of the law will definitely have a major impact on the insurance market and all active actors, to mention for instance the provisions regarding the re-insurance, RCA tariffs and other.

Outlook for 2009

- Despite the financial crisis, the banking sector in Moldova is expected to remain stable in 2009 and to avoid any liquidity-related problems both at individual banks' and system level.
- As central bank reduces the interest rates on its monetary policy instruments (REPO, obligatory reserves), the commercial banks are expected to lower the interest rates on loans as well.
- However because of the confidence problems, the banks are expected to maintain a cautious approach to lending and to rationalise the credits. Therefore the credits stock per economy is expected to remain at the previous year level.

14. Foreign trade: connecting markets

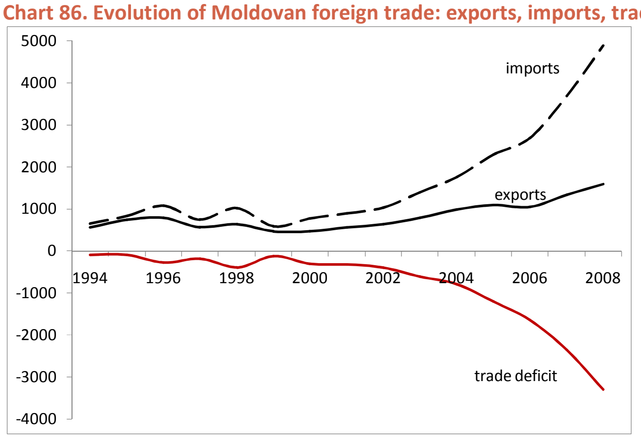
This chapter traces main transformations and trends followed by Moldovan foreign trade in the last 15 years. It shows how much geographical and product composition of trade has changed in the aftermath of country's trade liberalization. It also outlines main shocks and contentious issues faced in the process. Integration in global trade architecture has not been an easy walk and there are no reasons why it should be. Thus, the end of chapter is dedicated to the main challenges to be tackled in the near future.

A difficult start…

As many other transition economies Moldova followed difficult transformational path of an economy deeply integrated in fSU economic and trade system to a liberalized and open one. The evolution of Moldova's foreign trade reflects to a large extent the path followed by the Moldovan economy and main shocks that hit it. While the drivers behind it have varied across different periods of time one defining feature for evolution of Moldovan foreign trade has been soaring trade deficit.

In 1994-1999 both exports and imports followed more or less similar oscillating trends (Chart 86). Evolution of exports was by far and large determined by decline in real sector magnified by external shocks (starting from changing terms of trade in the wake of the Soviet Union demise and Russian financial debacle of 1998). As domestic economy remained depressed (putting aside brief growth episode of 1997) the exports remained sluggish and fluctuated around the more or less same levels. At the same time, the low domestic demand and dwindling disposable income of poverty-ridden population restrained growth of imports. Indeed, Moldova was one of the most exposed victims of the Russian financial crash. In its aftermath Moldovan exports nosedived, while slump in real household incomes thwarted imports.

Chart 86. Evolution of Moldovan foreign trade: exports, imports, trade deficit, 1994-2008, million USD



Source: Comtrade database, NBS

The slow but steady growth of the trade flows at the background of economic recession and rising poverty was mainly supported by gradual liberalization of Moldova's trade regime. The trade liberalization went a long way in those years. For instance, in 1993 tariffs applied could reach 300%, while in 2001 in the wake of the WTO accession the bound rates were established at the level of 35%[68]. In Moldova's case the bound rate represents rather a ceiling than actual rates applied, i.e. the tariffs applied could not exceed 35%, while usually were much lower. It also should be mentioned that Moldovan exports enjoyed much favourable trade regimes in the CIS countries, since by the

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[68] Republic of Moldova: Trade Diagnostic Study, World Bank, December, 2004.

mid-90's Moldova signed free-trade bilateral deals with all trade partners from this area. In 1994 similar free-trade agreements were also signed with Romania and Bulgaria, which also stimulated trade with these two countries.

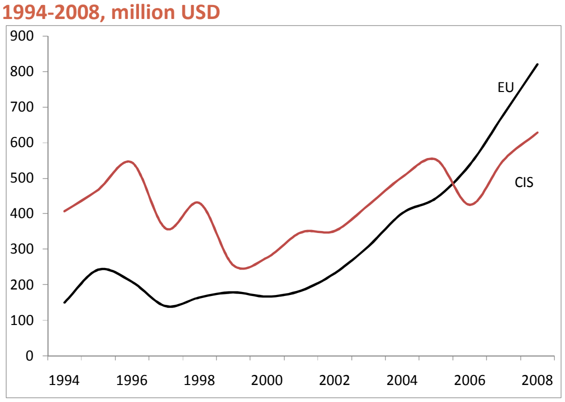
A new dawn…

However, starting 2000-01 the exports set on the recovery path propped up by growing external demand supported by region-wide economic recovery that followed crashes of the end of 90's. Indeed, if in 1994-2000 the average annual rate of exports was slightly negative (-0.64%), then starting 2000 up to 2008 the same indicator reached almost 17%. Moreover, if up to 2000 both exports and imports had similar oscillating trends, then starting with 2001 these trends start diverging as soaring imports "detached" from exports and drove trade deficit to new dizzying highs.

The exports' recovery has also been strongly associated with significant changes in the geographical structure of the exports. Since 2001 the exports have increasingly gone towards the EU markets, the trend that finally resulted in EU becoming main market for Moldovan goods (Chart 87). This evolution was propped up by quite diverse developments. Firstly, trade liberalization has led to geographical diversification of the exports, which in its turn resulted in faster growth of EU share of Moldovan exports comparative with CIS share. Secondly, exports to Russia (main CIS export market for Moldova) experienced a series of shocks, the most important of them being "wine embargo" (introduced in March, 2006) preceded by smaller bans on meat and vegetable products' exports (August, 2005). For many Moldovan wine-makers this embargo served as "rude awakening" and prompted industry-wide restructuring and pushed wine-makers to scale up wine exports towards the EU markets which in period from 2006 to 2008 more than doubled.

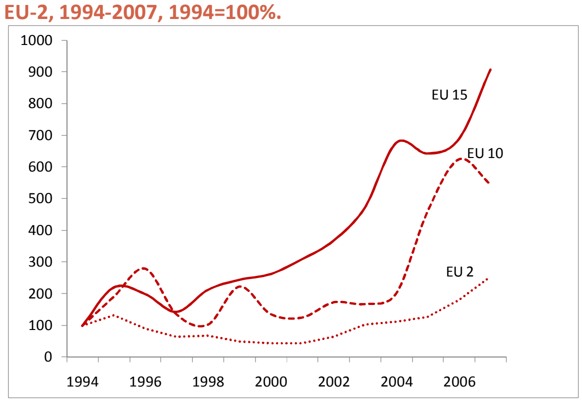
It should also be mentioned that in 2001 Moldova became WTO member. This achievement signified considerable and successful liberalization efforts of Moldova. By that time Moldova has already been rated as a country with one of the most liberal trade regimes while its rank on the latest Trade (MFN) Tariff Restrictiveness Index (TTRI) is 12th of 125 countries, much better than for its comparators in the ECA region or low-income country groups[69]. Nonetheless, ranked 111th out of 125 countries on the latest Market Access TTRI (including preferences), Moldova's exports face a more restricted access to international markets, overall, than those from an average low-income or ECA country.

Chart 87. Comparative evolutions of exports, EU and CIS, 1994-2008, million USD



Source: Comtrade database, NBS and EG calculations.

Chart 88. Comparative growth of exports to EU-15, EU-10, EU-2, 1994-2007, 1994=100%.



Source: Comtrade database, EG calculations.

EU considerably liberalized its trade policy towards Moldova, granting GSP (1999), GSP+ (2006) and ATPs (March, 2008). However, the impact of these consecutive steps seems to be limited, partly because of Moldova's inability to make full use of these preferences (mainly in agri-food exports since SPS standards implementation is particularly weak in Moldova), partly due to the fact that

[69] Republic of Moldova: Trade Diagnostic Study, World Bank, December, 2004; Moldova: Trade Brief, World Bank, 2009.

"trade gravity"[70] factors played much stronger role, while trade regimes with most of the CIS countries were more liberal[71].

Furthermore, while the consecutive EU enlargements of 2005 (the exports to the EU-10 has been the most sluggish) and 2007 have played an important role in growing Moldovan exports to the EU, exports growth to the EU core-members has been the most robust (Chart 88).

Since 1994 the composition of Moldovan exports has also changed significantly. Back in 1994 most of the exports both to the EU and CIS represented agri-food products, displaying at the same time reliance on the old traditional industries proper to the Soviet era. The composition of exports also highlights the significance of the exports to the CIS, which in their turn shaped to a large extent composition of the world exports.

On the contrary, composition of exports in 2007 reveals growing clout of the EU market as well as considerable changes within Moldovan exports to the EU. Thus, in Moldovan exports to the EU increasing role started playing textile exports (reflecting inclusion of Moldovan enterprises in European companies' production chains), while role of the traditional agri-food exports was in decline (Table 6). It is also striking how little changes occurred to the composition of the exports to the CIS and persisting dominance of the beverages (mainly wine) exports: slightly over 1/5 of exports both in 1994 and 2005.

Table 6. Main five categories of Moldovan exports to the World, EU and CIS, 1994 vs 2007.

	World	EU	CIS
1994	Beverages, spirits and vinegar (17.59%)	Sugars and sugar confectionary (17.5%)	Beverages, spirits and vinegar (21.83%)
	Edible fruits, nuts, peel of citrus fruit, melons (9.8%)	Vegetable, fruit, nut, etc. food preparations (10.48%)	Edible fruits, nuts, peel of citrus fruit, melons (12.74%)
	Vegetable, fruit, nut, etc. food preparations (8.04%)	Mineral fuels, oils, distillation products (9.75%)	Cereals (7.62%)
	Sugars and sugar confectionary (6.62%)	Beverages, spirits and vinegar (6.97%)	Tobacco and manufactured tobacco substitutes (7.57%)
	Tobacco and manufactured tobacco substitutes (6.3%)	Meat and edible meat offal (4.97%)	Nuclear reactors, boilers, machinery, etc. (6.96%)
2007	Articles of apparel, accessories not knit or crochet (10.54%)	Articles of apparel, accessories, not knit or crochet (20.99%)	Beverages, spirits and vinegar (20.39%)
	Beverages, spirits and vinegar (10.09%)	Articles of apparel, accessories, knit or crochet (10.92%)	Edible fruits, nuts, peel of citrus fruit, melons (7.13%)
	Articles of apparel, accessories, knit or crochet (7.16%)	Edible fruits, nuts, peel of citrus fruit, melons (7.18%)	Salt, sulphur, earth, stone, plaster, lime, cement (7.04%)
	Edible fruits, nuts, peel of citrus fruit, melons (6.9%)	Vegetable, fruit, nut, etc food preparations (7.01%)	*Nuclear reactors, boilers, machinery, etc.(6.5%)
	Vegetable, fruit, nut, etc. food preparations (5.9%)	Footwear gaiters, and the like, parts of (5.92%)	Vegetable, fruit, nut, etc. food preparations (5.95%)

*Note: * - both in 1994 and 2007 mostly composed of 'pumps for liquids' and 'refrigerators, freezers and heat pumps'.*
Source: Comtrade database.

Soaring imports: beware of remittances…

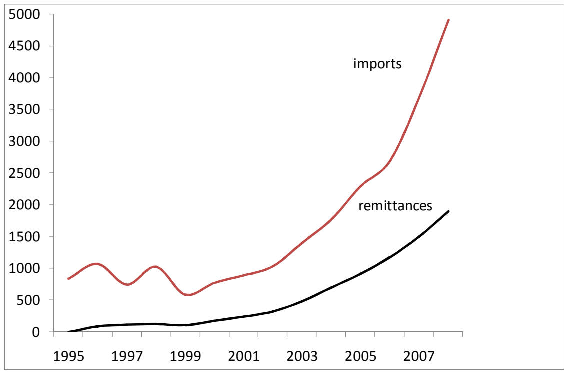
As it was already mentioned, the imports followed highly different path. Indeed, starting 2000 effects stemming from one important phenomenon started to kick in – remittances sent by Moldovan labour migrants from abroad (Chart 89). Since then remittances by far and large fuelled domestic

[70] The gravity theory of trade predicts bilateral trade flows based on the economic sizes of (usually GDP) and distance between two units, i.e. EU markets which are at least as close as CIS and considerably bigger should in time, *ceteris paribus*, become main importer of Moldovan goods.

[71] For more on this see: Ana Popa, Valeriu Prohnitchi, Alex Oprunenco, *Evolution of Moldova's exports: Role of Trade Regimes*, Expert-Grup, 2008.

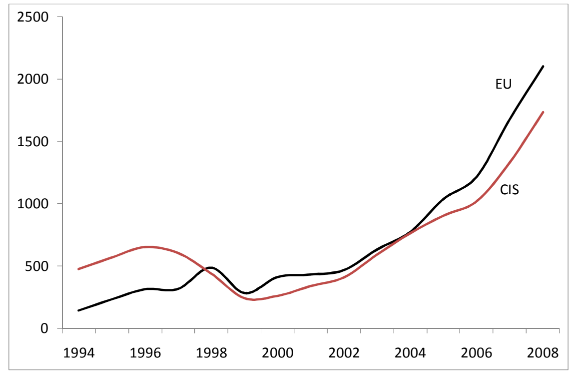
consumption and determined rocketing imports. As it can be seen, the imports followed remittances quite closely since 1999-2000 when a growing number of Moldovans started going abroad in search of better life, since then money made by them have supported and driven out of poverty significant share of population.

Chart 89. Evolution of remittances and imports, 1995-2008, million USD



Source: Comtrade database, NBM, NBS, EG calculations

Chart 90. Evolution of imports to the EU and CIS, 1994-2008, million USD



Source: Comtrade database, NBS, EG calculations

Geographical composition of Moldovan imports has had quite a similar evolution to that of exports. While in the beginning of period CIS countries were main exporters to the Moldovan markets, by the end of 90's was marked by significant contraction of the Moldovan imports from the CIS countries and EU exports occupied dominating position on Moldovan market (Chart 90).

Table 7. Main five categories of Moldovan imports from the world, EU and CIS, 1994 and 2007.

	World	EU	CIS
1994	Mineral fuels, oils, distillation products (55.16%)	Nuclear reactors, boilers, machinery, etc.[1] (15.36%)	Mineral fuels, oils, distillation products (71.9%)
	Nuclear reactors, boilers, machinery, etc. (5.61%)	Mineral fuels, oils, distillation products (14.05%)	Vehicles other than railway, tramways (3.1%)
	Electrical, electronic equipment (4.19%)	Electrical, electronic equipment (11.54%)	Nuclear reactors, boilers, machinery, etc.[3] (2.58%)
	Cereals (2.78%)	Pharmaceutical products	Electrical, electronic equipment (2.11%)
	Pharmaceutical products (2.4%)	Wool, animal hair, horsehair yarn, and fabric thereof (5.02%)	Paper and paperboard, articles of pulp, paper and board (1.71%)
2007	Mineral fuels, oils, distillation products (20.99%)	Mineral fuels, oils, distillation products (13.78%)	Mineral fuels, oils, distillation products (40.2%)
	Nuclear reactors, boilers, machinery, etc. (8.79%)	Nuclear reactors, boilers, machinery, etc.[2] (11.99%)	Iron and steel (5.66%)
	Vehicles other than railway, tramways (7.45%)	Vehicles other than railway, tramways (10.49%)	Tobacco, and manufactured tobacco substitutes (4.29%)
	Electrical, electronic equipment (5.97%)	Electrical, electronic equipment (6.85%)	Nuclear reactors, boilers, machinery, etc.[4] (4.18%)
	Plastics and articles there of (4.83%)	Pharmaceutical products (3.62%)	Vehicles other than railway, tramways (3.44%)

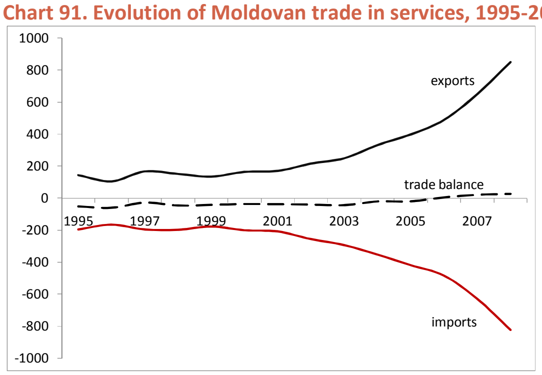
Notes: 1 - Included mostly 'machinery for dish-washing, bottle washing, filling' and 'industrial food and drink preparation machinery nes.; 2 - included mostly 'automatic data processing machines (computers)', 'electric apparatus for line telephony, telegraphy', 'central heating boilers, except steam generators', as well as both categories included in 1994, etc.; 3 - included mostly 'compression-ignition engines (diesel, etc.' and 'refrigerators, freezers, ovens, incinerators); 4 - included mostly 'refrigerators, freezers, ovens, incinerators', 'agricultural machinery, soil preparation, cultivation', 'harvesting, produce cleaning and grading machinery'.
Source: Comtrade database, EG calculations.

Different energy resources (mostly petrol) remained one of the most important imports across the whole period, which is of no surprise given Moldova's energy dependence (Table 7). Other key imports represent different equipments and machinery. Growing share of such imports as "vehicles other than railway, tramways" representing by far and large "vehicles for transport of persons, non buses", as well as such imports as medicaments, tobacco products, etc., considerably directed towards private consumption, shows how growing disposable incomes fuelled in part by remittances resulted in rising automobile imports and ownership in the country. At the same time, the imports of petrol cover both industrial and households needs.

A balanced service trade…

Trade in services evolved also quite dynamically (Chart 91). Thus, share of services in total exports more than doubled from 16.35% in 1995 to 34.04% in 2008. This share is quite high by regional standards and is bigger than the average share for Europe and Central Asia region. Although Moldova is not part of GATS, it has one of the most liberal regimes for services which is reflected on its very high overall GATS commitment index[72].

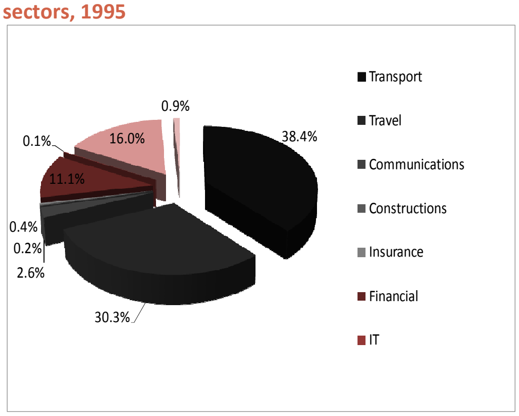
Chart 91. Evolution of Moldovan trade in services, 1995-2008, million USD



Source: NBM.

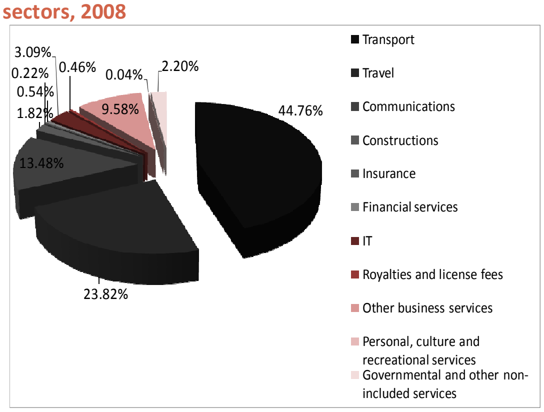
However, trends in evolution of the trade in services are quite different to those in trade in goods. Both exports and imports grew equally strongly throughout the period, thus keeping the trade deficit in services quite limited. Moreover, starting with 2006 Moldova has boasted trade surplus in services.

Chart 92. Composition of Moldovan services exports by sectors, 1995



Source: NBM, EG calculations.

Chart 93. Composition of Moldovan services exports by sectors, 2008



Source: NBM, EG calculations.

The composition of services exports passed through several changes in this period. Given the robust advancement of telecommunications sector it was reasonable to expect that these services will hold a bigger share in exports with time. Thus, if in 1995 the main services exported were transport, travel and other business services, then in 2007 transport and travel services exports were followed by

[72] World Bank, Moldova: Trade Brief, 2008, http://info.worldbank.org/etools/wti2008/docs/brief127.pdf

Communications services exports (Chart 92 and Chart 93). Perhaps, the robust growth in telecommunications services exports can be better explained by interplay of strong expansion of the sector and increasing accessibility of these services, on one hand, and by growing number of Moldovans abroad who use these services to communicate with their relatives back home.

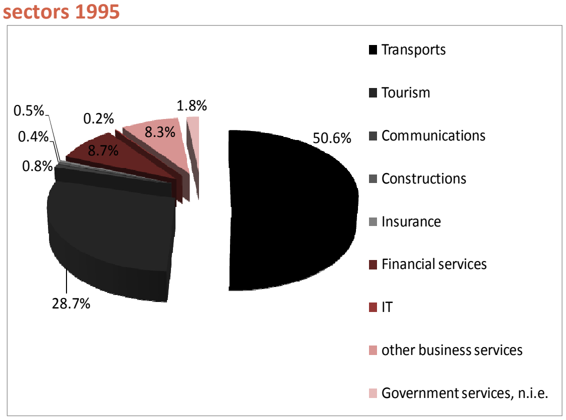
It can also be mentioned that transports services exports consolidated their share to a significant extent which is in line with the reported competitiveness of Moldovan exporters of these services[73].

Given the limited availability of the data on trade in services it is hard to assess fully the geographical composition of it. All in all, around 29% of services exports are directed to the CIS countries, with almost 28% held by Russia, Ukraine and Belarus. Overall Russia appears to be main destination for Moldovan service exports holding almost 21 % of total exports. For the EU data on service exports are available only for Germany and Romania, which held in 2008 4.9% and 9.2%, respectively.

The composition of services exported to some CIS and EU countries varies to a limited degree. The main exports to Russia are transit of gas, telecommunications and transports, while in Ukraine – transportation and travel services. The main exports in Germany are travel, transport and telecommunication services, while in Romania – telecommunications, transport and other business services.

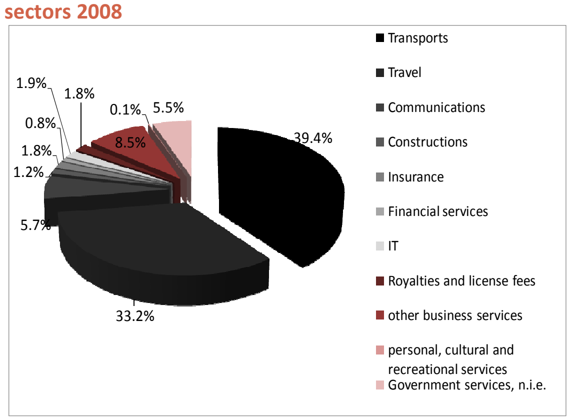
The structure of imports is quite close to that of exports; at the same time it changed only to limited extent throughout 1996-2008. The main shares of imports are held by transportation services (which share declined to some extent) and travel services. In the meantime, role of communications services grew but not to the extent observed in exports structure (Chart 94 and Chart 95).

Chart 94. Composition of Moldovan services imports by sectors 1995



Source: NBM, EG calculations.

Chart 95. Composition of Moldovan services imports by sectors 2008



Source: NBM, EG calculations.

As well as in the case with exports almost 30% of services' imports are coming from the CIS countries, mostly from Russia (19.7%), Ukraine (5.4%) and Belarus (2.9%). For the services imports from EU countries, again only data for Germany (5.8%) and Romania (10.9%) are available. The main imports are more or less the same from both CIS and EU countries: transportation, travel, communication services. However, while Moldova maintains surplus in services' trade with the CIS countries, it has negative balance in trade with EU countries (for which data is available): Germany and Romania alike.

[73] Free Trade Area between the Republic of Moldova and the European Union: Feasibility, Perspectives and Potential Impact, Expert-Grup, 2009

Challenges ahead

- The unfolding financial and economic crisis poses serious and multiple risks for Moldovan exports. First of all, as global demand is falling, while many of Moldova's trade partners are particularly hit, so is demand for Moldovan goods. The slump in exports has already been observed across most of categories of Moldovan exports. The worse is perhaps yet to come, as crisis is expected to continue throughout the current year. Secondly, one of major risks facing global trade system is an eventual comeback of protectionism. If bigger trade players decide to weather out global crisis behind the protectionist walls, the smaller countries, such as Moldova, may find themselves in dreadful situation of not having where to go with its goods and services. Therefore, this is in the best Moldova's interest to pursue as much as open regime for its exports as possible. ***Given that trade access often becomes limited because of non-tariff barriers it is of essential importance for Moldova to ensure full compliance with obligations that stem from its international organizational membership and as well as with international quality standards***.
- Current year may well become crucial for defining future trade and economic cooperation framework between the Republic of Moldovan and European Union. As it has already been shown[74] Moldovan authorities should pursue a deep and comprehensive free trade agreement with the EU for the sake of economic, political and institutional benefits. However, ***in order to obtain it Moldova has yet to pass a long way of continuing institutional reforms, ensuring implementation of relevant standards and proving its capacity to withstand competitive pressures of 'open' market with EU***. Not less important, the future negotiation team should come well-prepared in order to ensure that best care is taken of sensitive sectors of Moldovan economy.
- Pursuing enhanced opportunities for Moldovan exports, ***Moldovan authorities should not fall prey of its protectionist instincts or special interest as well***. If the Government decides to embark on protectionist path it should be ready to face up consequences as our trade partners may well decide to do the same. After all, given its small economic size, Moldova is more dependent on its partners than otherwise. Furthermore, the unfounded barriers that breach the international agreements to which Moldova is part may well result in sanctions being imposed on the country. The "import substitution" talk seemed to be quite popular in the election campaign. However, even taking into account its populist flavour, the steps aimed at transforming words in deeds would signify an important setback for Moldovan economy. As it was mentioned, setting arbitrary import barriers would come against country's international engagements, while it is rather questionable how any new Moldovan Government would ensure that "import substitution" results in rise of Moldovan competitive companies. Firstly, because any Moldovan Government has had a dismal record in "picking up" national champions and secondly, as effects of global economic meltdown are more and more felt in Moldova, the resulting budget constraints will leave the Government without serious financial instruments to support national favourites. Let's also not forget of Moldovan citizens who would be required to fund such "import substitution" schemes both as consumers and tax-payers. Instead, Moldovan Government should get preoccupied with instituting competitive environment in the country for both foreign and local companies. That is better to be done through dismantlement of institutional barriers and red tape, than via unpredictable and unstable support of hand-picked favourites.

[74] Valeriu Prohnitchi, Ana Popa, Alex Oprunenco, Evolution of exports from the Republic of Moldova to European Union: The role of trade regimes, Expert-Grup, 2009.

Outlook for 2009

- Foreign trade flows will remain under pressure as global financial and economic crisis brings havoc to the global trade. Therefore, in the forthcoming months the foreign trade flows will contract significantly. The contraction of exports will be shaped by slackening external demand and overall the contraction will be in 20-25% range. The imports are mostly constrained by decline in internal demand caused by sagging remittances. Since there are little signs of job recovery in major destination countries and remittances will continue to decline the imports are expected to plunge by 20-30% in 2009;
- As imports are expected to drop more than exports an improvement in foreign trade balance will occur. The trade deficit is expected to shrink by 20-25%;
- The trade in services will also suffer in the aftermath of the global financial and economic crisis. We expect significant contractions in the trade in transport, travel, and of course, financial services as the economic activity takes the hit. However, given the limited availability of the statistical data it is hard to estimate this decline.

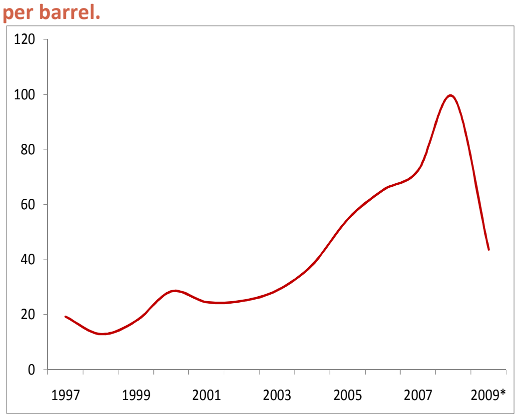
15. Global markets

This chapter looks at evolutions on the most important global commodity markets: oil, metals and cereals, as being important for the economic situation in Moldova. It also analyzes how similar fundamental factors defined converging and diverging trends at different periods of time. This chapter also looks at the way how combination of higher commodity prices and some tricky policy issues bred higher natural gas prices and much more unstable supply environment. Finally, the chapter speculates what policy challenges will surface as the effects of turbulent market get stronger.

Main commodities: united we fall…

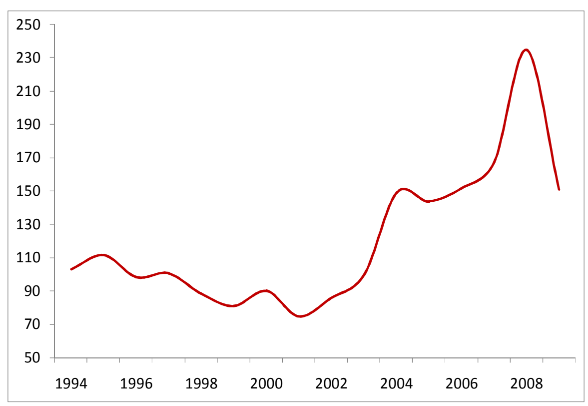
Throughout the last decade oil prices went upwards and back, from below USD 20 per barrel in 1997 to slightly over USD 125 when prices peaked in July 2008 and then as commodity markets crashed, the oil prices crumbled, currently hovering at USD 50 per barrel mark. An inexorable rise in oil prices started in the beginning of 2000, although it was preceded by hefty hikes in the 2nd half of 90's. The rise of oil prices meant that local petrol prices could not remain untouched as they rose from slightly over 4,5 MDL per litter (A-95) in 2001 up to more than 14 MDL in the mid-2008 while falling later to less than 10 MDL per litter. The rallying oil prices meant a bonanza for many oil-rich countries, however, put significant stress on many developed and oil-poor underdeveloped countries. The oil's rise in the recent years was mainly supported by soaring global demand, which grew from 70.1 million barrel per day (mbpd) in 1995 to 86 and 85.7 mbpd in 2007 and 2008, respectively. In China oil demand expanded more than two-fold, from 3.3 mbpd in 1995 to 7.9 mbpd 2008, while in the rest of non-OECD Asia from 6.1 mbpd in 1995 to 9.4 mbpd in 2008. The expansion in OECD countries was relatively modest from 44.9 mbpd in 1995 to 49.2 mbpd in 2007 and then falling slightly to 47.5 mbpd in 2008. Within OECD countries oil demand grew more robust in North America than in Europe reflecting probably also "greener" energy and tax policies in the latter.

Chart 96. Dynamics of oil prices in 1997-2009, y-o-y, $ per barrel.



**data for Q1'2009*
Source: US Energy Information Administration.

Chart 97. Dynamics of Global Steel Index* in 1994-2009 y-o-y.



** Global Steel Index includes weighted indexes of Carbon steel, Stainless Steel and Metallics (scrap, pig iron, DRI/HBI).*
Source: CRUgroup

The supply was matching the demand quite closely meaning that remaining stocks were very tight and various natural disasters or local conflicts posed significant risks of disruptions to oil supply. Besides that, previous era of cheap oil discouraged to considerable extent investment in oil exploration and production, especially in the areas where oil reserves are more difficult to tap in. At the same time, by mid-2000s oil reserves became concentrated in the national companies' hands with limited or no access by private foreign companies. This development probably impacted negatively global oil production given propensity of some states to employ windfall in oil revenue to achieve various political and social goals, while fending off participation of foreign companies meant limited access to know-how and state of art technologies.

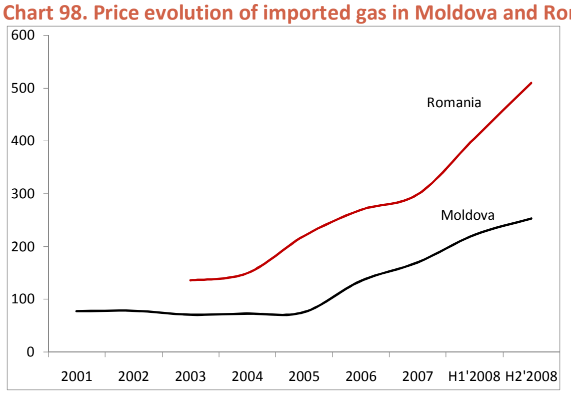
Given interplay between these fundamental factors as well as general price rally on commodity markets the creation of price bubble and its consecutive burst became a matter of time. Chart 96 and Chart 97 display the almost decade-long rally as well as decline that followed. As global financial crisis started unfolding, oil demand slumped in OECD countries and barely held up in China and Asia, while investors rushed away from commodity markets and in few weeks oil prices were in freefall. In less than two quarters the oil lost around two-thirds of its value with no sign of recovery in the near future. The data for March of 2009 show only stabilization of oil prices at current low levels around USD 50 per barrel, while further evolution largely depends on how deep and protracted is current financial and economic meltdown.

The metal markets followed quite similar evolution: after an almost inexorable rise started in 2001 the metal price index expanded more than three-fold up to mid-2008, and the prices were in freefall. In contrast with oil prices the metal prices' downwards trend does not show any sign of abating. Given continuous decline of demand for metal from South-East Asia following contraction of consumption demand in developed countries, and especially in the United States, as well as reluctance of investors to put their money in commodities (besides gold), the fall of metal prices may well continue in following months. The dire situation can be easily observed by evolutions in economy of Transnistria, where a huge steel-maker was forced to critically downscale its activities, while Moldovan exports of metals fell by 80% in January 2009 in comparison with the same month of 2008.

Natural gas: when prices become toxic

The supply of natural gas has been a thorny issue for Moldova both from the security of supply point of view as well as from that of adjustment to changing terms of trade. Overall, throughout 2001-2008 prices for imported gas grew more than three-fold in nominal terms from below USD 80 per 1000 c.m. to almost USD 253 per 1000 c.m (Chart 98). Two main factors were behind the sharp increase in gas prices: general growth of oil prices (as well as other energy resources) on which calculation of gas prices depends to large extent and revision of price policy by Gazprom towards the so-called "near-abroad", mostly from western CIS and Caucasus. This new price policy, although mostly justifiable on economic grounds, coincided with a more assertive Russian policy towards fSU countries which, to a varying degree, embarked on more pro-Western path in their foreign policy. In this context, Gazprom has increasingly started looking like an economic arm of Russian foreign policy. Currently gas supplies to Moldova are done on the basis of the long-term contract which includes formula for quarterly price calculation and envisages gradual convergence to the European prices. In forthcoming quarters the prices are expected to slide a bit at the background of slump in oil prices worldwide.

Chart 98. Price evolution of imported gas in Moldova and Romania, 2001-2008, USD per 1000 cubic meters



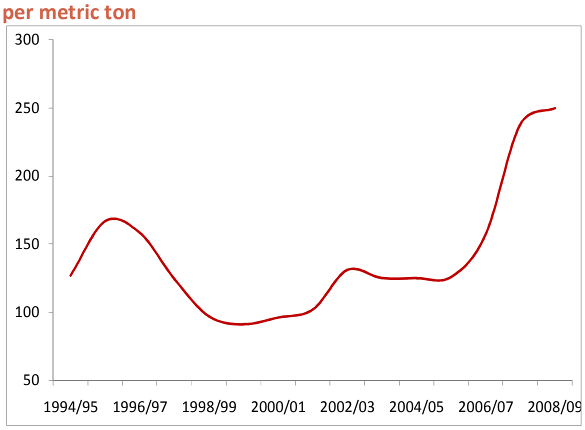
Source: National Energy Regulation Agencies from Moldova and Romania, EG calculations.

The energy shocks hitting Moldova were not related solely to the price hikes. At two instances the price spats between Russia and Ukraine resulted in major disruptions of gas supply, with the second instance of January last year being most critical. While this issue appears to be temporarily solved the situation will remain quite unpredictable in the forthcoming future.

The story of dear food

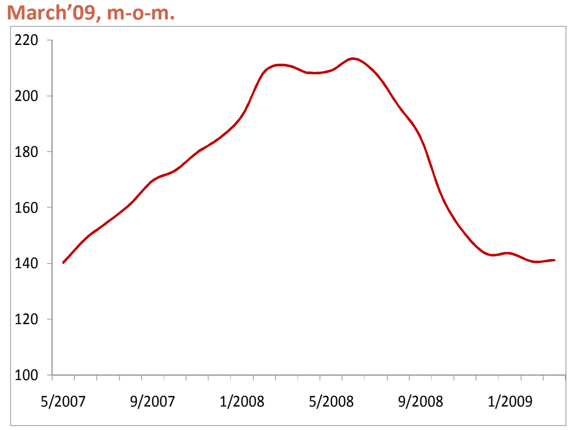
After quite lengthy period of cheap food the world was set to start accommodating to more sobering food prices, while economists worldwide started talking about era of "agflation". The steep rise was based on different developments, at first glance resembling those that motivated rally in oil and metal prices. The main fundamental reasons behind expensive food has been growing demand for food on global level, but especially on behalf of emerging economies of South-East Asia with its huge population rising from poverty. Furthermore, food demand in emerging economies has increasingly been connected with foodstuffs with bigger protein intake, such as meat and dairy products. However, production of these foodstuffs requires multiple inputs cereals (Chart 99) in order to increase cattle needed to produce meat and dairy products. Nonetheless, this rocketing demand was not limited to the basic foods, but also included vegetal oils and to a lesser degree sugar (Chart 100). For instance, Food Price Index calculated by FAO increase more than two-fold in the last 5 years (see chart 8). As in the case with oil and metals the rise of food prices was supported by speculative binge on the global financial markets. As dollar weakened, inflation risks grew and rosy growth perspectives were driving global demand investments on commodity markets looked like a safe bet. These assumptions proved to be not that safe after all as commodity markets collapsed in the wake of global financial crisis.

Chart 99. Dynamics of wheat prices in 1994/95 – 2008/09, $ per metric ton



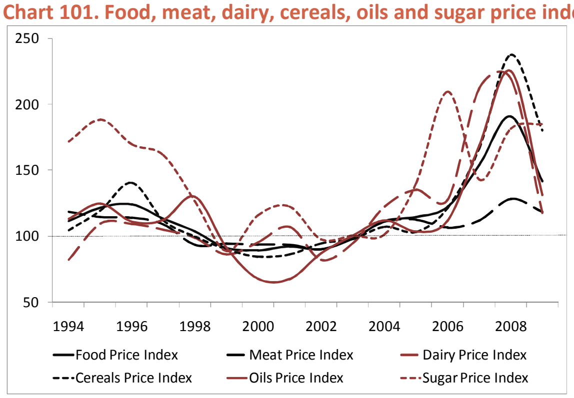
Source: USDA

Chart 100. Evolution of Food Price Index in May'07 – March'09, m-o-m.



Source: FAO

Chart 101. Food, meat, dairy, cereals, oils and sugar price indexes, 1994-2008.



Source: FAO

However, food prices have appeared to be weathering-out the global economic meltdown better than other commodities. Thus, even when most of commodity markets crashed, the food prices after initial drop managed to stabilize at the relatively high levels by the beginning of 2009 (Chart 101).

Challenges ahead

- Although solved at the moment, Moldova's energy security remains imperilled while no viable and sustainable solution being implemented. The options at the table may be combined and vary from ensuring backwards connection with the Romanian gas supply network, construction of Moldovan gas-holder, connecting to the future Nabucco pipeline, etc. The first option seems to be the most feasible technically and financially for Moldova and thus should be pursued as early as possible. This does not mean that other options should be put on the shelf, they should be studied and if feasible implemented in the longer-term. Given financial constraints that current global financial meltdown puts on the national budgets and donor aid, ***the newly-elect Moldovan Government is poised to focus on better prioritizing policy issues and to look at energy policy through 'winter' eyes*** otherwise Moldova may be up to ugly consequences instead of New Year celebrations.
- Apparently high food prices will remain one of the challenges face humankind, while the world's poor seem to be the main victim of the havoc brought by agflation. It well may be one of the main risks also for Moldova, for instance, rising food prices also made headlines in Moldova last summer as prices for some basic foods increased significantly. However, by the same token it can also be opportunity due to Moldova's traditional strength in agricultural production. Although, Moldova had agricultural trade deficit (beverages and tobacco excluded) in 2008 with the rest of the world it should not be viewed with fear: imports are highly driven by extraordinary internal demand fuelled by remittances. Rather, ***increasing food prices should foster modernization of Moldovan agriculture concerning technology use, standards implementation, companies' restructuring and state support policies***. Thus, agriculture modernization should become one of the main priorities of the next Moldovan considering growing importance of food security, agriculture competitiveness, still large share of rural population and development of countryside in general.

Outlook for 2009

- The prices for the main commodities seem to have stabilised after their collapse in the second half of last year. However, they will remain largely dependent on whether and when the recovery sets on. Since even the most optimistic scenarios put it not earlier than the second half of the year we can expect that oil prices will fluctuate between USD 50-60 in the near future. Further on, much will depend on speed and degree of recovery, but perspective of any new bubble on the commodities markets remains muted;
- The gas prices have already reduced somewhat in the 2nd quarter of 2009 and will slide a bit more as decline of oil prices takes some time to effect fully into the gas prices due the supply contract formula. Any major decline in gas prices seems to be unwarranted as oil prices seem to have stabilised so far, while major changes regarding the supply side are highly improbable.
- Food prices recovered much earlier than the prices of other commodities and will remain much more stable due to lower elasticity of food prices. However, the weather trends are obviously much less stable and predictable and can affect the prices even if financial turbulences recede. Under any circumstances it is highly unlikely that food prices become significantly lower than today.

16. Instead of conclusions: dealing with the consequences of the international financial crisis

Channels of contagion

Falling victim of a dramatic financial turmoil the global economy is now in the midst of its worst recession after the WWII. The IMF forecast for the global GDP growth in 2009 is -1.3% and can still be reviewed downwards. Despite the optimist post-electoral declarations of the Moldovan government, our country will not be spared. Even more, economic recession is already here, with a wide spectrum of bad consequences.

First of all, main trading partners of Moldova are in recession, which has already resulted in a decline of exports. In 2009 the Romanian economy is expected to decline -4.1%, while in Russia and Ukraine the negative growth can be even worse, respectively -6% and -8%. The biggest EU economy, Germany, is set to put a negative growth of -5.6%. For Moldova this can result in a 15%-20% drop of exports of goods and a 10% drop of exports of services in 2009[75].

Reversing Foreign Direct Investment flow will be another channel for spreading the impact of the global economic recession onto the Moldovan economy. While it is more difficult to make sound predictions about behaviour of the investors, a 50% decline of FDI inflows seems yet very optimistic for Moldova given the expectations of a 35% decline in global FDI and a 39% decline of FDI in Eastern Europe[76].

Another major way in which global recession will affect Moldova is migration and remittances. Evidence shows that many Moldovan migrants are presently returning home from Russia, but less from EU countries. However, we expect that most of the Moldovan migrants would prefer to be paid less in host countries than to come back to Moldova. Therefore, while migration will remain important in terms of number of migrants, the associated remittances are expected to decline by about 30% from USD 1.795 billion in 2008 to 1.250 billion in 2009, with immediate impact on domestic consumption, imports, budgetary revenues and GDP growth.

How deep the economic decline can be?

Because of the highly turbulent international and domestic environment it is really difficult to make sound economic forecasts for 2009. The IMF has recently published a -5% forecast for Moldova's GDP growth rate in 2009. This forecast is close to the Expert-Grup best-case macroeconomic scenario based on expenditure approach (-6%).

However, a deeper economic decline of -12% for 2009 is more likely at this stage. This forecast is based on macroeconomic trends in the first quarter of 2009 and an expected decline of 30% in the volume of remittances. This will result in a 12% decline of the households' consumption, a 59% of consumption of the private administrations and a 27% in the volume of imports. We expect that the public consumption in 2009 will decline by 20%, so that the government maintains a budget deficit at levels below 10% of GDP. Our anticipations for investment are very pessimistic, and we expect that gross capital formation in 2009 will decline by 40%. Exports will continue spiralling downwards by 18% in 2009.

[75] IMF, World Economic Outlook, Aprilie 2009.

[76] EIU, Eastern Europe in 2009: the Outlook for Foreign Direct Investment, available at http://www.dataresources.co.uk/contents/en-uk/EEBIC08_Laza_Kekic.ppt.

Our conservative approach for the value-added in the agricultural sector is +4.6% and this is the only sector that we expect to grow in 2009. Industry will post a -16% decrease of the Gross Value-Added (GVA), while the GVA in constructions sector will register a -33% rate of growth. We believe that the growth of the GVA in trade and public services will hover between -7% and -9%. The volume of the transport services is expected to plunge by 35%, while telecommunications are expected to remain largely unchanged. The growth forecast by sectors is based on the assumption that companies will be able to reduce their intermediate consumption proportionally to the reduction of their sales.

Key policy solutions

All in all, Moldova seems to be among the countries which will suffer the most as result of these second-round effects of the global crisis. This will happen not only because Moldova was more exposed in terms of foreign trade, migration and FDI, but also because of the long list of unfinished domestic economic reforms. Moldovan can do nothing to reverse the external negative factors, but behind the border barriers affecting economic growth are obviously in its realm.

A number of urgent measures are necessary in order to rebuild economic confidence, stimulate consumption and domestic supply. Below the most important policy actions are proposed. Some of them are quite radical, but the economic crisis that Moldova faces is very serious.

- ***Corruption and pervasive state remain significant barriers to economic growth, which have to be addressed urgently.*** Corruption and red tape have a particularly negative impact in times of crisis because if the companies are exposed to increased administrative burden, high unofficial payments and in the same time they have to pay taxes, they may find it better to enter the shadow economy and make only unofficial payments. Corruption in administrative bodies monitoring/controlling foreign trade is a particular area of concern (especially Customs Service, Moldova-Vin, Ministry of Agriculture and Food Industry).
- ***Business regulatory reform is far from being complete and has to be speeded up.*** While many important measures have been already implemented, others have met fierce opposition from some governmental factions. Because of these issues, Moldova fares poorly in all international economic and investment ratings. The most important problems are those related to issuance of the construction permits, issuance of market authorization by local authorities, issuance of sanitary clearances and land rezoning. Addressing these four problems is particularly important for reversing the decline of the trade and construction sectors.
- ***As a big budget deficit is looming ahead, the Moldovan Government has to look for additional budget revenue and to optimize the expenditures side***. Privatization and foreign debts in concessional terms are the best options, since domestic debt will drain resources away from investment purposes and create inflation. Politically- or economically-tied bilateral loans (Russia, China) have to be considered very cautiously. On the expenditures side, the Government will have to reconsider its social promises (of higher wages and social payments), and to push stronger the central public administration reform. The latter will not only reduce the fiscal costs of the administration but also contribute to corruption fight and thus increase the efficiency across economy.
- ***Social protection policy has to be streamlined and made more socially fair and economically efficient.*** In this context it is necessary to review the governmental price policy by reducing the basket of goods and services with governmentally controlled prices and trade margins. On the other hand the goals of social protection of the economically vulnerable people (rather than social categories) have to be pursued by direct subsidies. This will reduce directly the poverty rate, while making private investment more attractive in production of dairy products, bakeries and other goods with presently controlled prices. In the area of social insurance, the policy has to be target at gradual increase of the retirement age, abolishing of privileges and establishment of an adequate relationship between contribution and pension.

- ***Some fiscal tools should be considered as means of stimulating demand***. For instance, the VAT for the goods and services creating additional demand in the economy can be reduced (computers, constructions, cars), while the VAT and excises for other goods can be increased (luxury, alcoholic beverages, tobacco). Most probably, the Government will have to reintroduce the corporate income tax and it may be reasonable to consider the introduction of a flat corporate and personal income taxes. So far the progressive income tax has not provided any social benefits, because most of the tax payers are falling in low-income segments. Besides, introducing the flat-income tax will eradicate a number of loopholes for fiscal evasion.
- ***As inflation risks are downside, it is necessary for the National Bank of Moldova to review its monetary policy tools***. For the economy to start growing again, commercial banks have to provide more investment and consumption loans. With the y-o-y inflation rate reaching historically low levels (1.2% in March 2009), the National Bank has to reduce the rate of compulsory reserves (standing presently at 17.5%) and its REPO interest rate (11%). In late 2002-ealry 2003, when inflation pressures were much more severe (4-5% y-o-y), the REPO was 9.5% and the rate of compulsory reserves was 10%. At the same time, the National Bank has to gradually leave the foreign exchange market and to let national currency depreciate to a more competitive level. With all national currencies in the region depreciated in the recent half year, Moldovan exports are becoming increasingly uncompetitive.
- ***Even though immediate risks are not larger than on average, agricultural sector may suffer the hardest blow in long term.*** This sector has not achieved yet a path of sustainable and investment-driven development. In the future, the commercial banks will rationalize even more the credit to agricultural entities. Gradually allowing foreign companies to buy agricultural land for investment purposes represents the sole solution to attract investment in the sector, increase the rural labour productivity and reduce the rural poverty. In parallel with rising domestic price of the agricultural land the welfare of the land-owners will increase. This will make possible for Moldova to solve in long-term the problem of its big rural population.
- ***Exports of Moldova are expected to decline dramatically as result of falling global and regional demand.*** As its financial resources are very scarce to support the producers and exporters with direct payments, the few things that Moldovan Government can do are related to institutional and regulatory environment affecting international trade. All prohibitive or restrictive regulations that limit the exports have to be abolished: such as grains exports confined to railroad transportation, approval of export contract by Moldova-Vin and other agencies, generally cumbersome customs procedures. The VAT reimbursement has to be speeded up or interest rate to be paid for the periods when Government is using exporters' money. In the same time, it is necessary to refrain from erecting trade tariff barriers for protecting the domestic producers.
- ***Return of migrants and potential labour shedding are significant risks that may result in a high unemployment rate.*** The unemployment rate in 2008 was 4%, a very low level by any international standards. However, in 2009 at least 30-40 thousands retuning migrants and a similar number of fired workers (mainly from private sector) can join the group of unemployed and increase the unemployment rate at least to 9-10%. The relatively low-skilled migrants returning from constructions sites in Russia represent the potential workforce that can be used to implement big infrastructure projects in the country and other public works. It will be necessary to increase the scope of the active labour policy to channel the high-skilled labour force to alternative occupations, including in individually-owned businesses. Simplifying the migration legal framework is also necessary and the critical constraint here are the new legal provisions making compulsory the registration of the working contracts with the National Social Insurance Fund. This amendment has to be postponed for better economic times.
- ***Even though the effects of financial contagion seem to be very limited, the banking sector has to be carefully monitored and stabilized.*** Maintaining the public confidence in commercial banks is of vital importance for Moldovan economy. In this regard, a number of issues have to be solved; with the most important being the transparency of ownership in the sector and

transparency of credits provided to interconnected stakeholders. At the same time, the Moldovan banking sector has to remain open for entrance of those foreign players that provide transparent ownership information.

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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