

CENTRUL ANALITIC



*Monthly*  
**BUSINESS AND ECONOMY**  
*REVIEW*

**no.17 – February 2007**

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## Summary

In February 2007 the National Bureau of Statistics (NBS) published the preliminary data on **GDP** growth in 2006 (4.0%) and revised the data for 2005 (7.5% relative to previous growth rate of 7.1%). Unfortunately, the revised data do not improve substantially the poor quality of economic growth during 2005-2006. At the end of February IMF revised its forecast for Moldova's economic growth in 2007 from 3% to 4.5-5.0%. For the time being, EXPERT-GRUP keeps its forecast of the GDP rate for 2007 at 6.0-6.5%.

In January 2007 the **industry** continued its recession, the wine and brandy production reaching unimaginable low records (-80% and -60% as compared to January 2006). Paradoxically, the warm winter of 2006-2007 negatively influenced the industrial growth. Thermo-power generation plants (TPGP) cut back the electricity and thermal energy production by about 8%, resulting in 1.5 percentage point reduction of the industrial output. Positive evolutions of some branches (milling, confectionary, beer) were not significant enough to set off the recession of main branches.

According to revised statistical data, in 2006 the **agriculture** posted not stagnation as previously expected, but a recession of 4.4% determined by 8.5% drop of the output in the crops sector, only partially compensated by the growth of the livestock output. However, the abolition of the free trade regime with Romania could bring about in 2007 an output decline in the livestock sector as well. The main export article to Romania was the chicken eggs, which at present are sold by producers on the internal market on half prices. The agriculture subsidy policy announced for 2007 will be unable to counteract new external shocks after Romania joins the EU because of small amounts of subsidies and adverse selection of beneficiaries.

The **constructions** sector continued to lift up in January 2007. The number of companies executing construction-assembly works kept a positive trend, at the beginning of the year accounting for about 800 units. In 2007 companies have emerged which offer apartments in the medium price layer (300-400 USD/m<sup>2</sup>, but for an area more than 100m<sup>2</sup>). Nevertheless, the average prices in the real estate sector continued to increase in January.

The first month of 2007 was marked by a relatively temperate increase of **prices**. The monthly rate of inflation in January was 0.9% as compared to 1.9% in January 2006 and 1.1% in January 2005. The reduction of inflationary tension in January 2007 was explained, to a significant degree, by the producers' delay to adjust

prices for the next months, after the National Agency for Energy Regulation revisions of tariffs for electricity, thermal power and hot water. Adopted in February, this decision could bring in March a larger increase of prices than in January-February.

On the **labour market**, the real average salary increased in January 2007 by 11% as compared to January 2006. The real salary decreased in the beverages industry (-3%, as result of the output) and in education (-8.5%, an effect of legislative decisions in December 2006). January-February period was characterized by a great social tension, the employees from education threatening to organize general strikes and even undertaking some sporadic protest actions. The social tensions generate serious risks for current government, which recently has adopted a number of unpopular decisions (the entrepreneurial patent issue, the rise of the prices on public utilities, rise of the real estate tax). Not accidentally, after a series of negotiations with trade unions, the government has promised a phased increase of budget salaries starting with the 1<sup>st</sup> of April, not 1<sup>st</sup> of December 2007.

Although still there are no statistical data, it seems that the private **consumption** in the first two months remained on high records. EXPERT-GRUP estimates that the growth rate of consumption expenditures in January was 7%. This growth stems from the continuing rise of income coming from salaries and other sources, including from abroad. At the same time, the meager evolution of agriculture and wine-making sector let us to suppose that in January 2007 the discrepancy between salaries of rural and big urban areas continued to grow. This considerably restrains the growth of internal consumption and, consequently, the economic growth in general.

Spurred by the consumption growth, the revenues to public **budget** have increased either, depending to 35% on the VAT. The budget revenues raised by 14% comparing to the level planned for January 2007, while the budgetary expenditures were executed at the level of 66% of the planned one. Partially, this fact could be explained by technical delays in reflecting the expenditures within treasury system, partially by the lack of human and technical resources required for the funds absorption. In January, the government prohibited practicing four types of activity based on the entrepreneur patent. The budgetary costs of this decision are not high, 7.6 million lei annually, but social and political consequences could be serious.



In January-February 2007 the National Bank of Moldova (NBM) kept the rates of its **monetary policy** tools unchanged. At the same time, the NBM has intensified its anti-inflationary efforts, sterilizing in January about 1.5 billion lei of monetary liquidity, comparing to 1.0 billion lei in January 2006.

January and February did not bring significant changes in the evolution of **banking system**, this period of time being traditionally without spectacular evolutions. Nevertheless, we have witnessed some symptoms of the intensification of banking competition for offering cheap credits in the retail sector. The rates of interest on both credits and deposits have continued their growth. The difference between the average rate of interest on credits and on deposits narrowed down, confirming thus the intensification of competition.

On **financial markets** a precipitous decrease of the interest on bonds was noticed (from 14.33% in the beginning of January to 11.72% at the end of February for treasure bonds with 91-day maturity). It is noteworthy that the demand on auctions in last period surpassed the supply by at least 50%, the banks being interested in secure investment of available resources. The Moldovan leu appreciated against the US dollar, denying the traditional depreciation typical for this period. This happened due to the inflow of foreign currency in cash from Moldovan emigrants and the increase of the foreign investments volume in national economy. Symptomatically, in February the NBM and the Ministry of Economy decided to lower the exchange rate predicted for 2007 from 14.60 to 13.20 MDL/USD.

In January became publicly accessible the final data on **foreign trade** in 2006. The trade deficit reached the level of 1.6 billion USD, slightly higher that was estimated in BER-16. For the first time in the last nine years, the galloping deficit growth stems not only from the rapid expansion of imports, but also from the exports' compression. The growth of the weight of exports to the European Union is welcomed (35% relative to 29.7% in 2005), but not the absolute loss of positions on eastern markets. In 2007 the weight of exports to EU will exceed 52-54%, as a result of Romania's and Bulgaria's joining the EU. Speaking of the perspectives of Moldovan wines returning on the Russian market, they remain far away. The re-launching of the exports of animal and vegetal products to Russia inspires optimism, but a significant relief for the economy will come forth when the majority of the companies will be able to export.

After a remarkable fall of prices in the first days of 2007, starting with the middle of January the **oil** price started to rise again on the international markets, in the second half of February hovering at 60 USD/barrel. The trend of European currency depreciation dominated the **forex markets** in January 2007. On the contrary, in February the euro appreciated from 1.29 to 1.32 USD/EUR. This evolution stemmed from the pessimist statistical data disclosing a poorer than expected economic growth in the USA and the revival of geopolitical risks related to the Iranian nuclear dossier. On 27 February 2007 the world witnessed a significant fall of most important stock exchange indexes. The most considerable recession (-9%) was registered in China. The collapse of the Chinese stock exchange had immediate echoes throughout Asia and later in Latin America, USA, Europe and Russia. Due to its undeveloped financial system, Moldova is isolated from these negative influences. The small financial crisis of 27 February is unlikely to influence the global growth, but even if it would have an influence, this will appear as a decrease of the global demand for oil and oil prices.

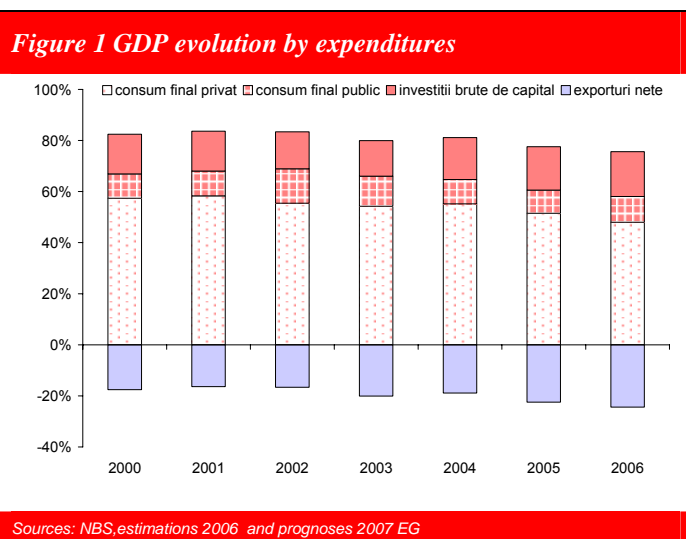
Our main trade partners showed in January-February a positive economic dynamics. **Russia** continued to benefit from high prices for gas and oil, but in future the weight of this branch in the economic growth will decrease. The **Ukraine**' GDP grew substantially in January 2007 (+9.3%), due to positive evolutions in industry (+15.8%) and constructions (+26.3%). However, the more tensioned relations between the governmental coalition and opposition jeopardize the economic development. **Germany**, the main European economy and the second Moldova's trade partner in the "old Europe" shows a solid economic revival, mainly due to exports and the enhanced international competitiveness of companies. **Italy**, the main Moldova's trade partner in the core EU seems to have a different economic evolution: the competitiveness of Italian companies suffer from rising labour costs, rigid conditions on the labour market and excessive regulation of the economic activity. After 1 January 2007 **Romania** became our main trade partner in the UE-27. Although Romania's economy grows very fast, its wine-making sector displays another dynamics. Romanian producers lost a part of exports to Germany and Japan, while the internal consumption in Romania rises. This situation gives the Moldovan wine producers both commercial opportunities to use and lessons to learn.

## Output

In February 2007 the National Bureau of Statistics (NBS) published the preliminary data on the GDP growth in 2006 and revised data for 2005. The GDP growth rate in 2005 was revised to 7.5% comparing the previous rate of 7.1%. The new indicator resulted from the reassessment (in positive direction) of the total output by 800 million lei and intermediary consumption by 620 million lei.

Unfortunately, the revised data do not improve substantially the poor quality of economic growth during the 2005-2006 years. At the end of February IMF revised its forecast on Moldova's economic growth in 2007 from 3% to 4.5-5.0%. For the time being, EXPERT-GRUP keeps its forecasts of GDP rate for 2007 at the level of 6.0-6.5%.

The indicator of 4% announced by NBS for 2006 practically matches the earlier EXPERT-GRUP estimates of the economic growth achieved by Moldova in 2006 (see **BER-16**). Due to macroeconomic shocks and internal structural weaknesses, the economic growth in 2006 was below the average achieved in 2000-2005 (6.3%). According to the agreements reached with Russian Federation the price for natural gas supplied by „Gazprom” will continue to rise at least until 2011. However, it will happen gradually and will not bring shocking effects, giving more time to companies to adapt.



Therefore, if in 2007 the barriers to Moldovan exports to Russia are successfully lifted, the return to the 2005 year production level may result in a quite robust economic growth. Not accidentally, at the end of February the IMF

upgraded its forecast for the Moldova's economic growth in 2007 from 3.0% to 4.5-5.0%.

The preliminary statistical data reconfirm the persistence of negative tendencies in the qualitative dimension of economic growth. The GDP structure by expenditures shows an enhancement of the consumption, investments and imports weight, and a marginalization of exports. (Figure 1).

In 2006 the GDP surpassed the level of 44 billion lei in current prices, which equals about 3.37 billion US dollars. At Purchasing Power Parity the GDP per capita for 2006 was estimated by EXPERT-GRUP to 3550 USD (Table 1).

**Table 1 The dynamics of the GDP and migrants' remittances**

|   | 2003 | 2004 | 2005 | 2006  |
|---|------|------|------|-------|
| GDP growth rate, %                        | 6.6  | 7.4  | 7.5  | 4.0   |
| GDP/ capita, USD, Purchasing Power Parity | 2785 | 3046 | 3360 | 3550e |
| Migrants remittances, % of GDP            | 24.4 | 27.0 | 30.5 | 31.9e |

Sources: NBS, National Human Development Report for GDP/capita and EXPERT-GRUP estimations 2006

The preliminary data on the Moldovan emigrants' remittances indicate their growing importance in financing the internal consumption. The income remitted in 2006 only through banking channels exceeded 850 million USD, being by 25% higher than in 2005. On the other hand, some alternative indicators hint that the rise of average incomes was paralleled by an increase of both poverty rate in rural areas and income disparities within the society.

## Industry

The beginning of 2007 did not bring structural changes within the sector, the industrial enterprises of all forms of property producing an output valuing 1558.5 million in current prices.

The index of the industrial production volume as compared to 2006 in equivalent prices was 89.8%, sinking to a record low level (Figure 2).

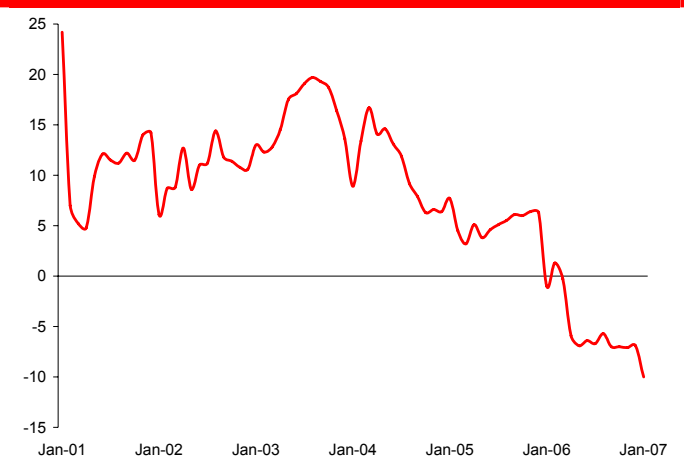
The recorded recession was based on many negative elements which influenced the industry evolution in this period. The interdiction of exporting Moldovan wines to Russian Federation placed the entire wine-making sector under an austerity regime. The output of wine sector in January dropped 5 times compared to the same period in 2006. Similar causes brought about the shrinking of brandy production volume by 3 times. Despite the drastic fall of output, the wine production

capacities were not destroyed; thus, theoretically, the identification of new sales markets could enable a rapid return to the previous production volume. Obviously, one more year of crisis could dramatically worsen the situation, as Moldovan winemakers risk remaining without local raw material.

Due to the favourable weather conditions, the consumption of electricity and thermal energy was lower than in January 2006. As a result, local companies reduced the electricity and thermal power distribution by 8% (causing the decrease of the total industrial output by 1.5%). The favourable weather conditions have also determined a decline of footwear production by 17%.

The negative declining tendency of tobacco production has persisted several years. In January 2007 the downturn continued despite the previous attempts of the government to save this branch by direct subsidies. In January the tobacco production fell by 23% comparing to January 2006 (contributing to the decline of the total industrial output by 0.5 percentage points).

**Figure 2 Industrial output growth, %, cumulative from January**



Sources: NBS, estimations 2006 and forecast 2007 EG

Taking into account the close relations between the industry of paper and carton products and the wine-making industry, the decline of the carton production by 16% is easy understandable.

The production of the food and drinks industry decreased by 28%. At the same time, there was registered an increasing output in several branches: milling products (by 2.1 times); forage production (by 1.7 times); confectionary production (by 1.6 times); mineral water and drinks production (by 36%); fats and oils production (by 27%); fruits and vegetable processing (by 26%); beer production (by 26%). But these

achievements are not quite significant and only marginally influenced the general industry evolution. However, it is likely that some important branches of food industry will get out the recession. In particular, we expect positive evolutions in the industry of meat and meat products. The protocols on meat exports acceptance were signed in January-February with both Ukraine and Russia and some companies have already restarted the exports (see **Trade partners**).

Major hopes regarding the industry recovery are inspired by the negotiations with Russia on re-launching the wine exports. Despite all current bureaucratic and technical tergiversations, it is possible that few Moldovan companies with a total or partial Russian capital will receive export quota to Russia. But what will do the remained wine producers?

## Agriculture

In February were published the revised data on the agricultural production in 2006. Contrary to the previous estimations attesting a stagnation of the agricultural sector, the new data indicate its recession by 4.6%. The growth by 4.4% of the animal production was unable to compensate the decrease of the crops production by 8.5%. To a large extent were felt the drop of the grain and beans production by 21%, of the fruit production – by 14% and of the grapes production – by 11%.

In 2007 the situation in agriculture continues to remain uncertain. Since January, when Romania became part of the EU, all exports to Romania are sent on the basis of the EU rules and requirements (see **Foreign trade**). In these conditions, the Moldovan producers either have to limit their business to the internal market, or to find new solutions for exporting. To a large extent suffered the poultry companies exporting chicken eggs to Romania. The over-saturation of the internal market with eggs brought about a price decline by approximately 60% until 0.5-0.6 MDL/unit.

The owners of the industrial refrigerators could count on a solution to the problem of apples they have in stocks. The prices for Polish products start rising due to the limited stock (in the conventional refrigerators), and the price of products kept in refrigerators with controlled temperature will be higher than the existent ones.

In February the Parliament adopted a Regulation on the use of the fund for subvention of agricultural producers.<sup>1</sup> But the total value of the fund is only 240 million lei, and the analysis shows that previously the financial resources were used inefficiently and adversely. Frequently, the final subsidy beneficiaries are not the

<sup>1</sup> Parliament Decision no.15-XVI, February 9, 2007.





agricultural producers, but the companies which buy and process the agricultural production.

The agriculture subsidy policy could bring about more palpable positive results only through an increase of subsidies and their more efficient distribution. Taking into account that the public budget balance is positive (see **Budget**), we consider that an increase of the fund is possible. It is possible also to ensure a higher efficiency in using current resources, initially by removing the practices which lead to adverse or even corrupted selection of beneficiaries. In particular, an analysis of the subventions' distribution shows that main beneficiaries are the big agricultural farms, while the peasant farms and small individual enterprises are discriminated.

At the end of February 2007, the government approved also the new rules for subsidizing the insured risks in the agriculture. The list of budgetary-subsidized risks was expanded and the compensation quota was raised to 60% of the cost of the insurance policy. It seems that in Moldova starts to gain ground a "culture" of insuring the agricultural risks too: if in 2005 only 90 thousand lei from 5 million allocated for subventions were used, then in 2006 already 4 million lei of the 15 million allocated were used by agricultural producers. Taking into account the rising demand for insurance services and the increase of agricultural risks in last years, in 2008 a significant rise of the budget allocation to approximately 25-30 million lei will be necessary.

## Constructions

In January 2007, the constructions sector continued to grow. For instance, according to the statistical data there was registered an increase of the production volume in the stone cutting, shaping and finishing (by 3.4 times); metallurgy industry (by 3.2 times); mining industry (by 2.8 times); cement and other construction materials (by 2.7 times); production of concrete and cement elements (by 1.9 times); metal goods production (by 30%); glass and the glass production (by 4%). Growing demand for residential and office facilities has favored the development of this sector.

The number of companies which performed construction-assembly works keeps on growing, at the beginning of the year counting around 800 units. The interest for construction is determined by the demand for residential apartment that remains high despite the high prices.

In 2007 a number of companies offering apartments in the medium price layer have emerged. The companies offered prices of 390 Euro/1m<sup>2</sup> but for areas larger than 100m<sup>2</sup>. However, the number of these offers is still very small to generate certain structural changes on the real

estate market. As the real estate agencies inform, the prices in the real estate sector continued to grow in January too.

The only way to ensure the accessibility of living spaces is the mortgage loans offered on interest rates accessible to common consumers. This tool will have more positive aspects. Firstly, it will reduce the financial pressures on those who want to buy apartments. Secondly, it will create opportunities for buying living space for a larger segment of population. Finally, this will sort out existing companies by removing the less serious ones.

## Prices

January 2007 was marked by a relatively moderate rise of prices (the name „relatively moderate” is used bearing in mind the monetary history of Moldova and ignoring the better performance of reducing inflation recorded by other state in the region). The monthly inflation rate in January was 0.9%, compared to 1.9% in January 2006 and 1.1% in January 2005. The tariffs for services rendered to the population changed slightly (0.2%). The price of non-food goods rose on average by 0.8%, mostly due to the growth of the prices for medicine. The first important decline of prices in 2007 was for some types of oil products. On January 19 the petrol stations reduced the prices for gasoline by approximately 3.4%, for diesel - by 2%, and for liquefied gas – by about 5%. The decrease of prices was caused by a corresponding lowering of prices for oil and oil products on the international markets. In January the food price experienced the highest increase – by about 1.4% - mostly due to the vegetables price rise (15%). In January there was noticed a decrease of chicken eggs price, attributed to the ban of exports to Romania after its joining the EU. This tendency became more visible in February.

EXPERT-GRUP considers that the slow-down of inflationary tensions in January 2007 is, to a large extent, a result of “postponing” inflationary expectations for next months. Waiting for final decisions of the National Agency for Energy Regulations (NAER) and local councils on the new tariffs for natural gas, electricity and thermal power, the producers chose to postpone for February-March the adjustment of selling prices to the new production costs.

These decisions were made on 14 February, when NAER adopted new tariffs for natural gas provided by SA „Moldova-Gaz”, for electricity production and thermal power distribution. As the Table 2 shows, the price rise is very significant and will result in negative social effects.

**Table 2 The variation of some tariffs in the energy sector**

|  | Previous tariff | Current tariff |
|--|-----------------|----------------|
| Natural gas provided to TPPs, lei/1000 m <sup>3</sup>  | 1745            | 1955           |
| Natural gas provided to household, monthly consumption under 30 m <sup>3</sup> , lei/1000 m <sup>3</sup> | 2196            | 2406           |
| Thermal energy, TPP-1, lei/Gcal  | 136,0           | 322,9          |
| Electricity TPP-1, bani/kWh  | 43,7            | 86,6           |

Source: "Monitorul Oficial".

It is possible that new rise of prices in the energy sector will impose the revision of sales prices in other sectors too. In particular, in February there was carried out a "technical" rise of prices for several bakery products produced by the state company SA „Franzeļuță"<sup>2</sup>. At the same time, the price rise for bakery products was to a certain extent influenced by the government decision to change the method of pricing some socially-important goods. For instance, in the case of bread, the costs of transportation to the store will not be anymore included in the 10% margin, but will be included in the production costs.

High prices for wheat on international markets (see **International markets**) and the removal of the ban for grain export could result in a deficit of wheat and quality flour on the internal market. The rise of wheat flour price could be already perceived on the internal market (4.2 lei/kg in February 2007 relative to 2.6 lei/kg in October 2006). This could be an additional reason for the upcoming rise of bread price in the first half of 2007, giving that the price for bread produced by SA „Franzeļuță" has not changed from November 2003.

## Labour market

In January 2007 the real average salary rose by 11% as compared to January 2006, reaching the level of 1780 lei. At the same time, the real salary decreased in the beverages industry (-3%) and in education (-8.5%). In the first case, the real salary decrease is a result of the output recession and the financial problems faced by wine-making companies. In the second case, the real salary drop stemmed from the Parliament decision to amend the Law on the salary system in the budgetary sector and thus, to postpone the basic salary rise for several budgetary categories, including for the employees from the education system, from the 1<sup>st</sup> of January 2007 to 1<sup>st</sup> December 2007<sup>3</sup>. By adopting this amendment, the Parliament violated the provisions of

<sup>2</sup> The name „technical price rise" belongs to the managers of SA „Franzeļuță". See the news „Franzeļuță specifies that operated "technical price rise" only for some types of bread", press agency "Basa-Press", 21 February 2007.

<sup>3</sup> The Law on the modification and completion of the Law no. 355-XVI of 23 December 2005 concerning the salary system in the budgetary sector, no. 442 of 28.12.2006.

the Law on Education<sup>4</sup>, which in the art. 53, p.6 stipulates that „the minimum salary of the didactical personnel will not be lower than the average salary of the employees from national economy".

As a consequence, the period January-February was characterized by greater social tensions, the employees from education threatening to organize general strikes and even undertaking sporadic protest actions. The legislative initiatives submitted by opposition to call off the above-mentioned legislative amendments along with the social tensions could lead to the intensification of the intra-parliamentary and extra-parliamentary political tensions. This thing will not help the government in the 2007 electoral year and could be used by the opposition parties to maximize their chances in the local elections. Moreover, in the pre-electoral period 2007, the government has already adopted some unpopular decisions, such as rising the prices on public utilities (see **Prices**) and amending the law on the entrepreneur patent (see **Budget**). Not accidentally, after a series of negotiations with trade unions, the government has promised a phased raise of budget salaries starting with the 1<sup>st</sup> of April, not 1<sup>st</sup> of December 2007.

Final statistical data on salaries in 2006 prove the real growth of the national average salary by 14%. At the same time, the analysis of statistical series for the 2003-2006 years shows a positive tendency to reducing the discrepancies between the average salary paid by sectors and spheres of activity (Table 3).

In agriculture, which is an extremely important sector from the social and economic point of view, the tendency of decreasing the relative salary still persists. This compromises the attempts of sustainable poverty eradication, since the rural poverty is the main component of the poverty phenomenon. Even more, according to recent information published by the National Agency for Employing the Labour Force, the creation of the jobs in the rural area progresses 5 times slower than in the urban area<sup>5</sup>. This only proves again that the rural economy in Moldova means actually an undiversified agrarian economy with precarious living conditions. These aspects represent the main barrier to the social and economic modernization of the country.

**Table 3 Salaries by sectors, % from the national average**

|             | 2003 | 2004 | 2005 | 2006 |
|-------------|------|------|------|------|
| Agriculture | 55   | 57   | 56   | 53   |
| Industry    | 145  | 138  | 135  | 124  |

<sup>4</sup> The Law on Education, no. 547 of 21.07.1995.

<sup>5</sup> The news „In 2006, 47.5 thousand workplaces were registered." was posted on the Ministry of Economy and Trade web-site, <http://www.mec.gov.md/news.aspx?NewsItem=14455>.



|                                   |      |      |      |      |
|-----------------------------------|------|------|------|------|
| Constructions                     | 139  | 152  | 152  | 144  |
| Trade                             | 84   | 91   | 90   | 88   |
| Hotels and restaurants            | 96   | 92   | 90   | 83   |
| Transportation and communications | 164  | 163  | 163  | 151  |
| Financial activities              | 328  | 295  | 262  | 228  |
| Estate transactions               | 126  | 125  | 127  | 121  |
| Public administration             | 118  | 109  | 103  | 127  |
| Education                         | 69   | 64   | 67   | 72   |
| Health and social assistance      | 64   | 76   | 74   | 78   |
| Standard deviation                | 67.4 | 59.7 | 53.6 | 46.7 |

Source: EXPERT-GRUP calculations based on the NBS data.

## Consumption

Following the fact that in January 2007 the salaries continued to rise (see **Labour market** section), and the rise of prices slowed down (see **Prices**), it could be estimated that population tendency for consumption remained high. Total consumption expenditures raised by about 7% relative to January 2006. We cautiously estimate that in January the growth rate of retail sales was 8%, and of services 4%.

At the same time, the evolution of agriculture and wine-making sector let us to suppose that in January 2007 the gap between salaries in rural and big urban areas continued to grow. This considerably restrains the growth of internal consumption and, consequently, the economic growth in general.

In February the government published a Strategy on the development of internal trade and a Decision on the development of a chain of supermarkets<sup>6</sup>. The Strategy provides building of 9 supermarkets in the first stage (towns Anenii Noi, Cahul, Comrat, Drochia, Hancesti, Rezina, Ungheni, Soroca and Orhei) and 3 supermarkets in the second stage (2 in Chisinau and 1 in Balti).

We have to mention that earlier several private retail chains have declared their intention to expand their affairs in the regions. The governmental plans will obviously undermine the private strategies. The Government's logic to raise the development of the internal trade on the level of national priority is unclear. Actually, this priority is doubtful. There are a lot of other spheres of economic activity (infrastructure, housing) where the public investment is much more suitable than in the internal trade. The development of the latter could be certainly left to the private sector.

## Budget

The 2007 budgetary year started on the same optimistic note as the previous one. The global public budget

revenues rose rapidly: by 14% compared to the planned level and by 34% relative to January 2006. The VAT remains the main source of budget revenues (ensuring more than 35% of global revenues collected in January 2007), and even consolidates its quota (comparing to 29.4% in January 2006).

**Table 4 The dynamics of the national public budget**

|  | Planned<br>M1-07 | Executed<br>M1-07 | Executed<br>M1-06 |
|--|------------------|-------------------|-------------------|
| Global revenues, MDL million                             | 1204.4           | 1377.8            | 1029.9            |
| Including, revenues from VAT, MDL million                | 428.0            | 398.9             | 303.0             |
| Including, taxes on income coming from business activity | 69.5             | 112.2             | 29.6              |
| Global expenditure, MDL million                          | 1999.5           | 1311.0            | 890.4             |

Sources: NBS, National Human Development Report for GDP/capita and EXPERT-GRUP estimations 2006

High quota of the indirect taxes in the total budget revenues is a lasting subject in the economical debates in Moldova. Despite the disadvantages of the high quota of VAT and excises in the budget revenues, it ensures a certain budgetary stability and gives the government time to adjust the budget to the realities in the production sector of the economy. This effect could be explained by the fact that the consumption is much more inert than the production. Thus, the revenues from consumption are more stable than revenues from the economic activity (profit, salaries etc.)

In 2006, the VAT and excises cushioned the public budget against negative influences of the real and foreign sectors. However, in 2007 the budget could be more sensitive to the wine-making industry's recession and to the halt of wine exports to Russia. In February 2007 the Ministry of Finances of Republic of Moldova estimated that monthly revenues lost by the public budget due to the stop of wine exports to Russia are about 40-50 million lei. At the same time, if at least half of the wine companies do not relaunch the exports to Russia or identify other sales markets, the future budgetary loss could become even bigger, because the recession of the wine sector will exert negative influence on agriculture, which will be followed by a gradual consumption decline.

Thus, the importance of other revenues than those collected from the indirect taxes should not be neglected. For instance, in January the deficit of revenues collected from VAT (-29 million lei) stemming from higher than expected VAT restitutions was to a large degree compensated by the excess of revenues from the tax on income on entrepreneurship activity.

<sup>6</sup> Government of Republic of Moldova, Decision on the development of a chain of supermarkets, no. 112 of 01.02.2007.

According to the Ministry of Finance' reports, the global expenditures in the public budget were executed in proportion of 65.6% from the planned level. (The service of the internal and external debts is maybe the only article of expenses where the government proves an exemplary financial discipline). The deviation from the global financial plan is mainly due to the non-execution of expenditures in the local budgets. However, the expenditures from the state budget were executed only in proportion of 72%.

There are two reasons which explain this situation (that certainly will endure during the 2007 year). The first reason is a technical one, determined by delays in circulation of the information within the treasury system. The second reason has a systemic nature and is determined by the lack of human resources required for an adequate financial management. This deficit is present at both local and central authorities' levels. Delayed execution of the budgetary expenditures testify Moldova's reduced capacities of financial absorption which could compromise, to a certain extent, the efficient use of external funds promised by the international community for the 2007 year.

Since January, 1<sup>st</sup>, 2007 the amendments to the Law on the entrepreneur patent, excluding some types of activity from this regime, have entered in force.<sup>7</sup> The economic activities on the patent basis are very important from the fiscal point of view. Presently, on the patent basis work approximately 44 thousand of individual entrepreneurs, which pay annually about 72 million lei for different taxes.

For 2007 this decision refers only to 4 types of activity pursued, according to the official information, by about 4.2 thousand citizens. Obviously, the ban of these activities does not bring about significant budgetary losses (approximately 7.6 million lei). But considering the way this decision was initially adopted, it could provoke serious social and political repercussions. Especially, there is a risk that many patent holders would be unable to open other types of enterprise, recommended by the government (LTD, individual enterprises) and would join the unemployed and emigrants cohorts. The government was also accused that by banning the commercial activities on the patent basis it actually intend to limit competition and support the interests of companies from the "organised trade" sphere. An additional argument used by the supporters of this position is that shortly after the amendments on the entrepreneur patent enter in force the government launched a set of normative acts for developing the internal trade and building a chain of supermarkets (see **Consumption**).

<sup>7</sup> The Law regarding the modification and completion of several legislative acts, no. 208 of 07.07.2006.

## Money

In January-February 2007 the National Bank of Moldova (NBM) kept the rates of its monetary policy tools intact. In December the basic NBM rate reached 14.5% and a new significant rise is unlikely in the near future. Such rise would be indicated only in case of amplification of the systemic inflationary risks, which currently is not the case in the Moldovan economy.

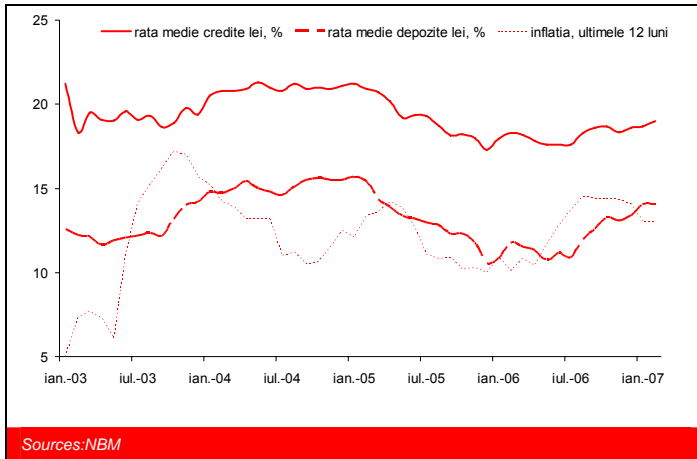
On the other hand, since in 2006 the NBM was assigned to control the inflation as its primary task, in 2007 the Bank has to intensify its presence on the monetary market and use more efficiently the available tools. In January 2005, the total volume of NBM operations for sterilizing the excessive liquidity was of about 1.5 billion lei, compared to 1.0 billion lei in January 2006. The NBM certificates became the main, although quite expensive, tool used for sterilizing the monetary mass. The interest rate paid for the NBM certificates reached in January 2007 13.9%, as compared to 1.6% paid in January 2006.

## Banking system

The first 2 months of 2007 did not bring any essential changes in the evolution of banking system, this period of time being traditionally without any spectacular evolutions. Nevertheless, it is necessary to notice that in January there was formalized the acquisition of the commercial bank "Mobiasbanca" by Societe Generale and there was organized the General Assembly of all bank's shareholders. In February several local commercial banks signed the agreements with foreign banks; this will allow local banks to receive cheap resources from abroad. Thus, we could outline the first symptoms of the intensification of banking competition for retail sector, in particular for financing the peasant farms and small enterprises from the rural area.

The interest rate on both credits and deposits has continued their growth from 2006. In January 2007 the rate of interest on the deposits in foreign currency reached 5.86% as compared to 5.62% in December 2006. The interest for foreign currency credits rose lesser from 10.97% to 11.12%. In January the average rate of interest on the deposits in MDL recorded the highest growth, reaching 14.03% compared to 13.40% in December 2006. The real interest rate in January was positive compared to the inflation in the last 12 months. In the same period, the average rate on credits in MDL gained 0.11 percentage points, reaching 18.70%.

*Figure 3 Evolution of the average interest rate, %*



It is noticeable that the average rate on credits given by commercial banks has grown slower than the average rate on deposits. For the moment, it seems that the resources for raising the interest on credits have been exhausted, whereas the deposit market has neither showed any concrete signs of the interest rate ascent.

In January - February the interest spread narrowed down. Such a situation could have two explanations: either the banks agreed to give up a part of their profit in order to attract further on the resources and not to lose their image and position on the market, or the banks overstated the supply on the deposit market and did not considered the price of these resources. Some banks offer an interest of 17% and even 17.5%. Most likely the average rate of interest on deposits and on credits will go down or at least will persist in the immediate future. This dynamics could be also favoured by a reduction of the annualized rate of inflation to 12.7% in January 2007 comparing to 14.1% in December 2006. Other factor could be the more evident drop of the interest rate on the treasury bonds traded on the primary market during the last period (see **Financial Markets**).

## Financial markets

In January-February, there was noticed a precipitous decrease of the interest on bonds traded on the primary market. Thus, if at the auction of 2 January, 2007, average nominal interest rate for the T-bonds with maturity of 91 days was 14.33%, then at the auction of 27 February it felt to 11.72%.

It is noteworthy that the demand at the auctions held in the last period surpassed the supply by at least 50%. At the auctions of 23 and 30 January 2007, when the first signs of decreasing interest rate for the T-bonds appeared, the demand for the T-bonds with maturity of 364 days was 48.8 million MDL and, respectively 50.5 million MDL, 4 times more than the supply limited to 12 million MDL. This data indicate that the banks are still interested to invest the available resources in T-bonds,

even for one year period, in conditions when the "season" of active crediting has not yet began and the banks have available resources. Although at the auction of 27 February the interest rate continued to fall for all types of T-bonds, the demand exceeded the supply by 39 million lei.

In January-February 2007, the average exchange rate on the foreign currency market was 12.9121 MDL/USD and 16.8310 MDL/Euro, on an upward path compared to the same period in 2006, when it was of 12.8923 MDL/USD and 15.5073 MDL/Euro, respectively. A significant appreciation of the European currency could be noticed, which mirrors the dollar-euro evolution on the international markets (see **Global markets**).

Analyzing the evolution of the exchange markets in January-February, we could observe that the Moldovan leu did not maintain the declining trend characteristic for previous years (2005, 2006). Traditionally, in the first months of the year, the national currency slowly, but stably depreciates against the US dollar. This year, the leu depreciation stopped on 17 January, when the highest exchange rate of 13.0281 MDL/USD was recorded. Since that day, the leu started to appreciate, sinking under the level of 13 MDL/USD by January 26, so that on 22 February it reached record lows of 12.7103 MDL/USD. This evolution resides in the continuing inflows of foreign currency from Moldovan emigrants; a major part of this money enters the circulation through exchange offices. The growth of the foreign investments volume in national economy could also contribute to the leu appreciation.

As a result of these tendencies, at the beginning of February, the National Bank of Moldova together with the Ministry of Economy decided to lower the exchange rate forecasted for 2007 from 14.60 to 13.20 MDL/USD. This will impose a revision of the public budget for 2007.

## Foreign trade

According to last statistical data, Moldova's trade deficit reached in 2006 the level of 1.6 billion USD. The galloping deficit growth stems from the rapid extension of imports and a new phenomenon of exports' compression. This phenomenon takes its source in the discriminatory non-tariff barriers imposed to the products from Republic of Moldova and in low competitiveness of the Moldovan companies.

The growth of the weight of exports to the European Union is welcomed (35% relative to 29.7% in 2005), but this happens not only because of rising exports to EU (+13.6% comparing to 2005), but also because of the compression of exports to CIS (-23.1%) and the reduction of their quota in the global exports structure



(40.3% compared to 50.5%). The Romania and Bulgaria joining the EU will also favour a statistical growth of the weight of exports to EU.

In the long run, the process of “forced” exports reorientation will be profitable for Moldovan companies due to the unavoidable adjustment to the international quality and management standards, more severe in the EU than in the CSI. At the same time, a part of companies and even branches will suffer in a short run. An eloquent example is the wine branch, the cornerstone of the Moldovan exports. The preliminary statistical data show that wine exports have shrunk by 45% comparing to 2005, being damaged by the restrictions mounted by Russian Federation. According to some IMF estimations, the 2005 year volume of wine exports would be possible to restore only in 2009.

The adverse shock supported by Moldovan wine producers was partially weakened by the rise of wine exports to other sales markets, mainly to Ukraine and Belarus. „Moldova-Vin” has even declared the Ukrainian market a strategic one, and signed a cooperation agreement with the Union of alcohol and tobacco producers and wholesalers of Ukraine. The agreement stipulates *inter alia* holding consultations on the legislative amendments and the conjuncture of both states’ alcoholic drinks markets.

With regard to the perspectives of the wine exports return to Russian market, they remained remote. The series of declarations, cancelled or effective visits of the Russian experts and the recommendations implemented by Moldovan responsible persons do not really get the Moldovan wine producers nearer the Russian market, while the recession of the wine production reached low records (see **Industry**). The Moldovan wines do not have yet a real access to the Russian market. We continue to be skeptical about the re-launching of wine exports, at least for short-term. Moreover, is important to take into account that only several companies from those exporting to Russia will be authorized to re-launch the exports.

In these circumstances, the situation of other Moldovan products exports has improved. First of all, the beef meat exports to Russia were resumed (they account for 75% of total meat exported before the restrictions in 2005); three Moldovan companies have received the necessary authorizations after the Ministry of Agriculture and Processing Industry of Moldova signed a protocol with „Rosselihoznadzor”. This positive evolution was followed by a decision of Ukrainian authorities to allow the resuming of beef meat imports from Moldova (banned in March 2006), but so far only one enterprise benefit from this right. In addition, a protocol of resuming the Moldovan vegetal and animal exports to Russia was

signed. But, it will be possible to export only through two Moldovan customs points, while in Russia the custom procedures will be done only in one terminal.

At the end of February, the EU lifted the restrictions imposed to honey imports from the Republic of Moldova to the single European market. This will favour the rise of honey exports in the next years, but with the condition that only high quality products will be exported.

We anticipate the upholding of the rising trade deficit trend for the next months. Any significant progress of diminution/lifting the trade barriers to wine exports are not expected in short time, while the process of increasing the competitiveness implies long-term efforts. On the other hand, the imports will continue to rise quickly.

## Global Markets

The oil price for WTI brand continued to vary around 60 USD/barrel. The price lowering tendencies are influenced by the low probability that the OPEC member states will adopt in the next future a decision on reducing the volume of extracted oil. However, the ascending trend of the oil prices seems to prevail, due to the reduction of the oil reserves in the USA and a possible rise in demand caused by an active consumption in China. The geopolitical risks in the Middle East have escalated again. In short-term, the experts anticipate the price to persist at 55-60 USD per barrel<sup>8</sup>. The February tensions coming from the Chinese financial markets do not seem to change radically the demand for oil and oil products on the Asian markets. The stability perspective is beneficial for Moldova, especially when the spring agricultural works will start soon and the agricultural producers need certainty over the oil derivatives prices.

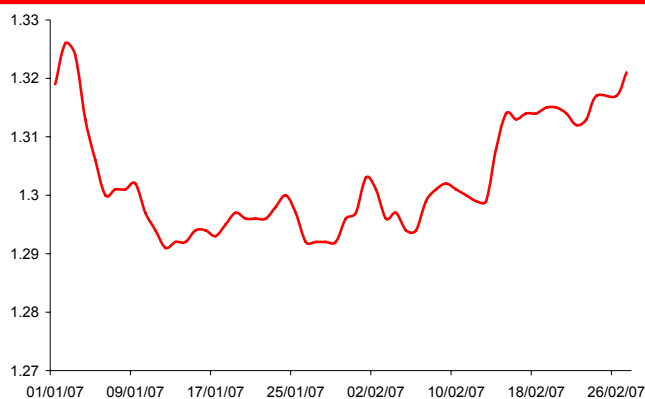
In January 2007 the global **wheat** forecast (the 2006/2007 period) listed an ascending evolution (+1.3 million tons) due to high production increase in Kazakhstan (+2 million tons comparing to the forecasted amount), counterbalancing the production decline by 0.7 million tons in Poland. The estimates also were influenced by the production growth in Belarus, Romania and Moldova and by the production decline in Ukraine and Armenia. At the same time, due to the growth of the food-related and residual wheat consumption, the world final stocks are estimated to be lower by 1 million tons. The forecasts of rising barley consumption (+0.2%),

<sup>8</sup> Sources: The Economist, BusinessWeek, Global Insight Inc., International Energy Agency *Oil Market Report*, International Monetary Fund, Kommersant.



coupled with the reduction of global (-1.4%), exerted a positive influence on the barley prices.<sup>9</sup>

**Figure 4 Evolution of the exchange rate euro/dollar**



Source: Rossbusinessconsulting

In January-February the euro-dollar pair registered a U-evolution (*Figure 4*) to a large extent mirrored by the evolution of the euro-leu exchange rate on the internal market. The depreciating tendencies of the European currency prevailed in January. In February the European currency appreciated from 1.29 to 1.32 USD/EUR. This evolution stemmed from the pessimist statistical data disclosing a slower than expected economic growth in USA and the revival of geopolitical risks related to the Iranian nuclear dossier.

On 27 February a significant fall of stock exchange indexes was noticed on all financial markets. The most considerable recession (-9%) was registered at Chinese stock exchange. The investors' concerns and the subsequent panic emerged due to rumours about the Chinese government's intention to strengthen the control over the portfolio investments. According to some data, only in one day the international investors withdrew from the Chinese market 110 billion USD. The fall of the Chinese stock exchange had immediate echoes throughout Asia and later in Latin America, USA, Europe and Russia. For the majority of experts, the events from the Chinese market were a long-awaited correction, but which will not have fundamental effects on the global market's evolution. There are few financial channels through which the events from the main international stock exchanges could influence the economy of Moldova. But, supposing that the February financial crisis influence negatively the global economic growth, this would be followed by a decrease of the oil prices, which are rather positive consequences for our economy.

<sup>9</sup> Sources: USDA, World Agricultural Supply and Demand Estimates, Wheat Outlook.

## Trade partners

In 2006, the oil exports had an important role in the maintenance of economic growth in **Russia**. But in the long run this branch will reduce its contribution to the economic growth. Both the price conjuncture on global markets and the physical limits of production will restrain to a certain extent the influence of this branch. On the other hand, the importance of the internal demand and investments in the innovative sectors of economy will increase. Thus, according to estimates of Russian Ministry of Economic Development and Trade, the contribution of external conjuncture to the GDP growth will drop from 2.6 in 2005 to 1% in 2007. In exchange, the rising investments (including the public investments in infrastructure) will ensure about 0.25-0.47%, reinforced also by increasing available income of the population. The reduction of inflationary tensions in the Russian economy (8% in January 2007) has also favoured the economic growth. At the same time, the state increases its role in the energy sector. Gazprom will delivery more gas to local market for ensuring the fulfillment of the national gasification' objectives and will depend to a larger degree by the imports of cheaper gas from Central Asia for ensuring the gas delivery to Europe and CIS. But this will not reverse the price increase for the natural gas distributed to Ukraine and Moldova.

In **Ukraine** the economy grew strongly in January 2007 (+9.3% comparing to January 2006), due to positive evolutions in industry (+15.8%) and constructions (+26.3%). However, the more tensioned relations between the governmental coalition and opposition jeopardize the economic development. The likelihood of the anticipated elections is largely discussed, but their result could strengthen the current governmental coalition. The latest rising of prices to public utilities is obviously very unpopular and offers new political opportunities for opposition.

On the other hand, the governmental coalition is also very diverse concerning the course of economic policy. The Party of Regions is interested to cut the social expenses and to direct the resources for reinforcing the economic growth. The position of its left-wing allies (Socialist Party and Communist Party) is diametrically opposite. In this situation, the Party of Regions could find allies amongst the representatives of movement „Nasha Ukraina”. But as long as the relations between these two political actors are determined by other than economic aspects, such an evolution is unlikely. Thus, the political risks will continue to have an adverse influence on the perspectives of a sustainable economic growth in Ukraine. Such evolution would be extremely unfavorable for Moldova.



**Table 5 The economic indicators of the main Moldova's trade partners, January 2007**

|         | GDP                  |                 | Industrial output, | Inflation,     | Unemployment    |
|---------|----------------------|-----------------|--------------------|----------------|-----------------|
|         | Last data            | 2007, prognosis |                    |                |                 |
| Russia  | 6.8<br>Jan.07        | 6.3             | 8.2, Jan.07        | 8.2<br>Jan.07  | 7.2<br>2006     |
| Ukraine | 9.3<br>Jan.07        | 6.0             | 15.8,<br>Jan.07    | 10.9<br>Jan.07 | 6.7<br>2006     |
| Romania | 7.5<br>2006,<br>est. | 6.5             | 7.1, 2006          | 4.0<br>Jan.07  | 7.5, Jan.07     |
| Germany | 2.6,<br>2006         | 1.8             | 5.5,<br>Dec.06     | 1.8<br>Jan.07  | 7.7, Jan.07     |
| Italy   | 1.8,<br>2006         | 1.3             | 5.0,<br>Dec.06     | 1.9<br>Jan.07  | 6,7<br>T3, 2006 |

Sources: *The Economist*, IMF, World Bank, Derjkomstat, Goskomstat, Eurostat, INS Romania, EXPERT-GRUP.

The economic evolutions in UE are very positive and the experts agree that the European economy has definitely recovered from the economic difficulties. The revised data on the economic growth in Euro-zone in 2006 (+2.7%) exceeded the prior estimates. More important, **Germany**, the main European economy (and the second Moldova's trade partner in the "old Europe"), shows a solid economic revival, mainly due to exports and the enhanced international competitiveness of companies. The economic reinforcement comes to support the increasing role of Germany in European affairs (the EU presidency), and also in the global affairs (the chancellor Angela Merkel is only in the middle of her mandate, while the most leaders of the global powers end their mandates in 2007-2008).

**Italy**, the main EU-core trade partner of Moldova seems to have a different economic evolution: the international competitiveness of Italian companies suffer from rising labour costs, rigid conditions on the labour market and excessive regulation of the production activity. The reforms, which the Prodi government tries to implement, collide with many political obstacles (mainly the heterogenic character of the governmental coalition) and are currently endangered by the political crisis in Italy<sup>10</sup>. If the difficulties from production sphere are followed by a reduction of the consumption expenses of the population, after a while the Moldovan exports to Italy may suffer.

After 1 January 2007 **Romania** became our main trade partner in the UE-27. Although Romania's economy grows very fast, its wine-making sector displays another dynamics. On the other hand, the wine consumption started to raise in 2005, which is extremely favourable for Moldovan producers. After a disastrous crop in 2005 (48% of the production in a normal year), Romania presently registers a wine trade deficit. The limited supply and rather high prices led to a loss of one part of

exports (especially to Germany and Japan), and determined Romanian producers turning to cheaper raw materials. The Association of Wine Producers and Exporters expects a more sizeable presence of the imported wines and an increase of the competition on the Romanian wine market in 2007. The heightened competition will require from the Romanian producers to increase the efficiency of the production processes and the wine quality. This situation gives the Moldovan wine producers both commercial opportunities to use and lessons to learn.

<sup>10</sup> Sources: Eurostat, OECD, The Economist, RBC.