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MOLDOVA Economic Update Fall 2019

Despite political instability, the growth remained robust in 2019. The outlook points to 3.6 percent growth in 2020 while identifying increasing downside risks. The fiscal position is under pressure as the pension deficit continues to rise. Prudent fiscal and financial sector policies are necessary to protect macro sustainability, while low productivity and judicial reform require immediate efforts.

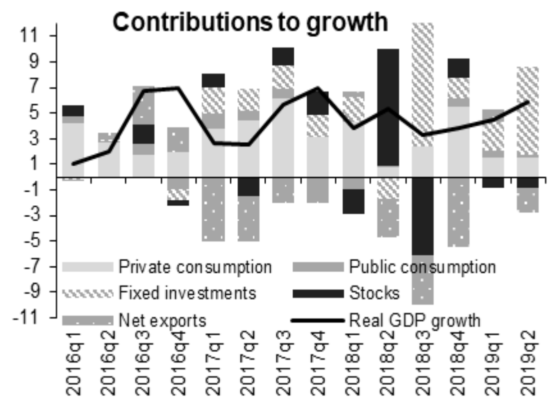
Recent Economic Developments

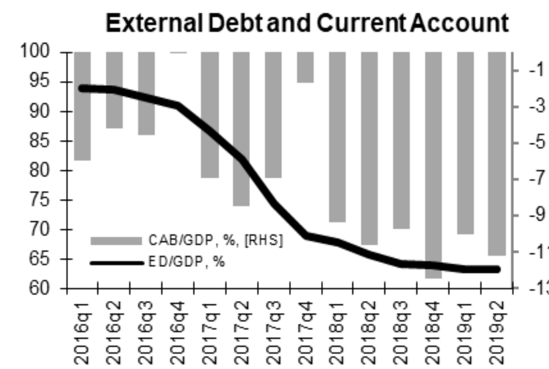
Despite heightened political instability, the economy continued to grow in early 2019. GDP came in at 5.8 percent in the 2nd quarter boosting half-year growth to 5.2 percent. A strong increase in wages (15.9 percent yoy) and pensions (14.2 percent yoy), on top of high public investment related to elections, spurred domestic demand; in the first half together they contributed 5.8 percentage points (pp) to growth. With strong domestic demand, and inertia from a stronger Leu, at end-2018, imports had expanded more quickly (2.9 percent yoy) than exports, resulting in net exports making a negative contribution to growth (0.6 pp). Supported by favorable financial conditions and government spending, construction (+2.2 pp) and industry (+2.1 pp) were the most buoyant sectors. Retail trade added 1.1 pp, while after three years of good yields, agriculture's contribution was marginal (+0.2 pp).

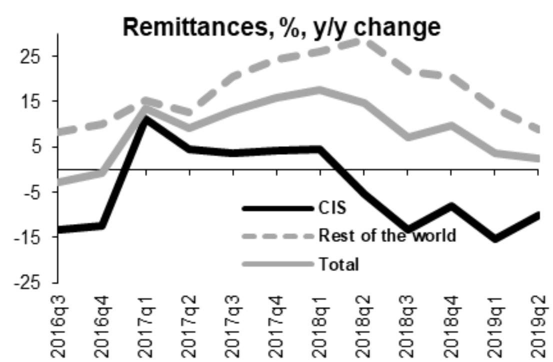
Monetary policy tightened against intensifying inflationary pressures and excess liquidity. Due to higher food and electricity prices, inflationary pressures are on the rise, but a weaker Leu and falling international prices for fuel through June were among the main disinflationary pressures. As a result, the annual inflation increased to 6.8 percent in October. In 2019, the policy rate went up twice, from 6.5 to 7.5 percent. The reserve requirement ratio for liabilities in Leu and nonconvertible currencies is holding at a record high of 42.5 percent to address excess liquidity.

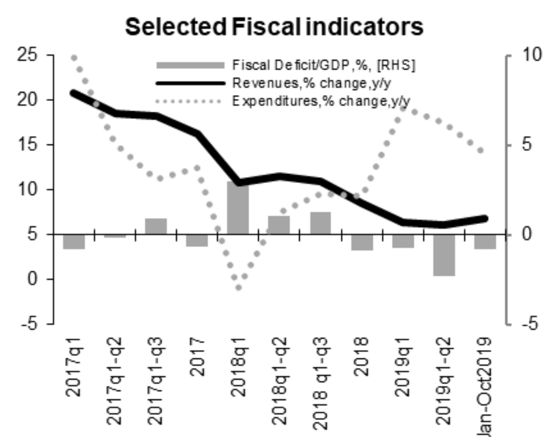
A larger trade deficit led to the deterioration of the current account deficit (CAD). Due mainly to robust imports and anemic exports, but also to declining remittances, in the first half of 2019 the CAD widened to 10.6 percent of GDP. Unlike in 2018, the deficit was mainly financed by the sale of reserves and foreign direct investments (FDI). After declining early in the year, by October foreign reserves had recovered to US$3 billion (more than 5 months of imports). By June 2019 external debt had dropped to 62.3 percent of GDP.

Led by policy reversals in 2018, public spending increased fast in early 2019. As of October 2019, revenues increased by 6.9 percent yoy mainly driven by a rise in VAT, excises, and social contributions. A strong increase in public sector wages, social spending and investments underpinned the expansion of spending by 14.1 percent, resulting in a deficit of 0.8 percent of GDP. Yet, the pension system deficit widened by 1.7 pp of GDP due to the reversal of the 2017 policy reform, which had to be financed by general taxes. As of August 2019, public and publicly guaranteed debt decreased to its pre-2014 level of 26.3 percent of GDP.









Medium Term Outlook

With lower remittances and slackening foreign demand, economic growth will remain moderate, and below historical values. Growth in 2019 is an estimated 3.6 percent; in 2020 the economy is projected to grow by 3.6 percent; and by 2021, if growth in main trade partners strengthens, Moldova's economy is projected to grow by an estimated 3.8 percent. The projections assume continued progress on the reform agenda, solid private consumption, and strong investment as financial conditions stabilize, business confidence builds, and social benefits and public wages continue the upward trend. After 2020 as exports slowly intensify along with external demand, the CAD will be held below historical values. On the supply side, non-tradable sectors (e.g., trade, ICT) and industry will have the most dynamism, while agriculture's contribution will continue to be marginal. In 2019 higher utility and food costs intensified inflationary pressures until the inflation corridor was breached in the second half of 2019. Over the medium term, as import prices and anemic demand-pull inflation factors ease, inflation will fluctuate within the target corridor. Mainly due to the 2018 pre-election spending spree and over-optimistic collection estimates, in 2019 the fiscal deficit will expand to 2.1 percent of GDP, as the latest budget amendments show. In the medium term, spending pressures will push up the deficit and public and publicly guaranteed debt.

Despite a positive macroeconomic outlook, there are considerable downside risks to sustainable growth in Moldova. With the country's heightened reliance on EU countries for trade and remittances, a further EU economic slowdown may reduce its exports, while continuous political instability may undermine the positive macro outlook and fiscal sustainability. Because there is little scope for raising more revenue, financing the deficit relies heavily on external borrowing. With financing needs on the rise, the fiscal position may also deteriorate due to structural inefficiencies and the increasing burden of wages and social transfers. Other risks to sustainability are the pension fund (see Special Topic) and contingent liabilities accruing from state-owned companies (SOEs) and the financial sector. Although regulation has been reinforced, further efforts are needed to ensure the efficiency of financial institutions and of the financial sector generally. Though the nonbanking financial sector is relatively small, its fast growth demands attention from regulators and supervisors to reduce the fiscal risks. In the long term, inefficient public spending and demographic vulnerabilities add to the pressure on fiscal policy, and debt will only be sustainable if Moldova's dependence on foreign financing is reduced, supported by longer average maturities for domestic debt; and deepening the secondary market would help reduce domestic debt roll-over and interest rate risks.

To strengthen potential growth, Moldova needs to increase its productivity. SOEs are still omnipresent even though they are less productive per employee, and their productivity is declining. They are a fiscal drain. Fighting corruption, streamlining bureaucracy, building up institutions, ensuring access to fair justice, and leveling the playing field in the economy all underly the need for transformational policy measures. Eliminating price controls and monopolies within the economy and strengthening competition would help free resources to support heightened productivity. Exports are still small despite recent diversification and a larger pool of greenfield FDIs, and they are still tilted to lower-value-added products. Meanwhile productivity is not only low but decelerating. Moreover, the pool of workers with the skills for which there is market demand is limited.

Table 1: Key Macroeconomic Indicators

	2014	2015	2016	2017	2018	2019F	2020F	2021F
Nominal GDP, *MDL billion*	133.5	145.8	160.8	178.9	192.3	210.2	227.4	248.0
GDP, *% real change*	5.0	-0.3	4.4	4.7	4.0	3.6	3.6	3.8
Consumption, *% real change*	4.4	-2.3	2.6	4.7	3.2	1.9	2.4	3.0
Gross fixed investment, *% real change*	10.0	-2.3	-2.8	5.2	14.0	9.7	7.6	8.3
Exports, *% real change*	0.9	2.6	9.8	10.9	4.8	3.3	6.3	7.5
Imports, *% real change*	3.1	-5.8	2.8	11.0	8.9	3.1	5.1	6.7
GDP deflator, *% change*	6.4	9.6	5.7	6.3	3.4	5.7	4.4	5.1
CPI, *% change, average*	5.1	9.7	6.4	6.6	3.0	4.7	4.8	5.0
Current account balance, *% GDP*	-6.0	-6.0	-3.5	-5.8	-10.4	-6.1	-6.3	-6.5
Remittances, *% change, USD*	0.4	-24.5	-5.0	13.2	11.9	3.1	3.0	2.9
Terms of Trade, *% change*	-2.1	5.1	3.0	0.5	-4.1	1.2	-2.0	-0.3
External Debt, *% GDP*	67.9	78.3	76.7	72.0	64.6	62.4	63.6	65.8
Budget revenues, *% GDP*	31.8	30.0	29.0	30.2	30.1	29.4	29.9	30.2
Budget expenditures, % GDP	33.3	31.8	30.5	30.8	31.0	31.5	33.0	33.6
Fiscal balance, % GDP	-1.5	-1.9	-1.6	-0.6	-0.9	-2.1	-3.1	-3.4
Public and Guaranteed Debt, *% GDP*	27.2	29.6	36.9	32.7	30.1	29.0	30.0	30.3

Source: Moldovan authorities, World Bank projections

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