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MOLDOVA Economic Update

April 8, 2015

- ***Despite regional challenges, Moldova's economy performed well in 2014.***
- ***We project real GDP to decline in 2015 because of negative shocks from weaker external demand, declining remittances and tighter financing.***
- ***Structural reforms across all sectors of the economy are essential for improving growth prospects.***

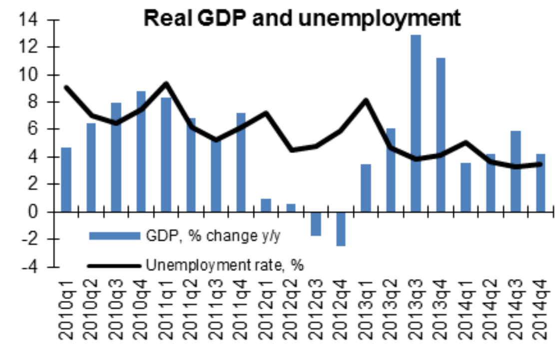
Recent Economic Developments

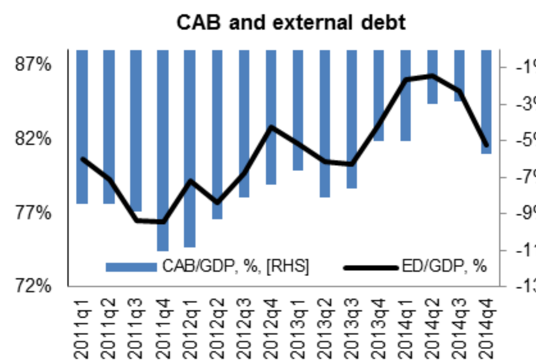
Real GDP growth slowed in the fourth quarter of 2014, bringing the full-year expansion down to 4.6 percent, less than half the pace in 2013. Strong growth in fixed investment (10.1 percent) was driven by higher public capital expenditure, while the expansion of private consumption was moderate (+2.9 percent) due to lower remittances in the fourth quarter. Even with growth of real exports faster than that of imports, the contribution of net exports to growth was nil. Destocking of 0.6 percentage points of GDP contributed negatively to growth.

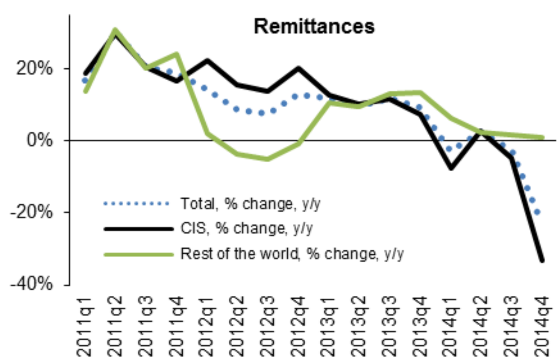
The pass-through from currency depreciation pushed consumer inflation to the upper bound of the target range of the National Bank of Moldova (NBM). Twelve-month inflation rose to 6.5 percent by February 2015. While higher than last year, inflation is still within the target of 5±1.5 percent for three years. In response to rising inflation, the NBM started to tighten the monetary policy. Since December, the NBM hiked the key policy rate four times by a cumulative 1000 basis points to 13.5 percent. The rate is now strongly positive in real terms.

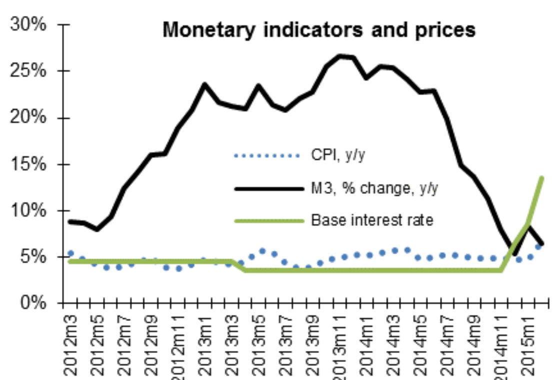
The unfavorable regional environment started to affect Moldova's external position. The current account deficit widened to 5.7 percent of GDP in 2014 due to a sharp drop of remittances from CIS countries in the fourth quarter. Meanwhile, exports continued their shift from CIS to EU markets. At the same time, heightened regional risks reduced foreign investment. The large depreciation of the Russian ruble in 2014Q4 and the reduction of remittances to Moldova put stronger pressure on local currency. From September 2014 until the end of March 2015, the Moldovan Leu lost over a fifth of its value against the USD. Foreign exchange reserves declined by a quarter to $1.8 billion, still covering 3 months of imports.

The Government faces fiscal pressures in early 2015 after maintaining fiscal discipline during 2014. In 2014, general government revenues grew 15.1 percent, including one-off telecom licenses revenue of 1 percent of GDP. Expenditure growth was at 14.9 percent, and the fiscal deficit remained at 1.8 percent of GDP. Since the 2015 state budget was not adopted in time, the budget system functioned according to the 2014 budget in early 2015. With a weaker economy and tighter monetary conditions, the Government faced challenges in financing higher recurrent expenditures, introduced in mid-2014.









Medium Term Outlook

We project Moldova's economy to go into a recession in 2015, followed by a slow recovery in 2016. In our view, economic troubles in Russia and Ukraine, together with Russia's restrictions on agro-food imports from Moldova will push Moldova's GDP down by 2 percent in 2015. The flexible macro-policy framework of Moldova's authorities, the trade reorientation to the EU, and the weak effectiveness of the trade restrictions on Moldova provide some – albeit small - buffer against the negative impact. We project a weak recovery by about 1.5 percent in 2016, as Moldova's main trading partners from the CIS are expected to recover only gradually, and EU growth is likely to remain below potential. We expect the current account deficit to stay below historical averages, but higher perception of risk in the region would constraint inflows of foreign investment and lending. Inflation is projected to temporarily increase above the target range of the NBM in 2015. We assume the authorities would introduce corrective fiscal measures to keep the budget deficit under 3.5 percent of GDP over the projected period.

Downside risks to the macroeconomic framework stem from the external environment, weaknesses in banking sector and fiscal pressures. First, the contraction in Russia and Ukraine could be larger, with a larger negative impact on growth in Moldova. Geopolitical tensions might intensify further with additional negative repercussions for Moldova's economy. Second, the soundness and transparency of the banking sector remain the main domestic policy challenge. In late 2014, the NBM entered special administration into three troubled banks that account for 20 percent of banking system's deposits. The authorities need to recognize the losses incurred by the state in the banking sector, to overhaul prudential supervision and improve governance of the sector in order to minimize further risks. Third, a failure to align fiscal policy with available financing might undermine recent achievements in Moldova's macroeconomic management.

In the longer term, strong structural reforms across all sectors of the economy are essential for improving Moldova's competitiveness and the living standards of its citizens. In March 2015, the development partners of Moldova, including the World Bank Group, presented a "Briefing Book" that contains recommendations on policy and reforms, to help the new Government respond to Moldova's development challenges. One of the areas that requires attention is pension reform. Currently, Moldova`s pension system pays inadequate benefits at a growing cost and provides weak incentives to contribute. In the medium to long run, the need for pension reform is reinforced by population aging. The ***Special Topic*** to this issue provides recommendations on how to restore the social sustainability of the pension system and argues that reforms should focus on the pay-as-you-go system before considering a mandatory fully-funded pillar.

Key Macroeconomic Indicators

	2009	2010	2011	2012	2013	2014	2015F	2016F	2017F
Nominal GDP, *MDL billion*	60.4	71.9	82.3	88.2	100.5	111.5	115.8	123.6	135.1
GDP, *% real change*	-6.0	7.1	6.8	-0.7	9.4	4.6	-2.0	1.5	4.0
Consumption, *% real change*	-0.9	9.2	9.4	0.9	5.2	2.9	-1.8	0.8	4.1
Gross fixed investment, *% real change*	-30.9	17.2	13.0	0.4	3.8	10.1	-7.3	2.3	5.2
Exports, *% real change*	-12.1	13.7	27.4	2.3	9.6	1.1	-1.1	3.7	6.5
Imports, *% real change*	-23.6	14.3	19.7	2.5	4.4	-0.4	-3.5	2.8	6.6
GDP deflator, *% change*	2.2	11.3	7.2	7.6	4.1	6.3	6.0	5.2	5.0
CPI, *% change, average*	0.0	7.4	7.6	4.6	4.6	5.1	6.5	5.5	5.3
Current account balance, *% GDP*	-8.2	-7.5	-11.0	-7.4	-5.0	-5.7	-4.8	-4.6	-4.4
Remittances, *% change, USD*	-36.2	13.2	21.7	10.7	10.7	-6.9	-20.0	2.0	6.0
Terms of trade, *% change*	0.1	0.0	-1.4	-0.6	-1.1	-1.5	5.5	-0.7	-0.9
Budget revenues, *% GDP*	38.9	38.3	36.6	38.0	36.7	38.1	38.7	37.6	36.4
Budget expenditures, *% GDP*	45.3	40.8	39.0	40.1	38.5	39.8	42.2	40.3	38.5
Fiscal balance, *% GDP*	-6.3	-2.5	-2.4	-2.1	-1.8	-1.8	-3.5	-2.7	-2.1
External debt, *% GDP*	79.6	81.0	76.4	82.6	83.6	81.8	108.9	105.4	98.3
Public and guaranteed debt, *% GDP*	28.7	31.9	30.4	33.2	31.7	32.8	39.3	37.4	36.9

Source: Moldovan Authorities, World Bank projections

Contact info: Ruslan Piontkivsky, Marcel Chistruga (mchistruga@worldbank.org)
(+373) 22 262262 www.worldbank.org/md