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MOLDOVA Economic Update

October 2, 2014

- ***Despite regional challenges, Moldova's economy has performed well so far in 2014.***
- ***Growth is projected to decelerate reflecting less favorable external demand and financing.***
- ***Strong structural reforms are essential for improving Moldova's competitiveness and growth prospects.***

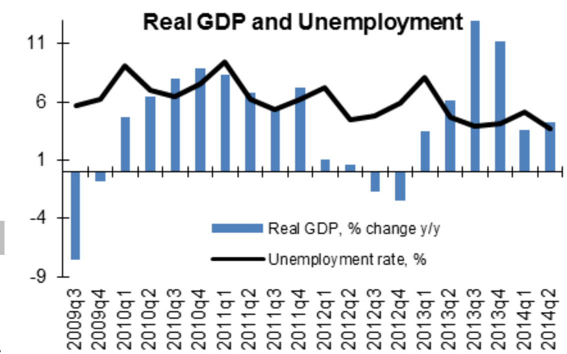
Recent Economic Developments

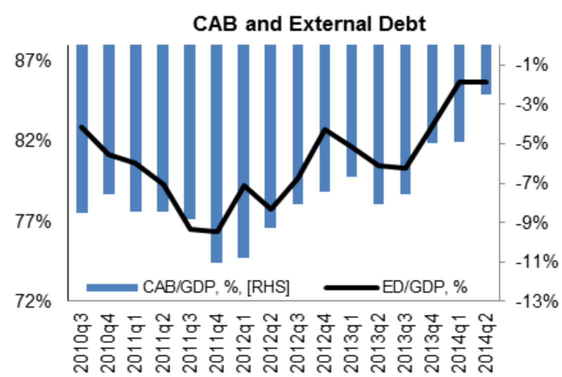
In the first half of 2014, Moldova's economy grew by 3.9 percent. After double-digit growth in late 2013 driven by rebound in agriculture sector, real GDP growth slowed in 2014. Fixed investments (+8 percent y/y) and exports (+6.7 percent y/y) were the main growth drivers on the expenditure side, while consumption stagnated at 0.9 percent y/y. Since real imports declined marginally, contribution of net exports to growth was high at 3.2 percentage points of GDP. Destocking of 2.2 percentage points of GDP contributed negatively to growth.

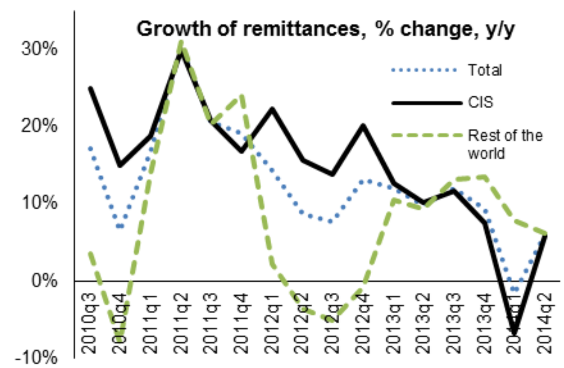
Consumer inflation remained within the target range of the National Bank of Moldova (NBM). By end-August consumer prices increased 5.1percent, y/y. As a result, inflation has stayed within the target of 5 +/- 1.5 percent for over two and half years. On the one hand, low growth in domestic consumption, good agricultural harvest and Russian restrictions on agro-food imports from Moldova (introduced in July-August) contributed to disinflationary pressures. On the other hand, continued soft stance of monetary conditions (NBM's base interest rate at 3.5 percent and credit to private sector growth of 19.6 percent, y/y, as of August) and depreciation of national currency to USD and EUR counterbalanced the downward pressures on prices.

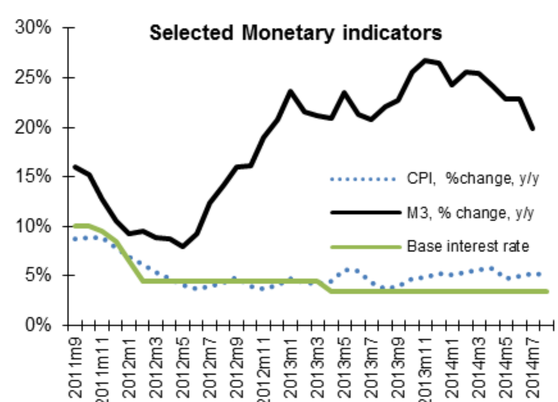
Despite unfavorable regional environment due to the Ukraine-Russia crisis, Moldova external position has remained strong. Depreciation of leu (MDL) to hard currencies reduced trade deficit. In addition, rebound in remittances from Russia in the second quarter led to a reduction of the current account deficit to 4.1 percent of GDP in the first half of 2014 (compared to 9.7 percent of GDP a year ago). At the same time, heightened regional risks and domestic structural weaknesses reduced inflows on the financial account. In particular, FDI amounted to only 1.9 percent of GDP in the first half of 2014. Although foreign exchange reserves declined by 4.4 percent in Jan-Sep 2014, they still could cover 5 months of imports.

The Government maintained fiscal discipline during Jan-Aug of 2014 because of lower than budgeted expenditures. General government revenue grew 18.5 percent, y/y, while expenditure growth was more modest at 13.7 percent, as actual capital spending lagged budgeted levels. Therefore, fiscal deficit was only 0.5 of GDP. Meanwhile, budget amendments (introduced in July) increased recurrent expenditures in 2014 by around 0.6 percent of GDP to be financed by one-off telecom licenses revenue.









Medium Term Outlook

We keep our growth forecast for 2014 unchanged from our April Update but revise the forecast for 2015-16 downward. In our view, after a solid growth in first half of 2014, GDP will slow down to 2 percent for the whole year, reflecting less favorable external demand and financing environment, Russian restrictions on agro-food imports from Moldova, and statistical base effect of high growth in the second half of 2013. We reduce our GDP growth forecast to 3 percent for 2015 and to 3.5 percent for 2016 due to expected weaker economic activity of trading partners, notably, Russia and Ukraine. However, Moldova's growth is projected to accelerate compared to 2014, as a result of recovery in EU that absorbs increasingly higher share of Moldova's exports. We expect current account deficit to stay below historical averages. In medium-term, however, as consumer confidence is regained and financing condition ease, current account will moderately widen. Inflation is projected to remain within the target range of the NBM. Deflationary pressures are expected to prevail in the short to medium term due to weaker economic activity, but the necessity of regulated tariffs' adjustment in 2015 will reduce this pressure.

Main downside risks to the macroeconomic framework stem from external environment, fiscal pressures and weaknesses in financial sector. Prudent macroeconomic policies with low fiscal deficits and a flexible exchange rate subordinated to inflation target served Moldova well over the past years. We assume the monetary policy to remain anchored in inflation. Most recently, exchange rate flexibility has helped to buffer external shocks and to preserve a positive contribution of net exports to economic growth. Looking forward, even more negative dynamics of main trading partners, especially eastern neighbors, is possible, so maintaining the current regime would reduce vulnerability. Higher commitment of recurrent expenditures, introduced earlier in 2014, would be a challenge for public finances in 2015. We assume no additional ad hoc increases are introduced and the budget deficit to remain under 3 percent of GDP over the projected period. Soundness and transparency of the financial sector remain the main domestic policy challenge. Failure to address the credit quality, liquidity and capital adequacy concerns at select banks would keep the macro-financial risks elevated.

Strong structural reforms across all sectors of the economy are essential for improving its trade competitiveness. Export growth is critical for Moldova's growth and poverty reduction prospects. DCFTA with the EU provides new opportunities to benefit from openness and deeper integration into a global economy. The ***Special Topic*** for this issue on ***Merchandise Trade Outcomes*** focuses on Moldova's recent export performance. While merchandise exports have grown substantially over the last decade, and have become more diversified and more sophisticated, Moldova still scores poorly on finding new markets and new products, as well as on export sustainability. This underscores the need for continued structural reforms to improve living standards of Moldova's citizens.

Table 1: Key Macroeconomic Indicators

	2009	2010	2011	2012	2013	2014F	2015F	2016F	2017F
Nominal GDP, *MDL billion*	60.4	71.9	82.3	87.8	99.9	107.9	116.6	126.7	139.7
Real GDP, *% change*	-6.0	7.1	6.8	-0.8	8.9	2.0	3.0	3.5	5.0
Consumption, *% change*	-0.9	9.2	9.4	0.9	5.2	1.1	2.8	3.2	5.0
Gross Fixed Investment, *% change*	-30.9	17.2	13.0	0.4	3.3	7.2	5.9	6.2	6.3
Export, *% change*	-12.1	13.7	27.4	2.3	10.7	3.0	3.4	5.0	6.8
Import, *% change*	-23.6	14.3	19.7	2.5	5.5	0.6	3.8	4.7	6.4
GDP deflator, *% change*	2.2	11.3	7.2	7.6	4.5	5.5	4.9	5.0	5.0
CPI, *% average*	0.0	7.4	7.6	4.6	4.6	4.9	4.7	5.0	5.0
Current Account Balance, *% GDP*	-8.2	-7.7	-11.3	-6.8	-5.0	-4.0	-4.1	-4.3	-4.6
Remittances, *% change, USD*	-36.2	13.2	21.7	10.7	10.7	4.0	3.0	3.5	4.0
Terms of Trade, *% change*	0.1	0.0	-1.4	-0.6	-1.0	-0.8	-0.2	0.2	-0.3
Budget revenues, *% GDP*	38.9	38.3	36.6	38.0	37.0	38.5	38.6	37.7	37.3
Budget expenditures, *% GDP*	45.3	40.8	39.0	40.1	38.7	41.0	41.6	40.2	39.5
Fiscal balance, *% GDP*	-6.3	-2.5	-2.4	-2.1	-1.8	-2.5	-3.0	-2.5	-2.2
External debt, *% GDP*	79.6	81.0	76.4	82.6	83.8	85.9	84.6	81.3	79.6
Public and Guaranteed Debt, *% GDP*	29.0	31.9	30.3	33.2	32.5	33.2	33.9	33.9	32.8

Source: Moldovan Authorities, WB projections

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