THE WORLD BANK

MOLDOVA Economic Update

2 April, 2014

- ***GDP growth outperformed expectations in 2013, and the external position remained strong.***
- ***We forecast growth deceleration in 2014 and assume that macroeconomic policies will remain adequate.***
- ***Significant downside risks are linked to volatile external environment, challenges in financial sector and to domestic political cycle.***

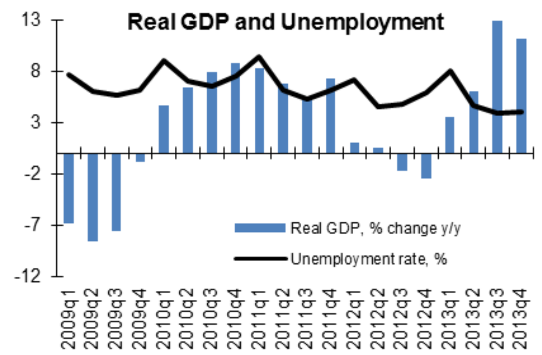
Recent Economic Developments

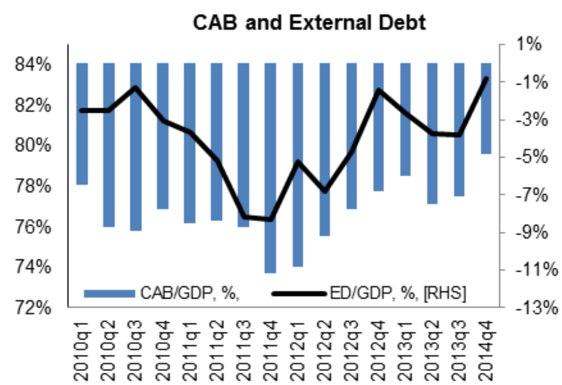
Moldova's growth in 2013 was record-high at 8.9 percent. In the fourth quarter of 2013, the economy grew by 11.2 percent y/y, driven by agricultural recovery and expansion following a poor harvest year. Overall in 2013, agriculture accounted for half the growth with 41 percent y/y increase. Food processing and machinery led manufacturing growth, which stood at 8.8 percent y/y. Private consumption was the main growth driver on the expenditure side (+6.5 percent), fueled by remittances and wage growth. The good harvest led to a buildup of inventories of 1.7 p.p. GDP, while fixed investment grew modestly at 3.3 percent y/y. Real exports increased almost two times faster than real imports (10.7 percent y/y vs 5.5 percent y/y), but there was zero contribution of net exports to GDP because of a much higher share of imports in GDP.

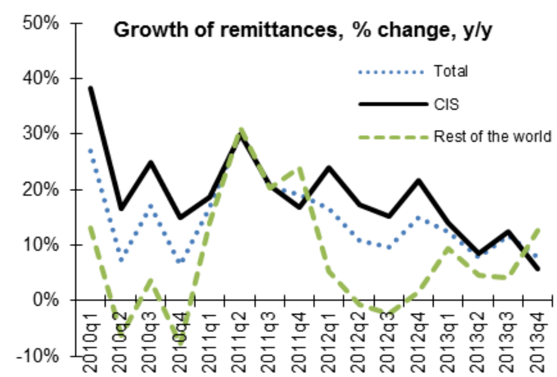
Monetary policy was consistent with the inflationary target of 5+/-1.5 percent. The NBM maintained consumer inflation within the target range for two years. In response to disinflationary pressures in 2013, the NBM loosened monetary policy, including by allowing moderate depreciation to USD and Euro. Money supply increased by 26 percent y/y and credit to private sector grew by 20 percent y/y in February 2014. As a result, consumer inflation picked up to 4.6 percent y/y by end-2013 and to 5.4 percent y/y by February 2014.

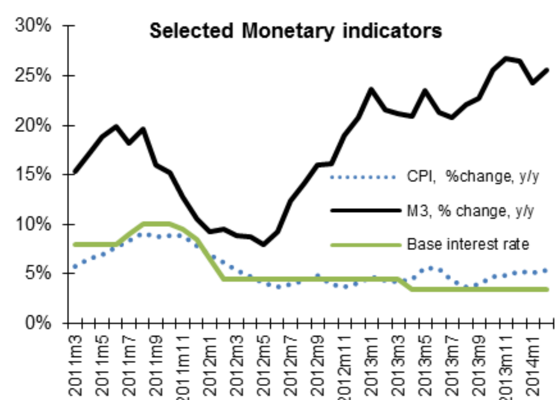
Moldova external position was strong. Real depreciation of the leu helped to reduce the current account deficit to 4.8 percent of GDP in 2013, as exports maintained price competitiveness and import growth was contained. Inflow of remittances reached a record high level in 2013, largely driven by the CIS countries. However, in early 2014, remittance growth appears to be weaker, as economic activity in Russia slows down. Foreign Direct Investment recovered to 2.6 percent of GDP. Overall, the external position enabled accumulation of foreign exchange reserves to more than 5 months of import cover.

Fiscal consolidation continued in 2013. Recurrent expenditures decreased as a share of GDP. Meanwhile, Moldova increased capital expenditures to 7.1 percent of GDP in 2013 (from 4.8 percent in 2010). The budget deficit marginally declined to 1.8 percent of GDP, helping to maintain macroeconomic stability. In early 2014, actual budget spending lagged planned levels, as revenue from taxes and external grants was short of targets.









Medium Term Outlook

We expect the GDP growth to decelerate to 2 percent in 2014, before increasing to 4–4.5 percent in 2015-17. After its outstanding performance in 2013, growth in the agricultural sector is projected to be modest in 2014, leading to an overall growth deceleration. In addition, Russian-Ukrainian tensions led to lower growth expectations in Russia and Ukraine that are among the main trade partners of Moldova. This will translate into slower export demand for Moldova's goods and services. Sluggish investment demand would reduce potential for remittances inflows from the CIS countries (accounting for some 2/3 of the total). From 2015 onwards, economic activity in major trading partners, including the EU, is expected to pick up, allowing faster increase in exports, remittances and investments to Moldova. We expect a moderate widening of the current account deficit, but in single digits by the end of 2017. In the base case, inflows of private and public external debt will ensure financing of this deficit, and will allow a moderate increase in foreign exchange reserves.

In the base case, we expect the macroeconomic policies to remain adequate, but with significant risks rooted in volatile external environment, the financial sector and in domestic political cycle. Monetary policy is anticipated to remain prudent, with inflation projected to be within the target range of 5 percent +/- 1.5 percent. In the short term, monetary policy will take a more neutral stance (compared to easing during 2013), since the headline inflation has exceeded the mid-point of the target range. The budget deficit is projected to remain under 3 percent of GDP in the medium term. Meanwhile the risks are non-trivial. A much sharper slowdown of economic activity in the eastern neighbors cannot be ruled out. Significant risks exist due to credit quality, liquidity and capital adequacy concerns at select banks and due to concerns over effective enforcement powers of the regulator. In addition, parliamentary election cycle later in the year could disrupt the achievements in macroeconomic management and reduce its flexibility.

To continue reducing poverty and promoting shared prosperity, it is crucial that Moldova pursues and implements reforms. In the past decade, Moldova experienced high poverty reduction, reflecting high upward economic mobility as many households escaped poverty while few fell back into poverty (see ***Special Topic*** for this Issue on ***Economic Mobility***). Despite the progress achieved to date, Moldova needs to pursue an ambitious reform agenda in order to converge with richer economies. The World Bank has supported the authorities' efforts to improve the business climate, promote financial sector stability and development, and improve the equity and efficiency of public expenditures with the First Development Policy Operation, approved in March 2014. To succeed, it is crucial to continue the initiated reforms even in a difficult external and political environment.

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	107.5	117.8	129.3	141.8
Real GDP, *% change*	-6.0	7.1	6.8	-0.8	8.9	2.0	4.0	4.5	4.5
Consumption, *% change*	-0.9	9.2	9.4	0.9	5.2	3.1	4.3	5.2	4.8
Gross Fixed Investment, *% change*	-30.9	17.2	13.0	0.4	3.3	3.5	6.1	7.5	7.4
Export, *% change*	-12.1	13.7	27.4	2.3	10.7	6.1	6.7	6.8	7.4
Import, *% change*	-23.6	14.3	19.7	2.5	5.5	3.9	6.4	7.5	7.2
GDP deflator, *% change*	2.2	11.3	7.2	7.6	4.5	5.5	5.4	5.0	5.0
CPI, *% average*	0.0	7.4	7.6	4.6	4.6	5.3	5.0	5.0	5.0
Current Account Balance, *% GDP*	-8.2	-7.7	-11.3	-6.8	-4.8	-6.7	-6.9	-7.1	-7.2
Remittances, *% change, USD*	-36.2	12.6	18.2	10.8	9.6	2.0	5.0	5.0	5.0
Terms of Trade, *% change*	0.1	0.0	-1.4	-0.6	-1.0	-0.5	0.2	0.5	0.1
Budget revenues, *% GDP*	38.9	38.3	36.6	38.0	37.0	38.1	38.0	38.0	38.2
Budget expenditures, *% GDP*	45.3	40.8	39.0	40.1	38.7	40.8	39.7	39.4	39.6
Fiscal balance, *% GDP*	-6.3	-2.5	-2.4	-2.1	-1.8	-2.6	-1.7	-1.4	-1.4
External debt, *% GDP*	80.2	82.3	77.6	82.1	83.3	84.4	83.5	80.0	79.5
Public and Guaranteed Debt, *% GDP*	29.0	31.9	30.3	33.2	32.5	33.1	32.9	32.0	31.5

Source: Moldovan Authorities, WB projections

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