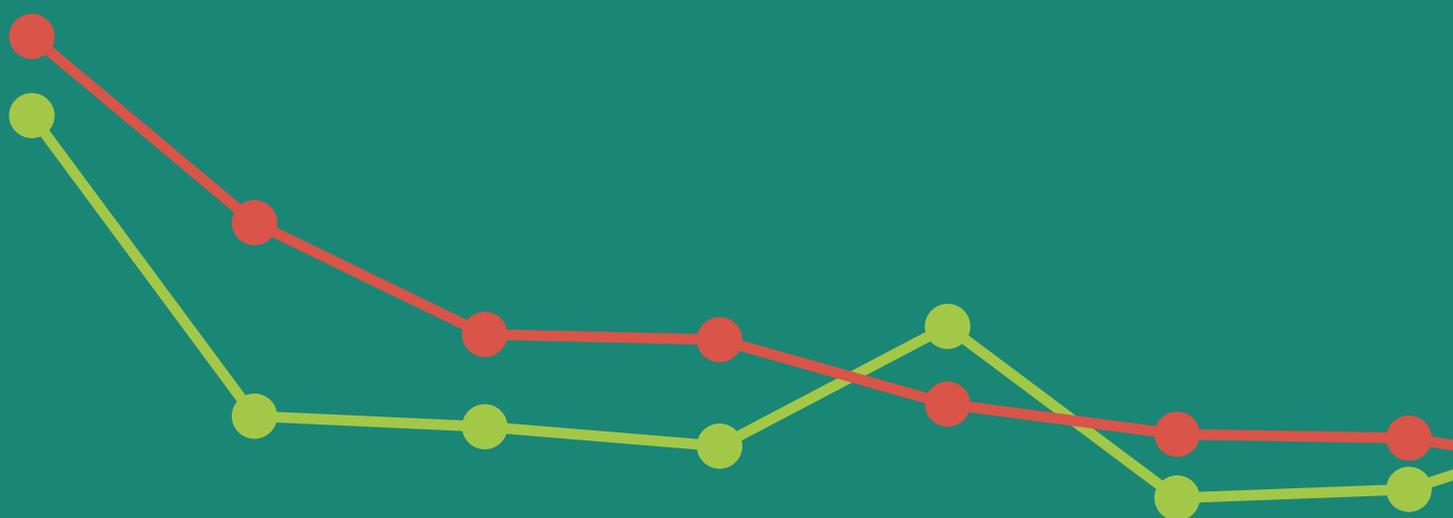




08/2015

Economic crisis - impact and response measures



Economic Outlook

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LIST OF ABBREVIATIONS

AA – Association Agreement with the European Union;

BNM – National Bank of Moldova;

BNS- National Bureau of Statistics;

B2B-Business-to- business (other corporate clients);

CPE – Centre for Economic Policies, IDIS "Viitorul";

CIS – Commonwealth of Independent States;

EUR- Euro;

IMF –International Monetary Fund;

CPI – Consumer Price Index;

FDI – Foreign Direct Investment;

MAIA – Ministry of Agriculture and Food Industry;

MDL – Moldovan leu;

ES – Economic Statewatch: analyses and forecasts;

p.p. - percentage point;

GDP - Gross Domestic Product;

RM – Republic of Moldova;

SITS – Standard International Trade Classification;

Q1, Q2 – First Quarter 1, Second Quarter, etc.;

Q1:15 – First Quarter 2015;

UAT –Territorial-administrative unit;

EU –European Union;

USD – US dollar;

FEZ –Free Economic Zone;

DCFTA – Deep and Comprehensive Free Trade Area.

ECONOMIC OUTLOOK

The Republic of Moldova economy is undergoing a difficult period of crisis, characterized by a slowdown in economic activities that were manifested by: decrease in population consumption, fall in industrial production, decline in agricultural productivity and sharp drop in foreign trade. All this occur against the background of national currency devaluation, significant rise in prices and inability of employers to increase salaries. All this will lead to lower living standards and further contraction in economic activity.

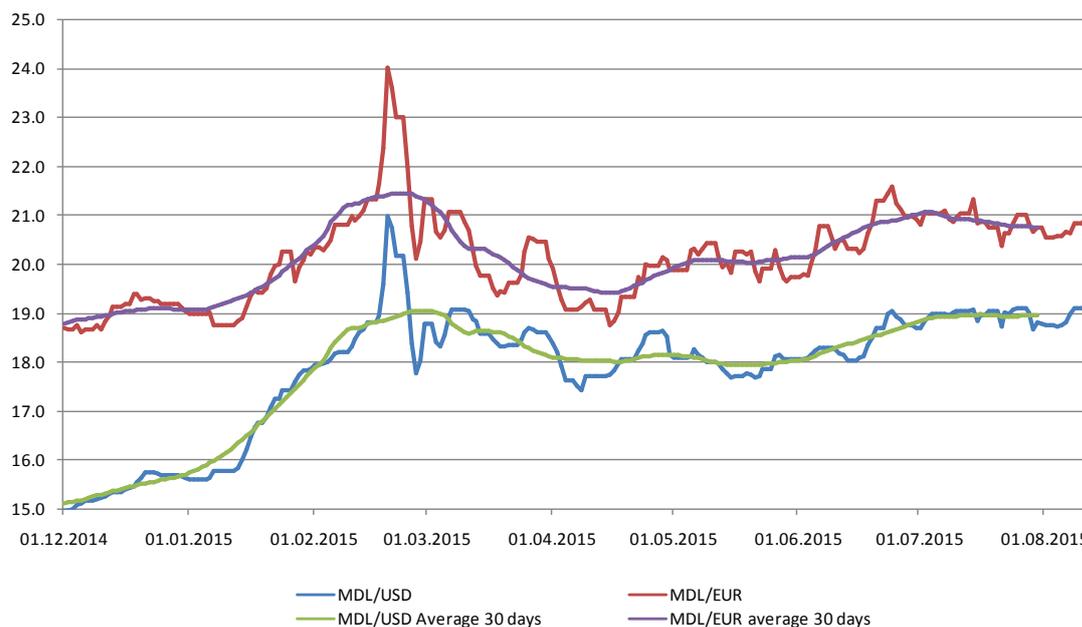
CPE estimates for 2015:

Prices	+15%
Exchange rates, annual average leu / USD	19,3 lei
Exchange rates, annual average leu / EUR	21,3 lei
Agricultural productivity	-14%
Industrial production	+3%
Retail trade	-7%
Exports	-10%
Imports	-20%
Transnistria's gas debt to Gazprom, billion USD	4,7

Situation in banking and finance sector

In Q1:15, M2 money supply fell sharply, by over 10%, being partly responsible for transferring lei resources into currency ones, contributing, at the same time, to a decrease in total money supply (M3), which contracted by 2,1%. In Q2:15, M3 money supply was largely recovered, which cannot be said about M1 and M2 components in national currency. Following changing in energy tariffs, in spite of the aggressive deflationary policy of the National Bank (BNM), **inflation will further grow and have a 2-figure value for 2015**. As it was forecasted at the beginning of the year, it is highly likely to reach 15%.

Against the background of sharp drop in purchasing power early this year and drastic fall in imports, **currency demand in the real economy plummeted**. Therefore, the gap between supply and demand did not deepen and even improved towards the middle of the year. Thus, the NBM has had ignorable interventions on the currency market. Although these factors have led to lower pressure on the exchange rate, **this balance will worsen by the end of the year**.

FIGURE 1. Exchange rate development: MDL to EUR and MDL to USD in 2015.

Source: compiled by the author based on NBM data.

Apart from objective factors of the real economy, **speculative transactions, currency outflow, as well as the position of banks under the NBM administration have triggered enormous turmoil in the currency market, panic, and as a result, high exchange rate volatility.** All this has resulted in losses for uninitiated participants in the currency market and economy paralysis. Although the macroeconomic indicators decreased, foreign currency balance was affected less than expected. Thus, a smaller increase in the average exchange rate for 2015 is expected, as compared to our forecasts at the beginning of the year, **1 USD \approx 19.3 MDL and 1 EUR \approx 21.3 MDL.**

It is certain that in winter the **currency balance is likely to destabilize and trigger a new deterioration of MDL rate against major foreign currencies** unless authorities resume negotiations with the IMF and sign a new funding agreement.

Energy sector and the implications of increased tariffs in the sector

Traditionally, the **issues related to tariffs were excessively politicized**, while politicians, instead of addressing issues directly pertaining to their competence (i.e. eliminate intermediaries in purchasing electric power), intervened by putting pressure on National Energy Regulatory Agency (ANRE) both at the declarative and practical level - ANRE budget for 2015 has not been approved so far.

As we predicted at the beginning of the year¹, natural gas tariffs were increased in early Q3: 15. However, tariffs have risen due to the evolution of the two main factors - exchange rate and purchase price of natural gas from the main supplier, OAO "Gazprom". The latter fell much below the level predicted in February and is likely to reach an annual average of 260 USD/1000m³ (compared to the initial forecast of 320 USD/1000m³). Under these circumstances, natural

¹ <http://www.viitorul.org/doc.php?l=ro&idc=121&id=4592&t=/PUBLICATII-PERIODICE/Monitorul-Economic-ME/Monitorul-Economic-nr-24-Q1-2015>

gas tariffs were increased by 15.4% on average as compared to the forecast of 45%. ANRE decision on this issue caused controversy both due to its approval procedure and the fact that the **tariffs published in Monitorul Oficial on 31 July 2015 were significantly higher than those announced at the public meeting.**

The forecast on the increase in gas transmission tariffs service proved to be right due to amendments to the Law on natural gas in July 2014 (**this tariff has soared more than 16 times and will cost us about 300 million more annually**). The forecasts on supplies of natural gas through the pipeline Ungheni-Iasi were right as well (volumes supplied were rather insignificant). We would like to emphasize that the solution found in respect to the tariff for gas transmission through this pipeline (that is the tariff previously approved for LLC "Moldovatrangaz" was applied to the SE "Vestmoldrangaz") will result in **huge operational losses, which will have to be covered from the state budget.**

In the context of electricity price rises, the **issue of lack of reliable interconnections between the Republic of Moldova and Romania**, thanks to which we could purchase considerably cheaper energy power from the EU, got on the political agenda.

Previous forecasts on maintaining the same purchasing price for electricity from the producer in Cuciurgan were confirmed. But in the supply chain between Kuchurgan power station and SE "Energocon" (which is 100% owned by the Government of the Republic of Moldova) appeared an intermediate company, registered in the Transnistrian region. Due to a slower devaluation of national currency, pressure on tariffs was lower and they were increased by over 35% as compared to 45% forecast at the beginning of the year. At the same time, proved right the forecast regarding delaying partly the increase in the tariff by failing to include in it the financial deviations accumulated especially in the second half of 2014 and the first half of 2015 - **amounts that will further put inflationary pressure on natural gas tariffs.**

Tariffs for thermal energy supply have not been adjusted so far. However, in the aftermath of revision of gas prices, they are to increase by 15-20%. If this tariff adjustment is postponed, the thermal energy sector will further decapitalize and incur debts. Like the REDs owned by the state, in this kind of scenario the power stations and the entire thermal energy sector will not be privatized in favourable conditions and will fail to attract external funding.

The water supply sector is vulnerable to political interference as well, particularly at local level. Moreover, since the Law on Public Service of Water Supply and Sanitation entered into force only on 14 September 2014, not all regulatory documents have been designed and approved so far. Therefore, for 2015 we do not forecast any significant changes in the tariffs for water supply.

Price developments in 2015

According to our estimates for 2015, the **inflation annual index increases monthly** amounting, for the period August 2014 - July 2015, to 8.6%, according to the BNS. This phenomenon prompts state authorities to constantly review inflationary estimates. The risks of the increase in energy prices have been confirmed, but their effects will only be felt in the second half of the year. Due to a slower increase of the exchange rate, prices growth slowed down in the summer months. At the same time, the difficult situation in the agricultural sector will trigger significant increases in prices for some food products at the end of 2015 and the beginning of 2016.

Furthermore, it is confirmed that, this year, **the trend in pricing depends mainly on exchange rate developments and revision of energy tariffs**. In the short term, the inflation will not decrease, contrary to the “expectations” of the BNM. The inflation will further depend mainly on the exchange rate and its volatility. Consumer basket, in such circumstances, will alter and consumer purchasing power will decrease, while the consumer basket will focus on basic needs.

In the short term, we consider that the BNM will maintain its anti-inflationary policy until annual inflation (!) returns within the corridor of 5% +/- 1.5% that is targeted. This event will take place, under the conditions of normal economy development, 12 months after the last event generating the inflationary process. In this case, the starting point is the recent increase in gas and electricity tariffs or the potential depreciation of national currency at the end of the year. It is a natural question why the BNM will react in this way. The answer lies in the approach applied, which does not relate to cause and effect analysis, but is a rather statistical-bureaucratic one, where the intervention will come to an end if the condition mentioned above is met. Only a deflationary miracle like a record agricultural harvest, which will not happen (see agricultural production development) or halving electricity cost worldwide can compensate for the previous inflationary phenomenon and might determine the BNM to renounce at its anti-inflationary pressure on economy. Otherwise, at least for another year, we will not witness any economic recovery and household income will further decrease. The BNM will report to the Parliament that it has taken all possible measures to stop inflation and keep it within the corridor of 5% +/- 1.5% that is targeted, even if this does not happen for over the next 12 months at least.

Agricultural production development

For the year 2015, the ES team estimated a 14% decrease in agricultural production. According to our estimates, **poor results in agriculture will be the result of low yields in the crop sector**, in particular of cereals of the first and second groups, and technical crops (sugar beet, sunflower). In the livestock sector, on the contrary, there will be some timid signs of economic activities recovery, the results of partially restoring livestock.

The main forecasts of the CPE for the agricultural sector are as follows: **in 2015, agricultural production will decrease by over 14%**, production of cereals and grain legumes will drop by 29%, fruit and berries by 11% and vegetables by 15%. **In 2015, the trade balance of the trade in agri-food products will be positive**, largely due to marketing agri-food products stocks produced in 2014.

In the crop sector, there is a decrease in agricultural production for all crops, due to the impact of the severe drought in the Q2: 15 and Q3: 15. According to the MAIA, in 2015, average annual yield of wheat and barley, as compared to previous year, decreased by 20%. About 60-65% of the harvested wheat is bread wheat. **For the first time in the last five years there are discussions to increase social bread prices**. In our opinion, **the bread price will be increased**. There are all appropriate conditions, especially from the political point of view, to take this kind of decision - **the government has at its disposal 3 years during which it can afford to make unpopular decisions**. The economic reasons for this decision are the unprofitability to produce social bread, increased prices for wheat flour, ingredients and energy. At the same time, the expectations for the harvest of other crops - cereals from group II, technical crops (sunflower, sugar beet, tobacco) are less optimistic. **We estimate, on average, at least a 30% reduction of these crops yields**.

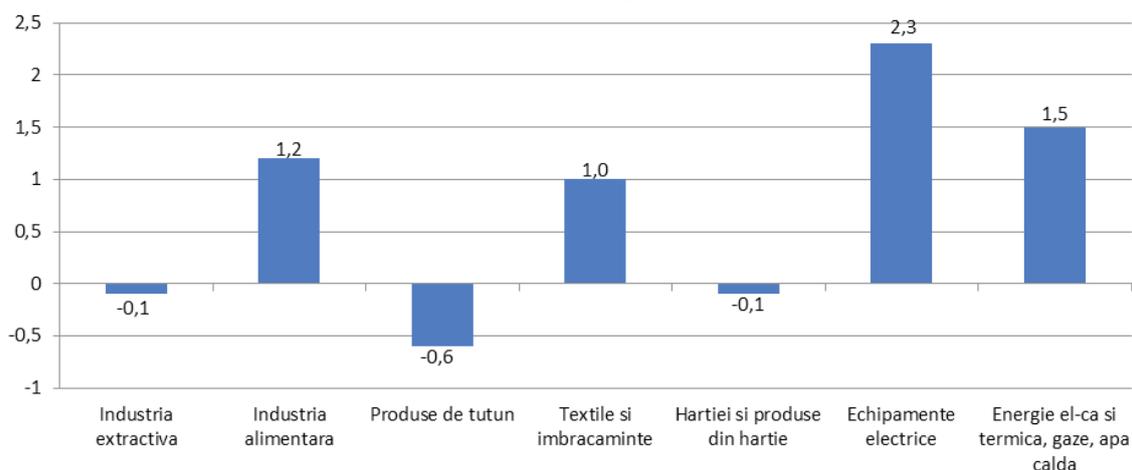
In the livestock sector, as we estimated in the previous issue of ES, **there was an increase in livestock production**. In January-July 2015, cattle and poultry production increased by 10,9%. This increase stemmed from increased cattle productivity and average number of animals.

The 2015 agricultural year is characterized as well by several risk factors, which were foreseen by us and have an essential impact on agriculture: **troublesome access to markets for agricultural products**, sector increased vulnerability to natural hazards, **low procurement prices for some agricultural products**, particularly for cereals, grain legumes, grapes and milk, **rigid funding of the agricultural sector**, **increased debts for distributing subsidies from the fund for subsidizing farmers**, **increased debts of processing enterprises to suppliers of raw materials**, **increased prices for plant protection products and fertilizers**.

Industry, services, investment - barometers of economic activity intensity

Contrary to forecasts, **there was a fairly robust growth of 5.9% in the industry sector in the first 6 months of 2015**. After accounting for over 8% in Q1:15, during Q2:15 the growth dropped by half. **Almost 40% of industrial growth over the first 6 months was due to one sector - manufacturing electrical equipment (2.3 p.p.), which increased in absolute values by 55%**. The energy sector contributed by 1.5 p.p. to overall industrial growth, the food industry contributed by 1.2 p.p. and textile and clothing by 1.0 p.p.². There is a clear trend of industrial production marked growth owing to export demand and consumers' basic needs (energy sector and food industry), while more modest growth and even reductions within the sectors oriented towards domestic market and B2B (primarily, extractive industry) may be a clear indication of continuous economic growth decrease. Given the slowdown in industry growth as well as the forecast on domestic consumption decrease, **we estimate that there will be a slowdown in industrial production growth of 2-3% by the end of the year**.

FIGURE 2. Main sectors contribution to industry growth in the first 6 months of 2015, %.



Source: compiled by the author based on NBM data.

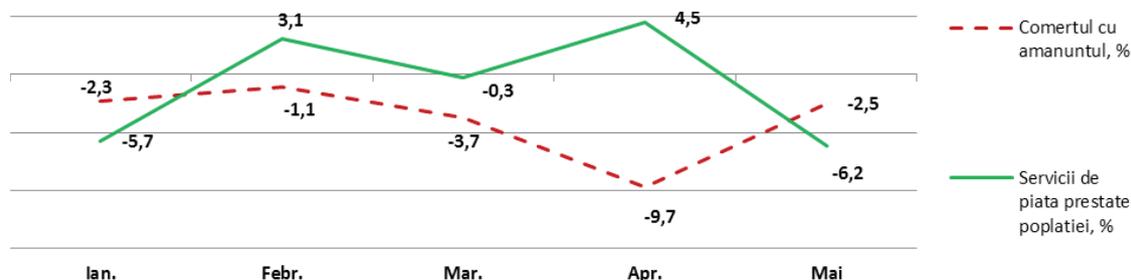
² at the same time, the highest increase in industrial production in Q1:15 was seen in the FEZs – more than 30%, for example in the FEZ Bălți the growth was more than two times. Almost 84% of industrial production in FEZ is concentrated in only 2 of them: Bălți and Ungheni.

The slowdown in investment activity can be another indicator of overall decreasing economic growth. Decreasing investment from public entities (by -2% in Q1 15, but likely much higher over the coming quarters) will have a negative influence on future production capacity. The investment of companies with foreign capital has decreased as well (by over 21%), which can be seen as an indicator of negative expectations of the country's economic prospects or the result of worsening business environment. Investments from the state budget have fallen by almost 50% in Q1:15, while those from UAT by 15%. Given the complicated situation of public finance, we forecast a more drastic reduction in investment from these sources over the coming quarters. All these trends and developments could determine the **decrease in investment down to 0% or even turn the trend into a negative one by the end of the year.**

The FDI decrease in the share capital of companies by 41% in Q1:15, as compared to the same period of the previous year, can be seen as evidence of the above conclusions. This is despite the fact that overall FDI increased by almost 3 times compared to Q1:14 up to \$ 75.5 million (highest level in the last 7 years). However, more than two thirds of these FDI were reinvested earnings and intra-group loans. More expensive loans, following restrictive monetary policy of the BNM, will contribute as well to decreased investment.

Retail trade and market services provided to the population, as we were anticipating at the beginning of the year³, declined last year. During the first 5 months, the retail trade fell by over 4%, while the value of services provided to the population decreased by over 1%. This is a direct consequence of national currency depreciation as well as the decrease in remittances from abroad that significantly reduced the purchasing power of population. Thus, we anticipate a **6-7% drop in the retail trade and 1-2% decrease in services provided to population.**

FIGURE 3. Retail trade and services provided to population developments in January-May 2015 as compared to the same period of the previous year, %

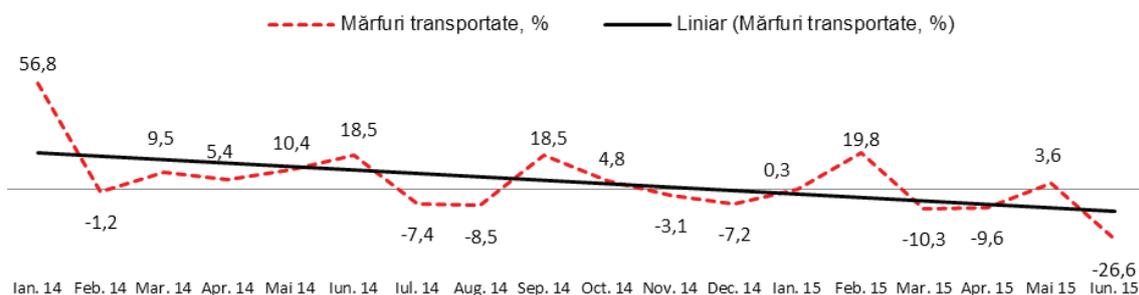


Source: compiled by the author based on NBM data.

Transportation of goods is, to a certain extent, a **barometer for the intensity of economic activity.** In the first half of the current year, it decreased by over 6.5%, which is another **indicator of the recession our national economy is heading to.** That occurred under the circumstances where, since January 2014 there has been a downturn trend in goods transportation. The volume of construction works performed by construction enterprises decreased by 1.2% in Q1:15. The volume of construction work will further decrease in the coming period given the fall in the volume of production in the extractive industry.

³ <http://www.viitorul.org/doc.php?l=ro&idc=121&id=4592&t=/PUBLICATII-PERIODICE/Monitorul-Economic-ME/Monitorul-Economic-nr-24-Q1-2015>

FIGURE 4. Transportation of goods development in January 2014-June 2015, %



Source: compiled by the author based on NBM data.

Foreign trade development, as a determinant of economic growth

IDIS team estimates on exports and imports for 2015 were very optimistic, forecasting decreases of 5% and 3% as compared to 2014⁴. The reality, however, shows, in the first half of the year, a decrease in goods exports of 15.3% compared to the corresponding period of 2014. Local exports amounted to 659.1 million USD (66.4% of total exports), 9.4% less than in January-June 2014. Moldovan exports volume fell in traditional markets of several major partners of the Republic of Moldova like the Russian Federation (-53.6%), Ukraine (-64.9%), Italy (-22.0%), Turkey (-46.7%), Germany (-12.4%), Bulgaria (-39.7%) and Poland (-13.0%). The sharp fall in exports on CIS market (37.3%) was not compensated by the trade flows to the EU market (0.9%), even under conditions where their share in total exports has increased from 53% to 63.1%.

Goods exports fell for goods in most groups classified according to SITS, the only exception being "crude materials, inedible, except fuels", which increased by 12.4%. The biggest losses were for beverages and tobacco (22.9%), chemicals and related products, n.e.s. (37.9%), manufactured goods classified chiefly by material (32%), food and live animals (10.4%).

We do not expect a sudden change of current general trends for Moldovan exports in the foreseeable future. All this, despite the illusory elimination of interdictions imposed to Moldovan companies to export crop production and alcoholic beverages to the Russian Federation. On the other hand, **we expect an increase in the exports of certain crops to the EU**, whose contribution to increasing overall exports will be insignificant.

The imports amounted to US \$ 1,984,900,000 over the same period, which is a decrease of 22,1% in comparison to the same period of 2014. **Goods imports decreased in the relations with all main trade partners** of the Republic of Moldova from the EU, the CIS, except for Uzbekistan and from third party partners from other countries except for Israel.

The share of imports from the EU and the CIS has not changed significantly and accounts for 48.5% (in 2014 - 48.8%) and 25.5% (in 2014 - 27.6%). Goods imports volume decreased for goods in most groups classified according to SITS: food and live animals 24,6%; beverages and tobacco 15,9% (beverages imports (alcoholic and non-alcoholic beverages decreased by 38.2% and imports of raw and processed tobacco increased by 9.3%); crude materials, inedible, except fuels 8%; mineral fuels, lubricants and related materials 26,8%; animal and vegetable

⁴ <http://www.viitorul.org/doc.php?l=ro&idc=121&id=4592&t=/PUBLICATII-PERIODICE/Monitorul-Economic-ME/Monitorul-Economic-nr-24-Q1-2015>

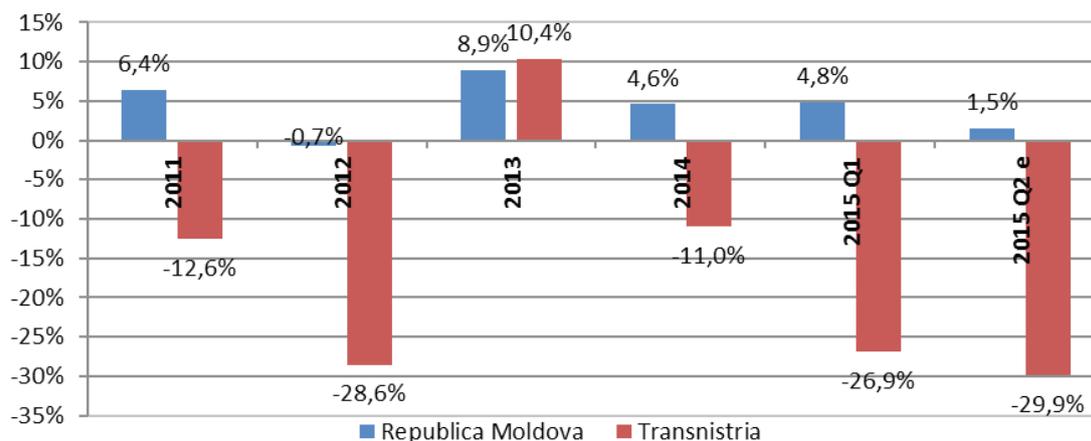
oils, fats and waxes 28,7%; chemicals and related products, n.e.s. 21,3%; manufactured goods classified chiefly by material 18,9%; machinery and transport equipment 23,5%; miscellaneous manufactured articles 18,1%.

For 2015, we expect a decrease in exports by 10% and imports by 20 %.

Crisis situation in Transnistria

In 2015 the Transnistrian economy continued to be further influenced by a range of factors that were manifested in 2014, among which there were regional instability and internal politic uncertainty, conjuncture fluctuations on external markets, devaluation of Ukrainian hryvnia, Russian rouble and Moldovan leu as well as business and consumer downturn. These factors have influenced the results of foreign economic activity, labour migration and remittances from abroad. The strengthening of the Transnistrian segment of the Moldovan-Ukrainian border at the end of 2014 - beginning of 2015 led to a **significant decrease in unregistered trade volume and smuggling in the region**. The region is still rather dependent on foreign funding by the Russian Federation. Decreasing demand for Transnistrian exports was compensated by higher deliveries of Transnistrian on Moldovan domestic market.

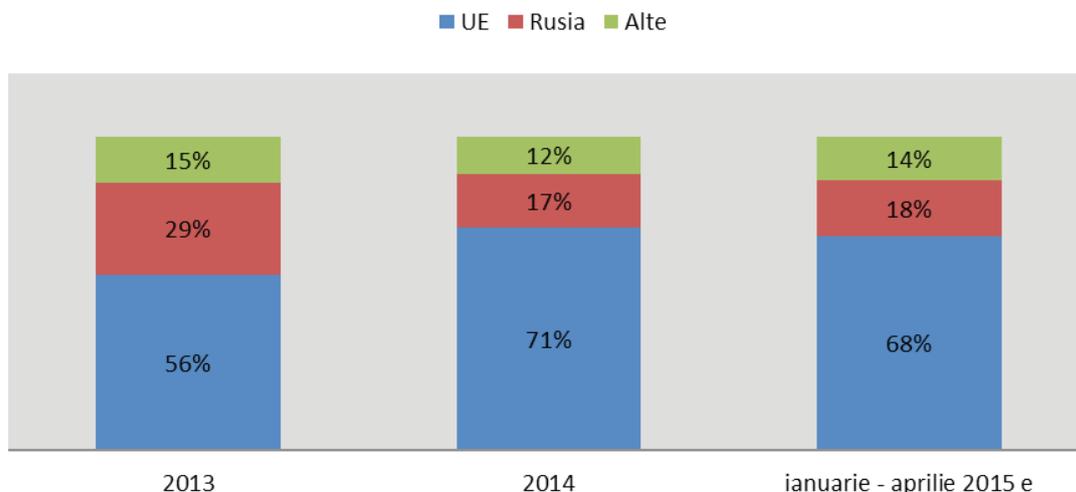
FIGURE 5. GDP dynamics of Moldova and Transnistria, 2011-2015, a/a, %.



Source: compiled by the author based on NBM and Transnistrian Republican Bank data.

In 2015, the Transnistrian businesses will continue adapting to changes of Moldova trade regime with EU, which is evidence of the region interest in European market. So far, **about 1,400 Transnistrian enterprises** being registered in the Republic of Moldova **take advantage of trade preferences with the EU, Turkey and the rest of the world**. In January-April 2015, Transnistrian exports to the EU increased by 15%, the **European Union being the main trade partner**.

FIGURE 6. Share of EU and Russian markets in the exports of Transnistrian companies, 2013 - 2015.



Source: compiled by the author based on EUBAM Activity Report, Q1 2015.

In April 2015, Chisinau introduced the mechanism of free trade through duty-free shops, seeking to license external trade on the Transnistrian segment of the Moldovan-Ukrainian border. **In 2014-2015 there is a significant increase in the supply of Transnistrian goods on the domestic market of the Republic of Moldova**, due also to companies that have not registered in the State Chamber of Registration of the Republic of Moldova.

General instability in the region triggered higher logistical risks in trade with Ukraine, making difficult the legal transit of people and goods through the Transnistrian region. At the same time, enhancing control on the Transnistrian segment of the Moldovan-Ukrainian state border, with EUBAM assistance, has reduced illegal migration, unaccounted trade in counterfeit goods and products and smuggling, in particular of cigarettes.

The state support from Russia and “gas subsidies” account for about 75-80% of the region’s budget revenues. The annual assistance from the Russian Federation is estimated at about 1 billion USD, that is the entire region’s GDP (in 2013 it amounted to 1.1 billion USD). Transnistrian debt to Gazprom reaches 4.5-4.7 billion USD. Given the Russian private investors leaving the region and budget expenditures reductions operated in the Russian Federation, the Tiraspol administration is not very likely to receive the financial aid demanded from Moscow. On 31 December, the autonomous trade preferences with the EU for Transnistrian exports expire as well.

Macroeconomic stability will still remain the region’s main economic goal in 2015, which has to be ensured by **further tightening of fiscal and monetary policy**. Maintaining a fixed exchange rate of the Transnistrian rouble at 11.0-11.3 for 1 USD and levelling this fluctuation is stated to be main aim of this policy.

The crisis situation in Transnistria will have a direct impact on the relations between Chisinau and Tiraspol in 2015. In the short term, Moscow’s wish to reduce the burden of subsidizing the region may weaken the rhetoric on status, bringing to the fore the EU assistance in carrying out structural reforms. The Tiraspol pragmatism can manifest in its negotiating ability in the framework of the DCFTA.

RECOMMENDATIONS for stakeholders

- Approval and implementation of a plan for financial stabilization and economic recovery.
- Completion of investigations in the case of BEM, Banca Sociala, Unibank and bringing to justice those responsible for the ongoing crisis in the banking sector.
- Conclusion of the agreement with the IMF as soon as possible in order to maintain the currency needed to cushion the winter hardships.
- Correction of 2015 budget and accelerating the process of drafting the Budget Law for 2016.
- Easing indirect monetary policy in particular the base rate that has little effect on CPI but contributes greatly to worsening the situation in real economy.
- Accelerate the implementation of reforms, in particular those laid down in the Association Agreement with the EU.
- The Government and the Parliament have to urgently restore the institutionalized dialogue with LPA, business community, academic and non-governmental sectors.
- Accelerating the implementation of measures included in the roadmap for government actions, in order to eliminate critical constraints for the business environment 2013-2014⁵ and the Roadmap for improving competitiveness⁶.
- Designing new strategies for developing industry, attracting investment and promoting exports under the provisions of the Association Agreement and, in particular, Titles IV and V.
- Drafting and approval of the Customs, Tax and Land Codes in a new version in line with European regulations in this area.
- Approving the Action Plan for implementing the National Strategy for Agricultural and Rural Development for the years 2014-2020⁷.
- Implementation of phase II of local finances reform - strengthening of the fiscal base, which will contribute to the increase in the tax base and financial capacity of LPA.
- Accelerate and invigorate the transposition and implementation of European and international standards.
- Conduct public awareness and dissemination campaigns concerning the DCFTA in rural and urban communities, including the districts of the left bank of the Dniester.

⁵ GD nr 765 of 25.09.2013 on the approval of the Roadmap for government actions in order to eliminate critical constraints for the business environment for 2013-2014; Monitorul Oficial nr.213-215/868 dated 27.09.2013.

⁶ GD nr 4 of 14.01.2014 on the approval of the Roadmap for improving competitiveness in the Republic of Moldova. Monitorul Oficial nr.17-23/27 dated 24.01.2014.

⁷ MAIA was to present to the Government the progress report on implementing the Strategy in June. All this, under the conditions where there has not been approved an Action Plan for implementing the Strategy.

IDIS „Viitorul” is a research, training and public initiative institution, which works in several areas related to economic analysis, governance, political research, strategic planning and knowledge management. IDIS serves as a joint platform bringing together young intellectuals concerned with the success of the transition towards market economy and an open society in Republic of Moldova.

The Institute for Development and Social Initiatives (IDIS) „Viitorul” is the legal successor of Fundatia Viitorul (Viitorul Foundation) and, overall, preserves the traditions, objectives and principles of the foundation among which: building democratic institutions and developing a spirit of effective responsibility among policy makers, civil servants and citizens of our country, strengthening civil society and criticism, promoting the freedoms and values of an open, modern and pro-European society.

