MOLDOVA Economic Update

May 4, 2017

- ***Moldova's 2016 recovery was driven by favorable conditions in agriculture and robust private consumption.***
- ***Supported by consumption and accommodative fiscal policy, growth is projected to maintain its positive momentum in the medium term.***
- ***While Moldova is rebuilding its macroeconomic buffers, major policy challenges related to governance— particularly in the financial sector—and efficiency of public spending remain.***

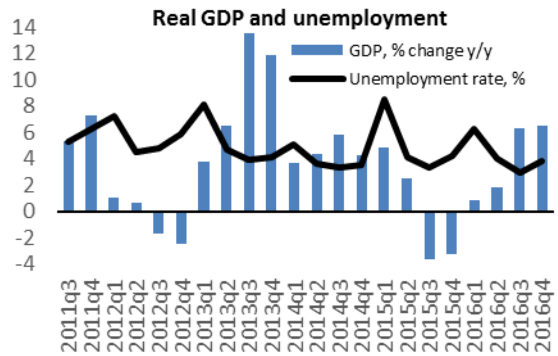
Recent Economic Developments

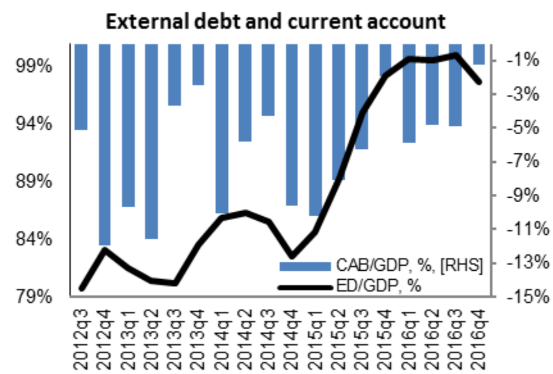
Moldova's economy has recovered from the 2015 recession and grew by 4.1 percent in 2016, supported by a strong recovery in agriculture and robust private consumption. A strong increase in wages and a good harvest supported growth in private consumption and a buildup of inventory stocks. These two categories contributed 5.4 percentage points (p.p.) to overall growth. At the same time the contribution of net exports (-1.3 p.p.) and fixed investments remained negative (-1.1 p.p.), with financing stagnant. On the production side, agriculture (increasing by 18.2 percent) and the trade sectors were the main sources of growth (both contributing 3.1 p.p.).

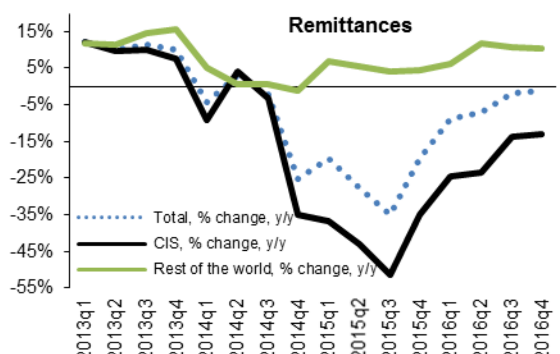
Consumer inflation is back within the target range. From September 2016—mostly due to the base effect— the CPI temporarily breached the lower limit of the (5+/-1.5) target range, decelerating further to 2.4 percent by December 2016, before bouncing back to 5.1 percent in March 2017. In response, the central bank stopped its accommodative monetary policy, keeping the policy rate at 9 percent since October 2016 and increasing the required reserves ratio in April 2017 to absorb the excess liquidity.

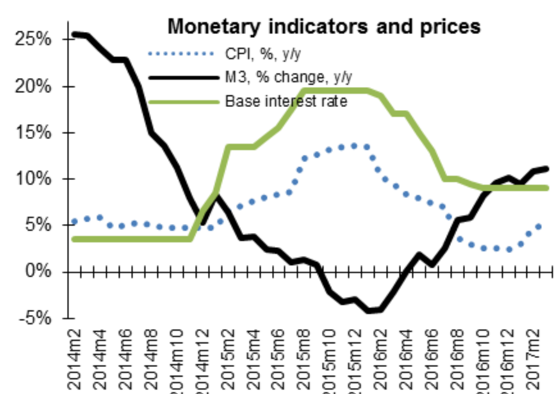
The external position has improved. Due to lower levels of imports and growth of exports the current account deficit (CAD) narrowed by 2.3 p.p.to 4.1 percent of GDP in 2016. A double digit increase in exports of cereals and sunflower seeds drove a 2.7 percent growth in merchandize exports. With low FDI, the CAD was mostly financed through debt. A flexible exchange rate and external assistance facilitated the accumulation of foreign reserves, covering more than 5 months of imports by end-2016. External debt decreased 0.3 p.p. to 97.7 percent of GDP, but was still 15.2 p.p. higher than in 2014.

External financial assistance (loans and grants) from IMF, WB, EU and Romania in the second half of 2016 eased the government's financing constraint. Still, budget execution (deficit of 1.8 percent of GDP) was significantly below the plan (deficit of 3.2 percent) as some expenditures were not financed in full due to late December disbursements of external budget support. Public expenditures fell by almost 2 percent in real terms, largely through lower capital expenditures, as social expenditures and the wage bill were maintained at budgeted levels. In the first two months of 2017, however, public revenues and spending recovered strongly. By end-2016, the public debt and guarantees had decreased by 2.3 p.p. to 44.2 percent of GDP.









Medium Term Outlook

Supported by consumption and fiscal stimulus, growth momentum will be maintained in 2017-19. Strong export growth, led by last year's record harvest, and of consumption, fueled by wages, is projected to underpin a 4 percent economic expansion in 2017. Following the under-execution in 2016, with high public transfers in real terms and capital investments, the fiscal deficit will widen in 2017 by 0.7 percentage points to -2.5 percent of GDP. In the medium term growth will slow to 3.7 percent in 2018 and 3.5 percent in 2019. Accommodative fiscal policy—in particular public investments—and remittances are expected to further sustain economic growth in 2018. The revitalization of foreign inflows, improvements in the financial sector and business environment will encourage the growth of investments. While the fiscal deficit is expected to widen to around 3 percent of GDP in 2018, public debt and guarantees are set to reflect the external assistance increase in 2017 and 2018, and slowly decline until end-2019. As growth strengthens and savings decline, the current account deficit will increase gradually, although below the historical averages. Inflation is projected to remain close to the targeted value of 5 percent. Poverty is projected to decline further against the background of positive GDP and wage growth and wider fiscal space. However, the pace of poverty reduction is projected to slow down on account of increasing utility tariffs, inflationary pressures, and continued structural labor market weaknesses. Over the forecast period, until 2019, the PPP US$5/day poverty headcount is projected to decline by some additional 5 percentage points.

There are both downside risks and higher growth opportunities to the baseline scenario. The first risk is that the lead-up to 2018 parliamentary elections could slow down the implementation of reforms. Secondly, weaker than expected growth in key economies, including the EU and Russia, could have a negative impact on growth in Moldova. Meanwhile, limited external demand, slow productivity growth and capital accumulation, combined with low labor force participation, point to a need to rebalance the drivers of growth. It is important to use the window of political stability in 2017 to advance key economic reforms to create a more transparent and rules-based environment for private sector employment creation. Key policy challenges stem from (i) the weak rule of law and the accountability of economic institutions, in particularly important for the restructuring of the financial system and the energy sector, (ii) numerous tax exemptions and efficiency of fiscal spending, particularly in education and health, and (iii) the need for wages to replace remittances and pensions as the main source of income growth for the worst-off. Meanwhile, the recently released results of the 2014 Population Census indicate that Moldova's population declined by over 11 percent since 2004. As the ***Special Topic*** to this issue argues, the population decline indicates that Moldova's economic indicators on per capita basis might be better than was thought. It also calls for follow-up work on the national statistics, since new population data could have implications for many aspects of economic and social life, and therefore, for economic policy decisions.

Key Macroeconomic Indicators, in percent of GDP unless otherwise indicated

	2011	2012	2013	2014	2015	2016	2017F	2018F	2019F
Nominal GDP, *MDL billion*	82.3	88.2	100.5	112.1	122.6	134.5	143.8	158.4	158.4
GDP, *% real change*	6.8	-0.7	9.4	4.8	-0.4	4.1	4.0	3.7	3.5
Consumption, *% real change*	9.4	0.9	5.2	2.7	-1.9	3.0	3.5	3.3	3.1
Gross fixed investment, *% real change*	13.0	0.4	3.8	10.0	-2.3	-3.0	2.9	3.8	4.5
Exports, *% real change*	27.4	2.3	9.6	1.0	2.9	8.8	9.4	3.8	4.0
Imports, *% real change*	19.7	2.5	4.4	0.4	-4.7	5.9	6.8	3.9	4.2
GDP deflator, *% change*	7.2	7.9	4.1	6.4	9.9	5.9	5.6	4.7	4.7
CPI, *% change, average*	7.6	4.6	4.6	5.1	9.7	6.9	5.3	4.8	5.0
Current account balance	-12.1	-8.7	-6.4	-7.1	-7.2	-4.1	-4.5	-4.8	-5.3
Remittances, *% change, USD*	21.7	8.8	10.2	-5.2	-26.1	-4.6	1.8	2.3	2.9
Terms of trade, *% change*	-1.4	0.8	-0.4	-1.2	3.8	-0.1	0.2	0.5	1.2
External debt	76.4	82.6	83.6	82.5	98.0	97.7	96.8	92.4	91.2
Budget revenues	36.6	38.0	36.7	37.8	35.7	34.2	35.4	35.5	35.3
Budget expenditures	39.0	40.1	38.5	39.6	38.0	36.0	37.9	38.5	38.0
Fiscal balance	-2.4	-2.1	-1.8	-1.7	-2.2	-1.8	-2.5	-3.0	-2.7
Public Debt and Guarantees	30.4	33.2	31.8	38.2	46.5	44.2	44.7	43.8	42.9

Source: Moldovan Authorities, World Bank projections

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