MOLDOVA

Highlights

- **The economy entered recession in 2015.** Real GDP fell by 0.5 per cent in 2015, influenced, among other things, by vulnerabilities in the banking sector, with the three banks affected by fraud liquidated in 2015. In the first half of 2016, GDP returned to modest growth of 1.3 per cent year-on-year.
- **The three largest banks remain under the special supervision of the National Bank of Moldova (NBM).** Concerns about ownership, related lending, corporate governance and portfolio quality constrain access to credit and affect the confidence of investors, lenders, depositors and consumers.
- **In July 2016, the authorities reached a staff-level agreement on an economic reform programme with the IMF.** Approval of a new programme for Moldova is contingent on fulfilment of prior actions by the authorities.

Key priorities for 2017

- **Long-standing vulnerabilities with respect to financial sector ownership, governance and supervision need to be resolved.** The situation in the banking sector needs to normalise to enable an increased flow of credit to the private sector. Strong supervisory and regulatory safeguards need to be in place and strictly enforced to ensure that the banking sector is protected from influence by vested interests.
- **The authorities need to deliver on the agreed prior actions to launch a new IMF programme.** Decisive steps need to be taken by the authorities to demonstrate commitment to reforms and to launch and implement the International Monetary Fund (IMF) programme. The new programme will provide an important anchor for reforms supporting anti-corruption efforts; it is expected to foster reforms in the financial, energy and fiscal sectors and business environment improvements. This will also unlock budget support from international development partners.
- **Sound fiscal and monetary policies should be maintained.** Macroeconomic policies should be geared towards building resilience and cushioning the fallout from the banking sector vulnerabilities. Fiscal planning needs to remain conservative in the face of limited external borrowing options and an expected rise in domestic public debt.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	-0.7	9.4	4.8	-0.5	1.5
Inflation (average)	4.6	4.6	5.1	9.7	6.8
Government balance/GDP	-2.3	-1.9	-1.9	-2.3	-3.2
Current account balance/GDP	-8.7	-6.5	-7.1	-6.4	-2.8
Net FDI/GDP [neg. sign = inflows]	-3.5	-3.1	-3.9	-3.5	-2.7
External debt/GDP	82.7	83.6	82.3	98.0	n.a.
Gross reserves/GDP	34.5	35.3	27.0	27.1	n.a.
Credit to private sector/GDP	37.9	42.0	36.4	31.3	n.a.

CONTINUES

Macroeconomic performance

Moldova's economy slipped into recession in 2015. Real GDP contracted by 0.5 per cent in 2015, driven by a 13.4 per cent year-on-year drop in agriculture. The contraction was smaller than expected amid concerns about the quality of statistics. In the first half of 2016, real GDP grew modestly by 1.3 per cent year-on-year, supported by 2.2 per cent year-on-year growth in household consumption. In the same period, gross fixed capital formation fell by 6.7 per cent year-on-year and exports of goods and services fell by 1.2 per cent year-on-year (both in real terms). In the absence of international budget support in 2015 and in the first half of 2016, the state budget was overstretched paying mandatory recurrent costs, and lacked the resources to invest meaningfully into infrastructure projects. Exports and remittances dropped significantly in the past year and the currency depreciated by 21 per cent against the US dollar in 2015. At the same time, fiscal and monetary tightening have helped to contain inflation and to keep official reserves stable at approximately US$ 2.1 billion as of September 2016 (close to six months of imports).

Inflation abated after accelerating to double digits at the end of 2015. In 2014-15, the NBM provided emergency lifelines of approximately 13 per cent of GDP to three banks affected by fraud. NBM took steps to limit the ensuing exchange rate and inflation pressures by raising the base rate from 3.5 per cent in December 2014 to 19.5 per cent in September 2015 and by increasing mandatory local currency reserves for banks from 14 per cent in December 2014 to 35 per cent in October 2015. This contributed to the increase in short-term sovereign borrowing costs on the domestic primary market from approximately 8 per cent in December 2014 to approximately 26 per cent in December 2015, making local currency borrowing by the Ministry of Finance prohibitively expensive. Inflation declined from 13.6 per cent year-on-year in December 2015 to 3.0 per cent year-on-year in September 2016. The inflation slow-down paved the way for monetary policy loosening. In February to September 2016, NBM's base rate was gradually lowered from 19.5 per cent to 9.5 per cent, helping to bring down the interest rate on short-term local currency government securities to approximately 8 per cent at the end of September 2016.

Public debt is expected to rise on account of the emergency support to the three failed banks. The public debt-to-GDP ratio was estimated at approximately 30 per cent of GDP in 2015. It is expected to increase to up to 50 per cent in 2016, mainly as the liquidity provided by the NBM to the three failed banks is reflected in the public debt stock. The public and publicly guaranteed foreign exchange debt, largely owed to multilateral official creditors, was relatively moderate at 22 per cent of GDP in 2015. Moldova's external debt-to-GDP ratio (public plus private) increased from 82 per cent at the end of 2014 to 98 per cent at the end of 2015 as the leu depreciation deflated GDP in US dollar terms.

The outlook depends on the implementation of a credible economic reform programme and on mitigation of vulnerabilities in the financial sector. The economy is forecasted to grow modestly by 1.5 per cent in 2016 and by 2.5 per cent in 2017, building on the anaemic growth witnessed in the first half of 2016. Credit flow in the economy continues to be affected by the banking sector challenges. Structural vulnerabilities and downside risks remain, although economic prospects are improved by the possibility of entering into the IMF programme.

Major structural reform developments

Banking sector challenges persevere. The large-scale fraud and liquidation of three banks (approximately one-third of the sector's assets) in 2015 dealt a significant blow to Moldova's international image. As of August 2016, Moldova's three largest banks (Moldova-Agroindbank, Moldindconbank and Victoriabank) representing 65 per cent of the sector's assets remained under the NBM's special supervision, amid concerns about opaque ownership, related lending, weak corporate governance and low portfolio quality. The banks' investments into high-yielding government securities have created an interlocking exposure between the sovereign and the banks.

CONTINUES

Moldova's business environment and competitiveness rankings remained weak. According to the World Bank-EBRD BEEPS V survey (2012-13), corruption, political instability and workforce skills are the three largest business environment obstacles. Electricity issues rank more prominently on the constraints list of large companies, while labour regulations represent one of the largest obstacles for younger companies. Informal payments in Moldova were reported to be more frequent than elsewhere in eastern Europe and the Caucasus. In the World Bank's *Doing Business 2017* report, Moldova ranks 44th out of 190 countries. Low scores in dealing with construction permits, getting electricity, enforcing contracts and resolving insolvency contrast with better scores in other indicators. In Transparency International's Corruption Perception Index (CPI) 2015, Moldova ranks 103rd out of 168 countries. Moldova ranks 100th out of 138 countries in the World Economic Forum's *Global Competitiveness Report 2016-2017*. On the overall composite metric of domestic competition, Moldova ranks 114th out of 138 countries.

IMF staff and the Moldovan authorities reached a staff-level agreement. In July 2016, the Moldovan authorities reached a staff-level agreement with the IMF concerning an economic reform programme, to be supported by a three-year Extended Credit Facility and Extended Fund Facility arrangement for a total of approximately US$ 180 million. The new programme targets improvements in the financial sector's governance and supervision. Structural reforms under the programme are aimed at supporting anti-corruption efforts, sustainable energy policy and reduction of fiscal risks. Approval of the arrangement by the IMF Executive Board depends on fulfilment of prior actions. The IMF programme is expected to unlock budget support from international donors. In August 2016, the government of Romania released the first loan instalment (€60 million) of budget support to Moldova.

The Prime Minister's Economic Council became operational. The Economic Council is an advisory body representing a platform for discussions between the government, business, development partners and the civil society. The Council's work rests on three thematic pillars: removal of constraints for businesses, facilitation of cross-border trade and attraction of investment.