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MOLDOVA
Economic Update

May 13, 2019

- *In the face of weaker foreign and domestic demand, growth is projected to remain subdued in the medium term.*
- *Despite strong revenue performance, due to lower external financing and tax cuts fiscal position will remain under pressure.*
- *Rising productivity levels is key to sustainable growth.*

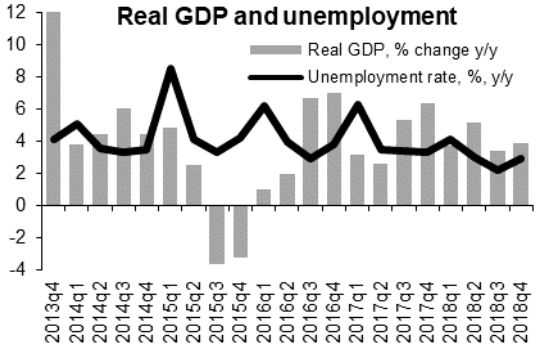
Recent Economic Developments

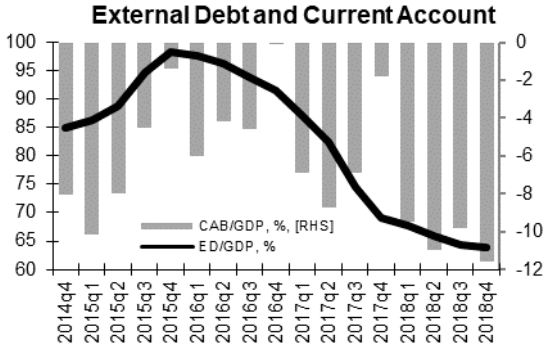
Despite strong investments, growth slowed to 4 percent in 2018. Tax cuts, wage increases, and remittances supported growth of disposable income, resulting in a 3.2 percentage points contribution of private consumption to growth. Lower inflation, favorable interest rates and solid public investments underpinned investment growth, resulting in a 4.2 percentage point contribution from capital formation. With strong domestic demand and stronger Leu, imports expanded more quickly (+8.9 percent) than exports resulting in a negative contribution to growth (-3.4 percentage points) from net exports. On the production side, favorable financial conditions and government spending expanded the construction sector, adding 1.1 percentage points to growth. The wholesale and retail trade and industry added another 1.8 percentage points. After three years of good yields, the contribution from agriculture was marginal (+0.2 percentage points).

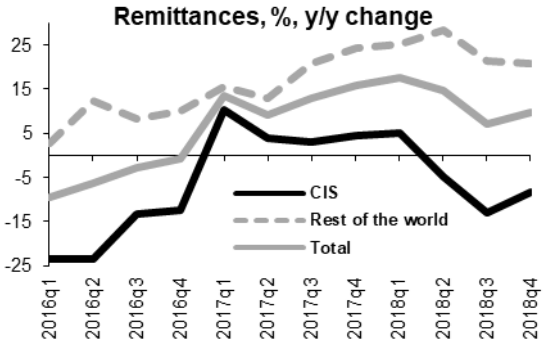
Inflationary pressures are on the rise after sharp deceleration in 2018. Good harvest, stronger Leu and low administrative prices contained inflation which by end-2018 averaged 3.0 percent. While still below the target corridor, due to base effects and weaker Leu after elections, inflationary pressures are currently on the rise. In addition, excess liquidity resulting from low financial intermediation persists in the system. The reserve requirement rate remains at a record high at 40 percent, while the base rate has been at 6.5 percent since end-2017.

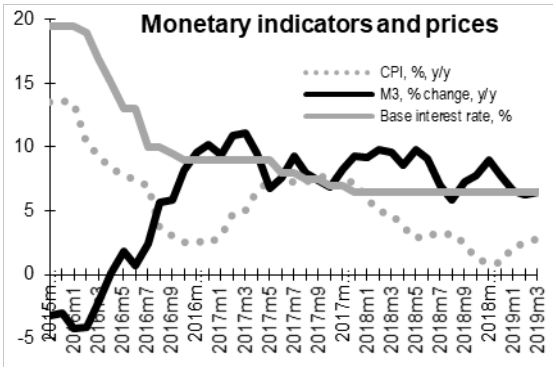
Against the backdrop of larger trade imbalance, current account deficit deteriorated. Mainly due to robust imports, the current account deficit increased by 4.7 percentage points to 10.5 percent of GDP in 2018. With FDI accounting for only 2.1 percent of GDP, external debt remained the main source of current account deficit financing. By end-April 2019 foreign reserves amounted to 2.9 billion USD, after reaching a record high of 3.1 billion USD in November 2018, still covering more than 5 months of imports. In 2018, due to appreciation and new GDP accounting, external debt decreased by 10.7 percentage points to 62.1 percent of GDP.

After a lower than planned fiscal deficit in 2018, spending increased rapidly. In the first quarter of 2019, revenues increased by 6.3 percent on the account of good collections in VAT (+ 11.5 percent) and social contributions (+8.4 percent). On the downside, corporate income tax revenues decreased 8.6 percent, year on year. As result of strong increase in non-financial assets (+45 percent), wages (+23 percent) and social spending (+15 percent), expenditures increased by 19.1 percent, resulting in a 0.7 percent of GDP fiscal deficit. With lower external financing and prominent GDP growth, the public and publicly guaranteed debt decreased to 30.5 percent from 32.7 percent of GDP in 2017.









Medium Term Outlook

Against the background of lower remittances, projected weaker foreign and domestic demand, economic growth will decelerate below historical values in 2019-2021. Expansionary fiscal policy measures adopted in 2018 - tax cuts, an increase in wages and public transfers - and constantly increasing financial intermediation activity will underpin growth in 2019. At the same time, lower growth in remittances and higher inflation that erode the disposable income will decelerate growth to 3.4 percent. As the impact of fiscal stimuli fade away after elections, consumer and business confidence, together with a continued normalization of financial conditions, will continue to support private consumption and investment in the medium term. The economy is projected to grow by 3.6 percent in 2020 and as the growth of the main trade partners strengthens, growth in Moldova will reach 3.8 percent by 2021. On the supply side, industry and non-tradable sectors will be the most dynamic, while contribution from agriculture is expected to be marginal. The expansionary fiscal policy introduced before the elections combined with higher agricultural prices and adjustments in regulated prices will build up inflationary pressures, pushing the inflation out of the corridor in the second half of 2019. Nonetheless, in the medium term, the monetary stance is projected to remain adequate and consumer inflation is envisaged to stay in the target corridor. As a consequence of tax cuts, increases in social spending and wages before elections and lower external financing, the fiscal space will be constrained. In 2019, the fiscal deficit will spike to -2.7 percent of GDP due to the election cycle. In the medium term, the fiscal deficit is projected to be higher than historical average, underlining the need for sound fiscal management. Albeit relatively robust exports mainly due to expansion of activities in free economic zones, the current account deficit is projected to steadily increase, but given the slowing growth it will remain below historical values.

With declining productivity levels, lower external financing and existing structural deficiencies, Moldova remains highly vulnerable to shocks. Political uncertainty and vested interests undermine the reform agenda and the investment process. The large share of the state in the economy, coupled with weak institutions and governance challenges, including in the non-banking financial sector, pose additional risks. Extreme weather may affect agricultural output, impacting overall growth and poverty. In the medium term, the fiscal position may deteriorate due to structural inefficiencies in public spending and increasing burden from wages and social transfers. Deficit financing also constitutes a risk in the near term, as it heavily relies on external financial sources, which may not materialize in the difficult post-election period, particularly in case of earlier elections. With higher projected inflation, the government may find it difficult and costlier to finance the planned spending on the local market, with the risk of crowding-out credit activity. Key long-term challenges to economic growth include population ageing, large emigration flows, and unsustainable economic growth relying on remittances-driven consumption and low levels of productivity. The *Special Topic* to this note argues that increasing productivity is the key solution to sustainable growth in Moldova. This requires major structural reforms in all sectors.

Table 1: Key Macroeconomic Indicators

	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F
Nominal GDP, *MDL billion*	119.5	133.5	145.8	160.8	178.9	190.0	207.1	224.6	244.8
GDP, *% real change*	9.0	5.0	-0.3	4.4	4.7	4.0	3.4	3.6	3.8
Consumption, *% real change*	5.3	4.4	-2.3	2.6	4.7	3.2	2.9	3.0	3.1
Gross fixed Investment, *% real change*	3.8	10.0	-2.3	-2.8	5.2	14.0	5.7	6.3	6.8
Exports, *% real change*	12.7	0.9	2.6	9.8	10.9	4.8	3.7	4.9	5.2
Imports, *% real change*	5.6	3.1	-5.8	2.8	11.0	8.9	3.8	4.0	4.7
GDP deflator, *% change*	3.9	6.4	9.6	5.7	6.3	3.4	5.4	4.7	4.9
CPI, *% change, average*	4.6	5.1	9.7	6.4	6.6	3.0	4.7	4.8	5.0
Current account balance, *% GDP*	-5.2	-6.0	-6.0	-3.5	-5.8	-10.5	-5.4	-5.7	-6.2
Remittances, *% change, USD*	9.6	0.4	-24.5	-5.0	13.2	11.9	5.4	5.1	4.9
Terms of Trade, *% change*	-0.4	-1.2	3.8	3.0	0.5	1.0	1.2	-2.0	-0.3
External Debt, *% GDP*	72.4	67.9	78.3	76.7	72.0	64.6	64.9	65.2	65.1
Budget revenues, *% GDP*	30.9	31.8	30.0	29.0	30.2	30.5	29.6	29.5	29.9
Budget expenditures, % GDP	32.3	33.3	31.8	30.5	30.8	31.4	32.3	31.6	31.9
Fiscal balance, % GDP	-1.5	-1.5	-1.9	-1.6	-0.6	-0.9	-2.7	-2.1	-2.0
Public and Guaranteed Debt, *% GDP*	31.8	27.2	29.6	36.9	32.7	30.5	31.0	29.9	30.3

Source: Moldovan authorities, World Bank projections

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