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MOLDOVA
Economic Update

May 17, 2018

- ***In the last two years, Moldova's economic growth was strong and driven mainly by private consumption.***
- ***Despite the electoral year, in the baseline scenario fiscal discipline is expected to be maintained.***
- ***With economic growth below historical average, structural reforms are needed for private sector growth and job creation.***

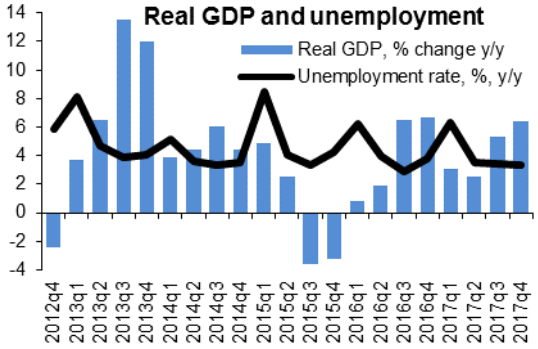
Recent Economic Developments

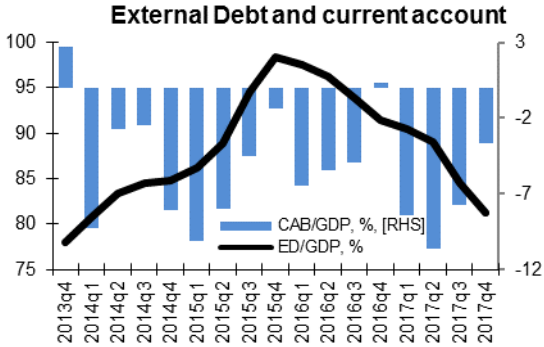
Led by private consumption, Moldova's economy grew by 4.5 percent in 2017. Fueled by remittances, strong growth in wages and the indexation of public transfers in 2016, consumption increased by 4.9 percent in 2017. Improved financial conditions and the recovery from the 2015 decline in public investments led to a recovery in gross fixed investments (+5.3 percent). Export growth was robust (+12.7 percent, y/y), supported by the good harvest of the past two years. Imports rapidly increased, propped by a stronger Leu. As a result, net exports subtracted from growth (-2.7 percentage points (p.p.)). On the production side, the main growth impulse came from retail and wholesale trade (+1.3 p.p.), followed by agriculture (+1 p.p.) and industry (+0.4 p.p.).

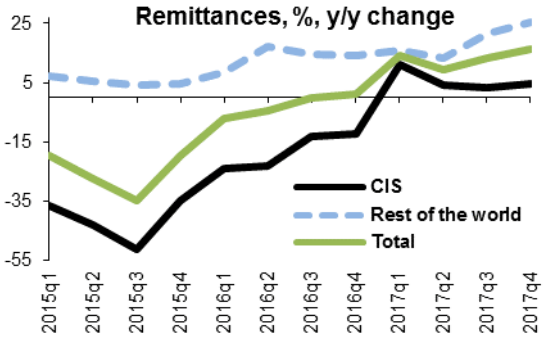
In 2018, consumer inflation is decreasing due to the base effect and lower imported inflation and regulated prices. In 2017, increases in regulated prices, higher prices of selected agricultural outputs, and stronger internal demand accelerated inflation, averaging 6.6 percent just above the target corridor of 5 percent +/- 1.5 percent. The latter factors were offset by the appreciation of Leu due to stronger foreign inflows and decrease in utility tariffs in 2018. Inflation started to decline and reached 3.7 percent y/y in April 2018. By end-2017, foreign reserves registered a record level, exceeding 5.5 months of imports.

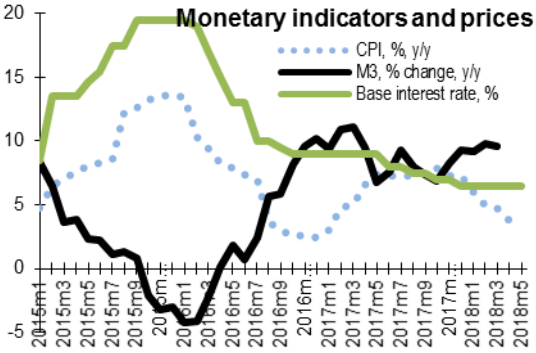
Widening current account deficit remains mainly financed by external debt. Reflecting strong imports growth, the current account deteriorated by 3.4 p.p. to -7.6 percent of GDP at end-2017. After declining in 2016, remittances increased 13.2% thanks to favorable external conditions. FDI doubled reaching 2.6 percent of GDP, however the current account deficit continues to be financed predominantly through external debt. Due to Leu appreciation, external debt decreased by 6 percentage points to 85.8 percent of GDP.

Following two years of underspending, fiscal space increased due to overperforming public revenues. As revenues outpaced the double-digit increase in expenditure (+12.5%) the resulted deficit was lower than the plan (-0.8% of GDP). In Jan-Apr 2018, supported by robust fiscal revenues due to improved compliance, buoyant foreign trade and increased economic activity, public revenues continued to be strong increasing 10.8 percent while expenditures decreased by 1 percent thanks to decreases in subsidies (-36 percent) and in interest payments (-48.4 percent). During the same period, spending on non-financial assets decreased by 28.2 percent, y/y. On account of stronger growth, public debt and public guarantees decreased by 4.9 p.p. of GDP, as compared to end-2016, reaching 38.9 percent of GDP in 2017.









Medium Term Outlook

Growth is expected to be robust but below historical averages. With higher real wages and the rebound in remittances, growth will be primarily fueled by private consumption. Favorable conditions on external markets will stimulate exports, however the contribution of net trade to GDP growth is likely to remain negative as imports will rapidly expand. Real growth in public transfers and the foreseen recovery in capital spending, with a focus on the road sector, will support growth in the near term, particularly in the 2018 electoral year. The stabilization of financial sector will improve financial intermediation allowing also for more private investments. Growth is expected to be robust and reach 3.8% in 2018 and 3.7% in 2019, still below the historical averages of 4.6%. In the baseline scenario, fiscal deficits are projected to remain below 2.5% of GDP in the medium term. Nonetheless, due to mandated indexation and valorization of pensions, wage increases, and additional envisaged public capital investments, fiscal deficit is expected to increase temporary reaching about 3 percent of GDP in 2018. Along with projected improvements in terms of trade and robust domestic demand, the current account deficit is expected to gradually increase in medium term but to remain below its historical average thanks to stronger exports. The inflation rate is expected to reach the lower bound of the target corridor in 2018 due to base effects and lower regulated prices and to gradually increase to the target of 5 percent in medium term. Against this background, the poverty rate measured at the Upper Middle-Income line of PPP US$5.5/day is projected to decrease by 4.6 p.p. in 2016-2019 to 11.7 percent, supported by continuous real wage growth, remittances and public transfers.

With economic outlook in the baseline scenario subject to considerable external and internal risks, further structural reforms are needed for private sector growth and job creation. Weaker growth of key trade partners and potential changes in international trade and migration patterns could undermine exports and remittances flows. Internal challenges are associated with adverse weather conditions and their effects on the agriculture sector, which employs about a third of the total employed population. Risks to the financial sector include poor governance throughout the system, lack of shareholder transparency and poor identification mechanisms of ultimate beneficial owners. Looking forward, the continuation of reforms to strengthen the transparency in the sector and improve financial intermediation remain a priority. Moreover, the increased demand observed for the unregulated and poorly monitored non-banking financial intermediation sector raises concerns. Parliamentary elections in 2018 could undermine the fiscal discipline and may also have an impact on the investor confidence and donor support in the medium term. While the authorities have made efforts to reduce macroeconomic risks, faster growth is necessary to converge with EU countries. Facing a demographic decline, Moldova needs deep transformational reforms that will create new and better jobs in the private sector. In this regard, reforming justice sector, improving business environment and enhancing the skills of the workforce remains paramount. The ***Special Topic*** argues that improvements in efficiency and relevance of higher education plays a key role for creating new and better jobs.

Table 1: Key Macroeconomic Indicators

	2012	2013	2014	2015	2016	2017	2018F	2019F	2020F
Nominal GDP, *MDL billion*	88.2	100.5	112.1	122.6	135.4	150.9	163.9	178.0	193.4
GDP, *% real change*	-0.7	9.4	4.8	-0.4	4.5	4.5	3.8	3.7	3.6
Consumption, *% real change*	0.9	5.2	2.7	-1.9	2.8	4.0	3.5	3.2	3.1
Gross fixed Investment, *% real change*	0.4	3.8	10.0	-2.3	-2.8	5.3	6.1	5.2	5.5
Exports, *% real change*	2.3	9.6	1.0	2.9	9.3	12.7	5.1	4.3	4.7
Imports, *% real change*	2.5	4.4	0.4	-5.2	5.9	11.4	5.3	4.4	4.9
GDP deflator, *% change*	7.9	4.1	6.4	9.9	5.6	6.6	4.3	4.7	5.0
CPI, *% change, average*	4.6	4.6	5.1	9.7	6.4	6.6	3.8	4.9	5.0
Current account balance, *% GDP*	-8.7	-6.5	-7.1	-6.4	-4.2	-7.6	-4.9	-5.1	-5.6
Remittances, *% change, USD*	12.7	9.6	0.4	-24.5	-5.0	13.2	4.5	4.3	4.1
Terms of Trade, *% change*	0.8	-0.4	-1.2	3.8	0.9	-4.5	7.4	0.2	0.2
External Debt, *% GDP*	82.6	86.1	81.4	93.7	91.8	85.8	86.3	86.8	86.1
Budget revenues, *% GDP*	38.0	36.7	37.9	35.6	33.9	35.5	34.3	33.8	33.5
Budget expenditures, % GDP	40.1	38.5	39.6	37.9	35.8	36.3	37.3	36.3	35.8
Fiscal balance, % GDP	-2.1	-1.8	-1.7	-2.2	-1.8	-0.8	-3.0	-2.5	-2.2
Public and Guaranteed Debt, *% GDP*	33.2	31.8	32.5	35.2	43.8	38.9	39.2	38.7	38.1

Source: Moldovan authorities, World Bank projections

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