



MOLDOVA

Highlights

- **Growth slowed in the past year.** After record growth of 9.4 per cent in 2013, the economy posted positive (albeit-lower) growth of 4.6 per cent in 2014 and 3.6 per cent in the first half of 2015.
- **Large-scale banking sector fraud has occurred.** Three major banks were placed under special administration by the National Bank of Moldova (NBM) in November to December 2014 after large bogus transactions were uncovered on their balance sheets. This undermined the confidence of investors, lenders, depositors and consumers, and created potentially significant contingent fiscal liabilities.
- **The difficult external environment amplified domestic economic vulnerabilities.** Lower export proceeds and remittances and substantially reduced international aid put pressure on the currency and foreign reserves and challenged the budget execution process.

Key priorities for 2016

- **Transparency and discipline in the financial sector need to be restored.** Following the uncovering of a major fraud in Moldova's three large banks, the authorities must take concrete steps to prevent further contamination in the financial sector and to punish perpetrators of the fraud.
- **The authorities need to take urgent measures to strengthen public institutions, reform the justice sector and fight corruption.** Key steps include measures to: reinvigorate state institutions and ring-fence them from interference from vested interests; increase the independence of the NBM; and ensure proper administration of justice to remove impediments to implementing public policies and improving the business climate.
- **A new programme with the International Monetary Fund (IMF) and implementation of the Association Agreement with the European Union (EU) can serve as useful reform anchors.** Structural and institutional transformation to improve competitiveness and the diversification of exports and production can help to improve Moldova's resilience to external shocks.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	6.8	-0.7	9.4	4.6	-2.0
Inflation (average)	7.7	4.6	4.6	5.1	8.4
Government balance/GDP	-2.4	-2.2	-1.8	-1.7	-3.9
Current account balance/GDP	-11.2	-6.8	-5.0	-3.7	-6.2
Net FDI/GDP [neg. sign = inflows]	-3.8	-2.1	-2.6	-2.1	-2.6
External debt/GDP	77.0	82.2	83.6	82.5	n.a.
Gross reserves/GDP	28.0	34.5	35.3	27.1	n.a.
Credit to private sector/GDP	33.6	37.9	42.0	36.5	n.a.

Macroeconomic performance

Economic growth has been volatile. Growth in 2014 was 4.6 per cent after a record 9.4 per cent in 2013. In the first half of 2015, Moldova's economy is estimated to have expanded by 3.6 per cent year-on-year, although risks for the year are clearly tilted to the downside due to the accumulated vulnerabilities in the financial sector, the weak performance of agriculture, the impact of lower external financing support on the government's liquidity position and substantial governance challenges. In the first half of 2015, remittances, which amounted to approximately 20 per cent of GDP in 2014, fell in US dollar terms by approximately 30 per cent year-on-year, while export proceeds dropped by approximately 16 per cent.

The currency has come under pressure. The leu depreciated against the US dollar by 16 per cent in 2014, with currency pressures mounting by the end of the year. Further depreciation of 22 per cent occurred during the first nine months of 2015. These currency pressures materialised, among other things, due to lower foreign exchange inflows, including lower export proceeds, remittances and external loan disbursements. The turmoil in the banking sector and the deterioration of confidence provoked an increased demand for foreign exchange cash. The NBM stepped up interventions to stem the decline. In October to December 2014, Moldova's official reserve assets decreased from approximately US\$ 2.65 billion to US\$ 2.16 billion, losing almost US\$ 0.5 billion. In January to August 2015, official reserve assets decreased by US\$ 0.35 billion, reaching US\$ 1.8 billion by the end of August 2015 (approximately four months of imports). The currency depreciation contributed to the acceleration of the annual inflation rate to 12.6 per cent in September 2015, which exceeded the NBM's upper bound (6.5 per cent) of the inflation target for the seventh consecutive month. In the first seven months of 2015, the NBM hiked its base rate five times, increasing it from 6.5 per cent in December 2014 to 19.5 per cent in September 2015.

Debt ratios have increased. Moldova's external debt-to-GDP ratio (public plus private) which stood at 83 per cent at the end of 2014 is likely to increase to approximately 100 per cent as the leu depreciation deflates GDP in US dollar terms. The end of 2014 net international investment position was negative at approximately 70 per cent of GDP, although the public and publicly guaranteed foreign exchange debt stock, mainly owed to multilateral official creditors, was relatively moderate at 22 per cent of GDP. Public debt stood at approximately 30 per cent of GDP in 2014 and is expected to increase to close to 50 per cent - mainly due to the emergency support to the three failed banks. Budget execution lacks longer-term perspective owing to the absence of international financing and an inability to borrow in the domestic market.

Short-term growth prospects are uncertain. Moldova's growth path is volatile due to a narrow economic base. Political and economic implications from the fraud in the banking sector, challenges in the budget execution and governance have amplified structural vulnerabilities and downside risks.

Major structural reform developments

The banking sector was rocked by a major fraud scandal. The NBM-commissioned report, made public in May 2015, identified a series of transactions involving the three major banks – Banca de Economii, Banca Sociala and Unibank – that involved opaque transfers of up to US\$ 1 billion (approximately 12 per cent of 2014's GDP) and led to a major deterioration in the banks' balance sheets. Publication of the report was followed by protests in Chisinau, with participants calling on the government to investigate the matter. In August 2015, the prime minister announced the start of the liquidation of the three banks, with the process expected to be completed as soon as practically possible. Payments of pensions and of social benefits through the three banks stopped from September 2015 and have been transferred to the state enterprise, Posta Moldovei, until payees entrust the function to another service provider (that is, a bank) and operations with cards and other accounts ceased from October 2015 and have been transferred to a number of commercial banks selected through a tender by the NBM. In October 2015, the parliament of Moldova initiated a legislative process to reverse an earlier amendment by the government (April 2015) of the law on financial institutions that cancelled the right to transfer shares in Moldovan banks as capital contributions to other entities.

Financial stability has been threatened by the banking scandal. In 2014-15, the NBM provided emergency loans to the three scandal-hit banks for an amount of almost 12 per cent of GDP. This is a lower-bound estimate of the budget and public debt-related costs of tackling the problems caused by the fraud. By the end of June 2015, the share of non-performing loans (NPLs) of total loans of the three banks under special administration increased to approximately 60 per cent, higher than the end of 2014 level by approximately 20 percentage points. This compared with a rate of approximately 10 per cent in the remainder of the banking system. In June 2015, Moldova's other three banks – Moldova-Agroindbank, Moldindconbank and Victoriabank – came under the National Bank's special surveillance, which allows the latter to obtain more detailed information and avert further spillovers.

The development of energy infrastructure continued amid delays in energy tariffs adjustments. Construction of the Iasi-Ungheni gas pipeline connecting Romania and Moldova's gas transport systems was completed at the end of August 2014 and has enabled Moldova to receive gas from Romania since March 2015. This can promote energy diversification for Moldova and help to foster competition in the local gas market, although, due to technical constraints, the pipeline can only supply a small region around Ungheni, which consumes 3 to 5 per cent of the country's yearly gas consumption. In addition, preparatory studies are under way for the construction of a pipeline between Ungheni and Chisinau. If supplemented with new gas compression facilities in Romania, the new pipeline would provide much larger diversification benefits. At the same time, continued delays in the adjustment of electricity, gas and heating tariffs have resulted in cascading debts and losses in the energy sector.

Moldova's business environment remains difficult. In the World Bank's *Doing Business 2016* report, Moldova ranked 52nd out of 189 economies, with lower scores in dealing with construction permits, getting electricity, enforcing contracts and resolving insolvency. Corruption poses a major challenge. Weak law enforcement and judicial administration, poor public governance and the strength of vested interests constrain implementation of radical anti-corruption measures.