MOLDOVA

Highlights

- **The Covid-19 crisis hit a stable but already decelerating economy.** Economic activity plummeted in the second quarter of 2020 by 14 per cent year-on-year. However, the relatively good macroeconomic position before the crisis, and access to external financing, helped the economy to cope with the shock.
- **The authorities adopted a package of measures to safeguard the economy.** These include tax deferrals, an increase in social benefits, monetary policy easing and measures to support liquidity in the banking sector.
- **Finalisation of the new gas pipeline increases Moldova's energy security.** The inauguration of the Ungheni-Chisinau gas transmission pipeline, connecting the Moldovan gas network to the European Union via Romania, is an important step towards geographical diversification of energy supplies.

Key priorities for 2021

- **Moldova should start preparing for opportunities from the expected post-Covid-19 shift in global value chains.** One of the long-term consequences of the pandemic is expected to be the restructuring of global supply chains, and Moldova, with its geographical proximity to western Europe, should strengthen its position by pursuing long overdue structural reforms to improve the business environment.
- **The authorities should advance institutional reforms and improve governance.** The success achieved in recent years in financial sector reform would not be sustainable without improvements in the rule of law and the fight against corruption. The creation of a level playing field, guaranteed by strong regulatory institutions, will be critical for investments.
- **The independence of the National Bank of Moldova (NBM) should be preserved.** The continued strengthening of professional capacities of the NBM and respect for its institutional independence are the best guarantees of financial system stability.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	4.4	4.7	4.3	3.6	-5.5
Inflation (average)	6.4	6.6	3.1	3.8	2.8
Government balance/GDP	-1.5	-0.6	-0.8	-1.4	-8.0
Current account balance/GDP	-3.5	-5.7	-10.4	-9.3	-8.3
Net FDI/GDP [neg. sign = inflows]	-0.9	-1.4	-2.2	-3.9	-1.0
External debt/GDP	75.0	70.6	63.9	62.0	n.a.
Gross reserves/GDP	27.3	29.0	26.1	25.6	n.a.
Credit to private sector/GDP	21.6	18.7	18.4	19.2	n.a.

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Covid-19: macroeconomic implications

The Covid-19 crisis hit an already-decelerating economy. Due to a near-standstill in the last quarter of the year, economic growth decelerated to 3.6 per cent year-on-year in 2019. This declining trend in growth continued in the first quarter of 2020 when GDP growth slowed further to 0.9 per cent year-on-year, driven by a fall in exports and stagnating private consumption. Investments in fixed assets remained strong, helped by construction activity picking up again on the back of an increase in the state subsidy for the First House programme. GDP plummeted in the second quarter of 2020 by 14 per cent year-on-year, on the back of a 17 per cent year-on-year drop in private consumption and a 15.6 per cent year-on-year fall in investments. However, net exports had a positive contribution to GDP due to a deeper drop in imports than exports. The exchange rate remained broadly stable and the inflation rate decelerated to 2.3 per cent in September 2020, below the target rate of 5.0 per cent, prompting the central bank to set a new historical low policy rate at 2.75 per cent.

Fiscal prudence and access to external financing have helped the economy cope with the shock. Public debt is estimated at around 28 per cent of GDP in 2019, leaving ample fiscal space for policy response. Multi-year efforts to clean up the financial system succeeded in putting it on a significantly better footing, with tightened regulatory and governance frameworks, a stronger regulator, and foreign strategic investors in the banking sector. At nearly US$ 3.5 billion in September 2020 and covering over six months of imports, international reserves held by the NBM are at comfortable levels. To help cover the widening external and fiscal gaps and anchor macroeconomic stability, the government secured US$ 235 million rapid financing from the International Monetary Fund (IMF) in April 2020.

Economic recovery is likely to be gradual and dependent on the recovery of global demand. Subdued demand for new cars is likely to weigh down demand for the automotive components industry, which is well integrated into global supply chains. On the other hand, a strong increase of remittances since May 2020 will most likely support the recovery of private consumption. After reaching a trough in the second quarter of 2020, the economy will likely remain in negative growth territory until early 2021. Taking all factors into account, we expect GDP to decline by 5.5 per cent in 2020 followed by a moderate recovery of 3.5 per cent in 2021, but downside risks to the forecast remain significant.

Policy response to Covid-19

The authorities have introduced significant mitigation measures to combat Covid-19. The initial emergency policy response of 2 per cent of GDP in April 2020 focused on tax deferrals, a temporary increase in social benefits, monetary policy easing and liquidity provision. The government reduced the value-added tax (VAT) rate for the hospitality sector from 20 per cent to 15 per cent, announced faster VAT reimbursements and provided subsidised lending to small and medium-sized enterprises. Tax payment deadlines were delayed to mid-2020 and tax audits and other controls were temporarily suspended. Firms that ceased operations during the state of emergency had their payrolls (personal income tax and social contributions) fully compensated by the state, and those that continued operating received up to 60 per cent. Social assistance to vulnerable groups includes expanding unemployment benefits and targeted social help. The NBM cut the policy rate in the face of shrinking aggregate demand and lowering inflationary pressures. It also allowed banks to defer loan payments and decreased the Moldovan leu reserve requirements to support liquidity in the banking sector.

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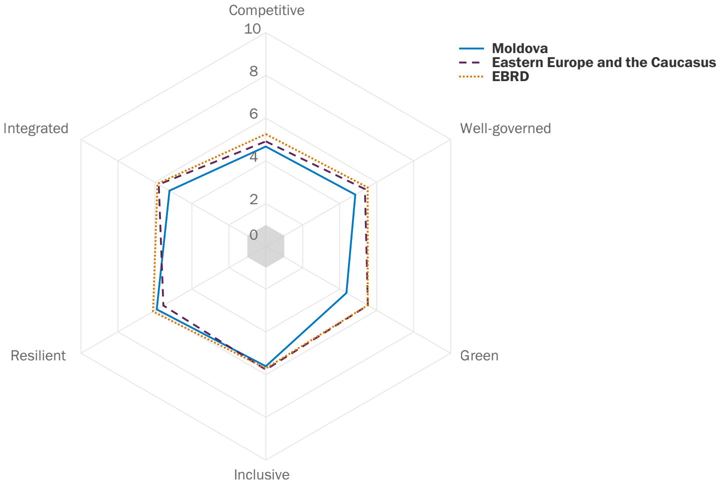
Assessment of transition qualities (1-10)



Structural reform developments

Reforms in the financial sector to ensure its stability continued. To prevent migration of risks from the banking to the non-bank financial sector, the authorities have been improving the regulatory and supervisory framework for the sector. According to new regulations introduced in February 2020, the non-banking sector is not allowed to accept deposits from the general public, all entities in the sector need to report the new credit activity to the credit bureaus, and the minimum share capital is increased to MDL 1 million (around US$ 60,000) from January 2021. Prudential requirements have been enhanced and a sanctioning regime introduced. The banking sector also saw the adoption and implementation of the enhanced Emergency Liquidity Assistance to solvent and viable banks from December 2019. On the NBM's approval of the new supervisory and management boards, a systemic bank exited temporary administration in February 2020.

Continued engagement with the IMF supports Moldova's reform agenda. The authorities finalised the sixth and final review under the three-year Extended Credit Facility and Extended Fund Facility arrangement with the IMF in March 2020. Negotiations for a new economic reform programme resulted in a staff-level agreement in July 2020 for a US$ 558 million three-year arrangement. When approved by the IMF Board, the new programme will support the Moldovan authorities in advancing institutional reforms aimed at tackling vulnerabilities in fiscal governance, non-bank financial sector oversight, market regulation, anti-corruption and the rule of law.

Finalisation of the Ungheni-Chisinau gas pipeline increases Moldova's energy security. The inauguration of the 120-kilometre-long Ungheni-Chisinau gas transmission pipeline in August 2020 marks the completion of the second stage of the Ungheni-Chisinau strategic infrastructure project, connecting the Moldovan gas network to the European Union via Romania. Construction of the interconnector between the Romanian city of Iasi and the Moldovan town of Ungheni was the first stage of the project. The Ungheni-Chisinau pipeline will add up to 1.5 bcm/year of gas supplies and support the geographical diversification of natural gas supply routes to Moldova. This project increases Moldova's energy security, because up until now the country has been nearly fully dependant on Russia for the import of gas.

A new customs code was adopted. The new code merges three laws into a single legal act in an effort to systematise and streamline the previous customs legislation. It also aims to liberalise and simplify certain customs procedures as well as promote the use of electronic documentation. Adopted in July 2020, the code will take effect in January 2022 with a transitional period provided for some of the articles.