Moldova–2012 Article IV Consultation, Concluding Statement

May 17, 2012

This note summarizes the mission's observations and recommendations, aiming to elicit views on policy issues that will be reflected in the staff report to be discussed by the IMF's Executive Board. The mission is grateful for the hospitality and collaboration it has received from the authorities and representatives of the private sector, labor, and civil society.

Macroeconomic developments and outlook

1. **Over 2010-11, supported by a strong reform program and a favorable external environment, Moldova's economy grew by an impressive 14 percent.** Growth was driven by buoyant domestic demand, financed by remittances, credit, and external capital inflows, and booming exports, spurred by robust external demand. Exports were further promoted by trade liberalization, greater access to EU and CIS markets, and investment in new production capacities. Nevertheless, the current account deficit widened to 12.6 percent of GDP by end-2011, as imports rose strongly as well. Core inflation stayed close to 5 percent. Headline inflation persisted in high single digits, pushed up by rising food and energy prices.

2. **Economic activity slowed considerably in early 2012, reflecting the weakening external demand, and the cold winter.** Industrial production and transportation in the first quarter declined from a year ago, while exports growth over the same period last year tapered to 6¾ percent. Inflation decelerated rapidly to 4.7 percent in April, partly due to declining food prices. On the other hand, wages and credit remained resilient.

3. **The economy is expected to improve going forward, but there are serious downside risks**. We project GDP growth at 3 percent in 2012, supported mainly by resilient conditions in Moldova's CIS trading partners. Structural reforms and large infrastructure public investment will further underpin medium-term growth. In the absence of new supply shocks, inflation would hover around the NBM's target of 5 percent. However, further deterioration in external conditions could significantly depress exports, remittances, capital inflows, and hence growth. Also, delays in donor support could open large balance of payments gaps.

Fiscal policy

4. **Moldova has made great strides over the last two years on the way to restoring fiscal sustainability.** In 2010, the authorities embarked on an ambitious path to bring the fiscal deficit by end-2012 down to a level that could be sustained without recourse to exceptional official assistance. They have appropriately chosen current expenditure restraint, particularly in the public wage bill and spending on goods and services, while raising social

assistance to protect the vulnerable and public investment to promote growth. As a result, the fiscal deficit declined from over 6.3 percent of GDP in 2009 to about 2.4 percent in 2011. The 2012 budget, supported by comprehensive tax policy and expenditure reforms, aimed to bring the deficit below 1 percent of GDP.

5. **However, the faltering fiscal adjustment in early 2012 necessitated strong corrective measures.** Revenue underperformed, partly reflecting the slowdown in the economy, but also a combination of policy loopholes and collection problems. In addition, unbudgeted expenditure commitments and delays in external assistance have put the budget in jeopardy. To address this situation, we recommend a swift passage of a package of policy measures that strikes the right balance between accommodating the revenue effect of the slowing economy and safeguarding the fiscal consolidation, with a view to keeping the budget deficit within 1.2 percent of GDP. The revenue measures should focus on eliminating policy loopholes and strengthening tax and customs administration, while rationalization in current expenditure should reflect the budget's changing priorities.

6. **Over the medium term, fiscal policy should be aimed at consolidating fiscal sustainability, while raising investment in the context of declining foreign assistance.** The authorities' plan to maintain a headline fiscal deficit close to 1 percent of GDP in 2013-15 is consistent with fiscal sustainability and available financing. Further reform-based rationalization of current expenditure to the tune of 2-3 percent of GDP and strengthening of tax revenue will be needed to make room for higher public capital outlays and targeted social assistance in view of declining external grants. This includes reforming the pension system to improve the replacement rate by increasing the retirement age, consolidating the large number of municipalities to reduce public administration costs, and expanding the education sector reform to improve quality and rationalize costs. The introduction of a fiscal responsibility framework would further enhance fiscal discipline and transparency.

Monetary policy

7. **Amid a rapidly falling inflation outlook and moderating activity, the NBM has aggressively relaxed monetary policy.** After tightening during the first three quarters of 2011, the NBM reversed course and cut the base rate by 550 basis points between November 2011 and February 2012. This caused a proportional reduction in the T-bill rates, but as yet only a small effect on commercial lending rates, which remain near 14 percent on average.

8. **After the sizable monetary easing, a pause is warranted.** The inflation outlook over the next two years is consistent with the NBM's 5 percent target. Since the effect of monetary policy occurs with a lag, a pause is needed to assess the impact of the enacted policy which is still making its way through the financial system. Further monetary policy adjustment would be warranted if the economic outlook deteriorates or demand-driven inflation pressures re-emerge. In case of supply shocks, we recommend that the NBM consider their likely pass-through to core inflation as a guide to adjusting its policy stance.

9. **The general conduct of monetary policy would benefit from further development and improved communication with the public.** Inflation targeting in Moldova has contributed to reducing the rate and volatility of inflation. That said, monetary policy remains complicated by a relatively weak transmission mechanism and volatile food and energy prices which make up nearly half the CPI basket. The NBM has had at times to respond to shocks to these prices to anchor inflation expectations. However, to avoid overreaction, more weight should be given to demand-driven core inflation trends in determining the policy stance and in communications with the public. Also, balancing a model-driven outlook assessment with policymakers' judgment would help take into consideration the uncertainty about the outlook and prevent policy overshooting.

External position

10. **The current account deficit significantly exceeds its estimated long-term sustainable level.** The large deficit reflects the availability of substantial private and official external funds to complement low domestic savings and support much needed investment. It is projected to narrow gradually to about 9½ percent of GDP in the medium term, as a result of increased export penetration of international markets sustained by new investment in the tradable sectors. External debt is expected to stabilize at 71 percent of GDP, but its elevated level renders Moldova vulnerable to external shocks.

11. **Further reserve accumulation is therefore warranted at this time.** In view of its highly open economy and dependence on external funding and remittances, Moldova is exposed to sudden stops in external inflows. Moreover, the NBM's international reserves are expected to decline against standard measures of reserve adequacy after 2012. A gradual increase of reserves to cover 85 percent of the short-term debt at remaining maturity would provide a more comfortable cushion against external shocks. The NBM should seek to accomplish this in a transparent way consistent with its monetary framework and with due regard to seasonal fluctuations in the supply of foreign exchange.

12. **The REER appears moderately overvalued.** The REER has appreciated by over 16 percent since early 2010 when it was broadly in line with fundamentals. This is well above the trend appreciation around 2 percent per year that could be attributed to the higher productivity in Moldova relative to its trading partners. IMF methodologies point to overvaluation in the 5–15 percent range, which does not pose an immediate threat to external competitiveness and has already began to correct itself.

13. **Our analysis suggests that trade, remittances, and private borrowing are the main transmission channels of external shocks into Moldova.** Banks are relatively insulated owing to low foreign assets and liabilities. Should an adverse scenario materialize, policies would need to balance between immediate stabilization needs, demand support, and medium-term objectives.

Financial sector

14. **Banks have generally remained liquid, well-capitalized, and profitable.** The non-performing loans (NPLs) ratio has slowly come down from its peak of 17 percent in April 2010 to 8 percent in September 2011. Since then, the NPL ratio has increased to about 13 percent by March 2012 mainly due to a methodological change which added about 2 percentage points, and deterioration of the portfolio in the majority state-owned BEM. In February 2012, the NBM put the small Universalbank in liquidation after it failed to resolve liquidity and capital deficiencies. The liquidation has proceeded well—taking advantage of the recently introduced bank resolution tools—with no impact on the overall stability of the banking system.

15. **The situation in BEM requires concerted decisive actions.** Over the last year, the BEM has extended some risky loans, raising significantly the level of its NPLs and hurting its profits. The bank has ample liquidity and capital buffers to manage the cost, and it has adopted some prudential measures requested by the NBM to limit further risks. However, urgent progress is needed to repair its balance sheet and improve risk management. Governance difficulties with minority shareholders have hindered progress, while poor coordination between financial sector regulators and the state, together with weaknesses in legal institutions, have permitted the problem to fester. The Government should ensure that BEM fully implements remedial measures including those prescribed by the NBM to clean up its portfolio, and take decisive measures to put an end to the bank's risky lending practices. To this end, it is critical to have a functioning Board of Directors in place at the BEM. Meanwhile, close monitoring of the bank by the NBM, including frequent on-site audits, should continue.

16. **Legally dubious bank takeover attempts underscore two fundamental weaknesses of the Moldovan economy—a weak judicial system and non-transparent ownership.** There is little hope of sustainable business development and foreign direct investment unless these weaknesses are addressed. To this end, we are hopeful that the judicial reform will be implemented without delay. And a speedy passage of the legal amendments to facilitate disclosure of beneficial owners in banks and their decisive implementation will test the authorities' commitment to improving the business climate. Alongside, the long overdue adoption of legal amendments to facilitate debt restructuring and execution of loan collateral would enable a quicker resolution of NPLs by banks, thereby increasing their willingness to lend and enhancing access to finance for the private sector.

Structural reforms

17. **Far-reaching reforms have boosted competitiveness and tapped new growth sources.** Moldova's main strategic tasks are to complete the transition to a fully-functioning market economy and converge to average European income levels. In the last two years, Moldova has embarked on comprehensive reforms in taxation, civil service, education, pension and social assistance, energy sector, external trade, and business regulation. With these reforms, the country has advanced by 18 positions to rank 81 in the World Bank's 2011/12 "Doing Business" survey and came second on its list of top reformers in the year. Completing these reforms will help attract new export-oriented investment in the period ahead.

18. **However, reforms have lagged behind in several important areas.**

- Better protection of property rights, a transparent and stable policy environment, and more efficient trade and investment regime are essential to attract investors. Steady implementation of the judicial and customs reforms is a priority to improve the business climate and raise potential growth to lift Moldova out of poverty. Concerted reform efforts in these areas can be effective in attracting FDI, and raise living standards within a few years.

- More efforts are needed to advance the energy sector restructuring plan designed in cooperation with the World Bank. Recent and historic arrears in the energy sector continue to present a large fiscal risk. More efforts are needed to resolve the accumulated arrears, improve collections and establish a reliable payment mechanism.

- The state's presence in the economy should be further curtailed. Despite potential employment concerns, privatization is often necessary to promote market-based behavior and ensure the financial viability of companies. In this context, we welcome the Government's plan to expand the list of companies subject to privatization.