At a glance

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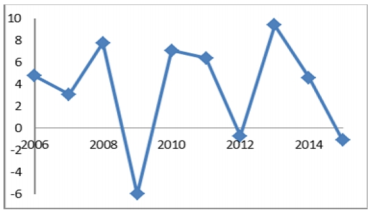
Moldova: A small, vulnerable economy

The economy of this small former Soviet republic, located to the north-east of Romania, is influenced by its proximity to both the EU and Russia. In recent years, Moldova's economy has been affected by political instability, exacerbated by perceptions of corruption as well as drought, the Russian and Ukrainian crises, and trade restrictions imposed by Russia after Moldova signed an Association Agreement with the EU in 2014.

An economy in transition

Moldova experienced a difficult transition after the break-up of the Soviet Union. The country lost a large part of its manufacturing and agricultural activities, based on state and collective farms set up during the Soviet era, due in part to the shock of the transition to a market economy and separation from the integrated Soviet economy. This led Moldova to fall into a crisis that lasted throughout the 1990s, and brought an exodus of much of the working-age population. As regional conditions improved, the economy began to recover in the 2000s, in part due to increased remittances from Moldovans working abroad, registering rapid GDP growth until the onset of the global financial crisis. Corruption, a lack of foreign investment (net inflows increased between 2006 and 2008 but then fell sharply) and vulnerability to external factors have slowed the transition. Moldova is the poorest country in Europe based on income per capita and GDP per capita. It has high unemployment, average monthly salaries of US$300, and the capacity for domestic consumption is limited. In 2014, 11.4% of people lived below the poverty line, though the percentage has steadily declined over the last ten years. The country is vulnerable to weather and climatic conditions, such as droughts, particularly in its southern part. A severe drought in 2015 and fewer remittances are likely to have deepened the poverty problem, particularly amongst agricultural workers. Moldova depends on the EU and Russia for trade. Russian restrictions on Moldovan imports after it signed an Association Agreement with the EU in 2014 buffeted the economy. In 2014, services accounted for 68% of GDP, industry 17%, agriculture 15% and manufacturing 14%. Moldova ranked 52nd of 189 in the World Bank's 2016 Ease-of-Doing-Business report. Around a third of GDP can be attributed to remittances, largely from Moldovans working in Russia, though these have fallen as a result of the Russian recession.

Figure 1 – GDP growth (annual %)



Data source: World Bank/IMF.

The Transnistrian economy

Armed conflict broke out in 1990 in Transnistria, a region on the left bank of the Dniester River, towards the east of the country. Moldova has since exerted no effective control in the region, which has its own central bank, currency (the Tranistrian ruble), de facto government, parliament, military and police service. Russian troops remain in certain zones. A legacy of the Soviet Union, much of Moldova's industry is based in Transnistria, including steel, textile manufacturing and electricity generation. Transnistria maintains close economic links with Russia, receiving subsidies such as natural gas, and pensions paid to elderly Transnistrians with Russian passports. The de facto government applied in March 2014 to integrate the region into Russia, but this was rejected by Moscow. This 'frozen conflict' threatens security and economic stability in the region, now exacerbated by the crisis in Ukraine.

Banking scandal contributes to recession

A banking scandal in which US$1 billion (equivalent to more than one eighth of GDP) disappeared from three local banks in 2014 contributed to increased economic and political turmoil. The scandal highlighted weaknesses in financial and banking regulation, and increased perceptions of corruption, reducing investor and creditor confidence. The scandal, combined with lower remittances due to Russia's recession and less

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external investment, as well as the drought and the Russian trade restrictions, caused the economy to contract in 2015. GDP declined by 1.1% in 2015, according to the IMF, but rebounded by 0.8% year on year in the first quarter of 2016.

National Bank measures to tackle currency depreciation and inflation

Uncertainty due to exposure to the Russian economic slowdown and the banking scandal caused the local currency (the leu) to depreciate, resulting in higher inflation and smaller foreign-exchange reserves. The leu fell by 21% against the US dollar in 2015 and by a further 4% in the first two months of 2016, but has remained stable since. The monetary policy response was aggressive after the government guaranteed deposits in three insolvent banks involved in the scandal at a cost of 12% of GDP, which contributed to inflation. The National Bank gradually raised the base interest rate, reaching a record high of 19.5% by August 2015, almost stopping credit growth, before reducing it again to 19% in January. The rate has continued to fall since. The National Bank spent US$900 million, equivalent to half the annual budget, rescuing the banks, according to consultants Control Risks. The EU stepped in to buy Moldovan goods affected by Russia's import restrictions, improving the situation in local currency terms.

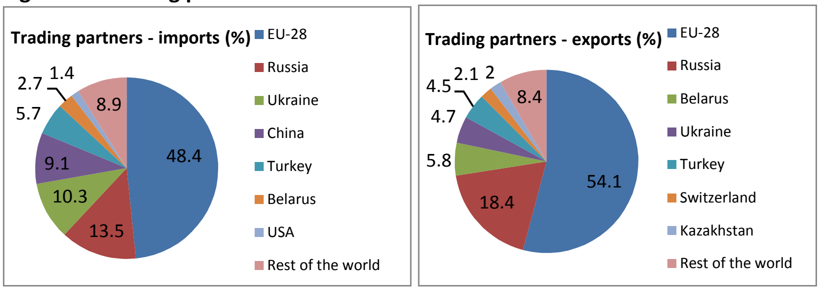
Government spending and fiscal reform agenda

Moldova's public debt was estimated at 51% of GDP and the budget deficit at -2.3% of GDP in 2015. Lower government revenues in 2015 (down 6% in real terms), including from taxes, due to a weaker economy, high interest rates and lower external financing caused Moldova to adjust spending. The government froze the procurement of goods and services and rationed capital expenditure, allowing it to prioritise social spending. The IMF has delayed the approval of new loans because of the slow pace of reforms and political instability, including the collapse of three governments in February, June and October 2015. The World Bank and EU have also been reluctant to disburse new funds. Public finances have been a key point of contention for the IMF, which has pushed for fiscal consolidation, efficiency savings and business-friendly structural reforms aimed at enhancing competitiveness, diversifying the economy and increasing growth. The IMF agreed on 27 July 2016 to pay out a new loan despite many of its concerns remaining unresolved. Romania offered Moldova a loan in October 2015 to encourage it to continue with its EU reforms. The offer was withdrawn due to political turmoil in both countries, but Romania's President finally signed off the five-year €150 million loan on 6 May 2016, following the Parliament's approval in April.

International trade

Moldova's largest trading partners are the EU and Russia. Moldova has few natural energy resources so is reliant on imports from Russia, to which it exports agricultural produce. Moldovan imports exceeded exports by an estimated €2 billion in 2015. The country continues to develop exports to the EU, in part to reduce its reliance on Russia. EU exports accounted for more than 50% of the total in mid-2015, compared to some 18% for Russia. In response to Moldova deepening its relations with the EU in 2014, Russia introduced a series of trade restrictions on meat, wine, and fruit and vegetables, citing health reasons. The meat ban has been partially lifted but the restrictions on wine imports are still in effect. Russia accounted for 95% of fruit exports in 2014, and the restrictions on fruit and vegetables caused estimated revenue losses of US$145 million. Moldovan exports to Russia halved in the first half of 2015, and Romania became its largest export market.

Figure 2 – Trading partners



Data source: European Commission.

EU-Moldova relations: Moldova is a member of the EU Eastern Partnership. It was the first former Soviet country to sign a Partnership and Cooperation Agreement (PCA) with the EU, in 1998. In 2014, Moldova and the EU ratified an Association Agreement and Deep and Comprehensive Free Trade Agreement (DCFTA). Transnistria also joined the DCFTA in January 2016, requiring the republic to carry out reforms over a two-year period in exchange for enhanced access to trade with EU Member States. Moldova and the EU have visa facilitation and readmission agreements and a Mobility Partnership, signed in 2008. Since 2014, Moldovans have been able to travel to the EU without a visa.