NEWSLETTER

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Strained fiscal situation and need for an IMF programme

Donors have reduced financial support to the government of Moldova in reaction to the bank fraud scandal, putting significant strain on Moldova's public finances. Indeed, revenues are expected for fall to 35% of GDP in 2015, down from 38% in 2014. Expenditures had to be reined back even more as the government is not able or willing to borrow money at current interest rates of 25%. Thus, expenditures are likely to fall to 36% of GDP in 2015, from 40% of GDP in 2014, to match lower revenues and a smaller deficit.

While the government was successful in balancing the budget, it had to reduce investment spending to almost zero. It is clear that those emergency measures cannot stay in place for much longer and the government is in need of an IMF programme. Indeed, without a clear commitment and credible steps towards such a programme, the government would have to conduct further spending cuts in order to be able to refinance its existing debt.

Background

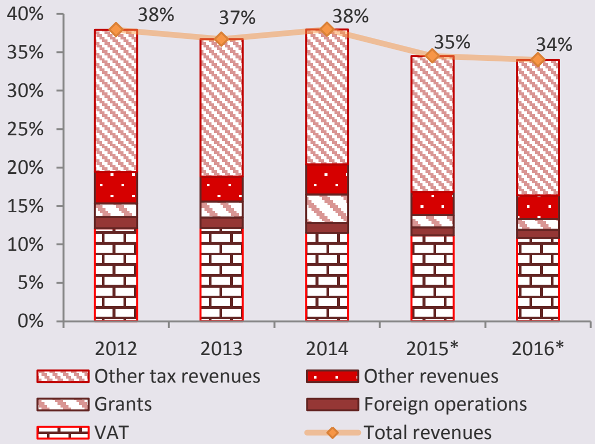
In reaction to the bank fraud, a number of international donors reduced their grants and loans. Continuation of their financial assistance has been made conditional on an IMF agreement. However, at this point in time it is not clear if or when such an agreement on an IMF programme can be achieved. Thus, this raises the question of what would be the situation of public finances in 2016 without an IMF programme. To answer this question we projected revenues, expenditures and the resulting deficit in 2016 assuming that there will be no IMF programme and frozen donor support. For the year to October, the Ministry of Finance has published detailed statistics of actual revenues and expenditures. This so-called executed budget provides a good idea of how finances were affected in 2015 and a foretaste of what can be expected in 2016 if no external financing is secured.

Public revenues

Given that grants amounted to almost 10% of revenues in 2014, the decision to reduce them had a significant impact on overall revenues for the government. Indeed, revenue statistics for the year to October suggest that income from grants is likely to fall by about 50% in 2015. In addition, revenues have come under pressure from a decline in import duties and VAT on the back of a 25% decline in imports. Overall, this means that revenues are likely to fall by 1.4% in nominal terms in comparison to 2014. While in nominal terms the reduction does not sound dramatic, this represents a significant revenue squeeze in real terms as inflation is expected to average 9.6% for 2015. Without revenues increasing by at least the rate of inflation, the government will not be able to cover the rising cost of wages and dearer procurement.

To get a better notion of the strain on revenues it makes sense to depict these in relation to the nominal GDP. This shows that revenues are likely to decline to 35% of GDP in 2015, which is a significant reduction compared to 2014 when revenues amounted to 38% of GDP. Although revenues may recover somewhat in 2016, this will not be enough to keep pace with rising prices. Thus, we expect revenues as share of GDP to decline further to only 34% by 2016.

Revenues as share of GDP

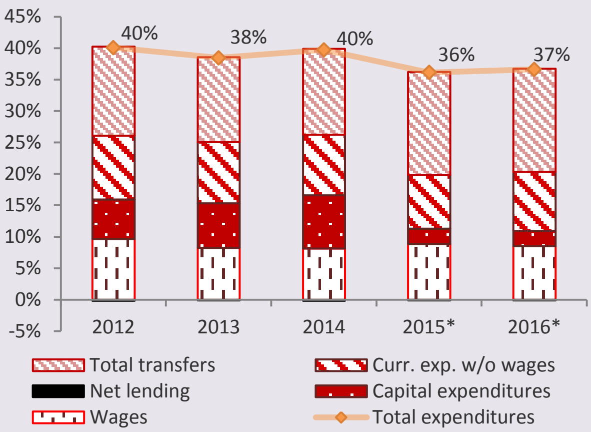


*Source: Own analysis based on the IMF and Ministry of Finance, *estimation/projection*

Public expenditures

Clearly, this loss of revenues had to be compensated by expenditure cuts. However, this did not affect current expenditures such as wages, which continued to increase by 17% in 2015. Thus, capital expenditures (investments) had to take the brunt of the cuts and are expected to fall by an eye-watering 69% in 2015. Those cuts in capital expenditure are equal to 6% of GDP and have the potential to derail the already weak economy if this measure continues for long. Total expenditures are likely to fall by 1.3% in 2015 – although expenditures would have had to increase by much more in order to keep up with inflation. Indeed, expenditures as share of GDP fell from 40% in 2014 to 36% in 2015. For 2016, we project that spending increases again to 37% of GDP as legally protected spending commitments such as wage and pension increases kick in.

Expenditures as share of GDP



*Source: Own analysis based on the IMF and Ministry of Finance, *estimation/projection*

Deficit and financing

For 2015, a deficit of 1.6% of GDP is expected. In 2016 our projections suggest that the deficit would have to widen to 2.6% in order to match increasing expenditures. However, there is the question whether the government is able to borrow enough money to finance such a deficit. Indeed, borrowing options are currently limited leaving external donor loans as the only way of budget or deficit financing. Already in 2015, the entire deficit was financed through donor loans. In fact, the government was actually forced to reduce its public debt as it was either not able or not willing to refinance existing debt when it became due. If the government cannot borrow additional money in 2016, it would have to cut expenditures by another 1% of GDP or increase revenues accordingly. Those measures both may be difficult to administer in the current economic and political climate.

Conclusions

The government actually reacted quickly and decidedly to the changing budget situation by successfully aligning expenditures to declining revenues. However, this came at the cost of large spending cuts, especially on investments. What is more, the government has to pay an ever higher risk premium in order to issue new debt or refinance existing debt requiring spending cuts elsewhere.

Thus, it is clear that the emergency measures taken cannot be kept in place for an extended period of time and the government needs to show how it intends to put public finances back on a sustainable footing. A new IMF programme has to be an essential part of such a fiscal stabilisation strategy. If the steps taken are credible, the government may be able to improve its access to domestic and external financing even before an agreement with the IMF is reached.

Another measure of the required fiscal stabilisation strategy is tight coordination with monetary policy. However, the government should avoid any political influence on the National Bank at all cost. Any attempt to finance the budget deficit by printing money (i.e. monetisation of deficit) is likely to push up inflation or trigger another exchange rate crisis.

Understandably, the IMF has required a number of measures, aimed at cleaning up the banking sector, as prior conditions for a new programme. Although the fulfilment of the latter is technically possible, so far there seems to be a lack of political will for the implementation of such measures. However, this may change as the economic costs of inaction keep rising.

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Note: A more comprehensive analysis of the topic is provided by the Policy Paper PP/04/2015 "Fiscal Policy: Challenges in 2016"

Available at: www.get-moldau.de

German Economic Team Moldova (GET Moldova)
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