NEWSLETTER
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Current economic situation and outlook

Despite being rocked by a massive bank fraud scandal, the Moldovan economy has reported robust, 3.6% growth in the first half of the year. That the economic effects of the scandal are not yet visible in the official statistics can be attributed to the fact that the non-performing loans have not been written down and have not yet affected GDP calculation.

The economic outlook, however, for the Republic of Moldova has greatly deteriorated as a result of the bank fraud. The IMF expects a 1.0% and the World Bank even a 2% decline in GDP this year. For 2016 forecasts suggest only low growth between 0.5% and 1.5%. Macroeconomic crisis management is necessary to reduce the risk of a further deterioration of the economic situation. This should include the stabilisation of the banking sector and the consolidation of public finances with the help of an IMF programme which would provide leeway for the National Bank to cut interest rates.

Current situation

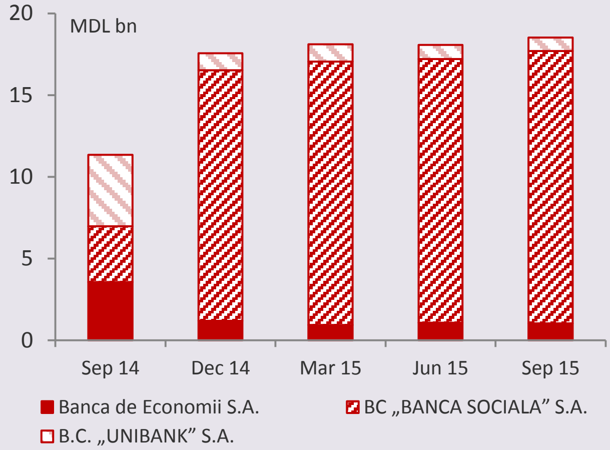
In 2014, the Republic of Moldova recorded robust economic growth of 4.6%. In the first half 2015, the Moldovan economy has, according to the official statistics, so far been spared a decline. The economy grew in the first half of 2015 by 3.6% over the corresponding period last year. However, industrial production decreased by 3% in August 2015, suggesting an imminent slowdown in economic momentum.

It is particularly interesting that, according to official statistics, the financial sector, of all sectors, appears to have made the largest contribution to economic growth in the second quarter of 2015. In the light of the bank fraud scandal, this fact raises some questions. One must consider that an indirect method is used to determine economic performance in the financial sector: The total value of loans is multiplied by the interest spread. Clearly, this method can only work if the value of the loans is known. However, in case of three insolvent banks, the value of the non-performing loans on the books has not yet been written down.

The fact that these loans have not yet been revalued is the reason that the economic performance of the banking sector, at least on paper, has remained unchanged and explains why the financial sector still contributes to economic growth in the official statistics.

Once the loans have been revalued, it will become clear that the financial sector has shrunk considerably. Considering that the financial sector currently makes up about 8% of value added, the Moldovan economy will have grown much more slowly in recent months than previously thought.

Loans outstanding of the three insolvent banks

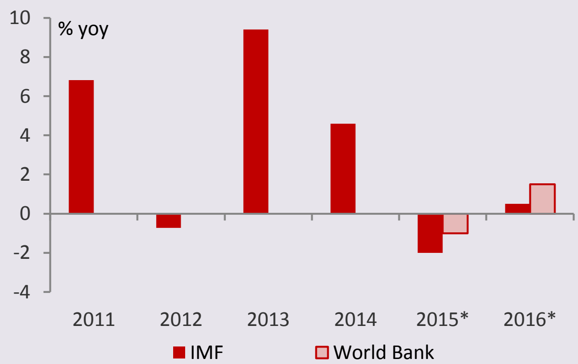


Source: National Bank of Moldova

Outlook

For this year, the IMF predicts a 1% decline in GDP and the World Bank even a 2% drop. Furthermore, forecasts suggest only weak growth between 0.5% and 1.5% in 2016—which represents a significant reduction from previous forecasts earlier this year.

Real GDP growth



*Source: IMF and World Bank, *estimates/forecast*

Indeed, it is unclear what will drive growth in the foreseeable future. Domestic demand, in particular, has been weakened by the banking crisis. Consumer demand is suffering from rising inflation and the associated decline in purchasing power. It increased in the second quarter of 2015 by a meagre 0.2%.

Even more pronounced is the weakening of private investment, which fell by 1.5% in the second quarter in the face of great uncertainty, a lack of credit, and high interest rates. In this context, official statistics also show that companies are increasingly exhausting their inventories, which is always an indicator of a lack of confidence.

Government spending

In light of the slump in private sector demand, now would be the time for the government to provide an economic stimulus. The Moldovan government, however, lacks the necessary funds. Indeed, we had warned some time ago about serious problems for Moldova's public finances and these problems are becoming increasingly apparent. The government recently issued a supplementary budget for 2015, which outlines a reduction in spending of about 1% of GDP and will further aggravate the economic downturn. In fact, government demand already fell in the second quarter by 0.5% over the same period last year.

Net exports

International trade is the only remaining factor responsible for growth. In the second quarter, exports increased by 4.1% compared to the same period last year. Since weak domestic demand led to a decline in imports of almost 4.4%, the rising net exports made a strong contribution to growth.

Monetary policy

In light of the current economic problems, now would be the time for expansionary monetary policy, particularly low interest rates. The current monetary policy, however, is caught up in the direct consequences of the banking crisis. Since the National Bank granted emergency loans to the three insolvent banks, money supply has sharply increased since October 2014. As a consequence, inflation expectations and inflation rose, with inflation itself reaching 12.6% in September 2015, which is high above the National Bank´s inflation target of 5.0% ± 1.5%. This expansion of the money supply now has to be neutralised with high interest rates (19.5% in September, compared to 3.5% the previous year). This rate increase is necessary to prevent the solidifying of inflation expectations—which are associated with high economic costs—but comes at a time at which both companies and the state urgently need a rate cut.

Conclusion

Once the bad loans have been written down, it may turn out that the economic situation in Moldova is bleaker than previously suggested. For the foreseeable future, economic growth will be slowed by the fallout of the bank fraud. Given the troubled outlook and the economic risks, the time has come for macroeconomic crisis management.

A key element of this should be the stabilisation of the financial sector and to contain risks, so that confidence is restored in the banking sector. Furthermore, the national budget must be consolidated while avoiding excessively pro-cyclical spending cuts. For this, an IMF programme is necessary. In addition, economic policy should address as priorities those reforms that provide short-term growth. Once such credible steps toward the management of the crisis have been taken, the National Bank can ease up on its restrictive interest rate policy.

However, it must also be stated that the possibilities for macroeconomic crisis management are limited because the current economic downturn is, in essence, the consequence of a crisis of confidence. Only when confidence in politics and the economy is restored, robust growth will return.

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