German Economic Team Moldova

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Fiscal Policy: Challenges in 2016

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Fiscal Policy: Challenges in 2016

Executive Summary

In reaction to the bank fraud, a number of international donors have reduced their grants and loans. Continuation of their financial assistance has been made conditional to an IMF agreement. However, at this point in time it is not clear if or when such an IMF programme will be negotiated. This raises the question of what would be the impact on public finances in 2016 without an IMF programme. To answer this question we projected **revenues, expenditure and the deficit in 2016** for the scenario of without IMF programme and frozen donor support.

Revenues: Given that grants amounted to almost 10% of revenues in 2014, the decision to reduce donor support had a significant impact on revenues. Indeed, income from grants is expected to fall by about 50% in 2015. Altogether we expect overall revenues to decline to 35% of GDP, 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.

Expenditures: Clearly, this loss of revenues had to be compensated through expenditure cuts. However, this did not affect current expenditure 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. In total expenditures as share of GDP fell from 41% 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.

Deficit and financing: For 2015, a deficit of 1.6% of GDP is expected. In 2016 our projections suggest a widening of the deficit 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 with external donor loans offering the only way to finance a deficit. If donor loans are going to remain at the same level for 2016 as they were in 2015 that would mean the government may have to cut expenditures by another 1% of GDP or increase revenues accordingly. Those measures may be difficult to administer in the current economic and political climate.

The government actually reacted quickly and decidedly on the changing budget situation, successfully aligning expenditures to declining revenues. However, it is clear that those emergency measures cannot be kept in place in the medium and long term. Additionally, there is the risk for the government at this moment that it cannot refinance its existing debt when it is actually due.

To reduce this risk, a **fiscal stabilisation strategy** is needed. The cornerstone of the latter has to be an agreement with the IMF on a new programme. This strategy and commitment have to be credible and should be clearly communicated to reassure domestic investors as well as external donors. If successful, the government may be able improve its access to domestic and external financing even before an agreement with the IMF is reached. Another measure of the fiscal stabilisation strategy is tight coordination with monetary policy. Once the fiscal adjustment path is clear, it may turn out that monetary policy can be less restrictive than it is the case otherwise. However, the government should avoid at all cost any political influence on the National Bank. Monetary policy has been an important anchor for stability in the past and any attempt to monetarize the budget is likely push up inflation or trigger another exchange rate crisis.

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1 Introduction

1.1 Objective of this policy paper

The Republic of Moldova was hit by a bank fraud scandal which has significant ramifications for the country' public finances through several channels. First, the bank fraud has triggered a recession which will negatively affect tax revenues. Additionally, interest cost for government debt increased significantly due to a higher risk premium and the hike of the base rate set by the national bank as a direct response to the bank fraud.

However, the factor affecting public finances most is the scale back of financial support from international donors. This means a reduction in grants which directly reduces revenues. Additionally, donors also reduced preferential loans and thus, an important source to finance capital expenditure.

The donor community including the European Union and the World Bank have made an agreement with the International Monetary Fund (IMF) for a new programme a condition for the continuation of the suspended donor grants and loans.

However, at this point it is not clear if at all and when an agreement with the IMF will take place and thus external financial support will continue. It is therefore crucial to understand how such a situation would affect public finances in 2015 and 2016. To answer this question we projected public finances in 2016 without an IMF programme and a continuously limited donor support.

The basis for our projections is the executed budget for 2015 for which data up to October 2015 was available at the time of writing. Indeed, significant parts of donor support have been withheld since spring 2015. Thus, 2015 public finances are a good indicator of what is to be expected in 2016. Both revenues and expenditures have been adjusted for factors such as inflation and economic growth to provide a realistic forecast.

In the following sub-chapter we briefly describe the current economic situation and outlook as this is a major factor for public finances in 2016. In chapter 2 we describe our projections for public finances in 2016 starting with revenues, then expenditures and finally analysing what kind of deficit this would imply and how it can be financed. Chapter 3 provides our conclusions and recommendations.

1.2 Current economic situation and outlook

In this section we describe the economic outlook as this is a driver for government revenues and expenditures.

After showing robust economic performance throughout 2014 as indicated by an annual growth rate of 4.6%, the economic outlook for the Republic of Moldova has deteriorated significantly in the aftermath of the bank fraud at the end of 2014. For 2015, growth prospects diminished with a 1% real GDP decline predicted by the IMF and even a 2% real decline predicted by the World Bank. Thus, the expected recession this year and sluggish growth in 2016 will negatively affect tax revenues of the government.

Additionally, emergency loans granted to the three insolvent banks, Banca de Economii, Banca Sociala and Uni Bank increased money supply and caused a sharp rise in inflation. In response the National Bank administered sharp increase in interest rates by 16 pp to 19.5% in order to get hold of inflation expectations. This in turn pushed up interest payments on government debt.

Otherwise, elevated inflation - which is expected to reach 9.6% in 2015 and 10.2% in 2016[1] – has an ambivalent impact on public finances. While tax revenues are likely to increase in nominal terms, the economic costs of high inflation become ever more visible. In particular, domestic consumption and with it import demand has weakened thus reducing revenues from VAT and import duties.

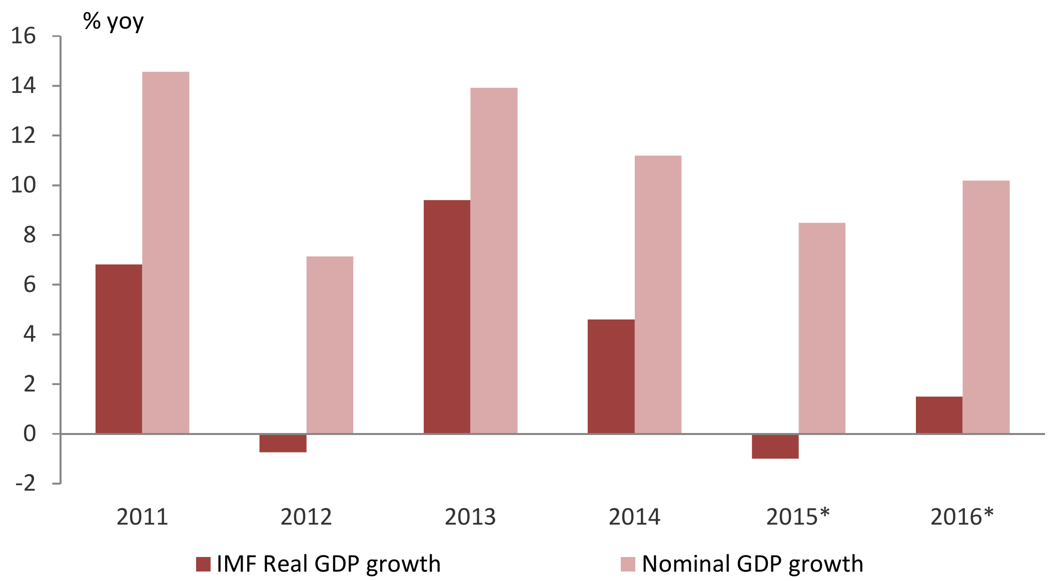
Another economic factor affecting VAT and import duty collection is the depreciation of the Moldovan Leu. This affects in particular import demand which is expected to fall by 4.4% in 2015.

Finally, there is the impact from fiscal tightening itself. As shown below, the government reduced spending by about 5% of GDP in 2015 which represents a significant negative economic shock.

To sum up, the economic slowdown is likely to negatively affect public finances. However, so far assuming a shallow recession, the impact of the slowdown on public finances is likely to be moderate. However, such a scenario requires that the government quickly adopts a strategy for fiscal and macro-economic stabilisation. Otherwise the risk remains that the economic situation worsens further which will then affect public finances. This in turn could require further fiscal tightening and could thus trigger a downward spiral.

Figure 1

Assumed real and nominal GDP growth rates



*Source: IMF, World Bank, *estimation/forecast*

[1] own forecast based on IMF and latest NBS data

2 Public finances in 2015 and 2016

The direct and indirect effects of banking fraud affect the Fiscal Budget in 2016. Below we discuss our projection of revenues, expenditures and deficit financing.

2.1 Revenues

We estimate that revenues for the government this year will amount to about MDL 42,500 m which means they stay almost unchanged compared to 2014. While this does not sound dramatic at a first glance, it represents a significant reduction given that inflation runs at almost 10%. Indeed, revenues expressed as share of GDP are likely to fall from 38% of GDP in 2014 to 35% of GDP in 2015.

Box 1 External financing: The importance of grants and loans

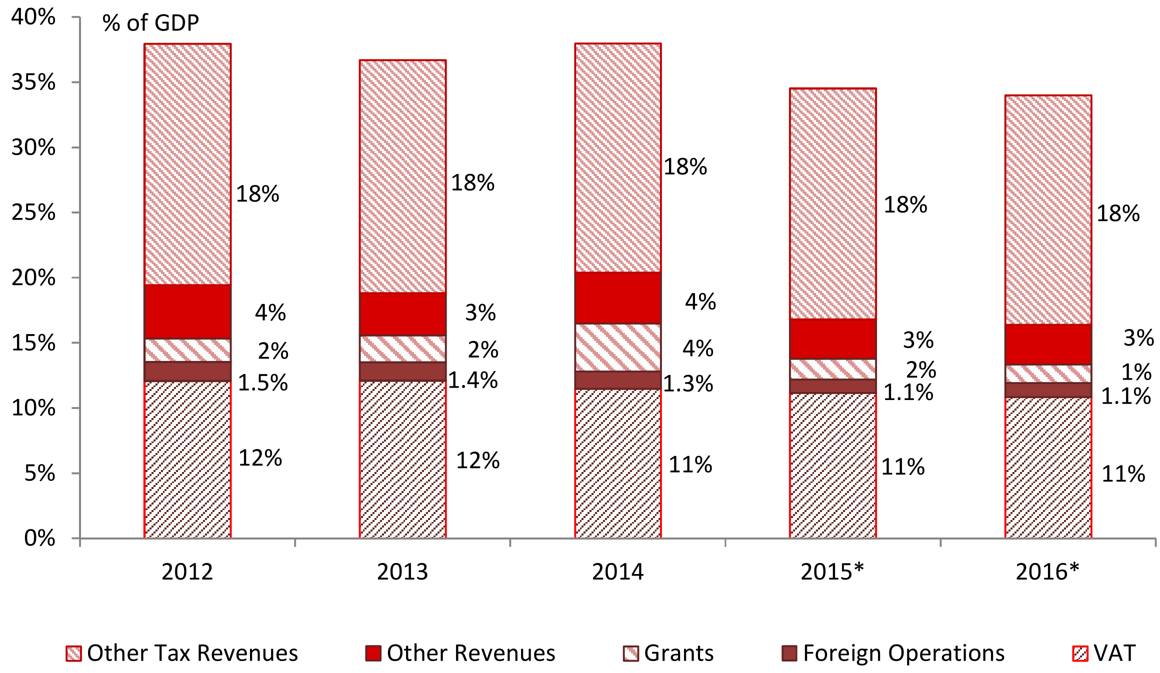
External financing in the form of loans and grants constitutes a major source of funds in the budget for the Republic of Moldova. Grants are funds provided by donors which do not have to be repaid. In 2014, grants amounted to MDL 4,127 m which is equal to 3.7% of GDP or 10% of revenues. This makes grants the third largest revenue source following tax and social funds revenues. Since 2010, typically 95% of total grants have been awarded to Moldova by external donors, i.e. other governments or international organisations.

In comparison to grants, donor loans are expected to be repaid after a certain grace period. Therefore, they do not constitute revenue but count as borrowing. Their value lies in favourable interest rates which are typically much lower than the rate available to the government through financial markets. In 2014 borrowing through donor loans amounted to MDL 1,408 m, the equivalent of 1.3% of GDP or 3.2% of expenditure.

For Moldova donor loans constitute on average more than 75% of the borrowing to finance a budget deficit. In 2015, even 93% of the deficit was financed through donor loans. Thus, without donor loans Moldova would have to reduce significantly its deficit which would require spending cuts or revenue increases.

Figure 1

Revenues expressed as share of GDP by major revenue component



Sources: IMF, Ministry of Finance of Moldova, Statistica Moldovei

Income from grants halved to MDL 1,900 m

Grants – especially budget support – is an important revenue source. The Moldovan government received grants worth MDL 4,127 m in 2014 – the equivalent of 3.7% of GDP. As such, grants accounted for 10% of total government revenues in 2014 (see Box 1). However, with an estimated amount of MDL 1900 m – equal to 1.6% of GDP – income from donor grants has more than halved in 2015.

For our projections we assume that income from grants will remain at the same level as in 2015 of about MDL 1,900 m. That is, our projections assume that there will be no IMF agreement and respective funding in 2016.

Import decline affects VAT and import duties revenues

Another factor adversely affecting government revenues is the decline in imports resulting in lower import duties and VAT revenues. Based on the executed budget up to October 2015, we estimate that revenues from foreign trade (mostly import duties) will have declined by about 12% over the entire year of 2015. Similarly, VAT revenue collection grew by only 5% this year which is not enough to cover inflation thus resulting in reduced revenues in real terms. The latter suggests that the slowdown in economic activity also contributes in curtailing tax revenues.

Revenue projections for 2016

All things considered, we project total revenues to be MDL 45,445 m in 2016 which would represent an increase of 9% compared to 2015. However, given elevated inflation, this increase is hardly enough to provide for the increased cost from higher wages and prices. Indeed expressed as share of GDP revenues actually are expected to fall to 34% of GDP in 2016 - down from 35% in 2015.

Conclusions

Government revenues stagnated in 2015 amidst a halving of grants received. Although we expect a slight recovery of revenues for 2016, this increase is purely due to inflation and will not provide any additional financial manoeuvring space.

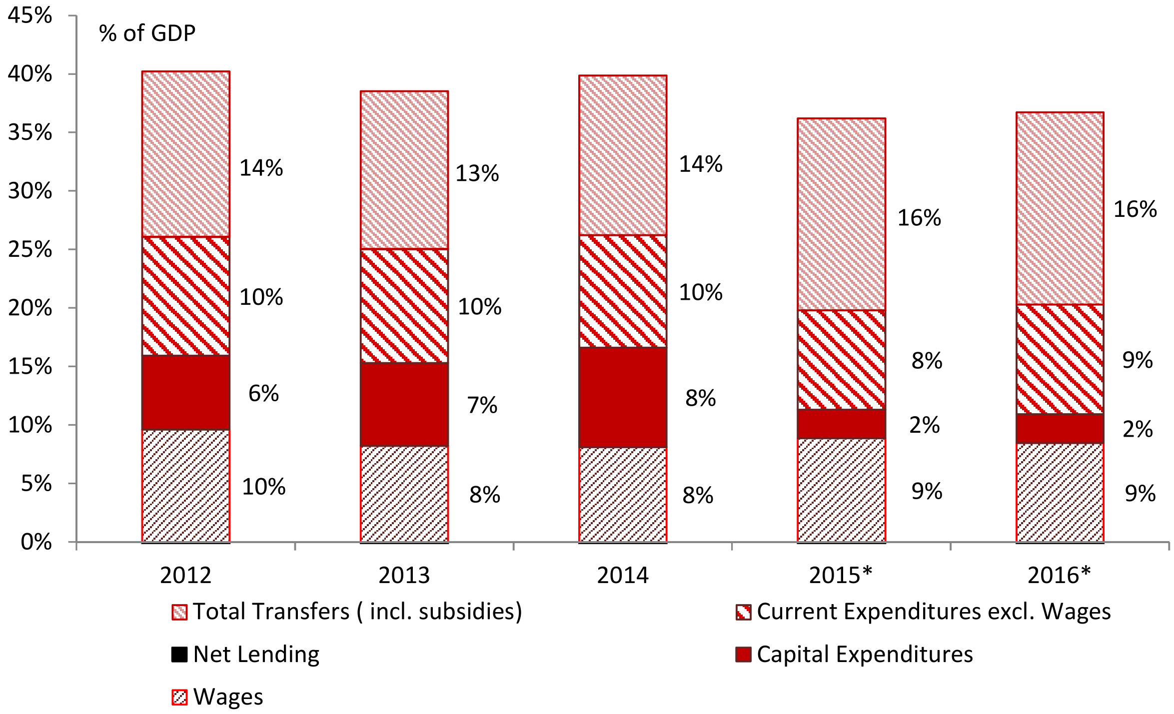
2.2 Expenditures

Given the constrained revenue side, how were expenditures adjusted to react in 2015 and what are the projections for expenditures in 2016?

We estimate total expenditure to decline to about MDL 43,800 m in 2015. While this only represents a 1% decline compared to 2014 expenditures as a share of GDP declined to 36% in 2015 after amounting to about 41% in 2014. Thus the government had to tighten expenditure by about 5% of GDP. However, the aggregated spending number masks a drastic difference between current expenditure (such as public sector wages) and capital expenditure.

Figure 2

Expenditures expressed as share of GDP for major expenditure components



Sources: IMF, Ministry of Finance of Moldova, Statistica Moldovei

Current expenditures

Despite the overall stagnation of expenditures, current expenditures are estimated to have reached MDL 40,966 m in 2015. This marks a substantial 17% increase compared to 2014. The main driver here will be a marked increase in public sector wages that are expected to grow by 18% in 2015.

Current expenditures have also been pushed higher by a sizeable increase in interest payments which were estimate to grow by 50% this year. However, interest cost still only amount to 2% of total expenditure.

In addition, transfers to households (i.e. social welfare) and to the economy (subsidies) are estimated to have increased markedly by 31%. In part, this reflects increased agriculture subsidies due to the draught that had been experienced this year.

The only sizeable reduction in current expenditure occurred in goods and services procurement which is likely to shrink by 10% in 2015.

Capital expenditure (investments)

The increase of current expenditures contrasts strongly to the expected 69% decline in capital expenditure as the government has held back on a large share of investments and repairs. Capital expenditure is likely to fall by about MDL 6,500 m in 2015– the equivalent of 5.4% of GDP. Thus, these cuts in capital expenditures represent a dramatic measure which is most likely to aggravate the economic slowdown.

Outlook for expenditures for 2016

We expect total expenditures to increase to about MDL 48,900 m in 2016. This is an increase of 12% compared to 2015 and reflects the fact that potential for further budget savings is exhausted while automatic and legally enshrined increases for wages and social security payments drive up expenditures. In addition, interest payments are expected to double. However, as share of GDP expenditure rises to 37% in 2016 only slightly up from 36% in 2015 suggesting that the expenditure increase mostly reflects increased inflation.

Conclusions

The government had to halt almost all of its capital expenditure in order to compensate for the loss of revenues and to be able to pay for current expenditure commitments. However, those sources of “easy savings” are exhausted. Thus, if any further savings are required over 2016 they would have to be aimed at current spending (public sector wages, entitlements).

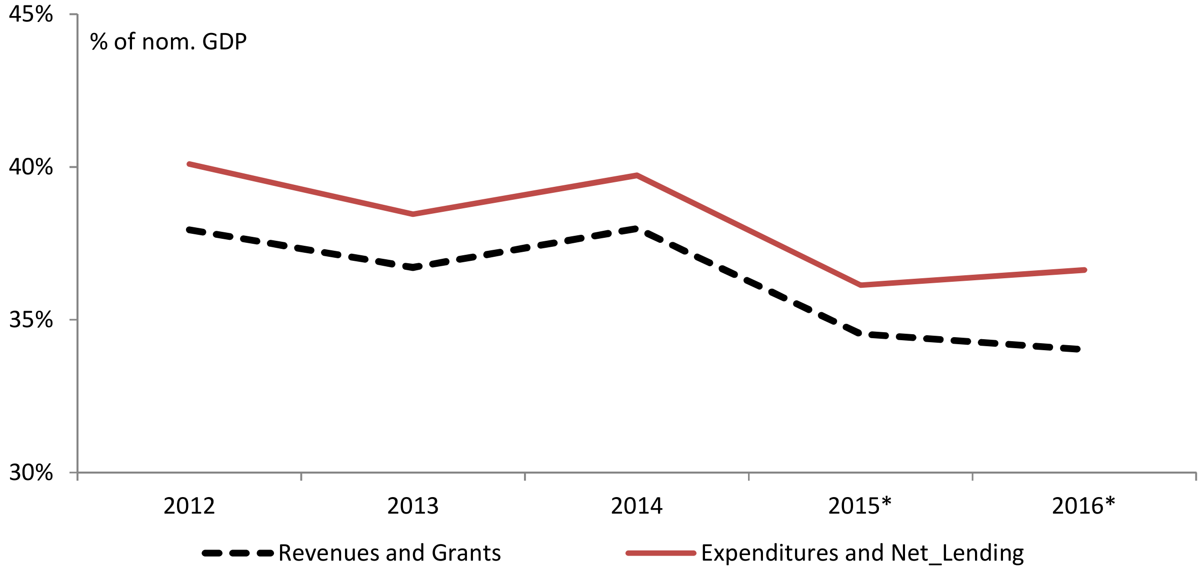
2.3 Deficit and financing

Deficit projection

To recall, our projections for the budget 2016 assume that there will be no IMF programme in the near future and thus donor support will be at a similarly low level as it was observed this year. For this scenario and based on our projections for revenues and expenditures in 2016, we would then expect a deficit of MDL 3,490 m in 2016. This deficit equals 2.6% of GDP in 2016, a marked increase compared to 1.6% in 2015.

Figure 3

Revenues and expenditures expressed as share of GDP



Sources: IMF, Ministry of Finance of Moldova, Statistica Moldovei

Financing situation in 2015

This raises the question whether the government can borrow enough money to finance the projected deficit in 2016. In normal times the Moldovan government would have three options to borrow or finance a deficit:

- External financing from donors (i.e. preferential loans)
- Revenues from privatisation
- Domestic debt (Moldova has no access to international financial markets)

Indeed, external financing through preferential loans constitutes an important source of borrowing for the government. This year we expect the government to receive donor loans totalling MDL 1,900 m. However, those are mainly project loans which finance specific projects that would not be taking place without the loan. Thus the expenditure for those projects and the borrowing provided for them through donor loans cancel out each other.

Donor loans are likely to be equivalent of 1.6% of GDP and exactly equal the deficit expected for 2015. Thus, in 2015 almost the entire deficit occurred because of capital expenditure for projects which were financed through donor loans. Currently other financing sources do not play any significant role.

Indeed, proceeds from privatisation were only about MDL 200 m in 2015. However, more critical for the fiscal policy of the government is the fact that at the moment the government seems not to be able to raise more debt domestically. The state actually reduced debt worth MDL 450 m in 2015 signalling that even refinancing of existing debt is difficult let alone increasing debt. Indeed, a recent auction was undersubscribed; the government was not able to place all the government bills it offered and investors demanded a high risk premium.

Financing situation in 2016

If there is no IMF programme, we do not expect the situation to change regarding the access to deficit financing for the government. At best, we could expect donor financing to continue at a stable level of around MDL 1900 m in 2016. That implies that the government may not be able to fully finance the expected budget deficit of MDL 3,490 m. Thus, there may be the need for further expenditure cuts or the need for revenue increases

Conclusions

Our projections suggest that the government would need to borrow approximately 2.6% of GDP in 2016. While this is not a big deficit under normal conditions, under the current conditions the government may not be able to borrow this amount of money. Thus, further expenditure cuts or revenue increases are required. Given the scale of cut-backs already seen in 2015, this represents major policy challenge.

3 Conclusions and recommendations

3.1 Conclusion from our budget projections

In 2015, due to a significant reduction in donor grants and donor loans the government was forced to drastically reduce expenditures in order to align them with lower revenues. The extent of the cuts administered was aggravated by the fact the state has currently only very limited access to borrowing.

The required expenditure cuts could only be achieved by stopping almost all investments and by making significant cuts in procurement. However, it is clear that the Ministry of Finance did have few other options to reduce spending. Indeed, the government can be credited with reacting in a timely manner and successfully balancing the budget in 2015. Through its swift reaction it avoided public finances becoming fully unsustainable.

For the presented scenario without an IMF programme and reduced donor support, our projections suggest a budget deficit of 2.6%. As it is currently unlikely that the government can borrow that amount of money, we expect a need for further expenditure cuts or revenue increases of about 1% of GDP in 2016. Administering those may be a challenge given that “easy” spending cuts have been exhausted already.

Indeed, it is apparent that the current situation can only be a temporary measure. Holding this regime up for 2016 would come at great costs and the risk of turning the economic slowdown into a protracted recession which in turn would put further pressure on public finances.

Thus, the government is in an urgent need to re-start external financing. The main instrument to achieve this goal is an agreement with the IMF. The good news is that – prior to the bank fraud – Moldova’s public finances were in a reasonable shape. Thus, so far the external financing needed is not huge.

3.2 Measures to stabilise public finances

The only viable option for the Government of Moldova in order to achieve fiscal stability is to obtain an IMF programme. This is a key requirement for donors to unfreeze grants and to increase preferential loans back to the previous level. It is unlikely that fiscal stability can be maintained in the medium and in the long-term without this external financing.

In addition, an IMF programme would be an important anchor for macro-economic stability providing much needed confidence to households, companies and investors. One of the main barriers to an agreement with the IMF is an external audit of the three banks Victoriabank, Eximbank and MIAB in order to determine their financial viability. While this is one of the prior conditions for an IMF programme, such an external audit needs to take place in the interest of banking sector stability.

Clear commitment and communication

However, even if the government takes action now, meeting the conditions of the IMF will take time. The time required for negotiating an agreement and the approval process could mean that an IMF programme is unlikely to take place before the second quarter of 2016 – possibly later.

Meanwhile, the most pressing problem for the government may be refinancing its existing debt. This requires reassuring domestic investors who are the main buyers on the primary market. To do so the government needs to communicate clearly that it is committed to obtaining an agreement with the IMF including what the steps are towards this objective. If this commitment and strategy is credible, investors may be willing to buy government bonds again. In addition, some external donors may re-start their support once an agreement with the IMF becomes clear.

Tight coordination of fiscal and monetary policy

Another measure towards fiscal stabilisation would be the improved coordination with the National Bank. A problem for monetary policy at this point is that the fiscal adjustment path is not clear. Thus, the National Bank cannot factor in the effect of the reduced public expenditure factor into its inflation forecasts. Only once the fiscal adjustment path is clear, monetary policy can be adjusted accordingly. That is, if it is clear how fiscal tightening is going to reduce demand and liquidity, monetary policy can be loosened or at least can be less restrictive than it would be the case otherwise.

Avoid political influence on monetary policy / monetarisation of public expenditure

However, a better coordination is not to be mixed up with political influence on monetary policy. Indeed, so far monetary policy has been an important anchor for macroeconomic stability. To maintain this stabilising role, the government needs to avoid any political influence on the NBM´s monetary policy decisions at all cost.

Especially, we argue strongly against using the NBM to finance public expenditures – so-called "monetarisation of public expenditure". This would only be a short term fix which would quickly lead to a macro-economic instability. Printing money in order to pay for government expenditures leads to rising inflation and is likely to trigger another currency crisis. Both combined would risk the macro-economic stability.

Final remarks

So far, the Ministry of Finance and the Government of Moldova have reacted largely in a prudential manner to prevent a fiscal crisis in light of the pressures on public finances. We recommend maintaining this policy stance by agreeing to an IMF programme in order to ensure stability of public finances in the medium and long term.

4 Annex 1 Projection: National Budget Balance of Moldova 2015 – 2016, MDL m

	2013	2014	2015	2016
			Estimated	Projected
Revenues_and_grants	36,900	42,447	41,867	45,445
Revenues	34,816	38,320	39,968	43,545
Tax_revenues	31,568	33,956	36,282	39,484
Corporate_income	2,052	2,431	2,613	2,880
Personal_income	2,206	2,447	2,678	2,951
VAT	12,174	12,852	13,522	14,495
Excises	3,508	3,428	3,760	4,030
Foreign_trade	1,417	1,458	1,290	1,444
Other	488	564	611	674
Social_Fund_contributions	7,756	8,363	9,033	9,953
Health_Fund_contributions	1,967	2,415	2,774	3,057
Non-tax_revenues	1,957	3,029	2,310	2,546
Revenues_of_special_funds_and_means	1,291	1,335	1,375	1,516
Grants	2,084	4,127	1,899	1,900
Domestic	36	81	100	100
External	2,048	4,047	1,799	1,800
Budget_support 2/	704	1,607	*NA*	*NA*
Project	1,242	2,307	*NA*	*NA*
Other_public_institutions	101	133	*NA*	*NA*
Expenditure_and_net_lending	38,651	44,393	43,799	48,935
Current_expenditure	31,640	35,074	40,966	45,813
Wages	8,296	9,088	10,765	11,355
Goods_and_services	8,811	9,652	8,784	9,679
Health_Fund	4,084	4,479	6,082	6,702
Other	4,727	5,173	2,702	2,977
Interest_payments	527	624	935	2,209
Domestic	*NA*	410	697	769
Foreign	*NA*	214	237	261
Transfers	13,567	15,214	19,905	21,934
Transfers_to_economy	1,337	1,619	2,379	2,622
Transfers_to_households	12,230	13,595	17,526	19,312

Social_Fund	10,698	11,997	15,544	17,129
Other_transfers	1,533	1,598	1,981	2,183
Other_current_expenditure	439	496	577	636
Net_lending	-106	-169	-137	-151
Capital_expenditure	7,118	9,489	2,970	3,273
Domestically_financed	*NA*	5,773	*NA*	*NA*
Externally_financed	*NA*	3,716	*NA*	*NA*
Grants	1,242	2,307	1,899	1,800
Loans	*NA*	1,409	*NA*	*NA*
Overall_balance	-1,752	-1,946	-1,933	-3,490
(excl._Project_loan_spending)	*NA*	-538	*NA*	*NA*
Primary_balance	*NA*	-1,322	*NA*	*NA*
(excl._Project_loan_spending)	*NA*	86	*NA*	*NA*
Financing	1,752	1,946	1,933	3,490
Discrepancy	7	23	*0*	*0*
Budget_financing	1,745	515	133	1,690
Central_government	1,465	222	-407	1,690
Net_domestic	*NA*	-10	-450	1,190
Net_foreign (excl. project loans) 3/	*NA*	40	-159	0
Privatization	*NA*	191	202	500
SUM Local_gov & funds	280	293	539	0
Local_governments	89	261	*NA*	*NA*
Social_Fund	126	-9	*NA*	*NA*
Health Fund	65	42	*NA*	*NA*
Project_loans	*NA*	1,409	1,800	1,800

Source: IMF, Ministry of Finance, own estimates

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