NEWSLETTER

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Current economic situation: investment-driven growth

Economic growth is expected to reach 4.2% in 2019, thus surpassing earlier forecasts. The main reason for high growth is the strong increase of investment by over 20% in the first half of 2019. This development is reflected by an expansion in the construction sector, which grew by ca. 27%.

Other indicators are developing as expected. In 2019, inflation will reach 5% - after only 3% in the previous year – and thus be in the range of the National Bank's target corridor. The exchange rate and currency reserves are stable, while remittances are declining due to low growth in Russia and the EU; this weakens private consumption.

There are little changes in foreign trade, with exports and imports both growing by only 2% during the first eight months of 2019.

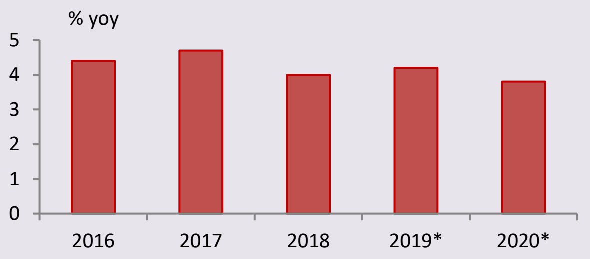
The budget deficit will probably amount to less than 3% of GDP and remains manageable.

Overall, the economy is growing at the previous year's pace. This trend is expected to continue also in 2020, with economic growth at around 3.8%. The future development depends on how successful the government will implement key reforms. A recent study of the German Economic Team outlines reform proposals that would support this process.

Investment as the main growth driver

After the Moldovan economy grew by 4.0% in 2018, a growth rate of 4.2% is expected for 2019. This comes as a surprise given the more cautious outlook at the beginning of the year and the considerable time that was necessary to form a new government. This created uncertainty, which investors usually do not like.

Real GDP growth



*Source: National Bureau of Statistics; *Forecast Ministry of Economy*

Nevertheless, investments developed strongly, rising by 20.3% in the first half of the year. Public investment even grew by around 50%, although this was distorted by the first quarter, when it more than doubled just before parliamentary elections. Private consumption and government spending are also contributing positively to growth in 2019. In contrast, the contribution of net exports – as in previous years – is negative, i.e., in absolute terms, imports are growing faster than exports.

On the supply side, the strong investment growth is reflected in construction activity. In the first half of 2019, the construction sector grew by 26.7%. At the same time, retail and manufacturing grew much slower in the first half of the year than in the previous year, with 5.7% and 3.6% respectively. Agriculture, on the other hand, performed poorly with a minus of 3.4%; however, the full extent of the decline will only become clear after the important third quarter figures will be published.

Inflation back in the National Bank's target corridor

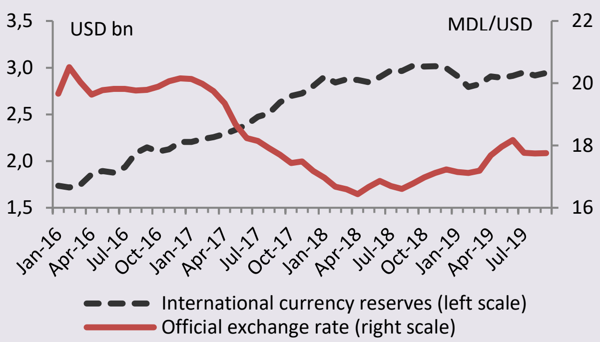
After only 3.0% in 2018, inflation will return to around 5% in 2019 and thus lie within the National Bank's target corridor of 5% +/-1.5% points. The increase is triggered by a rise in public sector wages before parliamentary elections, higher lending and a stronger rise of food prices. In order to ease the inflationary pressure, the National Bank raised its policy rate in two steps from 6.5% to 7.5% – in our view a reasonable reaction.

Exchange rate, reserves and remittances

Between February and June, the Leu lost about 6% of its value against the US dollar, but is slowly recovering after the new government has been formed.

Currency reserves are stable and have fluctuated around USD 2.9 bn since the beginning of 2018. This corresponds to around 5 months of import coverage; an appropriate level.

Exchange rate and currency reserves



Source: National Bank of Moldova

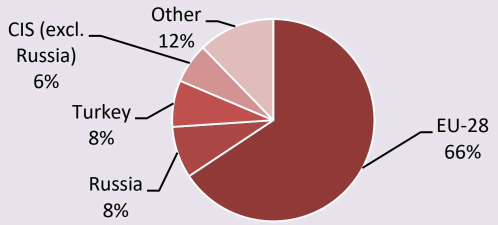
In contrast, remittances have been falling since the third quarter of 2018. This primarily affects private consumption, which is still heavily dependent on remittances. The reason for this decline lies in the relatively weak growth in the EU and Russia, where many Moldovan citizens work.

Low dynamics in foreign trade

After double-digit growth in trade in 2017 and 2018, exports and imports increased only by 2% in the first eight months of 2019. In this period, exports amounted to USD 1.79 bn and imports to USD 3.77 bn. The decline in exports of textiles as well as vegetable and animal fats and oils are responsible for the weak export growth. Textile exports fell by USD 30 m or 12%, fats and oils by USD 14 m or 19%. On the other hand, it is pleasing that exports in the machinery sector (cable harnesses in particular) increased by USD 68 m or 21% year-on-year. The EU is the main customer for cable harnesses; exports in this sector are closely linked to European FDI.

On the import side, textiles and oil products went down. Imports of textiles fell by USD 19 m or 7% and imports of oil products by USD 18 m or 3%.

Exports by regions



Source: National Bureau of Statistics; trade in goods in Jan-Aug 2019

From a regional perspective, exports to the EU fell by USD 40 m or 3% and to the CIS by USD 16 m or 6%. In the same period, exports to Turkey rose by USD 75 m, which equals 2.3 times the previous year's figure. This development can be explained at least in part by the diversion of trade flows, i.e., goods previously exported to the EU or the CIS are now delivered to Turkey. The EU's share of Moldovan exports fell slightly to 66%. However, the European Union remains by far the largest market for Moldovan products.

Budget deficit on the rise but still manageable

For 2019, the IMF forecasts a budget deficit of 3% of GDP. Due to the improved growth perspective, the deficit will probably lie below 3%, but still considerably higher than 1.1% of GDP in 2018. However, this must be seen in the context of the parliamentary elections in February 2019. In particular, public wages and social spending rose significantly.

The new government has already introduced measures to reduce the deficit, such as the abolition of tax exemptions and tax increases. These include the abolition of the reduced VAT rate for hotels and restaurants.

In addition, the IMF programme, which had been temporarily frozen, has been resumed. As a result, donors have provided funds for the government, which also includes macro-financial assistance by the EU. The deficit could thus be reduced even further and remains manageable.

Outlook

Investment-led economic growth in 2019 is expected to amount to 4.2% and will thus surpass earlier forecasts. For 2020, growth is expected to hit 3.8%, which roughly equals the level of recent years.

To a large extent, development beyond 2020 will depend on whether the government can fulfil the hopes placed in it and carry out fundamental reforms. These include freeing the institutions from vested interests, fighting corruption and establishing an independent judiciary.

However, there are also problems faced by companies that can be solved more easily and which yet significantly hinder the country's development. A list of such problems and respective relatively easy to implement reform proposals has recently been presented to the government by the German Economic Team.

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