
Country Report

Moldova

Moldova at a glance: 2005-06

OVERVIEW

The ruling Communist Party of Moldova (CPM) will continue to dominate Moldovan politics, having secured another majority in the March election and retained control of the presidency through a parliamentary vote in early April. The political scene is likely to be less polarised than during the CPM's first four years in power, although the unexpected calm experienced since the elections is unlikely to last. The government's poor financing options will limit fiscal loosening in 2005-06. The policy stance of the National Bank of Moldova (NBM, the central bank) will remain generally sound. However, large inflows of remittances will push up the money supply and prevent significant disinflation. The Economist Intelligence Unit expects average annual real GDP growth to slow to around 6% in 2005 and 5% in 2006, owing to a stronger base period and insufficient investment. The trade gap will widen, but remittances will help to keep the current-account deficit at around 5% of GDP.

Key changes from last month

Political outlook

- The Moldovan parliament passed a law on the status of Transdniestria in July, as called for in the settlement plan proposed by Ukraine in May. Nevertheless, the Moldovan and Transdniestrian governments continue to interpret the Ukrainian plan differently, and we still do not expect swift progress in resolving the stand-off over the Transdniestria region.

Economic policy outlook

- As expected, the recent IMF mission to Moldova did not produce any promises of a swift start to negotiations over a new lending deal. A new IMF financing deal is still not expected before 2006.

Economic forecast

- Although the leu has appreciated against the US dollar in recent months, the currency's strengthening has been slower than expected, and we now expect a somewhat weaker year-end exchange rate in 2005.

August 2005

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The Economist Intelligence Unit

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Moldova

August 2005

Summary

Outlook for 2005-06	The ruling Communist Party of Moldova (CPM) will continue to dominate Moldovan politics, having won another parliamentary majority in the March election and retained control of the presidency via a parliamentary vote in April. The political scene is likely to be less polarised than during the CPM's first four years in power, even if the unexpected calm experienced since the elections is unlikely to last. The government's poor financing options will limit fiscal loosening in 2005-06. The policy stance of the National Bank of Moldova (NBM, the central bank) will remain generally sound. However, large inflows of remittances will push up the money supply and prevent significant disinflation. The Economist Intelligence Unit expects average annual real GDP growth to slow to around 6% in 2005 and 5% in 2006. The trade gap will widen, but remittances will help to keep the current-account deficit to around 5% of GDP.
The political scene	The political consensus that formed in April remains largely in place. The CPM has begun to fulfil some of its promises to the opposition, but has faced criticism for shortcomings. The opposition parties have faced internal tensions and performed poorly in the Chisinau mayoral election. A Transdnestr settlement plan proposed by Ukraine has received broad support, but swift progress seems unlikely. Relations with Russia have remained cool, and the government has maintained its pro-European stance.
Economic policy	The government posted a small budget surplus in January-June and has proposed budget revisions that include a surplus for the year as a whole. It has also announced a further cut in the profit tax rate for 2006. A recent IMF mission to Moldova offered some praise but indicated that the start of negotiations on a new lending deal is still months away. Transdnestr has continued to privatise assets.
The domestic economy	Real GDP grew by 8.2% year on year in January-March. Sluggish agro-processing has pulled down industrial output growth. Year-on-year inflation fell below 13% in July. The currency has strengthened. Real wage growth has slowed, and unemployment has dropped below 10%.
Foreign trade and payments	With large inflows of remittances pushing up imports, the trade deficit expanded to around US\$400m in January-May. Russia has imposed trade restrictions and threatened higher gas prices. The current-account deficit rose to 5% of GDP in January-March.
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Political structure

Official name	Republic of Moldova	
Legal system	Moldova adopted a new constitution on July 28th 1994. The Transdnistr region has declared independence, which the central government has not recognised. The region inhabited by the Gagauz minority was granted special legal status in December 1994	
National legislature	Parliament, a unicameral assembly with 101 members, directly elected by proportional representation	
National elections	March 6th 2005 (legislative) and April 4th 2005 (presidential); next legislative and presidential elections due in 2009	
Head of state	President, Vladimir Voronin, sworn in on April 7th 2005 for a second four-year term	
National government	Constitutional amendments introduced in July 2000 diminished the role of the presidency and increased the powers of the government and parliament. The current government was approved by parliament in April 2005	
Main political parties	The Communist Party of Moldova (CPM) controls parliament, with 56 of the 101 parliamentary mandates. The only right-wing group in parliament is the Christian Democratic Popular Party (CDPP, 11 seats). In the centre are the three groups that contested the 2005 election as the Democratic Moldova Bloc (DMB), but then split up: the Our Moldova Alliance (OMA, 23 seats), the Democratic Party (DP, eight seats) and the Social Liberal Party (SLP, three seats)	
Council of ministers	Prime minister	Vasile Tarlev
	Deputy prime minister & minister of foreign affairs & European integration	Andrei Stratan
	Deputy prime minister	Valerian Cristea
Key ministers	Culture & tourism	Artur Cozma
	Defence	Valeriu Plesca
	Economics & trade	Valeriu Lazar
	Education & youth & sport	Victor Tvircun
	Environment & natural resources	Constantin Mihailescu
	Finance	Zinaida Grecianii
	Health & social protection	Valerian Revenco
	Industry & infrastructure	Vladimir Antosii
	Interior	Gheorghe Papuc
	Justice	Victoria Iftodi
	Transport & communications	Vasile Zgardan
Central bank governor	Leonid Talmaci	

Economic structure

Annual indicators

	2000 ^a	2001 ^a	2002 ^a	2003 ^a	2004 ^a
GDP at market prices (Lei bn)	16.0	19.1	22.6	27.6	32.0
GDP (US\$ bn)	1.3	1.5	1.7	2.0	2.6
Real GDP growth (%)	2.1	6.1	7.8	6.3	7.3
Consumer price inflation (av; %)	31.2	9.6	5.2	11.6	12.4
Population (m) ^b	3.6	3.6	3.6	3.6 ^c	3.6 ^c
Exports of goods fob (US\$ m)	476.8	567.3	659.8	806.0	995.2
Imports of goods fob (US\$ m)	770.3	880.1	1,038.0	1,428.5	1,753.5
Current-account balance (US\$ m)	-105.4	-36.9	-73.0	-132.3	-112.9
Foreign-exchange reserves excl gold (US\$ m)	222.5	228.5	268.9	302.3	470.3
Total external debt (US\$ bn)	1.7	1.6	1.8	1.9	1.9 ^c
Debt-service ratio, paid (%)	15.9	15.3	17.2	8.5	10.4 ^c
Exchange rate (av) Lei:US\$	12.43	12.87	13.57	13.94	12.33

^a Actual. ^b Excludes Transdnistr. ^c Economist Intelligence Unit estimates.

Origin of gross domestic product 2003	% of total	Components of gross domestic product 2004	% of total
Agriculture & fishing	21.7	Private consumption	89.3
Industry	20.8	Public consumption	16.4
Construction	3.5	Gross fixed investment	21.7
Services	53.9	Increase in stocks	3.6
		Net exports	-31.1

Principal exports 2004	% of total	Principal imports 2004	% of total
Food products	35.3	Mineral products	21.7
Textiles	17.4	Machinery & equipment	13.5
Vegetable products	12.2	Chemicals	9.1
Machinery & equipment	4.0	Textiles	8.6
Mineral products	3.1	Metal & metal products	6.3

Main destinations of exports 2004	% of total	Main origins of imports 2004	% of total
Russia	36.1	Ukraine	24.6
Italy	13.9	Russia	12.2
Romania	10.1	Romania	9.3
Germany	7.3	Germany	8.5
Ukraine	6.6	Italy	7.5

Quarterly indicators

	2003		2004				2005	
	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr
Consolidated government finance (Lei m)								
Revenue	1,760.6	2,020.1	1,462.3	1,768.7	1,917.6	2,372.4	2,008.7	n/a
Expenditure	1,472.1	1,962.6	1,439.7	1,956.1	1,828.3	2,162.9	1,750.7	n/a
Balance	288.5	57.5	22.6	-187.4	89.3	209.5	258.0	n/a
Employment, wages & prices								
Unemployed, registered (end-period; '000)	24.0	19.7	29.0	22.8	23.9	21.0	30.8	n/a
Nominal monthly wages (Lei)	921.3	1,088.6	967.3	1,087.5	1,123.2	1,282.4	1,147.9	n/a
Nominal monthly wages (% change, year on year)	30.6	23.0	26.7	25.8	21.9	17.8	18.7	n/a
Consumer prices (2000=100)	130.7	136.3	140.6	143.4	145.1	152.2	159.0	162.9
Consumer prices (% change, year on year)	15.4	16.8	14.6	13.0	11.0	11.7	13.1	13.6
Financial indicators								
Exchange rate Leu:US\$ (av)	13.92	13.32	12.91	11.95	12.03	12.42	12.52	12.60
Exchange rate Leu:US\$ (end-period)	13.31	13.22	12.41	11.95	12.16	12.46	12.62	12.58
Deposit rate (av; %)	12.2	13.8	14.8	15.1	15.1	15.5	15.2	13.5
Lending rate (av; %)	19.0	19.4	20.7	21.1	21.0	21.0	20.9	19.6
Money market rate (av; %)	11.3	16.1	15.3	14.3	12.0	11.2	6.9	4.5
Treasury-bill rate (av; %)	13.5	18.5	13.7	14.5	10.5	9.0	3.8	2.6
M1 (end-period; Lei m)	4,377.6	4,415.1	4,417.8	4,550.4	5,292.6	6,106.5	6,102.8	6,522.8
M1 (% change, year on year)	32.2	24.0	27.5	24.7	20.9	38.3	38.1	43.3
M2 (end-period; Lei m)	8,522.4	8,772.4	9,002.8	9,375.9	10,708.7	12,261.7	12,674.8	13,870.9
M2 (% change, year on year)	35.2	30.4	26.7	25.4	25.7	39.8	40.8	47.9
Sectoral trends								
Retail sales (Lei m)	1,954.5	2,071.2	1,561.2	1,898.8	2,194.3	2,620.3	1,939.3	n/a
Foreign trade (US\$ m)								
Exports fob	197.9	247.0	233.4	226.8	241.1	284.9	249.4	n/a
CIS ^a	111.8	128.9	117.4	114.5	124.6	146.0	121.0	n/a
Imports cif	-349.4	-476.1	-338.1	-433.0	-442.1	-558.6	-435.7	n/a
CIS ^a	146.7	199.4	151.1	183.0	193.8	237.9	187.5	n/a
Trade balance	-151.5	-229.1	-104.7	-206.2	-201.0	-273.7	-186.3	n/a
Balance of payments (US\$ m)^b								
Merchandise trade balance fob-fob	-150.4	-246.8	-94.8	-199.3	-193.6	n/a	n/a	n/a
Services balance	-16.2	-13.9	-15.2	-15.4	-19.8	n/a	n/a	n/a
Income balance	64.8	65.2	42.1	67.5	114.8	n/a	n/a	n/a
Net transfer payments	74.2	87.6	74.0	85.6	93.4	n/a	n/a	n/a
Current-account balance	-27.7	-107.9	6.1	-61.7	-5.2	n/a	n/a	n/a
Reserves excl gold (end-period)	284.1	302.3	309.6	295.8	391.6	470.3	461.3	482.6

^a Commonwealth of Independent States. ^b IMF data.

Sources: National Bank of Moldova; IMF, *International Financial Statistics*; TACIS, *Moldova Economic Trends*; Interstate Statistical Committee of the CIS; Department of Statistics and Sociology.

Outlook for 2005-06

Political outlook

Domestic politics

The ruling Communist Party of Moldova (CPM) will continue to dominate Moldovan politics, having won another parliamentary majority in the March election and retained control of the presidency via a parliamentary vote in early April. The political scene is likely to be less polarised than during the CPM's first four years in power, even if the calm experienced since the elections is unlikely to last. The improvement in Moldova's political prospects is largely explained by the CPM's decisive win in the parliamentary election, following which much of the opposition joined with the ruling party in backing the election of the CPM leader, Vladimir Voronin, to a second presidential term.

The coalition built by the CPM to secure Mr Voronin's re-election proved broader—and was achieved amid less acrimony—than had been expected. Mr Voronin secured the backing of two of the three constituent groups of the centrist Democratic Moldova Bloc (DMB), an alliance that came second in the March election; and the right-wing Christian Democratic Popular Party (CDPP), the only other group to make it into the new parliament. Of the opposition groups, only the centrist Our Moldova Alliance (OMA), which had entered parliament as part of the DMB, did not back him. In theory, a consensus in favour of pro-Western policies has existed since Mr Voronin turned the CPM away from its pro-Russian line, midway through his first term, but political considerations generally ruled out co-operation between parties and produced a highly confrontational political environment. However, since the election, political calculations may have changed sufficiently to give the pro-Europe consensus more substance. The parties that joined the CPM in voting for Mr Voronin now claim to be in “constructive” opposition, and even the OMA can be expected to back policies required as part of Moldova's EU Action Plan.

The extent of improvements possible should not be overestimated, however. The composition of the unusual alliance that backed Mr Voronin underlines the fluidity of political allegiances in Moldova and the unconsolidated nature of the country's parties. It is thus still unclear how closely the groups that agreed to elect Mr Voronin will co-operate with the CPM. This uncertainty reflects difficulties within some of the opposition parties. The CDPP leader, Iure Rosca, is under pressure from party members and might conclude that constructive opposition is not in his best interest. Similarly, the parliamentary faction of the Social Liberal Party (SLP), which left the DMB but voted for Mr Voronin, has faced a backlash from the party's members over its support for the president.

Co-operation between the CPM and the opposition may also break down over the ruling party's slow progress in fulfilling promises on political reform made at the time of Mr Voronin's re-election. Many of these mirror commitments made to the EU, and are unlikely to proceed as quickly as the opposition would like. Despite the CPM's shift to a pro-Western stance, its leaders want to retain a strong state role in the economy and maintain a tight grip over the media and politics. As in the past, this will give rise to accusations of illiberalism from the

non-communist parties, as well as bouts of social instability. It could also give the CDPP and the SLP ample reason to claim that the CPM has failed to live up to its commitments and to turn against Mr Voronin's leadership once again.

Transdnestr

A resolution of the long-standing dispute over the status of the breakaway Moldovan region of Transdnestr still appears a long way off—although more active involvement by the new government in Ukraine is giving a much-needed impetus to mediation efforts. A Ukrainian proposal to break the deadlock, published in May, has proved acceptable to both sides so far and has already produced some results. Transdnestr has nevertheless proved selective in its implementation of the Ukrainian plan—it has already started preparing for an election in late 2005 while ignoring the plan's initial requirement for greater democratisation—and has objected to the Moldovan parliament's interpretation of the initiative. Significant differences therefore still separate the two sides and, as a result, progress will continue to be slow. The unresolved Transdnestr issue is likely to remain a political distraction—and a deterrent to foreign investment—over the rest of the 2005-06 forecast period.

International relations

Frustrated by Russia's stance on a range of issues, the CPM has in recent years adopted a far more Western-oriented stance than in the past. Prospects for developing significantly closer ties with the EU are nevertheless limited. The CPM has repeatedly emphasised its commitment to a pro-European policy, but has shown little willingness to back up its rhetoric with economic or political reforms sought by the EU. At a more practical level, it lacks the bureaucratic capacity to implement quickly the three-year EU-Moldova Action Plan signed in February. Although more progress is likely during the CPM's second term, it is still expected to fall short of what is needed. Moldova's relationship with Russia will remain far cooler than when the CPM came to power in 2001. Moldova's leadership—already displeased by Russia's seemingly unco-operative stance—was further alienated by what it perceived as Russia's attempts to turn Moldovan voters against the CPM in the parliamentary election in March. The risk of a sharper deterioration in relations has increased since then, as Russia has toughened its stance, introducing more restrictions on Moldovan exports than previously expected and threatening to raise its gas export prices from 2006. These moves suggest that Russia is switching to a more aggressive approach in its attempts to ensure that its troops remain in Transdnestr.

Economic policy outlook

Policy trends

The government will continue to try to secure a new IMF programme, which remains a prerequisite for unlocking other sources of multilateral and bilateral financing. To this end, parliament approved the government's economic growth and poverty reduction strategy paper (EGPRSP) in December 2004, which provides the framework for World Bank lending under a new country assistance strategy (CAS). With the IMF insisting on concrete reforms, it is unlikely that new IMF funding will be available before 2006. Although multilateral financing would be valuable in easing the government's financing problems, the CPM remains hesitant about pushing through structural reforms

or policies that are opposed by well-connected business and bureaucratic interests. Relations with the multilaterals will continue to be strained as a result.

Fiscal policy The government has approved budgetary amendments, and is now targeting a small surplus in 2005—in line with our forecast that it would need to maintain a far tighter fiscal stance than suggested by the original budget. Given the strong budget performance in January-June, and the continued constraints posed by below-target privatisation and multilateral financing inflows, we expect the government to post a modest surplus (around 0.1% of GDP) for the year as a whole. This will reflect strong tax revenue inflows and restrained spending. Although some greater scope for multilateral borrowing and privatisation receipts seems possible in 2006, slow progress on reforms will still complicate relations with investors and multilateral agencies. Financing will remain limited as a result. The government is therefore expected to loosen its fiscal stance only slightly, producing a budget deficit of around 0.2% of GDP in 2006.

Monetary policy The goal of the National Bank of Moldova (NBM, the central bank) of ensuring price and exchange-rate stability continues to be complicated by large inflows of workers' remittances. Inflows of remitted incomes have risen by more than 50% year on year so far in 2005. The NBM will have to continue to intervene to soak up most of these inflows in order to limit currency appreciation and preserve export competitiveness. The central bank's interventions pushed money supply growth well above its original target in 2004, and will fuel further strong growth in 2005-06, despite a rise in sterilisation operations. The volume of sterilisations rose considerably during 2004 and continued to rise in January-June 2005. Even with these efforts, broad money supply growth accelerated from 45% year on year at the beginning of 2005 to over 50% in June.

Economic forecast

International assumptions

International assumptions summary

(% unless otherwise indicated)

	2003	2004	2005	2006
Real GDP growth				
World	3.9	5.1	4.2	4.0
Eurozone 12	0.7	1.9	1.2	1.8
EU25	1.3	2.4	1.7	2.0
Exchange rates				
Rb:US\$	30.69	28.81	28.30	28.50
US\$:€	1.132	1.244	1.227	1.260
SDR:US\$	0.714	0.675	0.680	0.671
Financial indicators				
€ 3-month interbank rate	2.33	2.13	2.05	2.00
US\$ 3-month commercial paper rate	1.10	1.48	3.41	4.63
Commodity prices				
Oil (Brent; US\$/b)	28.8	38.5	53.3	50.5
Food, feedstuffs & beverages (% change in US\$ terms)	6.6	8.6	-0.6	1.1
Total non-oil commodities (% change in US\$ terms)	9.1	13.5	1.5	-2.1
Industrial raw materials (% change in US\$ terms)	13.0	21.0	4.2	-6.2

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

With economic policy tightening in a number of countries and high levels of debt weighing on consumers, companies and governments, a global slowdown is in prospect for 2005-06. The Economist Intelligence Unit forecasts a deceleration in world GDP growth on a purchasing power parity (PPP) basis, from an estimated 5.1% in 2004 to 4.2% in 2005 and 4% in 2006. We have revised our oil forecast upwards, and now expect an average annual price of over US\$50/barrel for dated Brent Blend in 2005 and 2006. Although the cost of Moldova's oil imports will remain well above historical levels, high oil prices will help to sustain import demand in Russia—Moldova's key export market.

Economic growth

The authorities have released preliminary data for January-March 2005 showing an increase in real GDP of 8.2% year on year. The continued inflow of remittances is having an impact, and is likely to help to sustain household consumption. Investment is also playing a role: preliminary data put investment growth (including construction) at well over 25% year on year in January-March, in part owing to financing provided by remittances. Investment is nevertheless unlikely to continue to grow strongly enough to sustain the GDP growth reported for January-March over the remainder of the year. We expect real GDP growth of around 6% for the year as a whole—particularly as the large agricultural sector is likely to expand more slowly than in 2004. In the absence of swifter structural reforms and improvements in the business environment, economic expansion will remain predominantly consumption-driven in 2006 as well, with annual real GDP growth unlikely to rise above 5%.

Inflation

Year-on-year consumer price inflation accelerated during the final months of 2004 and the first four months of 2005. However, the trend has reversed gradually since then—with year-on-year inflation falling from 14.2% in April to 12.7% in June. Further gradual downward movement is expected over the forecast period, helped by relatively sound fiscal and monetary policies. However, continued large inflows of remittances are likely to preclude significant disinflation, with year-end inflation of around 9% expected in 2006. The inflows will continue to boost domestic demand and limit the extent to which the NBM is able to tighten monetary policy, given that it can only partly sterilise the large flows of remittances coming into the country.

Exchange rates

Moldova's currency, the leu, continues to be supported by large inflows of remittances. There is little risk that these inflows will drop substantially in 2005-06, and a gradual nominal appreciation, as seen in recent months, is expected to continue. The greater threat to currency stability comes from Moldova's narrow export base, which leaves it susceptible to external shocks. Another source of risk stems from the government's financing problems, which could force it to rely on direct lending from the NBM. The real appreciation expected in 2006 will also be a moderate source of risk over the forecast period, as it will affect Moldova's export competitiveness. Nevertheless, the currency remains substantially weaker in real terms than it was five years ago.

External sector

Moldova's trade imbalances are a significant concern. The country has a narrowly focused export base, which relies overwhelmingly on the Russian market, and on the agriculture and agro-processing industries. On the import

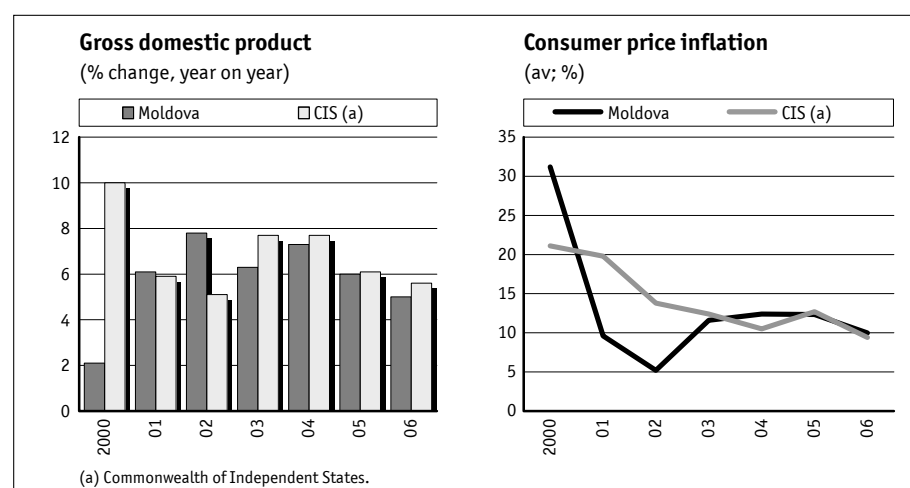
side, Moldova has to import almost all of its energy requirement. Demand for consumer imports in Moldova is rising rapidly, as incomes are boosted by remittances. These risks threaten to push the already large trade deficit well beyond 30% of GDP in 2005-06. The most serious risks relate to external shocks emanating from Russia, which recently imposed a ban on Moldovan meat and crop-based exports and has threatened to widen restrictions to include the all-important wine sector. Russia is also threatening to raise the price of gas exports to Moldova. Although our baseline forecast is that Russia is unlikely to ban Moldovan wine exports or to raise gas prices to the extent suggested, these remain serious concerns. Assuming that Russian-related shocks are contained, large inflows of remittances should help to counter much of the rise in import spending and contain the current-account deficit at around 5% of GDP.

Forecast summary

(% unless otherwise indicated)

	2003 ^a	2004 ^a	2005 ^b	2006 ^b
Real GDP growth	6.3	7.3	6.0	5.0
Industrial production growth	15.6	6.9	6.0	5.0
Agricultural production growth	-14.1	20.4	4.0	3.0
Consumer price inflation (av)	11.6	12.4	12.3	10.0
Consumer price inflation (year-end)	15.7	12.5	11.0	9.0
Lending rate (av)	19.3	20.9	18.0	16.0
Deposit rate (av)	12.6	15.1	13.0	11.0
Consolidated government balance (% of GDP)	1.6	0.4	0.1	-0.2
Exports of goods fob (US\$ m)	806	995	1,080	1,220
Imports of goods fob (US\$ m)	-1,429	-1,754	-2,150	-2,570
Current-account balance (US\$ m)	-132	-113	-153	-190
Current-account balance (% of GDP)	-6.7	-4.4	-5.0	-5.4
External debt (year-end; US\$ m)	1,902	1,924 ^c	1,936	2,079
Exchange rate Lei:US\$ (av)	13.94	12.33	12.54	12.40
Exchange rate Lei:US\$ (year-end)	13.22	12.46	12.48	12.30
Exchange rate Lei:€ (av)	15.79	15.34	15.40	15.62
Exchange rate Lei:Rb (av)	0.454	0.428	0.443	0.435

^a Actual. ^b Economist Intelligence Unit forecasts. ^c Economist Intelligence Unit estimates.



The political scene

“National consensus” remains in place—but only just

Although signs of strain are already apparent, the “national consensus” that emerged during the presidential election held in early April remains largely intact. The ruling Communist Party of Moldova (CPM) has begun to fulfil at least some of the promises it made to the opposition, and the position of both sides on a number of key issues remains broadly similar. As a result, the opposition parties have yet to repudiate the deal they struck with the CPM, whereby they agreed on April 4th to vote alongside the ruling party in the presidential election held in parliament, in return for promises of reform. The agreement ensured the three-fifths majority needed to re-elect the CPM leader, Vladimir Voronin, to a second presidential term, thereby avoiding deadlock and a new parliamentary election. Moldova had only just held a parliamentary election, in early March, at which the CPM was re-elected with a smaller majority than in 2001 (May 2005, The political scene).

The new-found political consensus centres on broad goals that the CPM and the “constructive” opposition—the part of the opposition that backed Mr Voronin’s re-election—profess to share. These include speeding up Moldova’s European integration, ensuring greater democratisation and resolving the stand-off over Transdniestria on the basis of a “3-D” formula (democratisation, decriminalisation and demilitarisation of the separatist region). The CPM has been moving in the right direction on these points. It has begun to implement the EU-Moldova Action Plan and the economic growth and poverty reduction strategy paper (EGPRSP), and has drafted a law defining the status of Transdniestria. It has also begun, albeit slowly, to accept domestic political reforms. The agreement that the CPM reached with the opposition in early April requires parliament to amend a number of laws to free up the media, improve the judiciary and ensure greater electoral transparency.

Government’s fulfilment of agreement is mixed

To achieve these objectives, the government in late May adopted a joint programme prepared by the European Commission and the Council of Europe. The programme contains many of the wide-ranging democratic reforms laid out in the EU-Moldova Action Plan, adopted by Moldova in February. Parliament also recently approved legislative amendments that increase the opposition’s influence over appointments to the Central Election Commission, the Court of Accounts and the Higher Magistrates’ Council. Finally, parliament also approved legislative amendments to curb the powers of the Security and Information Service, and a law outlining a set of “Basic Principles” regarding the status of Transdniestria.

On other fronts, however, the CPM has failed to satisfy the opposition’s demands. The CPM majority in parliament drew criticism for re-electing Valeria Sterbet to the chair of the Supreme Court in mid-June. The opposition alleges a conflict of interest, given that Ms Sterbet also heads the Higher Magistrates’ Council, which is tasked with nominating candidates for the Supreme Court. Parliament also failed to amend the law on the prosecutor’s office, or to consider the draft audio-visual code prepared by the opposition. The CPM’s only concessions regarding the media were to accept live television and radio coverage of parliamentary sessions, and to end government control over two

major newspapers, *Nezavisimaya Moldova* and *Moldova Suverana*. Although this move was welcomed by the opposition, the editorial line of the two newspapers does not yet appear to have changed significantly.

Internal opposition problems grow due to deal with CPM

The CPM's slow progress on some political reforms has strengthened those in the opposition who had decried the decision taken by their parliamentary factions to vote alongside the CPM in the April presidential election. Two of the three opposition groups that voted for Mr Voronin—the Social Liberal Party (SLP) and the Christian Democratic Popular Party (CDPP)—have experienced a rise in internal tensions as a result. Key members of the SLP leadership resigned, citing the parliamentary faction's failure to consult the party prior to backing Mr Voronin. The departing officials condemned the decision to vote with the CPM, claiming that the SLP's liberal, pro-market values were at odds with the more statist CPM line. The leader of the right-wing CDPP, Iure Rosca, has also suffered the consequences of his support for Mr Voronin's candidacy, in the form of a hostile reaction from grassroots party members, who see his position as antithetical to the party's long-standing anti-communist line.

Given the controversy sparked by their deal with Mr Voronin, the parliamentary factions of the CDPP and the SLP—as well as that of the Democratic Party (DP), which also forms part of the “constructive” opposition—are now under significant pressure to ensure that the CPM delivers on the promises that underpin the new-found consensus. A sizeable risk exists that the CPM's unwillingness or inability to fulfil all of its promises will force the constructive opposition to move back into full opposition later in the year.

Chisinau vote underlines opposition problems

The municipal election held in Chisinau, the capital, in July has underlined the problems faced by the constructive opposition. The vote itself proved inconclusive. Due to low turnout, the mayor's position—which was vacated by opposition leader Serafim Urechean after he won a seat in parliament—will remain empty until a new election is held later in 2005. The two rounds of the election held in July were disappointing for the main opposition candidates, who failed to make it into the second round (which was easily won by the CPM candidate, the finance minister, Zinaida Grecianii). The poor performance of the mainstream opposition stemmed at least in part from voters' disapproval of the deal they had struck with Mr Voronin. During the first round of voting, on July 10th, the CDPP candidate received only 7% of the vote—far below the 15% share of the Chisinau vote won by the CDPP in the parliamentary election four months earlier. The DP candidate also performed poorly, winning less than 2% support. In contrast, the candidate for the Liberal Party—a small non-parliamentary group, which had previously enjoyed negligible support—secured 7% of the vote. This suggested widespread protest voting by those who previously had backed the larger opposition parties.

OMA in a state of flux

The only opposition group that boycotted the presidential election in parliament, the Our Moldova Alliance (OMA), is also facing internal problems. Rumours persist of an imminent split in the party, which controls the largest bloc of opposition seats but has struggled to define a role for itself in the new parliament. Despite claiming to be in active opposition, the OMA broadly

shares the goals espoused by the other parliamentary groups, and has generally voted for legislative amendments proposed by the other opposition groups since April. One of the OMA's most visible figures, Dumitru Braghis, a former prime minister, has criticised his faction's decision to boycott the presidential vote, as he feels it cost him a parliamentary leadership post (presumably the vice-speakership, which went to Mr Rosca). As the OMA passed him over for key party leadership positions at its congress in June, Mr Braghis, who stood in the Chisinau mayoral election as an independent candidate, is widely expected to break openly with the OMA—and to take the more socially democratic wing of the party with him.

The OMA appears further weakened by the charges of corruption faced by Mr Urechean, the former mayor of Chisinau, who was elected head of the party at its June congress. Mr Urechean's decision to move from municipal politics to parliament—rather than surrender the parliamentary mandate he won in the March election—reflected an understanding that corruption allegations had dented his 2007 re-election chances as mayor, and an expectation that parliamentary immunity would help to protect him. However, the charges that he faces are likely to prevent him from establishing a major role for himself in national politics or from turning the OMA into a powerful opposition force. Mr Urechean's future is further clouded by growing indications that the CPM majority in parliament, acting on a recent request by the prosecutor's office, will vote to strip him of his parliamentary immunity later this year.

CPM modernisation still not on the immediate agenda

The difficulties faced by the main opposition groups have reinforced the CPM's position as the most important political force in Moldova. It is assured of controlling both parliament and the presidency until 2009, and still stands a chance of winning control of the most important municipality, Chisinau. However, the annulled Chisinau vote held in July suggests that the CPM faces difficulties of its own. The low turnout in that election—only around one-quarter of the electorate bothered to participate—is likely to have been in part due to dissatisfaction with the CPM, which has alienated some of its traditional support base by moving towards the political centre. Moreover, the vote share won by the CPM's candidate, Ms Grecianii, is likely to have been inflated by the timing of the election, which occurred when much of the population would have been on holiday. Least likely to be on holiday, and therefore disproportionately represented at the polls, would have been the CPM's core supporters—generally older and poorer voters. The CPM's waning popularity comes at a sensitive time for Mr Voronin, who is expected soon to begin modernising the party. Although this process is likely to start later in 2005, Mr Voronin is moving cautiously and has declared that the party's new statutes will be finalised no earlier than in October 2006.

Ukraine's Transdnistr plan increases hope for settlement

The current political consensus in Moldova is most apparent on the issue of Transdnistr, a region in the east of the country that broke away after a brief civil war in 1992. During Mr Voronin's first term in office, the opposition had consistently criticised the CPM for endorsing a federal solution to the stand-off over the region's status. The opposition argued that any settlement resulting in

a federal state would leave too much power in the hands of the Transnistrian leadership—which is widely seen as authoritarian—and would thereby jeopardise Moldova's EU aspirations. However, the appointment of a pro-European government in Ukraine earlier in 2005 has brought renewed momentum to the settlement talks—and the outlines of a solution that avoids the creation of a federal state and is hence more acceptable to the opposition.

In mid-May the Ukrainian president, Viktor Yushchenko, outlined in greater detail the Ukrainian settlement proposal first mooted in April. The plan has received the backing of all of Moldova's main political parties, even though many of the concerns voiced by the Moldovan side in April still pertain (May 2005, The political scene). The Yushchenko plan has also been endorsed by the Transnistrian side and by Russia, thereby raising hopes of a breakthrough in the long-standing stalemate. Russia, which maintains a military presence in Transnistria, is one of the mediators in the conflict, alongside Ukraine and the Organisation for Security and Co-operation in Europe (OSCE).

The Moldovan and Transnistrian sides nevertheless interpret the Yushchenko plan differently. Their initial agreement to Ukraine's proposal was in large part due to its intentional vagueness: it centred on the unobjectionable notion of encouraging democratisation in Transnistria and avoided contentious issues such as the withdrawal of Russia's military presence. On this and other issues, the two sides remain far apart. Transnistria still hopes to retain far greater powers than the Moldovan leadership will accept, while the Moldovan parliament, for its part, has already endorsed a set of additional demands that neither Transnistria nor Russia is likely to accept. Even on the question of holding a democratic parliamentary election in Transnistria—one of the first steps outlined in the Yushchenko plan—the two sides are of different minds. Although Moldova has indicated that it is unlikely to consider the Transnistrian election planned for December 2005 as fair and democratic—given the absence of basic democratic institutions or a free media in the region—the Transnistrian leadership is pushing ahead regardless in the hope that the election, if monitored by international bodies and deemed sufficiently open, will give it greater legitimacy internationally.

Transnistria

The Yushchenko plan

Ukraine's initiative for resolving the Transnistria conflict, first outlined in April by its president, Viktor Yushchenko, and then expanded on in Vinnitsia, Ukraine, in mid-May, has provided the greatest impetus to date in breaking the 13-year stalemate.

The plan is based on seven settlement principles:

- Transnistria is to create the necessary framework for central and regional multiparty democracy and civil society;
- Transnistria is to hold a free and democratic election to its parliament;
- Ukraine, the EU, the OSCE, the Council of Europe, Russia, US and other democratic states are to facilitate and monitor the election;
- Ukraine is to support the participation of the EU and the US in mediating in the conflict;

- The present peacekeeping contingent—staffed by Moldova, Transdnistr, Russia, Ukraine and the OSCE—is to be transformed into a civil and military observer unit under the auspices of the OSCE;
- Transdnistr is to admit international monitors to scrutinise its military-industrial complex; and
- Ukraine is to allow short-term OSCE missions on to its territory to monitor the movement of goods and people across the Ukraine-Transdnistr border, and urges the Transdnistr authorities to do likewise.

According to the plan's 18-month timeframe, the Chisinau parliament was to pass a bill on the main principles of Transdnistr's status by end-July 2005. Following this, Transdnistr is to hold an internationally organised and monitored election. If deemed fair, the election would enable deputies from Transdnistr's parliament to work with Chisinau parliamentarians to draft a law accepting basic principles regarding the status of the region; the law is then to be approved by the Transdnistr parliament.

The final step in the process would come with a treaty guaranteeing Moldova's observance of the law "on the special status of Transdnistr". The treaty is to be drafted by Moldova and Transdnistr, together with Russia, Ukraine and the OSCE, and in consultation with the US and the EU. Once the treaty is ratified, Moldova's law "on the special status of Transdnistr" would enter into effect.

Qualifying the plan

Moldova's political class has broadly endorsed the Yushchenko plan, while voicing a number of concerns. Moldova criticises the absence of any mention of Transdnistr's demilitarisation and decriminalisation, and is concerned that Ukraine's proposal still leaves room for Transdnistr to continue to play a role in shaping foreign policy—thereby effectively allowing the region's leadership to veto the withdrawal of Russia's military personnel from the region.

On June 10th Moldova's parliament unanimously approved a statement designed to address these concerns. The statement noted parliament's appreciation of Ukraine's efforts, but established additional principles needing to be addressed. The statement includes far greater specifics concerning the extent of democratisation required in Transdnistr, and establishes a timeline for the region's demilitarisation. According to the timeline, Russia would need to withdraw its armaments from the region by the end of 2005 and remove all personnel by the end of 2006.

Transdnistr and Russia have criticised the qualifications set out by the Moldovan parliament. Transdnistr's leadership claims that these negate the Yushchenko plan—which it interprets in a way that keeps many long-standing Transdnistr demands on the table. Specifically, Transdnistr expects to be able to continue to play a foreign policy role, to be treated as an equal in settlement proceedings, and to hold its own referendum regarding relations with the rest of Moldova.

Russia has used its membership of the OSCE to try to ensure that the Yushchenko plan does not harm Russian interests. In particular, Russia ensured that the OSCE parliamentary assembly's July 5th resolution endorsing the Yushchenko plan did not mention the qualifications introduced by Moldova's parliament on June 10th. Moreover, Russia's foreign ministry has interpreted the Yushchenko plan cautiously, described it as an interesting document that could be combined with elements of the controversial Kozak memorandum—a Russian-proposed solution that Moldova rejected in 2003 under pressure from the EU and others in the West.

Law on Basic Principles

On July 22nd the Moldovan parliament approved a Law on the Basic Principles of the Status of Transdniestr, as called for in the Yushchenko plan. The law describes Transdniestr as an autonomous unit of an integral Moldova, but defers further discussions on its official status until democratic elections are held in the region and Russian troops are withdrawn. The law defines the broad competences of the Transdniestrian parliament, while leaving its specific powers to be determined by future negotiations.

According to the law, localities in Transdniestr would have the right to decide by referendum whether to remain part of the region. This provision signals an attempt to empower the many ethnic Moldovans living in Transdniestr. The law concedes the region's right to conduct its own economic relations but states that Moldovan land, water and mineral resources are the common property of all Moldovans.

The law, which was passed by an overwhelming majority in the Moldovan parliament, is likely to face sustained criticism from Transdniestr and Russia. Most importantly, it offers Transdniestr a much weaker role in a unified Moldovan state—similar to the status of Crimea within the Ukrainian state. This falls well short of what Transdniestr has long demanded. The law also specifically excludes any mention of external guarantors or the existing format for mediating the conflict, both of which served to legitimise Russia's extended presence in the region.

Relations with Russia cool further

Having briefly distanced itself from the Transdniestrian leadership early in Mr Voronin's first term in office, Russia is now, at the start of Mr Voronin's second term, moving in the opposite direction—in line with a general deterioration in relations between the Russian government and its Moldovan counterpart. Russian support for Transdniestr was underlined in June, when a representative of the Russian presidential administration, Modest Kolerov, visited Chisinau and Tiraspol. In the Moldovan capital he met no government officials—only representatives of the media and some pro-Russian political parties. In contrast, in Tiraspol he met the Transdniestrian leadership and proclaimed the start of a new stage in Russia's relations with the breakaway region. The Moldovan government interpreted this as a signal of official Russian support for Transdniestr's claims of independence and summoned Russia's ambassador to a meeting at the Ministry of Foreign Affairs in order to voice its objection.

In addition to reinforcing Transdniestr's position and backing up Transdniestr's condemnation of the June 10th statement by Moldova's parliament, Russia has sought to influence Moldova's policies through various forms of economic pressure. Russia banned imports of Moldovan meat products in February, and then banned the import of Moldovan vegetables in May. In early July the lower house of the Russian parliament also voted overwhelmingly to request that the Russian government raise the gas price paid by a number of former Soviet republics, including Moldova (see Foreign trade and payments). As the vote in the Russian parliament came on the eve of the Chisinau mayoral election, it again raised suspicions in Moldova that Russia hoped to influence Moldovan politics to the detriment of Mr Voronin's CPM candidate—allegations of this sort first surfaced when Russia increased economic pressure on Moldova shortly before the parliamentary election in March (May 2005, The political scene).

Moldova reiterates its European aspirations

Moldova's worsening relations with Russia are both a result of—and a reason for—Mr Voronin's increasingly pro-European foreign policy orientation. Having come to office on a strongly pro-Russian platform in 2001, Mr Voronin has since embraced integration into the EU and other Western institutions as Moldova's main foreign policy goal. In early June Mr Voronin headed the Moldovan delegation at the Council of Europe summit, where he joined other heads of state in signing European conventions on the prevention of terrorism, on money-laundering and on human-trafficking. In early June he visited the NATO General Headquarters and the European Parliament, where he stressed the need for EU involvement in Transdnistr, and signalled Moldova's interest in signing a NATO Individual Partnership Action Plan (IPAP).

Although the rejection of the draft EU constitution by French and Dutch voters in May-June has dampened the EU's enthusiasm for further enlargement, this does not appear to be prompting a policy shift in Moldova. Given that the EU had never promised Moldova the possibility of membership, the fall-out from the EU constitution's failure is less for Moldova than for other aspirants closer to accession. The Moldovan leadership sees the long-term goal of EU membership as no less appropriate than before, and still considers that closer co-operation with Europe can bring concrete results in the short and medium term. Specifically, the CPM government hopes to secure better access to the protected EU market and more concerted EU involvement in resolving the Transdnistr question. Domestically, the government's pro-European direction allows it to broaden its appeal beyond traditional communist voters and insulate itself against criticism from its pro-Western opponents.

Significant questions nevertheless remain over the extent to which the CPM understands the need for political reforms as a precondition for closer EU relations. Although the CPM has begun to open up the political space, its willingness to allow opponents greater power, or more equal access to the media, is not yet clear. Even if the CPM were committed to greater political opening, weak institutional capacity would prevent rapid implementation of many aspects of the Moldova-EU Action Plan. The wide-ranging reforms promised by the government in the plan are almost certain to be hampered by a lack of trained personnel within most of the bureaucracy.

Economic policy

Strong revenue and under-spending mean budget surplus

Although the government's original 2005 budget targets a deficit, its finances have so far been in surplus—a consequence of strong revenue inflows and underspending. Based on its strong budget performance so far in 2005, the government has approved budgetary amendments that include a small surplus, of Lei33m (US\$2.6m), for the year as a whole. The proposed surplus is significantly smaller than the one recorded so far. In January-May the consolidated national public budget, which offers a broad measure of the budget situation, posted a Lei134m surplus. The consolidated national public budget includes the state and municipal budgets, the state social security and compulsory health insurance funds, and other extra-budgetary funds. During the same period of 2004 it had recorded a Lei148m deficit. More recent data

confirm that the strong budget performance continued in June, with the consolidated budget (which is less inclusive than the national public budget) posting a Lei154m surplus for January-June.

State budget

(Lei m unless otherwise indicated)

	2005 budget	Jan-May budget	Jan-May outturn	% of annual target
Total revenue	7,718	2,834	3,164	111.6
Current revenue	7,170	2,704	3,035	112.2
Tax revenue	5,796	2,033	2,413	118.7
Non-tax revenue	1,374	671	622	92.6
Total expenditure	7,986	3,621	2,789	77.0
General public services	684	330	220	66.5
Public order & safety	618	295	233	78.7
Education	972	486	327	67.2
Health	1,286	526	467	88.8
Social security	986	413	351	84.8
Agriculture, forestry, fishing & hunting	429	213	158	74.0
Debt servicing	790	321	232	72.3
External debt	269	130	120	92.4
Balance	-269	-786	374	-

Source: Ministry of Finance website.

Tax cuts are at least a partial success

The solid budget performance stems partly from the restrained level of state budget expenditure, which came in 23% below target during the first five months of the year. However, it is also partly due to strong revenue inflows to the state budget. These were 12% more than planned for January-May, with tax revenue inflows 19% above target (up by more than 40% year on year). Receipts from value-added tax (VAT), which provide around two-thirds of tax income, have performed particularly well, rising by 54% year on year in January-May, in part due to rapidly rising imports. At Lei1.6bn, VAT receipts were 22% above target. In past years, evasion and other collection problems had depressed VAT receipts despite high economic growth and buoyant consumption.

The strong tax performance appears, at least in part, to validate the government's tax-cutting strategy. Moldova reduced its profit tax rate from 28% in 2000 to 20% in 2004, and then to 18% at the start of 2005. The cut appears to have helped in bringing companies out of the shadow economy. A further cut in the profit tax rate—to 15%—is planned for 2006, but, according to Zinaida Grecianii, the finance minister, no additional cuts are planned thereafter.

Other tax rate reductions, however, have produced less impressive results. At the start of 2005 Moldova reduced the employer contribution to the state social security fund—which pays pensions, unemployment and other social benefits—by 1 percentage point to 27%, in order to encourage companies to report salaries. However, in January-May the Lei296m deficit on the state social security fund was more than double the target amount. Part of the deficit was due to expenditure—which came in 10% above target. However, a shortfall in revenue, which was 2% below target, also played a role. Both the social security fund and the health fund—which recorded a Lei75m surplus in January-May—are supposed to be deficit-free for the year as a whole.

The 2006 budget promises further tax reforms

In June the government published plans for additional tax changes designed to widen the tax base further. In 2006 the government intends to eliminate VAT exemptions for imports of fertilisers and pesticides, as well as for raw materials involved in the manufacture of medicines (although imports of the latter will now enjoy a preferential 8% VAT rate, rather than the standard 20% rate). In addition to the drop in the corporate tax rate, the government plans to reduce the income tax rate—from 9% to 8% for annual salaries of up to Lei16,200 (US\$1,290); from 14% to 13% for salaries of up to Lei21,000; and from 22% to 20% for higher incomes. The tax threshold, below which no income tax is paid, will rise from Lei3,500 to Lei4,500. One of the most controversial proposals concerns the real-estate tax. Although the government has proposed cutting the rate from 0.5% to 0.25%, it also announced that property values are to be reassessed on the basis of current market rates. The revaluation will start in Chisinau and Balti in 2006, followed by other cities and towns. Rural properties will be reassessed in 2009. In light of the remittance-fuelled property boom—and still low levels of more liquid incomes—the proposed revaluation has already sparked criticism.

2005 budget revisions boost revenue and spending targets

The budget amendments approved by the government in mid-July include a Lei609m rise in the revenue target for the year, of which Lei117m is to come from extra profits transferred from the National Bank of Moldova (NBM, the central bank). Total state budget revenue is now set at Lei8.15bn, assuming that parliament approves the revisions. On the expenditure side, the government has committed an extra Lei696m in spending, bringing the target to Lei8.11bn. Nearly half of the rise will be spent on capital projects. The rest will go towards salary increases, education and fuel subsidies for the agricultural sector.

IMF has yet to follow World Bank on financing

The government's relatively tight fiscal stance reflects constraints imposed by its limited financing options. Moldova is still unable to tap commercial debt markets abroad, and has had no IMF financing since 2002. The government continues to hope for a new IMF deal (the previous one expired in 2003) in order to ease its liquidity problems and enable a comprehensive rescheduling of its bilateral debts, which can proceed only once an IMF programme is in place. A deal with the Fund would also unlock a €15m credit expected from the European Commission.

The IMF sent a mission to Moldova in late June, but has said that negotiations over a new lending deal would not begin until at least the fourth quarter of the year. The IMF wants to see firm indications of reforms before agreeing to a new programme. It has been wary of lending in the absence of reform achievements since the Moldovan government failed to fulfil promises made at the time of the IMF's last disbursement in 2002. According to Thomas Richardson, who led the June mission, the IMF wants to see progress in implementing both the economic growth and poverty reduction strategy paper (EGPRSP), finalised in 2004, and the EU Action Plan, signed in February 2005. The mission nevertheless praised a number of achievements. These include increased efforts by the NBM to sterilise the large flows of remittances from Moldovans working abroad, and the implementation of a "guillotine law" that cancels redundant sub-normative acts. Among the IMF's recommendations are that the

government conduct an assessment of public offices and reduce public-sector staff. The IMF would also like to see a review of the State Board of Creditors, the existence of which has allowed well-connected businesses to enjoy preferential treatment.

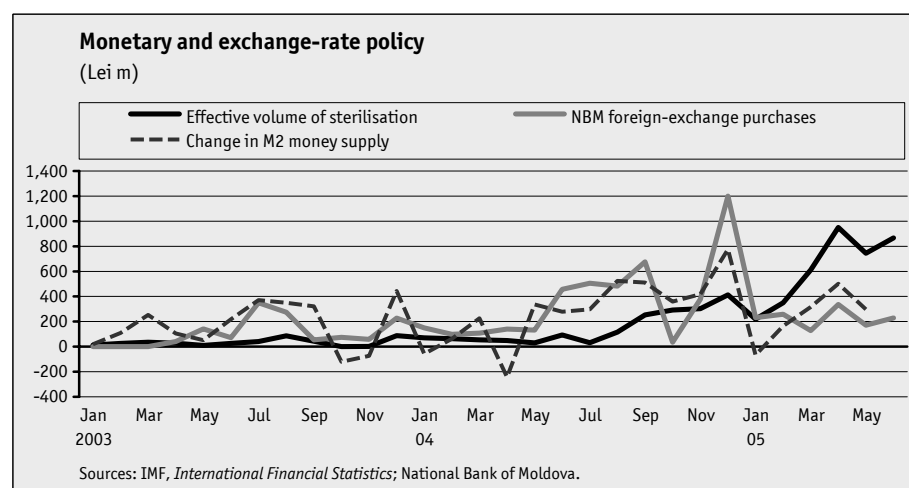
The World Bank has continued to disburse small credits for specific projects, most recently a US\$8.6m loan for improving the management of public finances, and US\$3m for land surveys. Both are on highly concessional, International Development Association (IDA) terms. The Bank has promised as much as US\$90m in new credits, although disbursements will depend on the extent of EGPRSP implementation.

Privatisations continue in Transdniestr

Economic reforms in the breakaway region of Transdniestr continue to lag behind those in the rest of Moldova. However, the leadership in Transdniestr is moving far more quickly than the Moldovan government with regard to privatisation. In 2004 privatisation earnings in Transdniestr reached an estimated US\$35m, against around US\$5m in the rest of Moldova. At the start of 2005 Transdniestr amended its legislation to allow current and former employees to participate in sales, and in January-May the state sold a further ten companies. The latest enterprise to be sold was the textile manufacturer Tirotext, one of the region's largest employers, which was bought by a local commercial bank, Agroprombank, for US\$22.9m. Both investors—who are largely, but not exclusively, Russian—and the Transdniestrian authorities continue to ignore a law passed by the Moldovan parliament at the end of 2004, which declared all sales not authorised by Chisinau to be illegal.

NBM boosts foreign-exchange purchases and sterilisation

In an attempt to prevent large inflows of remittances from excessively strengthening the currency and harming export competitiveness, the NBM intervened actively on the foreign-exchange market in January-June, buying US\$97m in foreign currency during that period, up from US\$78m in the year-earlier period. Remittances have risen rapidly in recent years, reaching US\$665m (26% of GDP) in 2004 and rising by more than 50% year on year in the first quarter of 2005, to slightly over US\$170m, according to the NBM. Unofficial inflows are likely to have pushed the total even higher.



Remittances are a further concern for the NBM because of their effect on the money supply—and hence inflation. During the past year the central bank has increased its sterilisation efforts in order to soak up excess liquidity and ease inflationary pressures. (Large-scale sterilisation attempts began in October 2004, but have intensified noticeably in recent months.) In April-June deposit auctions and the sale of NBM certificates—a new instrument introduced by the central bank at the beginning of 2005—mopped up Lei2.6bn (US\$203m) in excess liquidity. This compares with US\$1.2bn in the previous quarter, and just US\$170m in April-June 2004.

Even with the central bank's sterilisation measures, the money supply is still expanding more quickly than targeted. Broad money supply, as defined by the NBM (cash in circulation, bank deposits and money market instruments) had expanded by more than 50% year on year as of June—up from 46% in March and above the 45% growth rate targeted for the year as a whole. So far, this has not prompted the central bank to tighten other policies, particularly as inflation has trended downwards since April (see The domestic economy). The NBM has not changed commercial bank reserve requirements since it loosened them in July 2004, and has not adjusted the base rate (on 2-month T-bill purchasing repos) since February 10th, when it lowered it by 1.5 percentage points to 13%. The other rates that the NBM lowered in February—for overnight credits and Lombard facilities—have also remained unchanged.

The domestic economy

Real GDP rises by 8.2% in January-March

The latest data from the Department of Statistics and Sociology show the economy grew by a robust 8.2% year on year in January-March. No sectoral breakdown is available. Expenditure data indicate that household consumption still plays by far the strongest role, growing by 9% year on year and amounting to 98% of GDP during that period. Large inflows of remittances, as well as rising real wages, continue to drive this growth. Strong household demand appears to have persisted in the second quarter, according to other data: retail sales were up by 6.4% year on year and paid consumer services by 8.3% in January-June.

Gross domestic product by expenditure

(Lei m at current prices unless otherwise indicated)

	Jan-Mar 2004	Jan-Mar 2005	% of GDP	Real % change
Private consumption	5,470	6,972	97.8	9.0
Government consumption	1,265	1,432	20.1	0.2
Gross fixed capital investment	684	1,111	15.6	27.2
Exports	3,843	4,119	57.8	6.3
Imports	5,288	6,442	90.3	8.6
GDP incl others	5,900	7,131	100.0	8.2

Source: Department of Statistics and Sociology.

Some of the remittances are going towards investment, albeit to a far lesser extent. Gross fixed investment (including housing construction) rose by 27% year on year in January-March, but remained relatively low, at less than 16% of GDP. The effect of remittances is also apparent in net exports, which continue to drag down growth. Much of the remitted incomes are going towards imports,

which amounted to over 90% of GDP. Exports grew almost as strongly, but account for less than 60% of GDP. As in past years, government consumption has played almost no role in driving growth.

Industry growth slows to 4.6% year on year in January-June

The strong GDP growth comes despite a significant slowdown in the industrial sector. Industrial production in January-June was up by just 4.6% year on year (to Lei9.2bn), having risen at a double-digit rate year on year during the first half of 2004. Industrial sector growth has been decelerating steadily for over two years. So far in 2005 the slowdown has been due to weak manufacturing growth. Some of the smaller parts of the manufacturing sector are in a deep slump (particularly production of wood, scrap metal and appliances), while the large food and beverages sector, which accounts for almost 40% of total industrial output, grew by just 3% year on year in January-June.

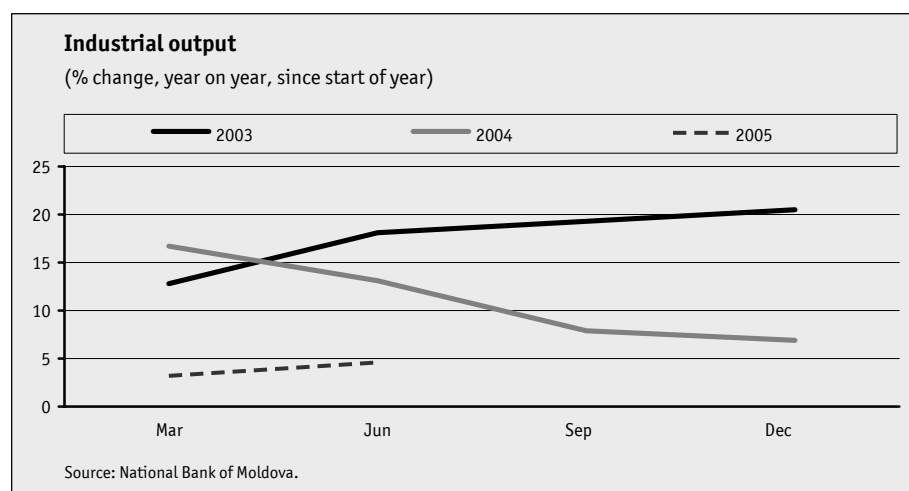
The slow growth of the food and beverages sector stems partly from the slump in output of processed meats, fruit, vegetables and bread. However, most importantly, it also reflects the sluggish performance of the wine sector—which alone accounts for nearly half of the country's agro-processing output. Booming wine production one year earlier in the wake of a strong grape harvest had been instrumental to the industrial sector's double-digit expansion. The 2004 grape harvest was less than the bumper harvest of the preceding year, which then slowed the pace of output growth in the wine-producing sector.

Outside the food and beverages sector, the industries recording the strongest growth are generally those servicing the construction boom that has resulted from massive inflows of remittances. Producers benefiting from strong construction demand include those making glass, chemicals (paint), cement and other building materials. As none of these industries is export-oriented, their strong growth does little to encourage diversification away from Moldova's narrow agro-processing export base.

Industrial production, Jan-Jun 2005

	% change, year on year	% of total
Manufacturing	4.6	65.3
Food & beverages	3.0	39.9
Processed meat	-15.0	2.2
Processed fruits & vegetables	-11.0	1.3
Milk products	18.0	3.9
Bread products	-2.0	2.9
Wine	5.0	17.0
Tobacco	-16.0	1.7
Chemicals	23.0	0.7
Textiles	1.0	1.5
Clothing	4.0	2.5
Glass & glass articles	47.0	3.5
Metals & metal products	26.0	1.1
Machinery & metal products	-5.0	2.1
Electricity	8.0	8.1
Water	16.0	1.7
Mining & extraction	8.0	1.0
Total industry incl other	4.6	100.0

Source: Department of Statistics and Sociology.



Farm output rises by 6.1% year on year in January-June

Agricultural output expanded by over 6% year on year in January-June. For seasonal reasons this largely reflected trends in animal-related production, which grew by slightly more than the sector as a whole and accounted for the vast majority of total output. With the grain harvest having started in early July, crops will play a far more significant role during the second half of the year—as will the agricultural sector in terms of its contribution to GDP. Although annual agricultural output still generally exceeds annual industrial output in Moldova, during the first half of 2005 it amounted to roughly one-quarter of it.

A relatively solid harvest is expected this year in Moldova. The grain harvest—collected in July and the first part of August—is estimated at 1.2m-1.4m tonnes. This is slightly above the 2004 harvest and far above the disastrous yields of 2003, when months of drought reduced the harvest to just 100,000 tonnes. The grape harvest, which begins in September, is expected to be roughly the same as in 2004 (640,000 tonnes) but lower than in 2003 (677,000 tonnes). Grape production suffered from low temperatures and excessive precipitation during much of the growing season, but the hot weather in late July and early August will have helped to boost sugar content and thereby improve wine quality.

Agricultural production Jan-Jun 2005

	Lei (m)	% change, year on year
Crops	248	3.8
Animals & animal products	2,012	6.3
Total incl services	2,384	6.1

Source: Department of Statistics and Sociology.

The agricultural sector is nevertheless under pressure from high fuel prices, government regulations and trade restrictions abroad. A surge in diesel fuel prices in the first half of July came just at the start of the harvest season and forced the government to announce a Lei120m plan to subsidise fuel costs for farmers. Grain producers, meanwhile, are being squeezed by export regulations introduced by the government in 2004. These have increased supply on the domestic markets and thereby depressed prices. Finally, both meat and crop producers have needed to find new markets, as a result of import bans imposed by Russia earlier this year (see Foreign trade and payments). So far at

least, the performance of fruit and vegetable exports in 2005 has been solid, with exports doubling year on year, to 77,000 tonnes, in January-June.

Year-on-year inflation moderates to 12.7% in June

Consumer price inflation peaked at over 14% year on year in April, having risen in almost every month since September 2004, when year-on-year inflation had been below 11%. In May and June the trend towards higher inflation began to reverse. Monthly price rises were essentially flat in May, and in June Moldova saw a month-on-month drop in prices for the first time for two years—owing to a particularly strong harvest-related decrease in prices for locally produced goods. This brought year-on-year inflation down to 12.7%. Despite the June figures, food prices have played the predominant role in pushing up inflation so far in 2005. Food prices were almost 19% higher year on year in June.

Prices for non-food goods were up by a more modest 11% year on year in June, with the increase stemming largely from higher oil prices, combined with rising prices for building materials (a result of the housing boom). Services prices were up by less than 8% year on year in June. The more modest rise reflected stable prices for utilities, which are administered by the state. Moldova's energy price regulator, which last approved an electricity price rise in 2003, has told the country's five distributors that it sees no reason for a rise this year, even though Union Fenosa, the Spanish owner of three of the distributors, has agreed to a higher purchase price from the Cuciurgan station in Transdnistr.

Disaggregated consumer prices (% change)

	2004				2005		
	Apr	May	Jun	Year	Apr	May	Jun
Total (year on year)	13.2	13.2	12.2	12.5	14.2	13.8	12.7
Month on month	0.9	0.5	0.1	-	1.4	0.1	-0.8
Since start of year	4.0	4.5	4.6	12.5	5.5	5.6	4.7
Food							
Month on month	1	0.2	-0.7	-	1.8	-0.3	-2.3
Since start of year	2.9	3.1	2.4	13.2	8.3	8.7	6.2
Non-food							
Month on month	0.8	1.1	1.3	-	1.3	0.6	0.4
Since start of year	3.4	4.6	5.9	12.0	3.3	4.0	4.4
Services							
Month on month	0.5	0.3	0.9	-	0.8	0.1	0.8
Since start of year	6.5	6.9	7.8	12.0	2.7	2.8	3.6

Sources: National Bank of Moldova; Economist Intelligence Unit.

Leu strengthens, but in real terms is weaker than in 1990s

The leu has returned to a trend of very gradual strengthening against the US dollar. At the start of August the Moldovan currency was just 1% weaker against the dollar than it had been at the start of 2005. However, it was down by 5% year on year, owing to gradual depreciation between July 2004 and April 2005. The leu's strengthening is in part related to seasonal factors: in mid-year the demand for dollars is generally lower, due to the reduced need for heating energy imports, while the supply of foreign currency is higher, owing to a spike in agricultural exports. Large inflows of remittances continue to play a key role in supporting the leu—according to preliminary data, remittances in the first half of 2005 were up by roughly half compared with the year-earlier period.

In real terms—adjusted for consumer price inflation—the Moldovan currency is estimated to have strengthened by around 2% against the US dollar since the start of the year, owing to only minimal nominal currency weakening and higher inflation in Moldova. The leu also appreciated in real terms against the currencies of Moldova's two main export destinations—the EU and Russia. Largely because of the euro's weakening against the US dollar, the leu was almost 12% stronger in nominal terms against the currency of its EU trading partners at the start of August than at the start of 2005. Combined with higher Moldovan inflation, this will have translated into even greater real appreciation. The extent of real leu strengthening against the Russian rouble is likely to have been less, owing to relatively high Russian inflation and less considerable nominal strengthening on the part of the leu (only around 2% against the rouble since the start of the year).

The leu's recent real strengthening against the currencies of its main trading partners should be put into perspective. According to data from the NBM, at the end of 2004 the real effective exchange rate was still almost 9% weaker than it had been five years earlier. Against the currencies of Moldova's main Commonwealth of Independent States (CIS) trading partners, the leu was more than 16% weaker in real terms than at the end of 1999, despite having appreciated considerably since early 2003. The trend against non-CIS currencies is less favourable from a competitiveness perspective. Although the leu weakened sharply in real terms in the second half of 2004, it had strengthened just as sharply during the preceding year and was roughly 2% stronger at the end of 2004 than at the end of the 1990s.

Exchange rate

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Lei:US\$ (av)												
2003	13.98	14.19	14.37	14.66	14.27	14.16	14.10	14.01	13.65	13.32	13.41	13.22
2004	13.20	12.91	12.63	12.09	11.78	11.98	11.96	12.02	12.12	12.30	12.48	12.47
2005	12.47	12.50	12.60	12.61	12.60	12.59	—	—	—	—	—	—
Lei:US\$ (end-period)												
2003	14.13	14.25	14.50	14.40	14.16	14.15	14.06	13.95	13.31	13.43	13.29	13.22
2004	13.14	12.71	12.41	11.80	12.01	11.95	11.96	12.07	12.16	12.46	12.48	12.46
2005	12.49	12.55	12.62	12.60	12.60	12.58	12.58	—	—	—	—	—
% change, month on month (end-period)												
2003	-2.2	-0.8	-1.8	0.7	1.7	0.1	0.6	0.8	4.8	-0.8	1.0	0.5
2004	0.6	3.3	2.4	5.2	-1.8	0.5	-0.1	-0.9	-0.8	-2.4	-0.2	0.2
2005	-0.2	-0.5	-0.5	0.1	0.0	0.2	0.0	—	—	—	—	—

Sources: IMF, *International Financial Statistics*; National Bank of Moldova.

Real wage growth moderates to 5% in January-June

Although wages continue to increase in real terms, the pace is significantly lower than in 2004. In January-June the average monthly wage was Lei1,219 (US\$95), up by 5% year on year in real terms. During the year-earlier period, real wages had risen by almost 12% year on year, and on the whole wage growth has been slowing since late 2002. This reflects slower nominal wage increases (the average wage in 2002 rose by almost 40% year on year) and rising inflation. The average salary in Moldova is still well under one-third of the average in Russia and in neighbouring Romania. Wages in the agricultural sector are particularly low, at only around 45% of the national average. Wages

are also relatively low—at between 70-80% of the national average—in the health and education sectors, even after recent increases.

Low wages give Moldova a comparative advantage for low-cost subcontracting, but they also drive many Moldovans abroad in search of higher earnings. The number of Moldovans working abroad is estimated to be between 400,000 and 700,000, out of a total population of only 3.6m. The number is unlikely to fall in the absence of improved earnings and employment prospects at home. Although the unemployment rate—measured according to International Labour Organisation (ILO) methodology—has fallen by almost 2 percentage points over the last year, it still stood at 9.6% of the workforce in January-March.

Wages

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Nominal wage (Lei)^a												
2003	773	750	763	780	792	808	818	830	839	851	867	892
2004	952	943	967	990	1,001	1,025	1,038	1,044	1,052	1,060	1,074	1,104
2005	1,146	1,127	1,148	1,178	1,196	1,219	-	-	-	-	-	-
Nominal wage (% change, year on year)												
2003	35.0	33.9	33.3	32.9	32.6	33.2	32.2	32.5	31.8	30.9	30.0	29.1
2004	23.1	25.8	26.8	26.9	26.5	26.9	26.9	25.8	25.4	24.6	23.9	23.7
2005	20.4	19.4	18.7	19.1	19.5	18.9	-	-	-	-	-	-

^a Cumulative average since start of year.

Source: National Bank of Moldova.

Foreign trade and payments

Trade deficit rises to almost US\$400m in January-May

Strong import demand and high fuel prices pushed up Moldova's import expenditure by almost one-third year on year in January-May. Combined with more sluggish growth in export earnings—growth was barely in double digits—the surge in import costs produced a trade deficit of almost US\$400m, against a deficit of just over US\$240m in the same period of 2004. Moldova's difficulty in containing its external trade imbalance reflects the rapid remittance-fuelled rise in incomes—which pushes up imports—and the nature of its exports, which are excessively centred on agriculture-related goods. These goods accounted for 55% of exports in January-May, and are poorly suited for any rapid penetration of new markets in western Europe. As a result, they continue to go primarily to traditional markets in the Commonwealth of Independent States (CIS).

Trade in goods

(US\$ m unless otherwise indicated)

	Jan-May 2004	Jan-May 2005	% change, year on year
Exports (fob)	382	424	11.0
Imports (cif)	-624	-819	31.3
Balance	-242	-395	-

Source: Department of Statistics and Sociology.

Textiles still account for much of the exports reaching the EU

Although the EU's importance as a trade partner has risen in recent years, the combined share of exports going to the 25 EU member states is still well below the share that goes to Russia. Moreover, much of the increase in exports to the EU has arisen from textiles subcontracting work undertaken on behalf of German and Italian firms. The ongoing rise in textiles exports—which increased by more than 20% year on year in January-May—has therefore been matched by a corresponding increase in textiles imports. Moldova's trade concentration reflects historical trade patterns, as well as the difficulty that its agriculture-related exports face in penetrating EU markets. Not only does Moldova's wine sector not enjoy the preferential access granted to regional competitors, such as Bulgaria, it has yet to develop the marketing, distribution and quality control needed to succeed outside the CIS. Only a minority of Moldova's wine producers are in a position even to try to do so. Some high value-added sectors have met with success—such as walnuts, all of which go to the EU—but these still account for a very small share of agriculture-related exports.

Reliance on Russia is posing serious threats

Moldova's reliance on the Russian market—which took more than 35% of its exports in January-May—has helped to boost the economy during the recent years of strong Russian import demand. However, it also brings significant risks, as was made manifestly clear in the wake of the 1998 financial crisis in Russia. Moldova's trade concentration has once again become a pressing concern, following a decision by the Russian parliament in February to recommend a boycott of key Moldovan export products. Later that month Russia banned the import of meat and meat products, causing Moldovan animal and animal product exports in January-May to fall by 5% year on year. In mid-May Russia instituted a ban on all Moldovan plant matter, including fruits and vegetables, citing poor certification and hygiene. So far Russia has not targeted Moldova's wine exports, of which more than 80% traditionally go to Russian consumers. Restrictions on these would have a serious effect—wine and spirits accounted for nearly 30% of Moldova's total exports in the first five months of the year.

Composition of trade

	Jan-May 2004	Jan-May 2005	% change, year	
	US\$ m	US\$ m	% of total	on year
Exports				
Food, beverages & tobacco	142.2	159.8	37.7	12.4
Textiles & textile articles	62.7	76.4	18.0	21.9
Vegetable & fruit products	46.1	56.1	13.2	21.7
Hides & leather goods	30.8	31.1	7.3	1.0
Machinery & equipment	13.2	20.1	4.7	52.3
Total incl others	382.0	424.0	100.0	11.0
Imports				
Mineral products	124.3	173.2	21.1	39.3
Machinery & equipment	72.8	116.4	14.2	59.9
Chemicals	61.7	84.8	10.4	37.4
Textiles & textile articles	55.0	67.8	8.3	23.3
Metals & metal products	32.5	47.3	5.8	45.5
Total incl others	623.9	819.0	100.0	31.3

Source: Department of Statistics and Sociology.

On the import side, Russia's monopoly position in supplying gas to Moldova is also a cause for concern. Russia is considering bringing the price it charges CIS consumers closer to that prevailing in west European markets. On July 8th the Russian parliament voted to increase gas prices paid by Moldova, the Baltic states, Ukraine and Georgia. If implemented, such a policy would push up the price Moldova pays for its gas imports from around US\$80 per 1,000 cu metres to as much as US\$140-160. Such an increase would lead to a sharp deterioration in the balance of payments and a drop in the competitiveness of Moldovan industry. However, it is expected that any rise in prices would come only gradually, and prices for Moldova are unlikely to reach those paid by west European consumers.

Consumption and investment push up imports

The rise in world oil prices over the past year has played a major role in pushing up import costs. Spending on mineral products was up by almost 40% year on year in January-May, accounting for just over 20% of total import costs. Ukraine is the country's main oil supplier and consequently its leading source of imports overall. Romania also is an important supplier of refined oil products. Although Moldova has started its own refining operations, it will still need to import its crude supplies. Aside from higher oil prices, the rise in import expenditure also reflects an increase in spending on capital goods, with purchases of imported machinery and equipment rising by almost 60% in January-May. This is promising—from the perspective of ensuring sustainable export growth over the medium term. However, the increase in imports is also a function of strong growth in purchases of consumer-related goods.

Main trading partners

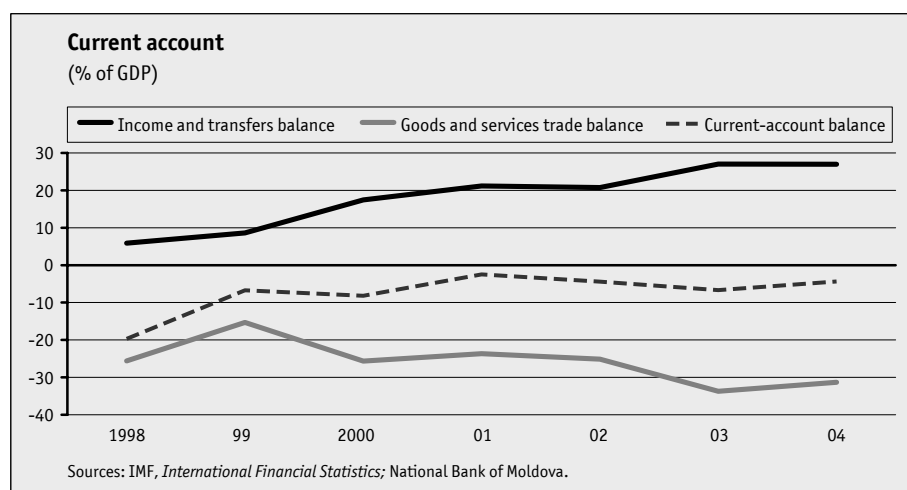
	Jan-May 2004	Jan-May 2005	% change, year	
	US\$ m	US\$ m	% of total	on year
Exports				
CIS	192.9	216.0	50.9	12.0
Russia	133.0	152.0	35.8	14.3
Ukraine	25.7	30.7	7.2	19.5
Belarus	25.2	23.7	5.6	-6.0
EU	123.9	120.9	28.5	-2.4
Italy	52.3	54.9	12.9	5.0
Germany	30.3	15.8	3.7	-47.9
Romania	35.7	47.8	11.3	33.9
Total incl others	382.0	424.0	100.0	11.0
Imports				
CIS	273.8	330.5	40.4	20.7
Ukraine	144.1	180.4	22.0	25.2
Russia	80.3	94.1	11.5	17.2
EU	206.6	274.4	33.5	32.8
Germany	54.1	70.1	8.6	29.6
Italy	48.5	53.3	6.5	9.9
Romania	47.3	72.8	8.9	53.9
Total incl others	623.9	819.0	100.0	31.3

Source: Department of Statistics and Sociology.

Current-account deficit equals 5% of GDP in January-March

The current-account deficit in January-March 2005 rose to US\$28m (5% of GDP), from US\$1m (0.2% of GDP) a year earlier. The increase was entirely due to the deficit in goods and services trade, which expanded to just under US\$200m (35% of GDP), almost double the level of the first quarter of 2004. The increase reflected rising energy prices and surging import demand, which pushed imports of goods up by 30% year on year, on a balance-of-payments basis. In contrast, exports of goods struggled, rising by just 7% year on year and covering less than 60% of import costs. One year earlier, exports had covered more than 70% of imports. Trade in services played less of a role in pushing up the overall trade deficit. Both exports and imports of services rose by slightly more than 20%, and the services deficit increased by just US\$5m. The range of traded services remains relatively narrow, with transport services accounting for around half of exports. Travel by Moldovans abroad accounted for just over one-third of services imports.

Large inflows of remittances from Moldovans working abroad continue to cover much of Moldova's massive trade gap. These remittances, which are measured partly as incomes and partly as transfers, rose by more than 50% year on year in January-March and amounted to US\$174m—more than 30% of GDP and roughly equal to the trade in goods deficit. The combined surplus on incomes and transfers covered roughly 85% of the goods and services trade deficit. Remittances are a well-entrenched feature of the economy (May 2005, The domestic economy) but are unlikely to continue to rise as rapidly as in past years. Although this is likely to mean higher current-account deficits in the future, some of the risk is mitigated by the fact that much of the current import boom is remittance-fuelled. Slower growth in remittances would therefore be likely to translate into slower import growth.



FDI falls year on year in January-March

Moldova relied on foreign direct investment (FDI) to finance its current-account deficit in January-March—given the lack of interest shown by outside portfolio investors and the limited external borrowing possibilities. The former meant that Moldova attracted just US\$1m in net portfolio investments in January-March, while the latter translated into a US\$32m outflow in other investments (which records debt flows). Despite their relative importance, FDI flows into

Moldova are still far below potential. In January-March 2005 net FDI inflows were just US\$45m, down from US\$54m one year earlier. FDI continues to be constrained by the slow pace of economic liberalisation and the government's reluctance to accelerate privatisation.

Balance of payments
(US\$ m)

	2003				2004				2005
	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr
Exports fob	174.9	175.7	202.4	252.2	236.5	227.3	245.0	286.4	253.2
Imports fob	-248.4	-327.4	-353.1	-499.6	-331.8	-428.2	-438.6	-554.9	-430.3
Trade balance	-73.6	-151.7	-150.7	-247.4	-95.3	-200.9	-193.7	-268.5	-177.2
Services exports	54.1	65.0	65.4	69.8	61.1	75.1	87.9	98.2	74.6
Services imports	-62.7	-67.4	-79.2	-90.5	-77.7	-86.6	-95.0	-117.8	-96.1
Net services	-8.6	-2.4	-13.9	-20.7	-16.6	-11.5	-7.1	-19.7	-21.5
Net income	44.9	55.6	65.0	68.6	36.2	65.6	95.5	139.3	82.5
Net transfers	68.5	74.1	74.2	87.6	74.6	86.7	89.0	113.4	87.9
Current-account balance	31.2	-24.4	-25.4	-111.8	-1.0	-60.1	-16.3	-35.5	-28.3
Capital & financial account	26.4	-6.6	-36.3	76.9	15.2	-4.8	-46.2	31.8	9.6
Direct investments	17.3	14.4	18.1	21.2	54.2	19.4	32.5	41.8	45.2
Portfolio investments	-6.0	-4.9	-5.2	-7.7	-5.1	-2.3	0.0	-3.0	1.1
Other investments	-2.3	-10.0	-21.8	74.3	-23.0	-38.8	18.7	54.4	-31.7
Errors & omissions	-57.6	30.9	61.7	34.9	-14.1	64.9	62.4	3.7	18.7

Source: National Bank of Moldova.