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Current Account Sustainability in Moldova: Policy Implications

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Current Account Sustainability in Moldova: Policy Implications

Executive Summary

In 2012 Moldova's current account deficit amounted to 7.0% of GDP, thus continuing a long tradition of large deficits in the past. In a recent publication we have shown that such a level is not compatible with mid-term external stability. On top, there are good reasons to expect a further increase of the current account deficit. In the short term, the expected economic recovery will most certainly contribute to more imports and a higher deficit. In the medium term, lower current transfers and in particular lower remittances will also tend to increase the size of the deficit. Consequently, the issue of the current account deficit has a quantitative importance which poses a challenge for policymakers.

Macroeconomic policy has been very prudent in recent years. The National Bank of Moldova allows the Lei to float against all major international currencies and focuses instead on stabilising the rate of inflation, with much success. The government has implemented a remarkable fiscal consolidation; the budget deficit in 2013 will amount to only 2.0% of GDP. Consequently, the current account deficit persists not because of macroeconomic policy, but despite a very appropriate policy mix. In policy terms this implies that there is no room for expansionary policies in the future, since such policies would further destabilise the external situation and the problem of current account deficit could become a very serious one.

This implies that structural problems are to blame for the lack of international competiveness of the Moldovan economy, as shown by the high current account deficit. In order to regain external stability, policy makers should focus on structural issues. In our view, two issues from a potentially long and certainly not new list of government's homework deserve highest attention. First, attraction of FDI in agriculture and manufacturing is of crucial importance, since it has a twofold positive effect. FDI not only provides a stable source of finance for the current account deficit, but it also increases productivity and net exports, thus reducing the current account deficit in the medium term. Second, national savings are too low in Moldova and need to be increased, in order to reduce the current account deficit. The government and the National Bank should draft and implement correspondent measures that are conducive for higher savings in the private sector.

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1. Introduction

Moldova's current account deficit has been traditionally high and 2012 was no exception, as the deficit amounted to 7% of GDP. One crucial question in this regard relates to the sustainability of the deficit: Is this a sustainable situation or are major policy adjustments needed to regain external stability? We dealt with this empirical question in a recent technical note[1] and came to the result that the current account deficit is too high, i.e. not sustainable. This insight leads to a further question: What are the implications of an unsustainable current account deficit for policy making? The objective of this paper is to answer this policy related question.

The structure of the paper is as follows. In section 2 we take an aggregate view of the topic and review the sustainability analysis, as conducted in our recent publication TN/01/2013. This is followed by a disaggregated view of the current account in section 3, which intends to shed more light into the structure and the nature of the deficit. Sections 4 to 6 deal with policy implications, both at the macroeconomic level as well as regarding the structural agenda. Section 7 concludes.

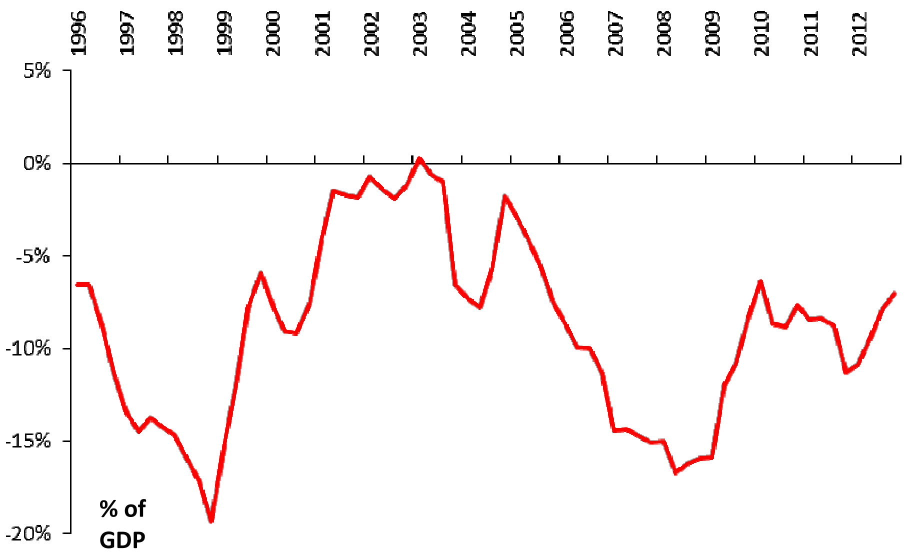
2. Current account deficit: Aggregate view and sustainability analysis

Moldova has seen high and persistent current account deficits in the past, as figure 1 demonstrates:

[1] See Technical Note TN/01/2013 "Current Account Sustainability in Moldova: Empirical Results", http://get-moldau.de/download/technicalnotes/GET Moldova_TN 01 2013_en.pdf

Figure 1

Current account balance in Moldova (1996Q1:2012Q4)



Source: National Bank of Moldova

Note: Graph shows 4-quarter trailing current account balance/GDP ratio

It is obvious from figure 1 that the current account balance underwent drastic swings over time, ranging from a maximum deficit of around 20% of GDP up to a (briefly) balanced position. In 2012 the deficit amounted to 7.0% of GDP, a value which raises the question of external sustainability. In our Technical Note TN/01/2013 we provided an empirical assessment of the sustainability of the current account deficit in Moldova in the medium- to long term, using three different accounting frameworks:

- Simple Benchmark Approach: Is the current account deficit fully covered by net FDI inflows?
- Intertemporal Solvency Approach: Is the external debt to GDP ratio stable?
- Portfolio Approach: Is the external debt to GDP ratio stable, taking into account the need of the economy to build up foreign reserves?

The results of our assessment are shown in Table 1.

Table 1

Comparative assessment of current account sustainability

Approach	Target Value CAD	Recent Value CAD	Assessment
Simple Benchmark	-1.5% of GDP	-7.0% of GDP	Negative
Intertemporal Solvency	-6.2% of GDP	-7.0% of GDP	Slightly negative
Portfolio	-4.4% of GDP	-7.0% of GDP	Negative

Source: Technical Note TN/01/2013, including an update of the recent value of the current account deficit.

All three accounting frameworks point to a target ratio for a sustainable current account balance in the range of -1.5% to -6.2% of GDP, depending on the concrete method. The latest value of -7.0% of GDP falls outside this range, even though not by a very wide margin. Thus, the current account deficit seems not sustainable from a macroeconomic point of view.

Conclusion: A quantitative assessment using different methods raises some doubts on the sustainability of Moldova's current account deficit.

3. Current account deficit: Disaggregate view

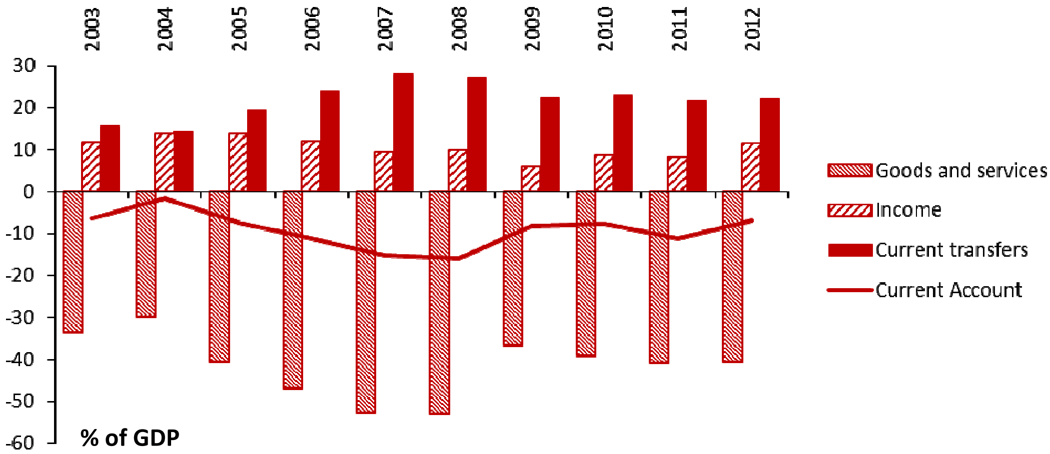
The main goal of this policy paper is to provide concrete policy recommendations on how to deal with Moldova's current account deficit, in particular on how to reach a broadly sustainable position. However, for the formulation of policy recommendations not only the aggregate view given in section 2 is relevant; equally important is a disaggregate analysis of the current account position and its individual components and sources. This section deals with such a disaggregate analysis.

3.1 Analysis of structure of current account deficit

The Technical Note TN/01/2013 mentioned above dealt with the headline current account balance in a relatively straightforward macroeconomic accounting framework. However, the current account is made up of several sub-accounts, reflecting different economic transactions between residents and non-residents, and it is worth looking at them individually in order to gain deeper economic insights.

Figure 2

Structure of Moldova's current account



Source: National Bank of Moldova

Figure 2 shows the development of the main components of the current account deficit, including the aggregate deficit. A number of interesting observations can be made.

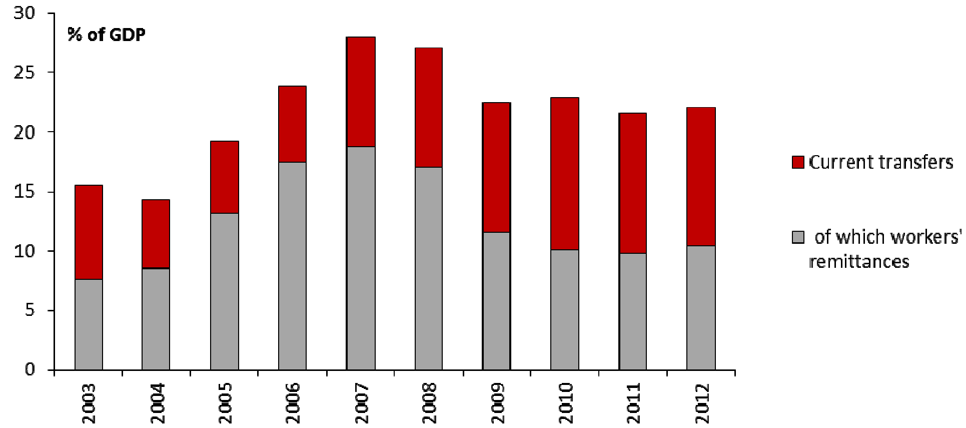
The balance of <u>trade in goods and services</u> is traditionally deeply in deficit. While values of more than -50% of GDP have been reached historically, the current deficit of 40.6% of GDP is still extremely high.

The <u>income balance</u> that records financial transactions related to income obtained from labour, FDI, portfolio and other investment is traditionally in surplus (11.4% of GDP in 2012).

<u>Current transfers</u> (unilateral transfers, which include workers' remittances, aids and grants, official assistance) are traditionally in huge surplus, amounting to 22.1% of GDP in 2012. Here, a more detail analysis reveals that around half of these transfers (10.4% of GDP) come in the form of worker's remittances.

Figure 3

Breakdown of current transfers



Source: National Bank of Moldova

Above breakdown reveals that despite the fact that the income and current transfers balance are persistently and significantly in surplus, the current account balance is traditionally in deficit. This raises additional questions regarding current account sustainability, as the surpluses in the income and current transfers balance are likely to be temporary factors, which won't extent to the long term.

Regarding the potential decline in worker's remittances over time, a counterargument often heard is that if remittances go down, this will improve the trade balance via two effects:

- Direct effect: A reduction in imports will take place, especially consumer imports. Indeed, a high empirical correlation between remittances and imports exists in Moldova. However, empirical studies for other countries estimate that a drop of remittances by 1 USD will reduce imports by only 0.13 - 0.2 USD (see Karapetyan/Harutyunyan (2013) and Khan et al. (2007) for more details)
- Indirect effect: An improvement in the trade balance via a weaker real exchange rate, since less financial inflows in form of remittances will reduce the typically observable appreciation of the real exchange rate.

It is notoriously difficult to detect and quantify the overall impact of both effects empirically for individual countries (see Jovičić/Mitrović, 2006, for Serbia). To our knowledge, no comprehensive study on Moldova exists.

Conclusion: The expected reduction in surpluses of income and current transfers balance over the medium term will raise additional concerns regarding the unsustainability of the current account deficit. This strengthens the need for policy action.

3.2 Analysis of sources of current account deficit

A current account deficit simply states that the country increased its (net) external indebtness over a certain period. This is not per se a bad thing, especially if the resources attracted from above are used for productive investment. The key question is thus: What is the additional external debt used for? Is it for financing productive investment ("good case") or for private consumption ("bad case")?

This reasoning brings us to the standard macroeconomic identity that the current account balance is equal to the gap between national savings (S) and national investments (I), both public and private.

Figure 4 shows the evolvement of Moldova's national savings and investments over time.

Figure 4

Savings and Investments in Moldova

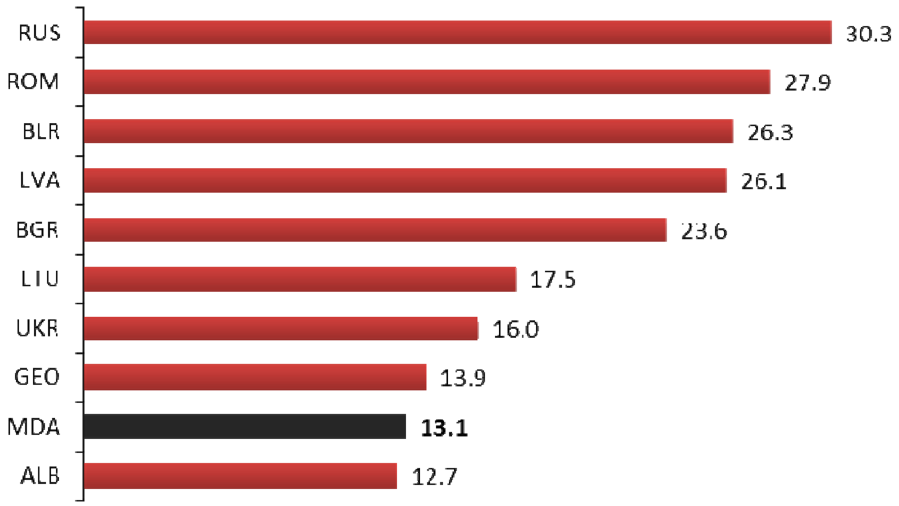
Source: World Bank
Note: Gross savings (national income + net transfers - consumption) are shown

Investments were always higher than savings in Moldova over the period shown, which simply repeats the message from figure 1 of the existence of a current account deficit over that period. However, some interesting dynamics can be detected from the analysis of the behaviour of S and I individually. After peaking in 2007, both indicators showed a clear downward trend until the recent past. While the growing current account deficit until this peak was thus accompanied by rising investments (given more or less stable savings), future developments after 2007 showed a less benign picture. Especially investments never really recovered from the steep fall in 2009.

To gain additional insights into the nature of the performance of S and I, we look at the level of Moldova's savings and investments in a regional cross-country comparison:

Figure 5

International comparison of savings rates (% of GDP, 2011)

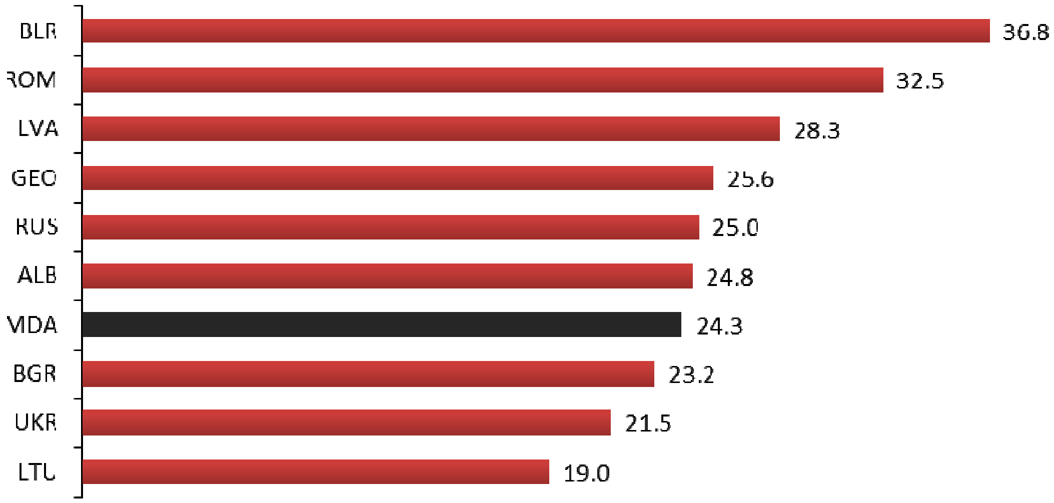


Source: World Bank
Note: Gross savings (national income + net transfers - consumption) are shown

Figure 5 reveals that Moldova's savings rate is very low in a regional context, placing it at the bottom of the peer group. The structurally low problem of national savings (implying very high consumption) can be thus considered a major economic reason for a high and persistent current account deficit.

Figure 6

International comparison of investment rates (% of GDP, 2011)



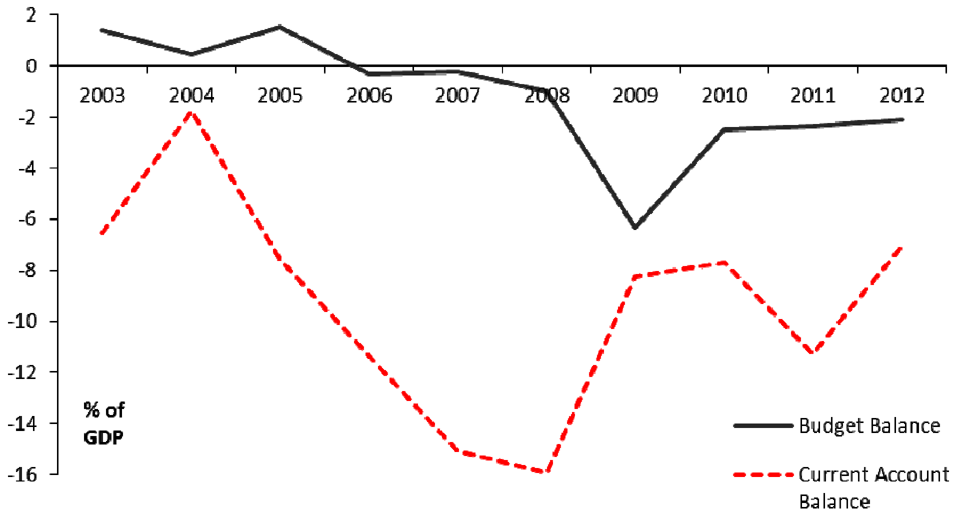
Source: World Bank
Note: Investment rates are derived by subtracting the current account balance from the gross savings in Figure 5

While the behaviour of the investment rate is better as compared to the savings rate, it can be still considered a suboptimal performance in a regional context, as many other countries invest more in their respective capital stock, with corresponding implications for economic growth.

Since the current account deficit (or the gap between savings and investments, to put it another way) can be rooted in the public and/or private sector, the next question would be to split the deficit into the relevant sectoral contributions. While we do not have individual savings-investment gaps for both the private and public sector, we can proxy the public gap between S and I with the budget balance. Figure 7 shows the current account and the budget balance jointly.

Figure 7

Current account and budget balance in Moldova



Source: National Bank of Moldova, Ministry of Finance of Moldova

While exhibiting rather similar dynamics, the public part of the current account deficit plays a rather limited role, especially over recent years. The problem is thus clearly with the private sector, which is responsible for the external imbalance.

Conclusion: The increasing external indebtedness implied by current account deficits is used mainly for consumption and not for investment purposes. This further questions the sustainability of the existing current account deficits and calls for higher savings in the private sector.

4. Policy implications: How serious is the need for policy action?

The results from section 2 suggest at a first glance a limited problem regarding the current account deficit, since the difference between the recent and the target values of the deficit are not huge.

However, this preliminary conclusion cannot be hold in view of important additional factors. One such short-term factor relates to the business cycle. In 2012 Moldova entered recession, with a decline in GDP of 0.8%. In such a time, the current account deficit typically contracts. However, for 2013 a recovery is forecast and GDP will grow by ca. 3%. In line with the expected recovery, import demand will go up and the current account deficit is likely to increase. Consequently, the deficit of

7% of GDP in 2012 underestimates the real size of the problem, as the deficit will be significantly higher in 2013.

But also medium-term factors point towards a substantial external stability problem. As shown in section 3, Moldova's has a huge surplus in current transfers. Such a surplus contributes to keep the current account deficit in bay. However, as shown by international experience, current transfers and in particular remittances tend to go down in the medium term. Once this happens in Moldova, the current account deficit is likely to expand. Finally, the consumption-driven nature of the current account deficit also points towards sustainability problems in the medium term.

Conclusion: The limited difference between target and recent values of the current account deficit does by no mean imply that policy action is not needed. We have good reasons to assume that the magnitude of the problem will increase both in the short- and medium term. This calls for immediate and decisive action.

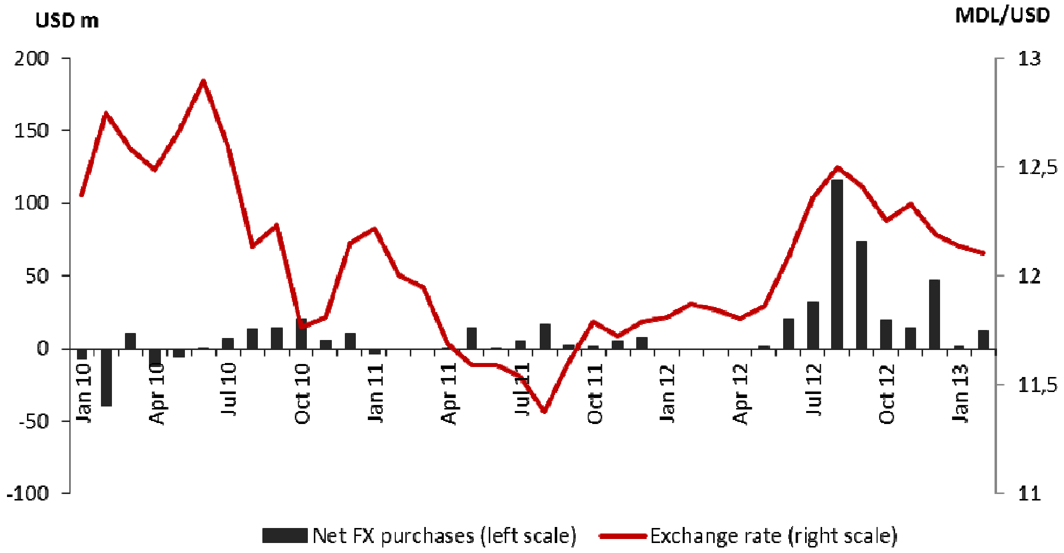
5. Policy implications: Macroeconomic policy

In many cases, an unsustainable current account deficit is the result of an inappropriate macroeconomic policy mix. In particular, unstable situations arise when policy makers try to maintain an overvalued currency, despite the markets pushing towards a depreciation of the national currency. Consequently, it is only natural to look first of all at Moldova's macroeconomic policy and to assess whether the high current account deficit is to some extent linked to it.

As shown by Figure 8, the National Bank of Moldova does not fix the external value of its currency. On the contrary, the Lei is allowed to float against all major international currencies (including the US dollar) and net FX interventions are rather limited. Consequently, exchange rate policy is not to be blamed for the large size of the current account deficit.

Figure 8

Exchange rate and net FX interventions

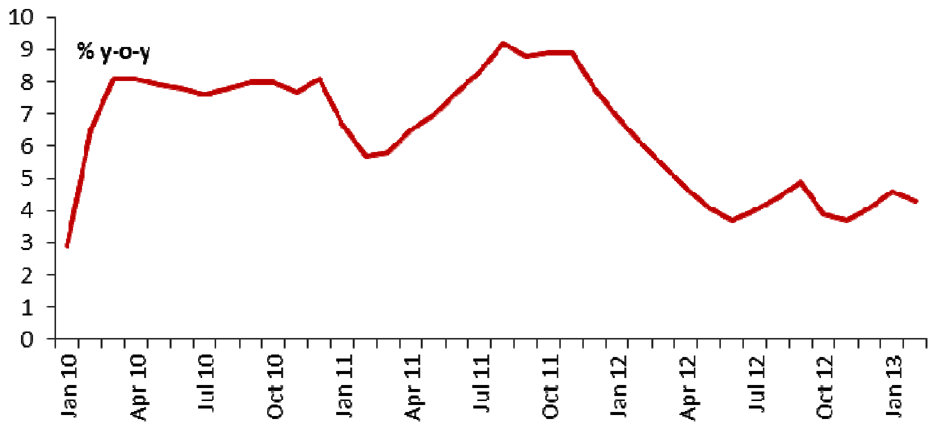


Source: National Bank of Moldova

The same applies to monetary policy. The National Bank has managed to stabilize inflation at a reasonable level in the context of its inflation targeting strategy. Thus, monetary policy is also not to be blamed for external imbalances.

Figure 9

Inflation (CPI)



Source: National Statistical Office

Finally, also fiscal policy has been adequate in recent years. In 2012, the budget deficit amounted to 2.1% of GDP and in 2013 a value of 2.0% of GDP is expected. By any standards, these are sensible levels that do not contribute to external imbalances.

Conclusion: The existing external imbalance in form of a high current account deficit is not due to an inappropriate macroeconomic policy. On the contrary, the imbalance persists despite a responsible macroeconomic policy.

The policy implications from this analysis are clear: There is not room whatsoever for a more expansionary macroeconomic policy. If fiscal or monetary policy were to become more expansionary, then the current account deficit could surge and the existing substantial problem would turn into a serious problem. A continuation of cooperation with the IMF is without doubt a very effective way to ensure an appropriate macroeconomic policy.

6. Policy implications: Structural reforms

An unsustainable current account deficit reflects a lack of competiveness of the economy. As shown in section 5, this lack of competiveness is not due to macroeconomic factors. Consequently, the roots of Moldova's competiveness problems lie in the real economy.

This brings us to the question of how to make the Moldovan economy more competitive. The list of urgent structural reforms is long and certainly not new. In order to avoid repetition, we will focus here on two selected issues, which in our view deserve to be treated with highest priority: FDI attraction and national savings.

FDI. The attraction of foreign direct investments (FDI) in agriculture and manufacturing is in the context of external sustainability of paramount importance. FDI into these sectors increase productivity and thus the competitiveness of the country, leading to higher net exports and a lower current account deficit. At the same time, FDI provides financing for a given current account deficit. Thus, FDI in agriculture and manufacturing contribute twofold to restoring external stability.[2]

Free economic zones. In this context it is worthwhile emphasizing the importance of free economic zones in the medium term. While free economic zones are certainly not the ideal instrument for FDI attraction in the long term, we think that they should be maintained and actively promoted in the medium term. Intensive talks to actual and potential foreign investors in manufacturing revealed a strong preference for stable conditions in the form of a free economic zone. But also the recent success of selected zones in attracting foreign manufacturers, such as Balti

[2] For more detailed recommendations regarding FDI into Moldova see our policy paper PP/02/2012, "FDI Attraction to Moldova: Facts, Potential and Recommendations", www.get-moldova.de.

and Ungheni, seem to suggest that this instrument has a role to play in Moldova in the near future.

Reform of vocational and educational training. Human resources are a key element in FDI attracting. As of today, vocational training in Moldova does not produce the workers demanded by modern business. As a consequence, foreign companies have to spend lots of money and time in training. In our view, a stronger demand orientation of vocational training would have a strong positive impact on FDI attraction.[3]

National savings. Also national savings is an important topic for regaining external stability. As shown in section 3, Moldova's national savings are rather low in the regional context, thus contributing to a wide current account deficit. The government should draft and implement measures to promote savings by households. However, further research is needed for putting forwards concrete recommendations in this field.

7. Conclusions

Moldova faces a problem regarding its external stability. At a first glance the problem is not huge, as suggested by a limited deviation of the recent current account deficit from the target value. However, there are good reasons to assume that the deficit will increase as the economy recovers from the recent slowdown in 2012. Furthermore, the disaggregated analysis points towards more sustainability problems in the future, once the importance of remittances and other current transfers goes down. But also the consumption-driven nature of the current account deficit is a reason to worry.

Consequently, we think policy makers should deal with the issue. However, the focus of policy should not lie in macroeconomic, but in structural measures. The rebalancing of the external sector and the needed improvement of Moldova's international competitiveness are crucial tasks at the level of the real economy.

[3] For more details see a forthcoming report by Berlin Economics on the topic.

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Annex 1: Balance of Payments of Moldova (2009 – 2012)

Item, USD m	2009	2010	2011	2012
Current Account	**-446.70**	**-448.99**	**-790.37**	**-510.87**
Goods	**-1,948.82**	**-2,219.52**	**-2,869.43**	**-2,924.18**
- Exports total (FOB)	1,326.92	1,590.44	2,277.06	2,227.98
- Imports total (FOB)	-3,275.74	-3,809.96	-5,146.49	-5,152.16
Services	**-39.75**	**-63.51**	**-2.60**	**-21.08**
Income	**321.24**	**507.12**	**565.90**	**829.29**
Current transfers	**1,220.63**	**1,326.92**	**1,515.76**	**1,605.1**
Capital and financial account	**415.01**	**420.78**	**704.05**	**427.01**
Capital account	**-17.54**	**-28.36**	**-29.72**	**-34.78**
Financial account	**432.55**	**449.14**	**733.77**	**461.79**
Direct investment (FDI)	138.57	193.90	260.45	139.43
Portfolio investment	-5.82	5.64	4.74	16.51
Other investment	98.91	544.60	746.50	803.72
Reserve Assets	200.55	-294.37	-278.11	-497.63
Net errors and omissions	31.69	28.21	86.32	83.86

Source: National Bank of Moldova

Annex 2: Detailed breakdown of current transfers (2009 – 2012)

Item, USD m	**2009**	**2010**	**2011**	**2012**
Current transfers	**1,220.63**	**1,326.92**	**1,515.76**	**1,605.1**
- Inflow	1,323.99	1,416.32	1,615.99	1,710.41
- Outflow	-103.36	-89.4	-100.23	-105.31
General government	172.44	243.46	227.29	235.68
- Inflow	186.16	250.25	236.77	244.78
- Outflow	-13.72	-6.79	-9.48	-9.1
Workers' remittances	627.24	589.23	685.98	755.85
- Inflow	635.21	608.47	701.37	769.29
- Outflow	-7.97	-19.24	-15.39	-13.44
Other transfers	420.95	494.23	602.49	613.57
- Inflow	502.62	557.6	677.85	696.34
- Outflow	-81.67	-63.37	-75.36	-82.77

Source: National Bank of Moldova

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