EXTERNAL ECONOMIC THREATS OF THE FINANCIAL STABILITY OF THE REPUBLIC OF MOLDOVA

Scientific researcher Tatiana PETROVA
National Institute for Economic Research, Republic of Moldova
E-mail: tancikk@mail.ru
Scientific Researcher Ph.D. Corina GRIBINCEA
National Institute for Economic Research, Republic of Moldova
E-mail: cgribincea@gmail.com

Abstract: *The external economic sector is a concentrated reflection of all macroeconomic balances that exist in the economy. The purpose of the work is to identify the existing and potential threats to the external economic subsystem of the national economy, the mechanism of their impact on the state of the banking system, the foreign exchange market and to assess the level of their impact on the financial stability of the Republic of Moldova. The main factors of the instability of the external economic sector that generate the threats of the emergence of a crisis situation are considered: the openness of the economy, the deterioration of external trade conditions, the slowdown in economic growth, the current account deficit of the balance of payments, the high external debt against GDP, the sharp rise in price / cheaper national currency and budget deficit. In this context, it is necessary to assess the threats of the financial stability of the Republic of Moldova in order to develop measures to prevent them.*

Keywords: *external economic threats, financial stability, crisis situation, Republic of Moldova.*
JEL Classification: *G01, G19, H12, P34.*

1. Introduction

The socio-economic situation in the Republic of Moldova at present stage is characterized by the existence of external and internal threats to the financial stability of the country, which cause serious negative consequences. External threats are associated with a high degree of dependence of economic activity of the Republic of Moldova on external sources of financing and imported goods for industrial purposes.

2. Scientific research methodology

Theoretical bases of definition of threats and risks of financial sector of economy and achievement of financial stability are detailed described in the studies of such authors as: F. Mishkin, A. Demirguk-Kunt, E. Detragiache, S. Lysondo, G. Kaminski, K. Reinhart, D. Stiglitz, C. Borio and other scientists. It can be highlighted that foreign economic sector is a concentrated reflection of all macroeconomic balances that exist in the economy. The methodology used to calculate the financial stability indicators of the external economic sector of the economy was published in the following IMF publications:

- Financial Soundness Indicators Compilation Guide (IMF, 2006);
- Balance of Payments Manual (IMF, 2014a);
- External debt statistics: guide for compilers and users (IMF, 2014b).

Direction of the Balance of Payments of the NBM elaborate balance of payments Based on the Fundamental Law of the National Bank of Moldova (National Bank of Moldova, 2018) which is a macroeconomic account, summarizing systematically a resident-non-resident transaction for a certain period of time.

3. Determination of crisis factors and indicators of the financial stability of the Republic of Moldova

In order to maintain financial stability, the Republic of Moldova needs to assess the existing and potential benefits of the national economic sub-systems and to develop measures for their prevention. The table no.1 shows factors of instability in the external economic sector that generates the crisis situation and the mechanism of their impact on the banking system and foreign exchange market.

Table no. 1. Mechanisms of crisis factors' impact

No	Crisis factors	Mechanisms of impact
1	Openness of the economy	The more open the economy is, the more it turns out to be dependent on external shocks
2	Deteriorating external conditions of trade	Reduction of prices for traditional export of goods or a sharp increase in the cost of imports means for the country the loss of foreign exchange earnings and a decrease in the incomes of banks serving them
3	The slowdown in economic growth	Decrease in the rates of economic growth leads to a deterioration in the solvency of the country, as well as bank borrowers on debt
4	Current account deficit in the balance of payments	A significant current account deficit is considered by investors as a threat of solvency on external debt
5	High external debt / to GDP, in %	High external debt is considered by investors as a factor of financial instability
6	State budget deficit	Significant funds for servicing the public debt lead to underfunding of other budget items and slowing economic growth
7	Inflation	High inflation leads to a real appreciation of the national currency
8	The sharp appreciation/ depreciation of the national currency	Because of the high share of foreign currency in the balances of banks, corporations, in the savings of the population, sharp fluctuations in the exchange rate can destabilize the system of prices and incomes. High devaluation expectations can provoke withdrawal of deposits by bank depositors
9	High level of financial risks in the banking system	The inadequacy of the amount of capital to the risks accepted, the imbalance between currency assets and liabilities, the high proportion of overdue loans in the banks' loan portfolio can cause both a bankruptcy of a separate bank and a large-scale banking crisis

Source: developed by the authors

The direction of the Republic of Moldova on increasing involvement of the national economy in the system of global economic relations, thereby increasing its dependence on global dynamics and conjuncture, carries with it increasing risks of a financial and economic system malfunctioning. The distinctive characteristics of imbalances for small countries with open economies are:

- Greater cyclicity;
- Greater variation in the length of the business cycle;
- High risks of changes in budget revenues;
- Significant current account deficit;
- The need for an anchor currency to maintain the exchange rate;
- Increasing the role of cost inflation (IMF, 2015).

The impact of external conditions on the characteristics of economic development is carried out in several directions. Firstly, this is a direct impact on the dynamics of exports and imports; secondly, mediated through the impact on the income level of the population, business and the state on the relevant elements of final demand; thirdly, the impact on price dynamics and through it on all other variables that somehow depend on prices (Uzyakov et al., 2003).

In 2017 the trade turnover of the Republic of Moldova grew by 19.6% and amounted to 7.256 billion USD. At the same time, exports increased by 0.41 billion USD, and imports - by 0.84 billion USD. In 2016 the negative trade balance reached 1.98 billion USD and in 2017 around 2.406 billion USD; its volumes were equal to the volumes of the annual export of goods (Figure no. 1).

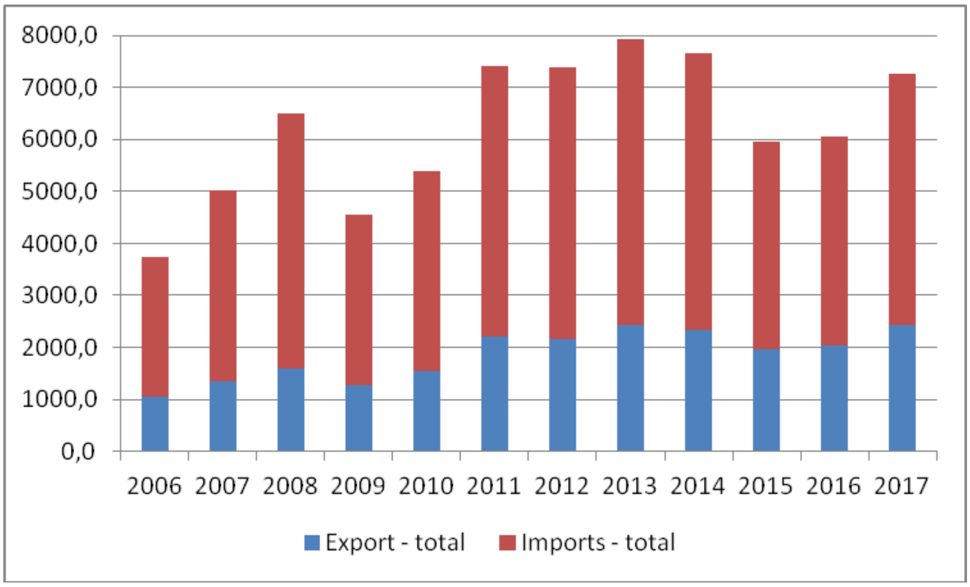

Figure no.1. Export and import growth of the Republic of Moldova, millions USD
Source: elaborated by the authors based on NBM data

The growth of imports outstrips the growth of exports in many countries. However, the trade balance deficit in Moldova is significant compared to other countries with economies in transition. At the same time, the terms of trade in the Republic of Moldova or the ratio of import and export prices are the worst in comparison with those of the main trading partner countries of the Republic of Moldova. According to the data for 2016, the volume of exports in relation to GDP in the Republic of Moldova is 43.6%, and imports -71.8% to GDP. The level of exports and imports to GDP in Romania is 41.3% and respectively 42.3% of GDP, in Russia -25.7% for exports and 20.5% for GDP for imports. The table no.2 shows the turnover of Moldova with the main trading partners in 2017.

Table no. 2. Moldova's goods turnover with major trading partners in 2017

	Romania		Russia		Italy		Germany		Turkey	
	mln. USD	%	mln. USD	%	mln. USD	%	mln. USD	%	mln. USD	%
Export	660,6	25,1	254,5	11,4	236,0	9,7	166,1	6,2	104,1	3,1
Import	694,5	13,7	571,7	13,3	331,2	7,0	390,6	7,9	304,3	6,8

Source: elaborated by the authors based on NBS and BNM data.

The tension in the external sector is due to the low level of export opportunities of the Moldova's economy. The main share of growth in exports represents agricultural raw materials (grain and sunflower seeds) and products on give-and-take raw materials. According to data for 2016 re-export[1] of foreign goods is 1/8 of total exports. A significant share in the import of the Republic of Moldova represents food and consumer goods.

A slight increase in exports of domestic goods compared with the growth of imports suggests a low efficiency of trade in the Republic of Moldova. At the same time, the decrease in the volume of foreign trade is characterized by an increase in the competitiveness index calculated as the level of coverage of imports by export deliveries[2]:

• The global competitiveness indicator increased from 44.2% in 2013 to 50.8% in 2017;

• The competitiveness indicator calculated for the zone of the CIS member countries has significantly decreased from 55.2% in 2013 to 40.3% in 2017;

• The competitiveness indicator calculated for the EU countries increased from 46.0% in 2013 to 67.5% in 2017.

The most significant impact on the economy of the Republic of Moldova is provided by operations on current transfers. About 60% of current transfers are personal remittances, received (current US $). Remittances are of particular importance to the national economy, partially contributing to the deficit of trade balance. Due to remittances, current expenses on imports are covered in a significant proportion (Figure no. 2). The import penetration factor (imports of goods and services / domestic demand) exceeds the level of 67,4% (in 2017), i.e. imports cover a large and growing share of aggregate domestic demand.

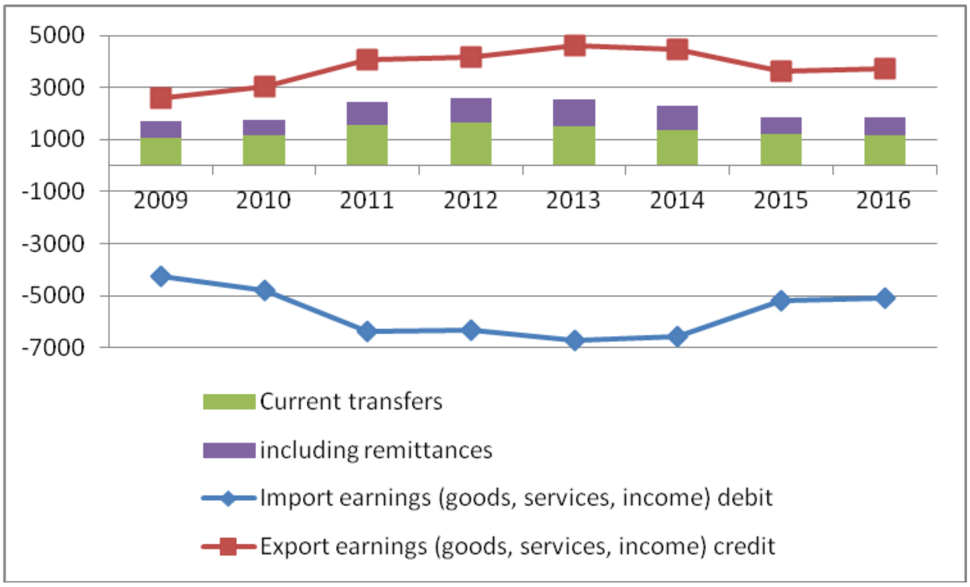

Figure no. 2. Current transfers in the Republic of Moldova, millions USD, 2009-2016
Source: elaborated by the authors based on BNM data

Despite the fact that remittances are used mainly for consumer purposes, they turned out to be drivers of GDP growth. Risks associated with the dynamics of the external

[1] In accordance with the methodology of the UN Statistical Commission, re-export refers to the export of foreign goods that were previously accounted for as imported goods; and re-exported goods are defined as goods that have already been imported into the country and exported to a third country without any significant processing. http://www.un.org/en/publications/pdfs/intl_trade_concepts_2010_eng.pdf
[2] the ratio of the export of goods of Republic of Moldova to the countries of the corresponding zone and the import of goods from the countries of the same zone

economic environment are generated by signs of the restoration of economic growth in the countries that are the main trading partners of the Republic of Moldova (Figure no. 3).

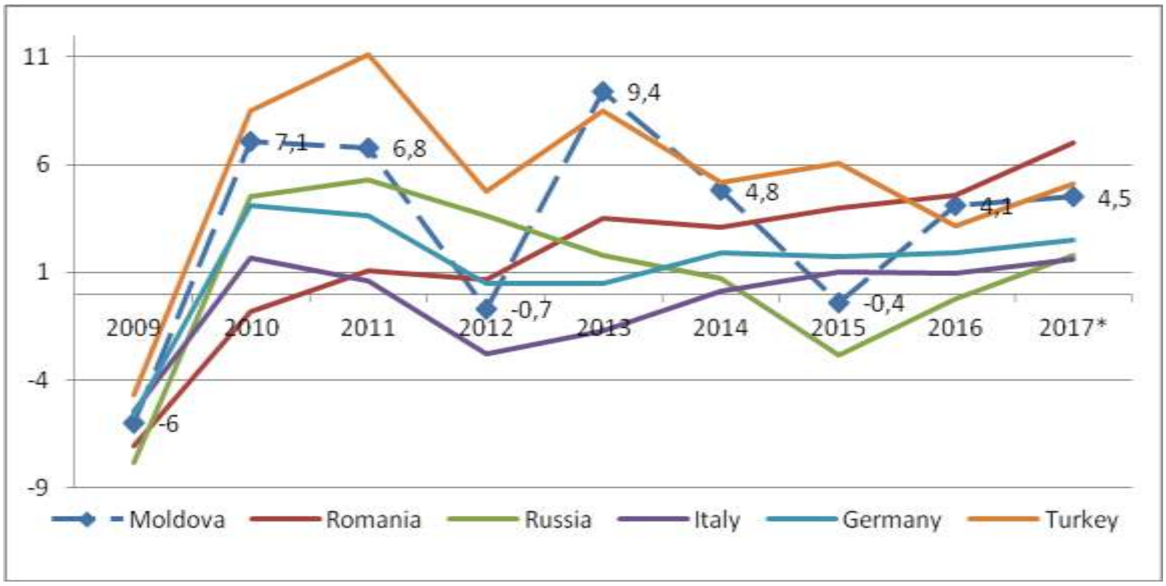

Figure no. 3. GDP, the economic growth rate of the main partner countries of the Republic of Moldova

*estimation

Source: Source: elaborated by the authors based on World Bank data

The demand for consumer goods and real estate caused by remittances contributes to the growth of such sectors of the Moldovan economy as: retail trade, construction, transport, financial intermediation and insurance, real estate and legal activities, household and other personal services, food industry, furniture and building materials production and thus contribute to the restructuring of the economy. Nevertheless, their potential to increase the monetary resources of the national banking system through savings accounts and, consequently, to stimulate economic growth through lending support in the small and medium-sized business sector is significantly underutilized due to low confidence in the banking system.

Most labor-exporting countries experience the consequences of the crisis with a certain lag. This situation is related both to the low efficiency of the financial sector, and to the preservation of the model for the development of the national economy, oriented to external economic factors of development. The main mechanism for the crisis transmission to the economy of the Republic of Moldova is affected by the fall in remittances. External imbalances are reflected in the country's balance of payments.

By international standards, Moldova represents the worst case of the current account:

• Imports exceed exports;
• National savings are less than investments;
• The country has a budget deficit (expenditure> income).

The stability of the current account imbalance should be considered, firstly, as operational stability for assessing the risks of the onset of currency and debt crises in the short run and, secondly, as intertemporal solvency in order to assess future sources of service and repayment of external debt in the medium- and long-term periods.

The possibility of taking corrective measures to achieve a secure position on external payments (deficit of goods, services and incomes) is financed through private and formal transfers, financial flows and the use of reserve and other financial assets or through the import of foreign savings (borrowings). Thus, the state budget of the Republic of Moldova for 2017 by 1/3 is provided by external financial sources[1].

A low level of economic growth, a high level of imports of energy resources and an increase in the cost of servicing external debt are a key threat to the stability of the financial and economic system of the Republic of Moldova.

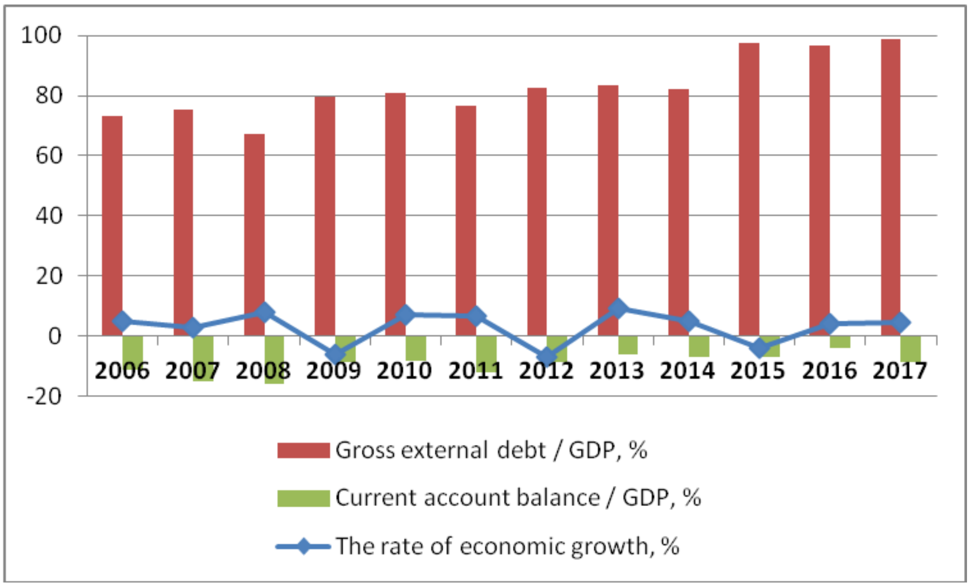

Figura no.4. Dynamics of gross external debt growth relative to GDP growth and external economic balance of the Republic of Moldova, %

Source: calculated by the authors based on BNM and NBS data

After the 2008 crisis, the total external debt of the country is growing at a rate exceeding GDP growth. At the end of 2017 gross external debt of the Republic of Moldova amounted to 6.75 billion USD and exceeded the country's GDP. In today's realities of the high degree of interdependence of most of the world's economies, the critical level of external debt represents a real threat to financial security.

Table no. 3. The total volume of loans received by the Republic of Moldova from the IMF, at the end of November 2017, in special drawing right

Type of arrangement / resources	Approval date	Expiration or Cancellation Date	Approved amount (million, SDR)	Amount Involved (million SDR)
CCFF	15-Jan-93 and 19-Dec-94	--	25,70	25,70
STF*	16,-Sep 1993	15-Sep, 1994	45,00	45,00
Stand-by	17-Dec, 1993	16-Mar 1995	51,75	51,75
Stand-by	22-Mar, 1995	21-Mar, 1996	58,50	32,40
EFF	20-May, 1996	19-May, 2000	135,00	87,50
PRGF	21-Dec, 2000	20-Dec, 2003	110,88	27,72

[1] In accordance with the concept of the external debt adopted in the IMF, it is advisable to classify the debt of the country only in those categories of the balance of investments that are not related to equity participation, that is, excluding direct investments and including reinvested earnings and securities ensuring participation in the capital

PRGF**	5-May, 2006	4-May, 2009	110,88	88,00
EFF	29-Jan, 2010	30-Apr, 2013	184.80	149.12
ECF	29-Jan, 2010	30-Apr, 2013	184.80	170.88
EFF	07-Nov, 2016	06-Nov, 2019	86.30	27.80
ECF	07-Nov, 2016	06-Nov, 2019	43.10	13.90

* STF was an interim IMF funding mechanism that provided assistance to member countries experiencing balance of payments difficulties caused by significant trade and payment system irregularities as a result of the transition from non-market trading practices to multilateral trade on a market basis.
** PRGF was replaced by ECF in 2009.
Source: IMF Republic of Moldova, 2017.

As of the end of November 2017, the total amount of outstanding loans and loans received from the IMF amounted to 261.3 million SDRs (about 370 million US dollars). The lack of sufficient funds to cover international obligations indicates the presence of serious internal imbalances. The volumes of outstanding loans together with a high share of debt in relation to GDP increase financial risks and reduce the potential for external borrowing of Moldova in conditions of acute shortage of financial opportunities for the implementation of reforms in a transforming economy.

The existing vulnerabilities caused both desirable and not desirable adjustments in the Moldova's economy. The desired adjustments in the opinion of the National Bank of Moldova include the redistribution of capital flows and the reduction of exchange rates, which help to alleviate the existing problems of competitiveness. Before 2013, FMI experts estimate the exchange rate of the Moldovan currency as overvalued. Moldovan leu began to depreciate rapidly against the major world currencies starting from 2014, with a loss of 34% of the value to the dollar for the year was registered in 2015. According to IMF experts (IMF Republic of Moldova, 2017), depreciation of the Moldovan leu leads to an increase in prices for goods and services. At the same time, the volatility of the national currency and the risk of excessive adjustment restrain investment and economic growth.

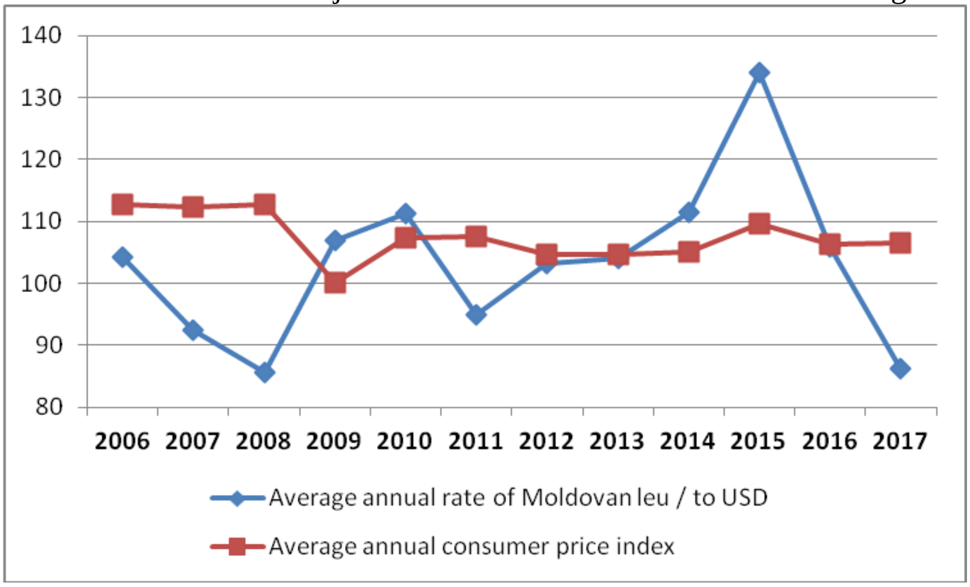

Figure no.5. The volatility of the Moldovan leu against the CPI, %
Source: calculated by the authors based on BNM and NBS data

The currency crisis of 2015 in the Republic of Moldova was manifested in fluctuations in the exchange rate of the Moldovan leu; decrease in the level of the country's foreign exchange reserves; loss of public confidence in the national currency; falling prices for domestic financial assets; a decrease in trust in state institutions and banks. As a result, cash savings could not be used to invest in the real sector of the economy, led to a breakdown in the country's financial system and financial instability in the economy.

The most important form of monetary regulation of BNM provides a stable level of inflation within the range of ± 1.5 pp from the target of 5%. Average annual price (CPI) increase in 2000-2009 was about 16.2%; in 2010-2011 7.5%; from 2012-2013 4.6%; in 2014 5.1%. In 2015, the growth of the CPI was 9.7%, exceeding the envisaged interval of targeting. Over the past 2 years, inflation was maintained at 6.4-6.7%. In transition economies in the long-term, inflation is approximately 50% dependent on the nominal effective depreciation of the national currency, by 40%: from unit labor costs and 10% from utility prices. Each percentage by which the money supply constitutes effective broad money exceeds the demand for the same money supply leads to an increase in inflation to 3.7% (МВФ Доклад по стране № 04/316). Increasing inflation increases credit risks and can cause further reduction of investments in the economy of Moldova.

Inflation is closely related to the dynamics of the money supply in circulation and the devaluation of the national currency. In turn, the dynamics of the exchange rate and the money supply are determined by the fluctuations of each other and the previous dynamics of inflation. The IMF estimates "the threshold level of inflation, above which inflation significantly slows growth, in 1-3% for industrialized countries, and for 11-12% for developing countries. Inflation and GDP growth are positively correlated if inflation is at low rates” (МВФ Доклад по стране № 04/316).

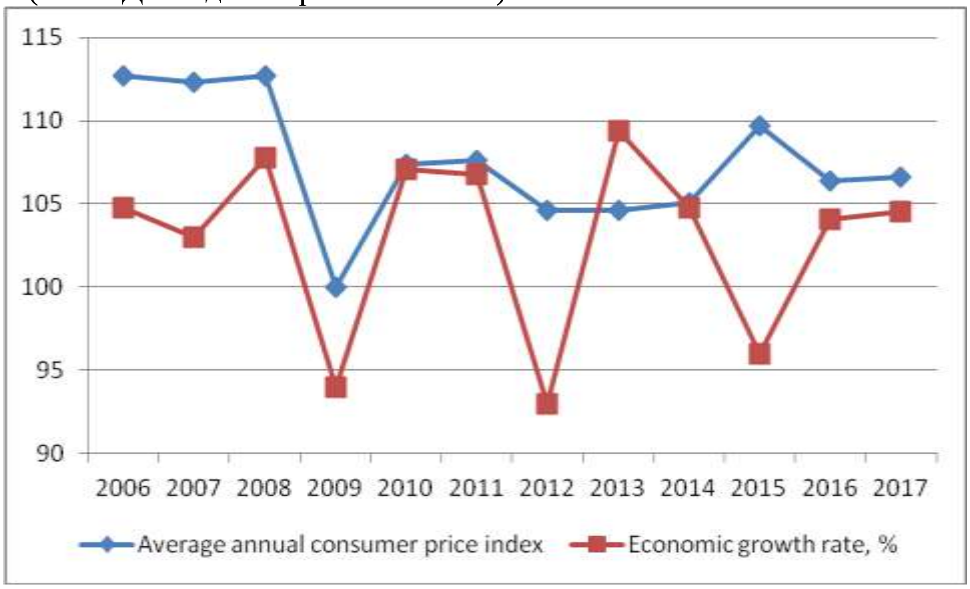

Figure no.6. Gross Domestic Product correlation with Consumer Price Index in the Republic of Moldova, 2006-2017, %

Source: calculated by the authors based on NBM data.

The existence of a model for the development of a labor-oriented economy, along with a weak financial system, makes the real sector vulnerable to external shocks and does not allow achieving sustainable economic growth. A significant amount of foreign currency causes a disproportionate increase in domestic demand. The growth of domestic aggregate demand increases imports. To the extent that this growth worsens the trade balance, it is a factor either of expanding the balance of payments deficit, or of the depreciation of the national currency.

Financial crises of recent years have caused the importance of timely information on the state of external assets and liabilities of the country as a significant indicator of external vulnerability. The imbalance of the current account of the balance of payments is a resource gap and is estimated by the size of the country's net investment position.

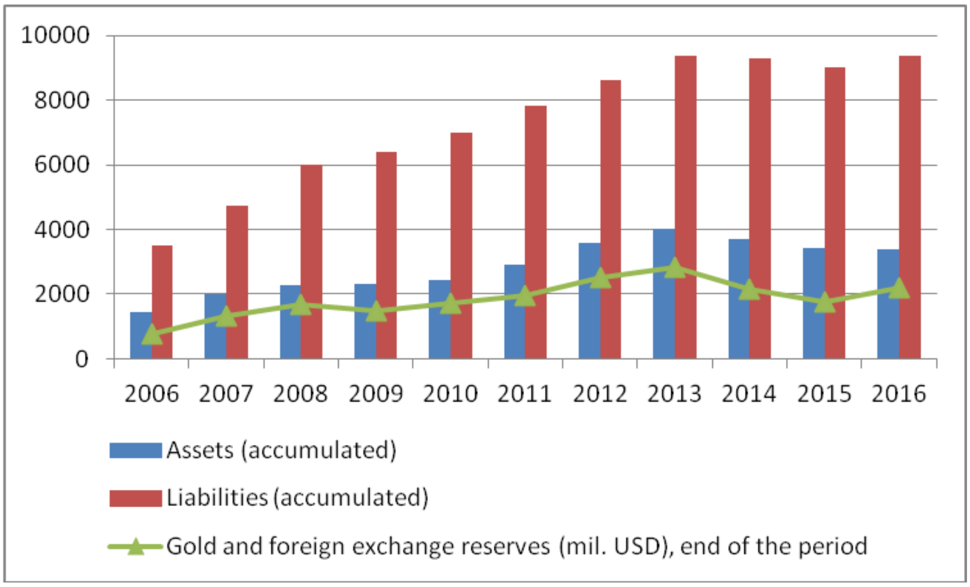

Figure no.7. Financial assets and liabilities, international investment position (IIP) of the Republic of Moldova, millions USD

Source: Source: calculated by the authors based on BNM data

The net international investment position (NIIP) (stock of external assets minus the stock of external liabilities) shows the difference between what the country owns and what it owes. "NIIP, in conjunction with the stock of the country's non-financial assets, constitutes the pure national wealth of the economy in question" (IMF, 2004).

Since 2013, the Republic of Moldova has seen a decline in the level of assets (mainly due to a reduction in the level of international reserves) and liabilities, including through a fall in the level of FDI in the national economy.

A high proportion of long-term foreign currency loans combined with the devaluation of the national currency caused an increase in unproductive loans, which led to serious liquidity constraints in the banking system. This, in turn, complicated the crisis of the monetary and financial system in 2015 and currently holds back the economic recovery of the Republic of Moldova.

4. Conclusions and contributions

The main risk factors for the instability of the external economic sector of the Republic of Moldova:

• Reduction of foreign exchange earnings (income from exports, remittances and foreign aid) leads to a decrease in consumption and investment, which in turn will lead to a reduction in overall government revenues.

• The current account deficit in the Republic of Moldova is significant, despite the support of the balance of payments from the IMF.

• The current account deficit reflects the increase in the country's debt to other countries. It is required to replenish it by selling goods for the currency or receiving stabilization loans.

• Unstable conditions of foreign trade do not stimulate export growth;

• The disincentive factor of exports is the discrepancy between the assortment of local products and European quality standards.
• Limited internal financial sources will be replaced largely by external resources; there is an increase in external debt and the related increase in budget expenditures for its repayment.

Thus, the existing threats of the external economic subsystem of the national economy of the Republic of Moldova are characterized by a high probability of the emergence of a new crisis situation. Political uncertainty also creates risks for reform and reorientation of economic policy programs, including in connection with the upcoming elections.

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