Council of the
European Union

Brussels, 19 April 2024
(OR. en)

8974/24

ECOFIN 458
UEM 99
COEST 264
ELARG 51

COVER NOTE

From:	Secretary-General of the European Commission, signed by Ms Martine DEPREZ, Director
date of receipt:	12 April 2024
To:	Ms Thérèse BLANCHET, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2024) 114 final
Subject:	COMMISSION STAFF WORKING DOCUMENT ECONOMIC REFORM PROGRAMME OF THE REPUBLIC OF MOLDOVA (2024 - 2026) COMMISSION ASSESSMENT

Delegations will find attached document SWD(2024) 114 final.

Encl.: SWD(2024) 114 final

EUROPEAN
COMMISSION

Brussels, 12.4.2024
SWD(2024) 114 final

COMMISSION STAFF WORKING DOCUMENT

ECONOMIC REFORM PROGRAMME

OF

THE REPUBLIC OF MOLDOVA
(2024 - 2026)

COMMISSION ASSESSMENT

Moldova submitted its first Economic Reform Programme (ERP) 2024-2026 on 15 January 2024. Moldova's first ERP submission includes the macro-fiscal framework, while information on structural challenges and reform plans were optional and not included this year. This is Moldova's first ERP after it was granted candidate status in June 2022. The ERP was endorsed by the Inter-ministerial Committee for Strategic Planning on 15 January 2024.

Table of contents

1. Executive summary

The Moldovan economy started to turn the corner in 2023 after five consecutive quarters of contraction, and the ERP projects a gradually strengthening recovery over the programme period 2024-2026. Moldova was significantly affected by the Russian war of aggression against neighbouring Ukraine as well as a severe drought in 2022 and the ensuing energy and food price shocks. These events severely diminished households' purchasing power, eroded investor confidence and undermined export growth. Growth returned in the third quarter of 2023, on the back of a strong rebound in the agricultural sector (following the severe drought in the previous year) and significant expansion in the IT industry, which has emerged as one of the most dynamic sectors in the economy since 2022. The ERP, the first submitted by Moldova since it became an EU candidate country in June 2022, projects real GDP growth of 3.5% in 2024 on the back of continued strong agricultural exports and growing private consumption as real wages continue to recover. The ERP projects that the recovery will accelerate in 2025 and 2026. The outlook suggests continued improvements in labour market outcomes, characterised by a persistently low employment rate and high levels of informal employment. Inflation surged in 2022 before decelerating almost as rapidly in 2023, thanks to falling global food and energy prices and a timely monetary policy response. It has now returned to the central bank's target range of 5% $^{+}$/- 1.5 percentage points and is expected to remain there over the course of the forecast horizon (i.e. until the end of 2026). The easing of monetary policy, which started at the end of 2022, should also support the recovery while fiscal policy focuses on gradually correcting the high general government deficits. Although the ERP does not present projections for the development of the current account balance, the Commission's 2023 autumn forecast projected that Moldova's current account balance would decrease, due to lower energy import prices and somewhat stronger growth in external demand in the coming years. The scenario presented in the ERP is plausible though subject to a number of significant downside risks related to developments in neighbouring Ukraine, the country's continued vulnerability to energy price shocks and weaker growth prospects in the country's main trading partners.

The ERP plans a gradual and front-loaded reduction of the deficit as the economic recovery takes hold, targeting a deficit of 4.6% of GDP in 2024 which will narrow further in 2025 and 2026. Moldova's public finances significantly deteriorated in 2023 (a deficit of 5% of GDP compared with 3.2% of GDP in 2022), reflecting weak growth and the high cost of measures to support households. Nevertheless, the budgetary outcome was significantly better than the planned deficit of 5.9% of GDP. This was largely due to (i) under-execution of expenditure and revenue overperformance due to high inflation; and (ii) the overestimated negative impact of a sizeable tax relief for small and medium-sized enterprises implemented from 2023. This negative impact has not yet materialised and constitutes a risk for 2024. After the slight reduction in the deficit (compared to the outturn) in 2024, the ERP projects more significant falls in the future, dropping to 3.8% in 2025 and 3.4% in 2026. Although the ERP does not present an estimate of the cyclically adjusted deficit, fiscal policy in 2024 and 2025 appears to appropriately balance the need to correct high deficits with the objective of supporting the nascent recovery. The bulk of the adjustment will be on the expenditure side, as support to households to mitigate the impact of high energy prices is phased out or made more efficient and better targeted. In 2025 and 2026, revenues will decline less quickly as a share of GDP than expenditure, though changes to the tax regime for cars and a new tax expenditure to support SME investment are set to undermine revenue growth towards the end of the forecast horizon. Crucial growth-enhancing public capital expenditure continued to be under-executed in 2023, albeit by less than in previous years, and a promising public investment management reform underpins the ERP's projections of increased investment in 2025 and 2026. After peaking at 37.2% of GDP in 2023, the public debt ratio is expected to fall slightly in 2024 followed by steeper reductions in 2025 and 2026, in part on account of the narrowing primary deficit and stronger economic growth. A relatively large share of public debt (60%) is denominated in foreign currency, which exposes public finances to exchange rate risks. However, a large part of the debt has been extended by multilateral creditors at highly favourable terms.

The main macro-fiscal challenges facing Moldova include the following:

- **Fiscal policy will need to increase much-needed public investment to support the nascent economic recovery and at the same time ensure fiscal sustainability via a fiscal adjustment that protects growth-enhancing spending.** Moldova faces a range of significant macroeconomic risks, including those related to Russia's war of aggression against Ukraine and energy supply risks that have recently re-emerged. The planned reduction of the fiscal deficit is therefore helpful in building buffers to mitigate future risks to the public finances. Public investment, although set to increase steadily from 2024 to 2026, remains well below the EU average and substantially below the level required to accelerate the country's convergence to EU income levels, in part due to persistent under-execution. The planned increase in public investment is underpinned by the expected implementation of the 'single project pipeline' (a key reform to the public investment management system) throughout the programme period. There is also scope to improve Moldova's capacity to produce macroeconomic and fiscal forecasts, including the cyclically adjusted fiscal balance, in order to better inform fiscal policy in light of the business cycle.

- **Given the limited fiscal space and competing spending priorities, public finance management reforms offer scope to broaden the revenue base and improve the efficiency of public expenditure.** To that end, the authorities plan to continue to pursue progress on the public finance management strategy for 2023-2030, in particular through measures to improve tax compliance and broaden the tax base. Tax expenditure reform is expected to identify measures to be phased out. Spending reviews, another relevant tool to create fiscal space, have seen uneven progress in recent years. The authorities are currently finalising a review of healthcare spending. Publishing the report following this review and setting out a clear implementation plan for reforms to healthcare spending would support the credibility of the authorities' efforts and strengthen the process for reviews in other major areas of expenditure. Similarly, assessing the efficiency of programmes which support access to finance for businesses, which remains persistently low, would ensure that they are more effective and represent good value for money. Last but not least, Moldova grapples with a large and loss-making sector of state-owned enterprises, which appear not to be adequately captured in the perimeter of general government at present. The authorities embarked on an ambitious reform of the sector in 2023. Progressing with further implementation steps in 2024, in particular on implementing the results of the 'triage' exercise and governance reforms, would be important for mitigating the fiscal risks and creating a level playing field for all businesses.

Moldova is facing a number of structural challenges as it seeks to promote inclusive growth, competitiveness and convergence with EU income levels.

Even though Moldova did not yet include a section on structural reforms in its first ERP as this was voluntary, the Commission has drawn on its long-standing engagement with the country, including through different macro-financial assistance operations as well as the 2023 enlargement report, to identify some of the major structural challenges that Moldova faces. Firstly, persistently low levels of public investment remain a major obstacle that prevents the country from meeting its large investment and infrastructure needs. In addition, labour force participation remains very low, and the shortage of skilled labour and skills mismatches, along with a large informal sector, represent a major bottleneck for businesses and foreign investors. Despite impressive efforts to mitigate the implications of the recent energy crisis, the developments in the energy sector continue to pose significant risks to public finances. Finally, following a short but strong recovery after the pandemic, Russia's war of aggression against Ukraine has had a strong negative impact on investment sentiment in Moldova, compounding pre-existing challenges linked to corruption, the rule of law, low levels of economic diversification and low-quality public services.

2. ECONOMIC OUTLOOK AND RISKS

The Moldovan economy started to turn the corner in 2023, with growth rebounding in the third quarter of the year after five consecutive quarters of contraction. Real GDP grew by 0.7% in 2023 according to the official preliminary estimate. The economy has been heavily impacted by a series of compounding shocks, in particular to energy and food prices. These shocks include an energy crisis beginning in late 2021, the start of Russia's full-scale war of aggression against Ukraine, and a severe drought in 2022. Despite the timely response of fiscal and monetary policy, these developments triggered economic uncertainty and high inflation, both of which weighed on demand. Output in the first half of 2023 fell by 2.3% year-on-year as falling real wages continued to weigh on private consumption, and agricultural exports suffered following the poor harvest in 2022. However, real GDP grew by 2.6% year-on-year in the third quarter largely thanks to a stronger harvest in 2023 driving growth in exports while imports continued to lag. Real wages, having continued to fall in the first quarter of 2023, began growing in the second quarter of the year on the back of quickly falling inflation. This contributed to slight year-on-year growth in household consumption in the fourth quarter, the first in nearly two years. As a result of the sharp decline in inflation, the central bank began cutting interest rates in a series of seven steps from a peak of 21.5% in December 2022 to 3.75% in March 2024. The current account balance improved strongly in 2023 to a deficit of 11.9% of GDP, having narrowed by over 5 percentage points compared to 2022 due to depressed demand for imports and lower energy prices.

The ERP presents a steadily strengthening economic recovery, with real output growth of 3.5% in 2024 accelerating to 4.0% in 2025 and 4.2% in 2026. Growth in 2024 is set to be driven primarily by private consumption, as real incomes recover thanks to inflation stabilising within the central bank's inflation target and lending picking up modestly in the context of accommodative monetary policy. The ERP projects that a recovery in investment will support stronger growth in 2025 and 2026, though stronger private investment is contingent on a stabilisation of the situation in neighbouring Ukraine. The ERP presents a gradually narrowing negative output gap in 2023 and 2024, before closing in 2025 and turning positive in 2026.

The macroeconomic scenario presented in the ERP is plausible though subject to downside risks related to the high uncertainty about the further economic fallout from Russia's full-scale war of aggression against Ukraine, energy dependencies and growth prospects in the country's main trading partners. While real GDP growth in the fourth quarter of 2024 was slower than implied in the scenario, this was driven by changes in inventories, whereas household consumption and investment nevertheless posted year-on-year growth. The scenario relies in part on a strong uptick in investment in 2025 and 2026. Reforms in train to improve the execution of the government's capital budget may support public investment in those years. Nevertheless, it is likely to take time before the impact of those reforms can be fully seen. A strong increase of private investment will depend heavily on developments in Ukraine, though private investment will also be supported by lower interest rates thanks to the disinflation that took place in 2023 as well as a number of government business-support programmes.

The ERP scenario is broadly aligned with the Commission's autumn forecast 2023 though the ERP assumes a slightly weaker growth in 2024 and 2025. The divergences reflect both different, but still plausible assumptions about the strength of exports and the responsiveness of imports to final demand growth, as well as the authorities' lower planned public investment in 2024 compared to 2023.

Starting from a weak initial situation, the labour market has shown modest improvements over the past year, though the labour market participation rate remains well below the regional average. Improvements were marked by a 2.8 percentage point year-on-year increase in the employment rate to 44.1% in Q3 2023, largely driven by an employment increase in agriculture thanks to favourable weather conditions in 2023 compared to the drought in 2022. The labour force participation rate exhibited a similar increase, though fell back slightly in the fourth quarter of 2023 to 44.7%. Unemployment increased slightly to 4.9% at the end of 2023. While unemployment remains low it now is well above the levels before Russia's full-scale invasion of Ukraine. Other factors which may have led to improvements in the last 2 years may include the return of workers from Russia and Ukraine and the impact of Ukrainian refugees, contributing to a 1% boost in the labour force in the first half of 2023.

Looking ahead, the ERP projects minor increases in the employment rate throughout the reporting period, primarily supported by a positive economic outlook and rises in nominal wages boosting overall demand in the economy. The projected employment rate of 44.8% in 2026 is in line with the government's objective of reaching a 45% employment rate, which appears within reach considering the strong outturn of Q3 2023.

Table 1

Moldova - comparison of macroeconomic developments and forecasts

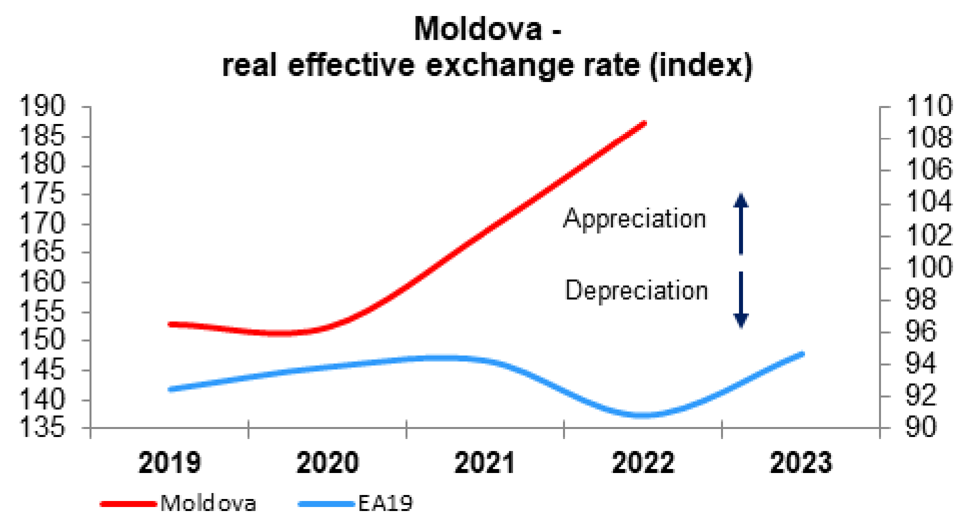
	2022		2023		2024		2025		2026	
	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**	COM	**ERP**
Real GDP (% change)	-5.0	**-5.0**	1.7	**2.0**	3.8	**3.5**	4.1	**4.0**	n.a.	**4.2**
Contributions:										
- final domestic demand	-6.1	**-6.2**	2.9	**1.7**	4.5	**4.0**	5.2	**4.2**	n.a.	**4.6**
- change in inventories	2.1	**2.2**	0.2	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- external balance of goods and services	-1.0	**-1.0**	-1.4	**0.4**	-0.8	**-0.5**	-1.1	**-0.2**	n.a.	**-0.4**
Employment (% change)	2.2	**2.1**	4.0	**:**	0.8	**:**	1.4	**:**	n.a.	**:**
Unemployment rate (%)	3.1	**3.2**	4.0	**:**	3.8	**:**	3.5	**:**	n.a.	**:**
GDP deflator (% change)	18.6	**19.3**	13.2	**11.6**	6.3	**5.8**	5.2	**6.3**	n.a.	**6.3**
CPI inflation (%)	28.7	**28.7**	13.4	**13.6**	4.7	**5.0**	5.1	**5.0**	n.a.	**5.0**
Current account balance (% of GDP)	-16.6	**-17.4**	-13.4	**:**	-11.7	**:**	-10.8	**:**	n.a.	**:**
General government balance (% of GDP)	-3.3	**-3.2**	-5.7	**-5.9**	-4.6	**-4.6**	-3.5	**-3.8**	n.a.	**-3.4**
Government gross debt (% of GDP)	32.9	**35.0**	35.3	**37.2**	37.5	**37.0**	37.4	**35.9**	n.a.	**34.2**

Sources: Economic Reform Programme (ERP) 2024, Commission Autumn 2023 forecast.

Inflation has been on a downward trend throughout 2023, falling steeply from 28.7% on average in 2022 to 13.4% in 2023. In response to the surge in inflation in 2022, the National Bank of Moldova increased its base rate to a peak of 21.5% in August 2022. Easing inflationary pressures subsequently allowed for a series of rate cuts starting in December that year, ultimately bringing the base rate to 3.75% in March 2024. Inflation re-entered the central bank's target range of 5% $^{+}/_{-}$ 1.5 percentage points in October 2023, with the deceleration driven in particular by falling food and energy prices as well as the appreciation of the leu. The ERP expects average inflation to continue to fall in the first half of 2024 given (i) the continued decline in imported inflation (including through lower energy prices); (ii) relatively moderate domestic demand; and (iii) further declines in food prices due to the stronger harvest. Inflation is expected to tick up again in the second half of 2024 as domestic demand picks up, and in particular as government support to households to pay energy bills diminishes and certain administered prices for electricity increase. The central bank projects inflation to then continue to decline modestly in the first three quarters of 2025 where the central bank's inflation forecast horizon ends.

The ERP does not present projections for the development of the current account balance, where developments in 2023 suggest a narrowing but still significant deficit. The Commission's 2023 autumn forecast projected a current account deficit of 13.3% in 2023, narrowing to 11.7% in 2024 driven in particular by lower energy import prices and stronger export growth as a result of the successful harvest in 2023, with the deficit narrowing further to 10.8% in 2025. Remittances as a share of GDP are projected to remain relatively high, albeit at a significantly lower level than before 2022. Moldova's current account balance is structural, reflecting its strong reliance on agricultural and low value-added manufacturing exports as well as its dependence on energy imports. The recent significant worsening was primarily due to the surge in the price of imported energy, and while Moldova has taken significant steps to improve energy security, its vulnerability to price fluctuations remains significant.

The ERP suggests that there has been a significant decline in price and cost competitiveness in 2023 and that the leu is significantly overvalued. Wages have risen steadily in recent years and the real effective exchange rate (REER) has been on a consistent upward trajectory since 2015-2016. Average nominal earnings increased by 15.5% annually in 2022, though this increase was overtaken by skyrocketing inflation in 2022 leading to a sharp decline in real wages by about 13%. Both minimum wages and public sector salaries further increased in 2023 while inflation has been declining, leading to a slight recovery of real wages by 3.4%. Modest productivity growth could not compensate for the higher real wages resulting in a general increase in unit labour costs. The rise in unit labour costs in Moldova has outpaced rises in regional neighbour countries, although unit labour costs in Moldova remain below the regional average. The sharp increase of the REER starting in Q2 of 2021 partly reflected the Balassa-Samuelson effect (i.e., an adjustment of the equilibrium REER for Moldova as a catching-up economy). The productivity differential with Moldova's main trading partners was gradually declining until the end of 2021, suggesting a catching up process. However, the ERP suggests a large REER gap in recent years reaching a peak in the second half of 2023. This, in fact, suggests that the leu is overvalued. The latest IMF estimations suggest an overvaluation of the leu of about 22% in 2022. Moldova's share of world exports increased only very marginally between 2016 and 2022. The steep increase in the REER last year could weigh on Moldova's exports more heavily in the coming years. Moldova's exports continue to be characterised by labour-intensive and low-productivity sectors such as agricultural outputs and textiles. This underscores the relevance of price and cost competitiveness especially in the short run. In recent years high productivity ICT services have become a more significant share of Moldova's exports, a trend which, if sustained, could help make its export base less sensitive to price/cost competitiveness.



Source: Economic Reform Programme (ERP) 2024 and ECB.

The mainly foreign-owned banking sector remained stable throughout the pandemic and ongoing geopolitical crisis. Bolstered by a series of measures taken by the central bank in response to a major banking fraud in 2014, the capital adequacy, liquidity and profitability of commercial banks have remained elevated or have risen in recent years. As of Q3 2023, capitalisation, at 30%, remains well above the regulatory minimum, and the liquidity coverage ratio, at 256%, exceeds the prescribed 100% limit by a large margin. This is partly driven by remaining legacies from the aftermath of the bank fraud case. Two banks, for instance, still hold additional sizeable capital and liquidity buffers against potential losses from ongoing litigation. In addition, reserve requirement ratios were increased in 2022 to counter inflation. They were then relaxed in 2023 in response to falling inflation though not returning to pre-2022 levels. This slight relaxation did not yet lead to increased lending to the private sector. The sector's increased profitability in recent years can primarily be attributed to the growth in interest income and fees. The ERP outlines a set of amendments to the legal framework to support financial stability and intermediation while further aligning its legal framework to the EU acquis.

Bank lending to households and businesses is at a relatively low level. While both credit and deposit growth have been volatile in recent years, deposits, especially in domestic currency, recorded the highest growth in 2023 since 2019. Conversely, credit growth experienced its lowest increase of less than 4% reflecting the sluggish recovery and still high uncertainty. This led to a decline in the loan-to-deposit ratio to 56.1% the lowest level in the last 5 years. According to the IMF, credit to the economy is projected to stand at a relatively low 21.4% of GDP, a decrease by 1.9 percentage points from 2022. Currency substitution is declining, with the share of deposits held in foreign currencies further declining by 3 percentage points to 36.8% in 2023. The share of non-performing loans (NPLs), continued to decline in 2023, falling by 0.8 percentage points from 6.4% in 2022 (due to a drop in the last quarter of 2023), possibly reflecting the slight economic recovery towards the end of the year. Both supply of and demand for credit are being hampered by uncertainty about the future impacts of Russia's war of aggression in Ukraine and the economic outlook coupled with new regulations about responsible lending. In addition, the lack of bankable businesses and the high level of informality in the economy further limits credit to the private sector. The government has, however, taken decisive steps to improve access to finance through several support programmes providing guarantees as well as interest subsidy measures. The impact of such programmes in the current context is still to be evaluated, including the risks of contingent liabilities.

Table 2:

Moldova - financial sector indicators

	2019	2020	2021	2022	2023
Total assets of the banking system (EUR million)	4708.0	4912.0	5897.4	6446.2	7952.5
Foreign ownership of banking system (%)	87.1	86.6	86.6	88.9	88.9
Credit growth (%, aop)	13.9	13.1	23.5	9.4	3.7
Deposit growth ** (%, aop)	7.7	16.5	13.1	5.4	19.9
Loan-to-deposit ratio *** (%, eop)	59.1	57.3	62.6	64.9	56.1
Financial soundness indicators (%, eop)					
- non-performing loans to total loans	8.5	7.4	6.1	6.4	5.6
- regulatory capital to risk-weighted assets	24.8	27.3	25.9	29.2	30.0
- liquid assets to total assets	50.6	50.7	48.6	52.2	54.5
- return on equity	14.6	8.7	12.3	17.0	16.3
- foreign exchange loans to total loans	33.3	30.5	26.5	30.5	25.8

* Q3.
** Total deposit growth.
*** Non-interbank loans to customer deposits.
Sources: National Bank of Moldova

3. Public finances

The under-execution of expenditure, together with a less significant revenue overperformance, led to a budget deficit of about 5.0% of GDP in 2023, significantly better than the planned deficit of 5.9%. Revenue overperformance compared to the 2023 amended budget was driven in particular by corporate income tax and excise duties which offset shortfalls in VAT and grants. The ERP does not provide an analysis for this general overperformance, though it may reflect weaknesses in revenue projections in the context of high inflation. In particular, the expected negative impact of a new 0% tax rate on reinvested SME income did not materialise in 2023, having been estimated at MDL 1.2 billion or about 2% of total tax revenue. The ERP now expects this negative impact to extend into the next 2 fiscal years. Strong performance from the above-mentioned revenue categories compensated for a shortfall in the level of grants from foreign donors. Compared to the outturn in 2022, revenue excluding grants was 9.5% higher in 2023 as a result of (i) a mix of tax increases, in particular in excise duties in accordance with commitments under the EU-Moldova Association Agreement; and (ii) underlying factors including rising public sector wages and high inflation.

Expenditures, both current and capital, were under-executed compared to the amended 2023 budget. General government current expenditure was 96% of the revised 2023 budget, with shortfalls in particular in goods and services but also the wage bill. More detailed breakdowns of expenditure outturn by policy sector are not yet available. More importantly, central government capital expenditure (i.e. excluding local government capital expenditure for which consolidated data are not yet available) was 83.4% of the amended 2023 budget, a significant shortfall but an improvement compared with 2022 reflecting more realistic spending targets including a downward revision in the amended budget in 2023. Compared to 2022, total expenditure was significantly higher (18%) driven in particular by much higher social transfers in the form of compensation for households to mitigate the impact of the energy crisis. In addition, public sector wages increased significantly in 2023, and interest payments nearly doubled due to higher rates on foreign loans and higher issuance of T-bills.

Table 3

Moldova - composition of the budgetary adjustment (% of GDP)

	2022	2023	2024	2025	2026	Change: 2023-26
Revenues	33.4	32.9	31.3	30.8	29.9	-3.5
- Taxes and social security contributions	30.0	29.3	29.2	29.1	28.3	-1.7
- Other (residual)	3.3	3.6	2.1	1.7	1.5	-1.8
Expenditure	36.6	38.8	36.0	34.6	33.3	-3.3
- Primary expenditure	35.6	37.0	34.4	33.3	32.0	-3.6
of which:						
Gross fixed capital formation	1.2	1.2	1.0	1.5	1.7	0.5
Consumption	:	:	:	:	:	:
Transfers & subsidies	16.0	16.6	15.2	14.8	14.2	-1.8
Other (residual)	18.4	19.3	18.2	17.0	16.1	-2.3
- Interest payments	1.0	1.8	1.5	1.3	1.2	0.2
Budget balance	-3.2	-5.9	-4.6	-3.8	-3.4	-0.2
- Cyclically adjusted	:	:	:	:	:	:
Primary balance	-2.2	-4.2	-3.1	-2.5	-2.1	0.1
- Cyclically adjusted	:	:	:	:	:	:
Gross debt level	35.0	37.2	37.0	35.9	34.2	-0.8

Sources: Economic Reform Programme (ERP) 2024, Commission calculations.

The ERP presents a fiscal strategy which aims to increase much-needed public investment to support the nascent economic recovery and at the same time ensures fiscal sustainability via a fiscal adjustment that protects growth-enhancing spending. The ERP projects a gradual, though front-loaded, narrowing of the deficit, to

4.6% of GDP in 2024 and to 3.8% in 2025, with a smaller decline to 3.4% in 2026. Revenue as a share of GDP is expected to shrink steadily from 32.9% of GDP in 2023 to 29.9% in 2026, driven by lower reliance on donor funding and a revenue-decreasing reform of car taxation in 2026. Expenditure is projected to decline more quickly as a share of GDP over this period, driven in particular by slower nominal growth in both the wage bill and social transfers. The latter reflects in part the phasing out and better targeting of compensation for high energy bills in 2024. The ERP projects a decline in public investment in 2024, in part reflecting more realistic targets as a result of a new effort to reform public investment management which strengthens the role of the Ministry of Finance in ensuring that projects included in the annual budget are mature. Public investment is projected to begin increasing again in 2025 and 2026. The ERP does not provide an estimate of the cyclically adjusted balance. However, considering the large positive output gap expected in 2026, and what was only a slight decrease in the headline deficit in that year, the projected fiscal stance might result in a pro-cyclical fiscal expansion in that year.

Expenditure measures in the 2024 budget include several potentially growth-enhancing measures to improve the efficiency of spending, although the ERP only provides estimates of the quantitative impact of a few of these measures**.** Better targeting of the Energy Vulnerability Reduction Fund to reach the most vulnerable parts of the population and a move away from covering energy bills to income support is expected to improve the efficiency of the fund. This will possibly lead to lower expenditure, while all other social protection expenditures previously covered by local budgets will be centralised under the national government. An additional spending measure in 2024 will increase the one-off childbirth allowance. Among other professions, teachers' salaries will be increased significantly following central government salary increases in previous years. Public investment ([1]) is projected to reach 2.4% of GDP reflecting a decrease compared with 2023, possibly indicating a more realistic planning of the capital budget, bringing it back to its pre-pandemic level and below regional peers. Support for business remains a key priority, with several measures aiming to promote investments and access to finance such as the '373' interest subsidy programme and the Credit Guarantee Fund.

Revenue measures for 2024 are expected to be relatively minor, with the exception of a tax expenditure to support investment by SMEs which was implemented in 2023 but the impact of which is expected now in 2024 and future years. The introduction of the 0% tax on non-distributed income for SMEs introduced in 2023 was expected to lead to a revenue loss amounting to 0.4% of GDP, which did not occur. Nevertheless, this impact is now expected in 2024 and 2025 instead. The ERP does not provide an estimate of the impact of the new customs code which came into force on 1 January 2024. However, the 2024 budget incorporates a decline in revenue from customs duties compared to 2023 amounting to about 0.1% of GDP. The ERP does not provide

---

1 Public investment is defined as the acquisition of fixed assets by the general government (item 31) in the annual budget execution reports of the national public budget.

cost estimates for the other revenue and expenditure measures for 2024, nor does it describe how these measures align with the government's priorities. For 2026, the ERP presents a significant drop in excise duties as a share of GDP resulting from the change in the taxation of cars from the excise regime to the VAT system.

The 2024 budget

Following the presentation of the draft budget on 1 December 2023, the 2024 budget was adopted by the Moldovan Parliament on 22 December 2023. According to the annual budget calendar, the government is supposed to submit the draft budget by 15 October and parliament should adopt it by 1 December. The 2024 budget aims to achieve a fiscal deficit of 4.6% of GDP and a primary deficit of 3.1% of GDP.

The budget provides for a 10-15% salary increase for teachers, police officers and workers in the judiciary. Compensation of energy bills through the Energy Vulnerability Reduction Fund will continue, albeit at lower amounts and with better targeting. The one-off allowance for the birth of a child will be increased.

Total revenue is expected to fall to 31.3% of GDP in 2024 due to a sharp decline in grant revenues (from 2.2% of GDP in 2023 to 0.7% of GDP in 2024) and a fall in foreign trade taxes as a result of the new customs code. Total expenditure is expected to fall to 35.9% of GDP, driven in part by savings on measures that had been implemented to support households and businesses facing elevated energy bills in 2022 and 2023.

After peaking in 2023, the public debt ratio is expected to fall slightly in 2024 followed by steeper reductions in 2025 and 2026. The debt ratio grew by 2.2 percentage points to 37.2% of GDP in 2023, driven by the large primary deficit and higher interest payments on short-term domestic debt, with inflation helping to mitigate the increase. The ERP projects a backloaded reduction in the public debt, beginning with a modest decline of 0.2 percentage points in 2024 before falling more steeply in 2025 (by 1.1 percentage points) and 2026 (by 1.7 percentage points). This decline is primarily driven by the deficit reduction in these years as well as by projected lower interest rates on domestic debt as monetary policy eases. The large stock-flow adjustment contributing to the falling public debt ratio throughout the ERP time horizon is not explained.

Although most of Moldova's public sector debt stock was extended on concessional terms by multilateral lenders, there was a modest increase in the share of domestic borrowing in 2023. A large share (59.5%) of Moldova's debt is denominated in foreign currency, contributing to significant exchange rate risk. At the same time, the average maturity (8.9 years) and conditions of the external public debt are favourable given that currently about 60% of public debt is owed to multilateral institutions including the IMF, the World Bank and the EU. Debt repayment needs on external debt will increase moderately in 2024 in part due to a revolving loan from the EBRD in 2022 to both finance emergency gas supplies and build up a strategic gas reserve. Domestic debt issuance continues to consist largely of T-bills maturing within 1 year due to the underdeveloped domestic financial market and prohibitively high interest rates in the last year, though the government's debt management strategy includes plans to extend the average maturity of domestic debt to deepen the market for government debt and facilitate domestic finance. The first successful issuance of a 10-year domestic bond took place in September 2023. Interest rates on longer-term government debt have fallen sharply over the course of 2023 as a result of monetary policy easing, with the rate on 2-year bonds falling from 13% in January 2023 to 5.5% in January 2024.

Table 4

Composition of changes in the debt ratio (% of GDP)

	2022	2023	2024	2025	2026
Gross debt ratio [1]	35.0	37.2	37.0	35.9	34.2
Change in the ratio	2.5	2.2	-0.2	-1.1	-1.7
Contributions [2]:					
1. Primary balance	**2.2**	**4.2**	**3.1**	**2.5**	**2.1**
2. 'Snowball effect'	**-3.1**	**-2.4**	**-1.6**	**-2.1**	**-2.1**
Of which:					
Interest expenditure	1.0	1.8	1.5	1.3	1.2
Growth effect	1.4	-0.6	-1.2	-1.3	-1.4
Inflation effect	-5.5	-3.6	-2.0	-2.1	-2.0
3. Stock-flow adjustment	**3.3**	**0.4**	**-1.7**	**-1.5**	**-1.7**

[1] End of period.

[2] The 'snowball effect' captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).
The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets, and valuation and other effects.

Source: Economic Reform Programme (ERP) 2024, Commission calculations.

Major sources of risk to the public finances are related to the possible interruption of the current arrangement for natural gas supply from Russia to the Transnistrian region as well as Moldova's vulnerability to economic shocks related to Russia's war of aggression in Ukraine and climate change. In 2023, the authorities agreed a continuation of the deal reached in December 2022 under which the MGRES power plant, located in the Transnistrian region, will supply about 90% of Moldova's total projected volume of electricity supply in the summer period and 65% in the winter, when combined heat and power plants near Chișinău will provide the balance of demand. The price of supply remains unchanged at USD 66/MWh, below the prevailing average price in the EU. However, the MGRES power plant relies on free Russian gas which transits Ukraine to reach the Transnistrian region. The current Ukraine-Russia gas transit agreement expires at the end of 2024, and it is not clear whether it will be possible to continue to import Russian gas to the Transnistrian region after that point. A failure to continue gas shipments would likely have fiscal consequences due to increased electricity prices and possibly serious economic disruption to the Transnistrian region and Moldova at large. The authorities are examining the potential costs associated with this risk.

In addition, Moldova's economy continues to remain exposed to the effects of Russia's war of aggression against Ukraine. Although food and energy prices declined markedly over the course of 2023, investor and consumer sentiment – therefore to some extent economic growth – will depend on developments in neighbouring Ukraine. In addition, Moldova remains highly exposed to risks associated with climate change, namely drought and floods. Extreme weather events have led to significant losses in the past, including a 30% drop in agricultural production as a result of the drought in 2022.

Although the ERP itself does not provide an overview of fiscal risks nor a corresponding sensitivity analysis, the government publishes a fiscal risk statement with the annual budget. For 2024, the government has identified macroeconomic shocks and negative financial market developments as elevated risks, alongside the possibility that the government would need to bail-out state-owned enterprises, in a context in which 40% of state-owned enterprises reported losses in 2021 and many lack adequate corporate governance standards. The latest analysis of fiscal risks related to state-owned enterprises dates from 2021, though the authorities have been taking steps under the IMF programme to improve the financial reporting of state-owned enterprises to the Public Property Agency. The authorities have committed to including an assessment of climate-related risks in the next fiscal risk statement.

The ERP presents a number of credible improvements to the quality of public finances. On the expenditure side, the relatively low level of potentially growth enhancing public investment is set to steadily increase, in line with the recommendations of the first enlargement report for Moldova published by the Commission in November 2023. This would be facilitated by the ongoing reform of the public investment management system, namely the establishment of a 'single project pipeline' for all investment projects regardless of financing source, vetted by the Ministry of Finance, for inclusion in the medium-term budgetary framework and annual budget. Furthermore, the reform of the Energy Vulnerability Reduction Fund planned for 2024 will shift towards better targeted support and ensure that the model for support incentivises energy savings, leading to more efficient and effective expenditure. Finally, the authorities are finalising a spending review into the health sector which should identify opportunities to increase efficiency in an important area of spending which amounted to 5.5% of GDP in 2023.

On the revenue side, while efforts are ongoing to broaden the tax base by assessing and eventually eliminating certain tax expenditures, which are sizeable in Moldova, the ERP presents a number of measures which represent new tax expenditures. In 2022 and 2023, the authorities published a tax expenditure report focused on measuring foregone revenues. The report started in 2022 with income taxes and VAT and expanded to other taxes including excises, import duties and real estate tax in 2023. The authorities have committed to taking this analysis one step further by conducting a cost-benefit analysis of existing tax expenditures with a view to identifying measures to be phased out. However, the ERP presents measures for 2024 that seem to introduce new tax expenditures such as for certain luxury goods and deductions for expenditure by trade unions and employers' organisations.

The numerical fiscal rule is not respected, and while the conditions for activating the escape clause remain in place, the rule has been suspended for longer than the permitted period. The public finance law stipulates that the budget deficit, excluding grants, should not exceed 2.5% of GDP, though capital investment financed from external sources can be excluded from the deficit. In 2018 and 2019, this fiscal rule was respected, but since 2020 the escape clause has been activated on the grounds a decline in economic activity (2020-2021) and exceptional circumstances endangering national security (2022-2024), although according to the law the escape clause may only be activated for 3 years in a row. The planned budget deficits for 2025 and 2026 also exceed the numerical rule though not when excluding foreign-financed investment projects. The Ministry of Finance is now considering proposals to amend the fiscal rule which may be an opportunity to examine its appropriateness in promoting countercyclical fiscal policy. There are no immediate plans to set up an independent fiscal council given capacity constraints, though the authorities plan to re-examine the issue in 2026 (the previous analysis was done in 2015-2016).

4. KEY STRUCTURAL REFORM AREAS

Moldova's first ERP submission includes only the macro-fiscal framework, while information on structural challenges and reform plans were optional and not included this year. The Commission identified the following macro-relevant structural challenges in the 2023 enlargement report based on an independent analysis drawing on input and discussions with the authorities and other stakeholders.

Moldova continues to struggle to properly identify, prioritise, evaluate, cost and implement public investment projects, leading to continual under-execution of the budget set aside for this purpose. In 2022, Moldova executed only about 60% of its budgeted public capital investment expenditure. In 2023, the execution of capital investment improved, but foreign-financed projects remain at risk of under-execution due to a lack of capacity to comply with the procedures and public procurement processes of foreign donors, in particular international financial institutions. Difficulties executing public investment plans limit the country from adequately addressing its very large infrastructure needs, including those related to energy security, transport connectivity, and trade facilitation. A new regulation governing the identification, selection and appraisal of all public investment projects funded from any source (the ‘single project pipeline’) was adopted in October 2022.

Moldova was hit hard by an energy crisis in 2021 which worsened in 2022 as a result of Russia’s war in Ukraine. With support from international donors and the EU, Moldova has since made impressive efforts to reform its energy sector, adopting the EU energy law and diversifying its gas supply, leading to the phase out of gas imports from Russia. During the last heating seasons, the impact of the energy crisis on households was mitigated through the EU-funded Energy Vulnerability Reduction Fund that provided support to about 760,000 out of 1.3 million homes in 2022-2023. In 2023, the government improved the targeting of the programme to increase its efficiency. In addition, for the 2024-2025 heating season Moldova intends to delink the support from energy consumption, moving from covering energy bills to cash transfers thus incentivising energy savings. The country continues to benefit from electricity at stable and low costs produced by the power plant MGRES in the Transnistrian region (territory not under the control of the government of the Republic of Moldova). This power plant runs on highly subsidised Russian gas which poses a major security of supply risk. In the coming months, the government is expected to prepare an analysis on the fiscal impact of a possible interruption of natural gas supply used for electricity generation.

The shortage of skilled labour is a major issue for both private and public-sector employers, while labour force participation stands at a relatively low level and skills mismatches persist despite relatively high level of spending on education. The main reasons for low labour market participation include informal employment, (seasonal) work abroad, low salaries as compared to social benefits, the relevance of remittances, a mismatch between the skill level of the workforce and what employers require and high level of home childcare preventing female employment. In 2023, a concept note on reforming the National Employment Agency was adopted. The employment support law has been modified to incentivise those receiving social benefits to enter the job market. To increase female employment, the government has made significant efforts to increase childcare services and to provide more benefits for parents, i.e., more flexible and higher maternity allowances as well as paternity leave. In addition, the government is developing a programme to combat undeclared work, and, as of March 2023, unannounced inspections were allowed in cases of undeclared work. A new director of the State Labour Inspectorate has just been appointed and new inspectors have been hired.

State-owned enterprises play an important role in the economy, and necessary reforms are still in the early stages. There are approximately 900 state-owned enterprises, while out of those a large number exist on paper only. In 2023, a triage of about 180 central government state-owned enterprises took place categorising them among: 1) those to be kept in state ownership, 2) those to be privatised (either immediately or following restructuring), and 3) those to be liquidated. However, no concrete actions have yet been taken to implement the results. In addition, the government set out a plan to improve corporate governance of state-owned enterprises and accountability, notably by adopting a model code of governance. Further steps included legal changes to set up audit committees at state-owned enterprises and to allow independent board members as well as the introduction of a process to professionalise boards through an improved selection process.

Foreign direct investment (FDI) as share of GDP has been historically relatively low in Moldova. Following a short but strong recovery after the pandemic, Russia's war of aggression against Ukraine has had a strong impact on investment sentiment in Moldova, with most foreign investors halting their investment plans. Nevertheless, there are signs that the situation has been stabilising since the beginning of 2023. FDI, however, has been concentrated in Moldova's so-called free economic cones which benefit from special tax regimes with investments often having limited knock-on effect on the local economy. The government supports industry and technology parks to attract foreign and local innovative companies as well as high skilled labour. A new programme dedicated to FDI promotion and attraction is expected to be adopted in 2024. The main implementing agency, Moldova Invest, has been restructured several times undergoing the latest reform in 2023. Looking ahead, the main measures to attract FDI will need to include qualification of the labour force, administrative support and aftercare services. In addition, the upcoming national strategy for economic development is expected to provide a broader vision to guide economic policy making, including a clear focus on promoting FDI, while the forthcoming Growth Plan should set out strategic short- and medium-term reform and investment priorities critical for economic convergence.

ANNEX: COMPLIANCE WITH PROGRAMME REQUIREMENTS

The Economic Reform Programme 2024-2026 was endorsed by the Inter-ministerial Committee for Strategic Planning, chaired by the prime minister, on 15 January 2024 and submitted to the Commission the same day.

As agreed in advance with the Commission, the ERP consists of the macro-fiscal framework only, as Moldova did not submit the chapters on structural reforms for this first round. The macro-fiscal framework is missing a number of elements, namely an alternative macroeconomic scenario and the sections on the structural balance, sensitivity analysis, and the sustainability of public finances. The Moldovan authorities alerted the Commission in advance that capacity constraints would prevent them from submitting these sections for this first round.

Inter-ministerial coordination

The prime minister designated the Ministry of Finance as the national ERP coordinator. The finance ministry worked closely with the Ministry of Economic Development and Digitalisation, the Ministry of Labour and Social Protection, the National Bank of Moldova and the National Bureau of Statistics in the preparation of the ERP. The document was also shared with experts from the EU-funded technical assistance project team at the Ministry of Finance for their input. The inter-ministerial coordination worked well.

Stakeholder consultation

The draft ERP was sent to a leading independent Moldovan think tank for comments and suggestions. As the ERP contains only the macro-fiscal framework and not the structural reform chapters, the document was not submitted separately for public consultation this year.

Macroeconomic framework

The programme presents a clear and concise picture of past economic developments, though it is limited by a lack of available data for example in the presentation of current account developments. The presented framework is coherent and consistent, though it does not provide an alternative macroeconomic scenario, nor does it provide a forecast for the external or financial sectors.

Fiscal framework

The major policy documents underpinning the fiscal framework are listed, though the link between the fiscal framework and specific priorities could be made more explicit. The programme contains references to obligations under the EU-Moldova Association Agreement, though it does not yet make reference to recommendations from the first enlargement report published in November 2023.

Key revenue and expenditure measures are generally not costed; only 3 of the 20 listed measures identify the estimated fiscal impact of the measure in question. Budget implementation for 2023 is presented up to the end of October 2023, the latest available data at the time of drafting. Moldova's fiscal reporting does not follow ESA2010 standards, and therefore does not meet the Commission's fiscal notification requirements.