

## ECONOMY AND FINANCE

# TOP 5 THE MOST IMPORTANT POSITIVE AND NEGATIVE ECONOMIC AND SOCIAL DEVELOPMENTS IN 2021 AND CHALLENGES FOR 2022

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The most important positive economic and social developments in 2021 were the rapid economic recovery after the 2020 recession, the rising tax revenues and fiscal consolidation, solving the 'gas crisis' and establishing a more predictable framework in the energy dialogue with the Russian Federation and Gazprom, boosting the social agenda and, last but not least, maintaining the stability of the national currency and strengthening the country's foreign exchange reserves.



The positive developments have been overshadowed by a number of negative trends and events as following: rising inflationary pressure and its impact on the low-income households, perpetuating the high budget deficit planned for 2022, worsening of the decision-making quality, postponing of major reforms, and reduced functionality of some public institutions.



The main challenges for 2022 are promotion of systemic reforms in the context of limited financial, human and time resources; poverty risks on the background of inflationary trends; slowdown of economic growth under the conditions of rapid economic development in 2021; reappearance of the 'gas crisis'; and the pandemic in the context of low vaccination levels.



# Table of contents

<b>1.</b>	<b>TOP 5 POSITIVE ECONOMIC AND SOCIAL DEVELOPMENTS/ EVENTS IN 2021</b> .....	<b>2</b>
	1. Rapid economic recovery after the 2020 recession .....	2
	2. Increased tax revenues and budget consolidation .....	2
	3. “Gas crisis” management and establishing a more predictable framework in the energy dialogue with the Russian Federation and Gazprom .....	2
	4. Boosting the social agenda .....	3
	5. Stability of the national currency and strengthening of the country’s foreign currency reserves .....	3
<b>2.</b>	<b>TOP 5 NEGATIVE ECONOMIC AND SOCIAL DEVELOPMENTS/ EVENTS IN 2021</b> .....	<b>4</b>
	1. Increasing inflationary pressure .....	4
	2. Large budget deficits become a “new normal” .....	4
	3. Worsening of the quality of the decision-making process .....	4
	4. Postponement or non-initiation of major reforms .....	5
	5. Reduced functionality of some public institutions .....	5
<b>3.</b>	<b>TOP 5 ECONOMIC AND SOCIAL CHALLENGES IN 2022</b> .....	<b>6</b>
	1. Promoting systemic reforms given the limited financial, human and time resources .....	6
	2. Poverty risks in the context of inflationary trends .....	6
	3. The slowdown in economic growth amid rapid growth in 2021 .....	6
	4. Risk of a “gas supply crisis” .....	6
	5. Pandemic due to low vaccination levels .....	7

## 1

## TOP 5 POSITIVE ECONOMIC AND SOCIAL DEVELOPMENTS/ EVENTS IN 2021

### 1. Rapid economic recovery after the 2020 recession

After the most severe recession in 2020 (-7 percent), we expect an economic growth of about 8-9 percent in 2021, which will compensate for the losses in 2020. The main factors were: favourable agricultural year, improved economic conditions in the region, stimulative budgetary policy, as well as the stabilization of political situation. As a result, in addition to the 'traditional' factors fuelling the economic growth in Moldova such as the final consumption of households, the fairly rapid increase in asset investment (mainly in machinery and equipment) made by economic agents from their own sources or loans has also prefigured. However, this trend still does not reveal a qualitative change in the economic growth paradigm, being rather determined by the resumption of investment processes postponed in 2020 due to the pandemic restrictions, worsening of economic situation in the region, increased uncertainty on the background of political developments and, last but not least, the drought that has had a dramatic effect on the agricultural sector. Moreover, the data suggest that the economic recovery is taking place against the background of the growing trade and current account deficits, with imports growing faster than exports. In these circumstances, the rapid economic growth of 2021, which is compensatory, temporary and associated with the growth of macroeconomic imbalances, may turn from an opportunity in 2021 into a challenge for 2022-2023, anticipating a slowdown in the economic growth, which could also create certain challenges for the budget execution. In this regard, the economy needs tangible progress in attracting investment in infrastructure and high value-added economic activities with export potential.

### 2. Increased tax revenues and budget consolidation

The rapid economic growth of 2021 has reflected into an even faster increase in tax revenues. As of the end of October, the tax and fee revenues have increased by 25 percent compared to the corresponding period of the previous year. Given the

specificity of the economic model, which is mainly based on consumption covered by imports, the largest contribution to this increase was made by the VAT revenues on imported goods (+ 31 percent), the excise duties on imported goods (+ 16 percent), and the customs duties and other import duties (+ 29 percent). At the same time, the spendings have increased much more slowly than the revenues (+10 percent), which has created conditions for the public finance stabilization process. Thus, the budget deficit established at the end of October amounted to MDL 2 billion, being much lower than the level of MDL 12 billion planned for the end of 2021. Obviously, the implementation of the compensation mechanism for the gas tariff, the increase of the minimum pension and other infrastructure projects will increase the spendings and the budget deficit by the end of the year. However, we can see the creation of favourable conditions for a lower budget deficit by the end of the year than planned. The EU financial assistance in the form of grants, aimed in particular at mitigating the effects of the rising energy prices (related to natural gas), is an important helping factor in ensuring the stability of public finances. In addition, an unfavourable side of this phenomenon is the under-execution of many economically and socially important expenditures/ commitments (eg grants, infrastructure projects), due to failures in the budget management and public procurement - a challenge that will remain valid in the future.

### 3. 'Gas crisis' management and establishing a more predictable framework in the energy dialogue with the Russian Federation and Gazprom

It is already a tradition for political changes in Chisinau to be followed by risks of disruption of natural gas supply (a similar situation of uncertainty took place in the autumn of 2019). This time, the challenges of negotiating a new contract with Gazprom have been complicated by the unprecedented rise in the price of natural gas on the international stock exchanges, which has strengthened Gazprom's trading position. Certain mistakes were also made by the government, in particular by trying to minimize the political factor in an issue that is political by definition (if Moldova wants a preferential

price over the market), as well as by the delayed negotiations on the new contract (in October), both mistakes being interconnected.

Despite the challenges, an agreement was reached with Gazprom on relatively favourable terms, which provides for a formula that allows the price to be set according to the overall price for oil and gas on the stock exchange, calculated at the 70/30 percent rate (the global price for oil and gas respectively) in the cold season and vice versa in the warm period of the year. Such a mixed formula makes it possible to reduce the price of natural gas compared to using only the stock market price as a reference. The agreed conditions are reasonable, favouring also the energy sector reform. The main elements are the clarification of the historical debt of the 'right bank' based on an international audit, as well as the implementation of the 3<sup>rd</sup> Energy Package (with reference to the separation of the energy supplier and carrier).

Another important element is that the government, with the support of development partners, has succeeded, for the first time in history, in importing gas from new sources and routes, which has set a positive precedent for diversifying the gas supplies and strengthening the energy security.

At the same time, a number of fundamental challenges remain for 2022 (and not only): the historical debt (especially the debt generated by the Transnistrian region), the implementation of the 3<sup>rd</sup> Energy Package (18 November 2021, the Energy Community found that Moldova violated the provisions of the Energy Community Treaty by not implementing the clause of separation of the supplier and carrier, and the certification of the MoldovaTransgaz company), the interconnection of the electricity networks with Ukraine and Romania, and the increase of energy efficiency. In this regard, the Government intentions to strengthen the energy security are welcome, in particular by introducing in the Gas Law the obligation to have gas reserves. However, the authorities must launch public consultations as soon as possible on the development of a concrete action plan in the field of strengthening the energy security, which was promised in October.

#### 4. Boosting the social agenda

There has been a qualitative boost in social policies in response to the gas crisis, the pandemic crisis, and the expectations of population in the context of the rising poverty rates after the 2020 crisis. In particular, the minimum pension was increased to MDL 2000, the compensation mechanism for the natural gas tariff increases was developed in record time, and a package of support measures was developed in the context of the pandemic: technical unemployment mechanism, granting of days off for parents/ guardians

taking care of children under pandemic restrictions, as well as two days off after vaccination, compensated from the state budget.

Likewise, it is appreciable the return to the calendar of increasing the retirement age, cancelled for electoral and populist reasons in 2020, when the then government abrogated the calendar of increasing the retirement age without providing funding sources for the measure. The return to the old calendar will strengthen the pension system, and together with the increase in the minimum pension and the early retirement mechanism, will also strengthen the confidence of the population in the system, which will create over time a fundamental precondition for reducing informal employment. This revision also removed the concerns about budgetary constraints of the international financial institutions, which, in turn, allows for the allocation of new financial assistance programmes.

The remaining immediate challenges include the high level of informal employment, increasing pressure on the pension system due to an aging population, and the social risks caused by rising prices.

#### 5. National currency stability and strengthening of the country's foreign currency reserves

With both import prices and import volumes rising, the trade and the current account deficits increasing, as well as the double-digit inflation, the Moldovan leu remains relatively stable. It has depreciated by only 2 percent against the US dollar compared to last year and shows no signs of a faster depreciation. At the same time, the level of official reserve assets amounted to about USD 3.8 billion at the end of November (although in October it exceeded USD 4 billion, but decreased due to the interventions of the National Bank of Moldova (NBM) on the foreign exchange market, being over USD 100 million higher than in the same period of the previous year. The rise was due to increased exports, remittances and external assistance, and allowed the NBM to maintain a stable exchange rate following the interventions on the foreign exchange market to prevent excessive fluctuations. Thus, during the year 2021, until the end of October, the NBM bought about USD 55 million and sold about 88 million, to cover the demand for foreign currency, mainly from importers. However, the biggest intervention, which also allowed a more pronounced depreciation of the national currency, was in November, when the NBM withdrew about USD 237 million from reserves to cover the demand for foreign currency, mainly caused by the gas crisis. This episode once again confirms the need to maintain an adequate level of foreign exchange reserves, which allows the monetary authority to maintain the stability of the national currency despite the shocks of the foreign currency demand or supply.

## 2

# TOP 5 NEGATIVE ECONOMIC AND SOCIAL DEVELOPMENTS/ EVENTS IN 2021

### 1. Increasing inflationary pressure

In November, the annual inflation officially became double-digit (12.4 percent), driven by three major factors. First of all, it is about the phenomenon of imported inflation, in the context of rising global prices (for example, in November, inflation in the euro area reached an all-time high of 4.9 percent, significantly exceeding the target set by the Central Bank of 2 percent). This was especially the case of construction materials (+ 22 percent), fuel (+ 33 percent), but also of the vegetables (+ 46 percent) that are largely imported. The second factor, which derives from the first one, is the adjustment of natural gas tariffs (+ 77 percent) and thermal heating (19 percent) as a result of signing a new contract with Gazprom, which provides for the adjustment of the price of imported gas according to the international stock market trends. The third factor is the increase in aggregate demand in the economy, against the background of economic recovery and expansionary fiscal policy. Price growth will continue in the coming months, and according to the NBM forecasts, the annual inflation will exceed 15 percent in 2022. This dynamic affects particularly the low-income households (quintiles I and II), which allocate about  $\frac{3}{4}$  of their total spendings for the goods and services whose price increased the most: food, utilities, and transportation.

### 2. Large budget deficits become a 'new normal'

Although a positive economic growth is planned for the next year (about 4 percent), the authorities have set a fairly large planned budget deficit (about MDL 15 billion or 6 percent of GDP), which is higher than the originally planned budget deficit for 2021, exceeding the maximum prudential ceiling set by the Public Finance Law and the budgetary-fiscal responsibility. It is true that this deficit is to be covered mainly through the development partners' support. However, in the context of the economic uncertainty associated with the Covid-19 pandemic, as well as the

growing climate shocks, the Government should promote a more cautious fiscal policy, keeping the budget deficit at around 2 percent of GDP. All the more so as this increase in the budget deficit is not accompanied by an equally large increase in capital investment, which is usually the only good reason to increase the budget deficit in conditions of economic growth: the capital investment planned for 2022 is 10 percent higher than that planned for 2021, while the planned budget deficit increased by about 25 percent. In addition, financing the deficit from domestic sources (state securities will cover about a third of the deficit) will be quite problematic and expensive in the context of tightening the monetary policy amid rising inflationary pressures. And the risk in the medium and long term is that the budget deficits, instead of being brought within prudential limits, are increased even in years of positive economic growth, which deprives the country of a significant shock absorber (eg in case of a shock/ crisis, there is no fiscal space for intervention) and, respectively, fuels macro-financial risks.

### 3. Worsening of the decision-making process quality

The legislative initiatives are often promoted without the positive opinion of the government, without sufficient consultations with civil society, and without impact assessments. In order to speed up some processes, they are deliberately promoted by parliament, to the detriment of such principles as decision-making transparency and evidence-based public policies (most recently highlighted by the Venice Commission in connection with the Law on the Prosecution). Relevant examples include the appointment of politically exposed persons as members of the councils of state enterprises, salary rise of the Constitutional Court judges, the hasty promotion of the draft State Budget Law for 2022, the Law on Prosecution, the legislation on media services (Audiovisual Code), and the energy legislation. We hope that these will be isolated cases and will be prevented in the future so as not to worsen the decision-making process.

#### 4. Postponement or non-initiation of major reforms

It is worth mentioning the problem of postponing several systemic reforms, such as the territorial-administrative reform, the local financial decentralization or the central public administration reforms. In addition, there have not been any firm commitments in 2021 from the government to actively promote the reforms in question. We assume that, as in the case of the deteriorating quality of the decision-making process, the new government has been constrained by old and new crises (worsening of the pandemic situation and the gas crisis, respectively). The latter have overlapped with the administrative deficiencies related to the reorganization of state institutions and the filling of vacancies (a process that has not yet been completed). The authorities need to prioritize the reform agenda in order to balance the solution of the old problems with the reforms related to the empowerment of the local public administration, which will help the government to manage multiple local problems (socio-economic, environmental, etc.).

#### 5. Reduced functionality of some public institutions

The dismissals and personnel outflow following this year's political changes have left the vast majority of ministries and

other public institutions with multiple vacancies, including for leadership positions. For example, the Ministry of Finance has only one secretary general and no secretary of state (four vacancies of secretary of state), the Ministry of Economy has only one secretary of state and three vacancies of secretary of state), the Ministry of Labour and Social Protection has only two secretaries of state and two vacancies, the National Financial Market Commission has only one deputy director, while the position of director and other positions of deputy directors remain vacant, the status of such institutions as the National Agency for Energy Regulation (ANRE) or the Competition Council remains uncertain from the perspective of their possible reorganization and the appointment of new members to the governing bodies. This problem reveals a serious crisis in the public service personnel due to unattractive pay and working conditions, as well as the constant undermining of the prestige of the public service in recent years. This is a key constraint in promoting quality public policies and reforms and removing it should be a top priority for the next year, by promoting a comprehensive public service wage reform (the public sector wages should be harmonized with those in the private sector) and reorganizing the public administration to increase efficiency and mobilize the necessary resources in order to substantially improve the working conditions of civil servants. At the same time, in the recruitment process, emphasis should be placed on the professionalism and integrity criteria, while the political criterion should be definitively excluded in order to ensure the proper functioning of the institutions and prevent 'political corporatism'.



# 3

## TOP 5 ECONOMIC AND SOCIAL CHALLENGES IN 2022

### 1. Promoting systemic reforms under the conditions of limited financial, human and time resources

While the year 2021 was one of adaptation and reorganization, the year 2022 should become the year of systemic reforms. However, the challenges lie in budgetary, human, time and political constraints. The government will need to mobilize the necessary resources to demonstrate that it is capable of promoting impactful reforms, especially since 2023 is an election year, which will complicate the promotion of necessary but unpopular reforms. This confirms that the year 2022 offers practically the only window of opportunity for initiating the respective reforms: here we refer to the social agenda reforms (day laborers, informal employment, pensions, minimum wage), as well as the territorial-administrative reform, the public administration reform and remuneration of civil servants, and the reform of state-owned enterprises.

### 2. Poverty risks in the context of inflationary trends

Inflation in 2022 is expected to exceed 15 percent, affecting mainly the low-income households. This will put pressure on the social protection system and stimulate economic and social inequalities. The government will need to increase the efficiency of social protection mechanisms so that they better target those most in need. At the same time, measures are needed to maximize the revenues in the State Social Insurance Budget (without increasing fiscal pressure), by combating informal employment and economy, raising the minimum wage and increasing the efficiency of the National Social Insurance Fund. In the context of the gas crisis, the problem of energy poverty is also emerging, which affects directly (increasing prices for energy sources) or indirectly (discouraging access to energy sources) the vulnerable sections of the population.

### 3. The slowdown of economic growth amid rapid growth in 2021

The rapid economic recovery in 2021 is not based on a new development paradigm, being accompanied by the growth of the triangle of macroeconomic deficits: the trade deficit, the current account deficit, and the budget deficit. The high baseline of comparison will automatically slow down the economic growth in 2022, and the uncertainty of the pandemic developments, the global inflationary trends or the risk of the gas crisis reappearance described below, will continue to influence the private investment appetite; public investment will also remain uncertain due to the risks of under-execution of income against the background of the economic slowdown, but also the increase of pressure on the social protection system in the context of the poverty risks mentioned above.

### 4. Risk of a “gas supply crisis”

Even though there is a new agreement with Gazprom, there are still many unresolved issues: the historical debt or the implementation of the 3<sup>rd</sup> Energy Package. Failure to resolve them will always be a source of risk regarding the gas supplies from Gazprom. The government needs to speed up the debt audit process and clarify the timing of the payment of the real debt to Gazprom (found and agreed after the audit), return to the implementation of the 3<sup>rd</sup> Energy Package, strengthen the independence of the National Agency for Energy Regulation (ANRE) (refraining from any initiatives that may politicize the institution), and at the same time, enable Energocom to compete on the internal gas market, to build up natural gas stocks (in Romania or Ukraine) and to strengthen the electricity interconnection with Ukraine and Romania (including accelerating the start of electricity interconnection construction with Romania).



## 5. Pandemic due to low vaccination levels

The new wave of the Covid-19 pandemic associated with the Omicron version risks endangering the health situation, especially after the winter holidays. This could significantly affect the economic activity and the social situation, in the context of a low vaccination rate, but also the lack of comprehensive support measures for the population and firms in the event of a worsening pandemic. The government needs to get ready tools to support the economy and the low-income households in the event of a worsening pandemic through al-

ready well-known mechanisms: wage subsidies, the *kurzarbeit* system (state subsidies for reduced working hours), state guarantees for urgent loans and increasing support for the unemployed for retraining. In general, early-warning signals need to be strengthened on the basis of a country-wide risk assessment and management system, especially in the area of critical infrastructure. In the vaccination promotion process the authorities should improve the communication strategy and public consultation with all stakeholders (including trade unions), but also to combine coercive measures with measures to encourage vaccination (by creating opportunities for those vaccinated).

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## TOP 5 THE MOST IMPORTANT POSITIVE AND NEGATIVE ECONOMIC AND SOCIAL DEVELOPMENTS IN 2021 AND CHALLENGES FOR 2022



The most important positive economic and social developments in 2021 are related to the rapid economic recovery after the 2020 recession, which allowed for increased tax revenues and budgetary consolidation. The solution of the 'gas crisis' and the establishment of a more predictable framework in the energy dialogue with the Russian Federation and Gazprom can also be highlighted. However, a number of key challenges remain valid for 2022: the historical debt (especially the debt generated by the Transnistrian region), the proper implementation of the 3rd Energy Package, the interconnection of electricity networks with Ukraine and Romania, and increasing energy efficiency. It should be mentioned the revitalization of the social agenda in response to the gas and the pandemic crises, as well as to the expectations of the population in the context of rising poverty rates after the 2020 crisis. In particular, the minimum pension was increased to MDL 2000 and a mechanism to compensate for the increase in the natural gas tariffs has been developed in record time as well as a package of support measures in the context of the pandemic. Last but not least, the stability of the national currency and the consolidation of the country's foreign exchange reserves have been ensured.



The negative economic and social trends/events of 2021 that stand out are related to the increase of inflationary pressure with repercussions on low-income households, planning a budget deficit too high in relation to the economic situation and especially the risks for 2022, worsening of the decision-making quality (promotion of many laws without sufficient consultation), postponement or non-initiation of major reforms such as the territorial-administrative reform, the local financial decentralization or the central public administration reforms, as well as the reduced functionality of certain public institutions.



One of the major economic and social challenges for 2022 is to promote systemic reforms in the context of limited financial, human and time resources. Another challenge is the poverty risks in the context of inflationary trends, in parallel with the slowdown of the economic growth against the background of the rapid economic development in 2021. Inflation in 2022 is expected to exceed 15 percent, especially affecting the low-income households. This will put pressure on the social protection system and stimulate economic and social inequalities. In addition, the rapid economic recovery of 2021 is not based on a new development paradigm, but is accompanied by a growing triangle of macroeconomic deficits: the trade deficit, the current account deficit, and the budget deficit. Respectively, the high baseline of comparison will automatically lead to a slowdown in the economic growth in 2022. There is also a risk of the reappearance of the 'gas supply crisis' due to the complicated energy agenda with the Russian side. Last but not least, the new Covid-19 pandemic wave associated with the Omicron version risks endangering the health situation. This could significantly affect the economic activity and the social situation, in the context of a low vaccination rate, but also the lack of comprehensive support measures for the population and firms in the event of a worsening pandemic situation.

Further information on the topic can be found here:  
[www.fes-moldova.org](http://www.fes-moldova.org)