

## ECONOMY AND FINANCE

# TOP 5 THE MOST IMPORTANT POSITIVE AND NEGATIVE ECONOMIC DEVELOPMENTS IN 2022, AND THE CHALLENGES FOR 2023

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Among the most important positive economic and social developments in 2022 were: obtaining by Moldova of the EU candidate country status, increased external financial support, development of support mechanisms for vulnerable sections of the population and companies, in parallel with strengthened efforts to fight informal economy, the management of the refugee crisis and the fact that, for the first time, Moldova has begun to implement a genuine agenda of strengthening energy security.



The positive developments took place against the background of several negative trends and events: stagflation - economic recession combined with high inflation, slow progress of systemic reforms, chronic budget deficits coupled with increasing social obligations, increased poverty rate and social inequalities, and decrease in investment activity on background of increasing uncertainty and business costs.



The year 2023 will be full of challenges and risks, the main ones being: the continuation of the war in Ukraine with direct and indirect repercussions on Moldova, the problematic execution of the state budget in the context of a difficult economic year and growing social obligations, the risk of new price increases for energy resources, the risk of electoral populism in the context of local elections, as well as the risk of undermining economic potential due to emigration and the disinvestment phenomenon.



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# 1

## TOP 5 POSITIVE ECONOMIC AND SOCIAL DEVELOPMENTS/ EVENTS IN 2022

### 1. Obtaining by the Republic of Moldova of the EU candidate country status

On 23 June 2022, the European Commission decided to grant the Republic of Moldova, together with Ukraine, the candidate country status for EU accession, thus giving it, for the first time, a clear European perspective. This has propelled Moldova-EU bilateral relations and Moldova's European integrationist agenda to a qualitatively higher level: Moldova has been incorporated into the European Enlargement Policy, which helps it differentiate itself, already in a categorical manner, from other participants of the Eastern Partnership. This success was determined, on the one hand, by the new geo-political realities as a result of Russia's military invasion of Ukraine, the Republic of Moldova being the second most vulnerable country in this context, and on the other hand, by the development partners' trust in the pro-European government in Chisinau (otherwise, Moldova could have been in the same "basket" with Georgia, which did not receive this status). At the same time, this success was also due to the vibrant civil society - an indispensable element for a European society -, which had an important role, in particular, in the management of the refugee crisis, as well as in completing the questionnaire on the basis of which the Republic of Moldova was evaluated by the European Commission. Of course, there is a complex reform process ahead, both to start the negotiations on the 35 chapters and, in particular, to complete the negotiations on each chapter, which will require effort, time, and substantial institutional and financial resources from the government. Therefore, it is crucial to maintain the firm and priority political commitment for the European integration, in parallel with the strengthening of the capacities of public institutions and the involvement of civil society in the process of implementing the commitments made in this context. The Republic of Moldova will become part of the EU only if the entire society will unite around this goal and contribute positively to its achievement.

### 2. Increasing external financial support

The year 2022 showed once again who the true friends and supporters of the Republic of Moldova are. While Gazprom was reducing, through unilateral decisions, the natural gas

supplies to Moldova, which also affected the electricity supplies on the left side of the Dniester, the development partners increased the financial support to Moldova to be able to procure gas and electricity from alternative sources. The direct budget allocations were also increased, which allowed the granting of compensations and other forms of support to the population and companies in the context of crises. Important projects for the rehabilitation of the road infrastructure, the development of renewable energy, the modernization of agriculture, and other projects of major importance were also financed from external sources. However, the most substantial aid came in the form of loans and grants to support the state budget, a fact that allowed the financing of the budget deficit, the promotion of important reforms (e.g. in the field of health or the modernization of the railway), and the promotion of an active and extensive policy of social assistance focused on supporting vulnerable groups in the context of price increases and recession. According to the data of the Ministry of Finance at the end of the 3<sup>rd</sup> quarter of 2022, MDL 9.6 billion was collected by the state budget and approximately MDL 2 billion more is to be collected by the end of the current year. A major problem with these amounts is that most of them come in the form of loans, the grants accounting for only 20 percent. Despite the fact that the level of external state debt remains within standard limits, the difficult economic and social conditions in which Moldova finds itself dictates the need to increase the share of grants in external financing – a message that must be actively promoted among development partners.

### 3. Development of support mechanisms for vulnerable sections of the population and companies in parallel with strengthening the efforts of formalizing the economy

In the context of the energy, inflationary, and economic crises, the Government managed to develop a series of support tools for vulnerable sections of the population and companies. In particular, it should be noted the development of the Energy Vulnerability Reduction Fund, the allowances for employees in technical unemployment in the amount of 50 percent of the basic salary in the event the activity of the entrepreneur is stopped, ii) the mechanism of the partial activity

regime (of the “Kurzarbeit type”), which provides for the granting of an allowance of maximum 50 percent of the average salary for the economy to the employees with partial activity regime, iii) the reorganization of ODIMM into the Organization for Entrepreneurial Development (ODA) facilitating the SMEs’ access to the Support Programmes, and iv) the establishment of the Fund for Entrepreneurship and Economic Growth of Moldova (FACEM) aimed at providing a low-cost state financing tool for investment projects initiated by entrepreneurs. The financing of these instruments was possible thanks to the support of the development partners, allowing for the cushioning the impact of the current economic and social shocks. At the same time, the institutionalization of these mechanisms completed the Government’s arsenal of anti-crisis tools that could be useful for future crises. In order to strengthen the sustainability of these measures, the Government has intensified efforts to fight informal economy, aiming at the fiscal consolidation based on the increase of the tax base. In this sense, the State Labour Inspectorate reform was launched as well as the revision of the approach regarding unannounced controls in the field of work. In addition, the subsidy mechanism for formalising the wages was developed and decisive policy interventions are planned regarding day labourers in agriculture and patent holders. These measures should be actively encouraged and promoted in order to ensure, in the context of the high budget deficit, a fiscal consolidation as least expensive as possible for economic development.

#### **4. For the first time, the Republic of Moldova began implementation of a genuine agenda for strengthening energy security**

In the context of the increase in world prices for energy resources and the risks related to the supply of natural gas from

Gazprom and electricity from the left bank of the Dniester, the Government started an active agenda of reforms in order to diversify energy supplies and capitalize on renewable energy sources. Thus, for the first time since independence, the Republic of Moldova began to store natural gas, being an indispensable element of the country’s energy security. At the same time, the state enterprise “Energoecom” was authorized to procure natural gas and electricity on the market, a fact that allowed the diversification of energy sources. Another important event refers to the connection of the electrical energy system of Moldova, together with Ukraine, to the ENSO-E Continental European Energy System, which allowed commercial energy exchanges with the EU, also contributing to the diversification of energy sources and, respectively, to the consolidation of energy security. The reforms in the energy sector, in particular as regards the transposition of the *acquis communautaire*, were also highly appreciated by the Energy Community Secretariat in the final implementation report<sup>1</sup>.

#### **5. Managing the Ukrainian refugee crisis**

After Russia’s military aggression in Ukraine, the Republic of Moldova became one of the main destinations for Ukrainian refugees, being among the top countries in terms of the number of refugees per capita. The government and the whole society showed solidarity with Ukraine, offering accommodation, food, clothes, and other forms of support, in conditions where the Republic of Moldova itself needed support, facing a budget deficit, inflation, and energy crisis. The way the crisis was managed and the solidarity of Moldovans with Ukraine were also highly appreciated by the international community, which provided additional support to help the Republic of Moldova face this challenge.

<sup>1</sup> [https://www.energy-community.org/news/Energy-Community-News/2022/12/07.html?fbclid=IwAR25aZNr5LiWMCp-V2FNA8CiUWKWyRUc9BlcG3b1IPHLg9\\_8wF6Yfo\\_3JOKQ](https://www.energy-community.org/news/Energy-Community-News/2022/12/07.html?fbclid=IwAR25aZNr5LiWMCp-V2FNA8CiUWKWyRUc9BlcG3b1IPHLg9_8wF6Yfo_3JOKQ)

## 2

# TOP 5 NEGATIVE ECONOMIC AND SOCIAL DEVELOPMENTS/ EVENTS IN 2022

### 1. Stagflation: economic recession combined with high inflation

The negative shocks of 2022 (Russia's military invasion of Ukraine, energy crisis, drought, and rising import prices) translated into stagflation: economic recession estimated at around 3-4 percent on the background of an average inflation of around 30 percent. The recession was driven by 3 major factors: (i) the war in Ukraine which led to the loss of markets in Russia, Ukraine, and Belarus, has undermined logistics and value chains, and most importantly, has affected investment and consumer sentiment; (ii) the drought that undermined the agricultural production, which was already affected by the increase in the price of agricultural inputs (in particular, fuel and fertilizers); and (iii) the severe tightening of monetary policy which, while preventing further inflation, has further worsened access to loans. Inflation was mainly determined by the increase in import prices of energy products, agri-food, and construction materials<sup>2</sup>. However, there were also some internal factors, mainly associated with the rapid growth of crediting (which served as the basic reason for the tightening of monetary policy), as well as a potential speculative factor, and certain deficiencies related to the competitive framework (e.g. the prices of industrial goods for local products were several times higher than those oriented for export). However, the economic recession of 3-4 percent in 2022 is not a dramatic one, against the background of a high comparison base (in 2021 the GDP grew by 13.9 percent) and the major crises this year. In addition, despite the high inflation, it should be noted the maintenance of macro-financial stability, especially through the lens of the resilience of the national currency, public finances, banking system, and the country's foreign exchange reserves, which will serve as the basis for the economic recovery in 2024.

### 2. Slow progress of systemic reforms

According to the 2022 State of the Country Report<sup>3</sup>, external successes resulting in increased donor assistance and the EU candidate status have failed to translate into domestic successes. Thus, a series of systemic reforms have either been postponed (e.g. the territorial-administrative reform, the local public administration reform, the pension system reform) or implemented at a slow pace (e.g. the justice reform, the public administration reform, the wage reform in the public sector, the public finance management reform, digitization or the reform of state enterprises). In the first case, the fault lies with the numerous shocks, crises, and emergencies that have "captured" the Government's agenda (e.g. the energy crisis, the war in Ukraine, inflation, and drought) and which, combined with the limited capacities of public institutions, have not allowed allocating time, energy, and resources for systemic reforms. However, another no less important reason relates to the system's resistance to reforms and its non-adaptation to democratic changes by sabotaging, directly or indirectly, change initiatives or/and hijacking the reform agenda. This problem was also aggravated by the limited experience of working for public institutions of the majority of heads of state institutions appointed during the period under analysis. In general, the system's resistance to reforms is not a new phenomenon for the Republic of Moldova, however, against the background of the pro-reform rhetoric of the ruling party and its electoral promises, the problem in question has become even more visible. At the same time, this dissonance between the democratic transformations and the rigidity of the system explains the political volatility and frequent changes of governments, against the background of the slow progress of systemic and structural reforms - phenomena observed especially since 2009.

<sup>2</sup> "Three elements for the solution to the inflation problem" („Trei elemente pentru soluția problemei inflației"), Expert-Grup, <https://www.expert-grup.org/ro/biblioteca/item/2356-trei-elemente-pentru-solu%C8%99Bia-problemei-infla%C8%99Biei>

<sup>3</sup> State of the Country Report 2022, Expert-Grup/ FES, [https://www.expert-grup.org/media/k2/attachments/RST\\_2022\\_RO\\_Final\\_1-\\_site.pdf](https://www.expert-grup.org/media/k2/attachments/RST_2022_RO_Final_1-_site.pdf)

### 3. Chronic budget deficits against the background of increasing social obligations

In 2022 the budget deficit was about MDL 14.6 billion or accounted for 5.2 percent of GDP, and for 2023 the Government plans an even higher deficit – MDL 18.5 billion or 6 percent of GDP. Against the background of the economic crisis, inflationary shocks, and a restrictive monetary policy, the promotion of an expansionary budget policy with high budget deficits becomes a necessity. In fact, in 2022 it allowed for the negative shocks to be cushioned and, despite unprecedented challenges, a milder recession was recorded compared to previous years (2009 or 2020). However, the main problem with the budget deficits during this period is that they are not sustainable, at least, for two reasons: (i) they are mainly financed by external preferential financing (which is temporary by definition), while, internally, the financing is limited and expensive, and the state promotes an irrational policy of taxation of the income obtained from investments in state securities; and (ii) they are mainly caused by the increase in social obligations that generate, in chain, other obligations, which will be increasingly problematic to honour in the future (the most eloquent example is the way the pension for the age limit for 2023 was indexed, the indexing coefficient being about two times lower compared to the previous formula). The maintenance of these unsustainable budget deficits also fuels negative expectations from the business environment, as firms anticipate that, sooner or later, these discrepancies are to be covered by increasing fiscal pressure (in this context, it is important for the Government to clearly communicate that future fiscal consolidation will be based not on increasing fiscal pressure but on expanding fiscal space by encouraging the formalization of the national economy).

### 4. Increasing poverty rate and social inequalities

According to the latest edition of the State of the Country Report<sup>4</sup>, there has been noticed an “inequality” in the distribution of the inflation effects on households, and the most affected will be the people from urban areas with low and medium incomes. Based on the estimates<sup>5</sup> it was found that if the average annual inflation in 2022 reaches 29.5 percent, and other influencing factors remain constant, the number of people living daily on less than USD 5.5 (at purchasing power parity, in 2011 prices) or MDL 53.6 (in current prices) would increase by 19.7 percent compared to the level of 2021. Thus, the absolute poverty rate is expected to increase from 24.5 percent in 2021 to around 27 percent in 2022. The trend is set to continue in 2023, when an average inflation of around 14-15 percent will be recorded. Although lower compared to 2023, the inflation is quite high compared to the optimal level. The increase in the poverty rate will put additional pressure on the public finance system, aggravating the budget deficit problem mentioned above.

### 5. Decrease in investment activity against the backdrop of increased uncertainty and business costs

The avalanche of economic shocks and the 2022 crisis has substantially reduced the investment activity. According to the latest data of the National Bureau of Statistics, in the first 3 quarters of 2022, the volume of investments in fixed assets, in real terms, decreased by 9.2 percent, while for the whole year the decrease could be over 10 percent. The main causes can be divided into two categories: (i) increasing uncertainty against the background of the war in Ukraine and the economic and social crisis; and (ii) rising costs of doing business against the backdrop of the monetary policy tightening that affected access to credit and made logistics more expensive. Therefore, that trend is set to continue in 2023, as both uncertainty and access to credit will remain major issues for the business environment.

<sup>4</sup> State of the Country Reform 2022, Expert-Grup/ FES, [https://www.expert-grup.org/media/k2/attachments/RST\\_2022\\_RO\\_Final\\_1-site.pdf](https://www.expert-grup.org/media/k2/attachments/RST_2022_RO_Final_1-site.pdf)

<sup>5</sup> To determine the inflation impact on poverty, there was used the method described by Fala (2022) in the publication “Inflation in the Republic of Moldova: causes, vulnerable groups, and policy recommendations” (available on [https://www.expert-grup.org/media/k2/attachments/Cauzele\\_si\\_efectele\\_inflatiei\\_analiza.pdf](https://www.expert-grup.org/media/k2/attachments/Cauzele_si_efectele_inflatiei_analiza.pdf))

# 3

## TOP 5 ECONOMIC AND SOCIAL CHALLENGES FOR 2023

### 1. Continuation of the war in Ukraine, with direct and indirect repercussions on the Republic of Moldova

The Russian Federation's military aggression in Ukraine shows increasingly obvious signs of turning into a protracted war<sup>6</sup>. This will remain the main challenge for the Republic of Moldova, at least for the following reasons: (i) the perpetuation of the increased level of uncertainty, affecting the investment appetite and discouraging private activity as a whole; (ii) the risks of power outages will be maintained against the background of the bombing by the Russian Federation of the energy infrastructure in Ukraine that the Republic of Moldova is also interconnected with; (iii) a potential increase in over-flight of missiles launched by the Russian Federation towards Ukraine; (iv) further undermining of the trade with Ukraine, the Russian Federation, and Belarus; and (v) maintaining the high level of logistics costs for import-dependent companies. In order to face this challenge, the Government must ensure full political, institutional, and financial support for the efforts regarding the fulfillment of the conditions for starting the EU accession negotiations, the consolidation of energy, informational, and military security.

### 2. Problematic execution of the state budget in the context of a difficult economic year and increasing social obligations

The execution of the state budget that was planned with a 6 percent deficit of GDP for 2023 could be one of the main challenges of the year, in the context of the perpetuation of the economic constraints of 2022: the uncertainty caused by the war in Ukraine, the still high inflation, the risk of the exacerbation of the energy crisis, and the limited access to credits. In addition, covering the budget deficit mainly from loans will lead to the continuous growth of the state debt that, although it will remain within acceptable and controllable limits, will increasingly affect the country

rating due to the unsustainable financing of the budget deficit (mentioned above). To meet this challenge, it is necessary to intensify advocacy efforts on increasing the share of grants in external financing and speeding up policies to encourage the formalization of the economy: supporting patent holders to formalize their businesses, subsidizing formalisation of wages, promoting non-cash payments, reforming the State Labour Inspection, streamlining controls and increasing penalties for tax evasion.

### 3. The risk of new price increases for energy resources

The year 2023 could be even more difficult from the gas and electricity price perspective. The contract with Gazprom remains highly uncertain after Gazprom's unilateral decisions to reduce the supplies agreed under the contract with MoldovaGaz, most likely perpetuating the current situation in which all the gas delivered by Gazprom goes to the Transnistrian region in exchange for electricity deliveries at the optimal price. This means that in 2023, the Republic of Moldova will have to procure natural gas from alternative sources, most likely from the stock market. The problem is that against the background of the sanctions, the gas price is going to remain high on the stock market, and storage will be increasingly difficult due to the insufficiency of storage spaces because of the expectations regarding the increase in prices of the participants in the international exchanges. Consequently, electricity could also become more expensive, because the electricity supplies from the left bank of the Dniester River do not nearly cover the consumption requirements on the right bank of the Dniester River, as electricity imports from Ukraine or Romania are needed, where the price, for objective reasons, is much higher. In order to face these risks and challenges, it is crucial to increase financial support from the state and donors for: (i) promoting energy efficiency (especially in the residential sector, where there are the greatest losses and, respectively, the greatest potential to improve energy efficiency) by creating the Energy Efficiency Fund, (ii) encouraging on a larger scale the development of renewable energy sources, through subsidy mechanisms; and (iii) strengthening the governance and professional

<sup>6</sup> <https://www.understandingwar.org/backgrounder/ukraine-conflict-updates>



capacities of the “Energocom” State Enterprise which is going to continue procurement of gas and electricity from international stock exchanges in order to diversify the supply of energy resources.

#### 4. The risk of electoral populism in the context of local elections

The year 2023 marks the beginning of the electoral marathon consisting of the triad of local elections, presidential elections (2024), and parliamentary elections (2025). Therefore, this could lead to increased pressure from the Parliament on the Government in the context of the increasing inclination of politicians towards populist initiatives. Thus, there is a risk of disrupting the reform agenda of the ministries by the electoral behavior of the politicians. For this reason, from the point of view of political economy, the year 2023 closes the window of opportunity for promoting reforms (which was opened in 2021-2022). Mitigating this risk is very important, especially from the perspective of maintaining a firm commitment to European integration and meeting the conditions for starting EU accession negotiations. Therefore, the presidential authority, together with civil society and the community of development partners, must put an increased emphasis on the accountability of parliamentarians through monitoring

the legislative process and promoting the principles of transparency, inclusion, and evidence-based policies. In addition, it is important to monitor and counteract any forms of political clientelism on the eve of elections (e.g. budget allocations to LPAs loyal to the government - a phenomenon observed in previous years<sup>7</sup>).

#### 5. The risk of undermining the economic potential due to emigration and the disinvestment phenomenon

The perpetuation of the war in Ukraine and the start of the 2023-2025 election periods will fuel an increased level of uncertainty that will be combined with growing concerns from the business community about possible measures to increase fiscal pressure against the backdrop of chronic budget imbalances. These trends could not only lead to the freezing of investments, but also to a certain disinvestment process and even the departure of some foreign investors from the country. In order to mitigate this risk, the Government's pro-business agenda must be focused more on the development of small and medium-sized enterprises, promoting integrity in the private sector, improving the competitive framework, encouraging the transition to the formal sector, promoting business association, and facilitating access to financing.

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<sup>7</sup> <https://www.expert-grup.org/en/biblioteca/item/2240-studiu-privind-clientelismul-politic-in-gestionarea-fondurilor-publice>

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## TOP 5 THE MOST IMPORTANT POSITIVE AND NEGATIVE ECONOMIC DEVELOPMENTS IN 2022, AND THE CHALLENGES FOR 2023



The year 2022 has abounded with both positive and negative economic and social developments and events. Among the positive ones, the following top-5 can be noted: (i) the Republic of Moldova has obtained the EU candidate country status, a fact that propelled the Moldova-EU bilateral relations and Moldova's European integration agenda to a higher qualitative level: Moldova is included in the European Enlargement Policy, which differentiates it, already in a categorical manner, from other participants in the Eastern Partnership; (ii) the increase in external financial support that showed once again who Moldova's true friends and supporters are and allowed for the diversification of electricity procurement, payment of compensations to vulnerable sections of the population, financial support of companies, implementation of infrastructure projects, and maintenance of the stability of public finances; (iii) the development of support mechanisms for vulnerable sections of the population and companies in parallel with the consolidated effort to fight the informal economy, a fact that cushioned the negative shocks of this year; (iv) the management of the refugee crisis, a fact that once again confirmed the fact that the Republic of Moldova is a truly European state capable of showing solidarity and mobilization in the context of extremely limited resources and capacities; and (v) the fact that for the first time, Moldova has started to implement a genuine agenda of strengthening energy security.



The positive developments took place against the background of negative trends and events: (i) stagflation - economic recession combined with high inflation, which led to (ii) increased poverty rates and social inequalities, as well as (iii) chronic budget deficits coupled with increased social obligations, which is going to be one of the main challenges of 2023. Another negative trend of 2022 was (iv) the slow progress of systemic reforms caused by the numerous shocks, crises and emergencies that "captured" the Government's agenda (ex.: the energy crisis, the war in Ukraine, inflation and drought) and which, combined with the limited capacities of public institutions, did not allow the allocation of time, energy and resources for systemic reforms. However, another cause, no less important, relates to the system's resistance to reforms and its non-adaptation to democratic changes by sabotaging, directly or indirectly, the change initiatives or/ and hijacking the reform agenda. Last but not least, (v) the decrease in the investment activity against the backdrop of increasing uncertainty and business costs was another negative trend of 2022.



The main challenges of 2023 refer to the continuation of the war in Ukraine with direct and indirect repercussions on Moldova (perpetuation of the increased level of uncertainty, power outages risks, intensification of the overflight of missiles launched by the Russian Federation on Ukraine, the further undermining of trade with Ukraine, the Russian Federation, and Belarus, maintaining the high level of logistics costs for companies that depend on imports, etc.). Another challenge is the problematic execution of the state budget in the context of a difficult economic year and growing social obligations, given the planned high budget deficit and its unsustainable financing. The risk of electoral populism in the context of the 2023 local elections could also create problems for the progress of systemic reforms. There is also the risk of undermining economic potential due to emigration and the disinvestment phenomenon, especially if the security situation in the region does not improve. Last but not least, there is the risk of a new wave of price increases for energy products in the event of the continuation of the war in Ukraine.

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