

Policy Brief: Socio-economic Impact on the Moldovan Economy since the War in Ukraine

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Overview

Over the past several years, the Moldovan economy has been afflicted by severe external shocks that exposed structural weaknesses of the economy which have been building up for decades. The unsustainable remittance-driven growth model combined with geographic proximity to and economic dependence on Russia and Ukraine contributed to the severity of the economic impact of the conflict. For the population, the main effect was the soaring of prices, in particular of food and energy, far above income growth, and as a result a significant deterioration of living standards of the most vulnerable population cohorts. This issue, together with an economic contraction and a huge refugee influx precipitated a social crisis.

The short-term policy response has generally been assessed favorably and supported by external partners, yet despite these efforts, large shares of the population remain affected by the decline in living standards.

The government's efforts to tackle the economic fallout from the war revolve around several aspects – in the short-term, ensuring security and affordability of energy supply by diversifying its sources and providing social assistance to households and refugees to mitigate price increases. In the longer term, Moldova needs to conduct structural reforms to improve competitiveness, gain access to new export markets, diversify the economy away from agricultural production, as well as improve the productivity in this sector, and provide high-quality employment opportunities for its citizens as an alternative to remittance-driven consumption.

These measures unfold in a difficult domestic (a lack of administrative capacity and market-based sources of funding) and external (the ongoing war) environment and are therefore largely dependent on support from international organizations and donor countries. This policy brief outlines some of the most relevant findings from a broader research (desk review) on the socioeconomic impact of the Russia-Ukraine war on Moldova, with a focus on the policy response by authorities and recommendations on where assistance from international organizations should be focused.

Structural weaknesses - background

Remittance-driven growth model

The remittance-driven model provided significant growth in previous years but has its limitations. The scarcity of domestic employment opportunities, low investments, and failure to diversify the economy away from agriculture sector and develop an export-focused manufacturing sector contributed to exposure to geopolitical, energy, and climate shocks.

The structure of the economy is such that large shares of the population are strongly affected by these shocks, putting a strain on social safety nets.

Moldova remains one of the most remittance-dependent countries in Europe. Remittances play a crucial role in households' income, particularly in rural areas, where they accounted for 14% of the total income in 2022. While in some cases they can partially counterbalance the effect of domestic recessions, the heavy reliance on remittances implies that disposable incomes are not only contingent upon the business cycles of external countries but also on financial cycles, exchange rates, and geopolitical shocks. The vulnerability is particularly pronounced in rural households. Their low wage and salary income make them particularly reliant on remittance inflows, revenue from the volatile agriculture sector, and social payments. With a large share of the population being exposed to unreliable income sources, Moldova has the highest poverty ratio in Europe (14% of the population living below USD 6.85 a day).

Vulnerability in food supply

The agriculture sector still accounts for more than 10% of Moldova's Gross Domestic Product (GDP), which is one of the highest in the peer group. It also constitutes a significant labor share, with around 20% of the workforce and 35% of the total employment employed in this sector – the highest among European countries. Additionally, agricultural products make up almost half of the country's exports. The high employment in the sector contributes to low overall productivity in the economy, results in a narrow tax base, and exposes a large share of the population to volatile income streams.

Moldova is particularly susceptible to weather and climate change shocks. Droughts affected the sector in 2020 and 2022, which together with high fertilizer and fuel prices (in 2022) resulted in a significant drop in agriculture production. Due to a lack of advanced resilience techniques, agriculture output in Moldova is the most volatile among peer countries, contributing to overall GDP volatility.

Changes in global commodity prices due to geopolitical and other factors strongly affect Moldovan households, owing to a high reliance on agriculture as a source of income, as well as a high share of food in the consumption basket.

Energy dependence

Most of the energy consumed in Moldova is imported, including virtually all supplies of coal, gas, and oil. Moreover, 74% (in 2021) of electricity is produced from imported gas in the breakaway region of Transnistria, complemented by electricity imports from Ukraine. As of 2021, 77% of the total energy supply was imported, (counting electricity from the Transnistrian region as an import). Prior to the war in Ukraine, the main origin country was Russia, which accounted for imports of all natural gas (including the quantity needed for electricity production), as well as a significant share of oil. Due to Moldova's turbulent political relationship with Russia, this dependence was a source of significant geopolitical risk for Moldova.

Immediate economic impacts of the war in

Ukraine

Driven by supply-side disturbances (incl. loss of markets in Russia and Ukraine), high production costs, falling domestic demand, and tight monetary conditions, Moldovan GDP contracted by 6.2% in 2022. The contraction was broad-based across sectors and accompanied by a fall in investments, rising unemployment, and closures of small businesses.

At the same time, food and energy prices started soaring already in 2021 and increased even more since the start of the war in Ukraine. This had a particularly strong impact on Moldova, considering the geographic proximity of the warring parties, simultaneous drought, and a very high share of food in the consumption basket. The headline inflation figure peaked at ~35% in October 2022 but moderated quickly thereafter. By mid-2023, monthly price growth had ceased, implying that prices have stabilized at a much higher level.

Energy crisis

The war in Ukraine severely disrupted Moldova's energy sector. A significant shift occurred in 2022 when Russia reduced and eventually halted gas exports to Moldova, and electricity imports from both the Transnistrian region and Ukraine were interrupted. This crisis prompted Moldova to diversify its energy sources and restructure its policy measures to ensure energy security. Also, it caused a surge in prices (mainly of gas and to a lesser extent electricity and fuel) which was partly transmitted to consumers and caused a major decline in living standards, as well as indirect effects to the rest of the economy (producer costs and core inflation).

Relocation of trade routes

Due to the war and trade sanctions, there has been a significant shift in trade routes, which can be observed at a micro level through changes in port turnovers.

Odesa port: The turnover of the Ukrainian Odesa port has been significantly affected by the war, with Russia blocking most of the trade via this port since the war began. Odesa was an essential port for Moldova, serving as a major logistics center for both exports and imports.¹ Based on government sources, Moldova managed to switch to alternative transportation channels, but it resulted in higher transportation prices.²

Giurgiulesti port: Giurgiulesti port in Moldova, being linked to international waters, became one of the destinations where cargoes switched to from Ukrainian ports. As a result, trade at Giurgiulesti port doubled in 2022.

Constanța port: Moldova also increased its reliance on the Romanian port of Constanța in response to the Russian blockade of Odesa. However, hinterland connections remain poor, with most shipping being transferred to/from trucks instead of the more efficient rail.

Food price effect

As a result of the war and blockages of Ukrainian ports, global cereal prices increased to record highs in 2022. Although Moldova is usually a net exporter of food, the poor 2022 harvest caused larger food imports from mid-2022 at very high prices. Farmers' costs were further boosted by the skyrocketing prices of fertilizers and fuel, which also contributed to the increase in food prices. Food inflation peaked at 38% in August 2022.

With food carrying a much larger weight in the consumer basket relative to EU countries (36.7% vs. 17.3%), rising global food prices have directly contributed to higher overall inflation in Moldova.

Impact of inflation on households and cost of living crisis

Households were severely affected by the changes in price levels and real incomes. While the aggregate erosion of purchasing power was significant, the effect was more pronounced for vulnerable groups (rural, self-employed, those from poor regions, and non-remittance recipients).

Increasing prices and tighter monetary conditions (to fight inflation) caused aggregate households' consumption to decline by 3% in 2022 in real terms. This has been more pronounced in food consumption, where data shows a 13% annual decline for 2022Q4 – especially for rural households, where the drop reached 15%. The decline in food consumption, including basic items such as vegetables, oil, and potatoes is an indicator of the severity of the crisis. Cuts in basic food consumption are typically involuntary, indicating high poverty risk and a lack of buffers in the form of household savings.

Energy consumption also declined due to increasing prices – in particular, gas consumption declined sharply compared to previous seasons due to high prices, a mild winter, and energy conservation measures. Electricity consumption also declined, to a much lesser extent. People reportedly turned back to bio-mass energy (waste and wood).

Impact on real income and poverty

The erosion of living standards can be viewed through the decline of wages (10.2%), remittances (3.4%), and overall disposable income (5.9%), all in real terms.

The decline in real wages was mainly the result of increased food and energy prices – their combined effect increased household expenses by 43% over two years, which outpaces the 30% growth in wages.

As a result of deteriorating real incomes, poverty increased significantly in 2022. The absolute poverty rate increased by 6.6% in Moldova, with significant variation between regions and sources of income. While in Chisinau the poverty rate increased only slightly (1.4pp), in the already poorer regions (Center and South) it increased by around 10 percentage points, and it almost reached the 50% level in the South region. The extreme poverty rate also increased more significantly in the poorer rural areas (by 5.4pp), contributing to inequality.

The impact also varies across sources of income, emphasizing the compensatory effect of remittances in preserving social safety. While households, where the main source of income was remittances, weathered through the crisis better (absolute poverty rate increased only by 2.6 pp), those who were self-employed in the non-agricultural sector (i.e. usually selling less essential products/services) saw a doubling of the poverty rate (a 13.3 percentage point increase).

Refugee influx and economic impact

A significant number of refugees remaining in Moldova (estimates of around 110 thousand people, out of a total inflow of ~800 thousand) has dampened the decline in consumption during 2022 but may also have had a pro-inflationary effect on prices during the period of high inflation.³ Although with moderate effect, the refugees also contributed to Moldova's labor force, with estimates of employment contribution ranging from 1114 as of August 2022 (ANOFM official data) up to 5000, which would represent 0.5% of total employment.^{4,5} Despite the government effort, studies pointed to a general lack of employment opportunities for refugees, particularly in rural areas. Together with relatively high aid received, skill mismatch and high seasonality in offered work, and lack of childcare, this led to about only 20-30% of sampled refugees reporting any form of employment in 2023.^{6,7}

Refugees (and host families) were beneficiaries of several financial support programs, which were not available to the general population affected by the cost-of-living crisis.

Policy responses and measures

Energy security

1. Diversification of Energy Sources:

- Moldova accumulated gas reserves in Ukraine and Romania from European sources, lessening dependence on Russian gas with assistance from the EBRD.
- Moldova connected to the ENTSO-E European electricity network and bolstered its cross-border connections, primarily with Romania. The increased cost and supply volume constraints remain challenges.
- Industrial consumers and municipal heating plants (~30% of gas consumption) switched to alternative energy sources, representing a significant move away from gas.

2. Stabilization and Ongoing Reliance:

- By 2023, energy security stabilized, with resumed electricity imports from the Transnistrian region and diversified gas supplies. However, indirect reliance on Russian gas persisted through electricity production in the Transnistrian region.

3. Measures to protect households from price impact:

- In Q4 2022, the government launched Energy Vulnerability Reduction Fund (EVRF), providing monthly compensation to shield vulnerable households from escalating energy bills. The fund represented approximately 1.8% of the GDP and suggests an ongoing need for similar support if energy prices remain elevated.
- Alternative fuels like firewood were subsidized, and major heating plants transitioned to these alternative sources.

Supporting the vulnerable population

The government accelerated the allocation of existing social assistance programs, including the Ajutorul Social Program and APRA heating assistance.

Supported by the UN, additional beneficiary programs were introduced targeting vulnerable families and refugees.^{8,9} The additional social program targeting the local socially vulnerable population comprises of 700 MLD (35

EUR) per month for 6 months and a one-off 1000 MLD (50 EUR) – significantly lower than refugee assistance.

Authorities increased the minimum wage by 14% in January 2023, with a planned wage increase for civil servants in 2023.

Moreover, pensions were increased by 13.9% in 2022, and starting from 2023, pension adjustments will be indexed in line with the growth in social security contributions. Overall social protection spending in the national budget increased by 30% in nominal terms in 2022.

External financing

The government has decreased its reliance on expensive short-term internal borrowing as a source of financing in 2022. Strong external support enabled the government to maintain relative stability.

- In 2022, direct external support (IFI or bilateral loans and grants) accounted for approximately 4.5% of GDP, with grants comprising 1.7% and the rest as loans.
- The main supporters include the IMF, WB, EBRD, and the EU, while bilateral country partners such as Romania, Germany, the US, and Norway also provided essential help to Moldova. External project financing, in addition to direct loans and grants, amounted to around 1% of GDP in 2022.
- Security of energy supply and diversification in 2022 was achieved with substantial support from international organizations - EBRD (EUR 500m) and USAID (\$300m).
- On a separate stream, the Refugee Response Plan 2023 contains a total of USD 427 million (3% of GDP) pledged assistance, targeting both refugees and local communities affected by the crisis.
- As pointed out by local experts, going forward, the EU accession would not just secure political stability, but also ensure the external financial support which is essential for the country.

Recommendations

Energy security

1. Continue supporting Moldova in diversifying energy sources to reduce dependence on a single supplier. Facilitate political discussion around the Transnistrian region's gas supply in order to potentially diversify away from Russia in the electricity generation, too. Enhancing the interconnectivity of the electricity network in Eastern Europe (both in terms of physical connections and regulation harmonization) would also benefit Moldova.
2. Develop contingency plans under various assumptions for both energy prices and geopolitical situation (availability of Russian gas). Ensure emergency funding lines are in place to secure supply under worst-case scenario. Regularly review and update contingency plans based on global energy trends, domestic consumption patterns and geopolitical risks.
3. Provide support for investments in renewable energy infrastructure to reduce vulnerability to global (and regional) energy market fluctuations and geopolitical risks.
4. Provide support for improvement of energy efficiency in homes and businesses to reduce overall demand. Energy intensity (per unit of GDP) of the Moldovan economy is among the highest in Europe, which suggests efficiency improvement (such as upgrading district heating systems) is a low-hanging fruit.
5. Provide funding for information and public education campaigns, as energy efficiency projects primarily rely on public acceptance and support.
6. Continue supporting both the domestic and the refugee population through measures such as EVRF, as long as growth in incomes does not fully offset the increase in energy prices. Ensure that assistance reaches the most vulnerable sections of the population, regardless of whether they are refugees or domestic citizens. Try to prevent the households from switching back to less efficient, more polluting biomass (waste and wood) energy by providing both the necessary financial means and education.

Supporting vulnerable population

1. Donor assistance to refugees and refugee-hosting households is substantial and generally covers a minimal consumption basket. As a recent study showed, the top reported needs among refugees in Moldova were financial support (97%), health services (81%), clothes and shoes (78%), food (73%), medicines (72%), and personal hygiene items (68%).¹⁰
2. Continue to provide assistance to the government in the integration process of the refugees. As employment is particularly low among the newly arrived (only 19% of those previously employed in their origin country found a job in Moldova according to the cited study above), one particular focus should be on creating better job opportunities for these people. This can be done by the application of a series of active labor market policies (i.e. improving public employment services and administration, providing training, creating sheltered and supported employment and rehabilitation, offering start-up incentives, etc.), in which donors can contribute not only by providing financial means but also by assisting the local authorities with best practices from the donor countries. The latter is especially important as the aforementioned study has also found that refugees have been the least satisfied with the employment agencies' services among all institutions.
3. The government measures to increase public spending will mainly benefit pensioners and wage earners, while increased support for the socially vulnerable population outside these groups is limited in time and scope. Thus, while assistance to refugees should continue unabated, donors should also focus on providing the necessary support for the most vulnerable sections of the domestic population, in particular to the rural self-employed, those outside the labor force, those not receiving remittances or social assistance from the government.
4. In order to prevent public discontent due to lack of support from the government, it would be useful to supplement the policies targeting local groups with information campaigns.

Supporting the economic recovery

Once the immediate impact of the conflict on Ukraine has been addressed and inflation pressures subside, attention of both the government and external partners should be focused on promoting economic recovery, i.e. the development of a diversified and competitive export-based and EU-

integrated economy which is the only way to mitigate some of the core vulnerabilities of Moldova in the long term.

While most of the obstacles to achieving this are for the government (combatting corruption, closing infrastructure gaps, conducting structural reforms, harmonizing legislation to European standards), donor organizations can play an important role in supporting vulnerable segments of the population through this process:

1. Provide support to large and vulnerable agriculture-dependent population by empowering farmers to boost higher value-added production. Consider investing in irrigation, adoption of modern technologies and providing access to finance and training for small farmers. Provide support for laboratories and other required infrastructure for access to the EU market.
2. Provide financial support for upgrading infrastructure, in particular, road/rail access to alternative harbors in light of the trade route diversion due to the war.
3. In light of the high migration outflow, invest in re-purposing abandoned housing for vulnerable and low-income populations.
4. Support education policies in order to improve human capital, particularly to address the gap between rural and urban areas (which scored higher on the 2018 PISA test by an equivalent of two grade levels),¹¹ considering the already high rural poverty rates.
5. Support reintegration of diaspora and transfer of their skills. Support the development of a forum for networking and exchanging knowledge between returnees and diaspora.
6. Support development of skills and re-education for persons outside the labor force, particularly youth in rural areas and/or regions with high risk of poverty. Provide financial stimulation for their employment, including entrepreneurship.

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