Monetary and Foreign Exchange Policy of the National Bank of Moldova for 2005

NBM Monetary and Foreign Exchange Policy Strategy and Objectives

The National Bank of Moldova in cooperation with the Government of the Republic of Moldova establishes and promotes its monetary and foreign exchange Policy within the context of the unique economic policy of the State. Since the introduction of the national currency in 1993 NBM has promoted a monetary and foreign exchange policy aimed at achieving the stability of the national currency through due ensurance of a relevant degree of national economy monetization.

The monetary and foreign exchange policy promoted by NBM is monetary targeted, providing the establishment of quantitative targets of money supply growth. The strategy of the NBM policy embodies the use of reserve money as operational objective and of broad money as intermediary objective.

The National Bank of Moldova shall over 2005 further implement a relevant monetary and foreign exchange policy aimed at achieving the NBM main objective – the realisation and maintenance of the stability of the national currency through establishment of monetary, credit and foreign exchange market conditions based on market economy principles.

I. Macroeconomic Trends, Banking System and 2004 Monetary Policy Assessment

Macroeconomic Situation

Gross Domestic Product (GDP) in January – September 2004 increased by 5.7% in real terms as compared to the relevant period of the previous year and amounted to 23071.7 million lei in current prices.

GDP structure was similar to those in previous years: services accounted for the largest share of 52.6%; industry – for 17.0%; net taxes on products and imports – for 14.8%; agriculture – for 18.0% and indirectly measured services rendered by financial intermediaries – minus 2.3%.

The weight of final consumption as at 3rd quarter-end accounted for 107.3% of GDP; of gross capital formation – for 21.5%; and of net exports – minus 28.8%.

The value of foreign trade with goods and services over the first nine months of 2004 amounted to US$ 2377.08 million, denoting a 27.2%-increase as compared to the relevant period of 2003, including of exports – by 25.8% and of imports – by 28.1%. As a result, the trade balance of goods and services registered a deficit of US$ 538.14 million, or by 32.1% more than in the same period of the previous year. This deficit was covered by the surplus registered by incomes and current transfers by 88.9%. The deficit of the current account of the balance of payments amounted to US$ 59.83 million.

Consolidated budget revenues during the first 10 months of 2004 amounted to 5856.2 million lei; and budget expenditures – to 5833.0 million lei.

State external debt as at 3rd quarter - end amounted to US$ 1890.81 million, including public debt and public guarantees – US$ 857.97 million and private debt – US$ 1032.84 million.

The growth rate of consumer prices in January to November 2004 was 10.7%, including of food products – by 10.0%; of non-food products – by 11.0%; and of services – by 11.5%.

Foreign Exchange Market

During the first 10 months of 2004 the evolution of the foreign exchange market was affected by the enlargement of foreign exchange flows related to export proceeds and excessive offer of foreign currency in the domestic foreign

exchange market (as a result of remittances from Moldovan citizens working abroad), as well as by the fluctuations of foreign currency supply and demand following the significant modification of the American dollar exchange rate against euro in the international market. Export revenues over the first ten months of the year amounted to US$ 898.4 million, surpassing by 24.3% the value in the same period of 2003. The value of the net foreign exchange offer by individuals as at the end of October 2004 totalled US$ 596.4 million, increasing by 65.1% from the relevant period of 2003 (US$ 361.2 million). The structure of foreign exchange flows in the first ten months of 2004 denotes significant weight of net foreign exchange offer by individuals (37.0% against 30.5% in the relevant months of 2003).

The nominal exchange rate of the national currency against US dollar in January to November 2004 appreciated by 5.6%.

Within the structure of total selling/buying turnover in the domestic forex market of transactions in main foreign currencies against Moldovan lei the weight of US dollar transactions reduced from 80.2% in January 2004 to 73.0% in October 2004 and the weight of euro transactions increased from 16.1% in January 2004 to 23.1% in October 2004.

Net NBM acquisitions in the domestic forex market in January to November 2004 totalled US$ 221.4 million.

International reserves increased by US$ 103.6 million from US$ 302.3 million as at end of 2003 to US$ 405.9 million as at end of November 2004 (which, based on the forecast for the 4th quarter of 2004 should cover 2.1 import-months).

Banking System

The consolidation of the banking system continued in January – October. Tier I capital of banks increased over this period by 326.2 million lei, or by

16.1% as against the end of 2003 and amounted to 2355.5 million. Total assets of the banking sector as at October-end amounted to 12513.7 million lei, registering an increase of 21.7% or by 2230.7 million lei as compared to December 2003.

Dynamics of monetary aggregates

Over the first eleven months of 2004 reserve money increased by 25.7% or by 976.1 million as compared to 31 December 2003 and amounted to 4780.1 million lei. Accordingly, currency in circulation increased by 633.3 million lei (23.1%) and total banking reserves – by 342.6 million lei (32.2%).

Broad money M3 enlarged from January to November 2004 by 28.1%. Broad money M2 rose by 30.4% over the relevant period, including deposits in lei – by 37.3%. Deposits in foreign currency (expressed in US$) grew by 31.0% as compared to the 44.3%-increase in the relevant period of 2003.

The balance of credits to economy rose in January to November 2004 by 1301.9 million lei (or 21.5%) as compared to as of 31 December 2003 and totalled 7357.1 million lei. The average interest rate on credits in lei over January to November 2004 accounted for 20.94% and the one on credits in foreign currency – for 11.39%. Thus, the dynamics of total lending in 2004 was in line with development trends of the national economy of the Republic of Moldova.

The multiplier of broad money M2 increased from 1.48 as at end of 2003 to 1.53 in November 2004.

Implementation of Monetary Policy Instruments

Interest Rates Policy

With the view to managing interest rates in the money market in 2004, the National Bank of Moldova promoted a transparent policy in establishing interest rates on instruments of monetary regulation, which had a signal role for the

financial market participants with regard to monetary policy orientation. The NBM interest rates policy was based on the analysis of inflationary trends, of monetary and macroeconomic indicators and of financial market condition and was directed towards the consolidation of economic positive dynamics.

Over the first eleven months of 2004 the base rate increased once (on 23.09.2004) from 14.0% to 14.5%; the interest rate on overnight credits and Lombard facility were kept at the same level of 17.0% and 16.0% per year, respectively; the interest rate on overnight deposits was raised (on 24.06.2004) by 2 p.p. to 5.0% per year. The interest rate on long-term (over 5 years) credits was maintained at the level of 11.5% per year.

Open Market Operations

The monetary context in 2004 requested the amplification of NBM sterilisation of excess liquidity in the banking sector, which was largely generated by the interventions of the National Bank of Moldova in the forex market.

Within open market operations NBM held selling auctions of securities from NBM portfolio and SS selling REPOs. The total value of such operations over the first eleven months of 2004 amounted to 1354.2 million lei.

Deposit Acceptance

The total value proposed by banks for placement at the 36 deposit auctions held in the first 11 months of 2004 amounted to 1001.9 million. The amount of accepted bids totalled 859.2 million.

Required Reserves

The regulation of reserve requirements was determined by the condition of the internal financial market. The mechanism of establishing reserves requirements was essentially modified in July 2004. These modifications provided the reduction of required reserves ratio from 12.0% to 10.0%; the separate formation of required reserves in Moldovan lei and in free convertible currency; the abrogation of the provision to maintain cash required reserves in

bank's vaults; and the inclusion of resources attracted in non-convertible currencies in the liabilities subject to compulsory reservation.

Refinancing of Commercial Banks

Considering the significant value of excess liquidity, banks did not apply for Lombard facility over January to November 2004. However, banks facing short-term liquidity deficit used overnight credits. NBM extended during the reported period overnight credits to 3 commercial banks in an amount of 15.8 million lei.

The ***Government debt to NBM*** as of 30 November 2004 totalled 2738.0 million lei as compared to 2144.0 million lei as of 31 December 2003.

II. Monetary and Foreign Exchange Policy for 2005

The monetary and foreign exchange policy of the National Bank of Moldova, including the main activities to be followed with the view to fulfil the NBM basic attributions for 2005 are worked out based on the Law on the National Bank of Moldova. The framework applied for the elaboration of the monetary and foreign exchange Policy of the National Bank of Moldova for 2005 included: 1) the forecast of economic development of the Republic of Moldova provided within the Framework of medium-term expenditures for the years 2005-2007; Poverty Reduction and Growth Facility (PRGF) that provides the GDP 6.0%-increase in 2005; and 2) the Law on the State Budget for 2005.

The monetary and foreign exchange policy of the National Bank of Moldova for 2005 is worked out based on the following considerations:

- inflation target shall be observed within 8.0% - 10.0%;
- population saving trends shall be similar to those in 2004;
- the forecast of the evolution of net foreign exchange offer in the forex market shall be similar to the trends denoted over 2004;

- state external debt shall be served as in accordance with the Law on the State Budget for 2005 and NBM shall repay IMF credits (US$ 23.9 million);
- NBM shall extensively use its instruments to sterilise excess liquidity in the market;
- the level of required reserves shall be adequate to the state macroeconomic evolution.

Based on the NBM forecast, broad money M2 shall increase in 2005 maximum by 45%, considering the enlargement of reserve money by 41.0%. Monetization level (ratio of broad money M2 to GDP) is expected to account for 31.4% as at end of 2005.

The State debt to NBM shall stay within the limits stipulated in the Law on the State Budget for 2005.

Instruments of Monetary Policy

The National Bank of Moldova shall further conduct a balanced interest rates policy, paying due consideration to the dynamics of inflationary processes; the condition of the money and foreign exchange market; and the macroeconomic indicators with the view to ensure due balance between internal saving and investments.

Furthermore, the National Bank of Moldova aims at enhancing its capacity to use interest rates and to assign them all prerequisites of an efficient monetary policy instrument. Within this context, the National Bank shall continue to permanently monitor the dynamics of interest rates applied by banking institutions with regard to both rates on accepted deposits and extended credits.

By promoting the interest rates policy NBM shall further apply the corridor method, where the interest on overnight credits shall be the highest rate and the interest on overnight credits – the lowest rate.

The rate on 2-month SS purchasing REPOs shall be considered as the base NBM rate to be used as pillar for the determination of interest rates on other instruments included in the rates' "corridor".

In 2005 NBM shall further determine the interest rate on long-term credits to be used upon service of loans previously extended by NBM.

Within the context of implementation of the monetary Policy for 2005 and depending on the macroeconomic evolution and money market condition, the National Bank of Moldova shall maintain the optimum liquidity in the banking system by conducting of both liquidity absorbing and liquidity providing operations.

The monetary policy instruments shall be developed as to ensure high effectiveness of the monetary policy. To consolidate excess liquidity absorption NBM shall extend the scope of applied instruments by adding to the existent ones (open market operations, attraction of deposits from banks, required reserves, Lombard facility, overnight credits / deposits) the issuance of Certificates of the National Bank of Moldova and shall duly inform the Ministry of Finance on issuance terms and values.

In 2005 the National Bank shall mainly conduct market operations for purposes of liquidity management to the detriment of administrative instruments (required reserves).

To maintain banks' liquidity NBM shall further apply standing facilities – overnight credit / deposits.

These financial instruments of the National Bank of Moldova shall allow Moldovan banks intensify the efficacy of their liquidity management and of payment risks mitigation.

Foreign Exchange Policy

The foreign exchange Policy of the National Bank of Moldova for 2005 provides the further free floating exchange rate regime of the national currency and the establishment of the official exchange rate based on prevailing exchange rates in the forex market.

Within this context the NBM shall have the right to make foreign exchange interventions if needed to attenuate excessive fluctuations of the exchange rate. Instruments of the foreign exchange policy shall include direct purchases of foreign currency, forex swap operations and forward transactions.

The foreign exchange Policy of the National Bank of Moldova for 2005 shall be continuously directed towards the maintenance of international foreign exchange reserves at a level acceptable to cover 3 import-months at least. NBM shall place its foreign exchange assets in investment instruments that comply with security and liquidity requirements.

Banking Supervision

With the view to maintaining a stable and consolidated banking system, the National Bank of Moldova shall continuously promote banking consolidation. Within this context NBM shall conduct measures aimed at: mitigating risks related to banks' active operations; increasing risk coverage by own capital; improving methods of assets' and liabilities' management; developing internal control systems; and consolidating the activity of management bodies. All these actions shall contribute to the amelioration of capacities to accumulate temporary free resources available in the market within banks denoting higher prudential requirements and shall ultimately enhance the capacity of these banks to satisfy increasing demands of the national economy and of individuals for banking services.

Special attention shall be paid to the following issues:

a) further increase of commercial banks' capital;
b) promotion of policies with regard to identification of owners holding considerable influence upon bank's management and activity;
c) development of internal control procedures aimed at determining common activities of debtors and bank's owners.

Note: The National Bank of Moldova reserves the right to review certain monetary indicators for 2005 in event international financial institutions and external donors resume the financing of the Republic of Moldova.