

Monetary and foreign exchange policy of the National Bank of Moldova for the year of 2007

Strategy and Objectives of the Monetary and Foreign Exchange Policy of the National Bank of Moldova

Pursuant to the Law on the National Bank of Moldova and in line with the Strategy of the Government of the Republic of Moldova and of the National Bank of Moldova concerning the development of the financial sector of the Republic of Moldova in the period of 2005-2010, the National Bank of Moldova in coordination with the Government of the Republic of Moldova shall establish and promote the monetary and foreign exchange policy as the component part of the state's single economic policy.

The National Bank of Moldova shall continue to promote in 2007 the monetary and foreign exchange policy, targeted at realizing its fundamental objective of ensuring and maintaining the prices stability.

I. Macroeconomic tendencies, banking system and monetary and foreign exchange policy evaluation in 2006

Legislation

The adoption in 2006 of Law no.191-XVI of 30.06.2006 on the modification of Law no.548-XIII of July 21, 1995 on the National Bank of Moldova marked the initiation of a new stage in the activity of the National Bank of Moldova. These changes referred, first of all, to Article 4 The fundamental objective of the National Bank of Moldova, which was modified from "achieving and maintaining the national currency stability" into "ensuring and maintaining the prices stability". At the same time, it is worth mentioning that the modifications operated to Article 41 stipulated the ban on extending loans and warranties in any form to the state or agencies thereof, including through state securities' purchase in the primary market.

The modification of the fundamental objective urged the National Bank to adjust the monetary and foreign exchange policy and instruments thereof to the new requirements, which primarily call for a profound and thorough knowledge of the inflation phenomenon within the Republic of Moldova. The dynamics of the economic situation in 2006 encouraged the promotion of more restrictive monetary and foreign exchange policy with a view to achieving the fundamental objective.

Relationship with the International Monetary Fund

In 2006 the Government of the Republic of Moldova, the National Bank of Moldova and the International Monetary Fund signed the Memorandum on Economic and Financial Policies for the period of 2006 – 2008.

Macroeconomic situation

The gross domestic product accounted in semester I, 2006 for 18 757.9 million lei in current prices, increasing by 5.0% in real terms as compared to the similar period of the previous year.

The GDP structure followed the tendency observed over the previous year: the services sector kept the prevailing share of 61.9%, the industry accounted for 15.2% of GDP, the agricultural sector scored 8.8%, the net taxes on products and imports equalled to 16.5% and the services of financial intermediates measured indirectly posted net of 2.4%.

The final consumption constituted 97.6% of GDP, including the gross capital formation of 30.0% and the net export net of 46.1%.

In January-September 2006 the value of the agricultural production added up to 10669.8 million lei, decreasing by 4.0% in real terms versus the same period of 2005. The value of the industrial production registered a reduction by 7.0% in real terms as compared to the first nine months of 2005 and equalled to 14958.8 million lei.

During the first six months of 2006 the current account of the balance of payments recorded a negative value in an amount of US\$ 206.3 million. The deficit of the external goods and services trade advanced by 34.3% as compared to the similar period of 2005 and accounted for US\$ 662.1 million. The goods and services export fell as against as in semester I, 2005 by 2.6%, while imports expanded by 12.4%.

In the period of January-October 2006 the cumulative inflation posted 10.8%, including the prices for foodstuff products went up by 4.6%, for non-foodstuff products – by 12.9% and for services rendered to the population – by 19.4%. Concomitantly, the industrial production producers' prices increased for the period of ten months of 2006 by 11.7%, including of the mining and quarrying industry – by 18.2%, of the processing industry – by 14.0% and of energy, heating, gas and water supply – by 0.8%.

In January-October 2006 the state budget accrued revenues in an amount of 8720.0 million lei, which represented 103.2% as compared to relevant provisions (8447.1 million lei). The state expenditures ran into 7931.5 million and accounted for 83.7% of the budget provisions for ten months of 2006. It should be noted that the revenues enlarged, as compared to the corresponding period of the previous year, by 120.5%, while expenditures – by 126.2%.

As of the end of October 2006 the state domestic debt totalled 3806.2 million lei, while the external direct public and guaranteed debt constituted US\$ 663.7 million.

Foreign exchange market

In the period of January-October 2006 the official nominal exchange rate of the national currency against US\$ depreciated by 3.1% (from MDL 12.8320 per US\$ 1 to MDL 13.2272 per US\$ 1), as compared to the depreciation of 1.2% (from MDL 12.4600 per US\$ 1 to MDL 12.6112 per US\$ 1) in the respective period of 2005.

The effective real exchange rate of the national currency (calculated as compared to December 2000 taking into account the inflation level of the commercial partners – countries and the modification of the monthly average exchange rate) depreciated by 2.6 percentage points versus December 2005 (94.7%) and accounted, in October 2006, for 92.1%. The effective real exchange rate of the national currency calculated as compared to December 2005 depreciated by 2.5 percentage points and constituted 97.5% in October 2006.

Over the first ten months of 2006 the National Bank of Moldova acted in the domestic foreign exchange market with a view to lessening the excessive fluctuations of the nominal official exchange rate of the national currency against US\$, using the following instruments: operations of US\$ sale/purchase in the net amount of US\$ 59.1 million and swap reversible instruments in an amount of US\$ 15.3 million.

In the first ten months of 2006 the growth dynamics of the net foreign currency offer from individuals amounted in relative values to 12.4% as compared to 45.9% of the respective period of the previous year.

Within the structure of transactions in the foreign exchange market of the Republic of Moldova in the period of January-October 2006 the US Dollar continued to prevail, while the shares of foreign currencies within the turnover of the transactions in the domestic foreign exchange

market distributed as follows: US\$ – 66.0%, EUR – 29.9%, RUB – 3.4% and other non-convertible currencies – 0.7%.

In the period of January-October 2006 the foreign exchange reserves advanced by US\$ 76.8 million, from US\$ 597.4 million at the end of 2005 to US\$ 674.2 million at the end of October 2006, which covered about 2.5 months of imports.

Banking system

As of 31.10.2006, on the territory of the Republic of Moldova there were 15 joint stock commercial banks, including 3 subsidiaries of foreign banks. The total number of banks constituted 956, out of which there were 224 branches and 732 representative offices.

Over the first 10 months the Tier I Capital increased within the system by 625.8 million lei (22.2%) and reached the value of 3443.8 million lei.

The share of foreign investments in the banks' capital accounted, as of 31.10.2006, for 55.2%, enlarging, as compared to the end of 2005, by 4.6 percentage points, as a result of the equity increase on the account of non-resident shareholders' investments.

During the period of 10 months of 2006 the total assets within the banking system raised by 21693.6 million lei or by 3754.4 million lei (20.9%).

Net credits held the highest weight of 54.9% within total assets. Over the analyzed period they increased by 2369.3 million lei (24.8%), and amounted, as of 31.10.2006, to 11918.2 million lei.

The weight of unfavourable credits* (substandard, doubtful and compromised) in the total credit portfolio equalled as of 30.09.2006 to 5.2%, decreasing as against as of 31.12.2005 by 0.1 percentage point. As of 31.10.2006 the credit loss provisions in the total of credits amounted to 5.3%, being at the same level as compared to the beginning of the year.

As of 30.09.2006 there were no essential changes recorded within the structure of credit portfolio*, according to the destination of investment operations. The highest weight of total credit portfolio was held as of 30.09.2005 by credits extended to industry and trade – 48.9%, followed by credits extended to agricultural sector and food industry – 20.4%, credits extended for real estate, construction and development – 9.2% and consumer credits – 8.6%.

The enhancement of the incomes basis was revealed by the essential weight of interest-bearing assets that reached the value of 81.9% of total assets or 17757.1 million lei. This fact allowed to banks to register in the first 10 months of 2006 net incomes in an amount of 553.2 million lei, which is by 158.1 million lei (40.0%) more versus the same period of the previous year.

Dynamics of monetary aggregates

Over the period of January-October 2006 reserve money reduced by 8.7% or by 606.5 million lei as compared to December 31, 2005 and accounted for 6396.4 million lei. The diminution of banking reserves during the reported period by 770.2 million lei (31.7%) was greatly conditioned by the decrease of means on commercial banks' correspondent accounts with the National Bank of Moldova determined by the sterilization operations of excess liquidity from the banking system and by budget expenditures restriction. Thus, the balance of the National Bank Certificates in circulation amounted as of the end of October 2006 to 841.2 million lei.

During the reported period the broad money M2 (cash in circulation + deposits in MDL + money market instruments) went up by 2.9% versus the end of 2005, and accounted for 11445.2 million lei. Within the structure of broad money the balance of deposits in national equalled to 6698.8 million lei (by 2.2%), while the balance of cash in circulation augmented by 162.6 million lei (3.6%).

* Data are submitted on a quarterly basis

Money supply M3 registered over the respective period an increase by 14.7% and reached the value of 18159.1 million lei. Deposits in foreign currency (expressed in MDL) enlarged considerably by 42.8%.

The value of recently attracted deposits constituted 10828.4 million lei, increasing by 29.5% as compared to the same period of 2005, including deposits in national currency advanced by 7.9%, while deposits in foreign currency (expressed in MDL) recorded an essential growth by 52.6%. In the reported period the average weighted interest rate on deposits in national currency constituted 11.56%, while deposits in foreign currency ran into 5.11%, decreasing by 2.03 and 0.04 percentage points, respectively.

The most emphasized advancement of deposits in foreign currency, or, to put it differently, the dollarization of deposits endangered both the efficient promotion of the monetary and foreign currency policy and the single economic policy of the state.

During the period of January-October 2006 the balance of credits to economy recorded an increase by 2614.6 million lei (or by 26.2%, which was higher as compared to the growth of 25.9% of the respective period of 2005) as against as of December 31, 2005 and added up to 12605.2 million lei.

Over the first ten months of 2006 the value of recently extended credits posted 12641.6 million lei, increasing by 19.6% as compared to the similar period of 2005, including credits in national currency – 7818.4 million lei, and recorded a growth of 11.2% as against the respective period of 2005. Recently extended credits in foreign currency expressed in MDL evolved by 36.2% and reached the level of 4823.2 million lei.

The average weighted interest rate on credits in national currency equalled in the respective period to 18.1%, while on credits in foreign currency it scored 11.06%, decreasing by 1.22 and 0.07 percentage points, accordingly.

Rates policy

During the year of 2006 the monetary and foreign exchange policy promoted by the National Bank of Moldova was targeted at achieving its fundamental objective, acting upon the interest rates on its instruments. At the beginning of the year the corridor rates was comprised between 2.0% per year on overnight deposits and 15.0% per year on overnight credits, while the base rate scored 12.5% per year and the rate on Lombard facility – 14.0%.

In June, based on the inflation dynamics and the evolution of interest rates in the interbank market, the National Bank of Moldova enlarged the interest rates on Lombard facility and on overnight credits by 1.0 and 2.0 percentage points, accordingly.

In October, taking into account the situation in the domestic money market and the evolvment of inflationist pressures, the National Bank of Moldova raised the base rate by 0.5 percentage point, established at the level of 13.0% per year.

As a result of increases operated on the interest rates of monetary policy instruments, the rates corridor was established, as of the end of October 2006, at 2.0% per year on overnight deposits and 17.0% per year on overnight credits.

Use of monetary policy instruments

In 2006 the excess liquidity, considered an impediment for the achievement of the fundamental objective, conditioned the proportions of sterilization operations within the banking system.

The issuance of certificates of the National Bank of Moldova, as well as the attraction of deposits from banks were the main instruments of liquidity managing within the banking system, applied over the first ten months of 2006.

The integral value of sterilization operations conducted by the National Bank of Moldova in the period of January-October 2006 constituted 6744.7 million lei.

The monthly average interest rate on sterilization operations advanced from 2.40% – in January to 10.99% – in October, while the average value for 10 months totalled 7.93% per year.

National Bank Certificates-selling operations. During the first ten months of 2006 the National Bank of Moldova carried out 44 auctions of NBM Certificates placement, offering NBC with terms of 14 and 28 days in the total amount of 4180.0 million lei.

The participants' demand accounted for 4242.0 million lei. Out of the announced offer, 95.6% were placed, while the value of the liquidity effectively sterilized through this instrument equalled to 3973.1 million lei. The interest rate on issued NBC fluctuated between the minimal value of 1.57% per year, registered in January, and the maximal value of 10.99% per year, registered in October. The average rate for the period of January-October 2006 amounted to 9.04% per year.

Deposits acceptance. Over the first ten months of 2006, 33 deposit auctions and 2 direct negotiations were conducted, offering an amount of 3555.0 million lei.

The integral value of commercial banks' demands within deposit auctions and direct negotiations ran into 2950.5 million lei, while the value of accepted deposits totalled 2771.6 million lei.

The average weighted term on deposits accepted, during the first 10 months, through auctions and direct negotiations accounted for 67 days, versus 49 days recorded in the same period of the previous year.

The monthly average rate on deposits accepted over the first 10 months of 2006 was placed between the minimal values in January – 2.555 per year and maximal values in August – 11.29%. the average weighted rate for the analyzed period equalled to 6.35% per year.

Required reserves. The value of required reserves in MDL for the period of October 16-31, 2006 constituted 854.6 million lei, increasing by 59.4 million lei or by approx. 7.5%, as against as of the end of 2005.

Required reserves formed by banks in US\$ and in EUR, also registered an ascendant trend over the analyzed period of 2006. Required reserves in US\$ and in EUR equalled, as of October 31, 2006, to US\$ 30.9 million and EUR 22.1 million, accordingly, increasing, as compared to the end of December 2005, by US\$ 7.2 million and EUR 8.3 million, respectively.

Refinancing of banks. The constant excess liquidity observed within the banking system in the period of January-October 2006 was determined by the fact that banks did not essentially resort to overnight credits and Lombard facilities. The National Bank of Moldova extended two overnight credits only, in an amount of 10.5 million lei.

Direct credits extended to commercial banks. The crediting activity carried out by the National Bank of Moldova over the first ten months of 2006 was expressed by the supervision of credits extended to commercial banks in the period of 1992-2002 for crediting the Housing Construction Cooperatives based on certain decisions issued by the Parliament and the Government of the Republic of Moldova.

The balance of credits extended to banks as of 31.10.2006 constituted 42.8 million lei, decreasing, as against as of 31.12.2005, by 8.9 million lei (17.2%), as a result of the payment of credits by the members of the Housing Construction Cooperatives.

It is worth mentioning that prescheduled reimbursements accounted, over the year of 2006, for 8.4 million lei of the value of credits paid within the analyzed period.

Relations of the National Bank of Moldova with the Government of the Republic of Moldova

In 2006 the National Bank of Moldova continued the reconclusion of loans extended previously to the Government and the reissuance of SS in the portfolio of the National Bank of Moldova. Within the structure of domestic state debt, the prevailing share was held by the debt to the National Bank of Moldova, which equalled, as of the end of October 2006, to 2521.0 million lei,

consisting of the debt on loans in an amount of 2121.0 million lei and the debt represented by state securities within the portfolio of the National Bank of Moldova in an amount of 400.0 million lei.

The state debt to the National Bank of Moldova dropped, as of 31.10.2006, by 90.0 million lei as against as of 31.12.2005 as a result of the payment by the Government of the Republic of Moldova of the partial amount out of 118.8 million lei, provided for by the Law on the state budget for 2006 to be paid over the year of 2006.

State securities within the portfolio of the National Bank of Moldova. The state debt to the National Bank of Moldova represented by state securities in the portfolio of the National Bank of Moldova kept, as of 31.10.2006, the same level as against as of 31.12.2005 and accounted for 400.0 million lei (at purchase price).

During the reported period the National Bank of Moldova conducted the reissuance of state securities from own portfolio, at market interest rates, with the leading maturity of 91 days. The interest rates of state securities accepted in the portfolio of the National Bank of Moldova varied between 1.01 and 7.94%, while the average weighted interest rate constituted 5.47% per year.

In 2006, with a view to coordinating the monetary, foreign exchange and budget and tax policies, the National Bank of Moldova and the Ministry of Finance established the Committee of Liquidity Management, the objective of which is to ensure an efficient communication and collaboration within the context of the attributions' fulfilment by both authorities in the light of liquidities management and monitoring.

II. Monetary and foreign exchange policy for 2007

The monetary and foreign exchange policy, including the main trends of the activity for fulfilling the basic attributions of the National Bank of Moldova for the year of 2007, were elaborated pursuant to the Law on the National Bank of Moldova. While working out the monetary and foreign exchange policy of the National Bank of Moldova for 2007, the following was taken into consideration: 1) Scenarios of the economy development of the Republic of Moldova presented within the Framework of medium-term expenditures for the period of 2007-2009, Strategy for Economic Growth and Poverty Reduction (SEGPR) stipulating a GDP growth by 4.0% in 2007; 2) The Law on the state budget for the year of 2007; 3) the Strategy of the Government of the Republic of Moldova and of the National Bank of Moldova on the development of the financial sector within the Republic of Moldova in the period of 2005-2010.

The monetary and foreign exchange policy of the National Bank of Moldova for 2007 has been worked out with a view to achieving the fundamental objective and maintaining the inflation rate within the limit of 10.0%.

In order to realize the fundamental objective within limits stipulated for the year of 2007, the National Bank of Moldova shall promote the monetary and foreign exchange policy taking into account the following monetary indicators:

- a) the increase of reserve money shall be comprised within the limits of up to 9.7%;
- b) the increase of broad money shall be comprised within the limits of up to 20.0%;
- c) the degree of monetization M2 (the ratio of broad money M2 to GDP) at the level of 32.0% as of the end of 2007.

The debt of the Government of the Republic of Moldova to the National Bank of Moldova shall be established within the limits coordinated by both parties and stipulated in the Law of the state budget for the year of 2007.

Monetary policy instruments

In 2007 the excess liquidity within the banking system shall keep a level comparable to that of 2006 and shall be influenced by in-flows of foreign currency from abroad, including investments and remittances, the interventions of the National Bank of Moldova in the foreign exchange market,

the value of the state's financial means transferred by the Ministry of Finance on accounts with the National Bank of Moldova, as well as the modification of the value of cash in circulation.

The decrease of the annual inflation rate requires the implementation of a set of macroeconomic policies, including, first of all, the monetary and foreign exchange policy, to determine the reduction of the excess liquidity and to moderate the inflationist anticipations. In order to handle this requirement, the National Bank of Moldova shall continue in 2007 to enhance the operations of sterilizing the excess liquidity by using all instruments at its disposal.

Open market operations

Open market operations represent the main operations of monetary policy, used both for the sterilization of excess liquidity (issuance of the National Bank Certificates, acceptance of deposits, REPO selling-operations, final; sales of state securities from within the portfolio of the National Bank of Moldova), and for banks' refinancing (REPO buying-operations).

The National Bank of Moldova shall perform the main operations on a weekly basis in the form of auctions as in accordance with the established schedule.

In the event that the liquidities from within the banking sector are affected by certain unexpected events from the monetary policy standpoint, the National Bank of Moldova shall conduct operations of liquidities adjustment through additional auctions or on bilateral basis.

Standing facilities

Standing facilities include overnight deposits placed by banks with the National Bank of Moldova and overnight credits used at the banks' initiative. These facilities shall be used with a view to maintaining the liquidity within the banking system at an optimal level and avoiding the excessive fluctuations of the interest rate on overnight credits / deposits.

Required reserves

In 2007, the National Bank of Moldova shall maintain the required reserves at a level optimal for the macroeconomic situation of the country.

Rates policy

The National Bank of Moldova shall continue to promote the rates policy by using the corridor method, the highest rate will be applied to overnight credits and the lowest rate to overnight deposits. The National Bank of Moldova shall establish the base rate for refinancing operations – REPO rate, which shall have the role of indicating the interest rate of the monetary policy promoted by the National Bank of Moldova. At the same time, with a view to improving the mechanism of transmission of the promoted rates policy, the National Bank of Moldova shall announce the maximal rate within the operations of liquidities sterilization.

Foreign exchange policy

The National Bank of Moldova shall maintain in 2007 a floating exchange rate regime and shall set out the official exchange rate of Moldovan leu as against US\$ based on exchange rates leading in the domestic foreign exchange market.

In this context, the National Bank of Moldova shall be entitled to conduct foreign exchange interventions with a view to repressing the excess fluctuations of the official exchange rate and to filling up the international foreign exchange reserves. Direct interventions in the domestic foreign exchange market, including forward transactions, as well as swap reversible foreign exchange operations shall be used as foreign exchange policy instruments.

Within the framework of foreign exchange policy implementation for the year of 2007 the National Bank of Moldova shall endeavour to maintain the international reserves at an acceptable level for covering three months or so of imports and shall continue to promote a prudent foreign

exchange policy, consistent with the fundamental objective of ensuring and maintaining the prices stability along with the placement of the state's international reserves into investment instruments complying with the security and liquidity criteria.

Relations of the National Bank of Moldova with the Government of the Republic of Moldova

In 2007 the National Bank of Moldova shall continue accepting the state securities reissuance at market rate, which were previously transferred to the National Bank by the Ministry of Finance, as a result of the conversion of credits contracted in the previous years by the Government of the Republic of Moldova, as well as servicing the state's debt made up of loans extended in the previous years, within the limits coordinated with the National Bank of Moldova and provided for in the budget law for 2007.

Loans previously extended will be reconcluded according to the conditions of ensuring the loans and related interests by SS at the market rate.

Pursuant to the provisions of the Strategy of the Government and of the National Bank of Moldova regarding the development of the financial sector of the Republic of Moldova in the period of 2006-2010, the National Bank of Moldova shall collaborate with the Ministry of Finance with a view to gradually cutting back the domestic state debt to the National Bank of Moldova.

In 2007 measures undertaken for the achievement of the monetary and foreign exchange policy of the National Bank of Moldova and the budget and tax policy of the Ministry of Finance of the Republic of Moldova shall be coordinated within the framework of the Committee of Liquidity Management, with the purpose of conducting a more efficient supervision and strategic monitoring of liquidities.

Banking supervision

In order to avoid the excess vulnerability of the banking system, as well as to enable banks to efficiently manage the credit, liquidity, exchange rate and interest rate risks and the country risk, the National Bank of Moldova shall promote a continuous improvement of the methods of managing assets and liabilities within banks, thus contributing to an adequate protection thereof and to the increase of banks' incomes.

Within this context, a special attention shall be paid to:

- The development of banks' capacity to plan and conduct business in an organized, prudent and efficient way;
- The improvement of methods of regular and timely management of the quality of banks' assets, as well as the bettering of methods of controlling capital and liquidity and of profitability thereof;
- The promotion of the continuous growth of the banking sector's transparency by maintaining in the banks' registers of veracious, complete and appropriate information and the disclosure thereof on a regular and timely basis.

Note: In event of certain macroeconomic changes within the economic and financial situation that can have an impact on the monetary and foreign exchange policy, as well as in the case of changes within the financing of the Republic of Moldova from international financial institutions, the National Bank of Moldova has the right to review, over the year of 2007, the Monetary and Foreign Exchange Policy.