MONETARY POLICY STRATEGY OF THE NATIONAL BANK OF MOLDOVA FOR 2010-2012

(amended by decision of the Council of Administration of the National Bank of Moldova no.267 of December 30, 2010, will be effective on January 1, 2011)

According to the Law on the National Bank of Moldova No. 548-XIII as of July 21, 1995, the National Bank of Moldova is the central bank of the Republic of Moldova, is an autonomous public legal entity that sets up and implements the state monetary and foreign exchange policies.

The monetary policy strategy of the National Bank of Moldova (NBM) for 2010-2012 has been elaborated following the implementation and the promotion of the monetary and foreign exchange policies during the year of 2009 and aims to complement the Strategy of the monetary and foreign exchange policy for the period of 2010-2012, published in the quarterly Report of the NBM No. 4, 2008.

This monetary policy strategy has a medium-term focus and shall set the priority guidelines for the activity of the National Bank of Moldova aimed at fulfilling its primary objective “to achieve and maintain price stability”.

In order to achieve and maintain price stability, the NBM establishes an inflation objective - measured by the consumer price index published monthly by the National Bureau of Statistics (NBS) - of 5.0 percent in 2010 with a possible deviation of ± 1.0 percentage points. During 2011–2012, the NBM shall aim at a stable inflation rate in mid–single digits.

Introduction

Following the approval in July 1995 of the Law on the National Bank of Moldova the primary objective of monetary policy was to achieve and maintain the stability of national currency, which determined the NBM’s monetary policy strategy and tactics.

Thus, until 2006, this ultimate goal of monetary policy implied two objectives: on the one hand, to ensure and maintain domestic stability of the national currency, approximated by the inflation rate and measured by the consumer price index, and on the other hand, to achieve and maintain, additionally and in parallel, external stability of the national currency measured by the exchange rate against major foreign currencies.

In 2006, following the approval of the Law No. 191-XVI dated June 30, 2006 regarding the amendments to the Law on the National Bank of Moldova No. 548-XIII from July 21, 1995, the primary objective “to achieve and maintain the stability of the national currency: was modified and the primary objective of the National Bank of Moldova “to achieve and maintain price stability” was adopted.

During 1994 – 2008 the monetary policy objective was achieved by targeting the monetary aggregates. At that time, the decision to adopt the targeting of monetary aggregates was deemed appropriate given the economic environment in the Republic of Moldova.

Implementation and promotion by the NBM of the regime of targeting monetary aggregates led to a decrease of inflation and to a macroeconomic stabilization, thereby leading to lower uncertainty and risks in decision-making process in the field of investments; stronger public confidence in the financial system of the state; and a more efficient implementation of the social reform.

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In 2009, the NBM has abandoned the regime of targeting monetary aggregates[1] and set the inflation rate objective of 9.0 percent by the end of the year with a possible deviation of ± 1.0 percentage points. During this period the national economy was seriously affected by the global economic crisis, effects of which materialized in significant reduction of the remittances from individuals from abroad, lower aggregate demand and external trade. These effects have fuelled negative expectations of the population and legal entities which prompted the NBM to intervene on the foreign exchange and monetary market in order to stabilize the macroeconomic situation. Thus, the economic developments that differed from those forecasted pushed the need to reorient the monetary policy towards the real economy.

STRATEGIC GUIDELINES OF MONETARY POLICY FOR 2010-2012

I. Explanation of monetary policy objective

Under the provisions of the 4th Article of the Law on the National Bank of Moldova, the primary objective is to achieve and maintain price stability.

Price stability can be defined as a situation in which prices' increase is low enough so that it does not have a significant impact on the economic decisions of the society.

The National Bank of Moldova considers that "the price stability" can be quantitatively defined by the inflation rate measured through the consumer price index published monthly by the National Bureau of Statistics, given that: (i) the public is familiar with that index and less with other measures of inflation; (ii) the consumer price index data are readily available and (iii) are not subject to revision; and last but not the least (iv) the principle of separation of interest between the institution that collects and calculates this index (NBS) and the institution that has inflation as its policy objective (NBM) is preserved.

While achieving and maintaining price stability is the fundamental objective of monetary policy, the NBM also has secondary macroeconomic objectives, namely promotion of economic growth and employment. These goals are pursued to the extent they do not affect the NBM's fundamental objective.

Maintaining low level of inflation and quantitative objective of monetary policy

The most important objective of the NBM is to achieve price stability and maintain the inflation rate at a low level so as to contribute to developing of a relatively stable macroeconomic framework that will enhance economic development and ensure a sustained growth.

Specifically, the NBM considers that low and relatively stable inflation will:

- maintain low nominal interest rates, which will encourage the long-term investment and enable legal entities to maintain their domestic and external competitiveness;
- discourage speculative activities and strengthen financial stability;
- support long-lasting economic growth and job creation, and will lead to productivity growth that brings real improvements in the standard of living of the population;
- protect the fixed income of socially vulnerable groups, that are mostly affected by the high inflation since it erodes the value of their investment income or social benefits (pension, allowances, etc.).

[1] see Chapter II. "Monetary policy regime"

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For 2010, the National Bank of Moldova hereby sets an inflation objective, measured by the consumer price index (CPI), of 5.0% per annum by end-year[2], with a possible deviation of ± 1 percentage point.

The inflation objective of 5.0% for end-2010, reflects a number of short- and long-term considerations in the period ahead. The short-term factors in 2010 include the current expectation of a gradual recovery of aggregate demand and a slight growth of real GDP; as well as the NBM's current projections of key international prices, notably energy and fuel. Among the relevant long-term factors, the NBM considers the continued convergence of the Moldovan economy toward its main trading partners, systematic productivity growth in all sectors and structural transformations in the economy. Therefore, the inflation objective is set higher than by the European Central Bank (ECB)[3] to avoid systematic and fast appreciation of the Moldovan Leu.

The tolerance band of ± 1.0 percentage point is needed because of:

- the time lag between the monetary policy decisions and their effect upon the inflation rate due to the inertia of the national economy;
- the statistical deviations that occur in measuring inflation, requires the existence of sufficient margin for small changes in relative prices, that appear consistently in each economy;
- the need to maintain some flexibility of the monetary policy in responding to short-term shocks;
- the general uncertainty regarding the current economic forecasts.

When some unforeseen shocks move or are expected to move inflation outside the declared interval, the monetary policy will have as a goal to bring inflation as close as possible to the objective during a medium-term horizon. During the same time horizon, monetary policy instruments will be implemented to achieve the inflation objective without causing excessive adverse impact on the economic activity.

Thus, monetary policy action would be warranted whenever the inflation outlook points to risks of missing the target range, even if current inflation is within the range; and conversely, a current deviation from the objective would not warrant action if inflation is expected to converge to within the tolerance band within a reasonable period of time.

At the same time, the NBM will take into account that, in reality, there may be a range of shocks and extraordinary events, whose reasons are wholly or largely outside the control of the monetary policy and they are not under the direct control of the NBM. Therefore, from the economic point of view, it would be irrational and costly for the monetary policy to try to reduce or eliminate the effects of such shocks in the short term.

Taking into consideration the above-mentioned factors and reasoning from the premises of the possible erosion of credibility of the monetary policy measures, the NBM defines a set of exceptions that can justify temporary deviations from the inflation objective. These external and unforeseen factors include:

- the impact of the administrative prices over the general level of prices;
- substantial deviations from the NBM's forecasts of the prices for raw materials, energy resources and other commodities and services;
- significant changes in other external economic factors, including investor sentiment and the flow of remittances, manifested in excessive and sustained exchange rate pressures;

[2] Inflation rate for the last 12 months.
[3] The primary objective of the ECB's monetary policy is to maintain price stability. The ECB aims at inflation rates of below, but close to, 2% over the medium term.

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- considerable changes in the volume and the structure of the agricultural output with the corresponding changes of the prices;
- changes in indirect taxes (VAT, excises, etc.)
- natural disasters or similar extraordinary events with cost and demand impacts on prices.

However, once the shocks caused by exogenous factors listed above, have unwound, the NBM will adjust monetary policy to bring inflation within the limits of the declared objective.

Better understanding of some exogenous factors will be possible through calculation and publication by the NBS of core inflation[4]. The NBM will continuously analyze the developments of both CPI and core inflation to separate endogenous factors from those influenced by monetary policy.

Looking ahead, the NBM plans to continue aiming at inflation around mid-single digits—barring substantial exogenous shocks—during the period.

In 2011, the National Bank of Moldova will maintain the conditions necessary for the continuation of disinflation process, will make effort to control the inflation rates on a downward trend recorded and projected for the years of 2010 - 2012.

Taking into account the delay in monetary policy impulses on inflation and the national economy, a higher degree of uncertainty over the internal and external economic environment and the need to increase the operational flexibility, the National Bank of Moldova broadens the monetary policy horizon no later than 24 months and broadens the objective range.

For 2012, the National Bank of Moldova will create conditions to set the inflation within the target range of 5.0 percent annually, with a possible deviation of ± 1.5 percentage points.

II. Monetary policy regime

In 2010-2012, the National Bank of Moldova will continue focusing on setting and achieving specific inflation objectives.

The actual monetary policy regime, namely the regime of monetary aggregates targeting, does not enable, under the existing circumstances, to achieve fully the primary objective due to the following considerations:

- the relationship between the evolution of monetary aggregates and the inflation rate, in the case of the Republic of Moldova, is less predictable, the dynamics of the correlation between them is diminishing each year;
- the existing monetary policy instruments, do not ensure fully the efficient management of the money supply (as a result of the monetary multiplier's instability and the change in the structural money demand), which would guarantee price stability;
- the need to calibrate the monetary policy according to evolution of inflation rate, and not according to an intermediate target;
- risks associated with the using of the exchange rate as a nominal anchor, in the context of an open economy and further liberalization of the capital account.

Due to above-mentioned factors, the National Bank of Moldova considers that the adequate monetary policy regime, which will allow achieving its primary objective, is the regime that is focused on achieving

[4] Price index that reflects the main inflationary pressure factors, which is determined by excluding from the consumer price index the temporary shocks of the regulated prices, the indirect tax changes and other

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specific inflation objectives with a number of relevant variables, such as monetary aggregates, interest rates, and the exchange rate, providing indirect guidance for monetary policy in the short term.

In this context, it could be mentioned that such regime has more advantages in comparison with other monetary policy regimes, namely it allows:

- to achieve and maintain price stability at moderate costs;
- a more efficient anchoring of inflation expectations;
- an increased responsibility of the National Bank of Moldova in achieving its primary objective;
- a higher degree of communication and transparency of the monetary policy measures.

Besides all of the above-mentioned advantages, the regime of direct inflation targeting is more flexible and operational, even in the case of an unstable relationship between monetary aggregates and inflation. At the same time, the NBM will regularly monitor the evolution of monetary aggregates during decision process regarding monetary policy instruments and actions towards achieving and maintaining price stability.

III. Monetary Policy Instruments

Achievement of primary objective will be done through **main monetary policy instrument**: open market operations, as well as through **auxiliary instruments**: standing facilities, required reserves ratio and foreign exchange market interventions. These instruments have a direct impact on the level of nominal interest rates on the money market over the short term.

The NBM will oversee the money market conditions in order to achieve the inflation objective by setting up the main short–term interbank market indicator – the base rate.

The level of the base rate will be set up by the Council of Administration of the National Bank of Moldova, according to Art. 26 of the Law on the National Bank of Moldova.

Open-market operations – main monetary policy instrument. Open market operations will be performed in the short term, aimed at balancing the supply and demand in the money market, will allow the NBM to influence the short-term interest rates in the interbank market.

Through open market operations, the NBM on the daily basis will oversee the money market in order to ensure the maintenance of interbank rate (CHIBOR) on short term at a level close to the base rate approved by the Council of Administration of the NBM.

Accordingly, the National Bank of Moldova will announce and publish in advance the schedule and the terms of the open-market operations. The NBM will inject liquidity only in case of lack of liquidity in the banking system.

Standing facilities conducted on the licensed banks' demand limit the fluctuations of short-term interbank interest rates (overnight), which can be significant sometimes and determine the interest rates corridor on the short–term money market.

Interest rates of standing facilities (overnight deposits and credits) will determine the thresholds of the corridor of the National Bank of Moldova's interest rates.

Standing facilities will be available for the licensed banks on demand, without limits, at the rates set up by the Council of Administration of the NBM.

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The required reserves will be an instrument of the monetary policy used to limit the excess of liquidity and to smooth out its impact on the interbank interest rates. They will play a prudential role as well, especially given the limited size of the Deposit Guarantee Fund. The required reserves are maintained on the licensed banks' accounts opened at the National Bank of Moldova at the rates established by the Council of Administration of the NBM.

The Council of Administration of the National Bank of Moldova will determine the level of the required reserves ratio, in national and foreign currency, according to the medium- and long-term inflation trend, the evolution of the macroeconomic indicators and the forecasts of the macroeconomic and monetary indicators in the medium and long term, inflation expectations, etc.

The interventions on the foreign exchange market and foreign exchange policy

The National Bank of Moldova will continue to promote a prudent foreign exchange policy, consistent and correlated with the primary objective to achieve and maintain price stability, and will invest the official international reserves into investment instruments that meet the safety and liquidity requirements.

The National Bank of Moldova will continue to maintain the floating exchange rate regime.

The efficiency of achieving and maintaining price stability will be supported by the floating exchange rate regime, because the systematical adjustment of the exchange rate can lead to changes of the interest rates that can be inconsistent and opposite to those that are adopted under the inflation objective. As a result, the National Bank of Moldova will not establish a predetermined exchange rate of the Moldovan Leu against other currencies.

However, the National Bank of Moldova reserves the right to intervene on the foreign exchange market to smooth out the excessive fluctuations of the official exchange rate and to supplement the international foreign exchange reserves.

At the same time, the NBM reserves the right to exceptionally intervene on the foreign exchange market when it is necessary to complement effects of the main policy instrument in achieving the inflation objective.

The instruments of the foreign exchange policy will be as follows: the direct interventions on the domestic foreign exchange market, reversible foreign exchange operations as SWAP, as well as forward transactions.

The NBM will foster the implementation of the hedging instruments by the banking system, which will mitigate the foreign exchange risk

IV. Transmission mechanism of the monetary policy

During 2010-2012, the NBM will continue to analyze and model the transmission mechanism of the monetary policy, in which the interest rate plays the main role in influencing the monetary, credit and foreign exchange markets.

In general, changes of the NBM's base rate are expected to affect the lending and borrowing rates in the economy, as well as the exchange rate of the national currency. Thus, the base rate is expected to determine the monetary conditions under which the national economy operates.

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Ultimately, changes of monetary conditions will have an impact on the demand of goods and services. Low interest rates, for example, stimulate the increase of spending and decrease of savings, as well as the depreciation of the national currency, which can stimulate exports and discourage imports. Similarly, the increase of interest rates encourages the decrease of internal spending and the appreciation of the national currency that can result in the decrease of exports and the increase of imports. High demand for domestic goods and services generates additional pressure on prices in the case when it exceeds the economy's capacity.

The National Bank of Moldova will permanently monitor and analyze the impact of monetary policy decisions upon lending behavior of the banks, as well as the effects of banks' activities on the real sector. Factors that may weaken these channels (underdeveloped financial markets, excess structural liquidity, etc.) would merit special attention, as would efforts to develop alternative transmission channels (e.g., promotion of de-dollarization to strengthen the lending channel).

Despite the fact that, during the last two years, the National Bank of Moldova has been using actively the base rate as a monetary policy instrument, the effects of it on the interest rates in the economy and the existence of a low elasticity between the real macroeconomic variables and the interest rate is still a major concern.

Because of all these considerations, the National Bank of Moldova will further promote the interest rate channel of monetary policy transmission, will modify the data collection of the interest rates on newly granted credits and attracted deposits by the banking sector in accordance with the international standards[5], which will allow to increase the modeling and analysis capacity, especially of monetary policy transmission mechanism.

Meanwhile, monetary policy decisions of the National Bank of Moldova are expected to have an impact on the inflation and the national economy with a time lag of several quarters.

A chain of events is activated which influences the consumption, sales, production, employment as well as other economic indicators. This means that monetary policy should be based on macroeconomic forecasts. The National Bank of Moldova must evaluate the current monetary conditions and must take measures to maintain sustainable economic growth.

At the same time, the efficiency of the transmission mechanism as well as the realization of the inflation objective depends on the stability and development of the banking sector. In this regard, the National Bank of Moldova will continue to monitor and will contribute to the increase of the degree of credibility of the banking system.

In order to sustain the development of the banking system, the National Bank of Moldova will continue to monitor the efficient application of the banks' internal procedures of evaluation and risk management and will stimulate the improvement of the internal audit system, based on the enhanced transparency of the banking services.

V. Decision making process, the communication and the transparency of the monetary policy

The Council of Administration is responsible for the development and approval of the monetary policy, as well as approving the **base rate, the required reserves ratio and the standing facilities corridor.**

Starting with January 2010, the Council of Administration will discuss monthly the implementation of the monetary policy. The schedule of the Council of Administration meetings on monetary policy will be

[5] According to the methodology of the International Monetary Fund and the European Central Bank.

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announced and published in advance. The Council of Administration reserves the right to decide on the monetary policy issues outside the published schedule, but only in exceptional cases. The monetary policy decisions made by the Council of Administration will be made public not later than the next day following the day the decision is taken.

In order to ensure the transparency of the decision-making process, the National Bank of Moldova will publish quarterly the Monetary Policy Report, which will contain the analysis of the macroeconomic situation and a forecast of the medium–term inflation and main macroeconomic indicators (2 years). The first report will be published at the beginning of February 2010. The schedule of publishing the Monetary Policy Report will be adopted by the Council of Administration and published on January 2010.

Thus to evaluate monetary policy, starting from 2011, National Bank of Moldova will publish quarterly Inflation Report, that will be the following of the Monetary Policy Report. This document in addition will include detailed analysis of primary objective realization, risk analysis of future objective achievement and in case of inflation and forecast of inflation overshooting over the determined limits National Bank of Moldova will present a correction action plan for guidance of inflation within the established limits.

In order to highlight the key role of the inflation in the monetary policy of the National Bank of Moldova, the NBM will begin with issuing a press release the next day after the new data on inflation will be released by the National Bureau of Statistics. In this press release the main factors that had an impact on inflation will be briefly analyzed and an assessment of the inflation forecast will be made.

VI. Cooperation with the Government of the Republic of Moldova and the central public authorities

The National Bank of Moldova will continue to cooperate with the Government of the Republic of Moldova and the central public authorities in order to promote the monetary policy.

This cooperation requires permanent exchange of information and dialog regarding the fiscal policy, especially tax changes, budgetary wage modifications, pensions and other social benefits and other measures that may affect the price level.

In order to establish a monetary framework necessary to achieve the primary objective, the National Bank of Moldova will cooperate with the National Bureau of Statistics and the National Commission of Financial Market.

The National Bank of Moldova in cooperation with National Bureau of Statistics will adopt a methodology and will separate the responsibilities regarding the monthly publication of the core inflation. At the same time, the NBM and the NBS will cooperate to ensure permanent exchange of information on price, macroeconomic, external trade and other indicators.

In addition, the National Bank of Moldova will cooperate with the National Commission of the Financial Market in the field of implementing the Standardized Reporting Forms of non-bank financial market participants designed to provide data necessary for the monetary Survey of the financial sector, including other financial institutions.

On the basis of this Survey the National Bank of Moldova will perform the analysis of the whole financial sector, namely: claims on and liabilities to other sectors of the economy and to non-residents, especially, in order to analyze the amount of loans granted by the financial sector.

This will allow the National Bank of Moldova to implement a monetary data collection system that will comply with the internationally accepted standards and will allow monitoring the dynamics of the monetary aggregates within the financial sector.

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In this period the National Bank of Moldova will cooperate with the National Agency for Energy Regulation (NAER) in order to obtain the information on the level and the change of the gas prices, electricity and others that have a big share in the consumption basket of the population.

VII. Cooperation with the International Monetary Fund

During 2010-2012 the Government of the Republic of Moldova, the National Bank of Moldova and the International Monetary Fund will continue to implement the provisions of the Memorandum on Economic and Financial Policies[6].

Also, the National Bank of Moldova, as a communication link with the International Monetary Fund, will report to IMF the main indicators related to the monetary market, credit market and foreign exchange market and will request technical assistance particularly in the field of monetary and financial statistics and will enhance the analysis and modeling capacity.

[6] To be approved by the International Monetary Fund in January, 2010

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