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Inflation Report no. 1, 2018

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Summary

In 2018, the annual inflation rate will gradually decrease within the set variation interval, but will return to the target level in the second half of 2019. The core inflation will be relatively stable over the year, recording insignificant fluctuations close to the 5.0 percent level. The growth rate of food prices will drop significantly this year, down to 4.2 percent, but in the coming year it could rise rapidly above 7.0 percent level. The annual growth rate of regulated prices will be characterised by considerable volatility: it will fall to around -3.0 percent in the current year and will return to a level of approximately 5.0 percent by the end of 2019. The annual growth rate of fuel prices will record a generally downward trajectory, being driven by periodic fluctuations determined by the annual base effect.

Aggregate demand will maintain a disinflationary trend over the next two years, largely due to restrictive monetary conditions. The pressures towards appreciation of the actual real exchange rate will further reduce the competitiveness of indigenous products, with the exception of trading partners in the European

Union, thus stimulating imports and slowing down exports. At the same time, through another channel, the appreciation will partly offset the loss of competitiveness by lowering imported costs and increasing productivity. Moreover, the appreciation of the Moldovan lei against the U.S. dollar will stimulate exports to the countries of the European Union.

Monetary conditions will, for the most part, remain unchanged throughout the forecasting period. The disinflationary pressures of the current year and pro-inflationary pressures of the next year do not warrant any relaxation of the monetary policy due to a delayed impact of monetary policy decisions on inflation.

The evolution of the global economy in 2017 denotes the recovery of external demand, which accentuates pro-inflationary pressures. The normalization of monetary policies in countries with advanced economies, in the context of their positive evolution, favours capital migration from emerging economies to the advanced ones, thus inevitably impacting foreign exchange rates. Both the increase in global demand and the U.S. dollar's falling below parity with other currencies determine global commodity prices to rise. Following the extension of the OPEC+ agreement at the OPEC meeting on 30 November 2017, oil quotations have risen sharply, reaching the last three years' peak of USD 70 per barrel in early 2018. The rise in oil prices has also led to the appreciation of the Russian ruble and a more favourable forecast on the evolution of the Russian economy as well as the economy of the region as a whole.

The current inflation forecast values remain close to the projected ones, although they were slightly decreased for the current year. Core inflation has been revised slightly upward throughout the forecasting period, the trajectory being similar to the one previously projected. The forecasted growth rate of food prices was decreased by up to 2 percentage points, mainly due to the strengthening of the Moldovan lei and the lower growth rate projections for international food prices. The anticipated cuts of regulated tariffs were reduced mainly in the middle of the forecast horizon as a result of the rise in oil prices. The forecasted growth rate of fuel prices was revised as a result of rising oil prices and the concurrent strengthening of the Moldovan lei.

Following a prominent ascendant trajectory recorded in the first half of 2017, in the fourth quarter of 2017, the annual average inflation rate recorded 7.5 percent, a level slightly higher than in the previous quarter. Thus, inflation reached its peak of 7.9 percent in October, recording a 7.3 percent level at the end of 2017. As a result, during the fourth quarter of 2017, the annual inflation rate continued to record values above the upper limit of the inflation target range set in the Medium-term monetary policy strategy. A high annual inflation rate was mainly maintained by pressures exerted by food prices as a result of the less favourable agrometeorological conditions for domestic fruit and vegetables recorded in 2017, as well as the sectoral shocks that triggered the rise in meat prices and some imported products. At the same time, high inflation values were also supported by the impact of tariff increases on some regulated services, especially at the beginning of the year. Core inflation maintained a relatively stable dynamics, remaining close to the inflation target. At the end of 2017, it was largely affected by the additional regulations adopted on the minimum retail selling price for cigarettes. The trend towards appreciation of the domestic currency in the reference period has mitigated the influence of the above-mentioned pro-inflationary factors. Estimates indicate that domestic demand has had a negligible impact on inflation over the reference period. In the following period, a steady decrease of the annual inflation rate is expected as a result of the gradual dissipation of the effects of tariff adjustments made in 2017, as well as the easing of food price pressures.

A more prominent annual growth rate of economic activity in the third quarter of 2017, compared to the first half of 2017, was determined by a rich harvest, especially of cereal crops, and an increase in aggregate demand. Thus, in the third quarter of 2017, GDP rose by 5.4 percent, year-on-year. The contribution

generated by household consumption grew notably compared to the previous quarters.

A positive contribution to GDP dynamics was generated by the investment component, thus the gross fixed capital formation recorded a level 5.5 percent higher, year-on-year. Like in the previous periods, the contribution of the stock change component to GDP dynamics remained strongly positive, having recorded 2.5 percentage points.

In the third quarter of 2017, external demand continued to influence GDP as in the previous quarter, with exports of goods and services increasing by 9.8 percent. Although to a lesser extent than in the first half of the year, GDP growth has been substantially slowed down by the evolution of imports. Thus, in the third quarter of 2017, they recorded a level 10.7 percent higher than in the similar period of 2016.

In terms of category of resources, the evolution of economic activity in the third quarter of 2017 was determined by the positive dynamics recorded in the majority of national economy sectors. At the same time, an important positive contribution was generated by the 10.1 percent increase in net product taxes. Monthly operating indicators, reflecting the evolution of the national economy sectors in the fourth quarter of 2017, as well as the effect of a rich agricultural harvest suggest that the national economy will maintain its positive dynamics through the end of 2017.

During the fourth quarter of 2017, the Executive Board of the National Bank of Moldova held three meetings on monetary policy decisions. Following the internal and external risk balance assessment and the short- and medium-term inflation forecasts, the Executive Board of the National Bank of Moldova decided, at its meetings held on October 25, 2017 and December 5, 2017, to reduce the base rate applied to the main monetary policy operations by 0.5 percentage points, from 7.5 percent annually (a decision adopted at the meeting of 28 August 2017) to 6.5 percent annually. Later, at its meeting held on December 27, 2017, it decided to maintain the base rate applied to the main monetary policy operations at the level of 6.5 percent annually.

The average interest rates on the balance of deposits placed at the licensed banks in domestic currency kept declining following the downward trend set by the base rate applied to main monetary policy operations of the National Bank of Moldova and as a result of the excess liquidity recorded in the banking system; hence, a decline in average interest rates applied on loans extended by the licensed banks was also recorded. In the fourth quarter of 2017, compared to the third quarter of 2017, the quarterly average interest rates applied on the balance of loans decreased by 0.45 percentage points for loans extended in domestic currency and only by 0.06 percentage points for foreign currency loans, having recorded values of 9.73 percent and 5.15 percent, respectively. The average quarterly interest rate on the balance of deposits in Moldovan lei placed with the licensed banks in the fourth quarter of 2017 reached 5.81 percent, having decreased by 0.34 percentage points compared to the previous quarter. The average quarterly interest rate for foreign currency deposits recorded 1.43 percent, having dropped by 0.22 percentage points compared to the third quarter of 2017.

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core inflation [3]
External environment [4]
inflation forecast [5]
forecast [6]

forecasting inflation [7]

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