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Monetary Policy

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Inflation Report no. 3, 2011

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Summary

Inflation developments

In the second quarter of 2011, the annual rate of inflation measured by CPI recorded an upward trend, increasing from 5.8 percent in March to 7.7 percent in June 2011, being largely consistent with the Medium-term Monetary Policy Strategy. At the same time, it corresponds to the forecast stipulated in the Inflation Report no. 2, May 2011, recording an insignificant deviation in the context of high uncertainty driven by food prices development and by the existing pressures on global oil market, as well as by the current increases in tariffs for regulated services. The annual rate of core inflation1 rose from 2.8 percent in March to 3.4 percent in June 2011, which led to the amplification of the difference between the rate of CPI and core inflation from 3.0 percentage points in March to 4.3 percent in June, thus outlining further the non-monetary factors influence on the inflationary process in Moldova.

Food prices contributed the most to the annual inflation rate formation in June 2011, as a result of regional and global food price increases, second round effects intensification from higher prices for fuel, gas and electricity tariffs at the beginning of this year, and as a result of more unfavorable weather conditions than last year for fruit and vegetables. At the same time, the regulated prices had a major contribution, as a result of fuel, heating and electricity tariffs increases recorded in the first semester of this year. Second round effects from higher prices for regulated services, fuel and food, and an increased demand led to higher prices of goods and services related to core inflation. Oil prices fluctuations on the global market, enhanced by the tensions in the Middle East and North Africa, contributed to the fuel prices increase.

In the first quarter of 2011, the gross domestic product recorded an increase in real terms of 8.4 percent as compared to the same period of the last year.

Although the domestic demand is the determining factor in GDP growth, some of it is directed towards goods from abroad, which led to a sharp increase in imports during this period. Import growth was surpassed by that of exports, with a significant positive contribution to GDP growth in the first quarter of 2011. Data on external trade, industrial and agricultural production, transport of goods for the first half of this year outlines the prerequisites for registering a moderate increase in GDP in the second quarter of 2011, compared with the first quarter of 2011.

The unemployment rate in the first quarter of 2011 was 9.4 percent, increasing by 0.3 percentage points compared to the same period last year. However, seasonally adjusted data for this indicator shows a slight improvement of the situation during the reference period compared with the fourth quarter of 2010. In the

first quarter of 2011, the average nominal wage of an employee in national economy increased on average by 9.6 percent against the same period last year, in April and May 2011 its growth was even more pronounced, reaching the level of 13.7 and 12.9 percent, respectively.

Monetary policy National

Bank of Moldova develops and implements the monetary and exchange rate policy aimed at ensuring and maintaining price stability. The NBM will ensure and maintain the inflation within the mid-single digit interval during 2011-2012.

Quantifying the inflation outlook in the short and medium terms, in the context of possible uncertainties and challenges of the reporting period, and to anticipate the inflationary pressures, the National Bank of Moldova has promoted a prudent monetary policy during the second quarter of 2011. At the same time, the NBM continued to manage the liquidity excess by sterilization operations on monetary market.

National Bank of Moldova intervened on the domestic foreign exchange market as a buyer of foreign currency during April to June 2011, to alleviate the excessive fluctuations of the exchange rate of the national currency against the U.S. dollar and to supplement the foreign currency reserves.

During the analyzed period, the volume of transactions of the National Bank of Moldova conducted on domestic foreign exchange market against MDL constituted the equivalent of USD 14.15 million.

In the second quarter of 2011, monetary indicators increased with a quarterly rate higher than the growth recorded in the previous quarter, the quarterly average in annual terms constituting 21.3 percent for M2 and 18.6 percent for M3.

In the current conditions of the banking system, after the increase of required reserves ratio by 3.0 percentage points during the second quarter of 2011, the interest rates on new deposits attracted by banks increased in quarterly terms, and new loans granted to individuals and legal entities recorded a downward trend.

To improve the transmission mechanism of monetary policy decisions, which is currently affected largely by significant liquidity in the banking system, within the meeting of May 26, 2011 the Council of Administration of the National Bank of Moldova decided to raise the required reserves ratio at the expense of funds attracted in MDL and nonconvertible currencies and at the expense of the funds attracted in freely convertible currency by 3.0 percentage points, setting a 14.0 percent value starting with the tracking period of funds attracted during July 8 - August 7, 2011.

Within the same meeting, the Council of Administration of the National Bank of Moldova adopted a decision on amending the Regulation on required reserve regime, which provides the application of a required reserves ratio of 0.0 (zero) percent for attracted funds, included in the calculation base, which maturity is more than 2 years. This change will increase the efficiency of banks cash management and will create some facilities to support the growth of funds attracted by banks in the long run.

Within the meeting of July 28, 2011, the base rate was increased from 8.0 percent to 9.0 percent and rates on overnight loans and deposits from 11.0 percent to 12.0 and from 5.0 to 6.0 percent, respectively.

Medium-term inflation forecasting

After a year of a fragile and uneven stabilization, the global economic growth is on a general downward trend, being jeopardized by problems such as unemployment, rising prices, sovereign debt risk and financial fragility. The latest data on global macroeconomic indicators show worsening of global economic situation and a slowdown in the process of recovering from the global financial crisis.

The real GDP gap showed positive values at the beginning of 2011, being over the potential level of the economic activity, which constitutes an inflationary factor for the next period. Compared to the projection of the Inflation Report No. 2, May 2011 where the output gap was negative, the output gap in the current round of forecasting has changed due to a higher increase than previously anticipated for the first quarter of this year. According to the current projections, the output gap will record positive values, thus recording an insignificant excess of demand.

The current projection places the annual inflation rate at the level of 8.4 percent at the end of the year while at the end of the next year at the level of 7.4 percent. Compared with the Inflation Report no. 2, May 2011, the annual inflation rate at the end of this year showed no deviations, while for the end of 2012 it was revised towards increase. The main causes of higher inflation for the next year are increasing food prices on international markets and the excess of the aggregate demand, which will occur over the next year.

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