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Inflation Report no. 1, 2011

Inflation Report no.1, February 2011 [1]

Summary

Inflation developments and its causes

The annual inflation rate in December 2010 stood at the level of 8.1 percent, by 0.1 percentage points higher the level of September 2010. In this way, the annual rate of inflation is largely in line with the projection published in the Monetary Policy Report no. 4, November 2010, the actual value is 0.3 percentage points higher than the projected one (7.8 percent), deviation caused by the recent developments in the fuel market against the backdrop of increasing petroleum products prices in foreign markets and depreciation of the national currency.

The annual rate of core inflation was 4.4 percent in December 2010 compared with the CPI inflation of 8.1 percent, which shows the high contribution of non-monetary factors in rising prices in Moldova. The food prices have contributed the most to the formation of inflation rate during 2010, as a result of weather deviations from the norm in the reference period and food prices fluctuations in the world market. At the same time, a major contribution has been exerted by regulated prices, as a result of changes in tariffs for services with regulated prices made in January and May. Fluctuations in oil prices on the world market and the exchange rate developments in 2010 have contributed significantly to the increase of fuel prices. At the same time, the second-round effects, caused by high fuel prices and food prices, have caused inflationary pressure on some goods and services related to core inflation.

The gross domestic product during January-September 2010 increased in real terms by 6.5 percent compared with the same period last year. Quarterly evolution of this indicator shows a more rapid recovery of economic activity in the third quarter of 2010, during which there was an increase of 8.0 percent compared with increases of 4.7 and 6.4 percent respectively recorded in the first and second quarters of 2010 compared to the similar periods of 2009. The domestic demand remains the determining factor in GDP growth, and the foreign demand, compared with the previous periods, boosted the economic activity recovery to a greater extent. However, a significant portion of domestic demand is oriented towards goods from the outside, as a result of lower competitiveness of domesticproducts, which greatly hampered the economic recovery of the Republic of Moldova.

In the third quarter of 2010, the NBS indicators show a deterioration of labor market situation in Moldova compared to the third quarter of 2009. The unemployment rate rose by 0.8 percentage points compared with the third quarter of 2009, representing 6.5 percent. This situation created on the labor market shows a delay in the process of creating new jobs in Moldova's economy, despite the positive signals of economic recovery at the beginning of this year. This suggests a reduced flexibility of the labor market, and the unemployed

reluctance to consider the options available because of low salaries. In January-November 2010, the average wage of a worker in the national economy increased by 8.2 percent versus the same period last year, the real wages remaining almost at the level of the last year. During the analyzed period, both in the budgetary sphere and the real sector of the economy has registered an average salary increase of 7.7 and 8.4 percent respectively versus January to November 2009.

Monetary Policy

National Bank of Moldova shall develop and implement the monetary and exchange rate policy oriented towards ensuring and maintaining price stability. In 2010, the monetary policy of the National Bank of Moldova has focused on securing and maintaining the annual inflation rate at the level of 5.0 percent at the end of 2010, with a possible deviation of + / - 1.0 percentage points.

Quantifying the inflation outlook in the short and medium term, in terms of possible uncertainties and challenges in the reported period, as well as to anticipate inflationary pressures, the National Bank of Moldova has promoted during 2010 a prudent monetary policy. Also, the NBM continued to manage the liquidity excess by money market sterilization operations.

In the fourth quarter of 2010, the National Bank of Moldova in- tervened on the foreign exchange market mainly as a buyer, the interventions being made to alleviate the excessive fluctuations of exchange rate of the national currency against the foreign currencies and to supply the domestic market with liquidity.

The evolution of monetary aggregates was influenced by the situation in the national economy affected by the global eco- nomic crisis in 2009, showing positive developments in termsof a pronounced economic growth during the fourth quarter of 2010.

With liquidity excess in the banking system and gradually reduction of credit risk, the interest rates of banks applied on new attracted deposits and new loans granted to individuals and legal entities have registered a pronounced decline in the marked in 2010.

In order to alleviate the inflationary pressures, within the last 2010 meeting, the Council of administration of the NBM decided to increase the base rate by 1.0 percentage point, up to the level of 8.0 percent.

Medium-term inflation forecast

In 2010, the main challenge for most of the countries was the management of the public debt, which also increased sig- nificantly the high unemployment rate, compared with 2009 when the main problems were the economic recession and identification of anti-crisis measures.

Global economy came out of recession in 2010, which was a characteristic of this year, but with a slow and uneven recovery pace and full of risks. Production and world trade recovered faster than originally anticipated and the financial conditions have improved. However, the developed countries are facing the repercussions of the massive growth in debt and the developing countries try to stabilize their economies.

Gradual depreciation in the first half of the single European currency against the U.S. dollar and appreciation of Chinese yuan renminbi and Japanese yen against the U.S. dollar in the second half of the year have generated heated debates, which caused some trade imbalances. The 2010 was marked by many natural disasters that have been felt in the world economy, the food prices reaching a record level in the

world market in December 2010 due to higher quotations for sugar, cereals and oilseeds.

The risks for 2011 are related to the disturbances recorded in the bonds international markets, which could significantly increase the pressure on public finances, resulting in a loss of confidence in the markets and causing a new significant decrease in the budget of states that are still in recession. There is also the risk of a further regression in the U.S. housing market and other countries with advanced economies will not be able to alone sustain the global growth.

As a result of the record of economic growth higher than expected during 2010, the output gap will close at the beginning of 2011. During the forecasting period, it will fall marginally below the level of non-inflationary GDP. The aggregate demand will have a slight disinflationary influence, being offset by the incentive nature of real interest rates.

The annual inflation rate will be placed at the level of 7.9 and 4.5 percent at the end of 2011 and 2012, respectively. Com- pared with the previous forecast round, the annual inflation rate projection rose by 0.6 percentage points for 2011 and decreased by 0.1 percentage points for 2012. The main determinants of the prospective inflation are still the supply factors, which will be reflected in the CPI mainly through food and regulated prices.

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