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Monetary Policy

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Inflation Report no. 1, 2014

Inflation Report no.1 February 2014 [1]

Summary

Inflation developments

The annual rate of inflation has returned close to the target stipulated in the Medium-term monetary policy strategy and reached the level of 4.9 percent in the fourth quarter of 2013, by 0.9 percentage points higher than in the third quarter of 2013. The rise in the CPI annual rate was driven primarily by increased inflationary pressures from food prices as a result of a modest crop of vegetables and potatoes in 2013. Core inflation recorded a reduced annual growth, given a moderate domestic demand. At the same time, the annual rate of core inflation remained on an upward trend in the fourth quarter of 2013 mainly due to the continuing national currency depreciation against the currencies of major trading partners. The annual rate of inflation in the fourth quarter of 2013 was by 0.5 percentage points higher than anticipated in the projection (4.4 percent) published in the Inflation Report no.4, 2013.

External environment

The global economy has strengthened in the second half of 2013 and could strengthen further in 2014, mainly due to the growth in advanced economies. However, global economic growth is still slow and remains below its potential, highlighting the problems of sovereign debt, high unemployment rates and the increasing deflationary risks. Most of the emerging economies have entered the slowdown stage of the economic cycle, which will reflect significantly on the global demand and international prices of commodities. Risks arising from financial market turbulence and volatility of capital flows are still persistent and the subsequent reactions of the monetary policy decisions of the major global players present strong uncertainties.

Economic developments

After the GDP grew by 6.1 percent in the second quarter of 2013, the annual GDP growth increased in the third quarter of 2013 up to 12.9 percent. As a result, Moldova's economy grew by 8.0 percent in the first nine months of 2013. The positive dynamics of the Moldovan economy in the third quarter of 2013 was due mostly to the impressive development of the agricultural sector after a draughty year, which resulted in export growth and a modest increase in imports. Thus, household consumption and gross fixed capital formation recorded increases of 8.9 and 1.2 percent, respectively, while exports grew by 15.0 percent. Imports' development was significantly lower than that of the exports, recording the level of 5.1 percent in the third quarter of 2013. Government final consumption has decreased by 0.9 percent. However, gross value added of agriculture has increased in annual terms by 59.8 percent, overshadowing the positive development of the other sectors of the economy. It should be mentioned that the GVA of goods sector increased by 35.2 percent, generating a contribution of 10.0 percentage points to the GDP growth. At the same time, the GVA of services increased more modestly (by 4.2 percent). Despite the fact that in the third

quarter of 2013 the GDP growth was higher than in the second quarter of 2013, the annual growth rate of net taxes on products decreased by 1.1 percentage points. In the third quarter of 2013, the labor market environment recorded an improvement. Thus, the number of employed persons increased by 4.3 percent and the unemployment rate was 3.9 percent, by 0.9 percentage points lower than in the same quarter of 2012. During October – November 2013, the annual average real wage growth in the economy was 3.2 percent, by 2.2 percentage points lower than in the third quarter of 2013.

Monetary policy

In the fourth quarter of 2013, within three meetings on monetary policy, the members of the Council of Administration of the NBM have reviewed the updated balance of risks for future inflation prospects in the short and medium term. Thus, there have been taken three decisions to keep the base rate at the level of 3.5 percent annually, a level set within the meeting of April 25, 2013. During the reporting period, the NBM promoted a stimulating monetary policy and its efforts were oriented towards combating disinflationary pressures and achieving the objective of keeping inflation within the range of ± 1.5 percentage points from the 5.0 percent target. In the fourth quarter of 2013, the average annual inflation was 4.9 percent.

In the fourth quarter of 2013, the growth rate of monetary aggregates remained high, the quarterly average in annual terms of the M2 monetary aggregate constituted 29.3 percent, (by 3.6 percentage points higher than the growth recorded in the previous quarter) and 26.2 percent for the M3 monetary aggregate (by 4.4 percentage points more than in the third quarter of 2013).

Average interest rates charged by licensed banks in the fourth quarter of 2013 recorded different developments. The average interest rate on new loans in national currency increased towards the end of the fourth quarter of 2013, recording a level of 12.51 percent in December 2013. At the same time, the average interest rate on new loans in foreign currency has increased up to 8.91 percent. The average interest rate on new deposits placed in national currency decreased significantly compared to the previous quarter, registering 5.82 percent, while those in foreign currency increased compared to September 2013, recording the level of 4.51 percent.

Medium-term inflation forecasting

The current projection indicates an annual CPI inflation rate of 5.4 percent on average for 2014, by 0.7 percentage points higher than anticipated in the Inflation Report no.4, 2013. For 2015, the forecasted average annual inflation rate is of 4.8 percent or by 0.5 percentage points more than in the previous report. The current projection places the annual inflation rate in the range of ± 1.5 percentage points from the inflation target of 5.0 percent annually throughout the forecasting horizon.

The increase in *food* prices in international markets, compared to the scenario published in the Inflation Report no.4, 2013, had the most significant contribution to the formation of the annual inflation rate. Also, the upward revision of the forecast for the CPI component was caused by a higher rate than was projected for the fourth quarter of 2013. This deviation was determined mostly by cooler than normal temperatures, recorded in the first half of October, which negatively influenced the collection, storage and marketing of vegetables and potatoes.

The contribution of core inflation to the annual inflation rate is lower than that recorded in the previous report. The downgrade forecast of this CPI component occurred as a result of a negative aggregate demand for the next eight quarters.

According to the current round of forecasting, the output gap is expected to be negative for the entire

forecasting horizon. Thus, according to the scenario, the output gap will change the shape of the curve as from the first quarter of the current year, decreasing until the third quarter of 2014. In the second half of the forecasting horizon, the aggregate demand will record values close to its potential level. An economic activity below its potential level in the long term will cause disinflationary pressures.

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