Monetary policy report

No. 3, August 2010

• 1 Grigore Vieru Avenue, MD-2005, Chisinau • www.bnm.md • E-mail: official@bnm.md •
• Tel. (37322) 409 006 • Fax (37322) 220 591 •

Note

Monetary Policy Report no. 3, August 2010 was prepared bearing on the most recent statistical data compiled by the National Bank of Moldova, National Bureau of Statistics, Ministry of Economy and Ministry of Finance.

Likewise selected were certain statistical data provided by the international community and by the Central Banks of the neighboring states.

The calculation of the statistical data was carried out by the National Bank of Moldova.

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• Tel. (37322) 409 006 • Fax (37322) 220 591 •

LIST OF ACRONYMS

ANRE	National Agency for Energy Regulation
NBM	National Bank of Moldova
NBS	National Bureau of Statistics of the Republic of Moldova
NBC	Certificates issued by the National Bank of Moldova
MTEF	Medium-term expenditure framework
CHIBID	Chisinau Interbank Bid Rate
CHIBOR	Chisinau Interbank Offered Rate
CIS	Commonwealth of Independent States
SDR	Special drawing rights
EUR	Common European Currency
IMF	International Monetary Fund
CPI	Consumer Price Index
PPI	Producer Price Index
MDL	Moldovan Lei
NEER	Nominal effective exchange rate of the national currency
OPEC	Organization of the Petroleum Exporting Countries
GDP	Gross Domestic Product
REER	Real effective exchange rate of the national currency
REPO	Sale and Repurchase Agreement
RUB	Russian rouble
USA	United States of America
EU	European Union
USD	US Dollar
SS	State Securities
FCC	Freely convertible currencies

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I. Macroeconomic developments

External environment

The global economy is recovering after the financial and economic crisis. According to the IMF estimates, the global economy has registered an annual growth rate of 5.0 percent in the first quarter of 2010. Due to the monetary policy measures, the governments' efforts in developing and implementing programs to stimulate the economies, the global economic growth rate in 2010 can reach the level of 4.6 percent.

However, the economic recovery is non-uniform; some developing countries (China, Turkey, and Russia) are already showing signs of revival and will record until the end of this year a growth rate higher than in developed economies. But in the most developing countries (in Eastern and Central Europe), the economic activity increase is relatively low or negative due to the instability caused by the increase of the budget deficits and due to the significant increase of the domestic public debt.

In this context, the process of global economic recovery depends on the medium-term economic growth in developing countries, including China, India, Brazil, etc. However, the public debt crisis, reduction of the international capital flows, maintenance of difficult conditions in terms of loans, high unemployment and unused production capacity in some European countries will have a negative impact on the global economic growth.

However, the EU member governments have decided that to overcome the difficulties it should be taken appropriate measures to reduce government spending or at least to establish a national downward trend of the budget deficits and at the same time to stimulate the economic growth. Governments of the European Union countries decided to reduce pensions, salaries and social benefits, other countries have adopted mixed measures: reduced expenditures and increased tax rates and excise duties.

Euro zone

According to the first estimates of the Eurostat, in the first quarter of 2010 compared to the first quarter of the previous year, the euro zone real GDP grew by 0.6 percent. Based on the forecasts, the real GDP for 2010 of the euro zone will show a moderate increase of 1.1 percent, but unevenly distributed in the economies of member countries. The global economic recovery, its impact on exports demand from euro zone and measures adopted to restore the budget and the financial system functionality should support the euro zone economy. However, it is anticipated that the recovery will be moderated in various sectors because of negative forecasts regarding the labor market conditions.

It should be mentioned that there is a risk that the sustainability of the economic growth are likely to be undermined by the financial shocks that were more pronounced during the second quarter of 2010 as reflected by a significant depreciation of the single European currency and stock market indexes decline. The fiscal problems of Southern European economies remain the main causes of financial instability and low level of investor confidence. However, there are signs that the situation is stabilizing thanks to macroeconomic policy measures whose adoption had been uncertain before, causing financial indicators to plummet.

As regards the price developments, according to preliminary estimates from Eurostat, the annual inflation in the euro zone stood at the level of 1.4 percent in June 2010, as compared to 1.6 percent in May 2010. In the second quarter of 2010, it is possible that the inflation will record again insignificant increases, taking into account the need for fiscal consolidation and increases in indirect taxes.

United States of America

The U.S. economy recorded an increase of 3.2 percent in the second quarter of 2010 compared to the same period of the last year and it is increasing for the fourth consecutive quarter. The GDP growth in this period was supported by the increase of household consumption, traditional momentum of the US economy, which

• 1 Grigore Vieru Avenue, MD-2005, Chisinau • www.bnm.md • E-mail: official@bnm.md •
• Tel. (37322) 409 006 • Fax (37322) 220 591 •

in real terms constituted 1.6 percent as compared to the first quarter of 2009. The external trade where the exports progressed faster than the imports was another important factor that contributed to the economic growth in the first quarter of 2010. The economic recovery has been supported by the manufacturing, but high levels of unemployment, reduced construction activity and investors concern regarding the recovery of the U.S. economy are the factors that limit the U.S. economy to grow faster. An inflation rate growth of 1.7 percent is forecast for 2010. More favorable financial conditions and the monetary policy will allow to the domestic demand growth to acceleration by the end of 2011, but the euro zone debt crisis adds uncertainty to the U.S. economic forecast.

Russian Federation

Russian economic growth in the first quarter of 2010 was 2.9 percent compared to the same period of the last year. Restoring the oil prices on international market in 2009, taking steps to end the banking crisis, encouraging the domestic producer and stimulating the domestic consumption are the factors that contributed to the economic growth. At the same time, the annual inflation rate in the Russian Federation reached the level of 5.8 percent in June 2010, the lowest level in the last years.

External and internal causes will lead Russia to emerge from the recession, such as rising oil prices, the situation in the global financial markets, domestic demand increase. However, the reductions in budgetary spending can have a negative impact on the GDP growth.

Romania

The strong recession of the end of 2008 and 2009 continues to have negative effects on the Romanian economy in the first quarter of 2010. The gross domestic product estimated for the first quarter of 2010 decreased by 2.6 percent in real terms in the respective period of the last year. The economic crisis has affected all the areas of activity, but the most affected was the construction sector, which was significantly reduced (by 17.3%) in the first quarter of 2010 compared to the same quarter of 2009.

At the same, the industry was the only branch that grew by 4.2 percent and that could be the main factor supporting the economic growth in the years 2010-2011. Net exports improvement had a positive effect on GDP, as a result of faster increase of the volume of exports of goods and services (19.5%) compared to the volume of imports (14.9%).

Simultaneously, there are pressures of inflation growth until the end of 2010 due to the increase of 5.0 percentage points of the value added tax.

Ukraine

The recession was particularly strong in Ukraine, which has reduced the real rate of the economic growth from 2.1 percent in 2008, up to minus 15.1 percent in 2009. The crisis depth was demonstrated by the stagnation of almost all economic sectors, and by the significant increase of the budget deficit. However, a modest growth, which continues today, was registered at the end of 2009. Thus, in the first quarter of 2010, the GDP rose in real terms by 4.8 percent compared to the same period of the last year. Available data shows that the economic recovery has been driven by the industrial production growth (10.8%), by the exports increase and slow growth in domestic demand.

Evolution of gas and oil prices

The global economic recovery and macroeconomic indicators improvement have helped to increase the oil demand from Asian countries and the U.S., which directly contributed to the increase of "futures" quotes on oil. During the first quarter of 2010, the upward trend in world oil prices registered in 2009 has continued. Forecasts of oil demand increases and continuous development of Chinese economy contributed to the prices increase with the economy recovery in a number of countries.

Also, the oil market was influenced by the dynamics of the U.S. dollar exchange rate against the major world currencies, weakening the oil prices expressed in U.S. dollars and thus contributing to the

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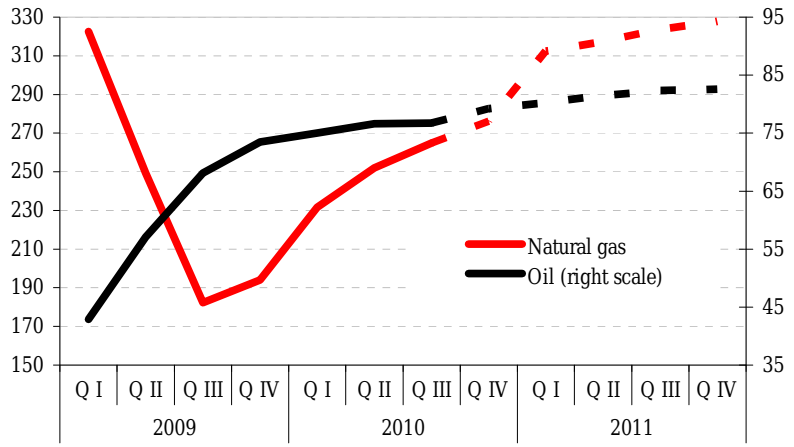
• Tel. (37322) 409 006 • Fax (37322) 220 591 •

attractiveness increase of the goods market for the speculative and investment capital. Therefore, in the first half of 2010, the average oil price constituted U.S. $ 75.6 per barrel[1], increasing by 51.0 percent compared to the same period last year.

The following contradictory factors had a significant contribution to the volatility of the oil prices: the tense situation in the U.S. oil market, sustainable growth of oil demand from China, the creation of oil reserves in some countries. Thus, by examining the average monthly price of oil we can see a more pronounced upward trend, the maximum monthly average value was registered in April 2010, reaching the level of U.S. $ 80.6 per barrel. Also, it should be mentioned that during May-June, the global oil prices quotes have seen a slowing trend, reaching an average value of U.S. $ 73.5 per barrel in June.

Chart no. 1.1. **The evolution and forecast of the natural gas price** (USD/1000 m^3) **and oil** (USD per barrel)



Source: NBM, Energy Information Administration (U.S. government's official statistics), http://tonto.eia.doe.gov/dnav/pet/hist/wepcuralsw.htm

Also, the increase of oil production within non-OPEC countries contributes to the increase of market demand and influences negatively the oil prices in the light of stored reserves. Besides, it should be mentioned that within the last OPEC meeting held on March 17, 2010 it was decided to maintain the oil production level at the existing one - 24.84 million barrels per day. At present the oil price is stable - U.S. $ 70.0 per barrel.

It is expected that during the years 2010-2011 the oil price will be within the limits from USD 70.0 to 85.0 per barrel. The respective values may be achieved not only through the influence of the fundamental factors, but also as a result of speculative actions of players in the oil market, being one of the significant factors of the global oil price formation. Considering the above reasons, there is a relative margin of error associated with long-term forecasts of oil prices. Thus, it is expected that a stronger recovery of the global economy will begin in the second half of 2010 and will increase the consumption of petroleum products which will lead to a slight increase in oil prices. Besides the above-mentioned, the International Energy Agency has recently revised its estimates for oil demand for 2010, declaring that it will increase by 1.8 percent as compared with 2009[2].

The purchase price of natural gas in the second quarter, announced by ANRE in 2010 constituted U.S. $ 252.0 for 1000m^3, for the third quarter it constituted U.S. $ 260.7 for 1000m3, representing an increase of about 3.0 percent compared to the previous quarter.

Taking into account that the European average gas price in 2010 will be around U.S. $ 300 for 1000 cubic meters[3], the moderate prices increase of petroleum products (gasoil and fuel) and the reduction coefficient - 0.9, we anticipate that the natural gas import price for the fourth quarter of 2010 will not change significantly compared with the previous quarter of this year.

In 2011 the import price of natural gas will be influenced mainly by the cancellation of the coefficient of the reduction at the imported gas price formation.

[1] Urals brand
[2] Source: www.oilmarketreport.org
[3] http://uk.reuters.com/article/idUKLDE65L1AS20100622

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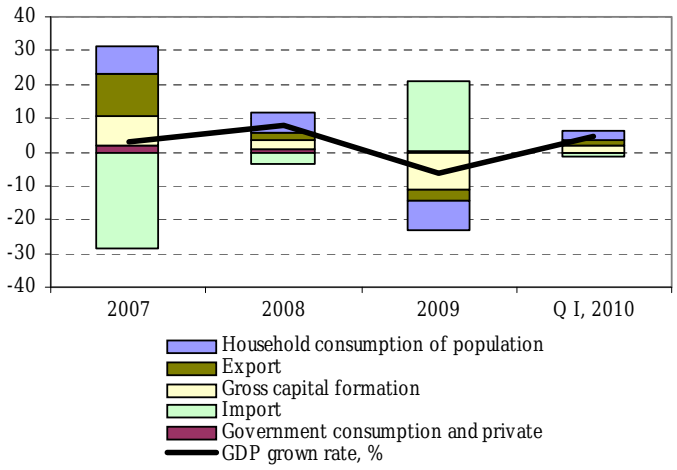
• Tel. (37322) 409 006 • Fax (37322) 220 591 •

Real sector

Gross domestic product

According to the statistics on national accounts, the Moldovan economy in the first quarter of 2010 has entered the recovery phase, largely due to the economic stabilization of the country's main trading partners. This has led, on the one hand, to the increase of transfers from abroad and restored people's expectations, thus increasing the final consumption and imports. On the other hand, the demand for domestic products has recovered, registering an increase of exports compared to the first quarter, 2009. The value added from the goods sector recorded a positive trend due to the increases in both industry and agriculture. Also, the gross value added for services has increased due to positive developments in trade, transport and communications, while the construction continued the negative trend which was also observed in the previous year. These tendencies are confirmed by the operative data on the industry, internal and external trade for the period of January to June 2010.

Chart no. 1.2. **Contribution of the components demand to the annual GDP growth** (percentage points) (% versus the same period of the previous year)



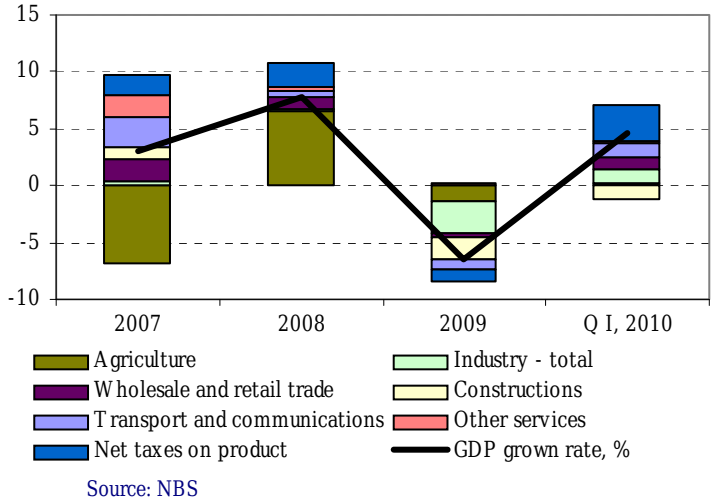
Source: NBS

According to the National Bureau of Statistics, the gross domestic product (GDP) in the first quarter of 2010 has increased in real terms by 4.7 percent compared to the same period last year.

Against the backdrop of the first signs of recovery in economic activity coming from outside, evidenced by the increase of the amount of remittances and by the recovery of demand for domestic products, there are prerequisites for restoring people's expectations about the future economic developments, which led, on the one hand, to household final consumption increase of 2.5% in the first quarter of 2010 as compared to the same period of the previous year (chart no. 1.2).

On the other hand, to prevent the accumulation of budget deficit related to the consequences of the economic crisis, the tightening measures have determined the reduction of government final consumption by 2.1 percent compared to the same period of 2009. After the considerable reduction of the gross capital formation in 2009, in the first quarter of 2010 this indicator showed an increase of 17.4 percent, driven by the positive developments in the "stock changes" component.

Chart no. 1.3. **Economy sectors contribution to the GDP growth** (percentage points) (% versus the same period of the last year)



Source: NBS

However, gross fixed capital formation recorded a decrease of 20.3 percent compared to the first quarter of 2009. The domestic demand increase determined the imports to increase by 1.3 percent. At the same time, the exports increase by 4.7 percent compared to the first quarter of 2009 and was generated by the economic activity recovery in the economies of trading partners of Moldova and national currency depreciation against their currencies.

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• Tel. (37322) 409 006 • Fax (37322) 220 591 •

By categories of resources (chart no. 1.3) in most sectors of the economy can be seen the beginning of the economic activity recovery. Thus, due to the recovery of both internal and external demand for domestic products, the gross value added of goods produced in the sector grew by 5.1 percent compared to the first quarter of 2009. The increase of the gross value added in agriculture by 3.5 percent and 5.6 percent in the industry has contributed to this evolution. Within the industrial sector, the sources of growth are the manufacturing and the "electricity, gas and water" component which rose by 6.8% and 6.9% respectively, while the extractive industry recorded a decline of 39.9% compared to the same period last year, but due to the small weight (0.7 percent) it did not have a significant negative impact.

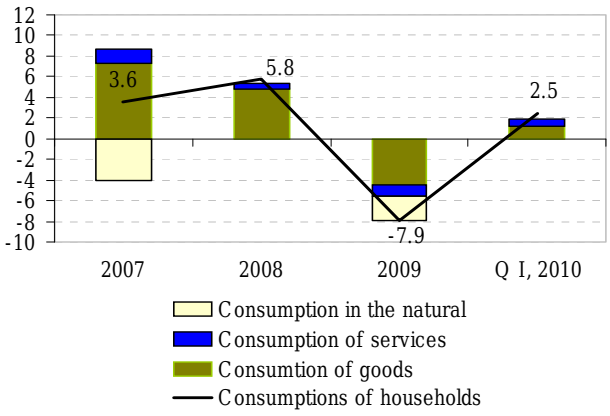
The gross value added for services recorded as a whole an increase of 1.3 percent compared to the first quarter of 2009, despite the severe decline in construction (23.2 percent). However, the gross value added in trade, transport and communications increased by 5.4 and 6.7 percent respectively. The GDP growth in the first quarter of 2010 has contributed the most (by 3.1 percentage points) to the increase of 20.6 percent of the net taxes on products.

Household Final Consumption

After a considerable decline during 2009 (7.9 percent), in the first quarter of 2010 the household consumption recorded positive values, increasing by 2.5 percent compared to the same period last year, which represented a significant sign that the Moldovan economy is in the recovery phase.

The increase of the consumption of goods by 2.1 percent in the first quarter of 2010, compared to the same period last year, is due to the decisive impact of the increase of retail sales of non-foodstuff products by 6.8 percent, whose weight in total sales is 64.4 percent. The expenses for services purchase from the domestic budget account have also recorded an increase in real terms by 2.2 percent. The final consumption of goods and services recorded tendencies of moderation, decreasing by 0.8 percent in the first quarter of 2010 compared to the same period last year. This evolution was caused mainly by higher average prices for marketing the agricultural products by agricultural enterprises with 20.6 percent.

Chart no. 1.4. **Contribution of components of the final consumption of households** (%, compared to the same period previous year)



Source: NBS

As for the ways for financing the consumption, the analyzed period has recorded essential changes. The main public funding[4] sources in the respective quarter reflected a positive trend, recording an increase of 6.5% in real terms[5] compared to the same period of 2009. The main source of funding in the first quarter, 2010 was represented by the total cost of labour (the wage bill) which recorded a decrease of 2.4 percent in real terms, having accounted for 44.0 percent of total funding sources of the consumption.

In the analyzed period, the remittances had a significant contribution to the consumption increase, which recorded an increase of 21.7 percent in real terms, followed by the social transfers with an increase of 10.0 percent in real terms, having accounted for 19.3 percent of total of funding sources of the consumption. The volume of household loans has decreased by 10.3 percent in the first quarter of 2010, contributing to the reduction of the final consumption of population by 0.3 percentage points.

[4] Main funding sources are approximated by the sum of the wage bill, social transfers, transfers from abroad as remittances from workers abroad
[5] In 2010 prices

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• Tel. (37322) 409 006 • Fax (37322) 220 591 •

Gross capital formation

The gross capital formation in the first quarter of 2010 increased by 17.4 percent in real terms compared to the same period last year, being another sign of revival of the economic activity along with the recovery of the household consumption.

The gross fixed capital formation in the first quarter of 2010 has decreased by 20.3 percent in real terms compared to the first quarter of 2009. The negative growth pace of the gross fixed capital formation was conditioned by the decrease in real terms of capital investments and expenditures for capital repairs of the fixed assets by 23.9 percent and by 8.8 percent respectively. Equipment and inventory purchases decrease of the budgetary institutions by 66.8 percent is another factor that has negatively impacted the gross fixed capital formation. The share of this component in the gross capital formation in the analyzed period constituted 87.7 percent and the gross fixed capital contribution to the growth of capital formation recorded a value of minus 26.8 percentage points.

The changes in inventories in the first quarter of 2010 have shown a positive dynamic, so its contribution to the gross capital formation constituted 44.2 percentage points.

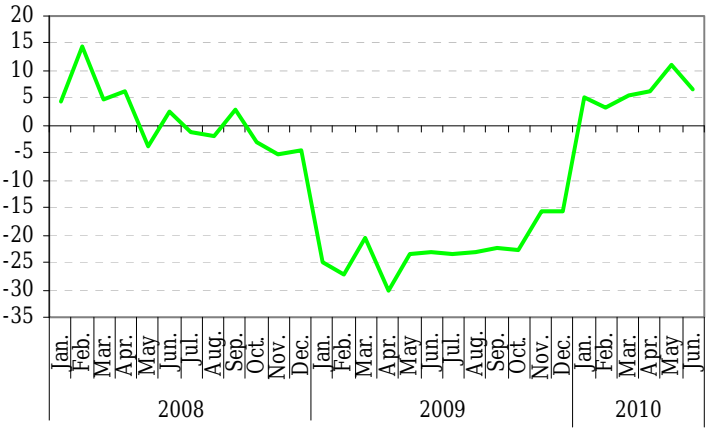
Industrial production

In January-June 2010, according to the National Bureau of Statistics, the industrial production volume in all forms of ownership has increased in real terms by 6.6 percent compared to the same period last year.

As compared to January-June 2009, the increase of the industrial production was determined by the increase of the output in manufacturing by 7.8 percent and in the energy sector - by 2.3 percent.

The increase in manufacturing production was determined by the increase of production in the following industrial activities: food and beverage industry, the production of clothing, fur preparation and dyeing and tobacco production, which contributed to the increase of the industrial production by 2.2, 1.5 and 1.1 percentage points, respectively. The upward trend of the industrial production is largely conditioned by the positive contribution of about 0.4 percentage points resulting from the industrial activity "production and distribution of electricity", which in January-June 2010 increased by 2.3 percent compared to the same period of the previous year.

Chart no. 1.5. **The evolution of industrial production in real terms** (%, versus the same period of the previous year)



Source: NBS

The industrial production growth related to the activities mentioned above was determined largely by the recovery in early 2010 as domestic demand and external demand.

At the same time, as compared to same period of 2009, during the analyzed period there were significant reductions in the following industrial activities: manufacture of wood and wooden items, medical and optical apparatuses and tools production and the manufacture of fabricated metal products, except machinery and equipment, which decreased by 31.0, 30.5 and 24.4 percent respectively.

However, on the whole, the industrial production has reversed the trend and since the first months of 2010 grew in real terms.

Agricultural production

According to information provided by the National Bureau of Statistics, the global agricultural production of all households in the period of January-June 2010 increased by 11.4 percent compared to the same period

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last year. This development was largely due to the increase of livestock production - by 12.7 percent (which has represented about 89.0 percent of total agricultural production).

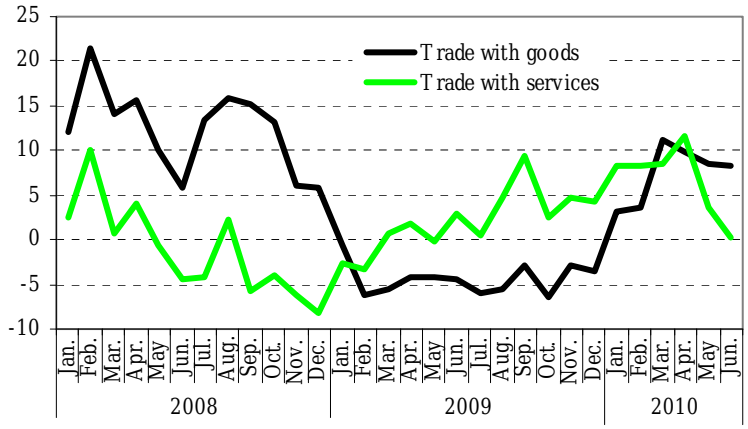
In the first half of 2010, the state of the livestock sector has been driven by positive growth trends of the livestock production in the most types of products. Thus, the increase of production of cattle, pigs and poultry was due to an increase of 44.0 percent of production volume of pigs and poultry -17.0 percent. Also, during January-June of 2010, the egg production increased by 13.0 percent compared to the same period last year as a result of higher average number of birds (about 20.0 percent). However, the milk production in all categories of households fell by 1.8 percent as a result of shrinkage of 28.9 percent of sheep's milk production volume.

According to the information provided by the State Hydro Meteorological Service, in April the weather conditions were good for growth and development of autumn crops, orchards and vineyards, the emergence of sugar beet, spring barley and peas as well as for sowing maize. The weather conditions in May 2010 were favorable for growth and development of autumn and spring crops, hoe crops. Rainy weather and air high humidity in the second half of June have created less favorable conditions for fruit ripening and contributed to the development of the vine diseases.

Internal trade in goods and services

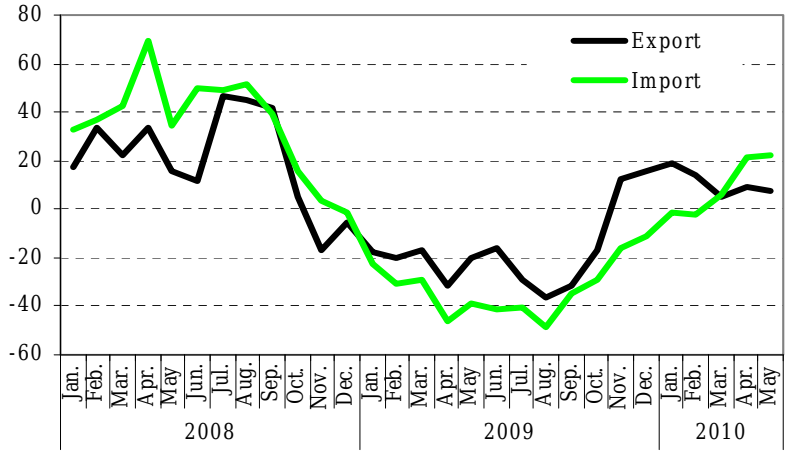
According to the National Bureau of Statistics, in the second quarter of 2010, the growth trend of both domestic trades in goods and in services rendered to the population has continued. From the beginning of 2010 until June, the business units have sold to population consumption goods by 7.6 percent more than in the same period of 2009 and paid services rendered to population by 6.7 percent more than in the same period of 2009. However, towards the end of second quarter of 2010, the growth rate of trade volume in goods and services rendered to the population in real terms has decreased, registering in June 2010 values of only 8.3 and 0.2 percent respectively more than in the same period of 2009.

Chart no. 1.6. **Evolution of the internal trade** (real terms, % versus the same period of the last year)



Source: NBS

Chart no. 1.7. **Evolution in real terms of trade in goods and services** (% versus the same period last year)



Source: NBS

Foreign trade

According to the NBS, an exports increase of domestic products of 10.4 percent was recorded in the period from January to May 2010 as compared to the same period last year. This increase was due to the positive trend of demand for domestic products registered in 2010. Although, in April and May were also recorded increases, as compared to the same period of 2009, there is a slight slowdown in the export growth. It should be mentioned that unlike the declining demand for domestic products by 0.9 percent from the EU countries (EU-27), during January to May 2010 compared to same period last year, a substantial increase in demand from the CIS countries was

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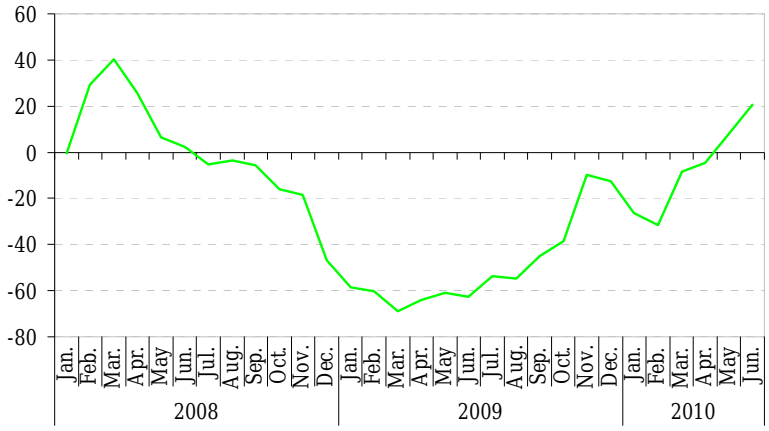
recorded - by 18.2 percent and particularly from other countries – by 42.3 percent.

The share of exports to EU countries fell by 5.5 percentage points from January to May 2009, while the share of exports to CIS and other countries rose by 2.5 and 3.0 percentage points, respectively. By groups of goods, substantial increases occurred in chemicals and products thereof (by 90.0 percent), crude inedible materials, except fuels (by 39.6 percent), exports of beverages and tobacco (by 24.1 percent), machinery and sports equipment (by 21.1 percent), while the demand for oils, fats and waxes of animal or vegetable (by 18.0 percent), foodstuff products and live animals (by 12.2 percent) have decreased.

A more pronounced upward trend of imports volume was recorded during 2010, being in May 2010 by 22.4 percent higher than in May 2009. Thus, during January-May 2010, the volume of imports grew by 9.3 percent compared to the same period of the previous year, largely due to the significant growth from April and May. The imports from the EU countries were 19.7 percent higher than in 2009, their share increasing by 3.8 percentage points, while the imports from the CIS countries decreased by 5.1 percent, their share also decreasing by 5.2 percentage points.

Chart no. 1.8. **Volume of transported goods** (versus the same period of the previous year)



Source: NBS

By commodities groups, significant increases were recorded in crude inedible materials, except fuels (by 49.6 percent), food and live animals (by 26.3 percent), chemicals and derived products, and manufactured goods, classified mainly by the raw material (each by 19.1 percent). At the same time, the imports of mineral fuels, lubricants and derived materials fell by 6.9 percent during January-May 2010 compared to the same period last year.

Unlike the first quarter of 2010, when the **freight transportation** has dropped, in June it continued its positive trend started in May, registering an increase of 20.6 percent as compared to June 2009.

Labour market

In the first quarter of 2010, despite the positive signals regarding the increase of internal and external trade and of the industrial production, the indicators provided by the NBS show that the labour market situation in Moldova has aggravated compared to the first quarter of 2009.

These differences indicate a greater rigidity of the labour market, i.e. longer duration needed for creating new jobs and filling them with qualified personnel. At the same time, the labour market situation shows the uncertainty of the economic agents on further development of the aggregate demand, which makes them to postpone the process of creating new jobs.

Workforce

In the first quarter of 2010, the economically active population decreased by 4.8 percent compared to the same period of the previous year, mainly due to the decrease of number of population involved in agriculture. The employment in this period fell by 6.2 percent compared to the first quarter of 2009. Within the structure of the active population, the employment share dropped from 92.3 to 90.2 percent.

Country unemployment rate constituted 9.1 percent, 1.4 percent higher than in the same period last year. Such a high value of this indicator was determined by the economic crisis that imposed to the economic agents and public institutions austerity measures. However, due to the seasonal factor there was recorded an increase in unemployment as a result of a large proportion of the employed population involved in agriculture. After excluding the seasonal factor (chart no. 1.9), the unemployment rate for the first quarter of

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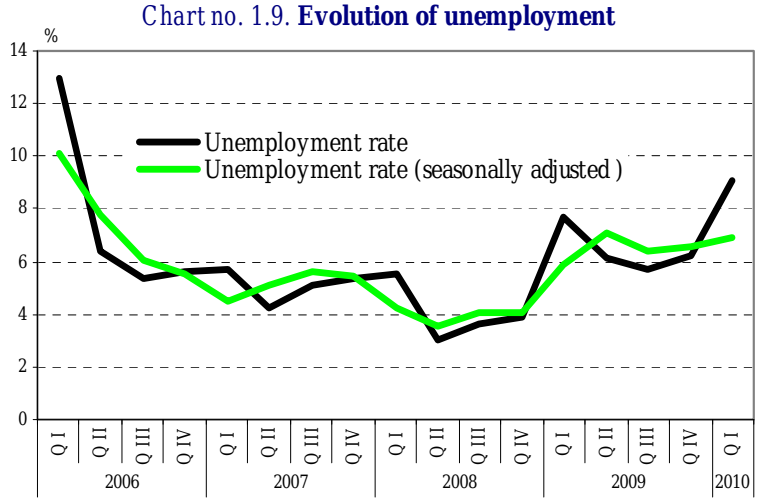
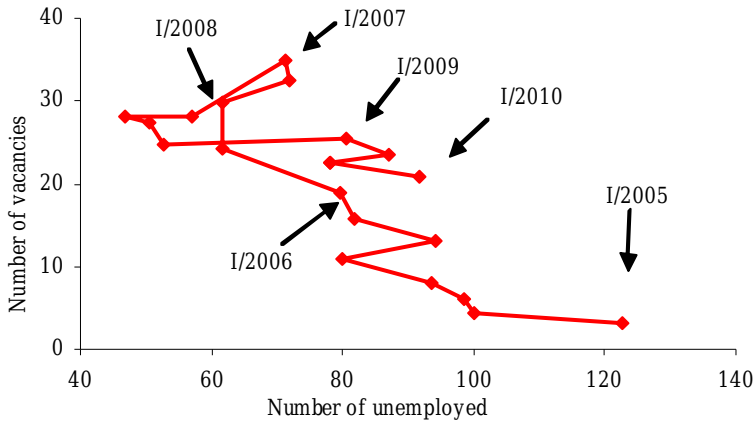
Chart no. 1.9. **Evolution of unemployment**



Source: NBS, NBM calculations

Chart no. 1.10. **Beveridge curve** (seasonally adjusted, thousands)



Source: NBS, calculations BNM

2010 constituted 6.9 percent compared to 6.6 percent in the fourth quarter of 2009 and 4.3 percent in the first quarter of 2008 (the period before the economic crisis).

The information from the Beveridge curve shows a considerable increase in the number of registered unemployed in the first quarter of 2010 compared to the fourth quarter of 2009 with about 22.0 thousand people, while the number of vacancies has declined only by 1600 vacancies. This shows the lack of flexibility of the labour market in Moldova, but well as significant discrepancies between the professional qualifications of the unemployed and working professional requirements regarding the vacancies.

In the distribution by the activities of the national economy it is shown a relatively stable evolution of employed people. The agricultural sector held the highest number of employed people. However, the seasonally adjusted data shows a downward trend of this indicator, in the first quarter of 2008, the share of population working in agricultural constituted 32.9 percent in the first quarter of 2010 - 26.9 percent. Compared to the first quarter of 2009, the population employed in agriculture decreased by 10.4 percent, which means that one person in ten who works in agriculture has gave up this activity.

However, two thirds of people working in agriculture have worked in their own auxiliary households. The share of people employed in public administration, education, health and social care constituted 22.3 percent in the first quarter of 2010, the concentration in this sector of the economy is growing. A positive evolution has also seen the retail and wholesale sector, the employment share in this area constituted 18.3 percent in the first quarter of 2010. Transport and communications sector has the lowest concentration of employment in the first quarter of 2010, its share constituting 5.7 percent.

Income

According to the NBS information, in the first quarter of 2010, the disposable income per person has increased in nominal terms by 12.2 percent compared to the same period of 2009. A major part of the total disposable income was represented by the earnings from wages and salaries of about 41.1 percent, the contribution being less compared to the first quarter of 2009 by 3.2 percentage points.

During January-May 2010, the average nominal salary in the economy increased by 6.2 percent compared to the same period of the previous year. According to the NBS information, during January-May 2010 the average salary in the budgetary sector registered a 7.7 percent increase and in the real sector - by 5.4 percent compared with the same period of the previous year.

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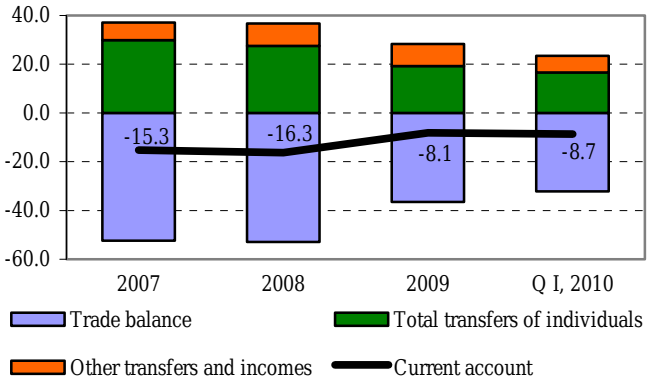
After several years of wage growth in industries, in the second half of 2009 and until now there was seen stability in wages. A different situation has persisted in health and social care, where in January-May 2010 there was registered an increase of earnings from wages and salaries by 7.3 percent. The wages growth pace in the agricultural sector registered a significant decrease during the years 2008-2010. In the first quarter of 2008, the growth rate of wages constituted 31.0, in the first quarter of 2009 - 11.2 percent, while in January to May 2010 constituted only 8.9 percent as compared to the same period of the previous year. The employees of the financial institutions still hold the highest salaries, while the lowest salaries were recorded in the agricultural sector, which explains the continuing decline of employment in this sector.

Balance of Payments

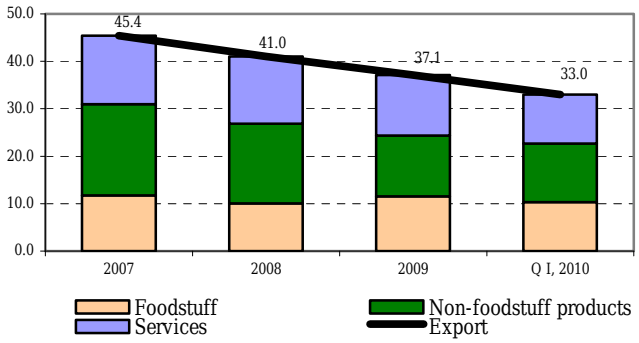
The consequences of the global crisis continued to affect the export of Moldova in the first quarter of 2010 but with a lower intensity and recorded some positive developments.

Chart nr. 1.11. **The share of the current account to GDP** (seasonally adjusted data), %



Source: NBM

Chart no. 1.12. **The share of exports in GDP** (seasonally adjusted data), %



Sursa: NBM

The **current account** of the balance of payments of Moldova in the first quarter of 2010 recorded a negative balance of minus U.S. $ 143.0 million, decreasing by 33.9 percent compared to the same period of 2009. The current account deficit ratio to GDP in the first quarter, 2010 was minus 8.7 percent, 0.6 percentage points more than in 2009.

The share of the individuals transfers and of the trade balance to GDP decreased by 2.6 and 4.4 percentage points respectively compared to the same period of 2009 (chart no. 1.11). Since 2009 the share of current account deficit has fallen in the normal allowable limit of 7.0 - 10.0 percent of GDP.

The share of exports in GDP has experienced a downward trend since 2007, representing 33.0 percent in the first quarter of 2010, declining by 4.1 percentage points compared with 2009 (chart no. 1.12). This movement is largely due to the exports of non-foodstuff products and services. The share in GDP of foodstuff products exported has nearly a relatively stable evolution. The decrease of 2.5 percentage points in the first quarter of 2010 of the exports of services in 2010 compared to 2009 was determined by the dynamics of transport and travel services, each of these services decreasing by approximately 13.4 percent.

The share of imports in GDP in the first quarter of 2010 has continued its downward movement, constituting 65.1 percent, decreasing by 6.9 percentage points compared to 2009 and by 26.7 percentage points compared to 2008 (chart no. 1.13). The dynamics of imports is largely due to the evolution of the non-foodstuff products (as in the case of exports) that within the imports structure has the largest share (of 48.7 percent in the first quarter, 2010).

The share of foodstuff products, energy resources and services in GDP has not substantially changed.

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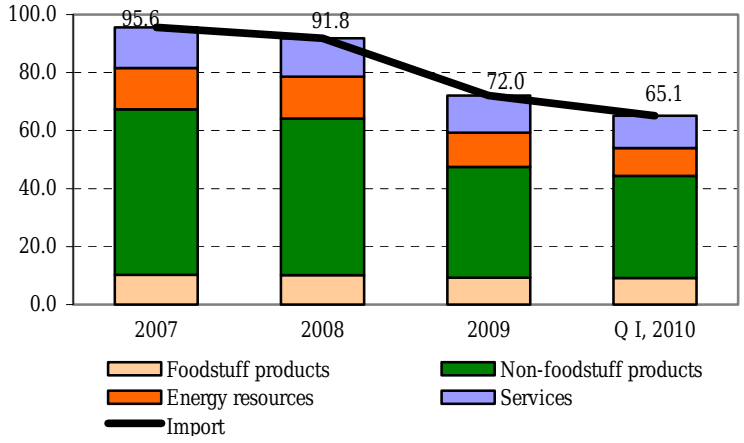
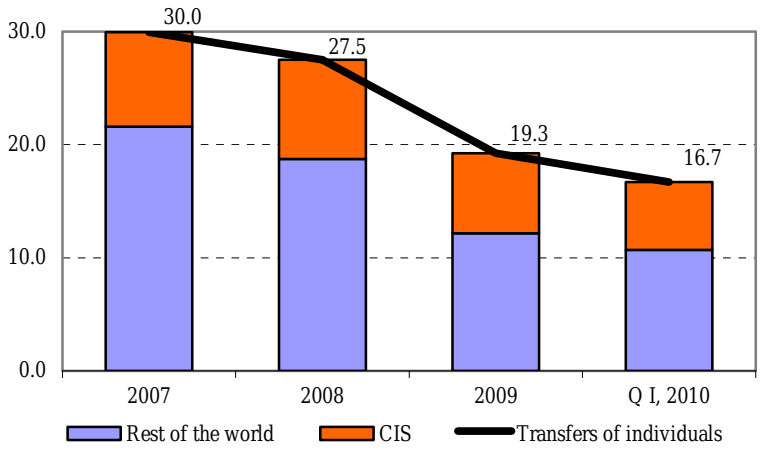
Chart no. 1.13. **The share of imports in GDP** (seasonally adjusted data), %



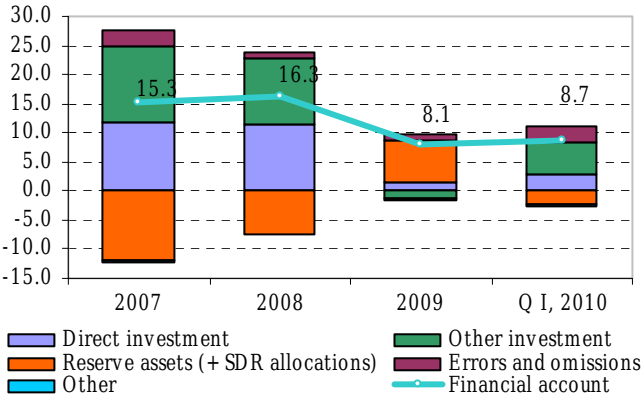
Source: NBM

Chart no. 1.14. **The share of transfers in GDP** (seasonally adjusted data), %



Source: NBM

Chart no. 1.15. **The share of the financial account in GDP** (seasonally adjusted data), %



Source: NBM

In 2009, the individuals' transfers had a share of 19.3 percent of the gross domestic product; in the first quarter of 2010 the proportion fell to 16.7 percent (chart no. 1.14). Most of those are received from the rest of the world[6] (including EU), recording in the first quarter of 2010 a decrease of share in the GDP by 1.5 percentage points compared with 2009, due to the persistence of the difficult economic situation in the recent years in the developed countries from where the most individuals transfers are made.

The individuals' transfers from the CIS countries (represented in most by Russia) have not suffered major changes compared to 2009.

Overall, the total of transfers in the first quarter of 2010 covered 52.3 percent of the balance trade deficit, decreasing compared to the previous years. This shows the reduction trend of the dependence of the national economy of the transfers from abroad, whereas for covering the balance of trade deficit, more and more use of alternative sources is being made.

Capital and financial account of the balance of payments recorded in the first quarter of 2010 a surplus in the amount of USD 89.1 million, decreasing by 72.2 percent compared to the same period last year.

The share of the financial account in GDP in the first quarter of 2010 constituted 9.2 percent, increasing by 1.1 percentage points versus 2009, which was marked by the significant increase in other investments, their share in GDP being of 5.2 percent (chart no. 1.15). Also, the positive contribution was made by the increase of direct investment that has a share of 3.0 percent of GDP, increasing by 2.0 times compared to 2009.

The foreign direct investment flows in the national economy during the period of January to March 2010 constituted USD 47.5 million in net, registering an increase of 43.0 percent compared to the same period last year.

[6] Geographic division according to the methodology of compiling of the balance of payments

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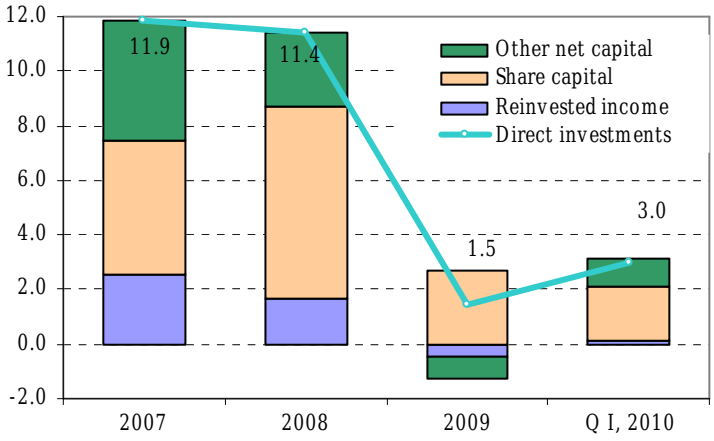
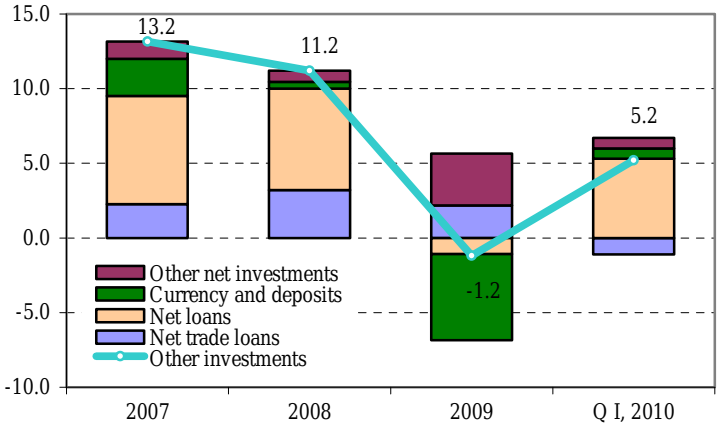
Analyzing the share of foreign direct investment in GDP we can see that it had a decreasing trend since 2007, registering a value of 1.5 percent in 2009, less by 9.9 percentage points compared with 2008 (chart no. 1.16).

Chart no. 1.16. **The share of the foreign direct investment in GDP** (seasonally adjusted data), %



Source: NBM

Chart no. 1.17. **The share of other investments in GDP** (seasonally adjusted data), %



Source: NBM

We can correlate this decline with the worsening investment climate as a result of the global financial crisis. At the end of the first quarter of 2010, the foreign direct investment stock accumulated in the form of share capital has been distributed by industry as follows: wholesale and retail trade, repair of motor vehicles, household and personal goods - with the share of 21.7 percent; manufacturing - 21.1 percent, financial activities - 25.3 percent, electricity, gas and water - 12.7 percent. The capital share in GDP in the first quarter of 2010 was 2.0 percent, down by 0.7 percentage points of the share of 2009.

The share of other investments in GDP in 2009 has sharply declined, reaching a negative level of minus 1.2 percent in 2008, constituting 11.2 percent of GDP (chart no. 1.17). The economic crisis contributed this distortion and has led the non-resident individuals to withdraw the deposits placed in banks of Moldova. Parent companies withdrew their loans previously granted to subsidiaries in the country. In the first quarter of 2010, the situation has slightly improved, the share of other investment in GDP reached the level of 5.2 percent, and the most significant positive contribution was from loans, which have a share of 5.5 percent of GDP. The increase of loans is due to the IMF, which granted credits and loans that were primarily directed to the government sector and monetary authorities. However, trade credit share in GDP experienced a decrease in the first quarter of 2010, recording the value of minus 1.4 percent.

At the end of the first quarter of 2010, the official state reserve assets totaled U.S. $ 1464.1 million.

During the reported period, the National Bank of Moldova capitalized U.S. $ 31.1 million from the financing program of the International Monetary Fund, reimbursing U.S. $ 2.9 million of loans previously granted.

The Government of the Republic of Moldova has capitalized new loans from abroad in the amount of U.S. $ 69.3 million, of which U.S. $ 61.0 million - from the IMF and U.S. $ 15.2 million have been repaid.

Moldova's **gross external debt** at March 31, 2010 constituted USD 4361.89 million, decreasing by USD 7.0 million compared to the end of 2009.

The external debt division by institutional sector was as follows: the governmental sector - 22.7 percent, the monetary authorities - 4.1 percent, the banking sector - 9.7 percent, other sectors - 45.5 percent,

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commitments to foreign direct investors - 18.0 percent. Long-term commitments have increased over the period of January to March 2010 by 1.1 percent, reaching a value of USD 2817.0 million, while the short-term commitments fell by 2.3 percent, up to USD 1544.8 million.

The stock of the public and publicly guaranteed external debt increased during the first quarter by 5.0 percent, due to the contraction of new loans, registering at March 31, 2010 the value of USD 1196.3 million.

The **international investment position** remained net debtor and amounted to USD 4152.8 million, the foreign liabilities exceeding the assets by 2.8 times.

Inflation

Consumer price index

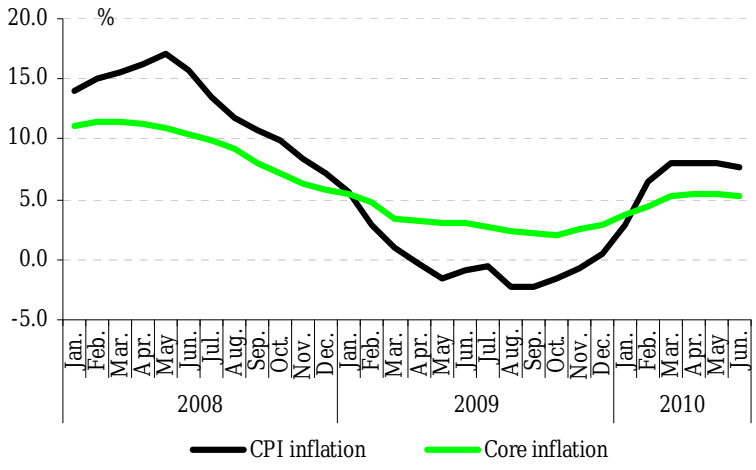
The main factors influencing the CPI inflation in the first half of 2010 were:

- tariffs modifications on services with regulated prices (gas, electricity, heat) conducted in January and May;
- MDL depreciation against the currencies of major trading partners of the Republic of Moldova;
- decrease of foodstuff prices due to favorable climatic conditions for the development of agricultural crops in the second quarter of 2010;
- increase in international fuel prices;
- moderate recovery of both external and internal demand of local goods and services, which determined that the Moldovan economy is still below the potential that would create significant inflationary pressures;
- the increase in indirect taxes made in January.

These factors have exerted both pro-inflationary and deflationary pressures, which led to an inflation rate of 5.4% in the first half of 2010 (June to December 2009).

The inflation rate for the last 12 months, measured by consumer price index, was 7.8 percent in June 2010 compared with the level of minus 0.8 percent recorded in June 2009 (chart no. 1.18). Thus, in the second quarter of 2010, the growing trend of this indicator that began in the second half of 2009 has stopped, due to lower food prices on the background of favorable weather conditions for certain crops in this period, which has managed to absorb the most of the increases effect of regulated price. However, in the second quarter of 2010, the consumer price index was above the level rerecorded in the same months of 2009.

Chart no. 1.18. **Annual rate of CPI and core inflation**



Source: NBS and NBM

To the formation of the annual inflation in June 2010 the most contribution had the following components[7]: regulated prices (2.4 percentage points) and core inflation (2.3 percentage points). At the same time the foodstuff products and fuel prices contributed by 2.0 and 1.1 percentage points, respectively.

However, in June 2010 the highest increases were recorded in services (by 10.1 percent), followed by non-foodstuff products prices (by 7.9 percent), foodstuff products prices – by

[7] The components of CPI inflation are: (1) core inflation (2) foodstuff prices (3) regulated prices (4) fuel prices.

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5.3 percent compared to June 2009.

Core inflation index[8]

The increasing trend of the annual core inflation started in October 2009 from 2.1 percent and continued at the beginning of 2010 so that it reached the value of 5.4 percent in April. After that, the annual core inflation rate recorded stabilization and its value in June constituted 5.3 percent (chart no. 1.18).

The core inflation rate increase from the beginning of 2010 was caused mainly by higher indirect taxes and second round effects, generated by the tariffs increase on some services with regulated prices. At the same time a significant impact on the annual rate of core inflation has been driven by the developments in the exchange rate of MDL against currencies of major trading partners.

Thus, the nominal effective exchange rate of the national currency has depreciated by about 5.0 percent in June 2010 compared to the same period last year. The exchange rate of MDL against U.S. dollar depreciated by over 15.0 percent compared to the average of June 2009 and the Russian rouble by 14.7 percent.

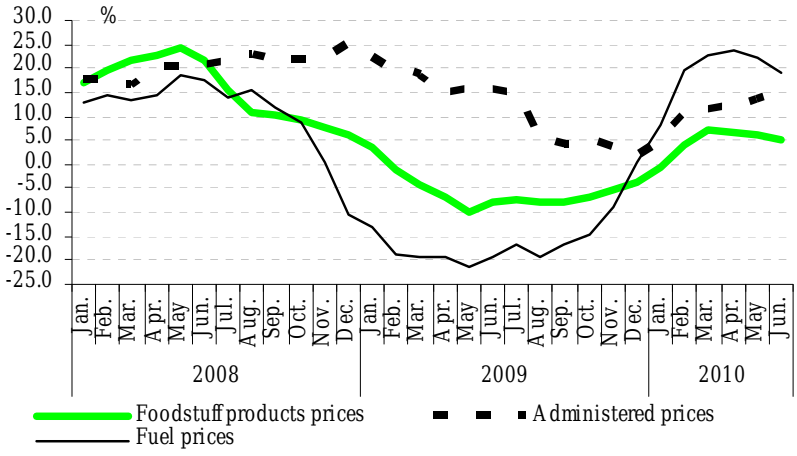
Ukrainian grivna and the European currency have appreciated during this period, generating inflationary pressures on prices of products included in the calculation of core inflation. As for the service category, it should be mentioned the price increases for catering services - by 7.4 percent compared with June 2009. As for goods, a considerable increase was recorded for medicines prices - by 22.2 percent compared to the same period last year.

Food prices

A moderation of annual growth rate of food price changes has been recorded in the second quarter of 2010. Thus, in June 2010 its value amounted to 5.3 percent compared to 7.0 percent recorded in March of this year.

The increase of food prices in annual terms during the reported period was due to considerable increase in sugar prices (by 66.0 percent) because of higher production costs. At the same time, at the beginning of the year, a significant increase in fruit and vegetable prices was recorded, which led the prices to increase in June by 21.2 and 12.0 percent respectively compared to the same period last year. The increase of vegetal oil prices by 13.2 percent constituted a significant cause of food price increases in the reported period. The negative contributions on food inflation have been exercised by lower prices for eggs and meat products 30.8 and 3.0 percent respectively as a result of increases in livestock and poultry production.

Chart no. 1.19. **Annual rate of CPI components**



Source: NBS

Besides internal factors, the increase in food prices was also driven by the global food price increases as they increased in June 2010 by about 7.5 percent compared to the same period of the last year.

Favorable climatic conditions for certain crops in the second quarter of 2010 determined the vegetable prices to fall during this period compared to the first quarter of 2010.

[8] The index calculated by the method of exclusion (they were excluded foodstuff products, fuel, products and services with administered prices) based on the CPI calculated by the National Bureau of Statistics of Moldova.

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Regulated prices

Due to changes in tariff prices from January and May 2010, needed to cover the full payment of actual costs and payments for purchase of energy from internal and external suppliers, in the first half of 2010 the regulated prices rate recorded an upward trend. Thus, if this indicator constituted 5.3 percent in January, in June 2010 the regulated prices increased by 15.7 percent compared to the same period of the last year.

The prices increase in public utility services by 17.5 percent has contributed the most to this evolution. Thus, in June 2010, prices in the natural gas in centralized pipelines rose by 13.5 percent compared to the same period of the last year, which led to an increase of 14.1 percent in gas tariff for the end-users conducted in May 2010. At the same time, the tariff increase in heating delivered by Termocom and CET-Nord resulted in heating prices increase by 25.3 percent compared with June 2009.

Electricity prices increased by 21.5 percent compared to the same month of the last year. However, a significant contribution to the development of regulated prices was driven by prices increase in passenger transport by 12.3 percent compared to June 2009 as a result of tariff changes in urban transport in some localities in the country.

Fuel prices

At the beginning of 2010 the annual growth rate of fuel prices continued the upward trend started in the middle of the last year, registering a value of 23.9 percent in April 2010. In the second quarter of 2010 this indicator had a downward path, so in June 2010 the fuel price growth rate was 19.1 percent compared to the same period last year.

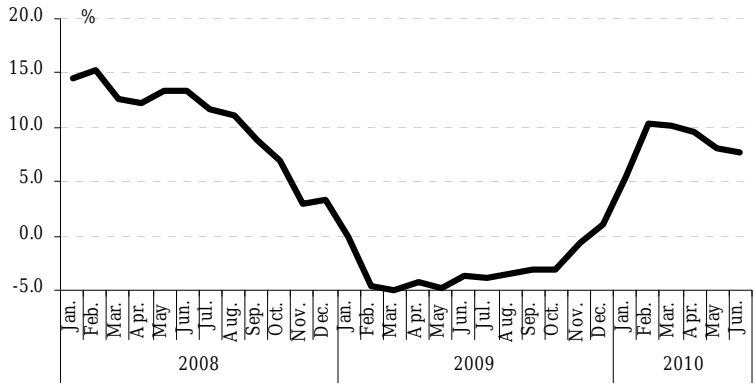
The fuel prices increase in this period was driven by the quotes increase of oil prices in the international stock market and price quotes of Platt's oil products that have created prerequisites for the increase in import prices of petroleum products on the domestic market. Thus, the price of Urals oil has reached the weekly value of over U.S. $ 80.0 per barrel in April and at the beginning of May 2010, and the average value in April (U.S. $ 81.3 per barrel) represented the maximum level for the last 19 months. However, in the first quarter of 2010, the average import price of gasoline, diesel and LPG increased by 64.4, 44.0 and respectively 69.2 percent compared to the first quarter of 2009.

In addition to the increase of import prices for petroleum products, the increase of the annual rate of fuel prices has been driven by the increase in excise duty on fuel made at the beginning of this year and by the depreciation of the national currency against the U.S. dollar during the reported period.

Industrial production price index

The annual rate of the price index of industrial production registered a downward trend, from 10.3 percent in February, up to 7.7 percent in June 2010 (chart no. 1.20).

Chart no. 1.20. **Annual rate of PPI**



Source: NBS

The most significant increase was registered in the energy sector so that the prices in the industrial sector grew by 18.6 percent compared to June 2009. In June 2010 the prices in manufacturing and extractive industry grew by 5.6 and 2.3 percent respectively compared to the same period of the last year.

The prices increase of the industrial production in annual terms was determined by the price increases in raw materials and food in international markets and the exchange rate

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of MDL against currencies of major trading partners of Moldova.

Budget execution

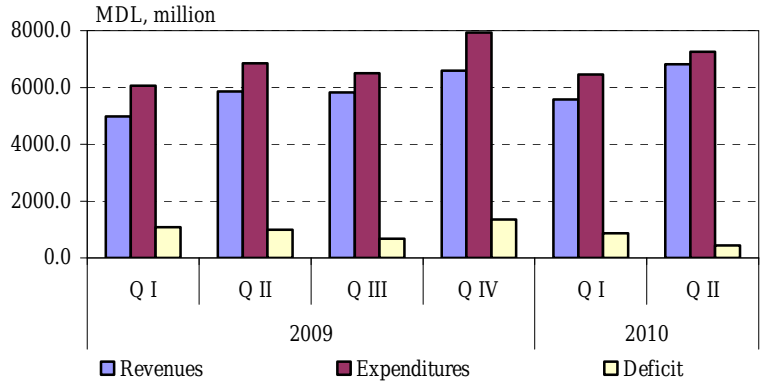
According to the information from the Ministry of Finance, during January to June 2010 the national public budget revenues have been accumulated in the amount of 12399.8 million lei, which represents 14.5 percent more than in the same period last year.

The tax revenues continue to hold the major share (82.5 percent) in revenues, the major income sources remaining to be the taxes on domestic goods and services, which increased by 20.0 percent compared with the same period of the previous year; the state compulsory social insurance contributions, which recorded a modest increase of 3.3 percent compared to the same period of 2009 and taxes income, which rose by 5.3 percent compared with the period of January-June 2009. As a result of changes in these indicators, tax revenue showed a value higher than the previous year by 12.8 percent.

At the expense of the general government budget resources, in the period of January to June 2010, there were made expenditures in total amount of 13705.1 million lei, which represents 6.2 percent more compared to the same period last year. The expenditure growth was caused mainly by the increase in spending on insurance and social assistance (by 13.8 percent) and education (by 20.3 percent).

The budget execution resulted in a deficit of 1305.3 million lei, which represents 62.8 percent of the value recorded in the same period of the last year.

Chart no. 1.21. **Indicators of the national public budget**



Source: Ministry of Finance

Government debt

On June 30, 2010, the state debt structure of the Republic of Moldova was represented in proportion of 29.4 percent of the domestic state debt and 70.6 percent of the external state debt. The internal state debt increased by 182.4 million lei compared with the situation from the beginning of the year and amounted to 5287.3 million lei. The internal state debt modification has occurred at the expense of increasing the SS issues by auctions and SS redemption placed through subscription. The balance of the external state debt amounted to 12717.8 million lei, the equivalent of U.S. $ 990.5 million, increasing by about U.S. $ 216.8 million compared with the balance from January 1, 2010.

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II. Promotion of the monetary policy

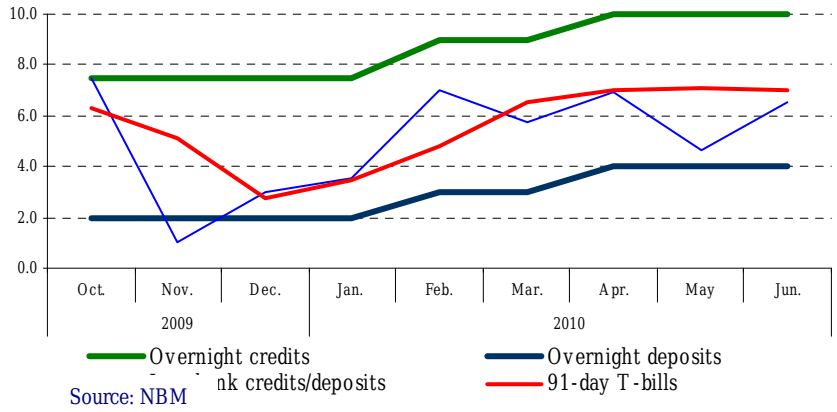
Monetary policy instruments

During the second quarter of 2010, the National Bank of Moldova kept its current money market conditions using monetary policy instruments to ensure the objectives stipulated in the medium term monetary policy strategy for the years of 2010-2012 to ensure and maintain the price stability.

Rates Policy

The monetary policy stance promoted by the NBM during the second quarter of 2010 was justified by the inflation forecast and inflationary pressures in the medium term. Thus, after the changes made in the previous quarter, the National Bank of Moldova, by the Council of administration decisions taken in the reported quarter has maintained the interest rates at its monetary regulation instruments established at the end of the previous quarter (7.0 percent - the base rate, 10.0 and 4.0 percent - the interest rates attached to the deposit facility, and respectively, overnight credit).

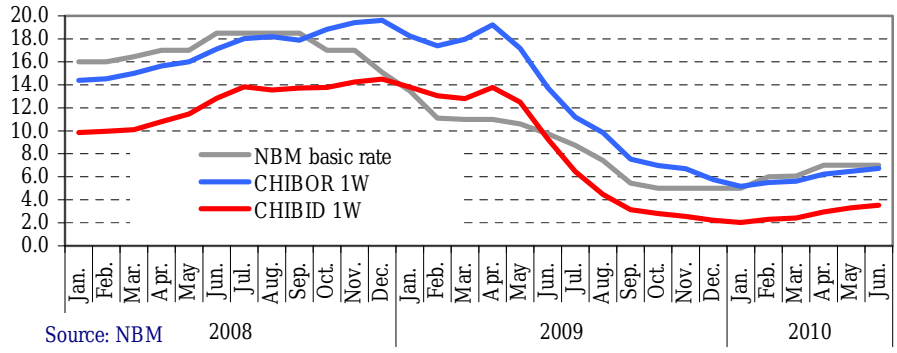
Chart no. 2.1. **Monthly evolution of interest rate corridor** (%)



Source: NBM

In the context of maintaining the base rate at the same level, state securities (SS) yields of 91 days recorded values of around 7.0 percent annually throughout the quarter. At the same time, the evolution of the average rate on the credit market / interbank deposits was uneven due to the small number of transactions and maturities that differ from one month to another: the average interest rate increased in April and June (by 6.94 and 6.57 percent annually, respectively), and decreased in May (up to 4.68 percent annually). It should be mentioned that in all three months of the quarter the interbank interest rates were placed at the bottom of the interest rates corridor below the base rate of the NBM (chart no. 2.1).

Chart no. 2.2. **Average monthly reference rate in the interbank market and the base rate of the NBM** (%)



Source: NBM

CHIBOR interbank reference rate of one week (1W) was lower than the base rate throughout the quarter, noting values between 5.91 and 6.98 percent annually (chart no. 2.2).

Open market operations

NBM Certificates-selling operations

During the second quarter of 2010, the excess liquidity in the banking system remained high and was sterilized exclusively by using the NBM certificates. The National Bank of Moldova has conducted two weekly auctions, and in the last decade of June, the frequency was doubled.

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• Tel. (37322) 409 006 • Fax (37322) 220 591 •

In the 29 auctions for the sale of CBN with a maturity of seven days and with the announcement of the maximum rate of interest equal to the base rate, the NBM has fully accepted the banks offers.

In the period of April to June 2010, the daily balance of sterilization operations has been steadily increasing; constantly registering values over 3 billion lei. As of June 30, 2010 the CBN balance in circulation reached the level of 3583.7 million lei.

Quarterly average balance of sterilizations constituted 3434.2 million lei, ahead of the 534.0 million lei, or by 18.4 percent, the level recorded in the first quarter of 2010.

During the reporting period the banks submitted requests only with the maximum rate announced by the NBM, thus the average interest rate on CBN issued by the NBM in the second quarter of 2010 has been of 7.0 percent annually.

State securities (SS) REPO-buying operations

During the second quarter of 2010, according the schedule placed on the official Web site, the National Bank of Moldova announced weekly auctions for cash payment operations within seven days – state securities REPO-buying operations at the fixed rate (the NBM basic rate); requests from banks were not recorded.

Lending activity

Under the conditions of the credit agreements between the National Bank of Moldova and licensed banks, according to which the banks that had opened credit lines to credit the economic agents from the real sector of economy in the second quarter of 2010, the National Bank of Moldova has granted loans to banks in the amount of 61.5 million lei, fully satisfying the demands of banks.

The amount of repaid loan during the reporting period constituted 160.1 million lei, including loans to banks for lending to the real sector of economy - 128.7 million lei, to protect the integrity of the banking system - 30.6 million lei and to credit the cooperatives for housing construction - 0.8 million lei.

Thus, as of June 30, 2010 the credit debt of the licensed banks to the National Bank of Moldova constituted 1141.6 million lei, being represented by the loans granted to banks to supplement the liquidity - amounting to 100.0 million lei, to protect the integrity of the banking system - 537.3 million lei, for crediting the real sector of the economy - amounting to 484.1 million lei and to credit the cooperatives for housing construction - 20.2 million lei.

On June 30, 2010, compared with the end of the previous quarter, the balance of loans granted to banks decreased by 98.6 million lei, or about 8.0 percent.

Standing facilities

The operating regime of standing facilities (deposits and overnight credits), established by the National Bank of Moldova allowed banks to manage their liquidity efficiently and offered to the NBM more flexibility in implementing the monetary policy.

The firmness of the liquidity control continued to accentuate in the reported quarter by sterilizing the liquidity surplus by using liquidity sterilization operations. Against this background, the banks resort to the overnight deposit facility was reduced compared with the previous quarter.

Thus, in the second quarter of 2010, the average daily balance of overnight deposits was 408.8 million lei, decreasing by 448.6 million lei, or 52.3 percent compared to the first quarter of 2010.

The overnight credit facility was not required in the reported quarter.

Required reserves

At the end of the second quarter of 2010, the amount of reserves maintained by banks in MDL constituted 1176.0 million lei, increasing by 93.5 million lei, or 8.6 percent compared to the first quarter of 2010.

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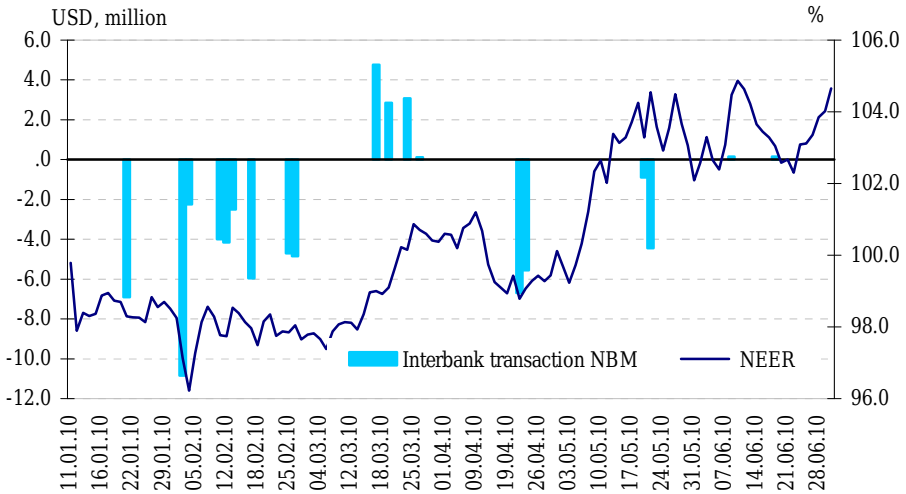
The amount of bank reserves held in dollars and Euros at June 30, 2010 were respectively USD 42.1 million and EUR 48.7 million, decreasing by USD 0.1 million (0.2 percent) and increasing by 0.2 million EUR (0.4 percent) compared to March 31, 2010.

The evolution of the required reserves both in MDL and in hard currency was determined by the change of the balance of the attracted funds subject to reservation.

Internal foreign exchange market interventions

The National Bank of Moldova continued to promote in the second quarter of 2010 a flexible foreign exchange policy and monitor the developments in the domestic foreign exchange market.

Chart no. 2.3. **Evolution of nominal effective exchange rate of the national currency (NEER) and the daily transaction volume of the NBM**



Source: NBM

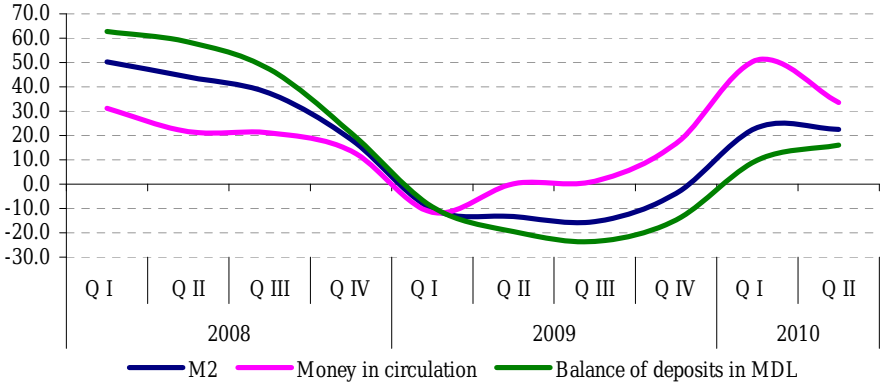
During the second quarter of 2010, the National Bank of Moldova intervened on the domestic foreign exchange market largely as a seller of foreign currency. The foreign exchange sales in the interbank foreign exchange market during April to June 2010 were caused by the erratic demand of the foreign exchange by the economic agents and constituted 17.6 million dollars. At the same time, swap transaction were performed in the amount of U.S. $ 0.8 million.

Thus, in the second quarter of 2010, the net volume of the NBM transactions conducted on domestic foreign exchange market constituted the equivalent of U.S. $ 17.52 million, including procurements of other foreign currencies - U.S. $ 0.08 million.

Dynamics of monetary indicators

Dynamics of the monetary indicators in the second quarter of 2010 showed a downward trend compared with the previous quarters, but remained at high levels as a result of the gradual liberalization of the monetary policy in 2009. However, the evolution of the monetary aggregates was influenced by the gradual recovery of the economy.

Chart no. 2.4. **Quarterly evolution of the components of M2 monetary aggregate** (increase compared to the same period last year, %)



Source: NBM

Money supply

The evolution of M2 monetary aggregate during the second quarter of 2010 increased approximately by 3.0 percent, due to more pronounced and

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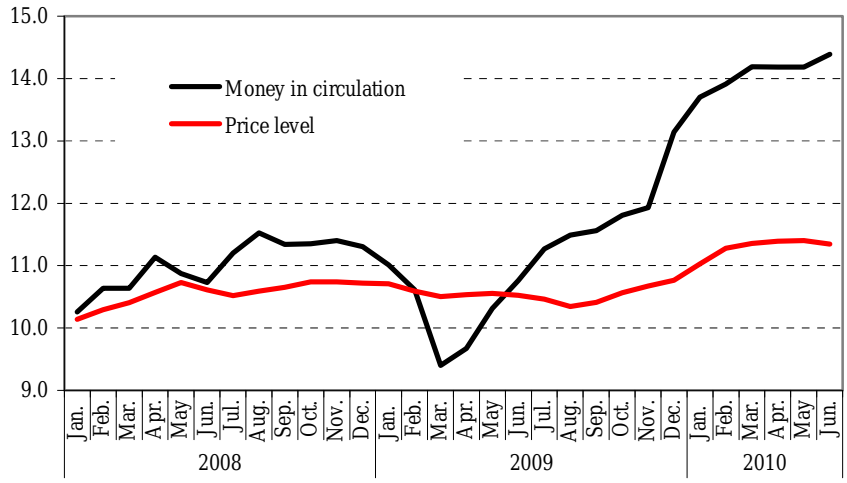
positive dynamics recorded in June 2010. The components of M2 aggregate in the second quarter of 2010 had positive developments. The main component of aggregate M2, the balance of deposits in MDL increased by 2.4 percent during the past 12 months and the pace of growth constituted 16.1 percent (chart no. 2.4). Although the dynamics of money in circulation (M0 monetary aggregate)[1] increased by 3.6 percent at the end of the second quarter of 2010 compared with the 4.0 percent decrease in the first quarter of 2010 - the demand for money remains significant. The evolution of money in circulation seasonally adjusted shows that in this period and the next 2-3 quarters has been and will be driven by the demand increase for money from the national economy that is recovering with higher rates than those anticipated. Under these conditions, the increase of the growth rate of money in circulation, higher than the inflation growth rate, will create favourable conditions for economic growth but will also generate additional inflationary pressures (chart no. 2.5).

Chart no. 2.5. **Dynamics of money in circulation and inflation**
(seasonally adjusted) (Dec. 2007 = 100%)



Source: NBM

During April-June 2010, the **money supply (M3)**[2] increased by 0.9 percent, registering a more positive dynamic to the decrease of 3.3 percent in the second quarter of 2009. Monetary aggregate M3 growth in the second quarter of 2010 is explained by the upward dynamic of deposits in national currency and money in circulation, but being partially offset by the downward dynamics of deposits in foreign currency (chart no. 2.7), which in April-June 2010 decreased by 2.8 percent.

Continuous deceleration of the process of attracting foreign currency deposits during the second quarter, 2010 had the major determinant the reduction of the deposits interest rates. Respectively, the share of balance of deposits in total deposits in foreign currency decreased from 50.2 percent in the second quarter of 2009 to 46.2 percent in the second quarter of 2010. It should be mentioned that, de-dollarization process is a positive signal for improvement of the monetary transmission mechanism of monetary policy.

The activity revival of the real sector, confirmed by the industrial production growth (by 6.6 percent in January-June 2010 compared with the same period of 2009) determined the increase of deposits in national currency in the second quarter of 2010, directly contributing to the increase of the monetary aggregate M2 in this period.

At the end of the second quarter of 2010, the share of sight deposits in total deposits in national currency constituted 30.1 percent, increasing by 1.5 percentage points.

The increase of the total volume of deposits attracted by banks during the second quarter of 2010 compared to the same period last year was due to the increase of deposits in national currency by 11.5 percent (532.3 million lei), in particular the deposits of legal entities - by 787.0 million lei (50.0 percent). At the same time, the volume of deposits in foreign currency decreased by 22.4 percent (1112.8 million lei), which led to the decrease in their share in total deposits structure by 4.0 percentage points.

[1] The money in circulation is the cash outside the banking sector
[2] Money supply M3 includes money supply M2 and deposits in foreign currency of residents expressed in U.S. dollars.

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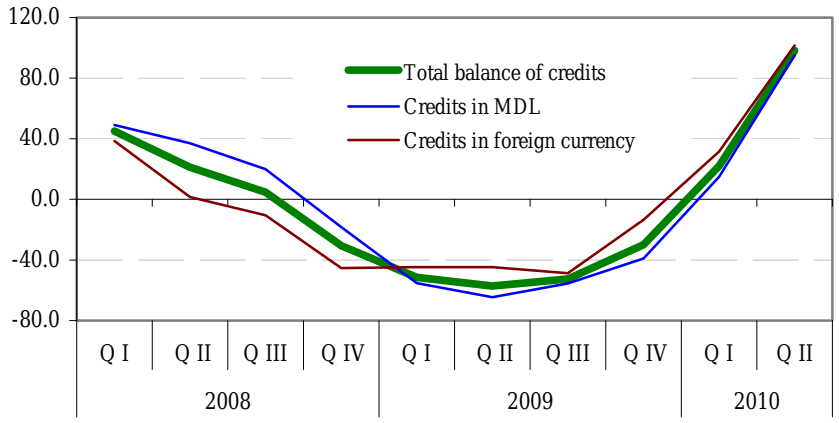
With significant reductions of the profitability of foreign currency deposits in the first quarter of 2009 there was a negative trend, the growth rate reaching even negative values from the beginning of 2010 (chart no. 2.7). The volume of term deposits of individuals attracted in foreign currency in the second quarter of 2010 decreased by 15.6 percent (628.6 million lei) compared with the first quarter of 2010, which shows that the population's interest to save money in foreign currency has decreased.

Credit market

During the second quarter of 2010, the dynamics of lending has increased its upward trend, registering an annual growth rate of 98.2 percent, reaching a value of 6160.3 million lei (chart no. 2.6).

Chart no. 2.6. **Evolution of new granted loans** (annual increase, %)



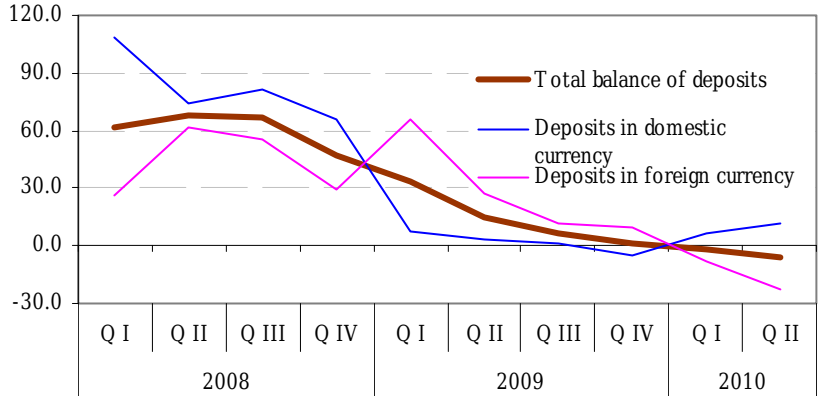
Source: NBM

The credit acceleration registered at the begining of the year is determined largely by the appearance of the first signs of economic stabilization and the expectations of economic recovery during 2010, thus the banks becoming less reluctant to grant loans.

The increase was characteristic both for the component in national currency and foreign currency. Thus, the growth rate of the volume of new loans in MDL constituted 95.1 percent (reaching 3135.1 million lei). Maturity structure analysis reveals that the positive dynamics increase of the component in MDL was due primarily to new loans with the term over 12 months. The most of new loans in national currency are still represented by the loans granted to the legal persons - 82.7 percent of total loans in lei, which rose by 83.4 percent compared to the same period last year. In turn, the new loans granted to individuals have stopped declining, noting a steep increase of 180.7 percent compared to the second quarter of 2009.

The growth rate of new loans in foreign currency had also a growing trend. The amplification of the positive dynamics is large due to the recovery of foreign trade that has fueled the demand for foreign currency loans for financing the import operations. Thus, the volume of new loans in foreign currency was about 101.6 percent higher than the previous year (accounting for the amount of 3025.2 million lei), thus continuing its upward trend from the begining of the current year.

Chart no. 2.7. **Quarterly evolution of new attracted deposits** (annual increase, %)



Source: NBM

Deposits market

The analysis of the evolution of new attracted term deposits reveals putting them on a steady downward slope from the third quarter of 2008. From the beginning of the current year, the new attracted placements recorded negative annual variations, constituting in the second quarter of 2010 minus 6.0 percent, compared to the same period last year, up to the level of 9036.2 million lei (chart no. 2.7).

It should be mentioned that in the

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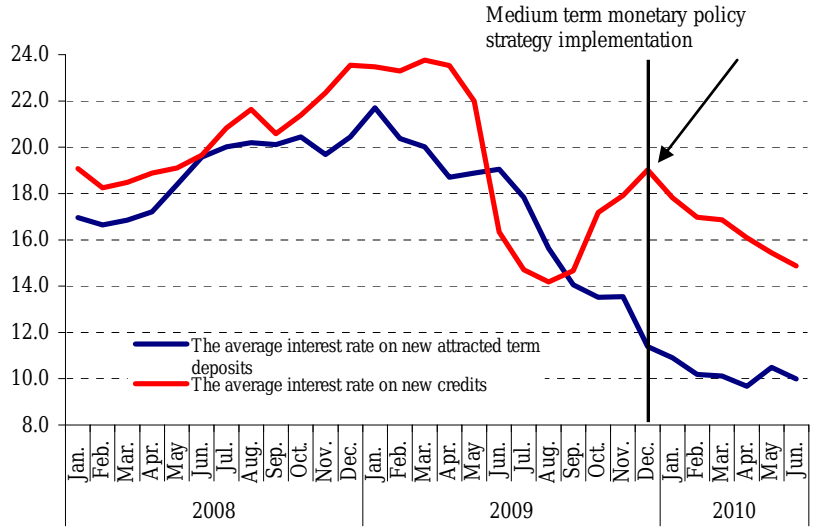
analyzed period, the reported decrease occurred only at the expense of reducing the growth of foreign currency deposits by 22.4 percent compared with the second quarter of 2009 (up to the level of 3852.8 million lei); characteristic situation on both customer segments. The negative impact of this decrease was partially tempered by the positive development of term deposits in MDL, of which the growth rate was 11.4 percent, entirely due to the positive development of placements in MDL of legal entities.

It should be mentioned that, the exacerbated trend of increasing erosion of deposits was due, on the one hand, to the reluctance of people to place deposits in the conditions of the global financial crisis. On the other hand, lower incomes and a significant reduction of interest on deposits discourage consumers to make placements with banks.

Interest rates and monetary policy transmission mechanism

In December 2009, the National Bank of Moldova approved the Medium-term monetary policy strategy, which was supported by the publication in early February of the first Monetary Policy Report. That report included medium-term projection of inflation and macroeconomic indicators. Following the developed forecasts, the Council of administration decided to raise the base rate twice by 1.0 percentage point, up to 7.0 percent at the end of the first quarter of 2010. These decisions were aimed at maintaining control of the inflationary process throughout the forecast horizon. During the second quarter of 2010, to mitigate the inflationary pressures and to ensure appropriate monetary conditions for maintaining price stability, the National Bank of Moldova has also continued total sterilization of surplus liquidity in the banking market.

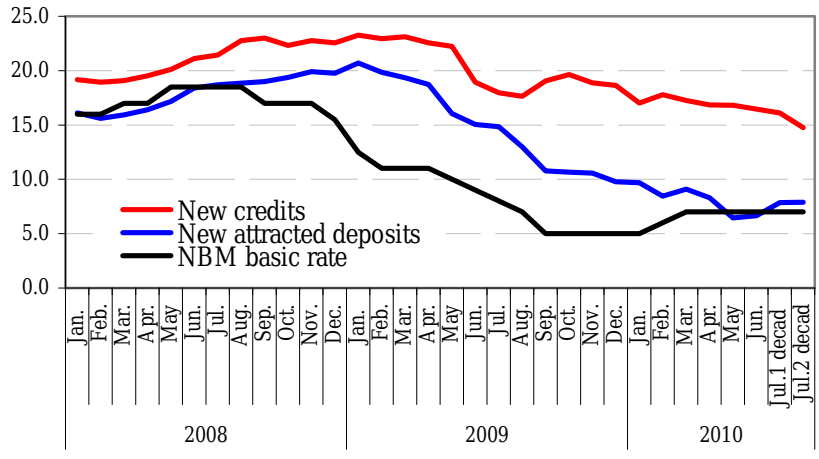
Chart no. 2.8. **The average interest rate on new attracted term deposits and on new credits granted from 6 to 12 months in MDL** (%)



Source: NBM

Thus, on the background of liquidity excess in the banking system and gradually credit risk reduction, the interest rates charged by banks for new attracted deposits and for new loans have continued to decline (chart 2.8). Following the downward trend in the first quarter, the weighted average interest rate on term deposits attracted in MDL has registered in the second quarter of 2010, a decrease of 2.07 percentage points and amounted to 7.01 percent. Quarterly average yield on loans in national currency was placed at the level of 16.7 percent, 0.64 percentage points less than the previous quarter (chart no. 2.9).

Chart no. 2.9. **Average interest rates in MDL** (%)



Source: NBM

In the context of the global economic crisis, higher interest margins was the main solution of banks to finance at a certain extent the rapid increase of provisions for bad loans, which is delayed while the main factor, today,

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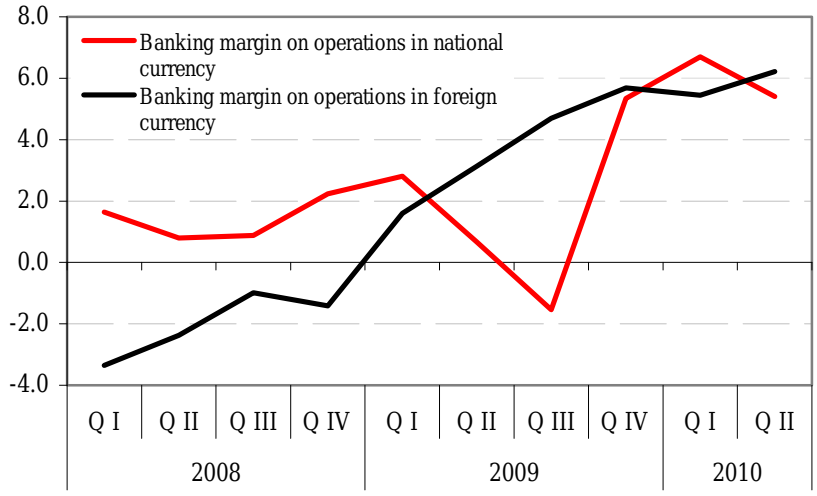
slows down the deduction in price of new loans.

The bank margins increase (the difference between the average rates on loans and deposits) occurred mainly at the expense of more drastic reduction of rates on deposits than the rates of new attracted loans.

It should be mentioned that the margin on foreign exchange operations since the fourth quarter of 2009 was stable and ranged between 5.44 and 6.22 percentage points, while the national currency operations in the first quarter of 2010 increased by 6.7 percentage points, thereafter, in the second quarter of 2010 decreased by 1.3 percentage points, reaching the level of 5.4 percentage points (chart no. 2.10). Therefore, the increase of the banking margin for operations in national currency and foreign currency operations was prompted by the need to cover losses incurred by banks as a result of credit portfolios worsening.

Chart no. 2.10. **Evolution of banking margin in operations from 6 to 12 months** (percentage points)



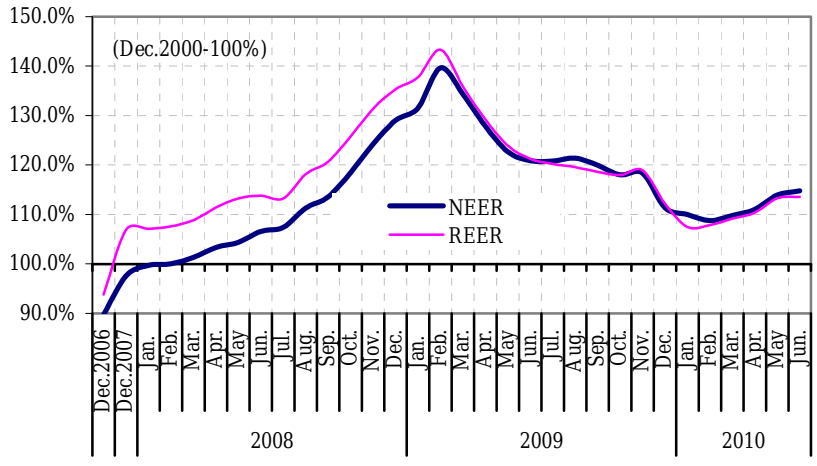
Source: NBM

However, based on the national economy trends, the level of liquidity and demand increase for money, in the third quarter of 2010 it is expected to reduce the interest rates on new loans and to increase the interest rates on new deposits attracted in national currency and respectively to reduce the banking margin.

Foreign exchange market (the exchange rate, real effective rate)

During the second quarter of 2010, **the official nominal exchange rate of the national currency** against the U.S. dollar depreciated by 3.5 percent and against the euro - has appreciated by 6.4 percent.

Chart no. 2.11. **Real and nominal effective exchange rate dynamics of the national currency calculated based on the share of the major trading partners**



Source: NBM

At the same time, **the real effective exchange rate of the national currency (REER)** calculated versus December 2000, has appreciated by 4.5 percentage points (chart no. 2.11). To the real effective exchange rate appreciation has contributed largely Romania (by 51.7 percent) and the euro zone countries such as Germany and Italy (by 30.8 percent), as trading partners of Moldova with a significant share in foreign trade (chart no. 2.12).

The stable trajectory of the official exchange rate of national currency against the U.S. dollar, recorded in the period of April 1 to 12, 2010, has reversed the downward trend reaching on April 22, 2010 the maximum level of depreciation for this month. The given depreciation of 1.6 percent compared to end in March 2010 took place against the backdrop of increasing the negative balance

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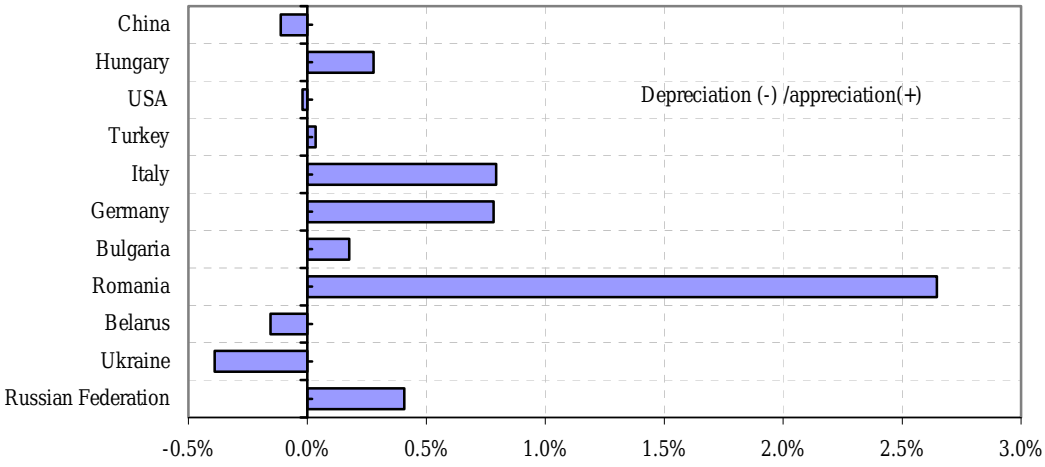
of foreign currency for foreign trade, uncovered by the foreign exchange inflows related to loans and external grants.

Chart no. 2.12. **Contribution of major trading partners of Moldova to the real effective depreciation** (2nd quarter, 2010 versus 1st quarter, 2010)



Source: NBM

During 23 to 30 of April 2010, the official exchange rate of the national currency against the U.S. dollar had a relatively stable trend, against the background of deficit mitigation of liquidity mainly because of the significant increase of foreign exchange flow related to credits and foreign grants.

In April 2010 the MDL against the U.S. dollar has depreciated by 1.5 percent in nominal terms and appreciated by 1.3 percentage points in effective terms compared to the end of March 2010.

The official nominal depreciation of the national currency against the U.S. dollar took place under negative balance of foreign currency for foreign trade in the amount of USD 177.7 million. At the same time, the net sales of foreign exchange by the licensed banks to legal entities constituted the equivalent of USD 190.2 million being covered by a rate of 86.3 percent of net supply of foreign currency from individuals (USD 164.1 million) which decreased by USD 18.9 million, or 10.3 percent versus March 2010. The MDL depreciation against the U.S. dollar in April 2010 was tempered by the sale transactions carried out by the NBM totalling USD 12.3 million.

During 1 to 16 of May 2010, the official exchange rate of the national currency against the U.S. dollar has maintained relatively a stable path. A depreciation of 1.5 percent was registered in the period of May 17, 2010 - May 23, 2010, compared to the end of April 2010. Subsequently, the official nominal exchange rate of the national currency against the U.S. dollar was relatively stable, with some major fluctuations by the end of the month. In May 2010, the official nominal exchange rate of the national currency against the U.S. dollar depreciated by 1.9 percent compared to April 30, 2010, and the real effective exchange rate of the national currency has appreciated by 2.9 percentage points compared to the previous month.

The depreciation of the official exchange rate of national currency against the U.S. dollar in May 2010 was conditioned mainly by the decline in net supply of foreign currency from individuals with U.S. $ 24.3 million compared to April 2010 and U.S. $ 43.2 million versus March 2010, totalling U.S. dollars 139.8 million and covering the net sales of foreign currency of the licensed banks to legal persons in the proportion of 85.7 percent (U.S. dollars 163.1 million). However, the negative net flow of foreign currency for foreign trade in the amount of U.S. dollars 182.9 million, remained basically at the level of April 2010. At the same time, a decrease in long open foreign exchange position of the licensed banks has been recorded, registering the lowest level of U.S. $ 15.0 million on May 14, 2010 (from U.S. $ 23.1 million on April 30, 2010). Also, an increase in short open foreign exchange position of the licensed banks was recorded, registering the highest level USD (-13.6) million on May 12, 2010 (from USD (-7.7) million on April 30, 2010). In May 2010, the National Bank of Moldova intervened on the foreign exchange market through U.S. dollars net sales operations in the amount of U.S. $ 5.4 million.

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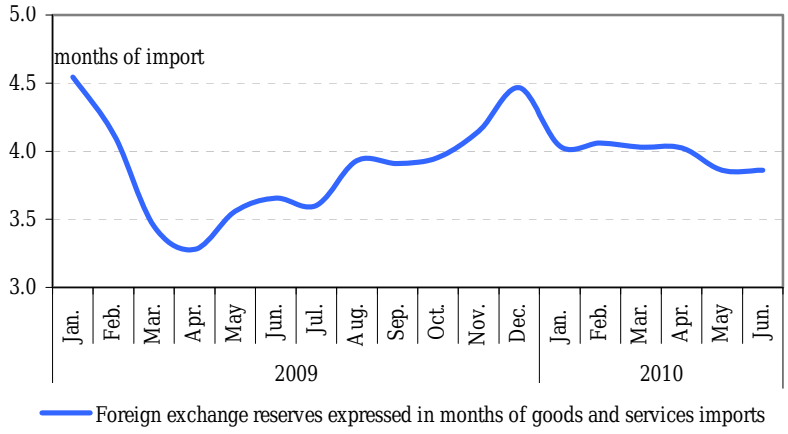
• Tel. (37322) 409 006 • Fax (37322) 220 591 •

At the beginning of June 2010 (the period June 1 to 6), the official exchange rate of the national currency against the U.S. dollar kept the trend registered in May 2010, depreciating by 0.9 percent compared to the end of May 2010. Further, by the end of June 2010, there was a 0.8 percent appreciation. Thus, in June 2010 the official exchange rate of the national currency against the U.S. dollar had a relatively stable trend, depreciating by 0.1 percent compared to the end of May 2010.

The insignificant depreciation of the exchange rate has taken place on reducing negative net flow of foreign currency for foreign trade by U.S. $ 37.9 million, or 21.1 percent compared to May 2010, up to the level of U.S. dollars 141.9 million, and on increasing the net supply of foreign currency from individuals by U.S. $ 22.6 million compared to May 2010, which totalled U.S. $ 162.4 million, covering 92.6 percent of foreign exchange net sales of the licensed banks to legal entities (U.S. dollars 175.3 million). The NBM did not intervene on the foreign exchange market in June 2010. The real effective exchange rate of the national currency in June 2010 has appreciated by 0.3 percentage points versus the previous month.

Chart no. 2.13. **Evolution of foreign exchange reserves expressed in months of goods and services imports**



Source: NBM

The evolution of the nominal exchange rate of the national currency against other foreign currencies followed the MDL exchange rate trend against the U.S. dollar adjusted to the U.S. dollar fluctuations against other currencies in the international markets.

During the second quarter of 2010, the state's foreign exchange reserves decreased by USD 42.3 million, or 2.9 percent, compared to USD 1464.1 million on March 31, 2010, up to the level of USD 1421.8 million on June 30, 2010, covering 3.9 months of imports (chart no. 2.13).

Fulfilling the provisions of the Memorandum of Economic and Financial Policies and consistency of the monetary program of the IMF with the monetary policy of the NBM

As of 30.06.2010 the NBM met the performance criteria established in the monetary program for the second quarter of 2010, and namely: net domestic assets (-590.1 million lei), the monetary base (-388.4 million lei) and net international reserves (USD 16.4 million). The possibility of maintaining the monetary base within the IMF planned limits was determined specially by the sale of foreign currency to commercial banks in the amount of USD 17.6 million, increase in the quality of excessive reserves management by banks and by the business seasonality. The listed factors and the monetary policy decisions aimed at sterilizing the excess of liquidity have allowed the stabilization of the monetary base growth rate.

Table no. 2.1. **Achievement of the monetary program** (million, lei)

	Effective on 30.06.2010	**Ceiling for** 30.06.2010	**Difference** versus the ceiling	**Difference** (%)
Net domestic assets	-6422.2	-5832.1	-590.1	-10.1
Net International Reserves (million, USD)	1373.4	1357.0*	16.4	1.2
Monetary Base	10470.6	10859.0	-388.4	-3.6

According to the adjustments made in accordance with p. 25 of Technical Memorandum of Understanding

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• Tel. (37322) 409 006 • Fax (37322) 220 591 •

III. Macroeconomic Forecast on medium term

External environment

In the first quarter of 2010, the global economic recovery continued its consolidation path. The economic recovery has taken place not only in countries with highly developed economy, but also in those with developing economies. Based on data from the first quarter of this year it is expected that in 2010 the annual growth rate of world economy will be 4.6 percent.

Moldova's partner economies in the medium-term macroeconomic forecasting will continue to recover and grow. The Euro zone will record in 2010 an increase of 1.1 percent and in 2011 - 1.4 percent. Next year Russian Federation will have values of 4.7 percent for the economic growth, and this year this figure will be over 5.0 percent. Russian Federation and the Euro zone are currently under their economic potential and therefore the demand inflationary pressures over the next two years are not foreseen.

In the Euro zone the inflation rate for the current year will not exceed 1.5 percent, which will remain unchanged the next year. In the Russian Federation over the next two years the inflation will be below 7.0 percent.

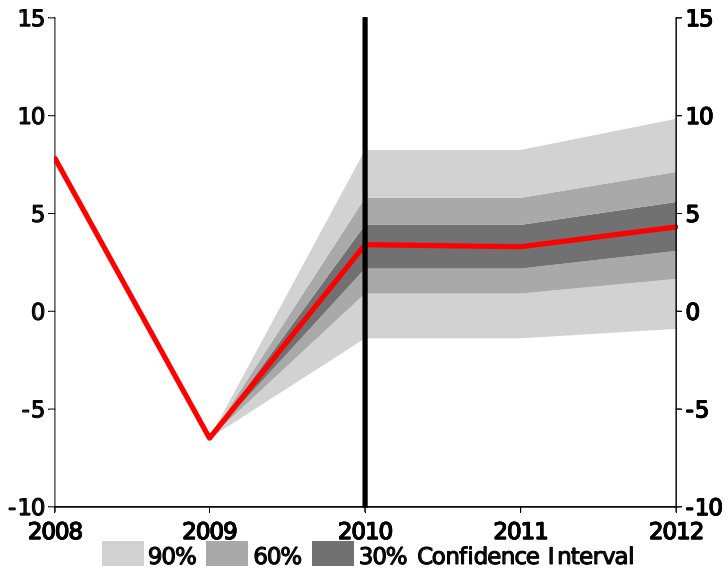
An inflationary factor remains to be the food prices on international markets, thus according to the forecasts their growth rate for 2010 will be less than the next years forecasts, being influenced by the adverse agro meteorological conditions in the current year and the global economic recovery.

According to the forecasts, the oil price will be within the range of USD 76.0 - 84.0 per barrel during the forecasting period, recording an upward trajectory. The prices of imported natural gas will increase in line with the increase of oil prices.

Prospects for the real sector

The effects of the economic decline registered in 2009 are currently manifesting by the level of economic activity which is lower than its potential (deviation of GDP is negative, i.e. the capacities of the national economy are under-used), which creates a situation where the disinflationary pressures remain to be persistent. According to the NBM assessment, the GDP has exceeded the minimum recession and since the end of 2009 has an upward trend, which was further strengthened during the first quarter of 2010.

Chart no. 3.1. **Annual rate of real GDP forecast** (%)



According to the current round of forecasting, the economic growth constitutes 3.4 percent in 2010 and 3.3 percent for 2011, the upward trend remaining to be registered for 2012 as well - by 4.3 percent. The GDP projection of the current round of forecasting takes into consideration the re-assessment of the cyclical positioning of the aggregate demand to more favourable levels of economic growth process due to the NBS publication of data on real GDP growth of 4.7 percent for the first quarter of 2010. This fact has changed the projection for the forecast period.

Therefore, the GDP potential was reconsidered, after which the GDP deviation has been re-evaluated. Although since the third quarter of 2010 there will be seen a diminishing trend in the difference between the

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• Tel. (37322) 409 006 • Fax (37322) 220 591 •

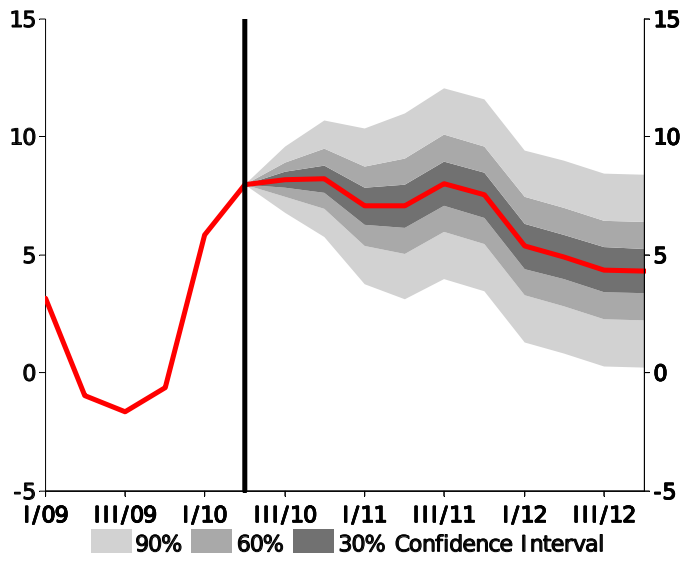
effective and potential GDP, the potential level of economic activity will be reached out of the forecast horizon. The exchange rate of the national currency against the U.S. dollar will register significant fluctuations throughout the forecast period, while for the same period the national currency will be appreciated against the EUR due to the international market trends. The nominal effective exchange rate will be relatively stable.

According to the information contained in the MTEF and due to the emergence of new data on budget performance, the fiscal policy on the real sector was reviewed. In 2010, the degree of fiscal expansion has been revised towards reduction, and the fiscal policy impact will be a neutral one for the rest of forecasting period.

Inflation outlook

According to the current projection, the annual rate of CPI inflation will amount to about 8.2 percent at the end of 2010, a level lower than the previous projection due to lower inflationary pressures. For 2011 the annual inflation rate is projected at a level of about 7.4 percentage points, which is due to possible increases in food and regulated prices. During 2012, the annual inflation will reach close to a long-term sustainable level of about 5.0 percent.

Chart no. 3.2. **Annual rate of CPI forecast** (%)



The core inflation will accelerate until the end of this year to levels higher than 6.0 percent, after which it will decrease continuously up to 3.5 percent by the end of 2012. This deceleration will be due to the dissipation of second round effects from supply shocks, as well as due to the deficit persistence of the aggregate demand.

Food prices in the second quarter of 2010 had a more positive evolution, with a growth rate lower than the previously anticipated one, due to the presence of more favourable agro meteorological conditions during the growing season this year, thus increasing the agricultural production demand. It is expected that this foodstuff products trend will persist by the end of this year. But the next year, the situation will be reversed as a result of higher futures prices in the international markets for some of the major foodstuff products.

The maximum contribution to the formation and registration of CPI inflation of 8.2 percent will be due to administered prices and core inflation that will be increasing compared to the third quarter of this year. The inflation at the end of 2011 will be 7.5 percent, and at the end of 2012 - 4.3 percent. The greatest contribution to the inflation increase will be caused by the increase in regulated and foodstuff products prices. The core inflation will increase as second round effect of the increase of the above - mentioned components.

The natural gas prices will have an upward trend in line with oil prices. Also this development takes into account the elimination of adjustment coefficient, whereupon the import price of natural gas will reach the average European price.

Currently the only factors influencing the inflation are from the supply side, while the economic activity is below its potential and does not create prerequisites for inflation for the forecast horizon.

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Risks and uncertainties

The risks relating to external environment evolution are generated by the fragility yet shown by the real economic recovery in the Euro zone and the latest statistic data on the growth rate of real GDP in the Euro zone and Russia require revision of the hypothesis on the external demand dynamics, which growth can contribute to the further inflation increase in Moldova.

Both the slow process of the economic growth strengthening and the recurrence of the turmoil in the international financial markets could lead to adverse effects on the Moldovan economy through exchange rate channels and foreign trade.

A lower international economic activity requires a smaller volume of export earnings and remittances from Moldovans working abroad. Consequently, the domestic consumption will decrease, thus decreasing the pressures on prices.

The investor uncertainty increase on the global economic recovery may create pressure to reduce the raw material prices on international markets, particularly the oil prices.

The deviation risks in one direction or another from the projected trajectories of the fuel prices, foodstuff products on the international market and regulated prices are still relatively balanced.

Any tax adjustments, particularly increases in indirect taxes or broadening their tax base would require an increase in expected inflation.

The excessive rainfall, especially during the harvest period in this year, could compromise the harvest, thus creating prerequisites for increasing foodstuff products prices.

For next year, a higher volume of rainfall would reduce the effects of international foodstuff products price increases, which will reduce the price increase, otherwise or as a result of possible frosts in the spring of the next year will result in exacerbation of prices increases for foodstuff products as a result of growth in international markets.

Table no. 3.1. **Forecast risks and uncertainties**

<table>
<tr><th>Inflationary</th><th>Deflationary</th></tr>
<tr><td>Fiscal adjustments:
• Excise duties
• Broadening the tax base of VAT
Unexpected rises in regulated prices</td><td>The decrease in international prices:
• Energy sources
• Raw materials</td></tr>
<tr><td rowspan="2">Political uncertainty in RM</td><td>Moderate recovery of world economy
• Reduced external demand
• Decreased flow of FDI
• Smaller volume of remittances
The low volume of loans</td></tr>
<tr><td>Reduced domestic demand
• Public Sector
• Private Sector
• Labor market: high unemployment, wage freezing (especially in public sector)</td></tr>
<tr><td rowspan="2">USD depreciation in the international foreign exchange market → increases in oil and natural gas prices → further increase of regulated prices.</td><td>Lending channel (foreign loans)</td></tr>
<tr><td>EUR depreciation against USD → MDL appreciation against EUR</td></tr>
<tr><td colspan="2">Weather conditions (harvest)</td></tr>
<tr><td>Drought</td><td>High volume of rainfall</td></tr>
</table>

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