National
Bank of Moldova

Inflation Report

No. 3, August 2018

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Note

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Eurostat, International Monetary Fund,

National Energy Regulatory Agency,

State Hydrometeorological Service.

Likewise were selected 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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List of acronyms

ANRE	National Agency for Energy Regulation
CPI	Consumer Price Index
ECB	European Central Bank
ECF	Extended Credit Facility
EFF	Extended Fund Facility
EU	European Union
EUR	European Single Currency
FCC	Freely convertible currency
Fed	Federal Reserve System
GDP	Gross Domestic Product
IMF	International Monetary Fund
MDL	Moldovan leu
NBC	Certificates issued by the National Bank of Moldova
NBM	National Bank of Moldova
NBS	National Bureau of Statistics of the Republic of Moldova
NEER	Nominal effective exchange rate of the national currency
REER	Real effective exchange rate of the national currency
RUB	Russian rouble
SDR	Special drawing rights
USD	U.S. Dollar

Summary

The new medium-term inflation forecast (eight quarters) was prepared based on of the updated macroeconomic analysis and underlying assumptions, taking into account domestic and international economic developments, including the dynamics of population consumption, remittances, foreign exchange market indicators, stock indices of commodities and energy resources, as well as changes in the external and internal trade conditions.

The annual inflation rate will follow a downward trajectory over the next three quarters and fall below the lower limit of the inflation variability interval, reaching the minimum level of 1.9% in the fourth quarter of 2018. Later, the trajectory will reverse, inflation returning within its variability interval in the second quarter of 2019 and recording 6.5% in the third quarter of 2019. Core inflation will record a similar trajectory, largely influenced by supply factors. The growth rate of food prices will decrease in 2018, reversing to the upward trend in the second half of the next year. The annual growth rate of regulated prices will fall to -4.4% in the current quarter, but will accelerate afterwards, exceeding a 10% level in the second half of 2019. Having recorded an increase during this quarter, the annual growth rate of fuel prices will have a downward trajectory throughout the forecasting period.

Aggregate demand will remain moderate over the forecast horizon as a result of the restrictive monetary and fiscal conditions to be maintained throughout next year.

The existing trade and geopolitical factors determine global economy to grow at a moderate pace. Currently, the US trade protectionist actions, which were replicated by China and other relevant economies, generate the major risk to global economy. The complexity of this risk arises from the uncertainty of the extent and viability of the phenomenon. Considerable risks are also generated by more restrictive financial conditions promoted in advanced economies, affecting emerging economies. Until recently, the negative effect of the transfer of financial capital from emerging to advanced economies was offset mainly by higher international commodity prices. However, the stabilisation of energy prices associated with trade tensions has led to slowing down of the growth rate of international prices, which could negatively affect economic growth in emerging economies.

The Eurozone's GDP projection was revised downwards based on a lower growth rate recorded in the first quarter 2018 due to low temperatures and political tensions, which affected Italy and Germany. The economy of the Russian Federation achieved some stability, overcoming the immediate consequences of international economic sanctions and benefiting from high oil prices. The trajectory of the EUR/USD cross-rate forecast has been updated as the US dollar has appreciated in recent months. The oil price will remain in the range of 70-80 US dollar/barrel over the next period and will record an average level of 72.2 US dollar/barrel in 2018 and 73.0 US dollar/barrel in 2019. Trade tensions between the US, China and the European Union have provoked a recent drop in international food prices, pushing down their trajectory for about two quarters.

The current inflation forecast was revised downwards through the second quarter of the next year and upwards for the rest of the forecast horizon. This revision was driven by an upward revision of core inflation through the first quarter of the next year and a downward revision for the rest of the forecast period. The growth rate forecast for food prices was revised downwards throughout the forecast period. The growth rate forecast for regulated prices was revised downwards through the second quarter of the next year and upwards for the rest of the forecast horizon. At the same time, the growth rate forecast for fuel prices was revised upwards throughout the forecast period.

The annual CPI fell from 4.7% in March 2018 to 3.2% in June 2018, thus falling below the inflation target interval. The CPI subcomponents kept recording a steady decrease in the core inflation level, driven by modest aggregate demand and the appreciation of the Moldovan leu, which were slightly offset by occasional sectoral shocks. Following a high base period of the previous year and a good crop of fresh fruits and vegetables in the second quarter of 2018, the annual food price index recorded a steady decline over the reference period. The annual rate of regulated prices continued to decline, driven

by the high base effect. The rise in international oil prices coupled with a slight depreciation of the domestic currency against the US dollar determined a rise in fuel prices in the domestic market. In the second quarter of 2018, the actual value of the annual CPI growth rate recorded no deviations from the level projected in the previous forecasting round. Over the next period, the annual inflation rate will remain below the lower limit of the inflation interval following the cuts implemented in electricity tariffs as well as a negligible impact continually generated by aggregate demand on prices. At the same time, the inflation's downward trend could be also attributed to the secondary effects of a decrease in tariffs on natural gas and electricity. During the second quarter of 2018, the annual industrial production price index maintained its downward trajectory, thus determining a number of CPI subcomponents to maintain the same trajectory over the next period.

The positive evolution of the national economy in the first quarter of 2018, as was projected in the previous forecasting rounds, was favoured both by the growth of aggregate demand as well as by the impact of a rich crop recorded in the previous year that fuelled the rise in exports. However, the growth rate recorded lower values, with GDP increasing by 3.7% compared to the first quarter of 2017. The growth in gross fixed capital formation was supported by investments in both the construction and the machinery and equipment sectors. The stock change generated a positive impact on the dynamics of economic activity. As in the previous year, in the first half of this year the volume of exports continued to grow, mainly supported by good agricultural crop and the demand from the EU countries. The volume of imports has also increased against the background of an increasing domestic demand as well as the appreciation of the domestic currency. By resource categories, in the first quarter of 2018, the GDP growth was largely determined by positive contributions generated by the industrial sector, trade, the information and communications sector, as well as by net product taxes. Statistical data for April-May 2018 outline conditions for a continued economic growth in the second quarter of 2018. Estimates suggest that economic growth will maintain in the second half of the year.

In the first quarter of 2018, the number of the employed population remained at the level of the beginning of the previous year, while the number of unemployed population diminished, which determined a negative growth rate of the economically active population. The unemployment rate has decreased both compared to the beginning of the previous year and to the fourth quarter of 2017.

In April-May 2018, the annual growth rate of the state budget's revenues recorded positive evolutions, rising by 14.1% compared to the similar period of 2017. However, the state budget's expenditures recorded a similar trend, increasing by 14.6%, compared to the similar period of 2017. This trajectory could generate pressures that would push upwards the domestic demand in the coming years. At the same time, the market situation favoured a further decrease of interest rates on state securities, which during the second quarter of 2018 decreased on all types of maturities.

In the second quarter of 2018, the excess liquidity amounted to 9.2 billion lei. A high amount of excess liquidity was largely generated by monetary issues following the NBM's interventions in the forex market and by public sector spending. Under these circumstances, banks preferred placements in low-risk instruments, such as placements in state securities or the National Bank Certificates (NBC).

Monetary aggregates in the second quarter of 2018 recorded a positive but moderate dynamics as compared to the previous quarter. At the same time, the main contribution to this evolution was largely determined by the increase in the volume of sight deposits, both in national currency and in foreign currency.

Following the trend of the base rate applied to the main monetary policy operations of the National Bank of Moldova and as a result of the liquidity surplus registered in the banking system, the average interest rates of banks licensed both on credits and on deposits continued their downward trend.

Chapter 1

Forecast

1.1 Internal environment

Inflation

The annual inflation rate will record a downward trajectory through the end of this year (reaching a level of 1.9% in the fourth quarter of 2018), after which the trajectory will reverse, inflation rising to 6.5% in the third quarter of 2019. For the next three quarters, inflation will record levels below the inflation range, returning within it in the second quarter of 2019 (Chart 1.1).

This year's decline in inflation has been mainly driven by the CPI components, namely regulated prices, food prices and core inflation, against the background of an aggregated disinflationary demand (Chart 1.2). At the same time, the fuel prices will slightly offset disinflationary pressures.

The last year's high base, weak aggregate demand, steady appreciation of the domestic currency and, last but not least, the electoral cycle will be the main factors to exert disinflationary pressures in 2018. In 2019, the evolution of the domestic currency, the anticipated adjustment of a number of tariffs, the scheduled increase in excise duties, the correction of the economic margins for economic agents and the low base will be the key factors for the inflation's rise, starting the first quarter of the next year.

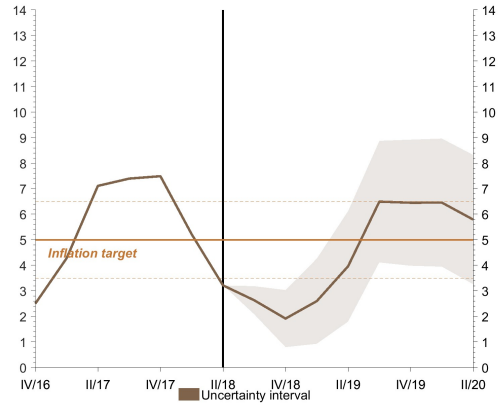
From its current level below the inflation range, in the fourth quarter of 2018, inflation will gradually fall to the minimum level of 1.9%. Subsequently, its trajectory will reverse and return within the inflation range in the second quarter of 2019, recording levels close to the upper limit of the range through the end of the forecast horizon[1].

The annual average inflation will record 3.2% in 2018 and 4.9% in 2019.

The core inflation will record a steady downward trend throughout this year, beginning to rise in 2019 and maintaining this trend through the end of the forecasting period, being largely driven by supply factors. The initial decline will be determined by (1) low aggregate demand, 2) high base of the previous year and (3) the appreciation of the domestic currency. Starting next year, it will increase as a result of (1) the

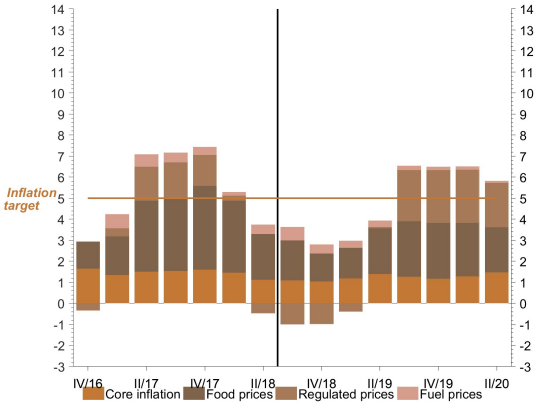
[1]Quarter II, 2020

Chart 1.1: CPI with the uncertainty interval (%, fap)



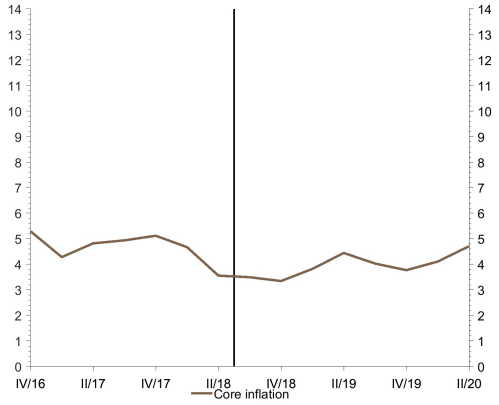
Source: NBS, NBM calculus

Chart 1.2: The CPI decomposition (%, pp, fap)



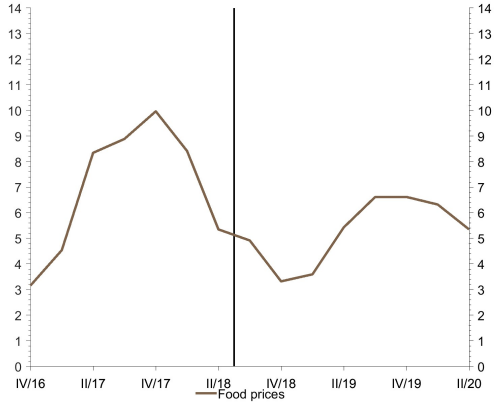
Source: NBS, NBM calculus

Chart 1.3: The core inflation (%, fap)



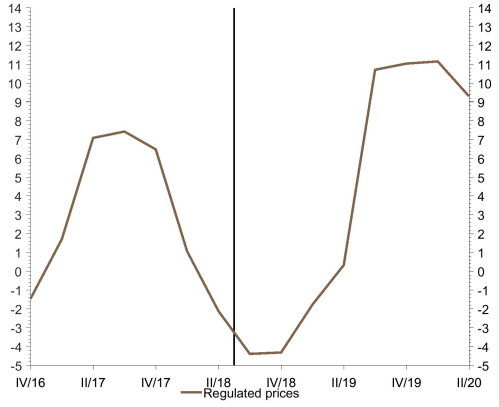
Source: NBS, NBM calculus

Chart 1.4: The food prices (%, fap)



Source: NBS, NBM calculus

Chart 1.5: The regulated prices (%, fap)



Source: NBS, NBM calculus

correction of the exchange rate of the domestic currency, (2) the increase in excise duties on a range of products, (3) the correction of the economic margins for economic agents. At the same time, the impact of inflationary factors will be offset by moderate aggregate demand (Chart 1.3).

The annual average rate of core inflation will record 3.8% in 2018 and 4.0% in 2019.

The growth rate of food prices will slow down during this year, but will increase in the second half of next year. The rate's slowing down to a fairly low level, to be recorded through the end of this year, will be driven by (1) high base and 2) strong appreciation of the domestic currency. The trend will reverse at the beginning of next year, the annual inflation rate rising to 6.5% in the third quarter. Factors that will contribute to this are (1) the increase of excise duties on a range of products, (2) a future upward correction of economic margins for economic agents, (3) the projected growth of international food prices, and (4) the next year's correction of the exchange rate of the domestic currency. The growth rate of inflation will slow down towards the end of the forecast horizon (Chart 1.4).

The average annual food price will record levels of 5.5% in 2018 and 5.6% in 2019.

The annual growth rate of regulated prices will fall to -4.4% in the current quarter, but will accelerate later, being expected to exceed 10% in the second half of 2019 (Chart 1.5). Negative values to be recorded in the second half of this year and the first quarter of next year will be determined by (1) expected tariff cuts on electricity and medicines, to take place in the third quarter, and (2) the high base of the previous year. At the same time, in 2019, regulated prices will increase as a result of the adjustment of tariffs for passenger transportation services, gas supply, electricity and other energy supply services (central heating, etc.).

The average annual rate of regulated prices will record -2.5% in 2018 and 5.0% in 2019.

The annual growth rate of fuel prices will record a downward trajectory throughout the forecasting period, after which it will rise in the current quarter. The last year's low base and the rise in oil prices, both accumulated and anticipated for the current quarter, will be the main factors of the initial growth of the annual growth rate. The annual rate's decline will be determined by a moderate decline in oil prices over the forecast horizon that will almost offset the depreciation of the domestic currency. The last year's high base will also determine the decrease in the annual growth rate. Scheduled increases in excise duties on fuels at the beginning of the next two years will mitigate the decrease in the annual rate throughout the forecasting period (Chart 1.6).

The annual average fuel price will record 6.8% in 2018 and 4.0% in 2019.

Demand

Aggregate demand will continue recording medium levels over the forecast horizon, as a result of restrictive

monetary and fiscal conditions to be recorded during next year (Chart 1.7).

According to existing assumptions, the *consumption* of the population and public administration will increase, thus fuelling imports growth. At the same time, *exports* will record higher growth rates than *imports* (agriculture 2.0%, major investments in the Free Economic Zones will contribute to an increase in exports). The evolution of *gross capital formation* will be driven, contrary to the previous year, by the increase in the public sector investment. Consequently, *fiscal impulse* is expected to be positive and rising through the end of this year, when the GDP's deviation will record levels close to zero. Starting next year, fiscal impulse is expected to decline, hence decreasing the level of aggregate demand.

External demand will positively influence internal demand. Strengthening of economic activity in the European Union and, in particular, in the Eurozone will support growth in exports and remittances.

According to existing anticipations, *agriculture* will record a 2% increase in 2018. This growth could be achieved even in the context of droughty weather conditions, as a result of the increase in labour productivity as well as the increase of the area of sown land (compared to 2017, when the area of sown land was smaller, so there is a reserve, potential unused land).

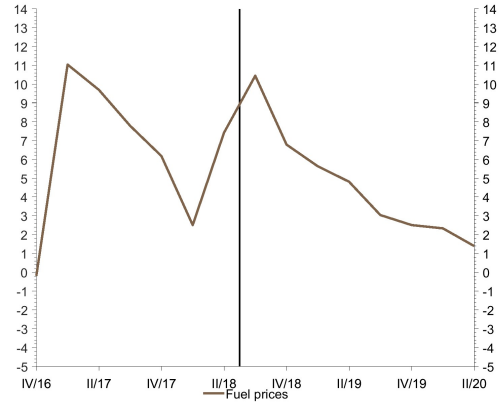
The *income*'s growth in the real sector of the economy will be determined by the evolution of economic activity in the previous years, the salary adjustments announced by the Moldovan Government, a good agricultural crop recorded in 2017 as well as the increase in exports.

Monetary policy

The monetary conditions will be restrictives, but downword during the forecasting period (Chart 1.8).

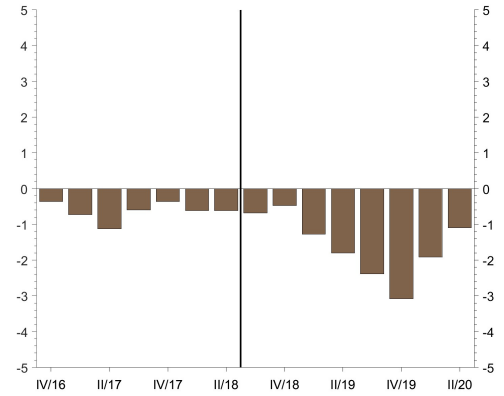
A significant contribution to the evolution of monetary conditions will be generated by the real exchange rate. Its deviation from the equilibrium level will gradually decrease throughout the forecasting period. This development will be determined by the evolution of the nominal exchange rate during that period. The real interest rate will influence insignificantly the evolution of monetary conditions. Its impact will be primarily determined by the low level of economic indebtedness. Deviation of the real interest rate will have a restrictive effect at the end of this year and in the first half of next year. Subsequently, over the last three consecutive quarters of the forecast horizon, it will reduce restrictive effects of the deviation of the real effective exchange rate.

Chart 1.6: The fuel prices (%, fap)



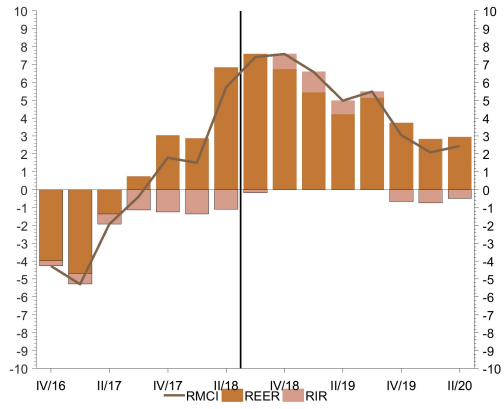
Source: NBS, NBM calculus

Chart 1.7: The GDP deviation (%)



Source: NBM calculus

Chart 1.8: The real monetary conditions index and decomposition



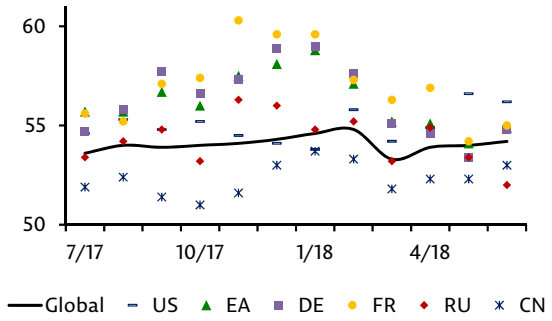
Source: NBM calculus

1.2 External environment

Global economy

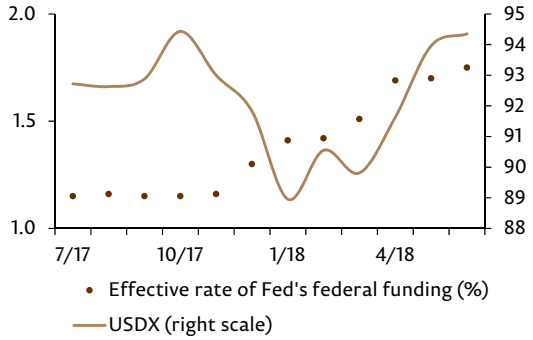
The disruption of economic growth by geopolitical factors has caused a slowdown of global economy. Currently, the

Chart 1.9: The evolution of the composite PMI index *



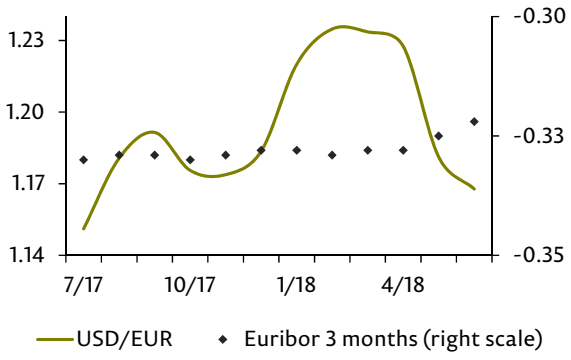
Source: Markit
*Composite Purchasing Managers' Index (PMI) -is an indicator (calculated by sampling) of economic health for the production and service sectors. The purpose of PMI is to provide decision makers, analysts and managers with information about current business conditions.

Chart 1.10: US dollar index evolution (USDX**) in Fed monetary policy context



Source: Fed, Bloomberg
**USDX is an index calculated using the weighted geometric mean of the US dollar value against a basket of foreign currencies: Euro – 57.6%, Japanese yen – 13.6%, Pound sterling – 11.9%, Canadian dollar – 9.1%, Swedish krona – 4.2%, Swiss franc – 3.6%.

Chart 1.11: The evolution of USD/EUR (monthly average) and interest rate in euro area



Source: ECB, Eurostat

biggest risk to global economy represent the US trade protectionist actions that were replicated by China and other partner economies. The complexity of the risk results from the uncertainty of the extent and viability of the phenomenon. Besides, the major risk represent the transfer of more restrictive financial conditions of advanced economies on emerging economies. Until recently, the negative effect of capital migration from the emerging economies to the advanced ones has been counterbalanced by an increase in international commodity prices. However, the recent trade-related and geopolitical tensions have slowed down the rise of international prices, which could negatively affect economic growth in emerging economies.

The composite PMI index (Chart 1.9) reflects a certain recovery of global economic activity, compared to the first quarter of 2018; at the same time, compared to the end of 2017, PMI denotes its slowing down. The phenomenon can be largely attributed to the economic cycle, as many of the advanced economies have reached their potential levels. At the same time, economic activity was periodically disrupted by the political factor (the political crises in Italy and Germany) as well as adverse weather conditions (very low temperatures in the first quarter of 2018, which were recorded in Europe). Emerging economies are adapting to the increasingly restrictive financial conditions applied by advanced economies, trade protectionist policies, and high international commodity prices. According to the revised IMF forecast[2], after a global economic growth of 3.7% that was recorded in 2017, in 2018 and 2019, *global economy* will grow by 3.9%.

In recent months, the *US dollar* has appreciated against other international currencies, the USD index reaching the level of 94.35 (Chart 1.10) at the end of June 2018. The Federal Reserve System (the Fed) increased the interest rate range by 0.25 p.p. at its meeting held in June 2018, the current level ranging between 1.75% and 2.0%. In addition, at the US Congress meeting in July 2018, Jerome Powell, the head of the Fed, confirmed his intention to increase the interest rate range over the course of this year. Investors also believe that the intensification of trade-related tensions between the US and its trading partners allowed investors who trade in US dollars to have the highest returns on investment, compared to transactions in other G10 currencies.

The *EUR/USD* cross rate decreased significantly in the second quarter of 2018. On a quarterly average, the euro depreciated 3.0% against the US dollar (Chart 1.11). The depreciation can be attributed to a technical correction as well as to the impact of an economic slowing down and political tensions periodically rising in the Eurozone. However, in June 2018, the annual inflation rate in the Eurozone reached 2.0% (the ECB-targeted level), whereas the unemployment rate fell to 8.5% in May 2018. These developments led the ECB, at its June 2018 meeting, to lay down a plan of the programme on ceasing asset purchases. Thus, the ECB intends to procure assets worth 30 billion euros per month through the end of September 2018, after which, in October-December 2018, the asset purchases will be reduced to 15 bln. euro per month. Starting 2019, the ECB will no longer purchase assets, but the base rate will remain at zero level through the summer of 2019.

[2]IMF: World Economic Outlook Update, July 2018

During the reference period, the *Russian rubble* depreciated by 8.6% against the US dollar (on quarterly average). A sudden depreciation, compared to April 2018 (Chart 1.12), was driven by a new package of US sanctions imposed on Russia. However, the depreciation has been avoided due to high oil prices and the adaptability of Russian economy to new international conditions.

The oil price in the second quarter of 2018 ranged between 70-80 US dollar/ barrel, recording a quarterly average of 72.4 US dollar/ barrel, an increase of 11.2%, compared to the first quarter of 2018 (Chart 1.13). Factors that led to the rise in oil prices are: (1) the reduction of oil production and oil reserves in the US; (2) the US intention to cut Iran's oil exports to zero and Iran's limited opportunities to shift into other supply markets; (3) the reduction of oil exports from Libya and a catastrophic situation in the Venezuelan oil industry; (4) the over-achievement of the OPEC + plan on reducing oil production. In June, at the OPEC + meeting, it was decided to return to the initial quotas for oil production, which means an increase in oil production by another million barrels per day.

The July 2018 primary statistical data have already reflected a rise in oil production in Saudi Arabia and the Russian Federation, resulting in the decline of international oil prices.

In June 2018, *international food prices* fell unexpectedly by an average of 0.9% on an annual basis (Chart 1.14). The decline was driven by the disruption of international trade following trade protectionist actions implemented by the US, China and other countries involved in the conflict. With no adverse weather conditions to affect global harvest in 2018, the disruption of international trade has become the sole source that shifted the trajectory of international futures prices for two quarters.

External assumptions

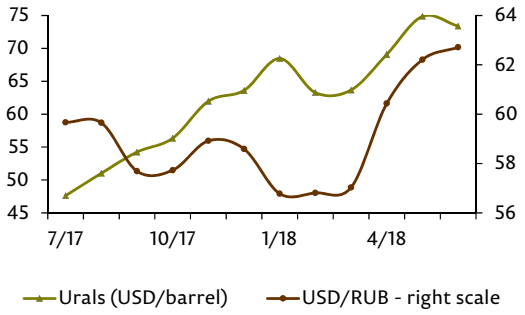
The current forecast maintains inflationary external assumptions (Table 1.1).

A downward revision of the Eurozone's GDP forecast can be attributed to a slower growth rate recorded in the first quarter of 2018 as a result of very low temperatures and political tensions in Italy and Germany. However, the outlook for the Eurozone's economy remains favourable, and the increase in consumption will contribute to reaching the inflation target set by the European Central Bank.

The economy of the Russian Federation has reached some stability, having overcome immediate consequences of international economic sanctions and taking full advantage of high oil prices.

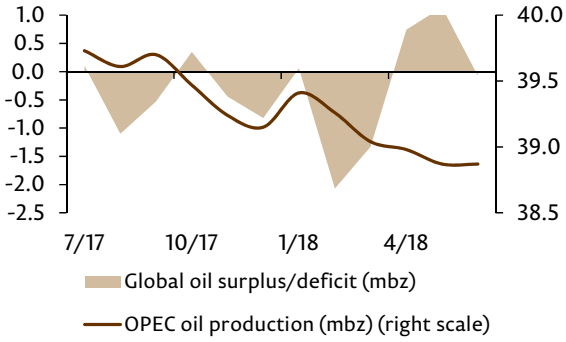
The forecast of the EUR/USD cross rate's trajectory changed as the US dollar has appreciated significantly in recent months. Annual averages projected in the current forecasting round for 2018 and 2019 are 1.19 and 1.20, recording a decrease of 3.1% and 4.0%, respectively, compared to the forecasting round of April 2018. However, the Chart 1.15 shows that the EUR / USD cross currency rate will gradually increase over the next eight quarters in view of the anticipated convergence of financial conditions of the US and the Eurozone.

Chart 1.12: The evolution of USD/RUB under the Urals price development



Source: ECB, Eurostat

Chart 1.13: The global oil market



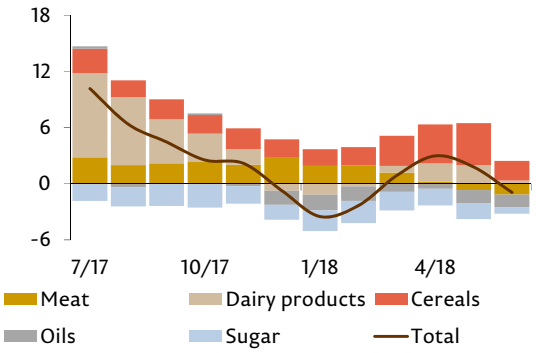
Source: U.S. Energy Information Administration

Table 1.1: Expected evolution of external variables (annual average)

	2018	2019
Economic growth in the euro area, %	2.2	1.8
Economic growth in the Russian Federation, %	1.8	1.9
Average annual inflation in the euro area, %	1.7	1.6
Average annual inflation in the Russian Federation, %	2.8	3.9
EUR/USD	1.19	1.20
USD/RUB	60.8	61.4
Urals brand oil prices (USD/barrel)	72.2	73.0
International food prices growth, %	-0.7	5.2

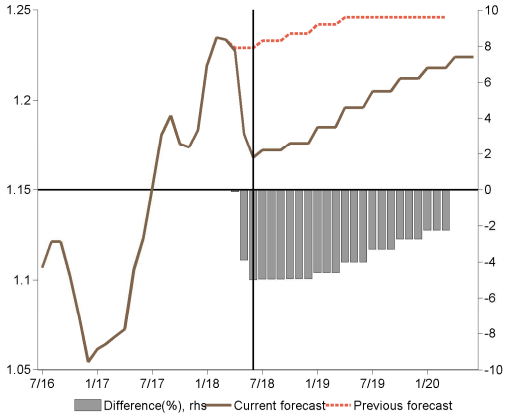
Source: Consensus Economics, Bloomberg, NBM calculus

Chart 1.14: The annual growth rate of FAO index on food world prices (%)



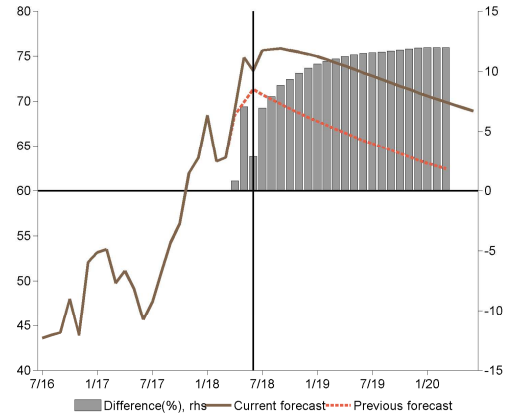
Source: FAO, NBM calculus

Chart 1.15: The evolutionary scenario of the EUR/USD exchange rate



Source: ECB, Consensus Economics, NBM calculus

Chart 1.16: The evolutionary scenario of the Urals brand oil world prices (USD/barrel)



Source: Ministry of Economic Development of the Russian Federation, Bloomberg, NBM calculus

In the coming months, oil prices will remain within the range of 70-80 US dollar / barrel and will record averages of 72.2 US dollar / barrel in 2018 and 73.0 US dollar / barrel in 2019. An upward revision of the oil price projections (Chart 1.16) was driven by the uncertainties regarding the behaviour of the international oil market's decision makers. Besides, the prolongation of the OPEC + plan on the oil production cut will determine the persistence of a global oil deficit. At the same time, situations in Libya and Venezuela are unlikely to improve in the near future, which fact will also contribute to reducing the volume of a global oil supply.

The disruption of international trade through trade protectionist actions implemented by the US, China and other countries involved in the conflict has caused a recent decline in international food prices and the shift of their trajectory for approximately two quarters (Chart 1.17). Therefore, in the current forecasting round, the scenario of the evolution of the annual growth rate of international food prices provides for an average reduction of 0.7% in 2018 and an increase of 5.2% in 2019. At the same time, it is likely that the 2018 crop to be harvested in the northern hemisphere would insignificantly adjust the trajectories of the international food price projections.

1.3 Comparison of forecasts

The current inflation forecast was revised downwards through the second quarter of next year, and upwards - for the rest of the forecast horizon (Chart 1.18). The main components that contributed to lowering the inflation projection were food prices and regulated prices, the effect of which is slightly offset by an increase in core inflation and fuel prices. At the same time, an upward revision of the inflation trajectory is determined by higher projections of regulated prices and fuel prices for the rest of the forecasting period (Chart 1.19).

The average annual inflation rate has been revised downwards 0.1 p.p. for 2018, and will be kept at the same level for 2019.

Core inflation was revised upwards through the first quarter of next year, and downwards - for the rest of the forecasting period. The main reasons of an upward revision were a higher effective inflation than was projected for the previous quarter, a higher aggregate demand for the current year, and a revision of the price elasticity asymmetry to the exchange rate evolution. A downward revision for the second half of the forecast horizon was determined by a smaller deviation of GDP growth as well as by the revision of the direct impact of indirect taxes and the effect of trade margins' correction (Chart 1.20).

The forecast for the average rate of core inflation was revised upwards by 0.6 p.p. for 2018 and downwards by 0.6 p.p. for 2019.

The projections of the growth rate of food prices were revised downwards for the entire forecasting period. Lowering of the food price growth rate was determined by (1) a lower inflation than was anticipated for the previous quarter, (2) a

weaker evolution of international food prices, (3) the revision of the price elasticity asymmetry to the exchange rate evolution, (4) the effect of the trade margins' correction in the post-electoral period, as well as (5) the direct impact of the adjustment of indirect taxes (Chart 1.21).

On average, the food price forecast was revised downwards by 0.8 p.p. for 2018 and 1.5 p.p. for 2019.

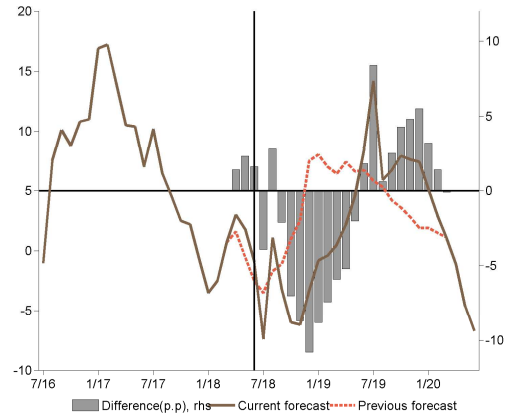
The current forecast for regulated prices was revised downwards through the second quarter of next year, and upwards - for the rest of the forecast horizon.

In this context, the regulated price projections maintained the same level for 2018 and were increased by 2.5 p.p. for 2019.

The fuel price growth forecast has been revised upwards throughout the forecasting period (Chart 1.23), driven by higher international oil prices and a lower exchange rate of the domestic currency, anticipated for that period.

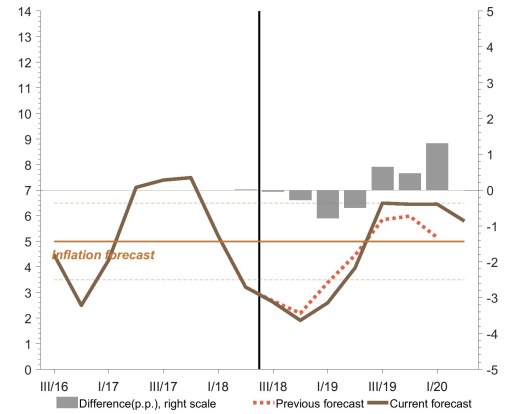
The fuel price forecast was increased by 0.7 p.p. for 2018 and 2.7 p.p. for 2019.

Chart 1.17: The evolutionary scenario of food world prices annual growth (%)



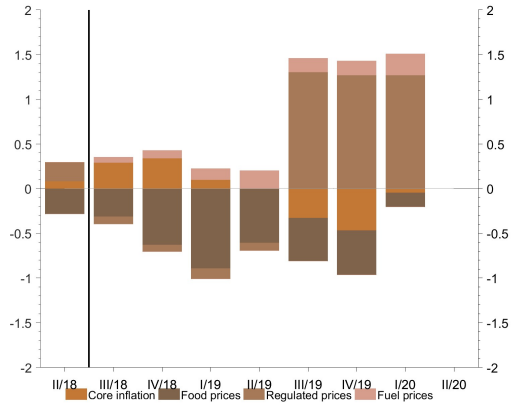
Source: FAO, Bloomberg, NBM calculus

Chart 1.18: CPI (% fap, p.p.)



Source: NBS, NBM calculus

Chart 1.19: Decomposition of the difference between the forecasts (p.p.)



Source: NBM calculus

1.4 Risks and uncertainties

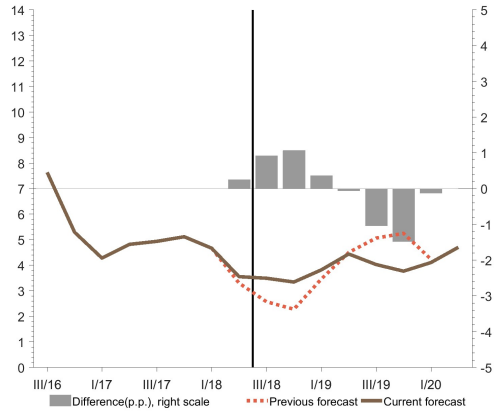
External sector

- **Trade-related and geopolitical tensions.** Trade protectionist actions continued in the second quarter of 2018. A major decision that was made by the United States and China was to introduce, as of 6 July 2018, bilateral taxes on imports of goods worth 34 billion US dollars. Moreover, there is a lot of talk about the US intention to introduce taxes for car imports from Europe. In addition, tensions were raised by the US decision to withdraw from the nuclear agreement signed with Iran, which implies stopping of Iranian oil purchases by the US.

  The problem is further scaled up by the US pressures exerted on its partners to join the decision on cutting Iranian oil imports, as well as by Iran's threats of closing the Strait of Hormuz in the event of international blockade. All these decisions and actions create far-reaching risks of disrupting international trade, affecting international commodity prices and manipulating foreign exchange parities (disinflationary).

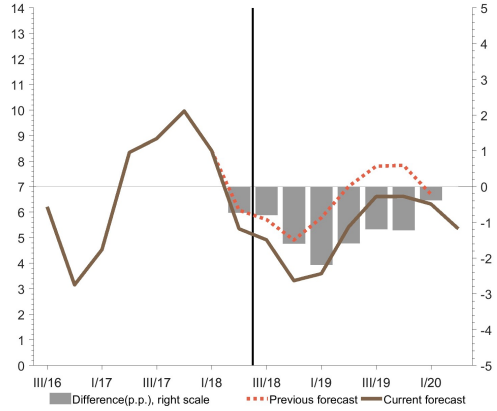
- **More restrictive financial conditions in advanced economies.** At its meeting held on June 14, 2018, the European Central Bank published a plan on cutting total asset purchases by the end of 2018 and maintaining the base rate at 0.0% until the summer of 2019. Since in June 2018 the annual inflation rate in the Eurozone has already reached the target level of 2% set by the ECB, experts anticipate that, starting the summer of 2019, the ECB will increase the base rate. At the same time, the Fed, the Bank of Japan, the Bank of Canada and the Bank of England continue to tighten monetary policies, thus causing migration of financial capital from the emerging economies to the advanced ones. This phenomenon affects foreign exchange parities and emerging economies (pro-inflationary).

Chart 1.20: The core inflation (% fap, p.p.)



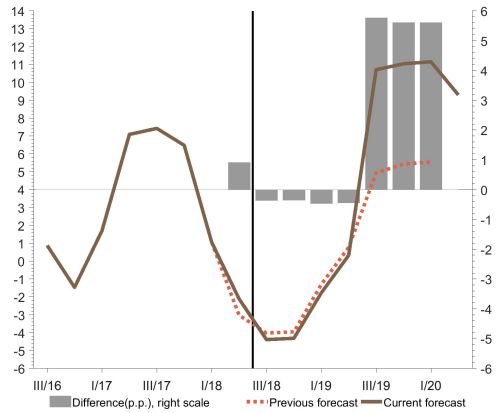
Source: NBS, NBM calculus

Chart 1.21: The food prices (% fap, p.p.)



Source: NBS, NBM calculus

Chart 1.22: The regulated prices (% fap, p.p.)



Source: NBS, NBM calculus

- **Uncertainty regarding the behaviour of the oil market decision makers.** Over the past two years, oil prices have been manipulated through the OPEC's oil production control policy. Thus, OPEC has managed to eliminate a global oil surplus and to triple oil prices. Recently, at the OPEC summit held in June 2018, it was decided to pursue further the oil production control policy, although introducing a number of changes in the production quotas, to compensate for the decrease in oil production in Venezuela and Libya. Thus, according to the latest OPEC report, both Saudi Arabia and the Russian Federation have already begun increasing their oil production. The increase in oil production is also supported by the US President Donald Trump, who insists on the Saudi Arabia's increase of oil production by another 2 mbd.

  At the same time, the US has decided to withdraw from the nuclear agreement with Iran and insists on the allies' halting Iranian oil purchases by November 4, 2018. Currently, the situation is uncertain, as it is not clear who will join the US decision on Iranian oil imports, how Iranian oil production would be affected by this decision, whether other OPEC members would increase their production quotas to compensate for the Iranian quota, or whether Iran would implement its threat of closing the Strait of Hormuz in case of international blockade. These uncertainties affect oil prices and create impediments to the delineation of future trends of oil prices (uncertainty).

- **Weak evolution of the regional economy in combination with the rise in prices.** Both macroeconomic statistics and forecasts denote the minimum economic growth in the region, which will cause a marginal increase in regional demand. At the same time, against the background of monetary depreciation and rising food prices fuelled by lower crop yields this year, experts anticipate the rise in inflationary pressures in the region (pro-inflationary).

Real sector

- **Uncertainties regarding the 2018 and 2019 harvests.** The 2018 and 2019 harvests and domestic food prices, respectively, will mainly depend on the agrometeorological conditions of the current and next years. Whereas it is difficult to anticipate weather developments, this fact lends a high level of uncertainty to the food price forecast for 2018 and 2019 (uncertainty).

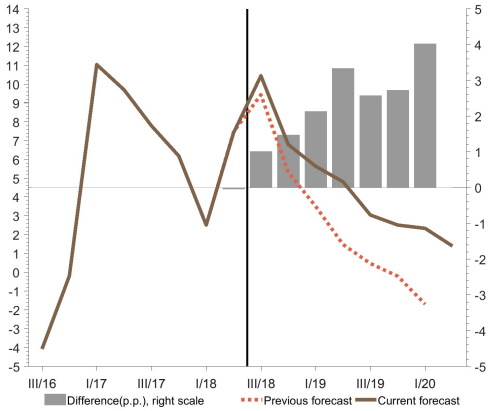
- **Price vulnerability to domestic agricultural products against the weather conditions in the near future.** Based on the recent years' experience, prices for domestic fruits and vegetables are, to a large extent, affected by adverse weather conditions such as frosts, droughts, abundant rainfalls, or by costs associated with harvesting, transportation, storage, and their marketing on local markets. Droughts or heavy rainfalls could cause rising of food prices above the projected values over the next few months (pro-inflationary).

- **Uncertainties regarding the timing and the scale of tariff adjustments for regulated services.** The medium-term inflation outlook is based on the assumption of

a significant tariff increase for a range of services, to be implemented in 2019, as a result of higher prices for energy resources, a lower-than-projected trajectory of the exchange rate, as well as certain financial deviations recorded in several domestic economy sectors. Since the level of tariffs on a range of regulated services has a considerable social impact, the timing of their adjustment can be determined based not only on economic factors but also on social or political objectives pursued by the decision-makers. Therefore, the timing and the scale of tariffs' adjustment cannot be projected with a sufficient degree of certainty (uncertainty).

- **Updating the methodology for setting ceiling prices for fuels.** In June and July, the ceiling prices for fuels, established by the National Energy Regulatory Agency NERA, have been suspended several times. Recently, the Moldovan Parliament approved a series of amendments and completions to the Law on the of Petroleum Products Market, which stipulates that the NERA shall set ceiling prices once every three months and not every two weeks, as it has been so far. The current methodology is to be aligned to these provisions in the following months. These developments create uncertainties regarding the level of fuel prices on the domestic market (uncertainty).
- **Approval of the new methodology for calculating tariffs for healthcare services.** According to the Ministry of Health of Moldova, the new methodology for calculating tariffs will allow to make their calculation more accurate and rational. Medical institutions have already begun re-evaluating costs and expenses for the services they provide, confirming that for a series of services, especially the expensive ones, tariffs could be reduced. It should be mentioned that the most significant increases in the tariffs for the CPI healthcare services occurred at the beginning of 2017, following the amendment of the Catalogue of tariffs for healthcare services at the end of 2016. As a result, the tariffs for public healthcare services have risen several times (uncertainty).
- **Increase in fees for kindergartens and nurseries following the increase in nutrition standards.** This initiative of the Moldovan Government aims to improve nutrition standards applicable in kindergartens and nurseries, starting September 1, 2018. Consequently, fees will increase from 165 MDL to around 200 MDL per month (inflationary).
- **Potential decrease of prices for medicines.** Following the adoption of additional regulations and as a result of the domestic currency's appreciation over this year, prices for medicines fell significantly. If there is any change in the assortment of medicines, listed in the Medicines Price Catalogue, or the evolution of the current exchange rate remains unchanged, prices for medicines could keep their downward trend through the end of this year (disinflationary).
- **Potential faster recovery of aggregate demand.** The medium-term inflation outlook is based on the assumption of a low aggregate demand that has minor impact on prices. An eventual significant increase in economic activity could generate additional inflationary pressures on core inflation and a series of food prices (pro-inflationary).

Chart 1.23: The fuel prices(% fap)



Source: NBS, NBM calculus

Monetary and public sectors

- **Excess liquidity in the banking sector.** Following monetary emissions in 2017-2018 and the NBM's interventions on foreign exchange market (foreign exchange purchases) totalling 572.5 million USD (approx. 10.14 billion MDL), the banking system accumulated excess liquidity in the amount of approx. 9.2 billion MDL. In the short term, the excess liquidity may have a positive impact on aggregate demand and foreign exchange rate, as well as generate inflationary pressures (pro-inflationary).
- **External partners' funding.** Originally, it has been agreed that in 2018 the Republic of Moldova will receive financing under the EU macro-financial assistance programme in the total amount of EUR 100.0 million (EUR 60.0 million as a loan and EUR 40.0 million as a grant). Currently, there are big uncertainties related to this financial assistance, which will put pressures on the execution and financing of the state budget within the projected limits in 2018 (disinflationary).

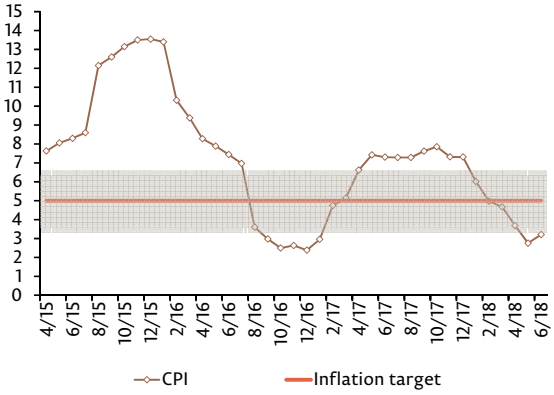
Chapter 2

Inflation development

2.1 Consumer Price Index

Given the high base period, modest aggregate demand, and a appreciation of the domestic currency against the euro, the annual CPI rate recorded a downward trajectory, falling below the inflation target range. In the second quarter of 2018, the annual inflation rate continued a downward trend it assumed at the beginning of this year, decreasing from 4.7% in March 2018 to 3.2% in June 2018 (Chart 2.1). Since May 2018, it has recorded values below the lower limit of the inflation range of 5.0% ± 1.5 p.p., stipulated in the medium-term monetary policy strategy. In the second quarter of 2018, the average annual CPI rate recorded a level of 3.2% and was 2.0 p.p. lower than in the previous quarter. A downward inflation trajectory, recorded in the second quarter of 2018, was largely determined by the effect of the high base period for food and regulated prices, modest domestic demand, and a steady appreciation of the domestic currency against the euro. At the same time, this development was partly offset by an upward trend of international oil prices. Over the next months, the annual inflation rate will remain below the lower limit of the inflation range, as a result of the cut in electricity tariff as well as a persisting marginal impact of aggregate demand on prices.

Chart 2.1: The annual rate of CPI (%)

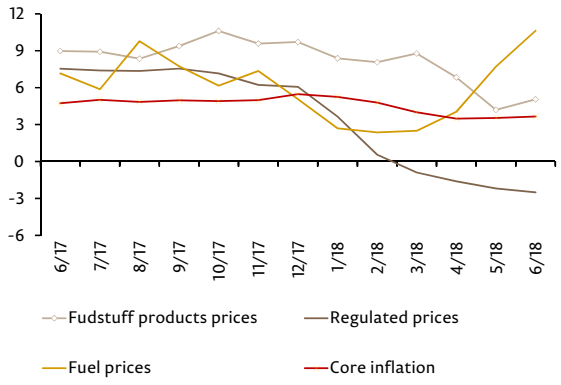


Source: NBS, NBM calculus

Core inflation

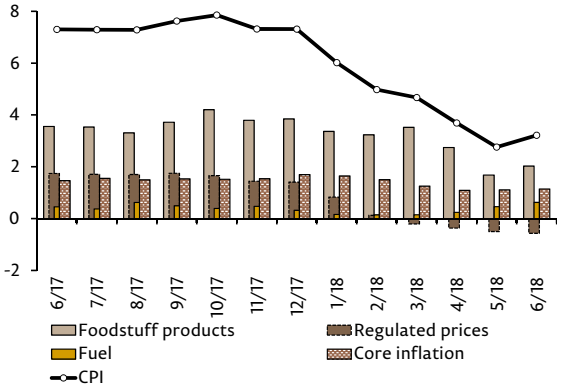
Core inflation continued its downward trajectory, driven by modest aggregate demand and the appreciation of the domestic currency against the euro. Inflationary pressures were generated by sectoral shocks. After a long period during which core inflation would record lower values than the annual CPI rate, in the second quarter of 2018, core inflation and the annual CPI rate recorded similar values. In the reference quarter, core inflation maintained its downward trend, yet weaker than at the beginning of the year. Thus, the annual rate of core inflation decreased from 4.0% in March 2018 to 3.7% in June 2018 (Chart 2.4). In the second quarter of 2018, the average inflation rate recorded a level of 3.6%, 1.1 p.p. lower than in the previous quarter. As a result, the contribution generated by core inflation to the annual CPI rate over the reference period diminished, recording 1.1 p.p. (Chart 2.3). According to estimates, aggregate demand exerted a low impact on core inflation, thus supporting its downward trend. On the one hand, a steady decline of the annual rate of core inflation was driven by: a steady appreciation of the

Chart 2.2: The annual rate the main subcomponents of the CPI (%)



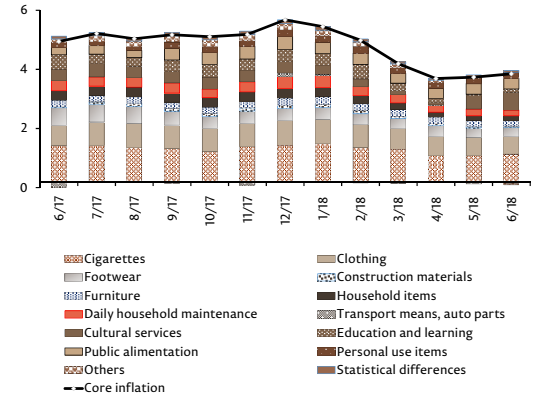
Source: NBS

Chart 2.3: The evolution of the annual inflation (%) and subcomponents contribution (p.p.)



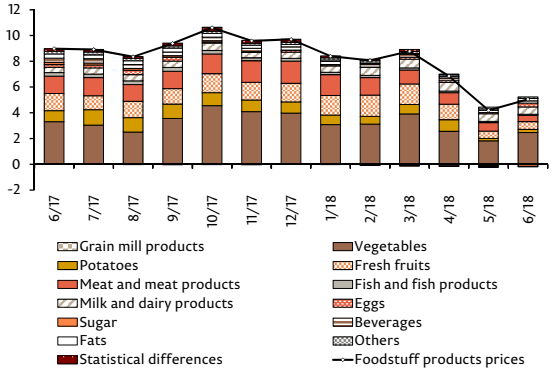
Source: NBS, NBM calculus

Chart 2.4: The subcomponents contribution (p.p.) to the annual rate of core inflation (%)



Source: NBS, NBM calculus

Chart 2.5: The components contribution (p.p.) to the annual rate of food prices (%)



Source: NBS, NBM calculus

domestic currency that favoured price stagnation in most of its sub-components, a fall in prices of some sub-components, such as transportation vehicles, as well as a decrease in the positive contribution generated by the education and training sub-component. On the other hand, during the reference quarter, inflationary pressures on the sub-components of core inflation were exerted by sectoral shocks, such as the increase in prices for tourism abroad (approx. 50%), as well as a persisting impact of the adjustment of excise duties on cigarettes. As a result, in June, cigarette prices were 18.1% higher, year-on-year, generating a positive impact on the evolution of core inflation in the reference period (Chart 2.4).

Food prices

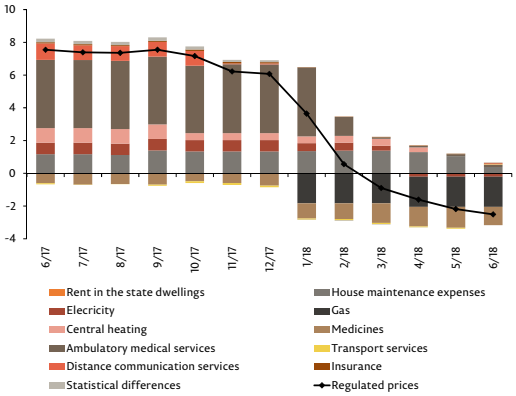
The annual growth rate of food prices recorded a downward trend over the reference period, resulting from the high base period of the previous year and a rich supply of fresh fruits and vegetables. Thus, in the second quarter of 2018, the annual growth rate of food prices decreased from 8.8% in March to 5.1% in June 2018, thus generating the major contribution to the decline of the annual growth rate of total inflation (Chart 2.5). A downward trajectory of the annual growth rate of food prices, recorded during the second quarter of 2018, was mainly driven by the dissipation of pressures accumulated in earlier periods. It should be mentioned that disinflationary factors predominated during the second quarter of 2018. Thus, a steady appreciation of the domestic currency against the euro, as well as a rich supply of fresh fruits and vegetables have formed preconditions for the decline of the annual growth rate of food prices. To note that, during the same period, prices for "meat, meat products and canned meat" stopped exerting inflationary pressures. As a result, in the second quarter of 2018, the annual growth rate of food prices recorded an average level of 5.4%, 3.0 p.p. lower than in the first quarter of 2018. Consequently, the contribution of food prices to the annual inflation rate decreased by 1.2 p.p, accounting for 2.1 p.p. in the reference quarter.

Regulated prices

The annual growth rate of regulated prices continued its downward trend, driven by the effect of the high base period. In the second quarter of 2018, a downward trajectory of the annual CPI rate was also determined by the evolution of regulated prices, although to a lesser extent than at the beginning of the current year. In this way, the annual growth rate of regulated price dropped from -0.9% in April 2018 to -2.5% in June 2018.

This development was mainly supported by a gradual exclusion from the annual growth rate's calculation of the effect of tariff increases on electricity, heating, water supply and sewage, which were implemented mainly in the second quarter of 2017. Regulated prices generated a negative contribution of 0.5 p.p. (lower than at the beginning of the year) to the annual CPI rate, being largely determined by the reduction of the gas supply tariff in March 2018 as well as the cut in prices for medicines in the first half of this year (Chart 2.6). In the following months, a downward trend of the annual growth rate of regulated prices is expected to continue, given the cut in electricity tariff implemented in July 2018.

Chart 2.6: The components contribution (p.p.) to the annual rate of regulated prices (%)

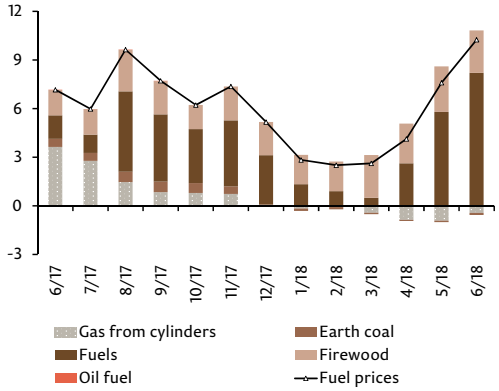


Source: NBS, NBM calculus

Fuel prices

The rise in international oil prices coupled with the depreciation of the domestic currency against the US dollar drove fuel prices to rise on the domestic market. The annual growth rate of fuel prices recorded an upward trajectory, rising from 2.5% in March 2018 to 10.6% in June 2018 (Chart 2.7). Their average rate recorded 7.5%, by 4.9 p.p. higher than in the first quarter of 2018.

Chart 2.7: The components contributions (p.p.) to the annual growth of fuel prices (%)



Source: NBS, NBM calculus

During the second quarter of 2018, the rise in prices for fuel oils contributed most to the increase in the annual growth rate of fuel prices. This development was supported by the rise in international oil prices. Thus, the price of Ural oil amounted to approx. 72.4 USD/barrel, up 11.2% compared to the first quarter of 2018.The effect of this increase was strengthened by the depreciation of the domestic currency against the US dollar in that period (around 1.6%).

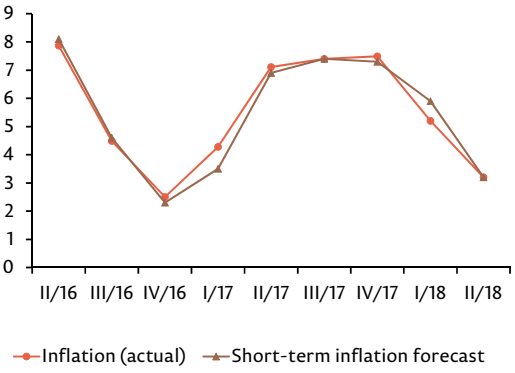
At the same time, it should be mentioned that, during the second quarter of 2018, ANRE twice suspended its decisions on the increase of fuel oils prices during the reference period:

1. The ceiling price of 19.79 MDL/litre for gasoline and 17.75 MDL / litre for diesel fuel was set on 29.05.2018 and suspended on 01.06.2018, prior to the examination of notifications received in this regard, including from the Government and the Parliament of the Republic of Moldova;
2. The ceiling price of 19.49 MDL/litre for gasoline and 17.41 MDL / litre for diesel fuel was set on 12.06.2018 and suspended on 13.06.2018.[3]

Thus, if these increases had come into effect, the increase in fuel prices would have been higher.

The price dynamics of "firewood" also contributed to the increase in the annual growth rate of fuel prices. At the same time, prices for "cylinder gas" and "coal" sub-components generated smaller contributions, compared to the first quarter of 2018.

Chart 2.8: The evolution and short-term forecast of CPI (%)



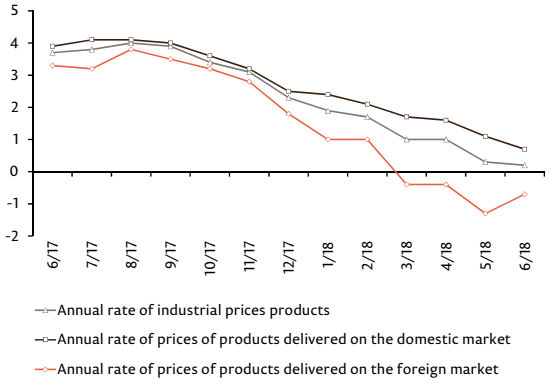
Source: NBS, NBM forecast

Table 2.1: The evolution and forecast of CPI and its components (%)

	De facto (%)	Forecast IR 2, 2018	Deviation (p. p.)
	Q II, 2018/ Q II, 2017	Q II, 2018/ Q II, 2017	De facto-forecast
CPI	**3.2**	**3.2**	**0.0**
Core inflation	3.6	3.3	0.3
Food	5.4	6.1	-0.7
Regulated prices	-2.1	-3.0	0.9
Fuels	7.5	7.5	0.0

Source: NBS, NBM calculus

Chart 2.9: The industrial production prices annual rate (%)



Source: NBS

2.2 Evolution of inflation in the second quarter of 2018 compared to the forecast of the Inflation Report no. 2, 2018

No deviation from projected values was recorded in the effective average annual growth rate of CPI in the second quarter of 2018. The average annual CPI data for the second quarter of 2018 indicate a level of inflation identical[4] to the projected one (3.2% in the baseline scenario).

In terms of sub-components, in April-June 2018, core inflation recorded a higher level (0.3 p.p.) then was anticipated for the second quarter of 2018, mainly as a result of higher prices for tourism abroad in May and June. In the case of regulated prices, there was a positive deviation from the forecast due to a delayed implementation of the anticipated decrease in electricity tariff; in reality, the tariff cut was implemented in July 2018. The aforementioned positive deviations were offset by the dynamics of food prices. In this way, the annual average growth rate of food prices recorded values below those projected in the baseline scenario (6.1%). The evolution of the annual growth rate of fuel prices in the second quarter of 2018 was in line with the projected figures, thus recording no deviation from the forecast.

2.3 Industrial output prices

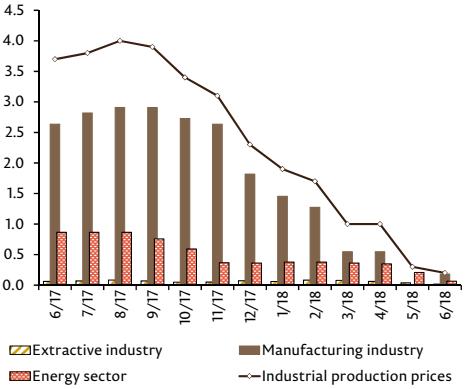
During the second quarter of 2018, the annual Industrial Production Price Index (IPPI) continued its downward trajectory recorded in the previous quarters. Thus, in the second quarter of 2018, it dropped to a level of 0.5% or 1.0 p.p. lower than in the first quarter of 2018. A downward trend of the annual IPPI was driven by the price dynamics of goods delivered both on the internal and external market (Chart 2.9).

[3]For the execution of the judgement of the Chisinau Municipal Court of 12.06.2018 on the application of the injunction against the execution of order no. 61 of 12.06.2018, in accordance with art. 178 of the Code of Civil Procedure under which the injunction relief is to be executed immediately, ANRE informs that starting with 15:01 hrs. on 13.06.2018 the retail ceiling price of the main petroleum products will be 19.15 MDL / litre for Premium A-95 gasoline and 17.09 MDL / litre for diesel fuel.

[4]Given a more prominent volatility of monthly values as well as the potential measurement errors that, normally, should not influence monetary policy decisions, the short-term inflation forecast is performed on a quarterly basis. The resulting value reflects the medium-term inflation projection, which is also determined on a quarterly basis and serves as the basis for monetary policy decisions. At the same time, it is reflected in Inflation Reports. However, the actual monthly CPI data, published by the NBS during the reference quarter, are analysed and compared with the short-term forecast for the whole quarter, to assess whether the main assumptions are confirmed or there is a risk of a significant deviation from the forecast.

The analysis of the annual IPPI evolution, by main sectors, suggests that its decline was determined by the price developments in the manufacturing sector (Chart 2.10). The decline in the annual growth rate of manufacturing prices was driven by the dissipation of inflationary pressures generated by food industry. The price dynamics of food industry can be attributed to a rich crop of agricultural products recorded in the second half of 2017 as well as to the abundant fruit harvest in the spring of 2018. At the same time, prices in the energy sector and mining industry generated a negligible impact on the developments recorded in industrial production prices.

Chart 2.10: The industrial production prices annual rate (%) and the contribution of its components categorised by main branches (p.p.)



Source: NBS, NBM calculus

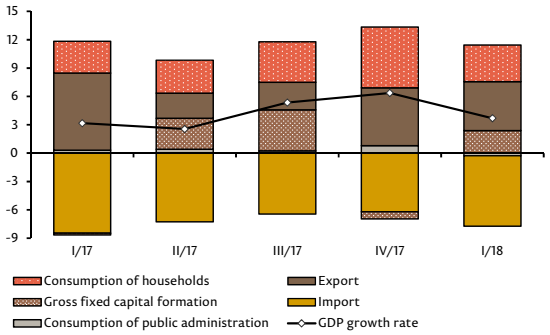
Chapter 3

Economic developments

3.1 Demand

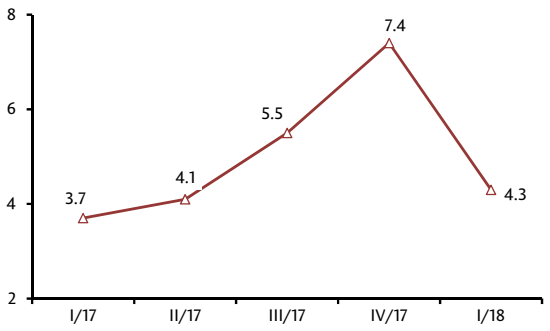
As projected, in the first quarter of 2018, the economic activity maintained its upward trend, though recording a slower growth rate. Its positive dynamics, like in the previous quarter, was fostered by both the growth of aggregate demand and the effect of a rich harvest recorded in the previous year, which fuelled exports growth.

Chart 3.1: The contribution of demand components to GDP growth (p.p.)



Source: NBS, NBM calculus

Chart 3.2: Evolution in real terms of the final consumption of households' (%, compared to the same period of the last year)



Source: NBS, NBM calculus

In the reference period, the GDP[5] increased by 3.7%, year-on-year, recording a growth rate 2.7 p.p. lower than in the fourth quarter of 2017. At the same time, the seasonally adjusted series reflects the GDP's decrease of 0.8%, compared to the fourth quarter of 2017. In terms of its components (Chart 3.1), a positive annual GDP rate, recorded in the first quarter of 2018, was determined both by the domestic and external demands. Thus, the annual growth rate of final household consumption recorded a level of 4.3% against the background of an increase, in real terms, in the disposable income of the population. At the same time, the final consumption of public administration decreased by 1.7%, compared to the first quarter of 2017. A positive contribution to the dynamics of economic activity in the first quarter of 2018 was generated by the investment component. Thus, gross fixed capital formation increased by 4.2%, generating a contribution of 0.9 p.p. to GDP growth, whereas stock change component generated a contribution of 1.5 p.p. Exports also generated positive contribution to the GDP's growth. Thus, in the first quarter of 2018, exports recorded values 13.6% higher than in the same period of the previous year. However, the positive contribution of the above-mentioned components was largely offset by the increase in imports by 11.6%, thus resulting in a negative contribution of 7.3 p.p. This development was supported by the increase in domestic demand, as well as by the appreciation of the domestic currency against the US dollar.

Household consumer demand

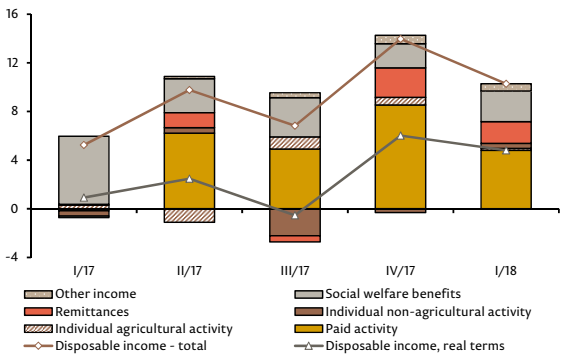
At the beginning of 2018, household consumption maintained its positive dynamics, though recording a slower growth rate. In this way, the annual growth rate of final household consumption recorded 4.3%, representing a decrease of 3.1 p.p. compared to the fourth quarter of 2017. A positive evolution of household consumption in the first quarter of 2018

[5]According to the National Bureau of Statistics (NBS), starting with the first quarter of 2018, the gross domestic product data are calculated according to the United Nations System of National Accounts calculation methodology, version 2008 / European System of Accounts version 2010 (SCN, UN-2008/SEC-2010). Detailed information on the applicable methodology will be published later on the NBS official website in the section News and Metadata.

was largely driven by the increase in consumer expenditure by 4.2%, as well as by the increase in expenditure on services by 2.8% (Chart 3.2).

Like in the previous periods, the increase in household consumption was supported by the rise in the population's disposable income. In this respect, the disposable income of the population increased by 10.3% in the first quarter of 2018, recording, however, a growth rate 3.7 p.p. lower than in the fourth quarter of 2017 (Chart 3.3). This development was mainly driven by revenues received by the population in the form of salary and social benefits. Positive, yet smaller, contributions were generated by the evolution of remittances, individual agricultural and non-agricultural activity, and other income components. In the first quarter of 2018, the annual growth rate of the disposable income of the population, in real terms, declined to 4.8%, recording a decrease of 1.2 p.p., compared to the fourth quarter of 2017.

Chart 3.3: Evolution of personal disposable income (%, versus the same period of the previous year) and subcomponents' contribution (p.p.)



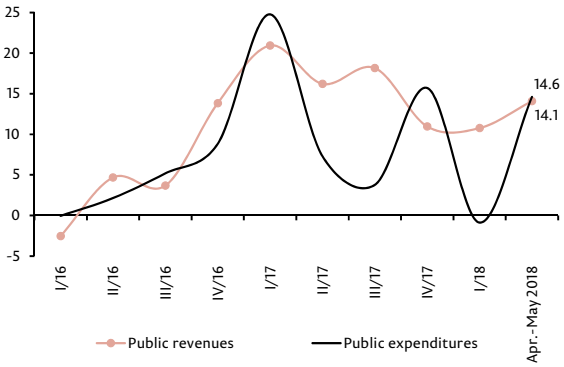
Source: NBS, NBM calculus

Public sector

Execution of the national public budget

According to the data provided by the Ministry of Finance, in April-May 2018, the state public budget revenues amounted to 9.1 billion lei (31.4% of GDP[6]), increasing by 14.1%, year-on-year (Chart 3.4). The major part of budget revenues was accrued from taxes and fees, accounting for 62.8% of total revenues. Social insurance contributions and compulsory insurance premiums accounted for 30.3%, whereas the share of other revenues and grants recorded 6.5% and 0.4%, respectively, of total budget revenues.

Chart 3.4: The dynamics of public revenues and expenditures

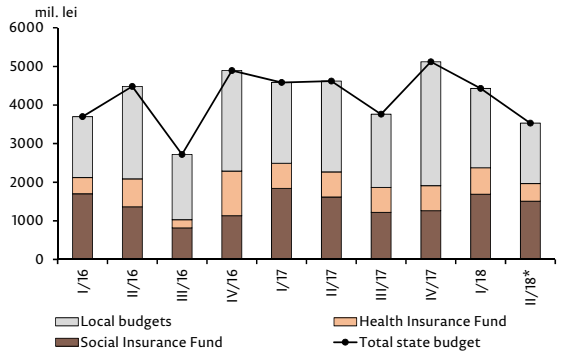


Source: Ministry of Finance

The state public budget expenditure, in April-May 2018, totalled 9.3 billion lei (32.2% of GDP[6]), recording an increase of 14.6%, year-on-year. Of total expenditure, the largest share was accounted for by the expenditure on social protection (38.3%), 16.7% of the budget being allocated for education and 13.5% – for health care.

It should be mentioned that 3.5 billion lei (an increase of 18.6%, year-on-year) were transferred in the April-May 2018 from the state public budget to the State Social Insurance Budget (SSIB), the Mandatory Health Insurance Fund (MHIF) and to the local budgets (LBs) (Chart 3.5). The largest share of budget allocations was channelled to the local budgets, around 44.3% of total budget transfers, followed by the allocations made to the SSIB, around 42.8%, the MHIF having received smaller financing, accounting for 12.9% of total allocations.

Chart 3.5: The evolution of budget transfers



Source: Ministry of Finance
* Apr.-May

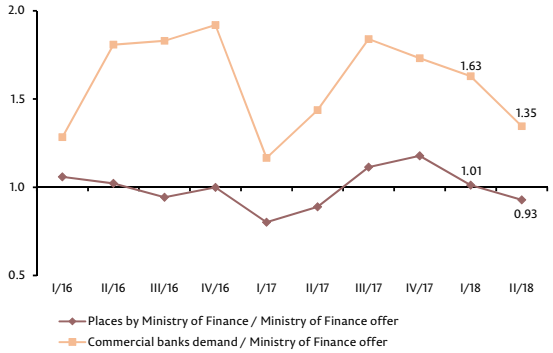
In this context, during April-May 2018, the execution of the state public budget resulted in a deficit of 0.2 billion lei, whereas, during the same period in 2017, the deficit recorded 0.15 billion lei. As of May 31, 2018, the state budget balance increased by 0.5 billion lei, as compared to January 1, 2018, and totalled 7.3 billion lei.

State debt

As of June 30, 2018, the balance of the state debt of the Republic of Moldova totalled 50.9 billion lei (27.9% of GDP[6]), recording a decrease of 1.4%, year-on-year. In annual terms, however, the

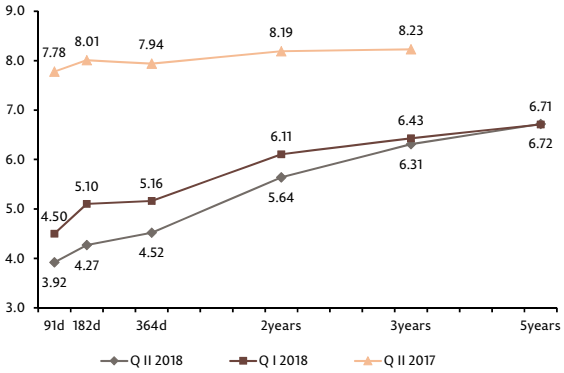
[6]GDP according to the NBM's estimation.

Chart 3.6: The demand and supply ratio on the primary market of state securities



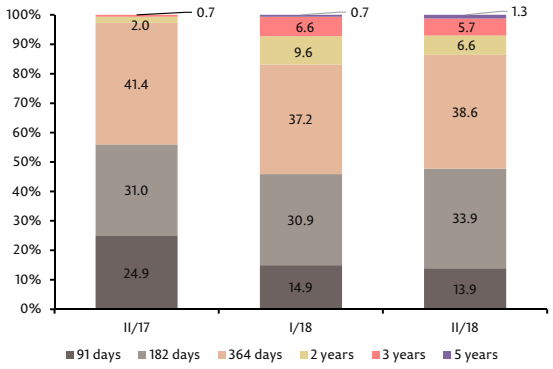
Source: NBM

Chart 3.7: SS yield curve (%)



Source: NBM

Chart 3.8: Structure of SS allocated on the primary market (%)



Source: NBM

state debt has increased by 0.5% as a result of the increase in the domestic state debt (with a positive contribution of 2.5 p.p.), partly offset by the external state debt (with a negative contribution of 2.0 p.p.). At the end of June 2018, state debt consisted of 55.2% external debt and 44.8% domestic debt.

At the end of June 2018, the external debt balance diminished to USD 1670.1 million, recording a decrease of USD 30.6 million (approx. 1.8%), compared to the beginning of the year. Recalculated in domestic currency, external debt totalled 28.1 billion lei (15.4% of GDP[6]).

As of June 30, 2018, domestic debt totalled 22.8 billion lei (12.5% of GDP[6]), having increased by 5.9% per annum. This evolution of domestic debt was driven by government securities issued on the primary market, the volume of which has increased by 21.6% over the last 12 months. As a result, at the end of June 2018, domestic debt consisted of government securities issued for the execution of state guarantees (58.3% of total debt), government securities issued on the primary market (32.6%) and government convertible securities (9.1%).

Primary market of state securities (SS)

During the second quarter of 2018, the Ministry of Finance issued state securities totalling 2205.4 million lei, by 7.1% less than initially offered. As a result of the excess liquidity in the primary market of government securities, the demand-supply ratio on the SS primary market recorded a level of 1.35, the volume of demand on the primary market amounting to 3196.4 million lei (Chart 3.6).

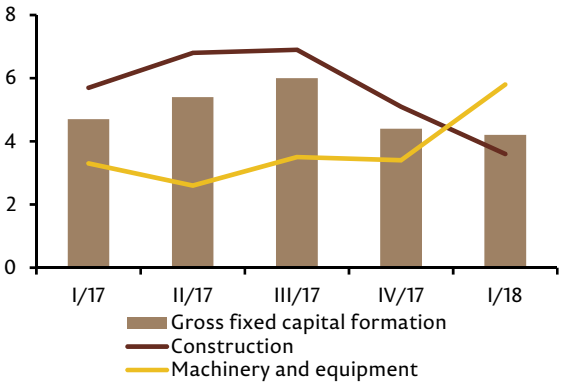
The market conjuncture allowed the Ministry of Finance to continue lowering interest rates on the SS, which decreased, during the reporting period, for all maturities; thus, interest rates on Treasury bills recorded a decline of 0.6-0.8 p.p., whereas interest rates on government bonds with two- and three-year maturity – a decline of 0.5 p.p. and 0.1 p.p., respectively (Chart 3.7). It should be mentioned that in March 2018 the Ministry of Finance issued, for the first time, government bonds with a five-year maturity. During the second quarter of 2018, they were traded at an average effective rate of 6.72%.

The structure of the SS portfolio, traded during the reference period, shows that SS with 364-day maturity recorded the highest demand, accounting for 38.6% of total transactions; these were followed by 182-day Treasury bills, holding a share of 33.9%, and 91-day Treasury bills accounting for 13.9% of total transactions. It should be mentioned that the share of government bonds with two-, three- and five-year maturity recorded 6.6%, 5.7% and 1.3%, respectively (Chart 3.8).

Investment demand

A positive evolution of gross fixed capital formation was supported by investments in both the construction and the machinery and equipment sectors. Stock change generated a positive impact on the dynamics of economic activity. In the first quarter of 2018, the investment component generated a positive contribution to the GDP's growth, accounting for 2.4 p.p. This evolution was mainly determined by the developments in the stock change that generated a 1.5 p.p. contribution to the GDP's growth, as opposed to the fourth quarter of 2017, when its contribution was negative. At the same time, the annual rate of gross fixed capital formation recorded a level of 4.2%, 0.2 p.p. lower than in the fourth quarter of 2017. The decline in the annual growth rate of gross fixed capital formation was determined by a 1.5 p.p. decrease in the annual growth rate of investments in the construction industry, reaching a level of 3.6%. At the same time, the annual growth rate of investments destined for the purchase of machinery and equipment accelerated by 2.4 p.p., amounting to 5.8% (Chart 3.9).

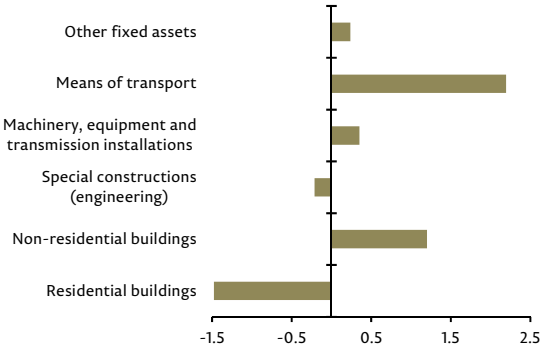
Chart 3.9: The annual dynamics of investments



Source: NBS

At the same time, according to the latest statistical data published by the NBS, in the first quarter of 2018, the annual growth rate of investments in tangible fixed assets[7] recorded a level of 2.3%. In terms of components, positive contributions to the dynamics of investments in fixed assets were mainly generated by such components as "transportation vehicles" and "non-residential buildings" (Chart 3.10). These developments were largely offset by the decline of investments in the construction of residential buildings.

Chart 3.10: Components' contribution to increase of investment in tangible assets in the first quarter of 2018 (p.p.)



Source: NBS, NBM calculus

In terms of the sources of investment financing, "local budgets" and "own funds" recorded a positive evolution, whereas capital formation through "foreign investments" and "state budget" recorded a negative dynamics.

Net foreign demand[8]

In the first semester of 2018, the annual growth rate of exports continued its upward trend recorded in the previous year, driven mainly by agricultural output and a higher demand from the EU. Thus, in the first quarter of 2018, the annual growth rate recorded a level of 28.4%, 2.0 p.p. higher than in the fourth quarter of 2017. At the same time, the annual growth rate of exports, recorded in the first two months of the second quarter of 2018, reached 28.6%, recording an increase of 0.2 p.p. compared to the first quarter of 2018. It should be mentioned that exports to the EU countries account for about two-thirds of total exports, thus generating major contribution to the evolution of total exports (Chart 3.12). In the first half of 2018, exports to countries classified as "the rest of the world" generated a positive contribution, although well below the one generated by exports to the EU countries. To note that, after a five-quarter period in which exports to the CIS countries generated positive

[7]Starting January 1, 2017 the statistical questionnaire 2-INV "Investments" was amended in order to align statistical instruments (applicable concepts and definitions, methods of the calculation and presentation of indicators) with the provisions of the new National Accounting Standards, which entered into force as mandatory on January 1, 2015.

[8]The data presented in this section are quarterly data reflecting the evolution of the Moldovan foreign trade, expressed in thousands of US dollars.

contributions to the evolution of total exports, in the second quarter of 2018, their dynamics slowed down, contributing to a decline in the annual growth rate of exports (Chart 3.12).

The analysis of exports by category of goods (Chart 3.13) demonstrates that a significant rise in the annual growth rate of exports in the first quarter of 2018 was determined by an increase in exports of agricultural products. Thus, a good agricultural harvest of 2017, coupled with an increased demand from the EU for these products, created preconditions for the increase in exports in the first quarter of 2018. Similarly to the fourth quarter of 2017, in the first quarter of 2018, an important contribution was generated by the category of "vehicles, optical devices and sound recording or reproducing devices" due to positive developments in the respective manufacturing sectors (especially free economic areas).

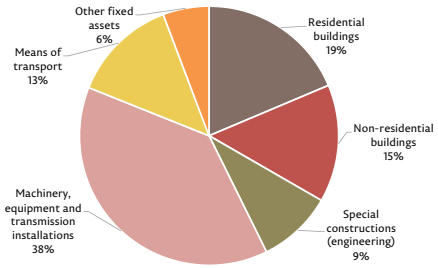
It should be mentioned that an increase in exports in the first quarter of 2018 was fuelled by exports of domestic goods. At the same time, re-exports also generated a positive, yet lower, contribution to the evolution of exports (Chart 3.14).

At the beginning of this year, the volume of imports continued to record an upward trend in conditions of a growing domestic demand and the domestic currency's appreciation. In the first quarter of 2018, the annual growth rate of commodity imports recorded a level of 28.7%, 4.9 p.p. higher than in the fourth quarter of 2017. At the same time, statistical data for the first two months of the second quarter of 2018 indicate a growth rate of 24.7%, thus reflecting a slowing down of imports' growth. It should be noted that, according to statistical data, in the second quarter of 2018, the annual growth rate of exports exceeded that of imports, thus contributing to the strengthening of net external demand.

In the first half of 2018, figures continued to reflect positive dynamics of imports from all categories of countries. However, since about 50% of Moldovan imports come from the EU countries, their contribution to the evolution of total imports is more important (Chart 3.15). At the same time, imports from countries classified as the CIS countries and "the rest of the world" generated smaller contributions.

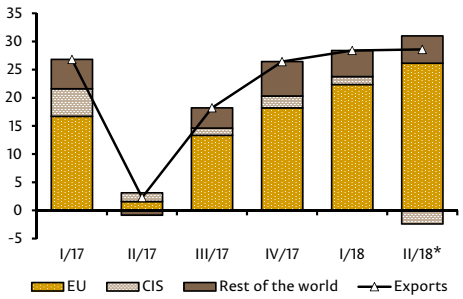
In terms of the categories of goods (Chart 3.16), the increase in the annual growth rate of imports in the first quarter of 2018 was mainly driven by the evolution of imports of "vehicles, optical devices and sound recording or reproducing devices", "mineral products", "products of the chemical and wood processing industry", "articles of metals, stones or ceramics" and "foodstuffs of vegetable and animal origin, beverages and fats", which generated positive contributions of 9.3 p.p., 5.0 p.p., 4.6 p.p., 3.5 p.p. and 3.5 p.p, respectively. It should be noted that high growth rates of imports, which were recorded during the last months, were determined by an increase in household consumption as a result of the growth of the disposable income of the population, supported by a steady appreciation of the domestic currency.

Chart 3.11: Structure of investments by tangible assets types, first quarter 2018 (%)



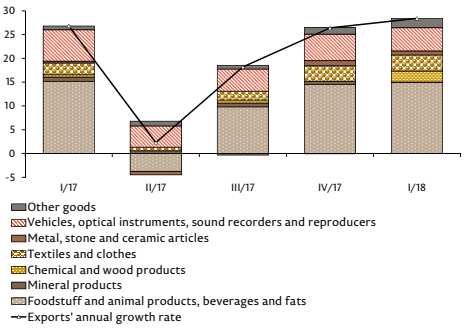
Source: NBS, NBM calculus

Chart 3.12: Evolution of exports annual rate (%) and contribution by categories of countries (p.p.)



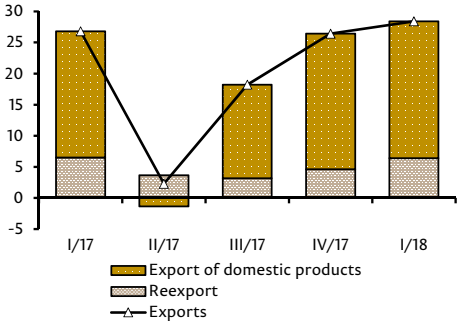
Source: NBS, NBM calculus
* Apr.-May

Chart 3.13: Evolution of exports annual rate (%) and components' contribution by groups of goods (p.p.)



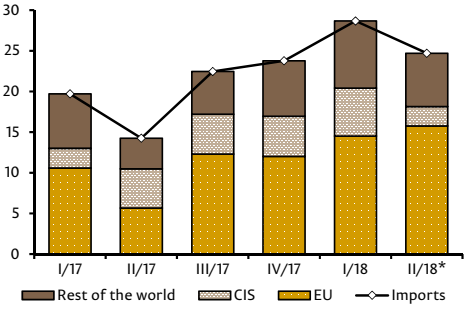
Source: NBS, NBM calculus

Chart 3.14: Evolution of exports annual rate (%) and contribution by origin (p.p.)



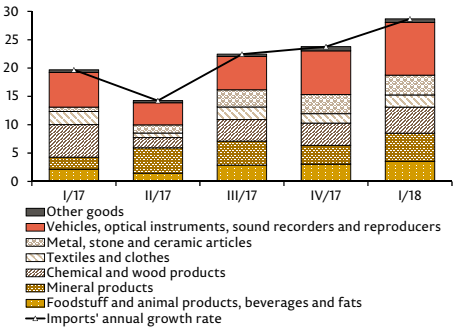
Source: NBS, NBM calculus

Chart 3.15: Evolution of imports annual rate (%) and contribution by categories of countries (p.p.)



Source: NBS, NBM calculus
* Apr.-May

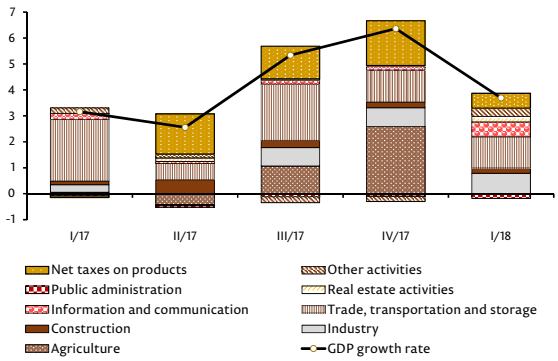
Chart 3.16: Evolution of imports annual rate (%) and components' contribution by groups of goods (p.p.)



Source: NBS, NBM calculus

3.2 Production

Chart 3.17: The contribution of economic sectors to GDP growth (p.p.)

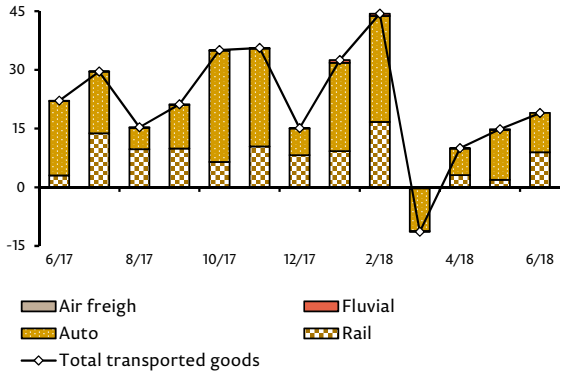


Source: NBS, NBM calculus

Chart 3.18: Evolution in real terms of industry (%, versus the same month of the previous year)

Source: NBS

Chart 3.19: Evolution of goods transport (%, versus the same month of the previous year)



Source: NBS

In terms of the categories of resources, in the first quarter of 2018, the GDP's growth was mainly driven by a positive contribution of industry, trade, the information and communications sector, and net product taxes. In this way, the gross value added from industry increased by 4.6%, year-on-year. The added value from the (wholesale and retail) trade sub-component recorded values 7.4% higher than in the first quarter of 2017. The information and communications sector grew by 9.0%. At the same time, net product taxes in the first quarter of 2018 generated a contribution of 0.6 p.p. to the GDP's growth. Positive, yet smaller, contributions were generated by the increase in gross value added from the construction industry (3.5%) and real estate transactions (2.5%) (Chart 3.17). At the same time, gross value added from the financial and insurance sector increased by 3.5%, compared to the first quarter of 2017. After the growth recorded in previous months, gross value added from agriculture remained at the level of the first quarter of 2017.

Operating statistics for April-May 2018 outline preconditions for a further economic growth in the second quarter of 2018. Thus, in the first two months of the second quarter of 2018, the annual growth rate of industrial output recorded an average level of 11.3%, 5.2 p.p higher than in the first quarter of 2018 (Chart 3.18). This evolution was driven by the acceleration of the annual growth rate of manufacturing industry (from 9.2% in the first quarter of 2018 to 10.4% in the first two months of the second quarter of 2018) as well as in the "production and supply of electricity, heating, gas, hot water and air conditioning" sector (from 4.1% in the first quarter of 2018 to 19.5% in the first two months of the second quarter of 2018). At the same time, the annual growth rate of production output in the extractive industry in April-May 2018 decreased by 5.2 p.p., compared to the first quarter of 2018, recording a level of 5.9%.

In the second quarter of 2018, positive developments were also recorded in the transportation sector. Thus, the annual growth rate of freight recorded an average level of 14.6%, 7.2 p.p. lower than in the first quarter of 2018 (Chart 3.19). At the same time, in the first semester of 2018, the railway, road, fluvial and air transport companies carried 14.9% more freight, compared to the similar period of 2017. This evolution was determined by the increase in the volume of freight shipped by air (38.9%), river (21.1%), railway (18.6%), and road (13.2%).

In April-May 2018, some positive developments were recorded in domestic trade. Thus, during the reference period, the turnover generated by the retail sales businesses as their main activity recorded an average increase of 8.4%, 2.0 p.p. higher than in the previous quarter (Chart 3.20). At the same time, the turnover of the B2C companies, in the first two months of the second quarter of 2018, recorded an average increase of 11.8%, 4.6 p.p. higher than in the first quarter of 2018. In the first two months of the second quarter of 2018, the turnover of wholesale businesses as their main activity recorded an average

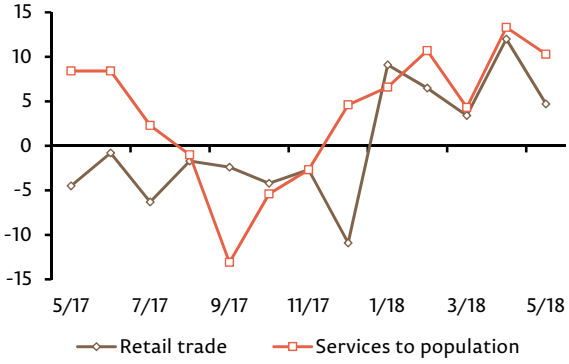
increase of 14.9%[9], 8.6 p.p. higher than in the first quarter of 2018 (Chart 3.21). At the same time, the turnover of B2B companies registered an average increase of 3.1% during the reference period, 0.5 p.p. lower than in the previous quarter.

Agricultural production

In the first half of 2018, the volume of global agricultural output increased by 7.2%, year-on-year. It should be mentioned that this evolution was mainly determined by a positive evolution of the vegetal sector (Chart 3.22). Thus, during the reference period, the annual growth rate of vegetal production recorded a level of 54.6%, whereas the level of livestock production – 0.7%.

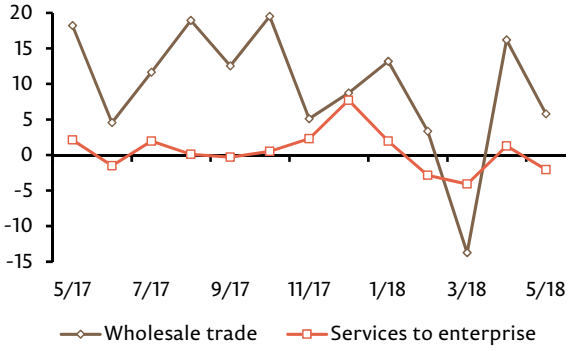
It should be noted that, in 2018, crop areas have increased by 0.7%, compared to 2017. Therefore, the increase in the area of sown lands coupled with favourable weather conditions for vegetal production create preconditions for an increase, in annual terms, in the volume of global agricultural output in 2018.

Chart 3.20: The evolution of domestic trade in real terms (%, versus the same month of the previous year)



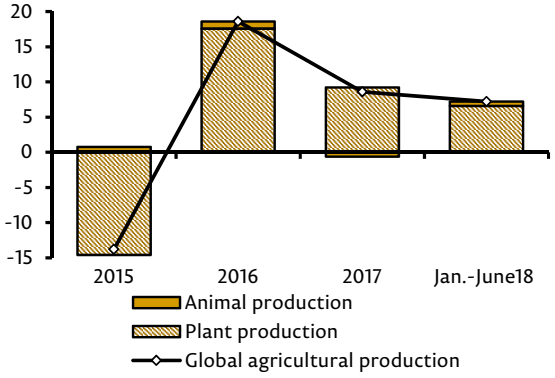
Source: NBS

Chart 3.21: The evolution of wholesale trade (deflated by annual CPI) (%, versus the same month of the previous year)



Source: NBS

Chart 3.22: Global agricultural production (%, versus the previous year)

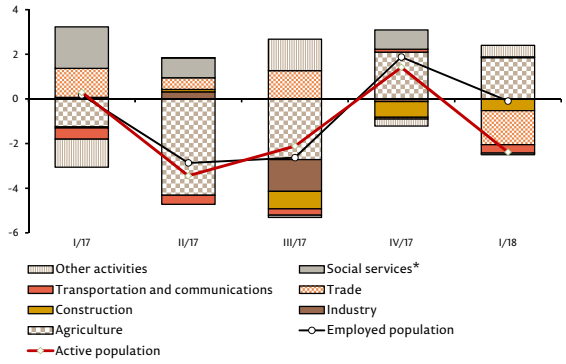


Source: NBS, NBM calculus

[9]Deflated by the annual CPI rate.

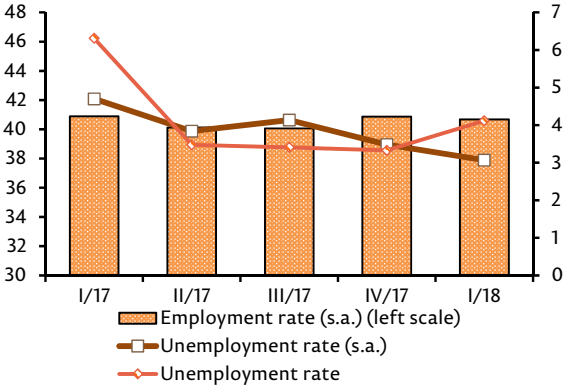
3.3 Labour market

Chart 3.23: Annual growth rate of employed population (%) and its formation by national economy sectors (p.p.)



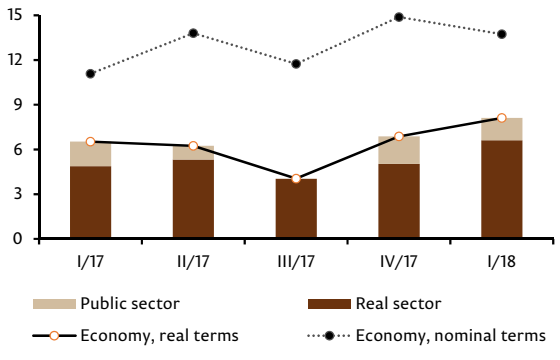
Source: NBS, NBM calculus
*Public administration, education, health and social care

Chart 3.24: Evolution of the unemployment and employment rate (%)



Source: NBS, NBM calculus

Chart 3.25: The payroll fund in the economy (%, compared to the same period of the previous year) and the contributions of the economy sectors (p.p.)



Source: NBS, NBM calculus

Labour force

The number of the employed population remained at the level of the beginning of the previous year, while the number of the unemployed population decreased, thus generating negative dynamics of the economically active population. In the first quarter of 2018, the economically active population decreased by 2.4%, year-on-year.This evolution was largely driven by the decline in the number of unemployed population. Thus, the number of unemployed population, estimated according to the International Labour Office (ILO) methodology, recorded 48.3 thousand, decreasing compared to the first quarter of 2017 (75.8 thousand). At the same time, the employed population remained almost at the level of the first quarter of 2017 (Chart 3.23). Given the structure of the national economy, the annual dynamics of the employed population was mainly determined by the decrease in the trade (-7.9%), construction (-13.9%) and transportation (-5.6%) sectors. At the same time, the above-mentioned developments were offset by an increase in the number of population employed in the agricultural sector by 6.7%, compared to the first quarter of 2017.

The unemployment rate has decreased compared to the beginning of the previous year as well as to the fourth quarter of 2017. In the first quarter of 2018, the unemployment rate, according to the ILO methodology, recorded a level of 4.1%, 2.2 p.p. lower than in the first quarter of 2017. The seasonally adjusted unemployment rate recorded 3.1%, dropping 0.4 p.p. compared to the fourth quarter of 2017. The seasonally adjusted employment rate recorded a level of 40.7%, 0.2 p.p. lower than in the fourth quarter of 2017 (Chart 3.24). According to the data provided by ANOFM[10] in the first three months of 2018, the number of redundancies decreased by 18.3%, year-on-year, whereas the number of job vacancies increased by 43.3%.

Payroll fund

The annual growth rate of the payroll fund continued to record its upward trend since the end of the previous year. In the first quarter of 2018, the payroll fund grew by 13.7%, whereas, in real terms, deflated by the CPI, it increased by 8.1%, year-on-year, as a result of positive contributions generated by the compensation funds of the real and budget sectors (Chart 3.25).

In the first quarter of 2018, the number of employees in the economy was higher than in the previous year due to the developments in the real sector of the economy. The average number of employees in the national economy was 0.5% higher than in January-March 2017, thus recording an upward trend over the last year due to positive dynamics of the average

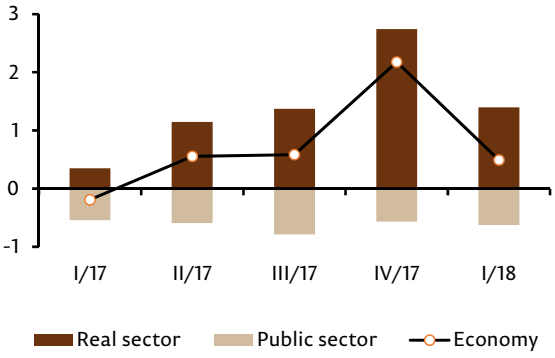
[10]The National Employment Agency of Moldova

number of employees in the real sector, which contributed by 1.4 p.p. to the evolution of the total number of employees. Thus, the public sector continued to exert a negative impact on the overall evolution of this indicator (-0.9 p.p. in the first quarter of 2018) (Chart 3.26).

The growth rate of personal income exceeded the growth rate of labour productivity. During the reference period, the average salary of a worker in the national economy increased by 13.2%, year-on-year. The average salary increased both in the budget and real sectors of the economy, year-on-year, by 14.4% and 12.5%, respectively.

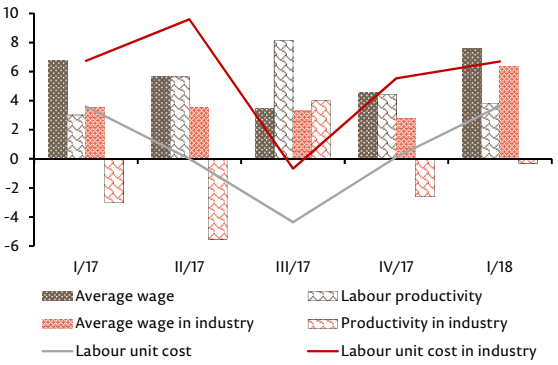
In the first quarter of 2018, the annual labour productivity, estimated for the whole economy, recorded a level of 3.8%, whereas in the industrial sector it fell to a negative level of -0.3%. At the same time, the annual growth rate of the average real wage, estimated for the whole economy, amounted to 7.6%, whereas in the industrial sector it reached a level of 6.4%. In this context, the annual growth rate of the unit labour cost for the whole economy increased by approx. 3.6 p.p., reaching a level of 3.5%, whereas in the industrial sector it recorded a level of 6.7%, increasing by 1.2 p.p. (Chart 3.27).

Chart 3.26: The average number of employees (%, compared to the same period of the previous year) and the contributions of the economy sectors (p.p.)



Source: NBS, NBM calculus

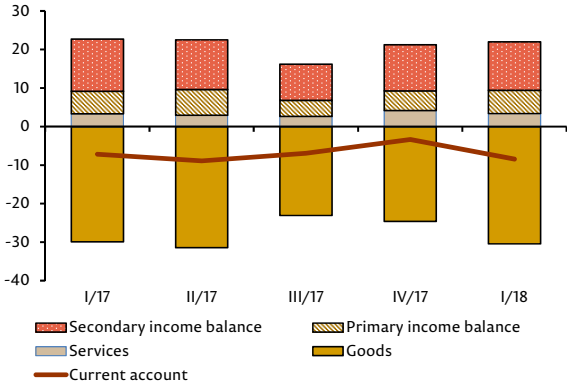
Chart 3.27: Average real wage and labour productivity in industry (%, compared to the same period of the previous year)



Source: NBS, NBM calculus

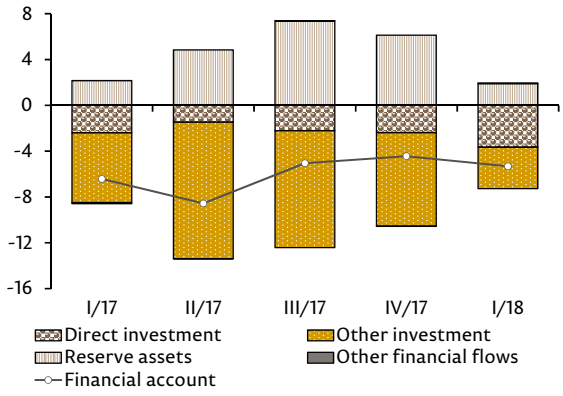
3.4 External sector of the economy

Chart 3.28: Current account share in GDP (%)



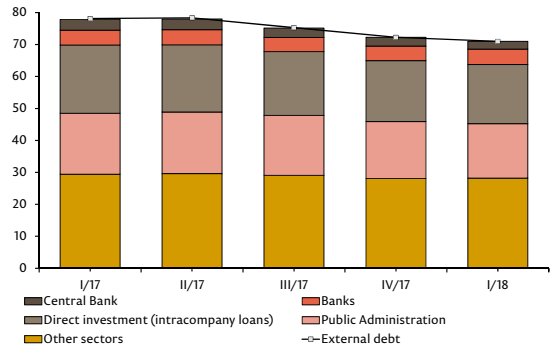
Source: NBM

Chart 3.29: Financial account share in GDP (%)



Source: NBM
Note: (-) – net capital inflows, (+) – net capital outflows

Chart 3.30: Share of external debt in GDP (%)



Source: NBM

At the beginning of this year, the current account deficit increased as a result of the increase in the negative contribution of the balance of goods. In the first quarter of 2018, the current account deficit of the balance of payments increased by 5.1 p.p., compared to the previous quarter, accounting for an 8.5% share of GDP (Chart 3.28). The deficit's growth in the balance of payments was determined by the increase in the negative contribution of one of its components – the balance of goods. At the same time, the shares of other components that generated positive contributions have recorded mixed evolutions; thus, the share of the "primary income balance" and the "balance of secondary incomes" increased, whereas the share of the "balance of services" diminished.

In the first quarter of 2018, an increase in net capital inflows was reported; thus, the financial account, as a share of GDP, recorded a level of 5.3%, 0.9 p.p. higher, compared to the fourth quarter of 2017 (Chart 3.29). It should be mentioned that this evolution was mainly driven by the increase in the volume of direct investments as well as a slower rate of reserve accumulation by the central bank. Direct investments, as a share of GDP, recorded 3.7%, whereas the reserve assets – 1.9%. At the same time, in the first quarter of 2018, compared to the fourth quarter of 2017, net inflows from "other investments" component recorded a decrease. In the first quarter of 2018, the "other investments" component accounted for a 3.6% share of GDP, 4.6 p.p. lower than at the end of 2017. This evolution was mainly driven by the developments in such groups as "cash and deposits" and "loans" (mainly repayments of external loans: public administration, non-financial corporations, households and non-profit institutions, the NBM, as well as deposit-taking entities).

In the first quarter of 2018, external debt accounted for 71.0% of GDP, 1.3 p.p. lower than in the fourth quarter of 2017 (Chart 3.30). It should be mentioned that no significant changes have been recorded in the external debt structure; thus, similar to the previous periods, the major share of 33.0% in the total external debt is held by economic agents[11], followed by the government sector[12] holding a 19.5% share and the direct investments component accounting for 18.5% of GDP.

[11] The cumulative debt of "Banks" and "Other sectors".
[12] The cumulative debt of "Public administration" and "Central bank" components.

Chapter 4

Monetary policy

4.1 Monetary policy instruments

Interest rate policy

The persistence of disinflationary pressures as well as the economic growth that will generate in the future disinflationary pressures have warranted the decision to maintain the base rate of the NBM in the second quarter of 2018 at the level of 6.50% per year.

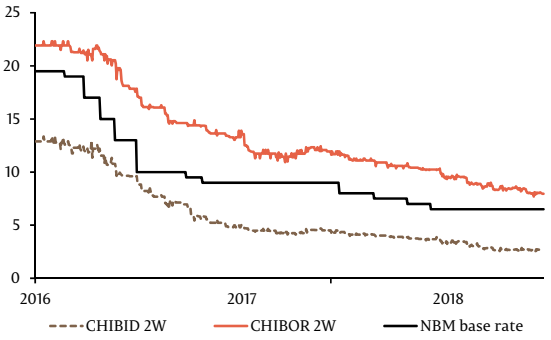
In the second quarter of 2018, the interbank money market quotations continued to decline, although at a slower rate than in the previous quarter. The level of Chisinau Interbank Bid Rate (CHIBOR) 2W, recorded at the end of the quarter, decreased by 0.35 p.p. compared to the previous quarter, dropping to the level of 7.96% (Chart 4.1).

Given a lower supply of 91-days state securities (SS) from investors (Chart 4.2), their interest rates have assumed an upward trend at the beginning of the quarter. However, this development did not reflect in the level of the average interest rate on 91-days SS recorded in the last month of the quarter, which was similar to the one recorded in the last month of the previous quarter (3.94% per annum). The interest rate recorded on the interbank money market was at the level of 6.14% per annum.

The quarterly average return on sale-purchase transactions on the secondary market of state securities amounted to 4.18%, recording a decrease of 0.48 p.p., compared to the previous quarter, against the background of the decreasing weighted average term to maturity from 193 days to 67 days.

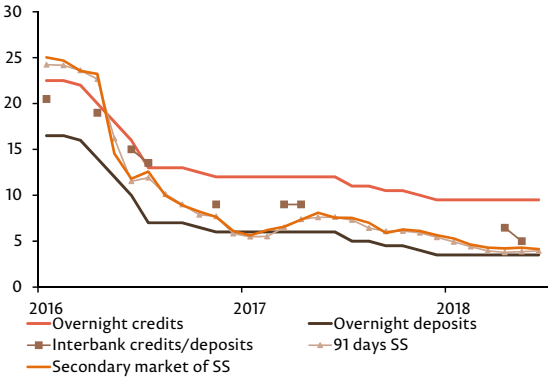
The quarterly turnover of the secondary market of state securities totalled 24.4 million lei, rising by 21.2 million lei, compared to the previous period. The bank-client transactions prevailed, accounting for 94.3% of total transactions.

Chart 4.1: The average monthly reference rates on interbank market and the NBM base rate (%)



Source: NBM

Chart 4.2: The monthly evolution of interest rates corridor (%)

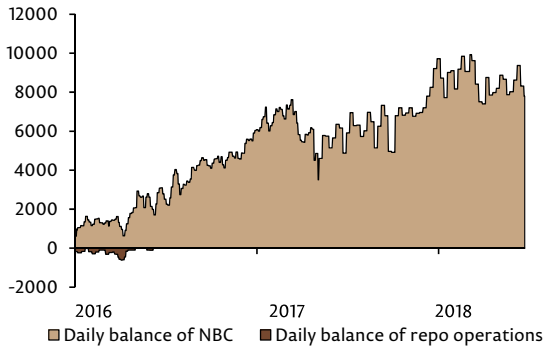


Source: NBM

Monetary market operations

During the second quarter of 2018, excess liquidity continued to be absorbed through the NBM's certificate (NBC) auctions.

Chart 4.3: The daily balance evolution of sterilization operations (MDL, million)



Source: NBM

The NBM's certificate auctions (NBC)

The NBM conducted weekly NBC auctions with 14-days maturity, setting the maximum interest rate equivalent to the NBM's base rate. In the second quarter of 2018, the weighted average rate of liquidity-absorbing operations recorded 6.50%, annually.

The stock of the NBC placements varied throughout the quarter, ranging from the minimum amount of 7 506.5 million lei to the maximum amount of 9 377.1 million lei. The average monthly balance of the NBC amounted to 8 272.5 million lei (-712.9 million lei compared to the first quarter of 2018) (Chart 4.3).

Lending activity

As of June 30, 2018, the loan exposure of banks to the National Bank of Moldova amounted to 0.04 million lei, being entirely accounted for by loans extended to banks in 1992-2002 for lending to housing cooperatives. Compared to the previous quarter, the balance of loans extended to banks decreased by 0.04 million lei. The assessment of loan portfolio, carried out in June 2018, identified no write-downs for loan losses.

Standing facilities

The conditions of accessing the NBM's standing facilities (overnight deposits and loans) allowed banks to manage their own liquidity efficiently and enhanced the NBM's flexibility in pursuing its monetary policy.

During the second quarter of 2018, interest rates on the NBM's standing facilities maintained the same level, recording 3.50% per annum for overnight deposits and of 9.50% per annum for overnight loans.

During the second quarter of 2018, banks accessed overnight deposit facility on a daily basis, whereas the loan facility was not requested.

The total volume of overnight deposits placed at the NBM during the reference quarter amounted to 51 474.3 million lei, thus recording a daily average balance of 826.1 million lei, by 8.8% higher than in the previous quarter. The amount of overnight deposits placed by individual banks ranged between a minimum of 5.0 million lei and a maximum of 1 100.0 million lei.

Required reserves

In the second quarter of 2018, the required reserve mechanism continued to ensure monetary control and liquidity management in the banking system.

Throughout the quarter, the ratio of required reserves held in Moldovan lei and non-convertible currencies was maintained at the level of 40.0% of the calculation base, whereas the ratio of required reserves held in freely convertible currencies remained at the level of 14.0% of the calculation base.

The banks' required reserves, held in MDL between June 16, 2018 – July 15, 2018, amounted to 13 879.1 million lei, recording an increase of 111.9 million lei (0.8%), compared to the end of the previous quarter (March 16, 2018 – April 15, 2018).

As of June 30, 2018, the banks' required reserves held in FCC at the National Bank of Moldova totalled USD 62.1 million and 119.2 million euro. Compared to March 31, 2018, the amount of required reserves held in the euro decreased by 4.2% and in the US dollars – by 7.0%.

Interbank money market

In the second quarter of 2018, due to the persistence of the liquidity surplus recorded in the banking system, the interbank loan/deposit market recorded a low level of activity. However, compared to the previous periods, in April and May, transactions were carried out totalling 240.0 million lei, at an interest rate of 6.14% per annum and the minimum market maturity.

Government deposits placed with the National Bank of Moldova

As of June 30, 2018, the balance of deposits placed by the Ministry of Finance at the National Bank of Moldova amounted to 521.9 million lei, out of which 498.9 million lei were intended for maintaining the state's liquidity reserve. The weighted average rate on deposit balance was 7.1% per annum, and the weighted average term to maturity – 788 days.

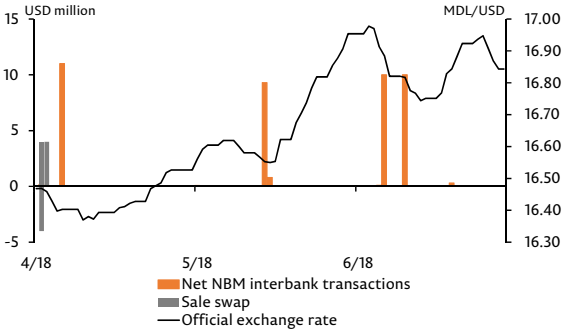
Interventions on the domestic foreign exchange market

During April-June 2018, the NBM intervened on the domestic forex market mainly as a foreign currency buyer (Chart 4.4).

During the reference period, the volume of transactions (excluding swap), carried out by the NBM against Moldovan lei on interbank foreign exchange market, amounted to 41.82 million US dollars, at value date, of which purchase transactions in the amount of USD 41.1 million, currency conversions carried out through the World Bank's institutions (IBRD and IDA), in the amount of USD 0.67 million, cash purchases in the amount of USD 0.04 million, equivalent to 0.03 million euro, as well as cash purchases in the amount of USD 0.01 million, equivalent to RON 0.06 million.

Besides, the NBM performed swap sales amounting to 4.00 million US dollars.

Chart 4.4: Evolution of official exchange rate MDL/USD and the volume of NBM daily transactions, II quarter 2018 (USD, million)



Source: NBM

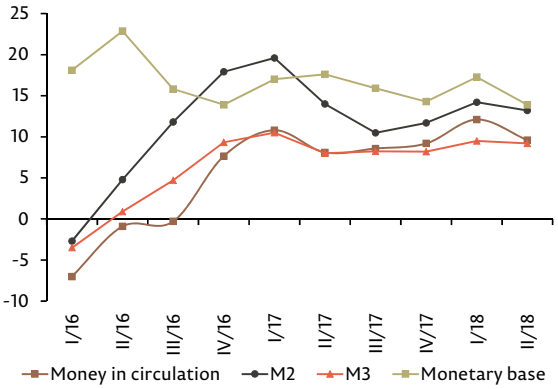
4.2 Evolution of monetary indicators

In the second quarter of 2018, monetary aggregates recorded positive developments, the quarterly average growth rate, in annual terms, amounting to 13.2% for M2 (decreasing 1.0 p.p. compared to the first quarter of 2018) and 9.2% for M3 (decreasing 0.3 p.p. compared to the previous quarter). The monetary base recorded a slower growth rate than in the previous quarter, its quarterly average reaching, in annual terms, 13.9% (Chart 4.5).

Money supply

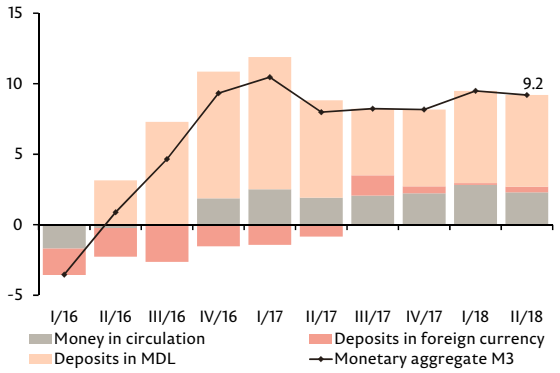
During the second quarter of 2018, broad money supply recorded average annual growth of 9.2%, driven by the increase in all its

Chart 4.5: The dynamics of monetary aggregates (%, annual growth)



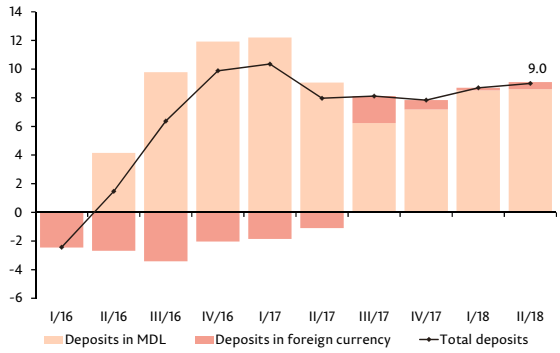
Source: NBM

Chart 4.6: The dynamics of monetary aggregate M3 (%, components contribution to the annual growth)



Source: NBM

Chart 4.7: The dynamics of total balance of deposits (%, components contribution to the annual growth)



Source: NBM

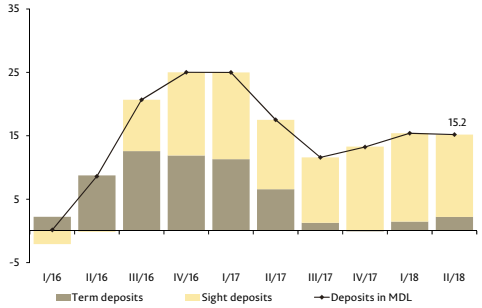
subcomponents. Thus, the growth of M3 was determined by the major contribution generated by domestic currency deposits, being followed by the contribution of money in circulation and foreign currency deposits (Chart 4.6).

A positive evolution of the domestic currency deposit component, recorded in the reference quarter (Chart 4.7), was almost entirely driven by the developments in sight deposits, the contribution of which has been exceeding that of term deposits for already seven consecutive quarters (Chart 4.8). In terms of the medium-term stability of financial sector, such development is less preferred as opposed to an increasing demand for term deposits. At the same time, in the second quarter of 2018, like in the previous quarter, the contribution of term deposits continued to record an upward trend, accounting for 2.2% of the total increase in domestic currency deposits (Chart 4.9). In the reference period, the growth rate of sight deposits placed in domestic currency slowed down by 3.2 p.p. compared to the previous quarter, corporate deposits accounting for the largest share of total sight deposits (Chart 4.10).

Over the last four quarters, the foreign currency deposits component has been generating a positive contribution to the dynamics of total deposits, having reversed to an upward trend in the second quarter of 2018 (Chart 4.11). During the reporting period, the evolution of foreign currency deposits has been entirely determined by the developments in foreign currency sight deposits, placed mainly by individuals (Chart 4.13). The component of foreign currency term deposits continued to generate negative contributions, a trend that has maintained since the first quarter of 2016 (Chart 4.12).

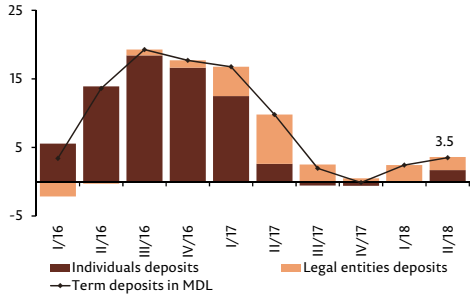
The growth rate of money in circulation decreased by 2.8% compared to the previous quarter; at the same time, the contribution of money in circulation to M3 growth decreased by 0.5 p.p. compared to the first quarter of 2018. The dynamic of money in circulation was determined by higher flow of cash received (largely as a result of the increase in the proceeds obtained from the sale of consumer goods), as opposed to flow of cash released by licensed banks (as a result of the decrease in the volume of foreign currency purchased from individuals).

Chart 4.8: The dynamics of balance of deposits in national currency (%, comp. contrib. to the annual growth)



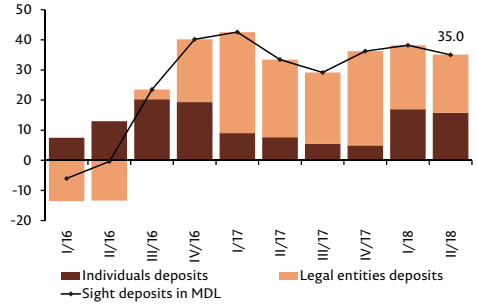
Source: NBM

Chart 4.9: The dynamics of term deposits balance in national currency (%, comp. contrib. to the annual growth)



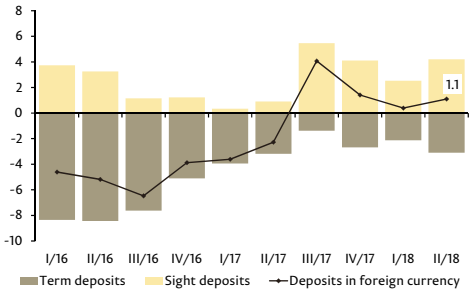
Source: NBM

Chart 4.10: The dynamics of sight deposits balance in national currency (%, comp. contrib. to the annual growth)



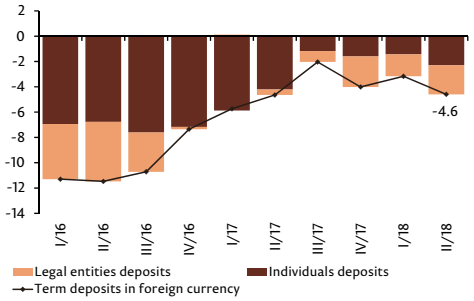
Source: NBM

Chart 4.11: The dynamics of balance of deposits in foreign currency (%, comp. contrib. to the annual growth)



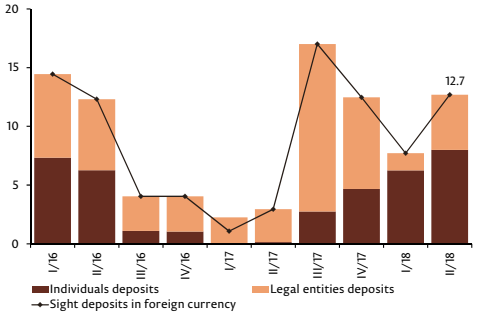
Source: NBM

Chart 4.12: The dynamics of term deposits balance in foreign currency (%, comp. contrib. to the annual growth)



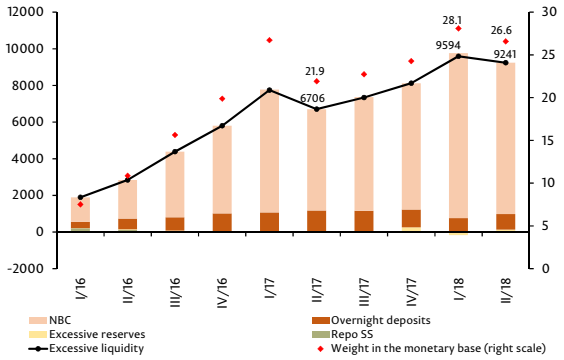
Source: NBM

Chart 4.13: The dynamics of sight deposits balance in foreign currency (%, comp. contrib. to the annual growth)



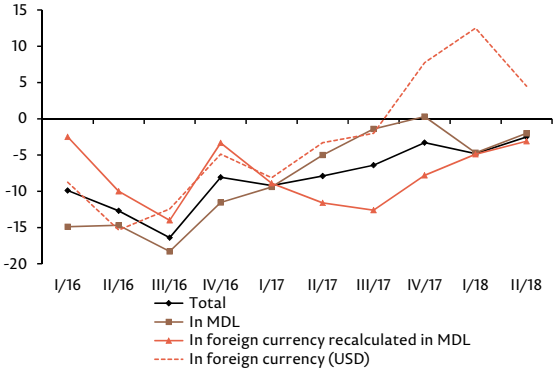
Source: NBM

Chart 4.14: Excess liquidity



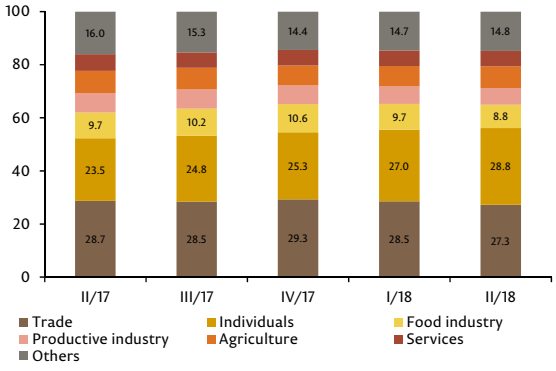
Source: NBM

Chart 4.15: The evolution of loans balance (%, annual growth)



Source: NBM

Chart 4.16: The structure of loans balance (%, in total)



Source: NBM

Excess liquidity

Excess liquidity in the banking system creates a potential risk of financial instability in the national economy. In the context of a weak loan demand from economic agents as well as unfavourable economic conditions (the share of non-performing loans recording a level of 14.7% in June 2018), banks will grow increasingly reluctant to accept high level of risk associated with lending operations. Hence redirecting their demand towards financial operations that ensure a low level of risk and a sufficient profitability, such as placements in SS and NBC, thus contributing to the increase in excess liquidity.

During the second quarter of 2018, the volume of excess liquidity in the banking system decreased, on average, by 353 million lei (-3.7%), recording an average of 9.2 billion lei (Chart 4.14).

Loan market

Developments in the balance of loans extended by licensed banks[13]

In the second quarter of 2018, the total balance of loans extended by licensed banks recorded a downward trend, totalling, at the end of the reference period, 32 653.0 million lei, thus recording a decrease of 2.5% compared to the end of the second quarter of 2017. This downward development was driven by the decrease in both its components: the balance of domestic and foreign currency loans (recalculated in domestic currency) (Chart 4.15).

The balance of domestic currency loans recorded a negative annual growth rate of 2.0% at the end of the second quarter of 2018. This evolution was driven by the decrease in the balance of corporate loans, partly offset by the balance of retail loans, which recorded an increase.

At the end of the second quarter of 2018, the annual growth rate of foreign currency loans extended by licensed banks, recalculated in domestic currency, recorded a decrease of 3.1%, which was also driven by the negative annual variation of corporate loans evolution (holding a share of 97.6% of total foreign currency loans). The downward trend of foreign currency loans, recalculated in Moldovan lei, was largely determined by the appreciation of the domestic currency against the main reference currencies.

In the second quarter of 2018, retail loans (28.8%) held the largest share in the portfolio structure of loans extended by licensed banks, followed by trade loans (27.3%). The share of retail loans in total loans recorded a significant increase of 5.3 p.p. over the last 12 months. The shares held by loan balances of other business sectors have decreased, compared to the second quarter of 2017 (Chart 4.16).

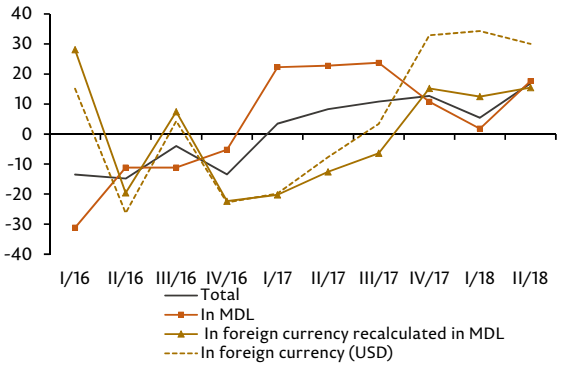
Developments of new loans extended by licensed banks

In the second quarter of 2018, licensed banks of the Republic of Moldova extended new loans in a volume 16.9% higher, year-on-year (Chart 4.17). This evolution was driven by the annual growth rate of loans extended in both domestic and foreign currency.

[13]Data analysis was performed based on the ORD 01.06 reports "Interest rates on loan and deposit balance", submitted by licensed banks prior to July 11, 2018.

Of total new loans extended by licensed banks during the reference period, domestic currency loans accounted for the largest share of 67.4%.

Chart 4.17: Developments of new granted loans (%, annual growth)



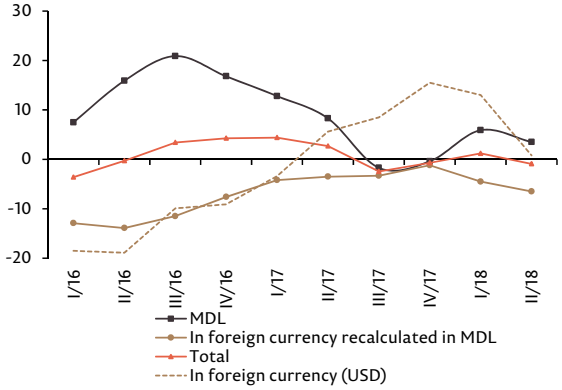
Source: NBM

Market of term deposits placed at licensed banks[14]

At the end of the second quarter of 2018, the annual growth rate of term deposit balances of licensed banks recorded a decline of 0.9%, driven by the negative growth rate of the foreign currency component (recalculated in MDL) (Chart 4.18). It should be mentioned that domestic currency deposits maintained their upward trend.

The annual upward trend of domestic currency deposits at the end of the second quarter of 2018 was largely determined by the evolution of corporate deposits. The negative annual growth rate of foreign currency deposits, recalculated in domestic currency, was influenced by the appreciation of the domestic currency against the main reference currencies.

Chart 4.18: The evolution of deposits balance (%, annual growth)



Source: NBM

Interest rates[15]

Evolution of base rate

During the second quarter of 2018, the Executive Board of the National Bank of Moldova has held two meetings on monetary policy decisions. Following the internal and external risk balance assessment and the short- and medium-term inflation forecast, the Executive Board of the National Bank of Moldova decided, at its meetings held on May 3, 2018 and June 5, 2018, to maintain the base rate applied to main monetary policy operations at the level of 6.5% per annum (the level set at the meeting of December 5, 2017). These decisions aimed at fostering a monetary climate, which would revitalise lending and saving activities, at further adjustment of the domestic economic environment to the volatility and uncertainty associated with the external macroeconomic situation; the ultimate objectives included the anchoring of inflation expectations, bringing and maintaining of the inflation rate close to the target of 5.0% in the medium-term, allowing for deviation of ± 1.5 p.p.

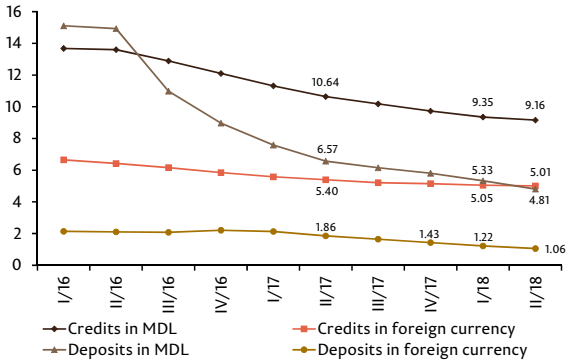
Evolution of interest rate on loan balance

During April-June 2018, the quarterly average interest rates on the balance of loans extended by licensed banks continued their downward trend, their average recording 9.16% per annum for loans in domestic currency (-0.19 p.p. compared to the first quarter of 2018 and -1.48 p.p. compared to the second quarter of 2017). This decline was largely determined by a stronger decline in interest rates applied on retail loans and by the decrease of the rates related to the balance of credits granted to legal entities. The above developments reflected the effect of the relaxation of the monetary policy, promoted by the National Bank of Moldova over the last ten quarters as well as the existence of excess liquidity in the banking system.

[14]The data analysis was performed based on the reports ORD 01.06 "Interest rates on the loan and deposit balance" submitted by licensed banks by July 11, 2018.

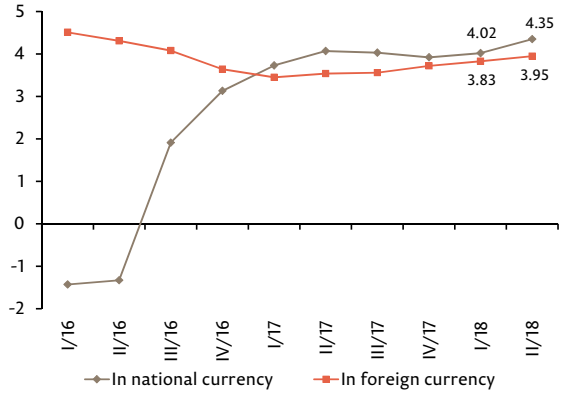
[15]The rates analysis was performed based on the reports ORD 01.06 "Interest rates on the loan and deposit balance" submitted by licensed banks by July 11, 2018 and does not include information on sight deposit rates.

Chart 4.19: The average interest rates of loans and deposits balance (%)



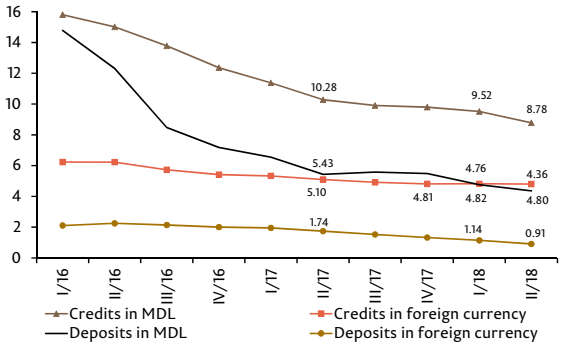
Source: NBM

Chart 4.20: The evolution of banking margin of loans and deposits balance (p.p.)



Source: NBM

Chart 4.21: Average interest rates of new volumes of loans and deposits



Source: NBM

During the second quarter of 2018, interest rate on the balance of loans extended in foreign currency was similar to the one paid on the balance of loans in domestic currency, although it recorded a smaller decline, the weighted average rate recording 5.01% per annum.

Evolution of interest rate on deposit balance

The quarterly average interest rates, paid on the deposit balance of licensed banks, kept declining following the downward trend set by the NBM's base rate applied to the main monetary policy operations.

Thus, the average interest rate on the balance of deposits placed in Moldovan lei, in the second quarter of 2018, recorded 4.81% per annum, recording a decrease of 0.52 p.p. compared to the previous quarter, and by 1.76 p.p. compared to the second quarter of 2017 (Chart 4.19). The evolution of the quarterly average interest rate on the balance of deposits in Moldovan lei was mainly driven by the decrease in average interest rates applied on the balance of domestic currency deposits placed by both corporate clients and individuals.

The quarterly average interest rate applied on the balance of foreign currency deposits recorded a new historical minimum of 1.06% annually in the reference period, having fallen by 0.16 p.p. compared to the previous quarter. Like in the domestic currency sector, the quarterly decrease of foreign currency rates was driven by the fall in average interest rates applied on the balances of both retail and corporate deposits.

Evolution of banking margin

In the second quarter of 2018, the quarterly banking margin[16] on the balance of operations carried out in Moldovan lei increased by 0.33 p.p. compared to the previous quarter, recording a level of 4.35%. The quarterly banking margin on the foreign currency balance recorded a similar trend and amounted to 3.95%, having increased by 0.12 p.p. (Chart 4.20).

Evolution of interest rates applied on new loans and deposits extended/taken by licensed banks

Following the monetary policy promoted by the National Bank of Moldova and the excess liquidity recorded in the banking system, the average weighted interest rates applied on new loans and new term deposits continued to decline during the second quarter of 2018 (Chart 4.21).

Compared to the previous quarter, the average weighted rate applied on domestic currency loans, extended by licensed banks, dropped to 8.78% annually (-0.74 p.p.), whereas the average weighted rate applied on domestic currency deposits decreased by 0.40 p.p., recording a level of 4.36% per year. These developments were driven by the declines in interest rates applied on loans extended to both legal entities and individuals. In the foreign currency segment, the average weighted deposit rates continued recording a downward trend, whereas the average weighted rates on loans did not record any major changes.

[16]Calculated as the difference between average interest rates applied on the loan balance and average interest rates applied on the deposit balance.

Developments in nominal and real effective exchange rates

During the second quarter of 2018, the official nominal exchange rate of domestic currency depreciated by 2.3% against the US dollar, while, against the euro, it appreciated by 3.8% compared to the end of the previous quarter (Chart 4.22).

On average, the Moldovan leu appreciated by 0.5% against the US dollar and by 3.3% against the euro, compared to the first quarter of 2018.

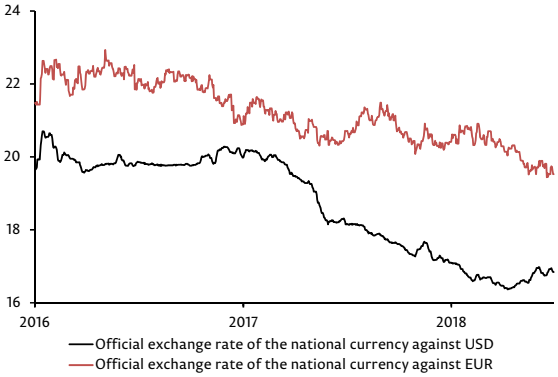
In the second quarter of 2018, similar to the Moldovan leu, the most currencies of the main trading partner countries fallowed a depreciation trend against the US dollar. Thus, at the end of the quarter, compared to the end of the first quarter of 2018, the following currencies depreciated against the US dollar: the Turkish lira – by 15.0%, the Hungarian forint – by 11.6%, the Polish zloty – by 10.1%, the Russian rubble – by 9.4%, the Czech koruna – by 8.6%, the Pound sterling – by 7.4%, the euro and the Romanian leu – by 6.3% (Chart 4.23).

In real terms, in the second quarter of 2018, the Moldovan leu appreciated by 3.9% against the currencies of the main trading partner countries (Chart 4.24). The nominal appreciation of the domestic currency against the partner countries' currencies was moderated by a slow rise in domestic prices (measured through CPI), compared to those recorded in partner countries. Significant contributions to the appreciation of the REER were generated by Russian Federation – 1.1 p.p., Romania – 0.8 p.p., and Turkey – 0.7 p.p. (Chart 4.25).

In the second quarter of 2018, certain changes occurred on the local forex market, which determined a lack of foreign currency to be recorded. This development was mainly driven by an increase in the foreign currency demand from economic agents, reflecting a deterioration in the trade balance[17], compared to both the previous quarter and year-on-year. In particular, an increased demand for foreign currency came from importers of petroleum products against the background of a recent increase in prices for these products on international markets. Thus, net foreign currency demand from legal entities increased by 25.2%, compared to the second quarter of 2017, reaching USD 546.1 million.

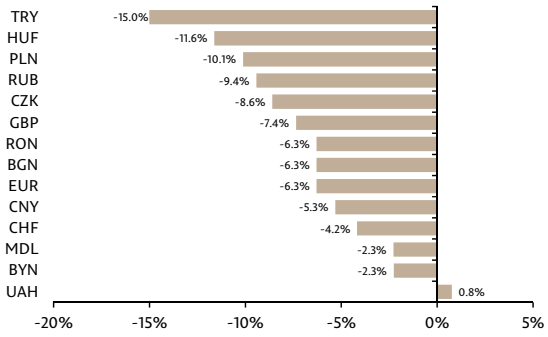
At the same time, net foreign currency supply from individuals, as compared to a strong growth of remittances to individuals (+17.5%, according to data from the first two months of the quarter, compared to the similar period of 2017), recorded values below expectations, largely due to a steady depreciation of the euro on both foreign and domestic markets. Thus, net foreign currency supply from individuals increased by no more than 6.5%, compared to the second quarter of the previous year, amounting to USD 525.1 million. In the currency structure[18] of the supply from individuals, the majority share continued to be held by the European single currency (60.2%), followed by the US dollar (22.9%) and the Russian rubble (11.6%) (Chart 4.26).

Chart 4.22: The fluctuations of the official exchange rate of MDL against USD and EUR



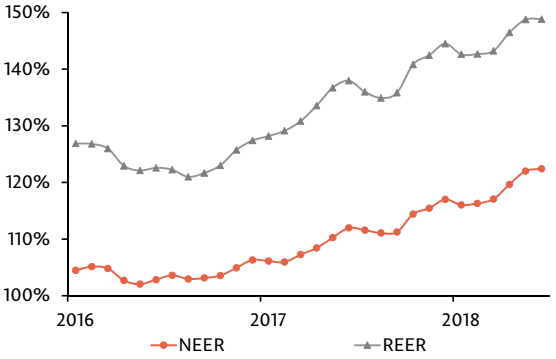
Source: NBM

Chart 4.23: The evolution of currencies of the major trading partners of the Republic of Moldova against the US dollar (30.06.2018/31.03.2018, %)



Source: NBM

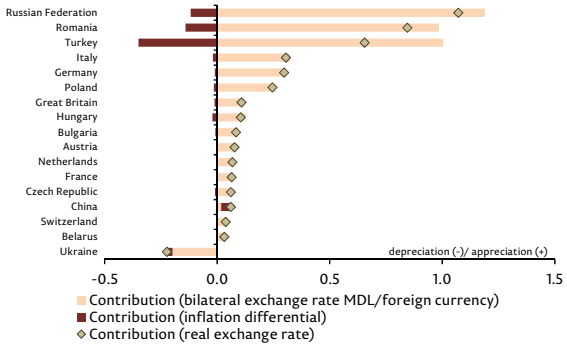
Chart 4.24: The dynamics of nominal effective exchange rate (NEER) and real effective exchange rate (REER) of MDL calculated based on the major trading partners weights (Dec.2000-100%)



Source: NBM

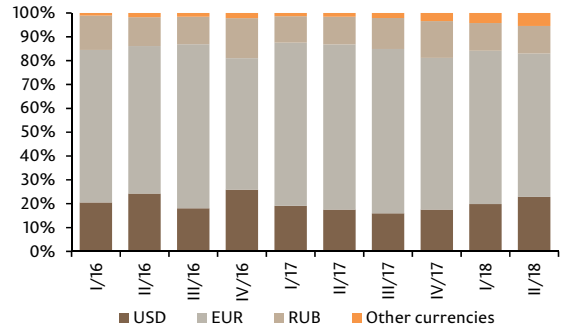
[17] According to the data recorded in the first two months of the quarter.
[18] Weights calculated at the constant exchange rate.

Chart 4.25: The contribution of the major trading partners of the Republic of Moldova to the real effective exchange rate modification in the second quarter of 2018



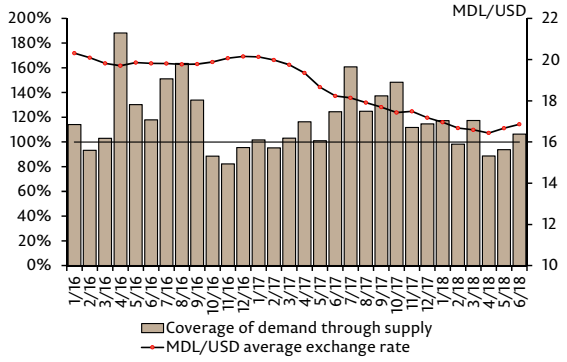
Source: NBM

Chart 4.26: The foreign currency structure of net foreign currency supply (foreign currencies are recalculated in USD at constant average exchange rate)



Source: NBM

Chart 4.27: The coverage rate of net sales by the net supply and the dynamics of the official exchange rate



Source: NBM

In this context, the net foreign currency supply from individuals covered 96.2% of the net foreign currency demand from economic agents, compared to the level of coverage recorded in the previous quarter (110.9%) and in the second quarter of 2017 (113.0%) (Chart 4.27). Nevertheless, the periods of foreign currency deficit were unevenly distributed over the quarter, some periods recording a foreign currency surplus, thus creating prerequisites for the NBM's interventions. Under these circumstances, the NBM purchased USD 41.1 million from licensed banks.

Looking at the monthly dynamics, at the beginning of April, the Moldovan leu appreciated against the US dollar in the context of a foreign currency surplus recorded at the end of the previous month. However, starting with the second week of April and, with some exceptions, through the end of May, the Moldovan leu has steadily depreciated against the US dollar. In April-May, the domestic interbank forex market recorded a foreign currency deficit. During this period, the net foreign currency demand from economic agents recorded a stronger increase than the net foreign currency supply from individuals; hence, the coverage degree of demand by supply was a subunit (88.7% in April and 93.7% in May). Compared to the same period of the previous year, in April-May there was an increased demand for foreign currency from large foreign capital companies for the payment of dividends, as well as from the main importers of petroleum products. Thus, according to the end-of-month data, the official exchange rate of the Moldovan leu depreciated against the US dollar by 0.4% in April and by 2.6% in May.

In June, the demand-supply balance on the foreign exchange market improved, the supply from individuals covering the demand from economic agents at 106.5%. Under these conditions, the exchange rate of Moldovan leu appreciated against the US dollar by 0.7%, compared to the last day of the previous month.

As opposed to the relationship of the Moldovan leu to the US dollar, the relationship of the Moldovan leu to the euro, during the reference period, was characterised by the Moldovan leu's steady appreciation against the euro. This development was driven by the evolution of the European single currency against the US dollar on foreign markets in the second quarter of 2018, during which the US dollar recorded its strongest appreciation over a quarter since 2016. The depreciation of the euro against the US dollar was intensified by the announcement of the ECB's intentions to reduce the volume of assets' acquisition under the quantitative easing programme in the near future. At the same time, the accelerating growth rate of inflation in the US has fuelled expectations for a faster increase of the Fed's monetary policy rate this year. Thus, the increase in the projected rate differential between the USA and the euro area further strengthened the US dollar's position, which appreciated against the currencies of both the developed economies and the majority of the emerging economies. Thus, during the reference quarter, the Moldovan leu against the euro has mostly evolved in a downward direction, its highest appreciation being recorded in May – 2.1%.

At the end of the second quarter of 2018, the balance of official reserve assets amounted to USD 2 899.8 million (Chart 4.28), recording an increase of USD 24.6 million (+0.9%), compared to the end of March 2018, mainly as a result of the disbursements of funds under the external financial assistance and the NBM's interventions of foreign exchange purchases.

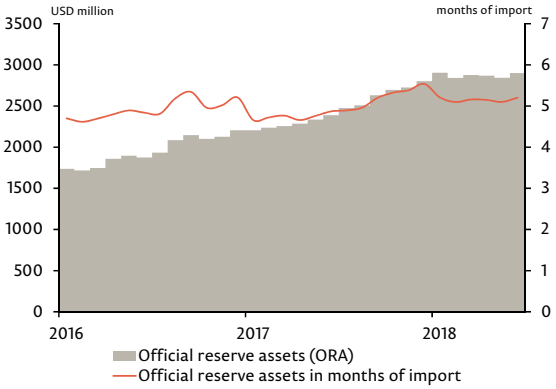
During the reference quarter, the IMF disbursed the fourth installment under the ECF/EFF[19] for a total amount of USD 22.5 million (SDR 16.0 million), of which SDR 14.5 million were disbursed to the NBM, and the remainder – to the Ministry of Finance for budget support.

The European Investment Bank also disbursed USD 23.7 million (equivalent to EUR 20.0 million) to support the Road Sector Programme and USD 2.2 million (equivalent to EUR 1.9 million) for the "Livada Moldovei" project.

World Bank Institutions (IBRD and IDA) granted loans and grants amounting to USD 3.7 million, mainly for "Competitiveness enhancement" project (USD 3.3 million), "Improving the health care system" project (USD 0.2 million), as well as other projects, whereas IFAD has allocated USD 2.1 million, of which USD 1.5 million as a grant, to the "Inclusive Rural Economic and Climate Resilience Programme" IFAD VI.

According to the data as of the end of the second quarter of 2018, the amount of official reserve assets recorded a sufficient level to cover imports of goods and services (5.2 months of imports[20]).

Chart 4.28: The evolution of official reserve assets expressed in months of import of goods and services (MBP6)



Source: NBM

[19] ECF – Extended Credit Facility; EFF – Extended Funding Facility.

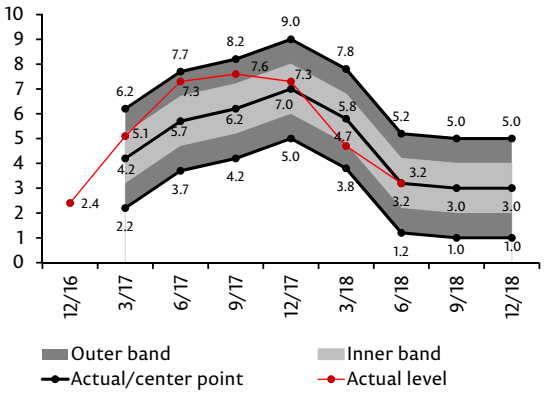
[20] Calculated based on the latest available forecast on imports of goods and services for 2018.

Chapter 5

Implementation of the provisions of the Memorandum on Economic and Financial Policies

5.1 Consumer price index

Chart 5.1: The inflation tolerance limits related to inflation consultation mechanism (%)



Source: NBM, IMF

Table 5.1: The tolerance limits of annual inflation rate (%)

	Outer band	Inner band	Actual/ Center point	Inner band (limit)	Outer band (limit)
2016					
31 Dec.	-	-	2.4	-	-
2017					
31 Mar.	6.2	5.2	5.1	3.2	2.2
30 Jun.	7.7	6.7	7.3	4.7	3.7
30 Sep.	8.2	7.2	7.6	5.2	4.2
31 Dec.	9.0	8.0	7.3	6.0	5.0
2018					
31 Mar.	7.8	6.8	4.7	4.8	3.8
30 Jun.	5.2	4.2	3.2	2.2	1.2
30 Sep.	5.0	4.0	3.0	2.0	1.0
31 Dec.	5.0	4.0	3.0	2.0	1.0
2019					
31 Mar.	5.8	4.8	3.8	2.8	1.8

Source: NBM, IMF

In the second quarter of 2018, the annual CPI rate recorded a level situated within the tolerance band's limits (Chart 5.1) set forth in the inflation provision of the IMF programme. Thus, in June, the inflation rate recorded a level identical to the centre point and situated within the narrow-band limits stipulated in the Inflation Consultation Mechanism.

Monetary policy commitments include a set of quarterly inflation targets (according to consumer price index (CPI) data published by the National Bureau of Statistics of the Republic of Moldova), set within the limits of tolerance bands. The narrow-band limits are set within ± 1.0 p.p. from the centre point, whereas the broad-band limits – within ± 2.0 p.p. from the centre point. In case of any deviation recorded from the established tolerance band limits, consultations with IMF experts or the IMF Executive Board's members will be required, focusing on: (i) the assessment of the pursued monetary policy and the degree of compliance with the conditions set forth in the IMF-supported program; (ii) causes of the recorded deviation, taking into account compensatory factors and proposed remedial actions, as required.

In the cases when the annual inflation rate exceeds the narrow-band limits set for the end of each quarter, the NBM will initiate consultations with IMF experts to determine causes of the deviation and to receive suggestions on policy actions to be taken. In the cases when the annual inflation rate exceeds the broad-band limits set for the end of each quarter, the management will consult with the members of the IMF Executive Board to determine causes of the deviation and to receive suggestions on the policy actions to be taken before applying for additional funding.

In the first half of 2017, the annual inflation rate recorded an upward trajectory, after which it had a relatively stable evolution in the second half of the year. Later, in the first quarter of 2018, the annual CPI rate assumed a downward trend. Thus, in 2017 and in the first half of 2018, the annual inflation rate recorded a level situated within the broad limits of the tolerance band, stipulated in the inflation provision of the IMF programme (Table 5.1).

5.2 The NBM's net international reserves

One of the quantitative performance criteria, based on which the IMF-supported program is assessed, is the threshold of the NBM's net international reserves (Table 5.2).

As of June 30, 2018, the NBM's net international reserves stock (at the program rate) amounted to 2 549.5 million US dollars, having exceeded the performance target of 2 431 million US dollars set for June 2018 in accordance with the IMF's updated Technical Memorandum of Understanding during the last IMF mission conducted to assess the implementation of the economic and financial policy programme.

Table 5.2: The NBM's net international reserves stock (USD, million)

	NBM net international reserve's threshold, set in the program agreed with the IMF	Stock of NBM's net international reserves (at the program course)
2016		
31 Dec.	1833.0	1894.2
2017		
31 Mar.	1818.0	1953.0
30 Jun.	1843.0	2053.5
30 Sep.	1962.0	2292.6
31 Dec.	2131.0	2463.3
2018		
31 Mar.	2368.0	2517.8
30 Jun.	2431.0	2549.5

Source: NBM, IMF

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