Inflation Report

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Note

Statistical data were taken from the National Bureau of Statistics,

Ministry of Economy, Ministry of Finance,

EUROSTAT, International Monetary Fund,

National Energy Regulatory Agency,

State Hydrometeorological Service.

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

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

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List of acronyms

NBM	National Bank of Moldova
NBS	National Bureau of Statistics of the Republic of Moldova
NBC	Certificates issued by the National Bank of Moldova
CIS	Commonwealth of Independent States
IMF	International Monetary Fund
CPI	Consumer Price Index
FCC	Freely convertible currency
IPPI	Industrial Producer Price Index
MDL	Moldovan Lei
OPEC	Organization of the Petroleum Exporting Countries
GDP	Gross Domestic Product
USA	United States of America
USD	US Dollar
SS	State Securities

Summary

Inflation

The annual rate of inflation measured by the CPI showed a downward trend, decreasing from 8.1 percent in December 2010 to 5.8 percent in March 2011, which is consistent with the Medium-term strategy for monetary policy. At the same time, it corresponds to the amount projected in the Inflation Report no.1, February 2011 (IR no. 1, 2011), recording a slight deviation in terms of increased uncertainty, as a result of the existing pressures on the world oil market, and of the current increases in tariffs of regulated services.

The annual rate of core inflation[1] constituted 2.8 percent in March 2011, making the difference between it and total inflation to be 3.0 percentage points, thus further outlining the non-monetary factors influence on the inflation process in Moldova. The regulated prices had contributed the most to the annual inflation rate formation in March 2011, as a result of increases in tariffs for services with regulated prices (gas, electricity and heating) made in May 2010 and February 2011. At the same time, the food prices had a major contribution, as a result of food prices fluctuations in world market, as well as the increases in transportation costs. Fluctuations in oil prices on the world market, enhanced by the tensions in North Africa and the Middle East, have led to increased fuel prices, which have contributed to the fuel prices growth. The second round effects, caused by fuel and food price increases generated inflationary pressures on goods and services prices related to core inflation.

The gross domestic product increased by 6.9 percent in real terms in 2010 as compared to the previous year. Taking into account that in 2009 the GDP constituted 6.0 percent, it shows that the Moldova's economy reached the level before the economic crisis. Domestic demand was the key factor in GDP growth. However, a significant part of domestic demand is oriented towards goods from outside, as a result of a lower competitiveness of domestic products, which constitutes a major impediment to the economic recovery in Moldova. External

[1]Decomposition of CPI inflation in these components is made based on the internal methodology of the NBM. Components of CPI inflation are: (1) core inflation (2) food prices (3) regulated prices (4) fuel prices.

demand has played a significant role in the positive evolution of GDP over the period. Data on foreign trade, industrial and agricultural production, transport of goods for the first months of this year outlines the prerequisites for registering a significant increase in GDP in the first quarter of 2011.

In the fourth quarter of 2010, the labor market situation in Moldova showed deterioration in compared to the forth quarter of 2009. The unemployment rate in the forth quarter of 2010 increased to 7.5 percent. This situation shows a labor market delay of the process of creating new jobs in Moldova's economy, despite the positive signals of economic recovery in 2010. The real average salary in the economy constituted 1.2 percent in the forth quarter of 2010 as compared to same period last year.

Monetary policy

National Bank of Moldova develops and implements the monetary and foreign exchange policy to ensure and maintain price stability. During 2011-2012, the NBM will guide the inflation within the mid-single digit interval.

Quantifying the inflation outlook in the short and medium term, with eventual uncertainties and challenges during the reported period, as well as to anticipate the inflationary pressures, the National Bank of Moldova has promoted a prudent monetary policy during the first quarter of 2011.

Also, NBM continued to manage the liquidity excess through sterilization operations on the monetary market. The National Bank of Moldova intervened in the domestic foreign exchange market with an insignificant volume during January to March 2011, as a seller of foreign exchange.

Monetary indicators increased in the first quarter of 2011 with a lower annual rate compared to the third and forth quarter of 2010, decreasing significantly towards the end of March, which is reflecting the positive impact of monetary policy pursued during 2009-2010.

In the current conditions in the banking system, after the base rate increase by 1.0 percentage points and the required reserves ratio increase by 3.0 percentage points during the first quarter of 2011, the interest rates charged by banks on new attracted deposits and loans granted to individuals and legal entities have slightly increased.

In order to anticipate the inflationary pressures and to maintain the inflation within the planned limits, on January 27, 2011 the Council of Administration of the National Bank of Moldova decided to increase the ratio of required reserves consisting of attracted funds in MDL, soft currencies, and freely convertible currencies by 3.0 percentage points, setting it in the amount of 11.0 percent starting with the tracking period of attracted funds 8 February - 7 March 2011.

Medium-term inflation forecasting

The world economy is continuing the process of recovery. Macroeconomic indicators published during this period show the development of manufacturing and construction sector, thus confirming a positive beginning of the year for the world economy. On the other hand, some macroeconomic indicators draw attention to the sustainability and pace of global economic recovery. Also, the disasters from Japan have determined the macroeconomic indicators to deteriorate, through the unprecedented damage and enhanced nuclear risk. Although the international analysts do not talk about a new recession for the world economy, it is mentioned that some risks have reacently intensified.

The beginning of 2011 was characterized by rapid and significant increase in food and oil prices, which caused disruptions to economic activities with intensive energy consumption and has led to pressure on consumer's budgets. Food prices increases and oil prices fluctuations represent a threat to the global pace of development and the most negative effects will be felt in emerging economies, which have been the engine of the global economic recovery.

Unemployment problem remains acute in 2011, which determined most developed economies to implement measures to enhance the labor market, which should contribute to economic growth of countries, even if the global economic conditions remain to be unstable.

During the forecast period, the real output gap will be in the negative range, showing disinflationary effects. The likelihood of inflationary pressures from an aggregate demand is low. Although the level of real interest rates will challenging contribute to the economic activity, however, the real effective exchange rate will eclipse the effect of the latter, so that the overall monetary conditions will help in the sense to diminish the inflationary pressures.

The NBM projections show an annual inflation rate of 8.4 and 5.7 percent at the end of 2011 and 2012 respectively. Reviewing the inflation forecast, in terms of increasing it, is mainly due to higher oil prices on international markets. This will be directly reflected in domestic prices by increasing the prices of imported energy (oil, natural gas), but also indirectly by increasing the production costs. Also, the depreciation of U.S. dollar against the euro will increase prices of imported products, whose share is significant in the CPI basket.

Chapter 1

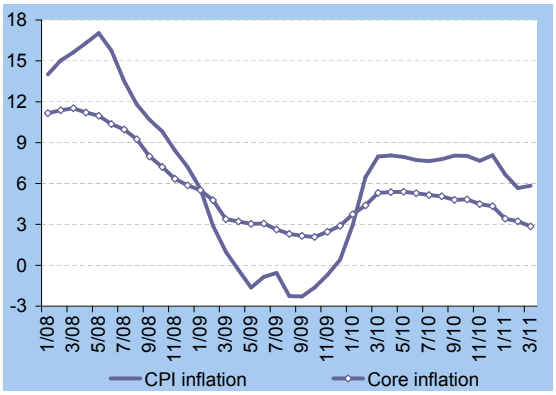
Inflation developments

In the first quarter 2011, the annual rate of inflation measured by CPI recorded a downward trend constituting 5.8 percent in March 2011, which is consistent with the short-term inflation projection published in the Inflation Report no. 1, February 2011. At the same time, the annual rate of inflation during the reporting period falls within the mid-single digit interval that is the medium-term objective of inflation stipulated in the Monetary Policy Strategy for 2010-2012. The annual rate of core inflation recorded a much lower value (2.8 percent) compared to the CPI, the difference revealing further the significant contribution of non-monetary factors to price increases in Moldova. The regulated prices have contributed the most to the annual inflation rate formation in March 2011, as a result of price increases in tariffs for services with regulated prices made in May 2010 and February 2011. At the same time, the food prices had also a major contribution, as a result of fluctuations of food prices in the world market, as well as a result of increase in transportation costs. Fluctuations in oil prices on the world market, enhanced by the tensions in North Africa and the Middle East, have led to increased fuel prices, which have contributed by 1.1 percentage points to the annual inflation formation. The annual rate of industrial producer price index had a downward trajectory for more than a year, constituting 4.9 percent in March 2011. As a result of positive developments in the field of construction, the construction prices in the first quarter of 2011 increased by 7.3 percent compared with the same period last year.

1.1 Consumer Price Index

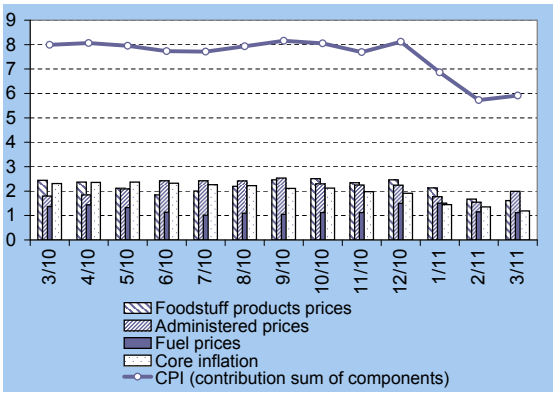
The annual rate of inflation measured by CPI registered a downward trend in the first quarter of 2011 decreasing by 8.1 percent in March 2011, after a relatively stable evolution during the second half of 2010, when the values fluctuated around 7.9 percent (Chart 1.1). Within the components structure in March 2011, the highest increase compared to March 2010

Chart 1.1: The annual rate of CPI and core inflation, %



Source: NBS

Chart 1.2: The evolution of annual inflation and subcomponents contribution, %



Source: NBS

(8.4 percent) was recorded for services, followed by food and non-food products prices (by 4.8 percent each).

Thus, in the first quarter of 2011, the CPI annual rate falls within the mid-single digit interval in 2011, which constitutes the medium-term objective of inflation stipulated in the Monetary Policy Strategy for 2010-2012. At the same time, the short-term inflation forecast published in the Inflation Report no. 1, February 2011 has been achieved, the actual value at the end of the first quarter of 2011 being only by 0.1 percentage points lower than the projected one (5.9 percent), constituting a slight deviation in terms of increased uncertainty, as a result of the existing pressures on the world oil market, and of the current increases in tariffs of regulated services.

The annual rate of core inflation[2] has experienced a downward trend in the reference period. Thus, it declined from 4.4 percent in December 2010 to 2.8 percent in March 2011, which resulted in a difference of 3.0 percentage points of the pace of CPI and core inflation for March 2011. Thus, the inflationary process in Moldova, like in the previous periods, is greatly affected by non-monetary factors. In this respect, impressive contributions have had the regulated prices, prices for fuel and foodstuff prices, which evolution has been influenced by factors such as prices of certain goods on world markets, climatic conditions, the central authorities' decisions, etc., factors that can not be controlled or predicted by the monetary policy actions of the National Bank of Moldova.

The regulated prices had contributed the most to the annual inflation rate formation (2.0 percentage points) in March 2011, as a result of increases in tariffs for services with regulated prices (gas and heating) made in May 2010 and February 2011. At the same time, the food prices had a major contribution (1.5 percentage points), as a result of food prices fluctuations in world market, as well as the increases in transportation costs. Fluctuations in oil prices on the world market, enhanced by the tensions in North Africa and the Middle East, have led to increased fuel prices, which have contributed by 1.1 percentage points to the annual inflation formation. The increase in core inflation has contributed by 1.2 percentage points to the formation of CPI inflation (Chart 1.2).

[2]Decomposition of CPI inflation in these components is made based on the internal methodology of the NBM. Components of CPI inflation are: (1) core inflation (2) food prices (3) regulated prices (4) fuel prices.

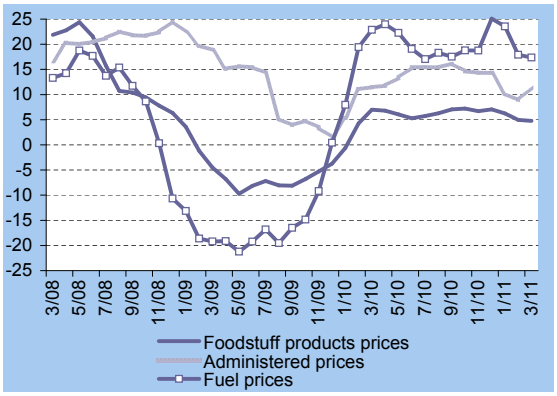
Core inflation index

For the forth consecutive quarter, the annual core inflation rate[3] continued its downward trend, recording in March 2011 the level of 2.8 percent as compared the levels recorded in January and February of 3.4 percent and 3.2 percent respectively (Chart 1.1).

These increases were fueled by second-round effects from increases in fuel prices, which increased transport costs, by increased demand for building materials as a result of construction sector revival and by increases in food prices, which have created favorable conditions for increases in catering. The inflationary pressures have been also mitigated by the appreciation of Moldovan leu against the U.S. dollar, Euro and Russian ruble during the first quarter of 2011 compared to the same period of the last year.

The following subcomponents had the most significant positive contributions to the annual increase in core inflation: "building materials", "catering", "clothing" and "footwear", which were mitigated by the significant negative contributions of "medications" during the first quarter of 2011. These contributions have been also influenced by the change in the weights of the subcomponents of core inflation, thus intensifying the negative contribution from the "medications", as a result of the increase in the weight from 11.4 to 12.7 percent. However, the positive contribution from catering increased after the weight change from 5.5 to 6.0 percent.

Chart 1.3: The annual rate of inflation subcomponents, %



Source: NBS

Food prices

In the first quarter of 2011, the annual growth rate of food prices declined from 7.1 percent in December 2010 to 4.8 percent in March 2011, as a result of lower growth in the first quarter of 2011, as compared to the same period of the previous year.

The increase in annual terms of food prices in March was mainly determined by the price increase to "vegetable oil", "milk and dairy products", "milling and bakery products" and "sugar" by 36.8, 10.6, 7.6 and 7.4 percent respectively compared to March 2010. The vegetable oil price increased because of the increase of raw material prices at the end of 2010, as the harvest in the Black Sea region was smaller. The increase in fuel prices that

[3]Index calculated by the method of exclusion (there were excluded food, fuel, products and services with administered prices), based on the CPI calculated by the National Bureau of Statistics of the Republic of Moldova.

directly affected the transportation costs has been an important factor that has contributed to the prices increase of "milk and dairy products". It has been also observed and increase in the purchase prices for raw materials. It should be mentioned that the pressures of fuel price and world wheat price have determined the increase in domestic price of "milling products".

Despite the fact that the sugar production increased by 2.5 times in 2010, the price for "sugar" was affected by the gap between domestic prices and those of Ukraine. Besides internal factors, the food prices increases was driven by the increases in global food prices, which have increased by 36.5 percent in March 2011 compared with the same period of the last year.

At the same time, the "potatoes", "eggs", and "vegetables" contributed negatively on food inflation rates, which fell by 14.7, 13.2 and 10.7 percent respectively. Lower prices in "potatoes" and "vegetables" were due to better weather conditions that have favored the storage and selling at a lower price compared to the first quarter of 2010, while the reduction of "eggs" price was influenced by the considerable increase in supply.

Regulated prices

In the first quarter of 2011, the annual rate of regulated prices had a lower trajectory compared to the end of the previous year, which outlines the idea that the increases in prices from the beginning of the previous year were more significant than the increases in the current year, largely due to the approval of new electricity tariff in January 2010, while this year the electricity tariff has been changed in April. Thus, the annual rate of regulated prices constituted 11.4 percent in March 2011 versus 14.3 percent recorded in December 2010. The increases in prices for regulated services in March 2011, compared to the previous year, was mainly caused by increases in tariffs for gas and heating supply made in May 2010 and February 2011, decisions reasoned by increases in import price of natural gas, which have stimulated further price increases for related services.

In this regard, the natural gas price has increased by over 13.0 percent in May 2010 and the heating supply price – by more than 15.0 percent. At the beginning of this year, the price for natural gas increased by about 14.2 percent while the tariff for heating supply increased by about 12.4 percent for residents of Chisinau city, while increases in other cities were even more pronounced. These increases have caused increases in utilities services by 14.3 percent in March 2011 as compared with same

period last year. Prices for passenger transport services rose by 3.6 percent, mainly due to higher prices in international rail transport.

Fuel prices

In the first quarter of 2011, the annual growth in fuel prices had a downward trend, decreasing from 25.1 percent in December 2010 to 17.4 percent in March 2011 as compared to the same period of the last year. This evolution was due mainly to higher excise duties on petroleum products in early 2010, fuel prices have increased more compared to the beginning of this year. The increases in fuel prices in March 2011, as compared to the same period last year, have been driven by increased import prices of derivative products as a result of higher world oil prices following the global economic recovery, but also as a result of recent tensions in Africa North and Middle East.

Thus, the Urals oil price reached in March weekly values of USD 110.0 per barrel, while the average value of the first quarter of 2011 (USD 101.3 per barrel) was by 35.1 percent higher than the same period of the last year. As a result, the domestic operators have increased the prices of gasoline, diesel and liquefied gas. At the same time, the price of fuel has been boosted by increased coal prices this winter, as a result of reduced supply in the region. The appreciation trend of the national currency against the U.S. dollar had a moderating effect on growth in fuel prices.

1.2 Comparing forecasts of the Inflation Report no.1, February 2011 with the inflation developments in the first quarter of 2011

The CPI developments in the first quarter of 2011 show the achievement of short-term inflation forecasts set out in the Inflation Report no. 1, February 2011. In the Inflation Report no. 1, 2011 was forecasted an inflation value of 3.4 percent for the first quarter of 2011 and taking into account that during this period was recorded a cumulative increase of 3.3 percent; the deviation from the actual forecast was 0.1 percentage points, or 3.0 percent of forecast. (Table 1.1).

Table 1.1: Evolution and forecast of CPI and its components

	De facto Mar. 2011 /Dec. 2010	Forecasted (IR) Mar. 2011 /Dec. 2010
CPI	**3.3**	**3.4**
Core inflation	0.7	1.9
Foodstuff products	4.7	4
Regulated prices	6.6	6.4
Fuel	4	3.1

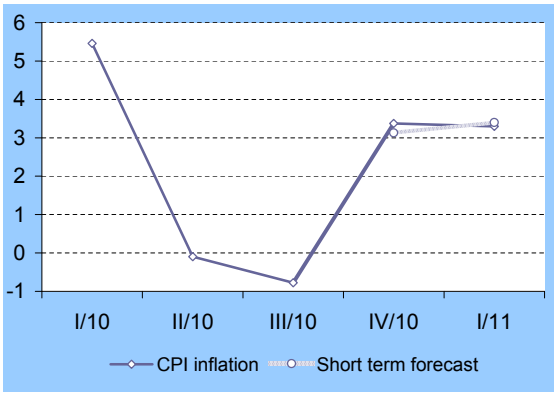
Source: NBM

Although the forecast for total inflation had a high degree of accuracy, within the projections for the subcomponents, have

been recorded certain irregularities, which were offset, however, so that the short-term forecast was not compromised. The most significant irregularity was registered in the core inflation (- 1.3 percentage points). This is largely due to the significant reduction in the price of medications from January 2011, as a result of the of new regulations, which could not have been anticipated by the econometric procedures used to estimate this component, but also as a result of the increase in the weight of this component in the core inflation from 11.0 to 13.0 percent.

Another reason for the recorded deviation was a possible overestimation, but also the late second-round effects from increases in tariffs for services with regulated prices which were adopted in February and had impact on the prices of goods and services in core inflation. The tense situation in North Africa and the Middle East has generated pressures on world oil prices, which caused a higher increase than expected in domestic fuel prices (by 0.9 percentage points). Positive deviations of a smaller magnitude were recorded in food prices (0.7 percentage points) and regulated prices (0.2 percentage points), but taking into account the high volatility of the premiums, but also ad-hoc nature of the latter, they should not cause concern. Overall, the assumptions about internal and external inflationary pressures stipulated in the Inflation Report no.1, 2011 proved out and the actual CPI inflation deviation from the expected value was insignificant.

Chart 1.4: CPI inflation (cumulative) and short-term forecast for switching to inflation targeting regime, %



Source: NBS

The evolution of CPI inflation and short-term inflation forecast is presented in Chart 1.4. Thus, it should be mentioned the lack of significant deviation between the actual and forecast value for the last two rounds of forecasting (forth quarter, 2010 and first quarter, 2011), indicating the effectiveness of processes and techniques applied in the short-term inflation forecast. At the same time, the deviations were both positive and negative, which outlines the lack of tendency of short-term forecasting process.

1.3 Industrial production price index

Starting with February 2010, the annual rate of industrial production price index recorded a downward trend, constituting 4.9 percent in March 2011. Within the structure, the largest increase was recorded in the prices of the energy industry, which is by 7.4 percent higher compared with March 2010, while prices in manufacturing and mining have registered similar growth rates in annual terms (5.2 and 4.4 percent respectively).

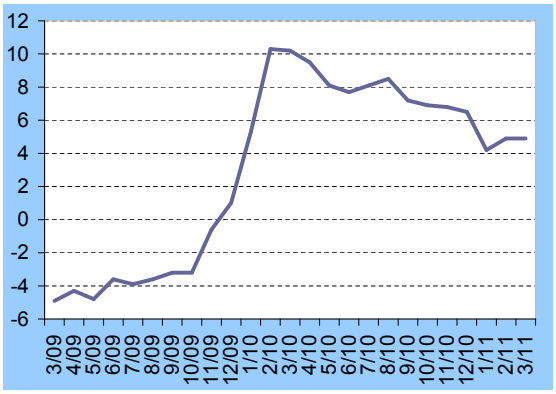
Prices increase in annual terms of industrial production was determined by higher prices for raw materials and food products in international markets, which reached a world record, and the exchange rate of MDL against the currencies of the major trading partners of Moldova.

1.4 Construction prices

In the first quarter of 2011, the annual growth rate in construction prices recorded the value of 7.3 percent compared to the same period of the previous year. It should be mentioned that in the last two quarters the annual growth rate has increased significantly, as a result of revival in the construction sector.

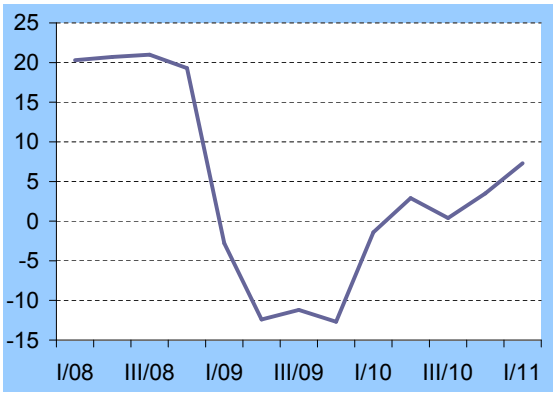
Within the structure of the national economy sectors, the largest price increases in the first quarter of 2011, as compared to the first quarter of 2010, were recorded in transport (by 14.7 percent), telecommunications (9.4 percent), dwelling building (by 8.9 percent), and electricity (by 7.0 percent).

Chart 1.5: The annual rate of IPPI, %



Source: NBS

Chart 1.6: Evolution of construction price index (%, compared to the same period last year)



Source: NBS

Chapter 2

Economic developments

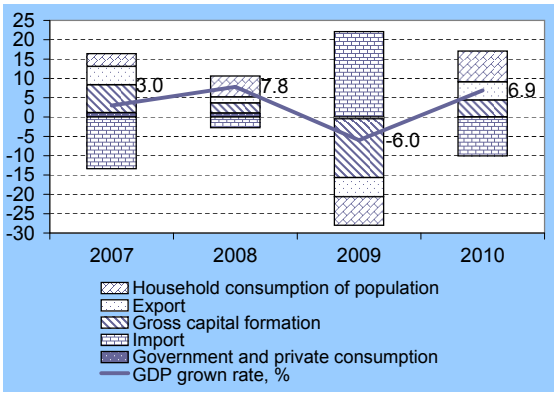
2.1 Demand and supply

According to the preliminary data of the National Bureau of Statistics, the gross domestic product increased by 6.9 percent in real terms in 2010 and tacking into account that in 2009 it decreased by 6.0 percent, it should be mentioned that Moldova's economy reached the level before the economic crisis. Domestic demand was the key factor in GDP growth, following the restoration of expectations on the development of the national economy, but also the increase in funding sources. By categories of resources, the emergence from the economic crisis has been driven by positive developments in all sectors.

Data on foreign trade, industrial and agricultural production, transport of goods for the first months of this year outlines the prerequisites for registering a significant increase in GDP in the first quarter of 2011. Thus, from the beginning of the year, the exports increased by 56.3 percent, while the import of goods - by 42.4 percent versus January - February 2010.

However, in January 2010 the industrial output on all forms of property has increased in real terms by 9.8 percent while in January – March 2011 the enterprises of railway, vehicular transport, inland water transport and air transport by 62.0 percent versus the same period of 2010. Also, in the first quarter of 2011, the agricultural output rose by 8.3 percent compared to the same period last year, being influenced mainly by the upward trend of the livestock sector.

Chart 2.1: Contribution of demand components to GDP growth, percentage points



Source: NBS, NBM calculus

Demand

In terms of uses (Chart 2.1), the domestic demand was the determining factor in GDP growth. Thus, following the restoration of expectations on the development of national economy, but also the increase of funding sources, the household consumption

rose by 9.0 percent in 2010, constituting the largest positive contribution to GDP growth. Similar cases have determined the gross capital formation by 18.7 percent, constituting a significant contribution to the evolution of GDP. Within the structure, it mainly increased due to gross fixed capital formation growth by 17.2 percent, because although it experienced a significant increase (81.0 percent), the contribution of component "variation in inventory" has been less significant. Final consumption expenditure of general government recorded a modest increase (0.3 percent) and thus did not cause significant changes in GDP growth. Stimulated by the economic recovery of Moldova's main trading partners, the exports have increased by 12.8 percent. However, the export growth was surpassed by that of imports that increased by 13.7 percent compared with 2009, as a result of increases in domestic demand. Therefore, the imports decreased a considerable part of the positive contribution of the aforementioned components. Thus, a significant part of domestic demand is oriented towards goods from outside, as a result of a lower competitiveness of domestic products, which constitutes a major impediment to the economic recovery in Moldova.

Household consumer demand The increase in domestic demand constituted the main determining factor of the economic growth during 2010. Thus, household final consumption growth was 9.0 percent as compared to 2009, due to the increase of its funding sources, and to restoration of people's expectations regarding the development of national economy. This increase contributed significantly to GDP growth.

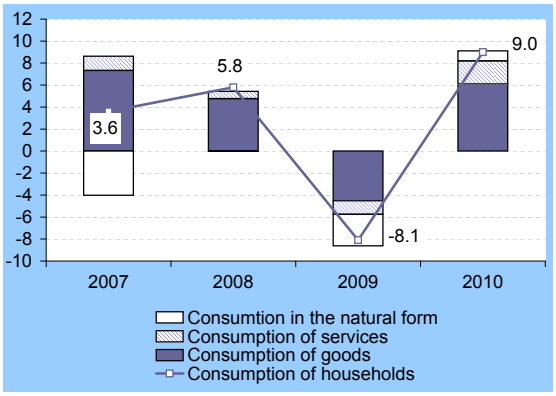
The increase of 10.7 percent in expenditure related to the procurement of goods for final consumption had the largest contribution to the household consumer growth in 2010.

This development is mainly due to the increase in non-foodstuff retail sales, which with a share of 68.1 percent in total sales rose by 11.2 percent in 2010 as compared to the previous year. However, spending on procurement of services recorded an increase in real terms of 7.6 percent, but their influence on final consumption growth was more modest. At the same time, the final consumption growth was determined by the increase of final consumption of goods and services in kind by 6.0 percent as compared to 2009. This development was mainly due to gross agricultural output growth in households. It rose by 7.9 percent in 2010 compared to 2009.

Household consumption growth was driven largely by the increase in main financing sources[4] (Chart 2.3).

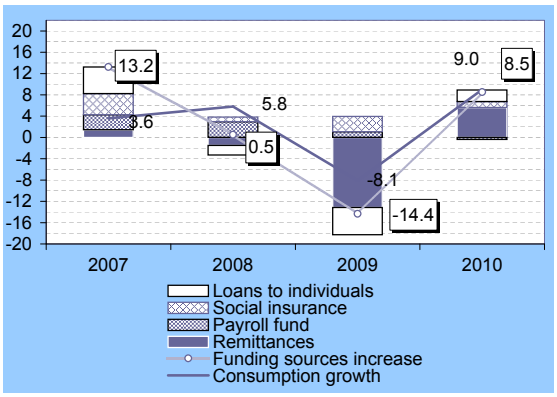
[4]Main funding sources are approximated by the sum of the payroll, social transfers, and transfers in the form of remittances from workers abroad.

Chart 2.2: Contribution of final consumption of households (percentage points)



Source: NBS, NBM calculus

Chart 2.3: Contribution of sources of funding to the growth of real household consumption (percentage points)



Source: NBS, NBM calculus

Thus, in 2010, the household consumption had a positive trend, recording a 8.5 increase in real terms[5] versus the same period of 2009, mainly due to the increase of remittances by 72.6 percent. At the same time, the increase of 72.6 percent of new loans granted to households held a significant positive contribution to the growth. Social insurance payments volume grew by 5.8 percent, but its contribution to the evolution of consumption funding resources in the reference period was insignificant. The main source of funding remains to be the total labor cost (wage bill) during the analyzing period, with a 41.4 percent share of total funding sources. It recorded a decrease of only 0.9 percent in real terms, generating a slight negative contribution to the dynamics of funding sources.

Government consumption

Final consumption of general government recorded a modest increase (0.3 percent) and thus the GDP dynamics has been not modified significantly.

Public sector

According to the data of the Ministry of Finance, during January-February 2011, the national public budget revenues have been accrued in the amount of 3743.3 million lei, representing an increase of 13.2 percent compared with the same period last year. Tax revenues continue to hold the major share (87.0 percent) in budget revenues, the main sources of income remain to be the taxes on domestic goods and services, which registered a 14.3 percent increase compared to the same period of the previous year, benefit obligations, which registered a lower value as compared to the same period of 2010 by 13.3 percent, and income taxes, which registered a 1.5 percent increase compared with January-February 2010. As a result of changes in these indicators, tax revenues have registered a higher value than during the previous year by 12.8 percent.

At the expense of the national public budget in January-February 2011 have been recorded expenditures totaling 4168.2 million lei, which represents 5.5 percent more compared to the same period last year. The increase in expenditures was caused mainly by increased spending on insurance and social assistance (by 6.4 percent) and education (by 3.1 percent).

National budget execution has resulted in a deficit of 424.9 million lei, which represents 66.0 percent of the value recorded during the previous year.

For the deficit financing was mainly used funds from the sale of converted SS (1358.3 million lei), income from the sale of

[5]In 2000 year prices

SS, which constituted 78.8 percent of the value recorded during the previous year, representing 890.8 million lei, loans granted by international financial organizations, which have remained about the same level compared to the period January - March 2010, reaching the level of 83.3 million lei.

State debt

On March 31, 2011 debt structure of the Republic of Moldova was established at a rate of 27.9 percent of the domestic state debt and 72.1 percent of the external state debt. Domestic state debt was reduced compared with the situation at the beginning of the year with 77.7 million lei and constituted 5227.2 million lei. Changes in the domestic state debt occurred at the expense of raising the issue of SS through auctions by 22.3 million lei and the SS redemption placed by subscription in the amount of 100.0 million lei. The balance of external debt amounted to 13540.8 million lei, the equivalent of USD 1137.0 million and decreased by about USD 25.0 million compared with the balance at January 1, 2011, due mainly to repayments of external loans that have exceeded the actual inflows of foreign loans.

Investment demand

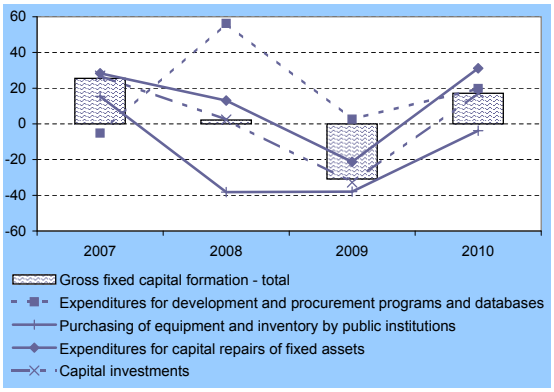
In 2010, the gross capital formation increased in real terms by 17.2 percent compared with the previous year. The positive growth rate of gross fixed capital formation shows that the process of investment is recovering and the investors' optimistic expectations about the future development of the country's economic situation is restoring. Positive contributions to the growth of gross capital formation had both components: "changes in inventories" increased by 81.0 percent, but, taking into account the large share (95.9 percent) of gross fixed capital formation, its increase of 17.2 percent had the most influence. The increase in gross fixed capital formation was determined by increases in the "capital investment", "expenditure for the development and acquisition of programs and databases" and "expenditure for capital repairs of fixed assets". At the same time, the "purchase of equipment and inventory by budget institutions" and "other[6]",component have reduced but their contribution to the evolution of gross capital formation was insignificant (Chart 2.4).

Net external demand

In 2010, the exports of goods and services increased in real terms by 12.8 percent, compared with the same period of 2009,

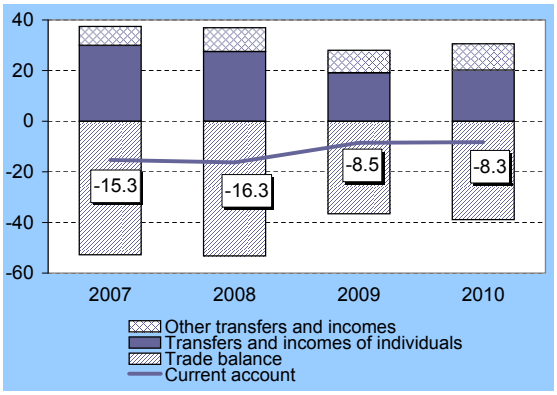
[6]The components sum of "fixed capital value growth in cattle", "stocks variation for unmounted equipment", "purchase of books for libraries", "expenses for geological prospecting" and "acquisition of literary and artistic original books".

Chart 2.4: . Gross fixed capital formation (% versus the same period of the previous year)



Source: NBS, NBM calculus

Chart 2.5: Current account share in GDP, %



Source: NBM

thus generating a significant contribution to GDP growth, and the imports of goods and services - by 13.7 percent, signaling the growth of domestic demand and increased competition for domestic products.

External sector

The year of 2010 was manifested by increasing development, not just the country's macroeconomic indicators, but also the balance of payments components.

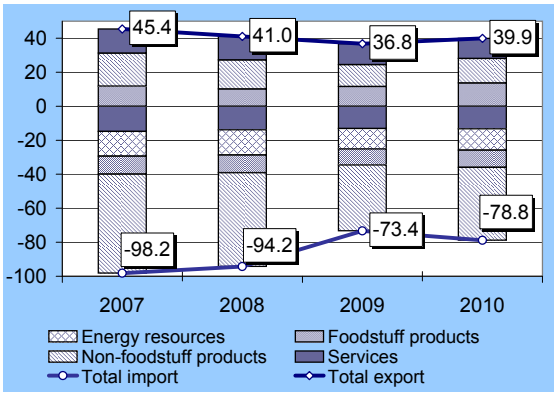
In 2010, all basic components of the current account[7] reported increases. Thus, the average current account deficit to GDP was 8.3 percent, below the level recorded in 2009, by about 2.0 times less compared to 2008, the year before the economic crisis (16.3 percent).

The balance trade deficit in goods and services, whose share in GDP was 38.9 percent for the reference period (Chart 2.5), had a decisive influence on the current account balance, being offset by increased volume and revenue transfers individuals (by 5.3 percent compared with 2009) and other transfers (17.5 percent compared with 2009).

Looking at imports and exports growth, it is observed the same increasing trend of these indicators (Chart 2.6). The year of 2010 was characterized by the growth rate of exports in GDP to about 39.9 percent, up by 3.1 percentage points as compared to 2009. Revival in external demand took place in all subcomponents: foodstuff products and non-foodstuff products. The share of foodstuff products increased the most by 18.3 percent in 2010 compared to the previous year. Imports have recorded a 78.8 percent share of GDP in 2010, increasing by 5.4 percentage points compared with 2009, the share increase has been determined by the non-foodstuff products share including: *machinery and appliances, chemical products, mineral products, base metals and articles thereof, etc*. In 2010, imports of energy has increased, whose share in GDP was 12.6 percent.

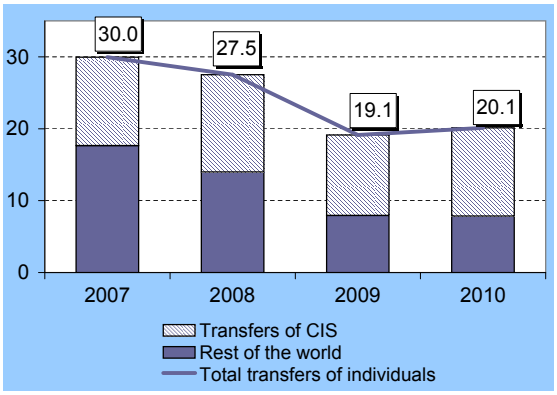
The share of individuals' transfers was 20.1 percent in GDP, increasing by 1.0 percentage points as compared to 2009 (Chart 2.7). Compared with the pre-crisis years, the transfers have substantially declined amid the financial crisis and the difficulties faced by the country where the immigrants work, due to fiscal austerity programs that have been implemented in European

Chart 2.6: The share of exports and imports in GDP, %



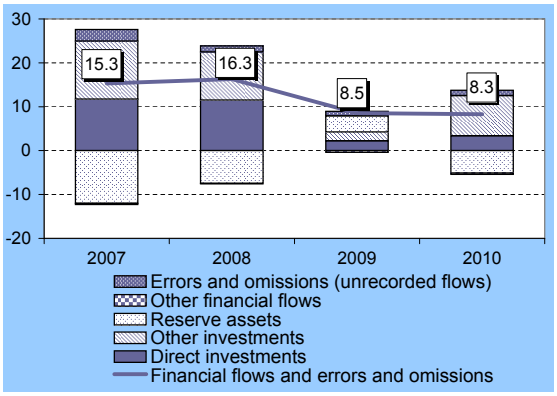
Source: NBM

Chart 2.7: Share of transfers in GDP, %



Source: NBM

Chart 2.8: Share in GDP of the movement of financial flows, %



Source: NBM

[7] Standard terminology according to IMF methodology was not used for the analysis of the current account. Total transfers of individuals include the compensation for labor and employee transfers (current account items), the remaining items, except those included in the Trade balance, are grouped in the category Other transfers and other income.

countries such as Spain, Greece Italy, Portugal, Ireland, etc. The transfers received from the CIS countries have a share in GDP of 12.3 percent; the remaining funds were transferred from other countries, with a share of 7.8 percent of GDP. Another important component of the balance of payments is the financial and capital accounts that reflect the financial flows (Chart 2.8), whose share constituted 8.3 percent in 2010. The needs of the national economy have caused increased external financing in the form of loans and commercial loans offered to local economic agents by the partners from abroad. With significant shares in GDP were observed: other investment by 9.2 percent, reserve assets by 5.1 percent and foreign direct investment by 3.4 percent.

During the analyzed period, the direct investment flows increased by 1.2 percentage points as compared to 2009. The direct investment flows were mainly directed in the share capital of the enterprises and have constituted 2.6 percent in GDP in the total of 3.4 percent of direct investment (Chart 2.9), the majority of investments directed in share capital come from EU countries. The stock of direct investments in GDP constituted 45.9 percent at the end of 2010, by 10.5 percentage points more than in 2008 (before the economic crisis).

During 2010, in the total financial flows, the component "other investment" holds the largest share in GDP - 9.2 percent, increasing significantly as compared to 2009 (Chart 2.10). The net loans with a share of 4.7 percent had the largest contribution in GDP, and the commercial net loans recorded a share of 2.6 percent. The volume of commercial net loans remained almost at the level of 2009.

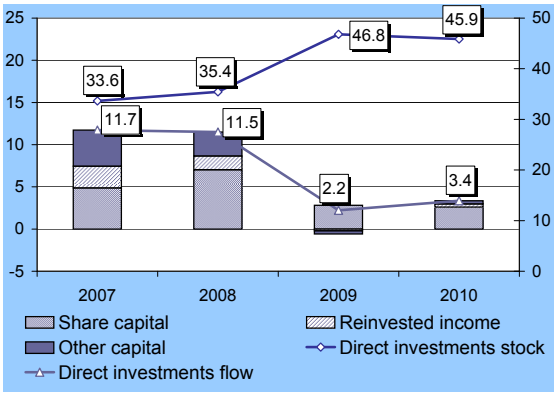
The loans were distributed by sector as follows: the government sector share - 2.9 percent, monetary authorities - 0.9 percent, and the banking sector and other sectors – by 0.5 percent (Chart 2.11). The lending stock constituted 36.6 percent in GDP, being almost at the level of 2009.

Foreign trade

The upward trend of exports has accelerated in the first two months of 2011, so that in January 2011 the exports of domestic products recorded the highest level over the past two years. In February the export growth rate slowed down, increasing by 49.5 percent, versus the level of 59.2 percent recorded in January as compared to the respective months of the last year.

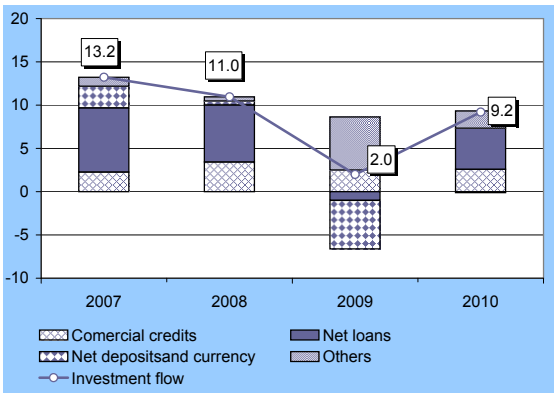
The more pronounced upward trend, started in 2010, shows considerable recovery in external demand against domestic products. Since the beginning of the year, the exports increased

Chart 2.9: Direct investment share in GDP, %



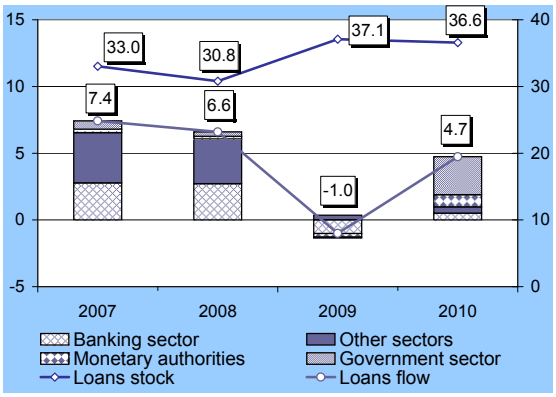
Source: NBM

Chart 2.10: Share of other net investments in GDP, %



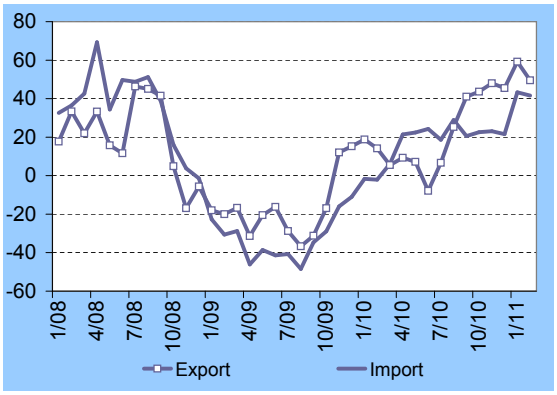
Source: NBM

Chart 2.11: The share of loans in GDP, %



Source: NBM

Chart 2.12: Developments in real terms of trade in goods and services (% versus the same period of the last year)



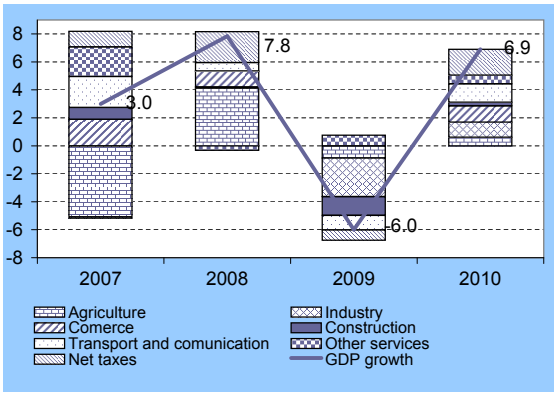
Source: NBS

by 56.3 percent compared to January-February 2010, due to significant growth in exports oriented towards the Russian Federation and Romania, the share of these countries having the largest in total exports. However, by groups of countries, the European Union countries have the most significant share (about 51.9 percent), exports in this area increased by 54.1 percent, while those oriented towards CIS countries increased by 41.8 percent compared with January-February 2010.

Within the structure of commodity groups, significant increases were recorded in "inedible raw materials, except fuels", "foodstuff and livestock", "miscellaneous manufactured articles", "machinery and transport equipment" which amounted to values by 4.7, 46.6, 35.6 and 39.8 percent respectively higher than in January-February 2010. At the same time, the demand for "beverages and tobacco" and "chemicals and derivatives unspecified elsewhere" decreased by 3.8 percent and 31.2 percent respectively during January-February 2011 versus the same period last year.

However, a similar situation occurred in imports of foreign products, recording in January 2011 the highest level over the last two years (43.3 percent), and in February the volume of imports increased by 41.6 percent as compared with February 2010, which once again emphasizes the recovery of domestic demand. Since the beginning of the year, the imports of goods increased by 42.4 percent versus January-February 2010 due to the considerable increase of imports from the Russian Federation, Ukraine and Romania, these countries holding the largest share in total imports. Within the structure of commodity groups, the most significant increases were recorded for "manufactured goods, classified mainly by raw material", "machinery and transport equipment", and "mineral fuels, lubricants and derived materials", which increased by 63.3, 48.7 and 43.8 percent respectively as compared to January-February 2010.

Chart 2.13: Economic sectors contribution to GDP growth, (percentage points)



Source: NBS, NBM calculus

Supply

By categories of resources (Chart 2.13) the entrance of the economy in the recovery phase is confirmed by positive developments in all sectors. The increase of net taxes on products by 11.6 percent had most significant contribution in the GDP growth. The gross value added growth increased by 6.1 percent in 2010, as a result of increases in "goods" and "services" components by 7.8 and 6.2 percent respectively, as compared to 2009.

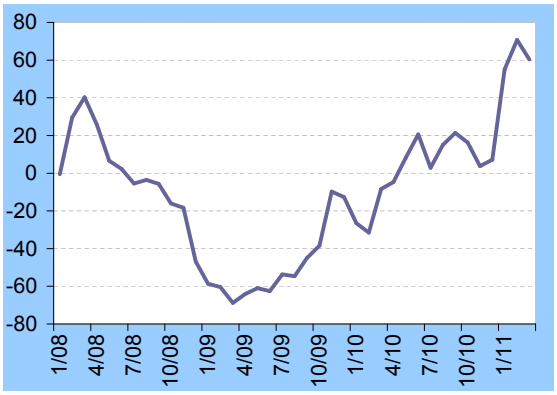
After several periods of negative development in 2010, it was recorded a significant positive contribution from industry, which

grew by 8.1 percent. This component was most affected by the crisis and has not yet reached the level of 2008. Agriculture grew by 7.2 percent compared with 2009. Construction sector, after severe decline in 2009 and with an increase of just 7.3 percent in 2010, is another sector that has not yet reached the level before the economic crisis. The most significant positive contributions to GDP in the reference period are generated by the development of trade, transport and communications which have increased by 8.9 and 11.0 percent respectively compared with 2009.

Goods transport

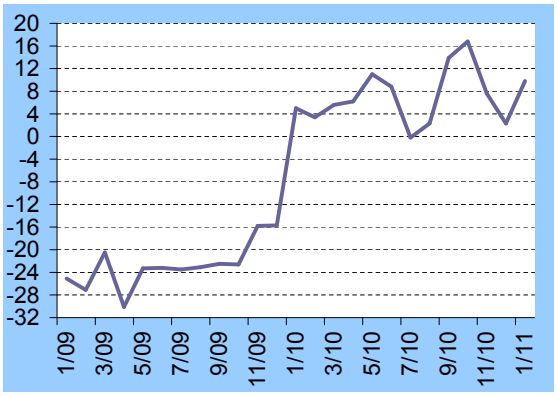
According to the National Bureau of Statistics data, the annual growth rate of the transported goods increased significantly at the beginning of 2011, recording in March 60.3 percent. It should be mentioned that this significant increase has been also influenced by the sharp decline of the analyzed indicator in March 2010, following the global crisis. The increase of the volume of transported goods was determined mainly by its growth in rail transport enterprises - by 74.3 percent, vehicular transport - by 46.6 percent and air transport - by 22.7 percent. At the same time, during January-March 2011 the rail transport enterprises, inland water transport and air transport have transported goods by 62.0 percent more than during the previous year.

Chart 2.14: The volume of transported goods (%, versus the same period of the previous year)



Source: NBS

Chart 2.15: Evolution of industrial production in real terms (%, versus the same period of the previous year)



Source: NBS

Industrial production

In January 2011, according to the National Bureau of Statistics, the industrial production volume in all forms of property has increased in real terms by 9.8 percent compared to the same period last year, so that it recorded acceleration in annual growth rate of industrial production volume in January 2011 compared with December 2010 by 7.5 percentage points. However, taking into account the severe decline in 2009, the industry has not yet reached the level before the economic crisis.

The increase of industrial production volume, compared with January 2010, was determined by the increase in extractive industry by 3.9 times and the manufacturing production by 19.4 percent. At the same time, the energy sector recorded a decline of 5.8 percent. The increase in manufacturing output was due to increased industrial production in the following activities: “metallurgy” – by 3.2 times, “machinery and equipment manufacturing” – by 1.9 times, “production of medical equipment and instruments, of measuring and optical instruments – by 1.8 times”, “leather articles and footwear” – by 1.7 times, “chemical industry” – by 44.7 percent, “machinery and appliances manufacturing” – by 41.7 percent; “rubber and plastic items production” – by 34.1 percent.

However, in the reference period, compared with the same period of 2010, there were reductions in volume production of the following components: "manufacture of grain mill, vegetable and animal fats, tobacco articles and textiles" – by 29.9, 16.3, 11.0 and 7.9 percent respectively.

Agricultural production

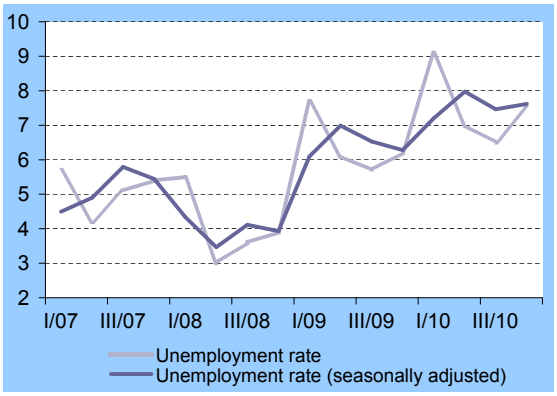
World agricultural production, in all categories of households, increased by 8.3 percent during January-March 2011, as compared to the same period last year. This development was mainly determined by the growth in livestock production by 8.4 percent.

In the first quarter of 2011, the state livestock sector has been driven by positive growth trends of cattle and poultry production with 15.3 percent, which was influenced in particular by increased production of cattle, pigs and poultry by 13.9, 25.5 and 5.3 percent, respectively. Also, during January-March 2011, the production of eggs and milk decreased by 2.0 and 5.4 percent respectively compared to the previous year.

2.2 Labour market

The unemployment rate in the forth quarter of 2010 constituted 7.5 percent, increasing by 1.3 percentage points, as compared to the previous year, indicating deterioration in the labor market situation in Moldova, despite positive signals regarding the economic recovery in 2010. In January-December 2010, the average wage of a worker in the national economy increased by 8.2 percent compared to the same period last year. During the analyzed period, both in the budgetary sphere and in the real sector of the economy was registered an average salary increase of 6.0 and 9.1 percent respectively, compared to January-December 2010.

Chart 2.16: Evolution of unemployment rate, %



Source: NBS, NBM calculus

Workforce

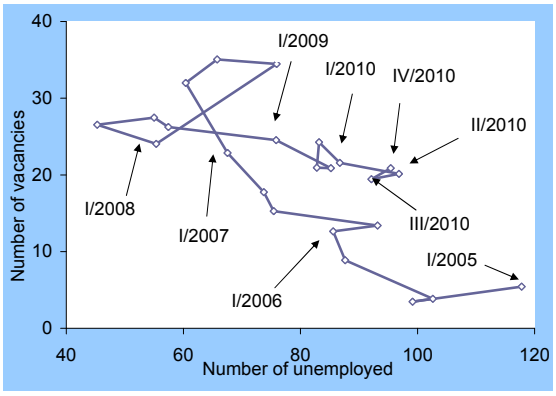
In the fourth quarter of 2010, the indicators provided by the NBS showed deterioration in the labor market situation in Moldova compared to the forth quarter of 2009. Thus, the economically active population declined by 3.7 percent versus the same period last year. At the same time, the number of people employed in this period declined by 5.1 percent versus the forth quarter of 2009, which resulted in decrease of population employed in agriculture, industry and construction.

Within the structure of the active population, the employment share was 92.5 percent, decreasing by 1.3 percentage points compared with the forth quarter of 2009, which contributed to the increase of unemployment rate at the country level up to 7.5 percent. In forth quarter of 2010, seasonally adjusted data remain almost at the level recorded in the third quarter of 2010, constituting 7.6 percent. This situation shows a labor market delay of the process of creating new jobs in Moldova's economy, despite the positive signals of economic recovery.

The information contained in the Beveridge curve shows an increase in unemployment rate of 3.3 thousands persons in the forth quarter of 2010 as compared to the third quarter 2010. At the same time, the number of vacancies increased by 1.4 thousands vacancies, which shows a modest increase in working places in the Republic of Moldova and at the same time, unemployed reluctance to accept the available positions because of low salaries.

By the distribution on the activities of the national economy, the largest concentration of population employed is registered in agriculture. Its share was 22.3 percent in the forth quarter of 2010, dropping by 1.4 percentage points compared with the same period last year. The share of employed in "public administration, education, health and social care" and "commerce" have increased compared with the forth quarter of 2009, recording values of 24.4 and 20.3 percent respectively. The share of employed in "construction" and "industry" sectors has decreased by 5.3 and 13.3 percent, respectively, as compared to the previous year. The "transport and communication" sector has the lowest concentration of employment in the forth quarter of 2010, representing a share of 5.9 percent.

Chart 2.17: Beveridge Curve (seasonally adjusted, thousands)



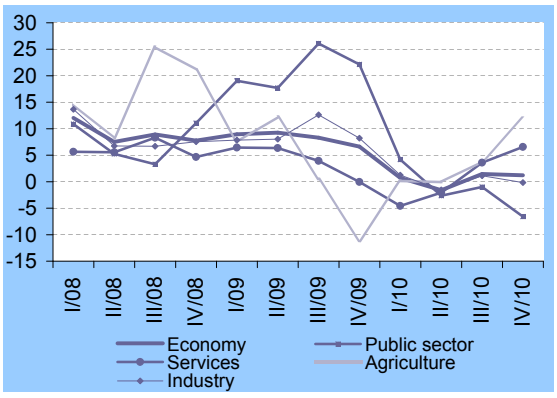
Source: NBS, NBM calculus

Wages

According to the National Bureau of Statistics, in January-December 2010, the average wage of a worker in the national economy increased by 8.2 percent compared to the same period last year, the real wages constituting 2972.2 million lei. In the analyzed period, both in the budgetary sphere and the real sector of the economy has registered an average salary increase of 6.0 and 9.1 percent respectively compared to January-December 2009.

The annual growth rate of the real average salary in the economy constituted 1.2 percent in the forth quarter of 2010 (by 0.2 percentage points less than in the previous quarter and by 5.4 percentage points less than in the forth quarter of 2009), amid

Chart 2.18: Real average wage (%, versus the same period last year)



Source: NBS, NBM calculus

the reduction of public sector wages by about 6.6 percent in annual terms (Chart 2.18). The largest decline was recorded in the public sector in December 2010 (-16.4 percent), as determined by the recalculations of teachers salaries included in December 2009, based on increases in line with the amendments of the Law no. 83 of 3 December 2009.

The annual growth rate of real average wages in the agricultural sector recorded in the fourth quarter of 2010 about 12.0 percent, accelerating by 23.2 percentage points compared to the same period of 2009, which explained the increase in agricultural production in 2010.

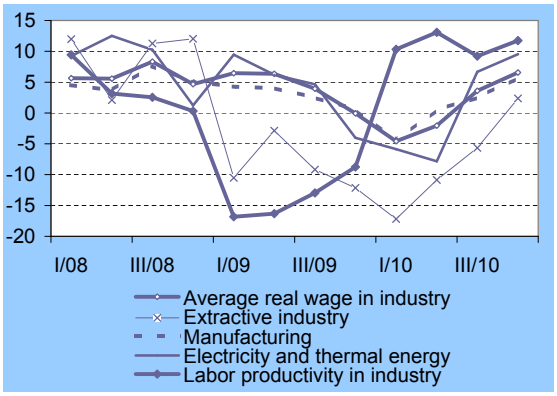
The annual average real wage growth in the industry continued to grow starting with the first quarter of 2010. the forth quarter of 2010 was marked by an increase of 6.6 percent, accelerating by 3.0 percentage points versus the previous quarter and by 11.1 percentage points versus the first quarter of 2010.

During October - December 2010, the labor productivity growth has accelerated to an annual basis compared to the third quarter of 2010 (by 2.5 percentage points), largely due to the recovery in industry.

The annual growth rate of real average wages in the mining industry turned upward since the first quarter of 2010, back on positive track in the fourth quarter of 2010.

Thus, the annual growth rate of wages was 2.4 percent (about 8.0 percentage points more than the previous quarter), which correlated with increased production in the mining industry: extraction of sand, gravel and clay. The energy industry has experienced a wage increase of 2.9 percentage points in the fourth quarter of 2010 compared to the previous one, contributing to the increase in electricity production.

Chart 2.19: Real average wage in industry, % versus the same period last year



Source: NBS, NBM calculus

Chapter 3

Monetary Policy

3.1 Monetary Policy Instruments

During the first quarter of 2011, the monetary policy pursued by the NBM was aimed to lead the inflation within the target range of NBM forecast.

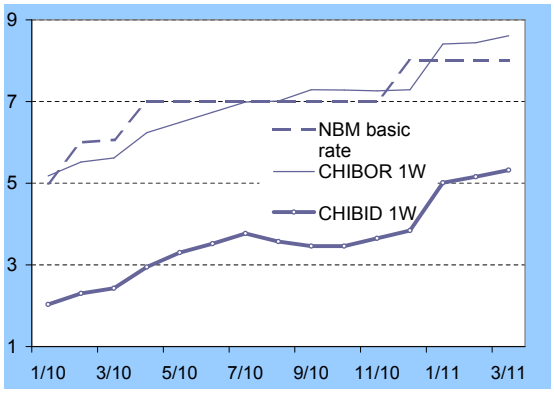
Interest rate policy

NBM, through its decisions taken during the three meetings of the Council of Administration carried out in the first quarter of 2011, kept the interest rates on monetary regulation instruments established at the end of fourth quarter of 2010 (8.0 percent - the base rate, 11.0 and 5.0 percent, respectively - the interest rates on credit and deposit facility).

CHIBOR interbank reference rate of two weeks (2W) increased immediately after the modifications carried out in the base rate of the NBM at the end of December 2010 and further noted slightly higher base rate of the NBM, registering 8.51 percent annually at the end of the first quarter of 2011.

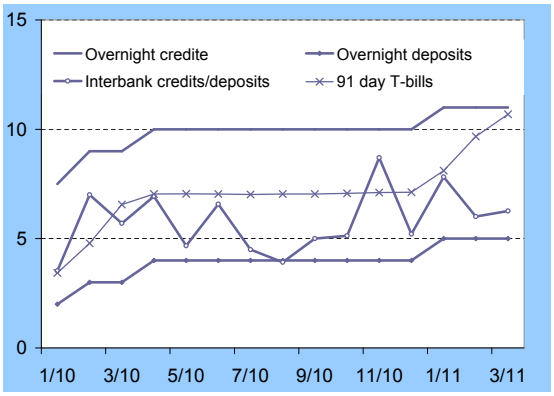
A similar trend, but to a greater extent, recorded the yields on state securities (SS) of 91 days, being on an upward slope throughout the quarter. Average monthly yields on state securities (SS) of 91 days grew from 8.11 percent annually, registered in January, up to 10.69 percent annually in March 2011, almost reaching the upper limit of the interest rates corridor set by the NBM. At the same time, the average interest rates on credits / deposits interbank market had a downward trend and remained at a level below the base rate of the NBM.

Chart 3.1: Average monthly reference rate in the interbank market and the base rate of the NBM,%



Source: BNM

Chart 3.2: Monthly evolution of interest rate corridor,%



Source: BNM

Open Market Operations

NBM Certificates-selling operations

During the first quarter of 2011, the excess liquidity in the banking system remained high and was drained exclusively by selling NBM certificates. The operations were carried out according to the schedule published on the official website of the NBM, two weekly auctions.

During the first quarter of 2011, the issued NBC had a maturity of 14 days, with some exceptions caused by holidays.

NBM carried out 25 auctions with the announcement of the maximum interest rate equivalent to the NBM base rate, which constituted 7.0 percent annually in the first week of the first quarter and 8.0 percent annually throughout the first quarter of 2011. The participants' requests were fully accepted.

Following that, the interest rates asked in the requests were equal to the maximum rate announced at the auctions, the NBC were sold to an interest rate equivalent to the NBM base rate. Throughout the first quarter of 2011, the weighted average rate on sterilization operations amounted to 7.89 percent annually.

Consistency of super liquidity sterilization by the NBM has determined the maintenance of NBC daily balance at a high level throughout the quarter, which represented mainly, values over 3000.0 million lei. Quarterly average balance of sterilizations constituted 3778.7 million lei, by 384.0 million lei over the level recorded in the fourth quarter of 2010.

Lending activity

Under the conditions of credit agreements between the National Bank of Moldova and the licensed banks, concluded in 2009 and 2010 (according to which banks were opened credit lines to credit the economic agents from the real sector of economy), in the first quarter of 2010, the National Bank of Moldova has granted loans to banks in the amount of 6.9 million lei.

The amount of reimbursed loans during the reference period constituted 136.6 million lei, including the loans granted to banks for crediting the real sector of economy - 70.1 million lei, to protect the integrity of the banking system – 65.5 million lei and to credit the construction of housing cooperatives - 1.0 million lei.

Thus, on March 31, 2011, the licensed banks creditor debt to the National Bank of Moldova amounted to 846.7 million lei, being represented by the loans for crediting the real sector of economy – 387.3 million lei, to protect the integrity of the banking system – 442.4 million lei, and to credit the construction of housing cooperatives - 17.0 million lei.

On March 31, 2011, compared with the end of the previous quarter, the balance of loans granted to banks decreased by 129.7 million lei, or about 13.3 percent.

In the reporting quarter, within the pledge structure, which assures the credit debt and relating interests of the banks to the NBM, no changes have occurred. On March 31, 2011, the pledge was represented of state securities, required reserves in Moldovan lei and required reserves in freely convertible currency held by banks at the NBM.

Standing Facilities

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

In the first quarter of 2011, the average daily balance of overnight deposits constituted 374.6 million lei, increasing by 94.0 million lei, or by 33.5 percent compared to the forth quarter of 2010.

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

Required Reserves

In the first quarter of 2011, the required reserves mechanism continued to exercise the monetary control and to manage the liquidity in the banking system.

During the reference quarter, in required reserves were made two important changes, regarding the increase of tracking periods of attracted funds and maintenance of required reserves and the increase of required reserves ratio.

In order to counter the inflationary pressures and keep inflation within the planned limits, on January 27, 2011 the Council of Administration of the National Bank of Moldova decided to increase the ratio of required reserves consisting of attracted funds in MDL, soft currencies, and freely convertible currencies by 3.0 percentage points, setting it in the amount of 11.0 percent

starting with the tracking period of attracted funds 8 February - 7 March 2011.

In January 2011, according to the Decision of the Council of Administration of the NBM no. 227 of 18 October 2010, the licensed banks have switched to a monthly tracking period of attracted funds and maintenance of required reserves. Extending the maintenance of required reserves for the period of a month will help to improve the operational framework of the National Bank of Moldova, to distribute more efficiently the liquidity within the banking system, to reduce the fluctuations in interest rates on the interbank money market, especially towards the end of required reserves maintenance period.

Required reserves maintained by banks in MDL. The amount of required reserves maintained by banks in MDL, according to the attracted means tracking period of February 8 – March 7, 2011, maintained by banks during March 8, 2010 to April 7, 2011, constituted 1835.2 million lei, increasing by 540.3 million lei, or by 41.7 percent compared to the tracking period of December 6 – 20, 2010, maintained by banks during December 21, 2010 - January 5, 2011.

Required reserves maintained by banks in FCC. The amount of required reserves maintained by banks in U.S. dollars and Euros on March 31, 2011 constituted USD 62.1 million and EUR 74.2 million respectively, increasing by USD 17.6 million (39.6 percent) and EUR 22.4 million (43.2 percent) compared to December 31, 2010.

The increase of required reserves both in MDL and FCC has been determined by the positive development of funds attracted in those currencies.

The positive evolution of required reserves has been determined by both the increase in required reserves ratio (by 3.0 percentage points) and the increase in attracted funds by banks.

Interbank Market for Loans/Deposits

In the first quarter of 2011, the total volume of transactions in interbank market amounted to 280.5 million lei, increasing by 61.2 million lei or by 1.3 times compared to the forth quarter of 2010.

Interbank loans/deposits operations hold the most transactions in the interbank market in the first quarter of 2011, about 98.5 percent. Their volume amounted to 276.2 million lei, increasing by 74.5 million lei, or by 36.9 percent compared with the forth quarter of 2010. The average interest rate on

interbank transactions in the reference quarter decreased from 7.70 to 6.43 percent annually, being by 1.27 percentage points less than that recorded in the previous quarter.

The transactions with a minimum market maturity have dominated in the analyzed period, the share of these transactions representing 85.5 percent of total turnover. The average term of interbank transactions has seen a relative decrease, from 23 to 8 days, compared to the previous quarter.

Intervention on the Domestic Foreign Exchange Market

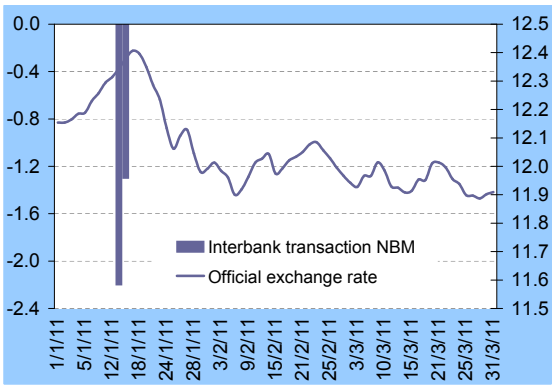
National Bank of Moldova has intervened on the domestic foreign exchange market during January – March 2011 as a seller of foreign currency with insignificant amounts.

During the analyzed period, the volume of transactions of the National Bank of Moldova carried out on the domestic foreign exchange market constituted the equivalent of USD 3.5 million – sales of USD.

During the reporting period, the NBM has carried out swap operations in the amount of USD 0.8 million.

It should be mentioned that, in the first quarter of 2011, the transactions (net sales) in foreign currency against MDL, carried out by the NBM on the interbank market, accounted for USD 35.30 million.

Chart 3.3: Evolution of the official foreign exchange rate (MDL/USD) and the daily volume of NBM transactions (million, USD)



Source: NBM

3.2 Dynamics of monetary indicators

Monetary indicators increased in the first quarter of 2011 with a lower annual rate compared to the third and forth quarter of 2010, decreasing significantly towards the end of March, which is reflecting the positive impact of monetary policy pursued during 2009-2010.

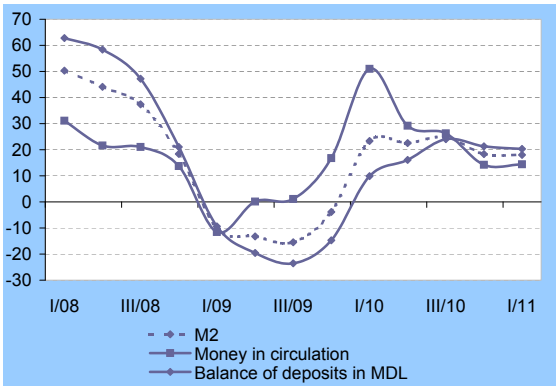
Money supply

Towards the end of March 2011, the money supply M2 in MDL rose by 18.0 percent compared to the same period of 2010. In annual terms, the growth rate of this indicator recorded a reduction compared to December 2010. However, despite the reduction in January of M2 aggregate components, in February 2011 was recorded a relative growth of these. Thus, the deposits

in MDL have increased by 20.3 percent and money in circulation - by 14.4 percent at the end of the first quarter of 2011.

During January - March 2011, the money supply M2 grew by 0.9 percent, by 6.7 percentage points below the level of M2 aggregate growth in the previous quarter, when it was recorded a growth of 7.6 percent. This growth is due to the increase in the balance of deposits in MDL by 4.1 percent versus December 2010, being offset by the decrease of money in circulation by 3.7 percent.

Chart 3.4: Evolution of the components of M2 monetary aggregate (annual increase, %)



Source: NBM

The money supply M2 structure reflects insignificant changes, the share decline being characteristic for money in circulation by 1.9 percentage points – up to 38.9 percent, in favor of deposits in MDL - 61.1 percent. The revival of the economic activity and of the lending process has determined the increase of money multiplication in the economy, and respectively, the increase of deposits in national currency, directly contributing to the increase of M2 monetary aggregate in this period.

Towards the end of the first quarter of 2011, the share of sight deposits in the total of deposits in national currency constituted 36.2 percent, decreasing by 2.1 percentage points compared to the previous quarter. Within the structure of deposits in MDL, the sight deposits decreased by 1.7 percent as a result of the decrease of 3.3 percent of deposits of legal entities, being partially offset by the increase of 3.1 percent of individuals' deposits. The term deposits have increased by 7.7 percent following the positive development of individuals' deposits - by 9.3 percent and the insignificant decrease of legal entities deposits - by 0.2 percent compared to the forth quarter of 2010.

The dynamics of money supply M3 in annual values was characterized by the growth of this indicator during January-February by 13.1 and 15.1 percent, respectively, values below the increase recorded in the last 12 months. However, money supply M3 has increased the growth pace in March to 15.4 percent. It should be mentioned that money supply M3 development during the first quarter of 2011 has been largely affected by the positive dynamic of deposits in MDL and in foreign currency.

During the first quarter of 2011***money supply (M3)***[8] increased by 1.7 percent compared to the forth quarter of 2010, below the increases recorded in the third and forth quarters of 2010. It should be mentioned that in the first quarter of 2010, the M3 monetary aggregate recorded a decrease of 0.1 percent. The evolution of M3 monetary aggregate was determined by the upward dynamics of all components: money in circulation,

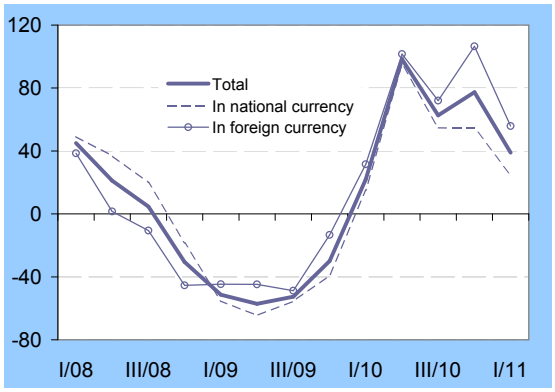
[8]Money supply M3 includes money supply M2 and deposits in foreign currency of residents expressed in U.S. dollars

deposits in MDL, deposits in foreign currency. The components of M3 monetary aggregate recorded a different dynamic: money in circulation decreased by 3.7 percent in the first quarter of 2011, while the deposits in MDL and foreign currency increased by 4.1 and 3.3 percent respectively. At the same time, the share of deposits in foreign currency in total deposits decreased from 45.6 percent at the end of the forth quarter of 2010 to 45.4 percent at the end of the first quarter of 2011. The reduction of share of deposits in foreign currency in total deposits was recorded throughout 2010 and in the first quarter of 2011 and represents a positive signal for improving the monetary policy transmission mechanism.

Credit market

At the beginning of 2011, the development of new granted loans recorded a more moderate annual growth compared to the end of the previous year, being by 38.9 percent above the level recorded in the first quarter of 2010 and recorded the amount of 6000.6 million lei (Chart 3.5).

Chart 3.5: Evolution of new credits (annual increase, %)



Source: NBM

The increase of this indicator was characteristic both for the component in national currency and foreign currency.

Thus, the volume of new loans granted in foreign currency rose against the first quarter of 2010 by 55.8 percent, reaching the level of 3072.5 million lei. The development of loans in foreign currency was mainly due to the increase of 55.3 percent of loans granted to legal entities to finance the foreign trade operations. In turn, new loans granted to households recorded a spectacular growth rate, noting a 2.3 times increase compared to the first quarter of 2010.

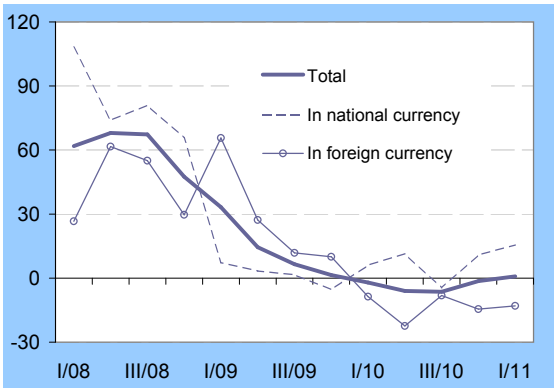
The new loans granted in national currency had a more modest trend, registering an annual growth rate of 24.7 percent, reaching the level of 2928.1 million lei. The volume reduction can be seen in both client categories, as compared to the end of 2010, but increasing as compared to the same period of the last year. Thus, the new loans granted to households grew by 37.1 percent and those granted to legal entities by 22.4 percent. In terms of maturity structure of loans in national currency, the new loans with the maturity over 12 months held the major share.

Deposits market

The annual growth rate of new attracted deposits has reversed its trend, after throughout 2010 was placed on a negative level.

Thus, in the first quarter of 2011, the deposits recorded an insignificant increase of 0.8 percent as compared to the same period last year, reaching the level of 9173.7 million lei (Chart 3.6).

Chart 3.6: Quarterly evolution of new attracted deposits (annual increase, %)



Source: NBM

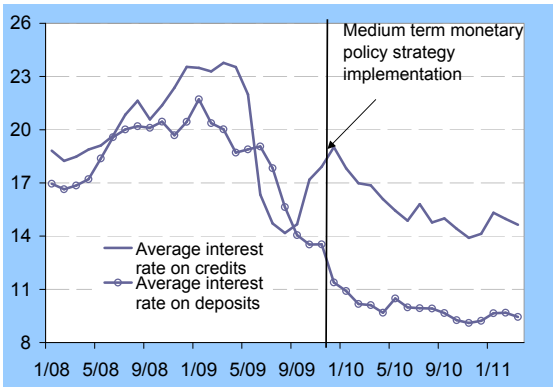
The aforementioned growth occurred exclusively at the expense of increased growth rate of the component in national currency (by 15.6 percent compared with the first quarter of 2010, up to the level of 5090.9 million lei), which occurred on the account of positive developments of term deposits in national currency of the legal entities.

The term deposits in foreign currency reduced by 13.0 percent compared to the first quarter of 2010, up to the level of 4082.8 million lei for both client catgories. The modest development of new term deposits was largely determined by people's reluctance to place deposits under a fragile global economic recovery. However, people's low income and lower interest on deposits as a result of liquidity excess in the market, were the main factors that have discouraged the banking investment.

Interest rates and monetary policy transmission mechanism

According to the provisions of the Monetary Policy Strategy of the National Bank of Moldova for 2010-2012, to ensure transparency of the decision-making process, during 2010, there were quarterly published Monetary Policy Reports containing an analysis of the macroeconomic situation, a medium term forecast of inflation and the main macroeconomic indicators.

Chart 3.7: The average interest rate on new attracted term deposits and on new deposits granted from 6 to 12 months in MDL, %



Source: NBM

In order to assess the monetary policy, starting with 2011, the National Bank of Moldova will quarterly publish the Inflation Report, which will be a continuation of the Monetary Policy Report. This document will contain a more detailed analysis of achieving the fundamental stated objective, risks analysis for further achievement of the fundamental objective and in the case the inflation rate and inflation forecast are above the established limits, the National Bank of Moldova will submit a corrective action plan to bring inflation back to the target range.

At the same time, there are monthly meetings of the Council of Administration of the NBM, where it is evaluated the current macroeconomic situation, trends and medium term forecasts of macroeconomic indicators. In addition, the inflation outlook on short and medium term is considered in terms of possible uncertainties and challenges that may arise in the future. The monetary policy pursued by the NBM in the first quarter of

2011 was aimed to lead the inflation within the target range of NBM forecast. Following the increases carried out at the end of the previous quarter, the Council of Administration of the NBM, decided to maintain the base rate at the level of 8.0 percent throughout the first quarter of 2011. This was done in order to maintain appropriate monetary conditions to ensure price stability and sustain the upward evolution of the national economy. Also, NBM continued to firmly manage the liquidity excess through sterilization operations on the monetary market. Under these conditions, the evolution of interest rate on loans and deposits attracted in MDL with terms from 6 to 12 months recorded a slight increase in the reported quarter, due mainly to the increases in loans in January 2011 and due to the increases in deposits in January and February (Chart 3.7).

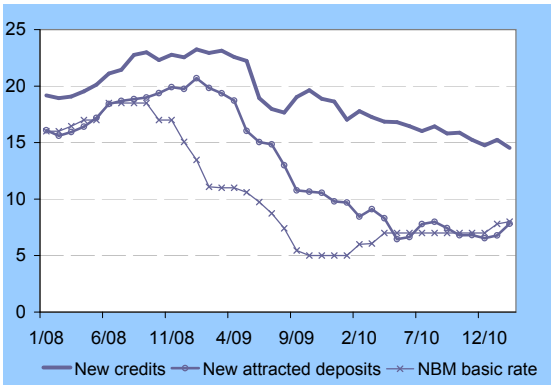
Quarterly values of the interest rates on term deposits in MDL increased by 0.71 percentage points and accounted for 7.42 percent compared to the forth quarter of 2010. Quarterly average yield on loans granted in national currency stood at the level of 14.71 percent, by 0.54 percentage points less than the previous quarter (Chart 3.8).

The banking margin (the difference between the average rates on loans and deposits), as a result of the decrease in average interest rates on loans and of the increase in average rates on deposit, both in national and foreign currency operations, was placed during the reporting quarter at a lower level (Chart 3.9). Thus, the margin on operations in national currency registered a reduction of 1.25 percentage points compared to the previous quarter, down by 7.29 percentage points. However, margin evolution on operations in foreign currency recorded a more modest decline of 0.35 percentage points, up to the level of 5.79 percentage points.

Thus, it can be seen the downward trend of interest margins in the conditions a relative stabilization of the economic situation, which partly contributed to cheaper new granted loans.

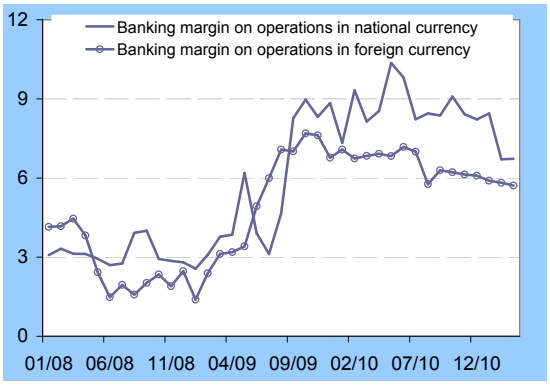
However, based on the national economy trends, the level of liquidity and increased demand for money, in the second quarter of 2011, it is expected to further reduce the interest rates on new loans and to increase the interest rates on new deposits and respectively to reduce the banking margin.

Chart 3.8: Average interest rates in MDL, %



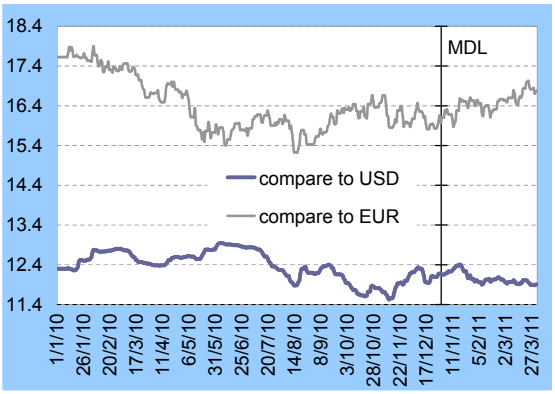
Source: NBM

Chart 3.9: Evolution of banking margin (percentage points)



Source: NBM

Chart 3.10: Fluctuations of official exchange rate of MDL against USD and EUR



Source: NBM

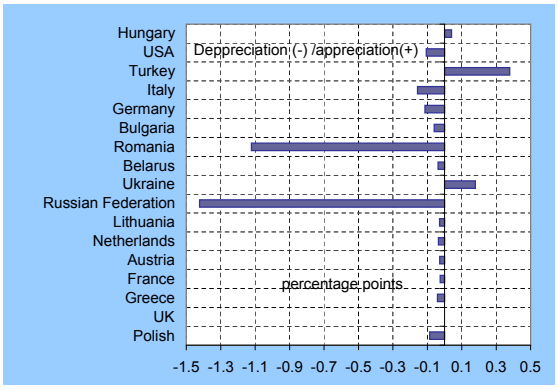
Foreign exchange market (the nominal exchange rate and real effective rate)

During the first quarter of 2011, the ***official nominal exchange rate of the national currency against the U.S. dollar*** appreciated by 2.0 percent and against the euro – depreciated by 4.2 percent (Chart 3.10).

The average official nominal exchange rate of the national currency against the U.S. dollar dollar recorded in the first quarter of 2011 depreciated by 1.3 percent, and against euro – by 1.8 percent against the average official nominal exchange rate of the national currency recorded during the previous quarter.

The real effective exchange rate of the national currency[9], calculated under the weight of the major trading partners, has depreciated by 2.7 percentage points versus the end of December 2010[10]. This depreciation was mainly determined by the significant nominal appreciation of the most foreign currencies of the countries from the region (the Romanian leu - by 10.1 percent, Russian ruble – by 6.5 percent and euro by 6.0 percent), which have considerable weight in the foreign trade of the Republic of Moldova.

Chart 3.11: Contribution of major trading partners of Moldova to the real effective modification in the first quarter of 2011

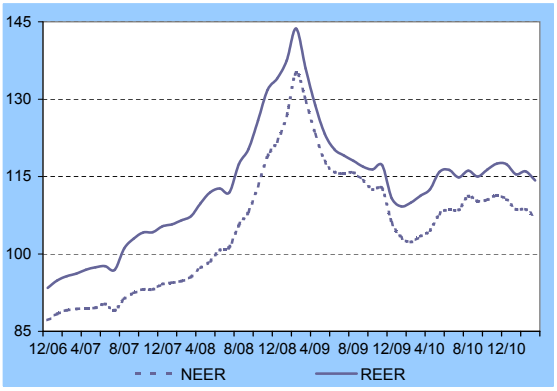


Source: NBM

Thus, almost all of Moldova's main trading partners have contributed to the real effective exchange rate depreciation, except three countries (Chart 3.11). The Russian Federation (with 1.4 percentage points) and Romania (with 1.1 percentage points) have particularly contributed to the depreciation of the domestic currency in real terms.

The fluctuation of foreign currency exchange rate during the first quarter of 2011 has reflected mainly the changes in the volume of liquidity in foreign currency on the domestic foreign exchange market following the changes related to foreign currency inflows and outflows.

Chart 3.12: Real and nominal effective exchange rate dynamics of the national currency calculated based on the share of the major trading partner (Dec. 2000-100 %)



Source: NBM

During January 2011, the ***average official nominal exchange rate of national currency against the U.S. dollar*** depreciated by 0.6 percent as compared to December 2010. Although, the net supply of foreign currency from individuals in the amount of USD 157.0 million covered considerably (by 95.7 percent) the net sales of foreign currency of licensed banks to legal entities, which constituted USD 164.0 million (Chart 3.12), the depreciation of the domestic currency in the respective month was determined by the accumulation of liquidity in foreign currency by licensed banks.

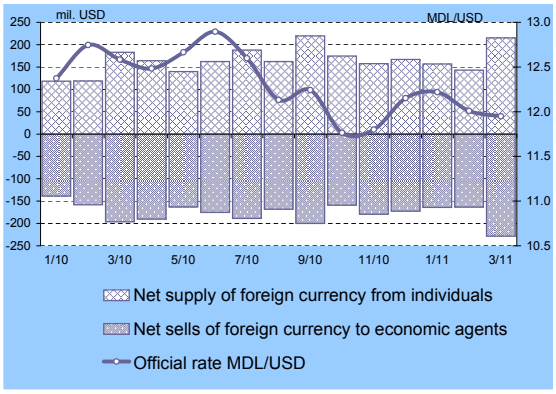
Thus, in the first half of January 2011, on the background of accumulation of foreign currency by licensed banks, in anticipation of increased demand from foreign traders, especially importers of energy resources, the ***official exchange rate of***

[9]Calculated compared to December 2000

[10]During the first quarter of 2011, for determining the real effective exchange rate of national currency, the share of main trading partners of the Republic of Moldova in foreign trade has been updated, reducing their number to 17 countries, which share in foreign trade, was more than one percentage

national currency against the U.S. dollar showed a more pronounced depreciated (by 2.1 percent) during the first quarter of 2011. During this period, the availability in foreign currency increased by U.S. $ 42.9 million versus the end of December 2010, reaching the maximum level on January 17, 2011 (USD 419.9 million) (Chart 3.13). It should be mentioned that to the increase of availability in foreign currency has also contributed the positive net flow of loans and investment in foreign currency of USD 10.7 million, registered during January 2011. During February 2011, the ***average official exchange rate of the national currency against the U.S. dollar*** appreciated by 1.7 percent. The exchange rate appreciation against the U.S. dollar took place under the conditions when the net sales of foreign currency of licensed banks to legal entities amounted to the equivalent of USD 163.5 million being covered at a rate of 87.6 percent by the net supply of foreign currency from individuals, which in February stood at the level of USD 143.2 million.

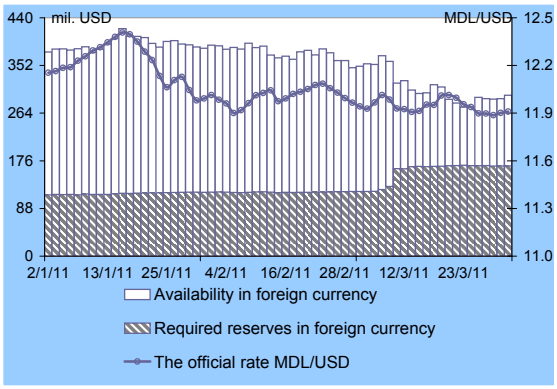
Chart 3.13: Coverage of net sales in foreign currency of legal entities by the net supply in foreign currency of individuals and the dynamics of the average official nominal exchange rate of MDL against USD



Source: NBM

The unmet demand for foreign currency of USD 20.3 million was mainly covered by the availability in foreign currency of licensed banks, which in February dropped by USD 25.2 million (from USD 386.1 million on January 31, 2011 to USD 360.9 million on February 28, 2011). However, at the end of February, the share of availability in foreign currency in total balance sheet net assets was 24.6 percent, the licensed banks having a comfortable level of liquidity.

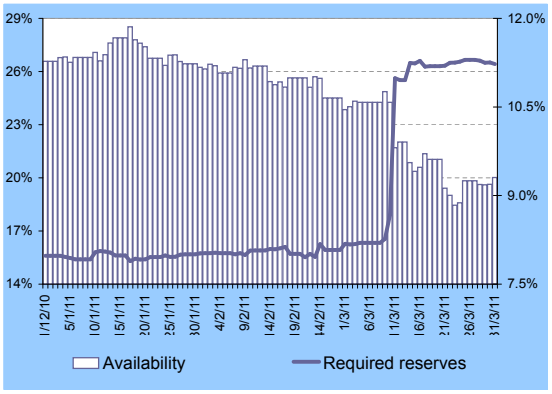
Chart 3.14: Dynamics of availability in foreign currency of minimum required reserve and of the official exchange rate of MDL against acsUSD



Source: NBM

In March 2011, there was a moderate appreciation in nominal terms of the***average official nominal rate of national currency against the U.S. dollar*** – by 0.5 percent, its volatility being in line with the lowest in the region. Although, during March is observed the upward trend of demand from legal entities, the net sales of foreign currency to legal entities accounted for USD 228.1 million, the significant increase of the supply of individuals (USD 215.3 million) created prerequisites to cover at a rate of 94.4 percent this demand. Insufficiency of liquidity in foreign currency of USD 12.8 million was mainly complemented at the expense of availability in foreign currency of the licensed banks.

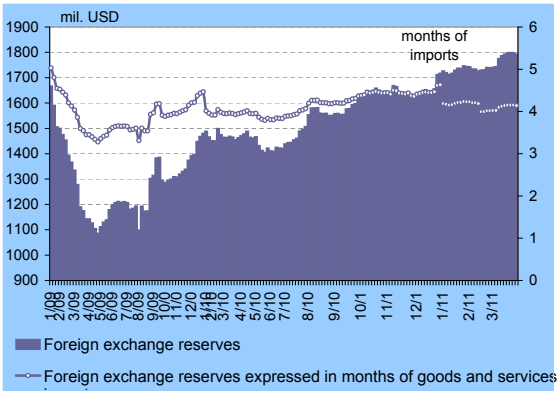
Chart 3.15: Dynamics of the availability share in foreign currency and of the minimum required reserves in total net balance sheet assets during the first quarter of 2011



Source: NBM

It should be mentioned that during March 2011, the availability in foreign currency decreased by USD 63.8 million, mostly determined by the required reserves ratio of the funds attracted in foreign currency from 8.0 to 11.0 percent. It should be mentioned that this has not led to increased demand for foreign currency from licensed banks, as they had sufficient liquidity to comply with the increase of reserves ratio (Chart 3.15). At the end of March 2011, the availability in foreign currency totaled USD 297.1 million, which share representing 20.0 percent in total net balance sheet assets in foreign currency (compared with 24.6 percent recorded at the end of February).

Chart 3.16: Evolution of foreign exchange reserves expressed in months of goods and services imports



Source: NBM

During the first quarter of 2011, the state reserves currency increased by USD 75.7 million, or by 4.4 percent, from USD 1717.7 million on December 31, 2010 to USD 1793.4 million on March 31, 2011, which covers 4.1 months of imports (Chart 3.16). The increase in reserves currency was determined mainly by the increase in required reserves ratio.

Chapter 4

Medium-term inflation forecasting

The world economy is continuing the process of recovery. Macroeconomic indicators published during this period show the development of manufacturing and construction sector, thus confirming a positive beginning of the year for the world economy. On the other hand, some macroeconomic indicators draw attention to the sustainability and pace of global economic recovery. Also, the disasters from Japan have determined the macroeconomic indicators to deteriorate, through the unprecedented damage and enhanced nuclear risk. Although the international analysts do not talk about a new recession for the world economy, it is mentioned that some risks have reacently intensified.

The beginning of 2011 was characterized by rapid and significant increase in food and oil prices, which caused disruptions to economic activities with intensive energy consumption and has led to pressure on consumer's budgets. Food prices increases and oil prices fluctuations represent a threat to the global pace of development and the most negative effects will be felt in emerging economies, which have been the engine of the global economic recovery.

Unemployment problem remains acute in 2011, which determined most developed economies to implement measures to enhance the labor market, which should contribute to economic growth of countries, even if the global economic conditions remain to be unstable.

During the forecast period, the real output gap will be in the negative range, showing disinflationary effects. The likelihood of inflationary pressures from an aggregate demand is low. Although the level of real interest rates will challenging contribute to the economic activity, however, the real effective exchange rate will eclipse the effect of the latter, so that the overall monetary conditions will help in the sense to diminish the inflationary pressures.

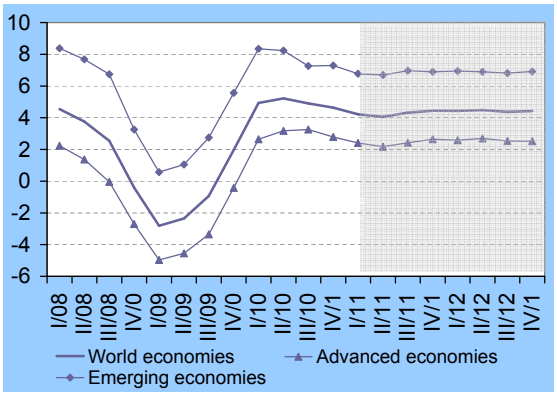
The NBM projections show an annual inflation rate of 8.4 and 5.7 percent at the end of 2011 and 2012 respectively. Reviewing

the inflation forecast, in terms of increasing it, is mainly due to higher oil prices on international markets. This will be directly reflected in domestic prices by increasing the prices of imported energy (oil, natural gas), but also indirectly by increasing the production costs. Also, the depreciation of U.S. dollar against the euro will increase prices of imported products, whose share is significant in the CPI basket.

4.1 External environment

In the first quarter of 2011, the world economy continued the economic recovery. Macroeconomic indicators published during this period show the development of manufacturing and construction sector, thus confirming a positive beginning of the year for the world economy, as compared to the last months of 2010. On the other hand, some macroeconomic indicators draw attention to the sustainability and pace of global economic recovery.

Chart 4.1: Annual growth in world economy, %



Source: IMF, World Economic Outlook – April 2011

Also, the disasters from Japan have determined the macroeconomic indicators to deteriorate, through the unprecedented damage and enhanced nuclear risk. Although the international analysts do not talk about a new recession for the world economy, it is mentioned that some risks have reacently intensified.

Governments in developed economies are concerned about the large public debt and have resorted to reducing public expenditure. In Europe these are more visible, especially in Greece, Portugal and Ireland, countries that needed financial support from the European Union and International Monetary Fund. In the USA, the Congress adopted the law that will reduce the expenses and financial incentive programs, after which is expected a large reduction in public sector staff..

As compared to April 2011, the International Monetary Fund (IMF) published that the economic growth in the global economy in 2011 and 2012 will be 4.4 and 4.5 percent respectively. For the advanced economies, the forecast has been changed, thus in 2011 in advanced economies is expected a growth of 2.5 percent, by 0.1 percentage points lower than earlier forecast, and for 2012 is expected a growth of 2.6 percent, by 0.1 points percent more. The forecasts for emerging economies remained the same, as both in 2011 and 2012 is expected a 6.5 percent economic growth.

The beginning of 2011 was characterized by rapid and significant increase in prices, which led to pressure on consumer's

budgets. The increase in world energy prices, which began at the end of last year, has caused disruption in economic activities with intensive energy consumption. The increased demand in major emerging economies such as China, India, Russian Federation and Brazil, represents another cause of long-term price growth. Food prices increases represent a threat to the global pace of development and the most negative effects will be felt in emerging economies, which have been the engine of the global economic recovery. As expected, food prices will remain at a high level for some time, reflecting a high fuel cost, and if this continues, the consumption will be affected as well.

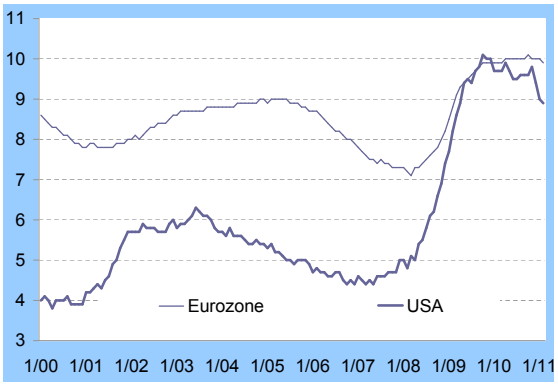
An important event that led the world economy to imbalance in the first quarter of 2011 constituted the conflicts in North Africa and the Middle East. The direct and immediate visible result of these events was the increased price of crude-oil in international markets. Every day the oil price quoted on international stock exchanges registered new records, the highest levels in the past two years. These fluctuations have had a profound impact, especially on emerging countries and in particular China and India, which are the largest consumers of oil, but also on European and American market. It is expected that, if the oil price will not drop, the impact on production costs will substantially increase.

The catastrophic earthquake in Japan blocked the country's economy and led it to a temporary recession. In addition to recording the largest losses in history caused by a natural disaster, the Japanese economy suffered from the decrease in industrial output. This has caused problems in supplying goods to foreign partners, which led to increased prices. In addition, the higher oil demand in Japan, to cover the energy deficit caused by the destruction of the Fukushima nuclear power plant, led to increased oil prices on international markets. Also, the market capitalization in March was in decline and the yen appreciation has affected the exports.

Unemployment problem remains current in 2011 as well, which determines the most developed economies to implement measures to stimulate the labor market. In the U.S.A., for instance, according to the U.S. Bureau of Labor Statistics, the unemployment rate fell to a minimum level in the last two years of 8.8 percent in March. This change in the U.S. labor market should help to increase the world's largest economy, even if the new situation is not considered to be stable enough yet. In the euro area, the labor market situation remained precarious, and the expectations on a possible recovery are not optimistic.

Although some countries like Germany, Holland, Switzerland recorded little progress, there are countries like Spain, Ireland and the Baltic countries whose situation becomes more precarious. Also, the labor market in the Russian Federation has

Chart 4.2: Unemployment rate in advanced economies, %

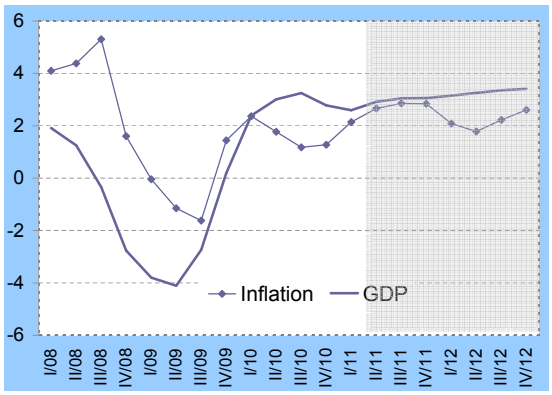


Source: Eurostat

worsened in the first months of 2011.

United States of America

Chart 4.3: The annual rate of inflation and GDP in the U.S., %



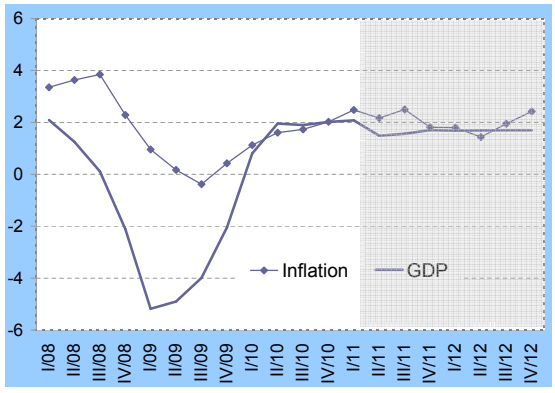
Source: Bureau of Economic Analysis. U.S. Department of Commerce,U.S. Bureau of Labor Statistics, Consensus Forecasts

In the fourth quarter of 2010, the U.S. economic growth was 2.8 percent versus the same period last year, according to the latest estimates of the U.S. Bureau of Economic Analysis. The real GDP growth reflected a sharp slowdown in imports, acceleration in consumer spending, growth in fixed capital investment and acceleration in exports, which were partially offset by negative contributions of investment and public spending.

In the first months of 2011, the U.S. economy has gradually recovered, but the growth is not fast enough to reduce high unemployment rates. At the same time, the indicators of consumption and production increased rapidly, the labour market has slowly improved. Although the unemployment rate has fallen below 9.0 percent for the first time in the last two years, a total U.S. labor market recovery is expected only four or five years later, according to the recent forecasts of the IMF. To get the full picture of the situation, it should be mentioned that the unemployment rate does not reflect the fact that many people have not found a job, but that more people have given up to look for a job and disappeared from the official statistics.

For 2011 and 2012 is forecast that the U.S.A. will register a growth of 2.9 and 3.3 percent respectively. The biggest concerns regarding the U.S. economy are public debt and budget deficit, high unemployment and low inflation. After the European Central Bank raised the interest rates, it is expected that Federal Reserve will begin to increase the interest rates so as to avoid overheating of the economy.

Chart 4.4: The annual rate of inflation and GDP in the euro area %



Source: Eurostat, Consensus Forecast

In the first quarter of 2011, the consumer prices in the U.S.A. increased on average by 2.1 percent. For 2011 and 2010 it is expected that the inflation will be 2.7 and 2.1 percent, respectively.

Euro zone

According to Eurostat, the annual economic growth recorded in the euro zone constituted 2.0 percent in the fourth quarter of 2010. Consumer spending, imports and exports have increased, while the investment in fixed capital has decreased. Moreover, the economy in the euro zone had a differentiated dynamic, with strong performance in countries that are doing better, while the countries with high debt and high budget deficits continue to face a weak economic activity and high unemployment.

The recent economic data on economic developments in the euro zone confirms that the dynamics of economic activity continues to be positive, but shows a high uncertainty. In April 2011, the European Central Bank increased its base rate from 1.0 to 1.25 percent in order to diminish the inflation. Also, it is expected two more increases this year. This move will impact the real estate market; the commercial banks in the euro zone have already raised the rates for mortgage holders. Another effect is that the too rapid increase of borrowing costs will adversely affect the economic growth of the euro zone economies facing big debts - so-called peripheral countries - Ireland, Greece, and Portugal - which need all the international bailouts. The increase in 2011 and 2012 will constitute 1.7 percent, reflecting the tightening of fiscal policy and the region's dependence on banking loans to finance the investment from the private sector.

According to Eurostat, the average inflation rate in euro zone constituted 2.5 percent in the first quarter of 2011 versus the same period of the last year, half of it being generated by fuel price increases. For 2011 and 2010 it is projected an inflation of 2.4 and 1.8 percent respectively.

Russian Federation

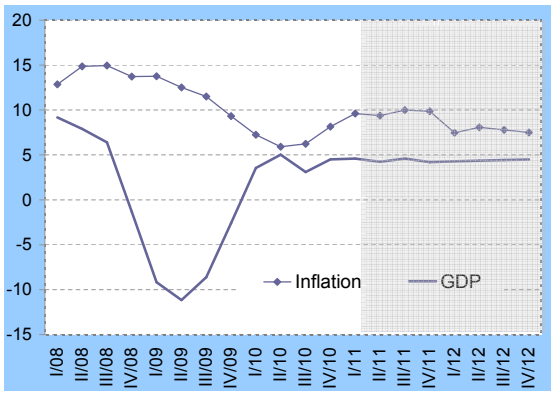
In the fourth quarter of 2010, according to the Federal State Statistics Service of Russia has registered an annual growth of 4.5 percent. This reflected primarily higher volume in manufacturing, trade, transport and telecommunications. Also, constructions increased by 6.1 percent in the fourth quarter of 2010 for the first time in the past two years. The agriculture and the financial sector have stagnated as a result of the unprecedented drought in the summer of 2010.

In the first months of 2011, the Russian Federation continued the economic recovery. Thus, the industrial production increased by 5.9 percent as compared to the same period of 2010. The growth recorded in the Russian economy is due primarily to increased oil and gas stock price, as a result of too much dependence on the export of oil, gas and other materials.

The economic growth of the Russian Federation in both 2011 and 2012 will be 4.4 percent. Russian accession to the World Trade Organization (WTO) will help to increase the investment opportunities in the Russian economy and, respectively, to strengthen the Russian ruble as a result of the increase in foreign investment flows. However, in the context of Russian ruble appreciation, the exports will be less profitable.

Consumer prices, whose rapid growth began in the summer of 2010, have contributed to an average rate of inflation of 9.6

Chart 4.5: The annual rate of inflation and GDP in the Russian Federation, %



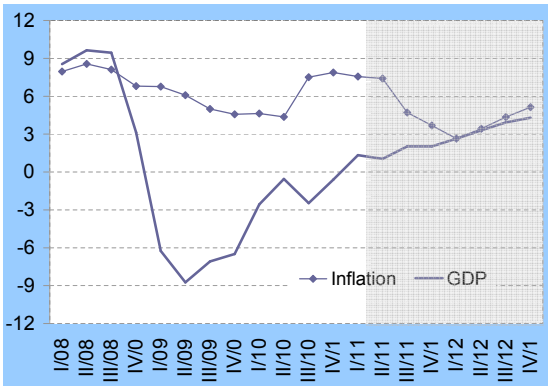
Source: Federal State Statistics Service of Russia, Consensus Forecast

percent in the first quarter of 2011 as compared to the same period last year, food having the largest contribution. In 2011 and 2012 it is expected an inflation of 9.5 and 7.9 percent respectively.

Romania

According to the National Institute of Statistics, Romania's gross domestic product declined by 0.6 percent in the fourth quarter of 2010 compared to the same period in 2009. International context, external shocks have made the Romanian economy to get back into negative range. The consumption has been further reduced and its dynamic was not able to develop the economy. Workload increases were registered in agriculture, industry and financial activities.

Chart 4.6: The annual rate of inflation and GDP in Romania, %



Source: National Institute of Statistics, Consensus Forecast

Workload increases were registered in agriculture, industry and financial activities. Constructions, trade, hotels and restaurants, transport and telecommunications and other services reduced their workload. As a result of progress made throughout the economy, the volume of taxes on products collected to the state budget and the net taxes on products decreased by 3.1 percent. Final consumption expenditure of households has decreased as a result of lower sales of goods through retail outlets. A positive effect to be emphasized is related to improving the net exports, due to higher volume of imports than that of exports. As compared to the third quarter of 2010, the gross domestic product increased slightly by 0.1 percent (seasonally adjusted) in the last quarter of the last year.

In the first quarter of this year, Romania's economy returned to growth. The economy was boosted by strong external demand, encouraging signals received, particularly from manufacturing. Romania continues to face the negative effects of pro-cyclical fiscal policy in the recent years, which led to the decoupling of regional recovery of the Romanian and the EU economy. The domestic demand has been affected, in turn, by tighter fiscal policies.

Romania could register an economic growth of about 1.6 percent in 2011, the exports being the main growth factor, thus maintaining the vulnerability to the EU demand. Although the economic growth will be poor in Romania in 2011, the fiscal consolidation is of critical importance to ensure a lasting recovery of the economy. But 2012 looks much better for Romania, forecasting a GDP growth of 3.6 percent, in the context of returning of private consumption, investment and public consumption, but also maintaining the positive performance of exports and industry.

The increase in international prices has also influenced the Romanian economy, therefore the average inflation constituted 7.6 percent in the first quarter of 2011 as compared to the first quarter of 2010. In March 2011, Romania recorded the highest annual inflation in EU countries - 8.0 percent. The average inflation in 2011 and 2012 is expected to be 5.7 and 4.0 percent respectively.

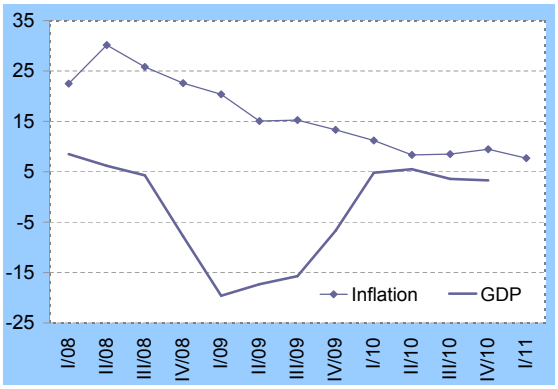
Ukraine

According to the second estimate, the economic growth in Ukraine was 3.3 percent in the fourth quarter of 2010 compared to the same period of the previous year, by 0.3 percentage points higher than previous estimate, but this is the lowest quarterly economic growth in 2010.

Manufacturing, production and distribution of energy, gas and water, constructions, transport and communications were the sectors that have continued with a stable growth rate. The unclearness of IMF financing program, the banking system that was affected by the stress of too large external debt and the weak economy had a negative impact on Ukraine's economy.

State Statistics Committee of Ukraine reported for the first quarter of 2011 an average inflation of 7.7 percent compared to the same period last year.

Chart 4.7: The annual rate of inflation and GDP in Ukraine, %



Source: State Statistics Committee of Ukraine

Evolution of natural gas and oil prices

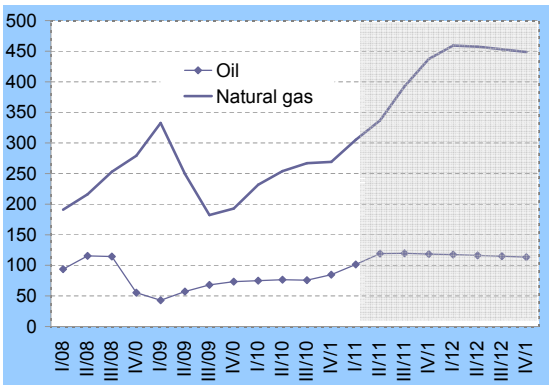
Gradual recovery of the global economy overlapping with the improvement of the macroeconomic indicators have favored the increased oil demand from countries in Asia and the U.S., which contributed directly to increased listing futures on oil. During the first quarter of 2011 has continued the upward trend in world oil prices, which began in 2010. Thus, the quotations in world oil pricesl[11] during the analyzed period reached average values of USD 101.3 per barrel, increasing by 35.1 percent compared to the same period last year.

The evolution of oil prices was mainly conditioned by geopolitical factors during the analyzed period. In this context, the political conflicts in the countries of North Africa and the Middle East have helped keeping the oil prices at high levels. The continuing increase in oil futures prices is caused by the irregularities in the supply of oil in those countries.

The forecasts of increasing demand for oil have contributed to oil prices increase, in the context of economic revival in several

[11] Urals brand

Chart 4.8: Evolution of forecast of natural gas prices (USD/1000m^3) and oil (USD per barrel)



Source: NBM, Energy Information Administration (U.S. Government Official Statistics), http://tonto.eia.doe.gov/dnav/pet/hist/wepcuralsw.htm

countries and further development of the Chinese economy. In 2010, the demand for oil constituting on average 87.9 mb / day, following the recent estimates in 2011 it will increase to 89.4 mb / day, recording an increase of 1.7 percent in annual terms[12].

Similarly, the oil market was influenced by the dynamics of U.S. dollar exchange rate against the major world currencies, affecting the prices of petroleum products denominated in U.S. dollars and thus contributing to increase of the attractiveness of the property market for speculative and investment capital.

Also, the natural disasters in Japan constituted another factor that influenced the oil prices, which has intensified the investors' concerns over oil demand, which contributed to high volatility in prices. The consequences arising from the situation in Japan affects the premature completion of a certain level of energy demand. It is worth mentioning that the recent events do not fully justify the high levels of oil prices, but recorded a sharp increase in risk premiums, which shows amplification of fears of oil shortages on the market in the future quarters.

Since the emergence of shortcomings in supplying oil from Libya, OPEC member countries are to fill a large part of oil deficit, so as to ensure greater integrity of the oil market. It should be mentioned that the OPEC reference basket amounted to 101.3 barrels in the first quarter of 2011, increasing by 21.0 percent compared with the previous quarter.

It is expected that during the following quarters of this year the Urals brand oil prices will be within the range of USD 117.8 to 120.1 per barrel.

The purchase price of natural gas in the first quarter of 2011 announced by "Moldova-Gaz" SA is USD 305.0 per 1000 m3. We anticipate that in the second quarter of 2011, the natural gas import price will be USD 336.8 per 1000 m3[13], which represents an increase of about 10.4 percent as compared to the previous quarter.

4.2 Medium-term forecasting

Aggregate demand

The evolution of GDP in 2010 mainly reflected the economic recovery started in the second half of 2009. The annual growth

[12]Source:http://www.opec.org/opec_web/en/press_April_2011.pdf
[13]NBM calculus

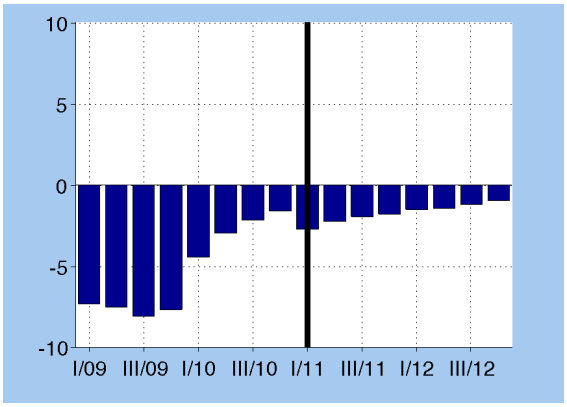
rate of real GDP constituted 6.9 percent. The growth rate of potential GDP is evaluated further to values below those before the economic crisis. Real GDP growth reflected positive contributions of final consumption, gross capital formation, and positive developments in exports, driven by global economic recovery and in particular of the main economic partners.

Similar to the previous forecast in the Inflation Report no. 1, 2011, the real output gap will remain negative for the most part of forecasting horizon, thus limiting the potential price increase. The existence of surplus production capacity offers businesses the ability to accommodate any pressure generated by return of demand rather by increasing the supply of goods and services than by increasing sales prices. Thus, for the entire forecasting horizon, the demand deficit will gradually decrease.

The fiscal impact, as compared with the forecast of the Inflation Report no.1, 2011, has a less favorable contribution on the prices, as a result of indirect taxes increases in April of this year. Overall, the fiscal policy will be slightly expansionary over the next two years.

Although, the interest rates will increase in nominal terms, the incentive character in real terms will persist. The real effective exchange rate will have a slightly restrictive impact, and at the end of the forecasting horizon it will move to a neutral level.

Chart 4.9: Output gap forecast (%)

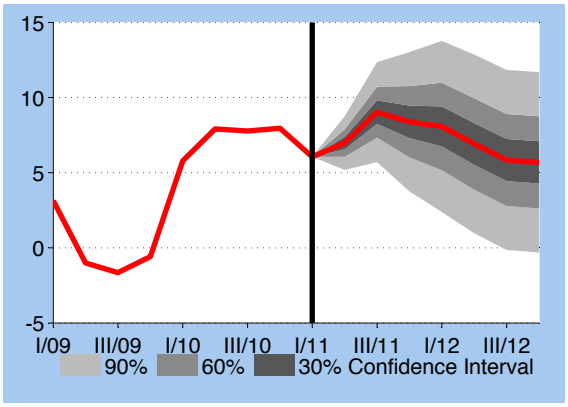


Source: NBS, NBM calculus

Inflation

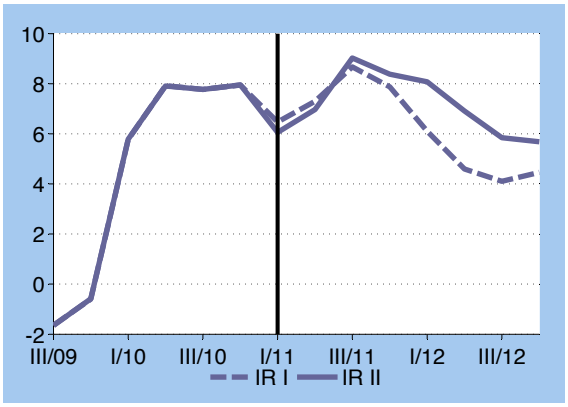
According to the current forecasts, the annual CPI is placed at the level of 8.4 percent at the end of 2011, and at the end of the next year at the level of 5.7 percent. The projection of annual rate of inflation in the current round of forecasts, compared to the forecast of the Inflation Report no.1, 2011, is situated at a higher level due to supply-side pro-inflationary factors, which are beyond the control of the National Bank of Moldova. The increase of oil prices on international markets and therefore increasing the import prices of natural gas is an inflationary supply-side factor, which is persistent for the entire forecast period and requires an increase in regulated prices. Another inflationary factor, in the current round of forecasting, is the more depreciated exchange rate of the U.S. dollar against euro, which at the end of 2012 will record similar levels as forecasted in the Inflation Report no.1, 2011. Inflationary pressures from food prices over the forecasting period will be insignificant, recording a similar trend as forecasted in the Inflation Report no.1, 2011.

Chart 4.10: The annual rate forecast of total CPI, % annual



Source: NBS, NBM calculus

Chart 4.11: Comparison of forecasts: total CPI, % annual



Source: NBS, NBM calculus
II I -Inflation Report no 1, february 2011
IR II -Inflation Report no 2, may 2011

The projection of annual rate of core inflation provides a slightly upward trend until the first quarter of 2012, when it will reach a maximum level, followed by a decrease towards the end of the forecast period. Compared to the forecast of the Inflation Report no.1, 2011, the annual core inflation trajectory is at the top level in the first quarters of the forecast, while the end of the forecasting period the core inflation will have a lower evolution. Currently, real GDP is below its potential, the output gap is maintaining negative throughout the forecasting period, thus the likelihood of inflationary pressures from the demand-side is reduced, in the foreground emphasizing the supply-side factors.

Risks and uncertainties

Balance of risks on inflation projection in the baseline scenario is still regarded as asymmetric. The supply-side risks have a high probability, which may cause a higher trajectory in the annual rate of inflation.

A pronounced risk is the continuing increases in world oil prices as a result of continued global economic recovery, the increased demand will put pressure on oil prices. However, the continuation of tensions in the Middle East will be another factor that will increase oil prices in foreign markets. As a result, the necessary conditions for increased domestic fuel prices will appear, but also pre-conditions for imported gas price increase, which eventually will lead to higher prices of regulated services.

Moreover, there is a risk of inflationary pressures from global food prices, especially grain prices, taking into account the minimum international level of grain reserves and the prohibitions recent introduced in some countries on the export. The beginning of a new agricultural season could bring positive changes in global food production, and respectively to lower prices. It should be mentioned that according to information provided by the State Hydrometeorological Service, in the first quarter of 2011 the multi-autumn crops were not affected by negative temperatures and the moisture in the arable layer is within the norm of the respective period. Thus, the current inflation forecast for 2011 and 2012 was carried out based on favourable conditions for crop development, without any assumptions about unfavourable agro-weather phenomena. However, the incidence of adverse shocks such as the reduced amount of rainfall or flooding on the contrary would reduce the supply of fruit and vegetables and would cause increased pressure on food prices.

Following the increase of monetary policy rate by the European Central Bank and in the context of continuous accommodative

policy by the U.S. monetary authorities, the probability of Euro appreciation against the U.S. dollar remains high, therefore the Moldovan leu could depreciate against the U.S. dollar. This will lead to increased export volume of domestic production, thus stimulating the domestic economic activity, and to increased price growth, creating, at the same time, inflationary pressures through imported goods prices.

Another risk factor is related to the future development of the domestic political situation, which can lead to increased uncertainty for investors. Also, the prospects of developments in the area in question may influence the degree of the expansionary character of public finances, reflecting on prices by stimulating the aggregate demand, or immediately through indirect taxes.

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Appendix A

Statistical tables

Table A.1: Monetary policy rates, %

	Ukraine	Russian Federation	Romania	Hungary	Belarus	Poland	Kazahstan	Moldova	Turkey	Armenia	Georgia*
2008											
Dec.	12.0	13.0	10.3	10.5	11.5	7.5	n/a	15.1	17.0	n/a	8.0
2009											
Jan.	12.0	13.0	10.3	9.8	13.6	6.8	10.5	13.5	15.3	7.1	8.0
Febr.	12.0	13.0	10.0	9.5	14.0	6.5	10.0	11.1	13.8	6.8	7.0
Mar.	12.0	13.0	10.0	9.5	14.0	6.3	9.6	11.0	12.4	7.5	6.5
Apr.	12.0	13.3	10.0	9.5	14.0	6.3	9.5	11.0	11.4	7.6	6.0
May	12.0	12.2	9.6	9.5	14.0	6.3	9.5	10.6	10.8	7.4	6.0
Jun.	11.0	11.6	9.5	9.5	14.0	6.0	9.2	9.7	10.3	6.4	6.0
Jul.	11.0	11.2	9.0	9.4	14.0	6.0	8.7	8.7	9.8	5.6	6.0
Aug.	10.3	10.8	8.6	8.4	14.0	6.0	8.2	7.4	9.3	5.3	6.0
Sept.	10.3	10.6	8.5	8.0	14.0	6.0	7.7	5.5	8.8	5.1	6.0
Oct.	10.3	9.8	8.5	7.3	14.0	6.0	7.1	5.0	8.3	5.0	6.0
Nov.	10.3	9.4	8.0	6.9	14.0	6.0	7.0	5.0	7.9	5.0	5.0
Dec.	10.3	9.0	8.0	6.4	13.5	6.0	7.0	5.0	7.8	5.0	5.0
2010											
Jan.	10.3	8.8	7.6	6.2	13.5	6.0	7.0	5.0	7.8	5.2	5.0
Febr.	10.3	8.7	7.1	5.9	13.3	6.0	7.0	6.0	7.8	5.7	5.0
Mar.	10.3	8.5	7.0	5.7	13.0	6.0	7.0	6.1	7.8	6.4	5.0
Apr.	10.3	8.2	6.5	5.5	12.8	6.0	7.0	7.0	7.8	6.8	5.0
May	10.3	8.0	6.3	5.3	12.2	6.0	7.0	7.0	7.8	7.2	5.0
Jun.	10.3	7.8	6.3	5.3	12.0	6.0	7.0	7.0	7.8	7.3	6.3
Jul.	10.3	7.8	6.3	5.3	12.0	6.0	7.0	7.0	7.8	7.3	6.5
Aug.	8.0	7.8	6.3	5.3	11.3	6.0	7.0	7.0	7.8	7.3	6.5
Sept.	7.8	7.8	6.3	5.3	10.7	6.0	7.0	7.0	7.6	7.3	7.0
Oct.	7.8	7.8	6.3	5.3	10.5	6.0	7.0	7.0	7.5	7.3	7.5
Nov.	7.8	7.8	6.3	5.5	10.5	6.0	7.0	7.0	5.9	7.3	7.5
Dec.	7.8	7.8	6.3	5.6	10.5	6.0	7.0	7.0	5.3	7.3	7.5
2011											
Jan.	7.8	7.8	6.3	5.8	10.5	6.3	7.0	8.0	5.3	7.3	7.5
Febr.	7.8	7.8	6.3	6.0	10.5	6.3	7.0	8.0	5.3	7.6	8.0
Mar.	7.8	8.0	6.3	6.0	11.3	6.3	7.4	8.0	5.3	8.2	8.0

*At the end of the period
Source: Official websites of the central banks of the respective countries

Table A.2: Required reserve rates of countries in the region, %

	2010												2011		
	Jan.	Febr.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Febr.	Mar.
Ukraine	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Russian Federation	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	3.3	4
Romania	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Hungary	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Belarus	3.5	3.5	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	4.5
Poland	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Kazahstan	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Moldova	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	10.3	11.0
Turkey	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.5	5.6	6.0	6.0	8.9	9.0
Armenia	29.1 mlrd. AMD	27.5 mlrd. AMD	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Georgia*	4.0	4.0	3.9	3.9	3.8	3.9	3.5	3.6	5.3	5.2	5.1	5.0	10.5	15.3	16.0

*At the end of the period
Source: Official websites of the central banks of the respective countries

Table A.3: Annual consumer price index, %

	2010												2011		
	Jan.	Febr.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Febr.	Mar.
Ukraine	11.1	11.5	11.0	9.7	8.5	6.9	6.8	8.3	10.5	10.1	9.2	9.1	8.2	7.2	7.7
Russian Federation	8.1	7.2	6.5	6.1	5.9	5.7	5.5	6.2	7.0	7.5	8.1	8.8	9.7	9.6	9.6
Romania	5.2	4.5	4.2	4.3	4.4	4.4	7.1	7.6	7.8	7.9	7.7	8.0	7.0	7.6	8.0
Hungary	6.4	5.7	5.9	5.7	5.1	5.3	4.0	3.7	3.8	4.2	4.1	4.7	4.0	4.1	4.5
Belarus	6.6	5.9	6.4	6.6	7.1	6.9	6.8	7.7	9.0	9.7	10.3	9.9	10.6	13.0	13.9
Poland	3.5	2.9	2.6	2.4	2.2	2.4	2.0	2.0	2.6	3.0	2.8	3.2	4.0	4.0	4.4
Kazahstan	7.3	7.4	7.2	7.1	7.0	6.8	6.7	6.5	6.7	7.3	7.7	7.8	8.1	8.8	8.6
Moldova	2.9	6.5	8.1	8.1	7.9	7.8	7.6	7.8	8.0	8.0	7.7	8.1	6.7	5.7	5.8
Turkey	8.2	10.1	9.6	10.2	9.1	8.4	7.6	8.3	9.2	8.6	7.3	6.4	4.9	4.2	4.0
Armenia	7.0	9.4	8.8	6.8	6.3	5.8	7.8	9.6	8.6	9.1	9.6	9.4	10.6	12.4	11.5
Georgia	2.7	5.6	5.9	5.6	4.0	3.7	7.0	9.5	9.8	9.6	10.5	11.2	12.3	13.7	13.9

Source: Official websites of the central banks of the respective countries

Table A.4: Monetary policy real rates, %

	2010												2011		
	Jan.	Febr.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Febr.	Mar.
Ukraine	-0.8	-1.1	-0.7	0.5	1.6	3.1	3.2	-0.3	-2.5	-2.1	-1.3	-1.2	-0.4	0.5	0.0
Russian Federation	0.6	1.4	1.9	2.1	2.0	1.9	2.1	1.5	0.7	0.2	-0.3	-1.0	-1.8	-1.7	-1.5
Romania	2.3	2.5	2.7	2.1	1.8	1.8	-0.8	-1.2	-1.4	-1.5	-1.4	-1.6	-0.7	-1.3	-1.6
Hungary	-0.2	0.2	-0.2	-0.2	0.1	0.0	1.2	1.5	1.4	1.0	1.4	0.8	1.7	1.8	1.4
Belarus	6.5	7.0	6.2	5.8	4.8	4.8	4.9	3.3	1.6	0.7	0.2	0.5	-0.1	-2.2	-2.3
Poland	0.0	0.6	0.9	1.1	1.3	1.1	1.5	1.5	0.9	0.5	0.7	0.3	2.2	2.2	1.8
Kazahstan	-0.3	-0.4	-0.2	-0.1	0.0	0.2	0.3	0.5	0.3	-0.3	-0.6	-0.7	-1.0	-1.7	-1.1
Moldova	2.0	-0.5	-1.9	-1.0	-0.8	-0.7	-0.6	-0.7	-0.9	-0.9	-0.6	-1.0	1.0	2.4	2.1
Turkey	-0.4	-2.1	-1.7	-2.2	-1.2	-0.6	0.2	-0.5	-1.5	-1.0	-1.3	-1.1	0.3	1.0	1.2
Armenia	-1.7	-3.4	-2.2	0.0	0.8	1.4	-0.5	-2.1	-1.2	-1.7	-2.1	-2.0	-3.0	-4.3	-3.0
Georgia	2.2	-0.6	-0.8	-0.6	1.0	2.5	-0.5	-2.8	-2.5	-1.9	-2.8	-3.4	-4.2	-5.1	-5.2

Source: Official websites of the central banks of the respective countries