National
Bank of Moldova

Inflation Report

No. 3, August 2017

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

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

All rights reserved. No part of this publication may be reproduced, and the use of data in studies is allowed with the proper specification of the source.

National Bank of Moldova
1 Grigore Vieru Avenue
MD-2005, Chișinău
Tel.: (373 22) 822 606
Fax: (373 22) 220 591

ISBN 978-9975-4353-6-9
ISBN 978-9975-3138-5-8

© National Bank of Moldova, 2017

Contents

Summary **3**

1 Inflation development **6**

1.1 Consumer price index 6

1.2 Comparing the forecast from the Inflation Report no. 2, 2017 to the inflation evolution in the second quarter of 2017 11

1.3 Industrial output prices 12

2 External environment **13**

2.1 World economy, financial and raw materials markets . 13

2.2 Development of important economies 15

2.3 Development of the neighbouring countries' economies and the main trading partners 16

3 Economic developments **17**

3.1 Demand and output 17

3.2 Labour market 25

3.3 External sector 27

4 Monetary Policy **29**

4.1 Monetary Policy Instruments 29

4.2 Dynamics of monetary indicators 32

5 Medium-term inflation forecasting **39**

5.1 Assumptions of the external environment 39

5.2 Assumptions on regulated prices 41

5.3 Medium-term forecasting 42

List of acronyms

ANRE	National Agency for Energy Regulation
CHIBOR	Average interest rate at which the contributors banks are available to lend funds in MDL to other banks, on the interbank monetary market
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
ECB	European Central Bank
ECF	Extended Credit Facility
EFF	Extended Fund Facility
EU	European Union
EUR	European Single Currency
FCC	Freely convertible currency
Fed	Federal Reserve System
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
IPI	Industrial Production Index
MDL	Moldovan leu
NBC	Certificates issued by the National Bank of Moldova
NBM	National Bank of Moldova
NBS	National Bureau of Statistics of the Republic of Moldova
NEER	Nominal effective exchange rate of the national currency
OPEC	Organization of the Petroleum Exporting Countries
REER	Real effective exchange rate of the national currency
SDR	Special drawing rights
SS	State Securities
USA	United States of America
USD	U.S. Dollar

Summary

Inflation development

In the second quarter of 2017, the average annual inflation rate was 7.1 percent, by 2.8 percentage points more compared to the previous quarter. In June 2017, inflation was 7.3 percent. As a result, during the second quarter of 2017, inflation was above the upper limit of the inflation target set in the Medium-term monetary policy strategy. The increase of the annual inflation rate was mainly determined by the impact of the adjustment of certain regulated services tariffs and by the increase of food prices due to the atypical meteorological conditions. At the same time, this process was supported by the effect of a low base period of 2016 and by the consequences of excise duty adjustment for some categories of goods. The appreciation trend of the national currency has mitigated the inflationary pressures mentioned above. Core inflation recorded a more modest dynamic during the reporting period, accounting for 4.7 percent in June and fell below the lower limit of the target range mentioned above due to the weak domestic demand. The annual rate of food prices increased from 5.0 percent in March 2017 to 9.0 percent in June 2017. At the end of the second quarter of 2017, regulated prices increased by 7.5 percent than the same period of the previous year. At the same time, the annual rate of fuel prices decreased from 12.5 percent in March 2017 to 7.2 percent in June 2017. In the second quarter of 2017, the actual annual inflation rate was slightly higher to that anticipated within the forecasting round presented in the Inflation Report no. 2, 2017.

External environment

Many events took place internationally in the second quarter of 2017, which contributed to the change in trajectory of the main macroeconomic indicators. As of 15 June 2017, Federal Reserve System decided to increase, for the second time this year, the interest rates range by 0.25 percentage points. At the same time, both the Bank of England and the European Central Bank revealed for the first time the possibility to decrease the degree of monetary stimulation in the next future. In these circumstances, the foreign exchange balance turned towards the appreciation of the European single currency and Pound Sterling, while U.S. dollar was disadvantaged by the loss of investors' enthusiasm for the projects announced by the USA's new president. Inflationary pressures decreased in emerging economies due to the stabilization of local currencies. The Central Bank of the Russian Federation decreased on 16 June 2017, for the third time this year, the reference rate by 0.25 percentage points, to the level of 9.0 percent, so that in May 2017 this reached the minimum level of the annual inflation of 4.1 percent. Raw materials market

has been subject to the USD depreciation and oil price reduction. OPEC decided during its meeting of 25 May 2017 to extend the agreement of decreasing the oil production volume, which led to losing the confidence in the OPEC capacity to rebalance the oil market in the circumstances where the United States of America and Canada continue to enhance the exploitation degree of the shale wells.

Economic developments

In the first quarter of 2017, GDP recorded an increase of 3.1 percent compared to the same period of 2016. The annual dynamic of the economic activity at the beginning of 2017 was significantly lower than in the second half of the previous year. The positive evolution of GDP in the first quarter of 2017 was determined mainly by the rich harvest of the previous year, which created premises for a pronounced increase in exports. Thus, exports recorded an increase of 23.0 percent in the first quarter of 2017. At the same time, the economic growth was also supported by the domestic demand. Household consumption increased by 4.2 percent, in the context of a slight increase in household income during the reporting period. Investments contributed positively to GDP dynamics due mainly to the component change in inventories and to the increase of gross fixed capital by 3.3 percent compared to the same period of the previous year. The final consumption of public administration decreased by 0.1 percent. The economic activity dynamics was significantly offset by the increase of imports by 17.0 percent, evolution that may be attributed to the increase in domestic demand and to its orientation mainly towards the foreign market products and to a low base period effect since the beginning of 2016, generated by the imports adjustment amid the significant depreciation of the national currency during that period. By categories of resources, the GDP growth in the first quarter of 2017 was determined mainly by the positive contribution of trade and of the “transport, information and storage” subcomponent. In the first quarter of 2017, both the economically active population and the number of employed population recorded a negligible evolution compared to the same period of the previous year, increasing by 0.3 and 0.2 percent, respectively. The unemployment rate was 6.3 percent in the first quarter of 2017, recording a marginal dynamics compared to the beginning of the previous year.

Monetary policy

In the second quarter of 2017, there were held three meetings of the Executive Board of the National Bank on Moldova on monetary policy decisions. Following the assessment of internal and external balance of risks and the inflation outlook in the short and medium term, the NBM Executive Board decided at the meetings of 27 April and 24 May 2017 to maintain the base rate applied on main monetary policy operations at the level of 9.0 percent. Thereafter, during its meeting of 28 June 2017, the Executive Board decided to reduce the base rate applied to main monetary policy operations

by 1.0 percentage points, from the level of 9.0 percent annually (level established at the meeting of 27 October 2016) to the level of 8.0 percent annually.

Following the downward trend of base rate applied on main monetary policy operations of the National Bank of Moldova, the average interest rates on deposits balance in national currency continued its downward trend and consequently, the average rates on credits granted by banking system recorded a tempered decline.

During the reporting period, compared to the first quarter of 2017, the annual average interest rates related to the balance of credits recorded a decrease of 0.68 percentage points on credits in national currency and of 0.18 percentage points on credits in foreign currency, recording the levels of 10.64 and 5.40 percent, respectively. The average interest rate on deposits in MDL was 6.57 percent during the second quarter of 2017, decreasing by 1.02 percentage points compared to the previous quarter. The interest rate of placements in foreign currency constituted on average 1.86 percent, lower by 0.27 percentage points than in the first quarter of 2017.

Medium-term inflation forecasting

According to the current round of forecasting, output gap will register a low and constant recovery for the entire forecasting period. However, it will remain negative for the first four quarters. Thereafter, il will record insignificant positive values. The placement of the economic activity below its potential level, in the first our quarters, will cause disinflationary pressures, while the positive values of output gap during the last four quarters of the forecasting horizon will generate inflationary pressures, although insignificant ones. Real monetary conditions will have a heterogeneous impact on the demand. Real effective exchange rate will manifest restrictive effects for the entire forecasting period. Real interest rate will be incentive in the first part of the forecasting horizon, after which, by the end thereof, it will fuel a weak restrictive character of the monetary conditions.

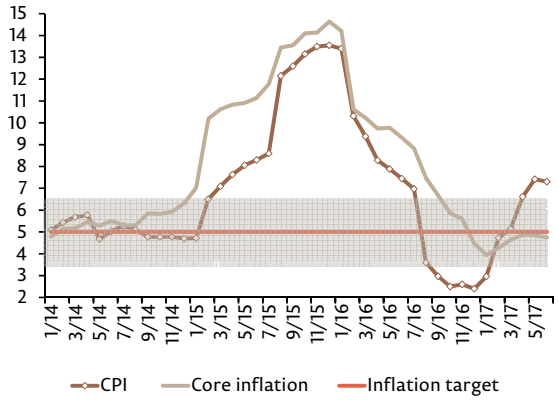
The annual inflation rate will also continue to record a higher level in the third quarter of 2017, after which it will fall rapidly to the lower limit of the target range. In the first quarter of 2018, inflation will return within the range and will remain mainly close to the lower limit until the end of the forecasting horizon. This will reach the maximum level of 7.4 percent in the third quarter of 2017, while the minimum level of 3.5 percent will be reached in the fourth quarter of 2018 and in the first quarter of 2019. Compared to the values registered in the Inflation Report no. 2, 2017, the average annual values of the annual inflation are higher by 0.3 percentage points in 2017 and by 0.7 percentage points in 2018.

Chapter 1

Inflation development

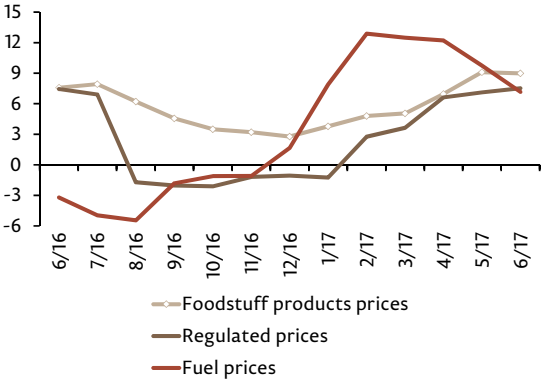
The annual inflation rate kept its upward trend recorded in early 2017, increasing in June up to 7.3 percent. As a result, during the second quarter of 2017 it stopped above the upper limit of the inflation target range stipulated in the Medium-Term Monetary Policy Strategy. The annual average inflation rate in the second quarter of 2017 accounted for 7.1 percent, higher than in the previous quarter. The growth of the annual inflation rate was mainly determined by an increase of tariffs for some utility services, by atypical weather conditions that led to the increase of prices for fruits and vegetables, by the impact of excise adjustment for some categories of goods, and by the effect of a reduced base period in 2016. The core inflation recorded a shyer dynamic during the reference period, dropping to the lower part of the above-mentioned range. The effective value of the annual inflation for the second quarter of 2017 is slightly higher than the one predicted in the forecasting round related to the Inflation Report no. 2, 2017.

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



Source: NBS, NBM calculus

Chart 1.2: The annual rate of food, regulated and fuel prices (%)



Source: NBS

1.1 Consumer price index

After a firm downward trajectory recorded in the previous year, the annual inflation rate for CPI maintained, in the second quarter of 2017, its upward trend signaled in the first half of the current year. Thus, it increased from 5.1 percent in March 2017 up to 7.3 percent in June 2017 (Chart 1.1). As a result, the inflation rate stopped, during the reference period, above the upper line of 5.0 percent (± 1.5 percentage points) range stipulated in the Medium-term monetary policy strategy. In the second quarter of 2017, the annual CPI average rate amounted to 7.1 percent, by 2.8 percentage points higher than in the previous quarter.

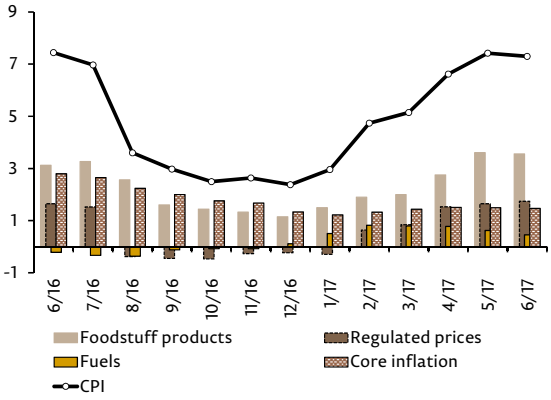
The core inflation recorded significant lower values than the cumulative one, keeping in the lower part of the abovementioned range. Thus, it had a faster trend and reached 4.9 percent in April, but later on it slowed down and dropped to 4.7 percent in June 2017. The core inflation amounted to 4.8 percent in the second quarter of 2017, by 0.5 percentage points higher than in the first quarter. As a result, the contribution of the core inflation to the formation of the annual CPI rate increased, in the second quarter of 2017, by 0.2 percentage points, up to 1.3 percentage points.

However, the upward trajectory of the annual CPI inflation rate was largely driven by the increased food and regulated prices. Thus, the contribution of food prices increased by 1.5 percentage points, making up 3.3 percentage points in the second quarter of

2017, due to atypical weather conditions for agriculture that were recorded in April. The impact of regulated prices, resulting from the tariff adjustment to some utilities, increased by 1.2 percentage points, making up 1.6 percentage points. The national currency appreciation trend during the reference period mitigated the effect of the abovementioned pro-inflationary factors. At the same time, the trend associated with the oil products price decline on the international market, contributed to the reduction of the fuels price contribution to the annual CPI rate by 0.1 percentage points, making up 0.6 percentage points (Chart 1.3).

According to the component structure, food prices increased by 9.0 percent, for services – by 8.9 percent, and for non-food goods – by 4.2 percent in June 2017 compared with June 2016.

Chart 1.3: The evolution of the annual inflation (%) and subcomponents contribution (p.p.)



Source: NBS, NBM calculus

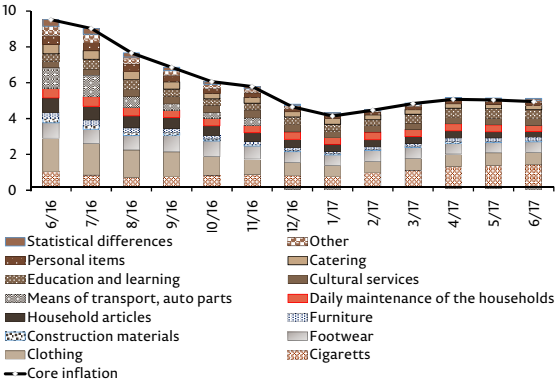
Core inflation

The annual average core inflation rate was 4.8 percent in the second quarter of 2017, higher by 0.5 percentage points than in the previous quarter.

The trend pattern drawn by the core inflation reflected further the impact of the amendments made to the Tax Policy of Moldova for 2017. Under a still shy aggregate demand, some sectorial shocks constituted the main sources of inflationary pressures on the core inflation during the reference period.

Thus, in the second quarter of 2017, the "cigarettes" component contributed with the most significant positive share to the price dynamic (Chart 1.4). The increase of cigarettes prices was driven by the amendments made to the tax policy of the country in 2017 on excise increase.

Chart 1.4: The subcomponents contribution (p.p.) to the annual rate of core inflation (%)



Source: NBS, NBM calculus

The improvement of food program for children in kindergartens generated an increase of food payments, thus contributing with a higher share of the "education and training" component to the core inflation dynamic. Moreover, the increase of "clothing", "footwear" prices contributed to the core inflation with a significant share similar to that recorded in the previous quarter.

Given the fact that a large share of goods included in the core inflation calculation were imported, the appreciation of the national currency against the currency of trading partners of the Republic of Moldova partially slowed the growths signaled to different subcomponents. A significant decrease in prices was registered on "vehicles, car parts" segment that could generally be linked to the appreciation of the national currency against EUR and USD, considering that a large share of positions in those categories, monitored by the NBS, depended on MDL/EUR, MDL/USD quotation. Thus, in the second quarter of 2017, the average exchange rate of the national currency registered an annual appreciation of 5.3 percent against the U.S. dollar (up to 18.8 MDL/USD) and 7.9 percent (up to 20.6 MDL/EUR) against the European single currency.

In June 2017, the annual core inflation rate did not change greatly compared with the previous month, accounting for 4.7 percent. According to the subcomponent structure, the most major price growths were registered for "cigarettes" (28.3 percent), "education and training" (11.4 percent), "footwear" (9.1 percent), and "clothing" (4.7 percent) etc.

Food prices

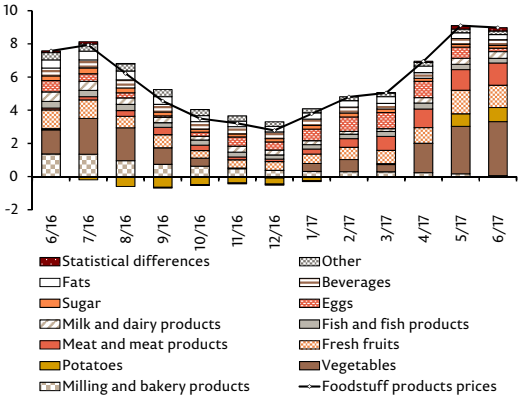
In the second quarter of 2017, the annual food prices rate recorded an average level of 8.3 percent, by 3.4 percentage points higher than in the first quarter of 2017.

The upward dynamic of the annual rate was generally driven by the increase of contribution from "fresh vegetables", "potatoes", "fresh fruits", and "meat and meat products and preserves" groups (Chart 1.5). The increase of the prices of potatoes, fresh vegetables and fruits was mainly caused by an uneven thermal regime, accompanied by snowfall and sleet in April. The current year's harvest (products with strong seasonal character) that was put on the market influenced greatly the prices' upward trend.

On the international market, the annual food prices rate in the second quarter of 2017 settled at the average level of 9.2 percent, by 6.8 percent lower than the level recorded in the first quarter of 2017.

The annual increase by 9.0 percent of food prices in June 2017 was largely driven by the increase in prices for "fresh vegetables" (33.5 percent), "potatoes" (32.7 percent), "fresh fruits" (18.8 percent), and "meat and meat products and preserves" (6.1 percent).

Chart 1.5: The components contribution (p.p.) to the annual rate of food prices (%)



Source: NBS, NBM calculus

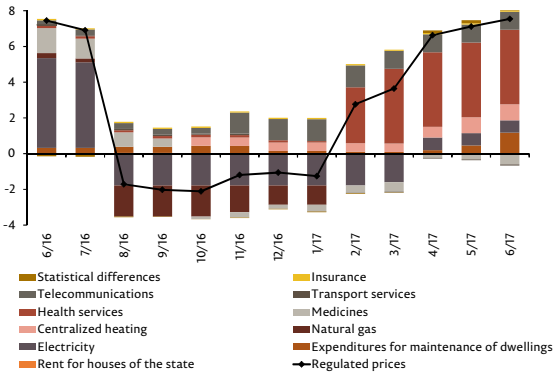
Regulated prices

The annual regulated prices rate followed an upward trend recorded in early 2017. As a result, it amounted to 7.1 percent in the second quarter of 2017, by 5.4 percentage points higher than in the previous quarter. This dynamic was caused both by the effects of healthcare tariff increase in the previous quarter [1], and the tariff adjustments made during the second quarter of 2017.

Thus, during the reference period, the electricity subcomponent increased by 2.9 percent in April after which, on 17 March 2017, ANRE (National Energy Regulatory Authority) passed several decisions aimed at adjusting the electricity production, delivery and distribution service tariffs to the following operators: Î.C.S. "Gas Natural Fenosa Furnizare Energie" SRL, S.A. "RED-Nord" and S.A. "RED Nord-Vest".

According to the information provided during the meetings, the main factors that contributed to the update of electricity production, delivery and distribution prices were: change in the update parameters according to the Macroeconomic Indicators Forecast for 2018-2020, evolution of the annual average exchange rate of the national currency against the U.S. dollar, increase of capital cost resulted from investments made by the applicant enterprises. It should be noted that the new tariffs for electricity productions, delivery and distribution services came into effect on 24 March 2017, the date they were published in the Official Monitor[2] and thus had been partially disclosed for March 2017

Chart 1.6: The components contribution (p.p.) to the annual rate of regulated prices (%)



Source: NBS, NBM calculus

[1] http://lex.justice.md/md/341845/

[2] https://monitorul.fisc.md/official_magazine_rm/in-monitorul-oficial-de-maine-24-martie-vor-fi-publicate-urmatoarele-documente-oficiale.html

(1.0 percent). Also, during the said meeting, a decision was made to increase the electricity production, delivery and distribution service tariffs for the following operators: S.A. "TERMOELECTRICA" and S.A. "CET-Nord". The new tariffs for heating supplied to consumers by S.A. "TERMOELECTRICA" came into effect on 1 May 2017, and the tariffs for heating supplied by S.A. "CET-Nord" – on the date of their being published in the Official Monitor, i.e. on 24 March 2017, being disclosed under an increase of central heating subcomponent by 2.0 percent in April and by 4.4 percent in May within the CPI. Given that the tariffs for heating increased, the hot water supply tariffs also grew by 5.1 percent in May 2017.

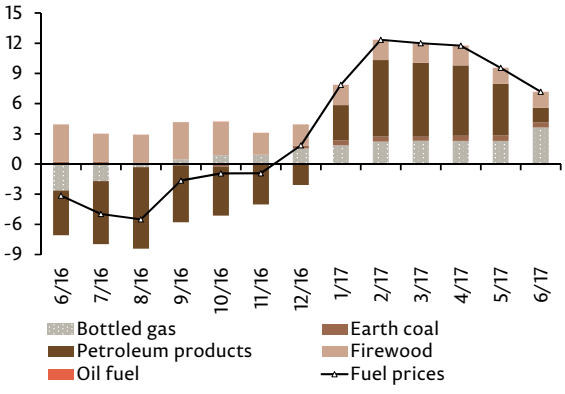
In early quarter 2 of 2017, the water and sewerage network tariffs grew in the Southern Moldova which led to an increase by 2.3 percent of this subcomponent within CPI. Also, during the meeting of 19 May 2017, ANRE approved new tariffs for public water supply, sewerage and wastewater treatment service for the operators S.A. "Apă-Canal Chișinău" and Î.M. "Apă Canal" from Ungheni. This resulted in an increase of the water and sewerage network subcomponent within the CPI by 4.5 percent in May 2017 and by 15.2 percent in June 2017. Moreover, there was a smooth mitigation of the abovementioned factors, similar to the previous periods, caused by a negative contribution of prices on medication.

Fuel prices

During the second quarter of 2017, the annual fuel prices rate registered a downward dynamic, dropping from 12.5 percent in March 2017 down to 7.2 percent in June 2017. The average rate accounted, in the reference period, for 9.7 percent, by 1.4 percentage points lower than in the first quarter of 2017 (Chart 1.7).

This development trend of the annual fuel prices rate during the second quarter of 2017 was driven by the decrease of contribution from "fuel" prices. Thus, it reached 4.6 percentage points, by 1.6 percentage points lower than in the first quarter of 2017. This dynamic was supported by the decrease of international fuel prices and the trend of appreciation of the national currency against the U.S. dollar (Box 1). In this respect, the price for Urals oil in the second quarter of 2017 accounted for about USD 48.6 per barrel, decreasing by 6.7 percent compared with the previous quarter, and the currency appreciated by 6.0 percent compared with the first quarter of 2017. It should be noted that as of September 2016, the annual rate of prices of "bottled gas" reached the positive range. Thus, in the second quarter of 2017 the share of this subcomponent made up 2.7 percentage points, by 0.6 percentage points higher than in the previous quarter. During the reference period, the general contribution of prices of "fire wood" accounted for 1.7 percentage points and contributed to the formation of the annual fuel price rate, by 0.3 percentage points lower than in the first quarter of 2017. A positive input to the formation of the annual fuel prices rate was held by the prices of "earth coal". Thus, in the second quarter of 2017, the share of this subcomponent to the formation of the annual rate amounted to 0.6 percentage points, by 0.1 percentage points higher than in the first quarter of 2017.

Chart 1.7: The components contributions (p.p.) to the annual growth of fuel prices (%)



Source: NBS, NBM calculus

Box 1

How are fuel prices set in the Republic of Moldova?

Given the lack of some its own energy resources, the Republic of Moldova imports significant amount of oil products, natural gas and electricity from abroad for domestic economic needs. Thus, the energy resources prices, among which the fuel prices on the domestic market, are strongly influenced by the international and regional prices of oil products and the national currency exchange rate against the U.S. dollar, given that they are purchased in foreign currency. Moreover, a certain impact on the fuel prices on the domestic market is triggered by the fiscal policy, and namely by the excise value on oil products.

In order to be able to implement its mission on ensuring a non-discriminatory, loyal competition and to operate efficiently the energy resources market, ANRE must, among its basic tasks, approve the oil product tariffs according to its approved methodology and supervise its correct application. In this sense, on ANRE approved a new Methodology on oil product prices' formation and application[1] on 31 March 2016, setting a direct correlation between the domestic market prices and regional stock exchange quotation rate on oil products.

Thus, according to the aforementioned methodology, ANRE sets a ceiling price for fuel retailing based on the formula, as follows:

$$PP = \left(CM_{(i)} \times CV + AC\right) \times \frac{\rho}{1000} + MCS_n + VAT$$

where:

PP – ceiling price of oil retailing *(MDL/l)*;

$CM_{(i)}$ – average value of average quotations (published in the last 14 consecutive days) Platts Cargoes FOB MED (Italy) or Platts Cargoes FOB NWE (*USD/ton*);

CV – official average national currency exchange rate set by NBM against U.S. dollar for the last 14 days (*MDL/USD*);

AC – excise quota (in absolute amount for a ton) applied according to the Fiscal Code of the Republic of Moldova *(MDL/ton*);

ρ – average density of main oil products, set for petrol as 0.758 kg/l, diesel fuel – 0.841 kg/l;

MCS_n – specific trade margin related to the trade of oil products in year "n" (*MDL/l*);

VAT – value added tax quota (in absolute amount for a ton) applied according to the Fiscal Code of the Republic of Moldova (*MDL/l*).

For example, on 11 July 2017, ANRE set a ceiling price for petrol of MDL 16.32 per liter, based on the following data:

- Official average exchange rate (for 28 June – 11 July) of 18.17 MDL/USD (published by NBM);
- Excise for 1 ton of petrol – MDL 4560 (published in the Fiscal Code for 2017);
- VAT quota (20% of the ceiling price) of MDL 2.72 per liter (calculated by NBM);
- Trade margin for petrol of MDL 3.35 per liter (set by ANRE).

Given that this information and the aforementioned formula can determine that the average price of average Platts Cargoes FOB MED (Italy) or Platts Cargoes FOB NWE quota for 28 June – 11 July was about USD 493 per ton.

$$16.32 = (CM_{(i)} * 18{,}17 + 4560) * 0{,}758/1000 + 3.35 + 2.72$$

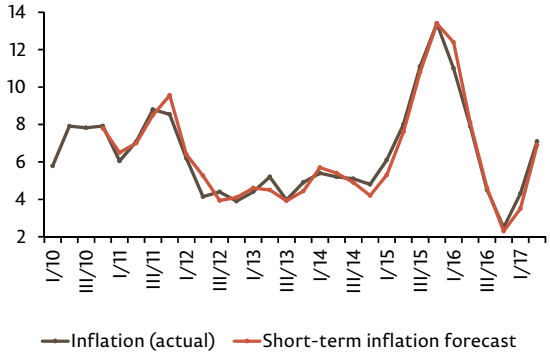
According to the new methodology, ANRE sets the ceiling price for petrol and diesel fuel retailing every 14 consecutive days, on Tuesday and publishes it on its website at 1:00 pm. The same day, every oil market operator will, based on the ceiling price determined by ANRE, set the fuel retail price that will be published on its website and will display it on an information board at petrol stations. The prices set by the operators will be effective and applied for all consumers on Wednesday, at 00.01 am. The operators will not be entitled to retail at higher prices than the ceiling price set by ANRE[2].

[1] ANRE, Decision No 102 of 31.03.2016 on the approval of the Methodology on Oil Product Price Formation and Application.
[2] http://www.anre.md/ro/content/preţurile-plafon-de-comercializare-cu-amănuntul-carburanţilor.

1.2 Comparing the forecast from the Inflation Report no. 2, 2017 to the inflation evolution in the second quarter of 2017

CPI data in the second quarter of 2017 show an average inflation (7.1 percent), slightly higher (by 0.2 percentage points) than the forecasted one (6.9 percent) (Table 1.1). The positive deviation from the forecast was mostly determined by the food price forecast. Thus, the average food price rate in the second quarter of 2017 was by 1.1 percentage points higher than the forecasted one, mostly due to atypical weather conditions that occurred in April generating inflationary pressure on the prices of fruits and vegetables on the domestic market. A small positive deviation (0.1 percentage points) was registered for the regulated service prices forecast as a result of some tariffs for water and sewerage network that were higher than it was anticipated. The abovementioned deviations were partially mitigated by a core inflation lower by 0.4 percentage points than the one that was anticipated during the forecast round in April, a fact due to a more appreciated trajectory of the national currency. Similarly, under national currency appreciation trend in the second quarter of 2017 and a low trajectory of fuel prices on the international market, the fuel prices forecast was by 1.5 percentage points lower than the anticipated one.

Chart 1.8: The evolution and forecast of CPI since the implementation of inflation targeting regime (%)



Source: NBM

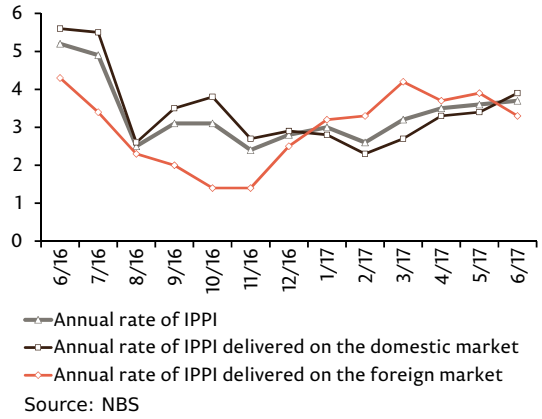
Table 1.1: The evolution and forecast of CPI and its components

	De facto (%)	Forecast IR 2, 2017	Deviation (p. p.)
	Q II, 2017/ Q II, 2016	Q II, 2017/ Q II, 2016	De facto-forecast
CPI	**7.1**	**6.9**	**0.2**
Core inflation	4.8	5.2	-0.4
Food	8.3	7.2	1.1
Regulated prices	7.1	7.0	0.1
Fuels	9.7	11.2	-1.5

Source: NBS, NBM calculus

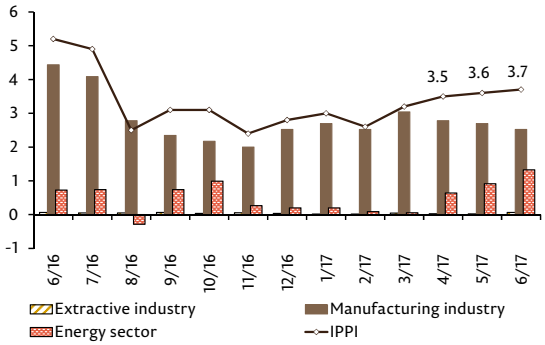
1.3 Industrial output prices

Chart 1.9: The IPPI annual rate (%)



Source: NBS

Chart 1.10: The IPPI annual rate (%) and the contribution of its components categorised by main branches (p.p.)



Source: NBS, NBM calculus

In the second quarter of 2017, the annual industrial prices rate was at the average level of 3.6 percent, or by 0.7 percentage points higher than in the first quarter of 2017. The upward development of the annual IPPI rate was influenced by the price dynamic of goods delivered on the domestic market (Chart 1.9). Thus, during the analyzed period, the annual IPPI rate for goods delivered on the domestic market increased by 0.9 percentage points, up to 3.5 percent. At the same time, the annual price rate for goods delivered on the external market settled at the level of the previous quarter, i.e. of 3.6 percent.

Having analyzed the annual industry prices rate by branch, it becomes clear that its dynamic is mostly determined by the evolution of prices in the manufacturing industry (Chart 1.10) In the second quarter of 2017, the manufacturing industry prices contributed in average by 2.8. percentage points to the formation of the annual IPPI rate. It should be noted that the manufacturing industry prices dynamic was influenced by the increase of "food industry" and "textile industry" prices. At the same time, in the second quarter of 2017, a firm positive share from the energetic sector can be outlined, determined by the increase of electricity, heating, and water supply prices. Thus, the share of the energetic sector was 1.0 percentage points in the second quarter of 2017 and that of the extracting industry remained minimal (0.04 percentage points).

Chapter 2

External environment

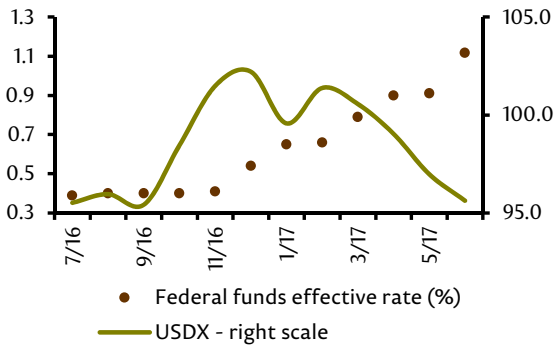
2.1 World economy, financial and raw materials markets

World economy keeps evolving under great risks that dictate the high level of the main macroeconomic indicators' volatility. The currency market is outlined by an increased attention to currency policies connected with the main currencies of international circulation. On 15 June 2017, the Federal Reserve System increased the interest rate range by another 0.25 percentage points for the second time during this year. The European Central Bank and the Bank of England have recently signaled, for the first time, the possibility to reduce the monetary incentive as the domestic consumption increases and the inflation is getting closer to the targeted level. At the same time, the emerging economies record a decrease of inflation pressures due to the domestic currency stabilization. On 16 June 2017, the Central Bank of the Russian Federation decreased the reference rate by 0.25 percentage points, up to 9.0 percent for the third time during the current year, giving that in May 2017 an annual minimal inflation level of 4.1 percent was reached. The raw materials market was subject to U.S. dollar depreciation and oil price reduction. During the meeting OPEC of 25 May 2017, it was decided to extend the term of agreement to cut oil output, given that the United States of America and Canada continued to over-exploit the shale oil wells.

In the second quarter of 2017, *U.S. dollar* depreciated against most international circulation currencies, so that on 15 June 2017 the Federal Reserve System increased the interest rate range by 0.25 percentage points for the second time during this year. This difference occurred due to unsatisfactory statistics on the labour market and consumer prices evolution in USA. In June 2017, the unemployment rate in USA slightly increased up to 4.4 percent, while the annual inflation dropped to 1.6 percent, when the targeted level was of 2.0 percent. Another important factor on the currency market was the first signals from the European Central Bank and the Bank of England regarding the possibility of diminishing monetary stimulus in the near future, which contributed to the significant appreciation of the European single currency (Chart 2.2) and the British pound.

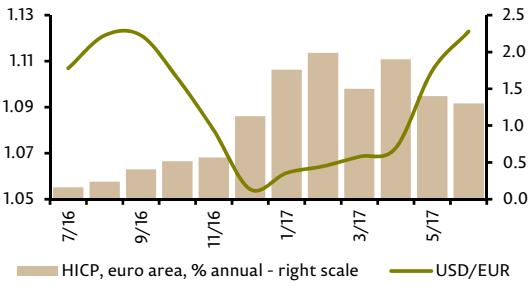
Thus, on a quarter-based average, the U.S. dollar depreciated by 3.2 percent against the European single currency, by 3.1 percent against the pound, by 2.2 percent against the Japanese yen, by 1.9 percent against the Swiss franc, and by 1.6 percent against the Canadian dollar during the analyzed period. In late June, the

Chart 2.1: U.S. dollar index (USDX) evolution in Fed monetary policy context



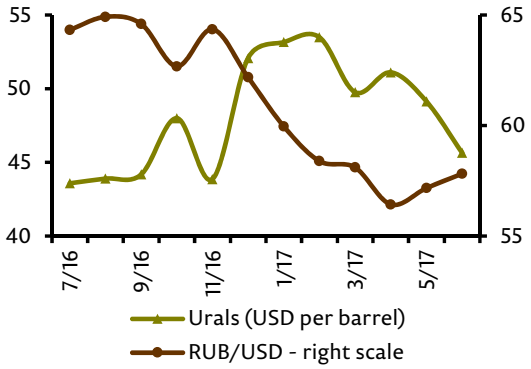
Source: Fed,Bloomberg

Chart 2.2: The evolution of USD/EUR parity (monthly average) and inflation in euro area



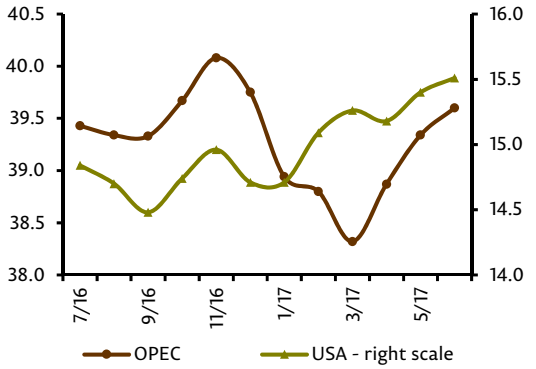
Source: ECB, Eurostat, NBM calculus

Chart 2.3: The evolution of RUB/USD (monthly average) under the influence of the oil price developments



Source: Central Bank of the Russian Federation, Ministry of Economic Development of the Russian Federation

Chart 2.4: Oil production, millions barrels per day



Source: U.S. Energy Information Administration

USD index (USDX)[3] decreased to 95.63, the lowest level recorded after the USA presidential elections from November 2016 (Chart 2.1).

Similarly, in the reference period, the *great emerging economy currencies* appreciated against the U.S. dollar following an increase of raw material prices due to the increase of the global demand. Thus, during the analyzed period, on a quarter-based average, the Indian rupee appreciated by 3.7 percent against the U.S. dollar, the Turkish lira – by 3.0 percent, and the Chinese yuan – by 0.4 percent. At the same time, the Brazilian real depreciated by 2.3 percent against the U.S. dollar, and the Argentine peso – by 0.3. percent, under the domestic political problems circumstances.

Regionally, the *local currencies* had a mixed evolution, appreciating against the U.S. dollar and depreciating against the European single currency. In the second quarter of 2017, the Russian ruble appreciated on a quarter-based average by 2.9 percent against the U.S. dollar and depreciated by 0.2 percent against the European single currency. It should be noted that the parity of the Russian ruble against the U.S. dollar during the analyzed period was settled by the oil price reduction (Chart 2.3). Also, the Ukrainian hryvnia appreciated by 2.2 percent against the U.S. dollar and depreciated by 0.9 percent against the European single currency, while the Romanian leu appreciated by 2.5 percent against the U.S. dollar and depreciated by 0.7 percent against the European single currency. For comparison purposes, the Moldovan leu appreciated by 6.0 percent against the U.S. dollar and by 3.1 percent against the European single currency.

In the second quarter of 2017, *the Urals oil average price* was of USD 48.6 per barrel[4], dropping down by 6.7 percent compared with the first quarter of 2017 (Chart 2.3). The oil market was marked by the OPEC decision made in the meeting of 25 May 2017 at Vienna on the extension of the agreement to cut oil output until March 2018. The effort to balance the oil demand and supply outlined the issue related to the excess of oil at global level to which the market reacted by cutting the oil price. During the reference period, the OPEC and non-OPEC countries, engaged in the agreement to cut oil volume, increased the oil output compared with the first months of 2017. OPEC output increase was due to the recovery of oil output in Libya and Nigeria. Moreover, USA and Canada had continued to over-exploit the shale oil wells (Chart 2.4). Other factors that contributed to the oil price reduction during the analyzed period was little demand for gasoline, the concerns about China's economy evolution and the loss of trust in OPEC's capacity to rebalance the oil market.

According to IMF, *the international prices of analyzed raw materials* reduced by 5.6 percent in the second quarter of compared with the first quarter of 2017 and increased by 8.7 percent compared with the second quarter of 2016. Of these, the international *food prices* reduced by 0.6 percent compared with the previous quarter and were by 0.3 percent above the level recorded in the same period of 2016. The prices of *metals* reduced by 8.3 percent in the second quarter of 2017 on a quarterly basis and were higher by 17.3 percent than those

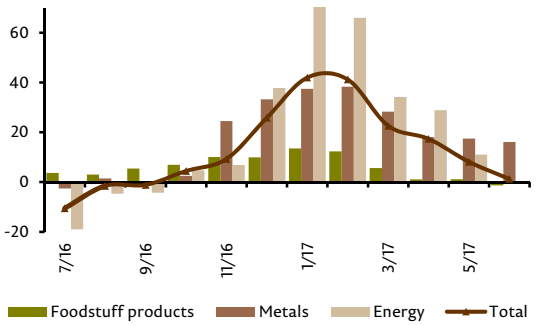
[3]USDX is an index calculated by weighted geometric mean of the USA dollar against foreign currency basket: EUR – 57.6%, JPY – 13.6%, GBP – 11.9%, CAD - 9.1%, SEK – 4.2%, CHF – 3.6%.

[4]Arithmetic mean, NBM accounts

recorded in the same period of 2016. The quotations of energy resources decreased by 7.2 percent compared with the previous quarter and increased by 12.7 percent in the second quarter of 2016. The slowdown of commodities price increase was due to the depreciation of the U.S. dollar, the negative reaction of the market to the extension of OPEC agreement to cut oil output and the enhanced risks on the world demand evolution (Chart 2.5).

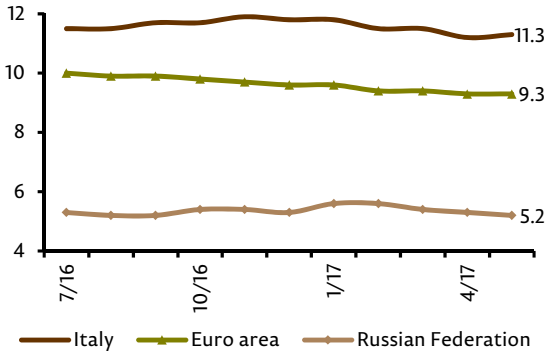
A shady situation continues to be recorded on *the labour markets* favored by emigrants from Moldova for work. In May 2017, the unemployment rate in the euro area maintained at the lowest level of 9.3 percent after March 2009. At the same time, after a significant drop, the unemployment rate in Italy is slightly increasing again, registering 11.3 percent in May 2017. In Romania, the unemployment rate is continuously dropping, making up 5.4 percent in May 2017, which is significantly lower than the average for the recent years. In Russia, the unemployment rate is dropping as a result of an increase in seasonal jobs. In May 2017, the unemployment rate in Russia was of 5.2 percent, dropping by 0.4 percentage points compared with the average unemployment rate recorded in the cold season of the year (January-February 2017) (Chart 2.6).

Chart 2.5: The annual growth rate of world prices indexes (%)



Source: IMF, NBM calculus

Chart 2.6: The unemployment rate in the euro area, Italy and Russian Federation (%)



Source: Eurostat, Federal State Statistics Service of the Russian Federation

2.2 Development of important economies

In the first quarter of 2017, the gross domestic product (GDP) of the *United States of America* increased by 0.4 percent compared with the previous quarter and by 2.1 percent compared with the same period of 2016. The year 2017 started with a slow increase of 1.1 percent of the industrial output during January-May 2017, compared with the same period of 2016. The unemployment rate in USA registered an increase by 0.1 percentage points in June 2017, reaching up to 4.4 percent. Also in June 2017, the consumer prices in USA increased by 0.1 percent compared with the previous month and by 1.6 percent compared with the price level of June 2016 (Tabelul 2.1). The unemployment rate and consumer price rates statistics arises concerns as to the sturdy recovery of the United States of America's economy and represents one of the reasons for caution showed by the Federal Reserve System on the decrease of the currency incentive.

The GDP of the *euro area*, increased by 0.6 percent in the first quarter of 2017 compared with the previous quarter and by 1.9 percent (seasonally adjusted) compared with the first quarter of 2016. Moreover, in early 2017, the industrial output in the euro area increased by 1.8 percent compared with the same period of 2016 – Germany – 1.9 percent, France – 1.1 percent and Italy – 1.8 percent (Table 2.1). The unemployment rate in the euro area in May 2017 kept to the minimal level of 9.3 percent recorded after March 2009. Due to the slowdown of energy resources prices increase, the annual inflation in euro area dropped to 1.3 percent in June 2017 (in April and May 2017, the annual inflation in euro area was 1.9 percent and 1.4 percent, respectively), out of which food prices increased by 1.4 percent, energy resources prices – by 1.9 percent, and the service prices – by 1.6 percent (Chart 2.2).

Table 2.1: The evolution of GDP, CPI and IPI in the selected economies(%)

	GDP QI,17/ QIV,16 (s.a.)	GDP QI,17/ QI,16	IPI Jan.-May17/ Jan.-May16	CPI Jun.17/ Jun.16
USA	0.4	2.1*	1.1	1.6
Euro area	0.6	1.9*	1.8	1.3
Germany	0.6	1.7*	1.9	1.6
France	0.4	1.0*	1.1	0.7
Italy	0.4	1.2*	1.8	1.2
Romania	1.7	5.7	7.8	0.9
Russian Federation	-0.5	0.5	2.0**	4.4
Ukraine	-0.3	2.5	-1.3	15.6

Source: Eurostat, national bureaus of statistics concerned
*based on seasonally adjusted series
**Jan.-Jun.2017/Jan.-Jun.2016

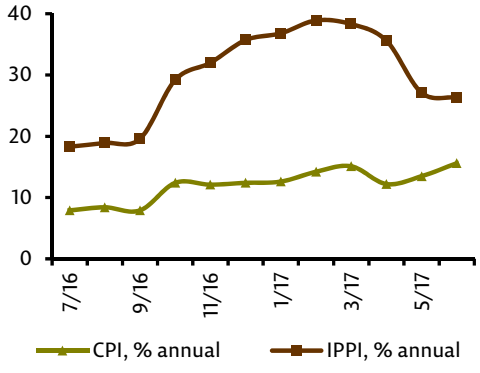
2.3 Development of the neighbouring countries' economies and the main trading partners

GDP in *Romania*, in the first quarter of 2017 was, in real terms, higher by 1.7 percent than in the fourth quarter of 2016, and increased by 5.7 percent as gross series and 5.6 percent as seasonally adjusted series compared with the same quarter of 2016. In January-May 2017, the industrial output increased, in comparison with the similar period of the previous year, by 7.8 percent as gross series and by 8.5 percent as seasonally and working-day adjusted series. The labour force market in Romania recorded a slightly downward trend and in May it was registered an unemployment rate of 5.4 percent. In June 2017, the consumer prices stagnated compared with the previous month but were higher by 0.9 percent than in June 2016 (Table 2.1).

In the first quarter of 2017, the *Russian Federation's* economy straitened by 0.5 percent compared with the fourth quarter of 2016 and increased on average by 0.5 percent compared with the first quarter of 2016. In the first quarter of 2017, the industrial output increased by 2.0 percent compared with the same period of 2016. At the same time, in January-May 2017, the retail trade straitened by 0.8 percent, while the exports and imports increased by 31.8 and 24.1 percent, respectively, when compared with the same period of 2016. The unemployment rate in the Russian Federation in May 2017 dropped by 0.1 percentage points, reaching 5.2 percent. It should be noted that following the increase in tariffs for utilities and prices for agriculture products due to the small harvest caused by draught, consumer prices slowly accelerated in June 2017 and the monthly inflation made up 0.6 percent. The consumer prices increased by 4.4 percent in June 2017, compared with the same period of the previous year, being by 0.3 percentage points higher than in May 2017. During this year, the reference rate was subject to a three-fold decrease under the Central Bank of the Russian Federation's initiative, the last occurring on 16 June 2017, when after a decrease by 0.25 percentage points, the reference rate reached the 9.0 percent value (Table 2.1).

In the first quarter of 2017, the GDP of *Ukraine* straitened by 0.3 percent, compared with the fourth quarter of 2016 and increased by 2.5 percent compared with the first quarter of 2016 (Table 2.1). In January-May 2017, the industrial output in Ukraine straitened by 1.3 percent, the construction output increased by 20.8 percent, and the agriculture output straitened by 0.9 percent. Moreover, on the annual basis, the exports increased by 26.8 percent and the imports – by 24.3 percent in January-April 2017. The consumer prices and the industrial output prices registered a significant upward trend, increasing by 15.6 and 26.3 percent, respectively in June 2017 (Chart 2.7).

Chart 2.7: The evolution of consumer prices in Ukraine (%)



Source: State Statistics Service of Ukraine

Chapter 3

Economic developments

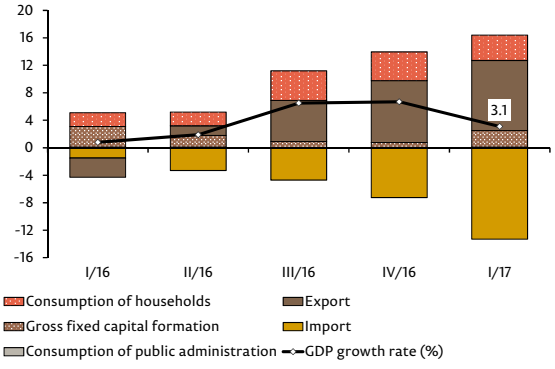
3.1 Demand and output

The economic activity has known a shy annual dynamic at the early stage of this year, after having recorded an increase in the second half of the previous year. In the first quarter of 2017, GDP increased by 3.1 percent compared with the same period of the previous year. During this time, the economic activity was positively influenced by the previous year's bumper crop, contributing to the increase of exports and the domestic demand, thanks to slightly larger available revenue of the population. Nevertheless, the slowdown of the economic growth was determined by the firm dynamic of imports that significantly reduced the positive share generated by other GDP subcomponents. Also, the seasonally adjusted series reflected a drop by 0.7 percent of GDP compared with the fourth quarter of 2016.

Demand

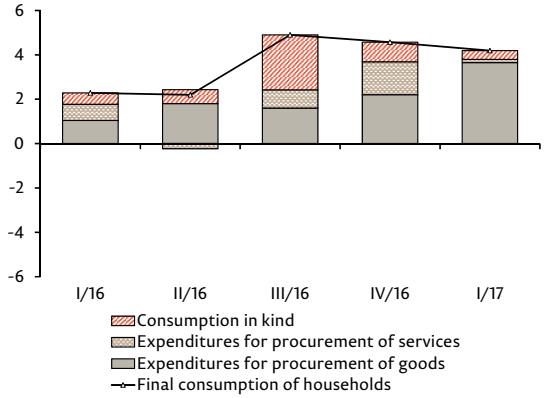
Based on uses (Chart 3.1), the positive GDP rate in the first quarter of 2017 was due to domestic and external demand. Thus, the final household consumption increased by 4.2 percent, generating a share of 3.7 percentage points to the annual GDP rate formation. This evolution was upheld by a slight increase of people's available revenue. The final consumption of the public administration recorded an insignificant evolution, dropping by 0.1 percent compared with the first quarter of 2016. If during the previous year, the investment structure generated a positive share to GDP dynamic based only on inventory variation subcomponent, in the first quarter of 2017 the gross formation of fixed capital recorded an increase by 3.3 percent, generating a share of 0.7 percentage points to the economic activity dynamic. The biggest impact on the positive dynamic of the economic activity was held by the exports evolution. The exports recorded an increase by 23.0 percent that could be mostly assigned to the bumper crop of the previous year. In this regard, in January-March 2017, food and live animal export increased considerably compared with the same period of the previous year. As it has been noted above, the economic activity was substantially slowed by the import evolution. Thus, in the first quarter of 2017, the imports were by 17.0 percent higher than in the same period of the previous year. This evolution can be assigned both to the boom of domestic demand and its direction to the external market, and to a reduced base period effect from early 2016,

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



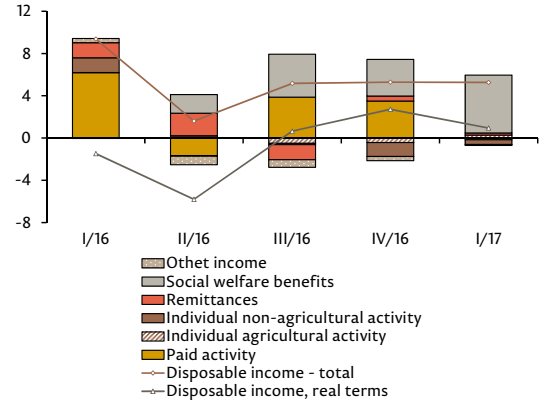
Source: NBS, NBM calculus

Chart 3.2: Components' contribution (p.p.) to the final consumption of households' growth (%)



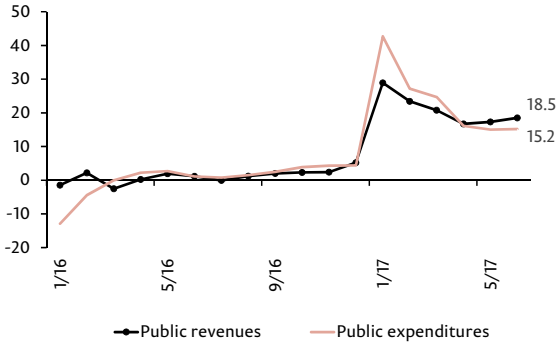
Source: NBS, NBM calculus

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



Source: NBS, NBM calculus

Chart 3.4: The dynamics of public revenues and expenditures (%, annual growth)



Source: Ministry of Finance

generated by imports adjustment due to significant depreciation of the national currency in this timeframe.

Consumer demand of the population

In the first quarter of 2017, the annual rate of household final consumption increased by 4.2 percent, by 0.4 percentage points lower than in the previous quarter. The positive evolution of people's consumption was largely determined by the goods consumer dynamic. Thus, the expenses for the purchase of goods increased by 5.0 percent, contributing by 3.7 percentage points to the annual household final consumer rate (Chart 3.2). Similar to the previous periods, the consumption in natural form recorded a positive annual dynamic, increasing by 3.6 percent and, thus, bringing in 0.4 percentage points. Also, the expenses for service purchase recorded a slow evolution (0.5 percent) compared with the first quarter of 2016, generating a positive contribution of 0.1 percentage points.

The annual household consumer dynamic was advantaged by the positive evolution of people's available revenue. Thus, in the first quarter of 2017, the annual people's available revenue rate made up 5.3 percent, similar to the one in the fourth quarter of 2016 (Chart 3.3). This annual rate value was determined by the income related to social benefits, generating a positive share of 5.5 percentage points for annual rate formation. It should be noted that, the share of social benefits increased by 2.0 percentage points compared with the previous quarter, while the share of salary-based activity decreased by 3.7 percentage points. Also, the remittances held a positive share of 0.2 percentage points in the formation of the annual rate, while individual non-farm activities generated a negativ contribution of 0.4 percentage points. The income from salaries and other joint income contributed by -0.3 percentage points to the annual rate formation. In the first quarter of 2017, the annual increase rate of the people's available revenue in real terms made up 0.9 percent, by 1.8 percentage points lower than in the fourth quarter of 2016.

Public sector

Execution of national public budget

According to the data provided by the Ministry of Finance, the government revenues amounted to MDL 24909.2 million in the 6 months, by 18.5 percent above the level of revenues for the same period of 2016 (Chart 3.4). The major part of budget revenues came from taxes and fees, accounting for a share of 65.7 percent (MDL 16353.6 million). Contributions and compulsory insurance premiums held a 29.2 percent share (MDL 7272.8 million), and the share of other revenues and grants was of 4.8 percent (MDL 1198.4 million) and 0.3 percent (MDL 84.4 million), respectively, of the overall budget revenues.

National public budget expenditures amounted to MDL 25010.7 million in 6 months of 2017, increasing by 15.2 percent compared with the same period of 2016. Of the total expenditures, the social protection expenses held the largest share (37.7 percent), education – 18.7 percent, and healthcare – 13.3 percent. 9.4 percent and 8.5 percent, respectively, were allocated for state services for general purpose and economy-related services, while national defense, public order, and national security services

benefitted from 7.8 percent of budget expenditures. Other areas received modest financing.

National public budget execution resulted in MDL 101.5 million deficit in the first 6 months of 2017. During the same period of 2016, the national public budget execution recorded a deficit of MDL 678.1 million. The national public budget accounts' balance, as of 30 June 2017, increased by MDL 1215.9 million, compared with 1 January 2017, accounting for MDL 5996.3 million.

State debt

As of 30 June 2017, the state debt of the Republic of Moldova amounted to MDL 50657.3 million, lower by 0.3 percent than in late 2016. The state debt at the end of June 2017 consisted of external state debt, with a share of 57.5 percent and internal state debt of 42.5 percent. The state debt increased by 42.3 percent or by MDL 15060.9 million compared with 30 June 2016, due to the increase of the internal state debt (by a positive share of 36.5 percentage points) and the external state debt (by a positive share of 5.8 percentage points).

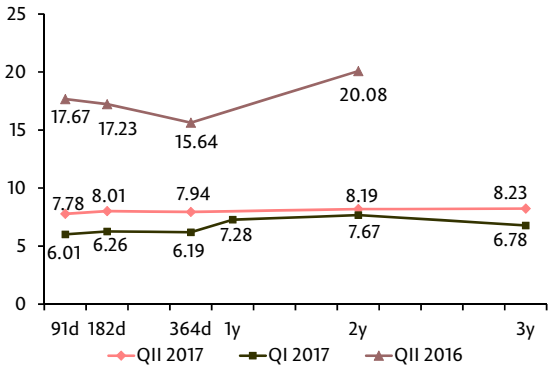
In January-June 2017, the balance of the external state debt, recalculated in national currency, decreased by about MDL 135.5 million or by 0.5 percent due to the appreciation of the Moldovan leu, making up MDL 29130.7 million in June 2017. At the same time, the external state debt in foreign currency amounted to USD 1604.6 million, recording an increase by about USD 139.9 million or 9.5 percent compared with the beginning of the year. During the first semester of 2017, the net external financing reached a positive value, accounting for USD 68.3 million. Also, USD exchange fluctuation against other currencies had positive values and held USD 71.7 million. During the first semester of 2017, MDL 169.0 million were used to cover the external state debt.

As of 30 June 2017, the internal state debt accounted for MDL 21526.6 million, by MDL 7.0 million higher than in late 2016. The internal state debt increased 2.5-fold compared with the same period of 2016. The internal state debt changed largely due to the issuance of state securities in October 2016 so that the Ministry of Finance could meet its payment liabilities arising from the state guarantees No 807 of 17 November 2014 and No 101 of 1 April 2015, amounting to MDL 13.3 billion. Also, during the analyzed period, the amount of state securities issued on the primary market reduced by 5.3 percent. Due to such evolutions, in late June 2017 the internal debt was formed from state securities issued on the primary market (28.4 percent), converted state securities (9.6 percent) and state securities issued to cover state guarantees (62.0 percent). In January-June 2017, MDL 621.5 million were paid to the internal state debt.

State securities yield curve

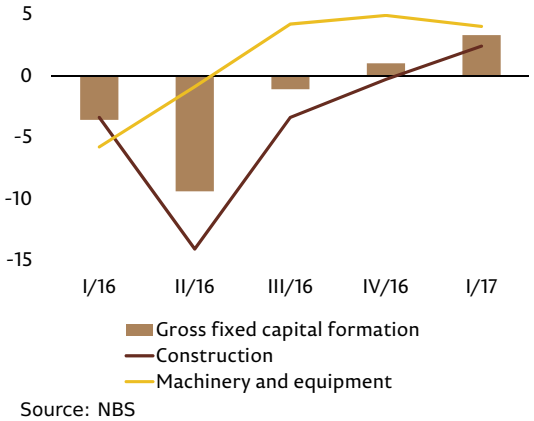
In the second quarter of 2017, the volume of state securities traded on the primary market amounted to MDL 2112.3 million, by 22.6 percent lower than in the previous quarter. The volume of securities realeased into circulation during the reference period was by 11.1 percent lower than the volume initially announced by the Ministry of Finance. The ratio between the demand of the auction participants and the supply from the issuing authority was 1.44.

Chart 3.5: SS yield curve (%)



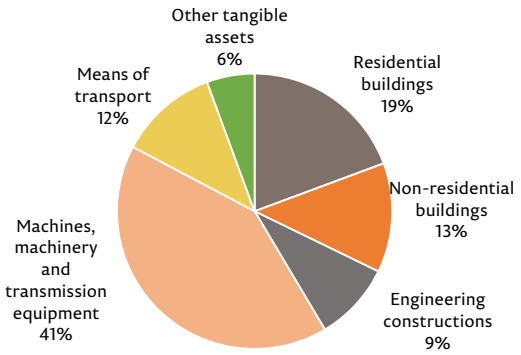
Source: NBM

Chart 3.6: The annual growth rate of investment (%)



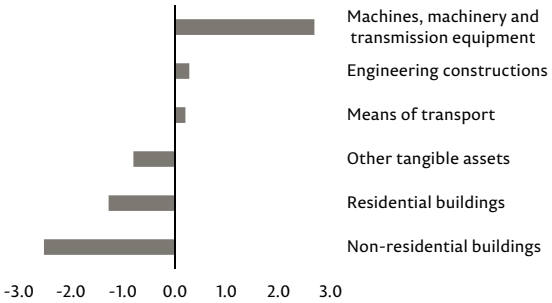
Source: NBS

Chart 3.7: Structure of investments in tangible assets in the first quarter of 2017



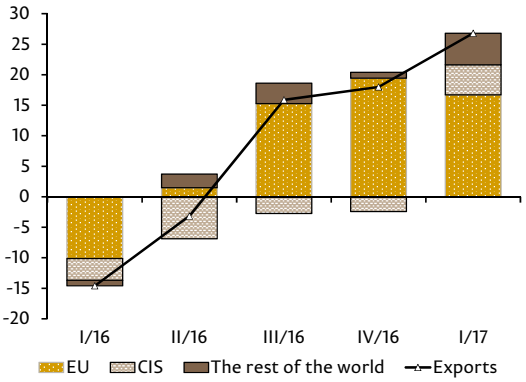
Source: NBS, NBM calculus

Chart 3.8: Components' contribution to increasead investment in tangible assets in the first quarter of 2017 (p.p.)



Source: NBS, NBM calculus

Chart 3.9: Evolution of exports annual rate (%) and contribution by categories of countries (p.p.)



Source: NBS, NBM calculus

The effective average interest rate of treasury bills with 91-day maturity accounted for 7.78 percent, by 1.8 percentage points above the average interest rate level recorded in the previous quarter. 182-day treasury bills were placed at an effective average rate of 8.01 percent, by 1.7 percentage points higher than in the first quarter of 2017, and those of 364-day maturity – 7.94 percent, by 1.7 percentage points higher than in the previous quarter (Chart 3.5).

2-year maturity state bonds were traded at an average effective rate of 8.19 percent, higher by 0.5 percentage points compared with the previous quarter. 3-year maturity state bonds were traded at an average effective rate of 8.23 percent, higher by 1.4 percentage points compared with the previous quarter.

364-day maturity treasury bills held 41.4 percent of the total transactions, the largest share in the amount of state securities released into circulation during the reference period, followed by 182-day treasury bills with 31.0 percent, while 91-day treasury bills accounted for 24.9 percent. The share of 2-year maturity state bonds accounted for 2.0 percent, while that of the 3-year maturity state bonds – 0.7 percent.

Investment demand

If the investment component generated the previous year a positive share to GDP dynamic mostly due to inventory variations subcomponent, in the first quarter of 2017 the gross formation of the fixed capital registered an increase as well, contributing by 0.7 percentage points to the economic activity dynamic. Thus, the fixed capital investments increased by 3.3 percent, due to the increase of investments in construction by 2.4 percent, and in machinery and equipment by 4.0 percent (Chart 3.6).

At the same time, according to the operative information provided by NBS, in January-March 2017, the volume of investments in long-term assets decreased by 1.2 percent, compared with the same period of the previous year. The intangible assets investments increased by 14.3 percent. Also, the tangible assets investments[5] further recorded a more moderate negative annual dynamic, compared with the previous periods (-1.4 percent in the first quarter of 2017, compared to -22.6 percent in the first quarter of 2016).

The groups "machines, machinery and transmission equipment" (holding a substantial share), "engineering constructions" and "means of transport" (Chart 3.7 and Chart 3.8) had the most significant positive contribution to the fixed assets. This evolution had been outweighed by the decrease of investments in "constructions and buildings" and "other fixed assets", especially "land".

In terms of funding of long-term assets investment, the negative dynamic was largely determined by the enterprises and population's raising of capital evolution (-4.7 percent). This component held 75.0 percent in the amount of investment assets.

[5]As of 1 January 2017 The Statistical questionnaire 2-INV on investments has been amended to adapt the statistical tools (terms and definitions used, methods of accounting and presentation of indicators) to the new National Standards of Accounting, that came into effect as binding on 1 January 2015.

A major adjustment was recorded within the investments funded from the state budget (2.2-fold). This was largely due to the low base effect that was triggered by the slow adoption of the state budget for 2016.

Net external demand[6]

In the first quarter of 2017, the annual exports rate (denominated in U.S. dollars) accounted for 26.8 percent, or by 8.8 percentage points higher than in the fourth quarter of 2016. This development was mostly determined by the reanimation of exports to CIS countries and the maintenance of firm growth rate of those to EU countries. Thus, in the first quarter of 2017, exports to EU and CIS countries increased by 26.4 and 24.7 percent, respectively, generating a positive share of 16.7 and 4.9 percentage points, respectively (Chart 3.9). It should be noted that, in the first quarter of 2017, the exports to CIS countries returned to the positive pattern following a break of 4 years when only negative growth trends had been registered. Also, exports to "rest of the world" countries increased by 30.1 percent. However, under a lower share, these exports contributed only by 5.2 percentage points to the growth of total exports.

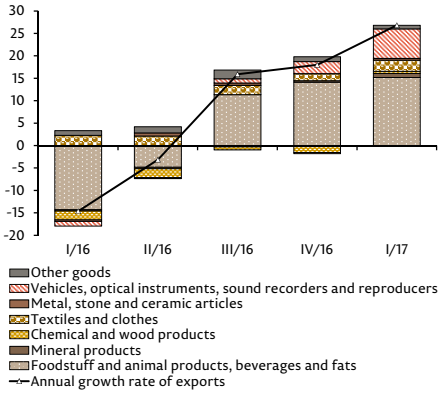
The analysis of exports by groups of goods (Chart 3.10) reveals the significant positive contribution of the group "products of the animal kingdom, beverages and fats" (15.2 percentage points in the first quarter of 2017) for the third consecutive quarter, conditioned by the annual growth of exports of such products by 36.0 percent. Most exports of agri-food products during the recent three quarters have been triggered by the strong growth of the agricultural sector in the previous year (the amount of agricultural products increased by 18.2 percent in 2016). Also, the exports of goods from the groups "vehicles, optical and sound recording or playing apparatuses" and "textile and clothing" increased by 35.9 and 13.1 percent, respectively, contributing by 6.6 and 2.5 percentage points, respectively to the growth of overall exports.

In the first quarter of 2017, the annual rate of imports recorded a strong acceleration, compared with the late 2016. Thus, in the first quarter of 2017, the annual rate of imports of goods amounted to 19.7 percent, or by 9.9 percentage points higher than at the end of the previous year.

It should be noted that in the first quarter of 2017, further animation of imports was triggered by their evolution on all categories of countries (Chart 3.11). Thus, imports from EU and "rest of the world" countries increased by 23.2 and 25.8 percent, respectively, contributing to an annual import rate growth by 10.6 and 6.7 percentage points, respectively. At the same time, CIS imports increased by 8.4 percent, conditioning 2.5 percentage points to the annual import rate formation (Chart 3.11).

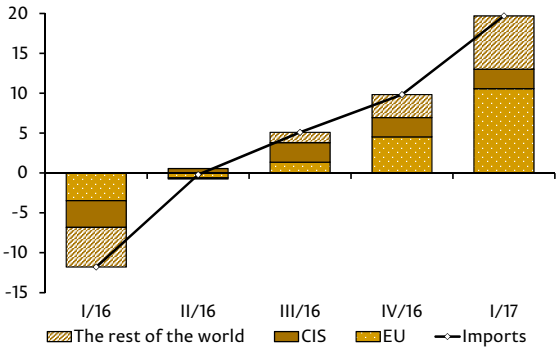
By groups of goods (Chart 3.12), most of the annual imports rate was largely influenced by the import growth of "vehicles, optical and sound recording or playing apparatuses", "chemical and wood processing industry products" and "textile and clothing", generating a positive contribution of 6.1, 5.7 and 2.3 percentage points, respectively.

Chart 3.10: Evolution of exports annual rate (%) and subcomponents contribution by groups of goods (p.p.)



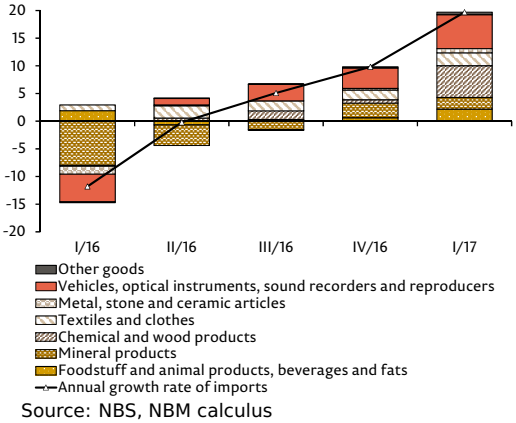
Source: NBS, NBM calculus

Chart 3.11: Evolution of imports annual rate (%) and subcomponents contribution by categories of countries (p.p.)



Source: NBS, NBM calculus

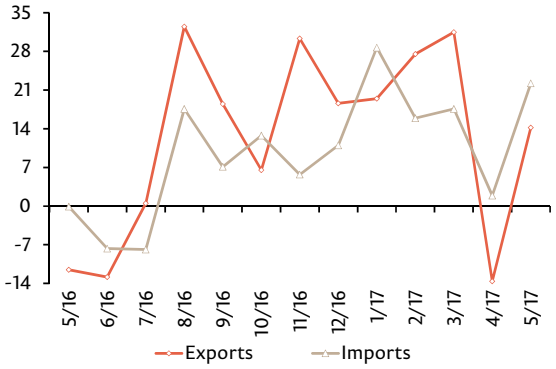
Chart 3.12: Evolution of imports annual rate (%) and subcomponents contribution by groups of goods (p.p.)



Source: NBS, NBM calculus

[6]Quarter data on the evolution of external trade of the Republic of Moldova, denominated in thousands U.S. dollars, were used.

Chart 3.13: The evolution of foreign trade (f.a.p., USD, %)



Source: NBS

The operative external trade data of the Republic of Moldova for the first two months of the second quarter of 2017 show a slowdown trend (Chart 3.13). The annual imports rate for this timeframe accounted for 12.1 percent, by 7.7 percentage points lower than in the first quarter of 2017. Also, the annual exports rate recorded 0.6 percent, by 26.2 percentage points lower than in the first quarter of 2017.

Production

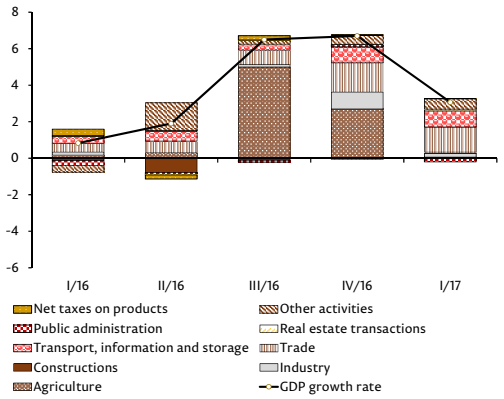
By categories of resources, GDP growth was mainly determined, in the first quarter of 2017, by the contribution from the subcomponent trade and transport, information and storage (Chart 3.14). These[7], as a whole, increased by 10.5 percent compared with the same period of the previous year. Agriculture and construction generated similar shares (by 0.1 percentage points), increasing by 1.8 and 2.7 percent, respectively, compared with the first quarter of 2016. The gross value added (GVA) of the industry sector was by 1.2 percent higher than in the same period of the previous year. The only segment that generated a negative share to GDP growth was the subcomponent "public administration and defense; compulsory social insurance; education; healthcare and social assistance". The value added related to it decreased by 1.2 percent, compared with the first quarter of 2016, triggering a negative contribution of 0.2 percentage points.

In the first two months of the second quarter of 2017, the annual industrial output increase rate recorded an average negative level of 1.2 percent, by 2.7 percentage points lower than in the first quarter of 2017 (Chart 3.15). This dynamic was determined by a slowdown in the annual manufacturing industry (from 1.3 percent in the first quarter of 2017 to -1.7 percent in the first two months of the second quarter of 2017) and in "electricity and heating, gas, hot water and air conditioning production and supply" sector (from 4.8 percent in the first quarter of 2017 to -3.6 percent in the first two months of the second quarter of 2017). At the same time, the annual extraction industry output increased by 27.6 percentage points in April-May 2017 compared with the first quarter of 2017.

In the second quarter of 2017, the annual growth rate of transported goods recorded an average level of 27.8 percent, or by 11.6 percentage points higher than in the first quarter of 2017. It should be noted that this strong growth of the annual rate was largely determined by the growth of transported goods by road (Chart 3.16). At the same time, rail, road, waterways and air carriers transported by 22.5 percent more goods in January-June 2017 than in the same period of 2016. This development was determined by an annual growth of goods transported by rail (32.7 percent), road (19.1 percent) and air (2.0-fold). Also, annual waterway transportation rate decreased by 19.6 percent.

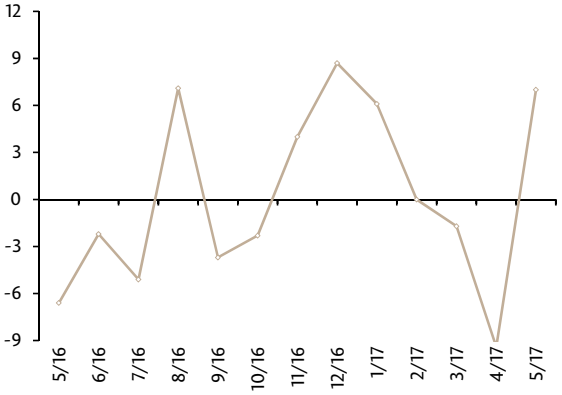
The data on domestic trade for April-May 2017 show a decrease both of the trade in services and trade in goods (Chart 3.17). Thus, the turnover in retail companies recorded an average decrease of 5.7 percent, by 0.6 percentage points lower than in the first quarter of 2017. Also, the turnover of service companies recorded, in the first two months of the second quarter of 2017, an average decrease of 0.1 percent, by 1.3 percentage points lower than in the previous quarter.

Chart 3.14: The contribution of economic sectors to GDP growth (p.p.)



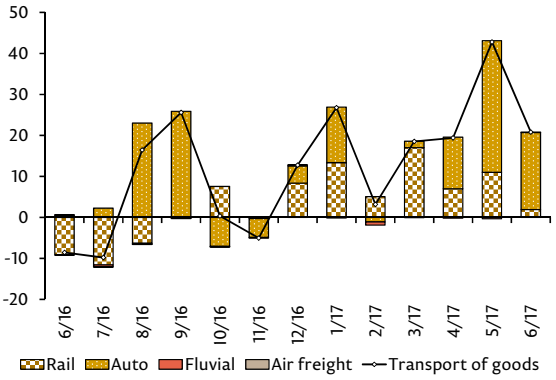
Source: NBS, NBM calculus

Chart 3.15: Evolution in real terms of industry (%, versus the same month of the previous year)



Source: NBS

Chart 3.16: Evolution of goods transport (%, versus the same month of the previous year)



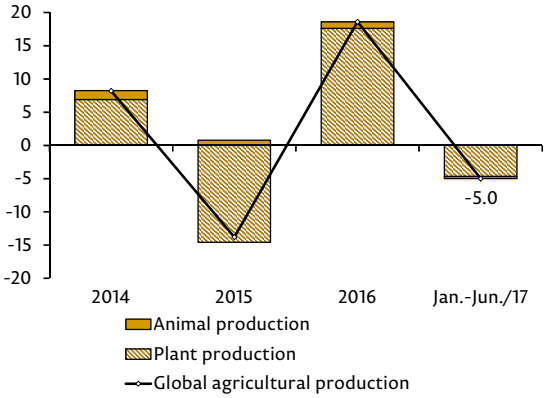
Source: NBS

[7] Wholesale and retail, maintenance and repair of vehicles and motorcycles, transportation and storage, accommodation and public catering.

Chart 3.17: Evolution of domestic trade (%, versus the same month of the previous year)

Source: NBS

Chart 3.18: Global agricultural production (%, versus the previous year)



Source: NBS, NBM calculus

Agricultural production

In the first half of the year 2017, the volume of global agricultural production decreased by 5.0 percent compared with the same period of 2016 (Chart 3.18). This evolution was largely determined by a drop in vegetal production by 28.4 percent, resulting from the late harvesting of agricultural products, that was influenced by an uneven thermal regime accompanied by snowfall and sleet in April. Also, the slight drop of animal sector production (-0.4 percent) was generated by a negative evolution of “milk” (-3.9 percent) and “cattle and poultry” (-0.8 percent) production. During the reference period, the “eggs” production increased by 6.6 percent.

3.2 Labour market

In the first quarter of 2017, the share of both employed and active population was slightly higher than in the same period of the previous year. The unemployment rate registered a marginal dynamic compared with the one from the beginning of the previous year. The wage fund recorded a real increase compared with the first quarter of 2016.

Workforce

In the first quarter of 2017, the share of both active and employed population recorded a small evolution compared with the same period of the previous year, increasing by 0.3 and 0.2 percent, respectively (Chart 3.19). According to the analysis of the national economy, the annual dynamic of employed population was supported by the increase of employment in trade, by 7.2 percent and in social services, consisting of public administration, education, healthcare and social assistance, by 9.7 percent. The number of people employed in the industry sector increased by only 0.5 percent. At the same time, the agricultural, construction, transport and communications sectors recorded a drop in employment by 4.4, 1.3 and 7.0 percent, respectively compared with the first quarter of 2016. Negative evolutions have been signaled in real estate transactions, financial activities, hotels and restaurants, the employment in these sectors decreasing, in general, by 12.0 percent.

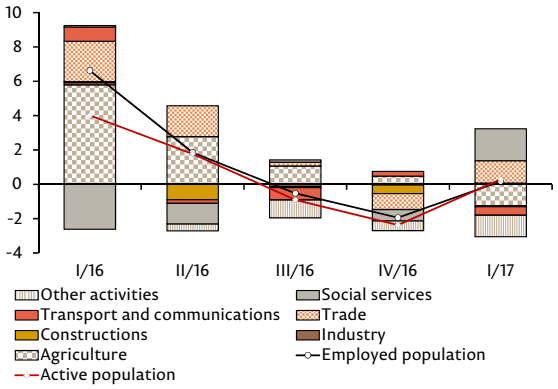
The unemployment rate in the first quarter of 2017 constituted 6.3 percent, recording a marginal dynamic (0.1 percentage points) compared with the first quarter of 2016 (6.2 percent). Also, the seasonally-adjusted unemployment rate accounted for 4.3 percent, by 0.3 percentage points higher than at the end of the previous year. The occupancy rate was of 41.7 percent, by 1.3 percentage points higher than in the fourth quarter of 2016 (Chart 3.20).

Wage fund

In the first quarter of 2017, the wage fund increased by 11.1 percent, while in real terms, deflated by CPI, it increased by 6.5 percent compared with the same period of the previous year. Moreover, the average share of employees per national economy was by 0.2 percent lower than in January-March 2016 (Chart 3.21).

During the reference period, the average wage in the national economy increased by 11.3 percent compared with the first quarter of 2016. Both the budget and the real economy sectors recorded an increase of the average wage by 12.6 and 10.7 percent, respectively, compared with the corresponding period of 2016. During this period, the annual growth rate of the real average wage per capita accounted for 6.7 percent, by 3.7 percentage points lower than in the fourth quarter of 2016 (Chart 3.22). This growth was determined by both the wage dynamic in

Chart 3.19: Annual growth rate of employed population (%) and its formation by national economy sectors (p.p.)

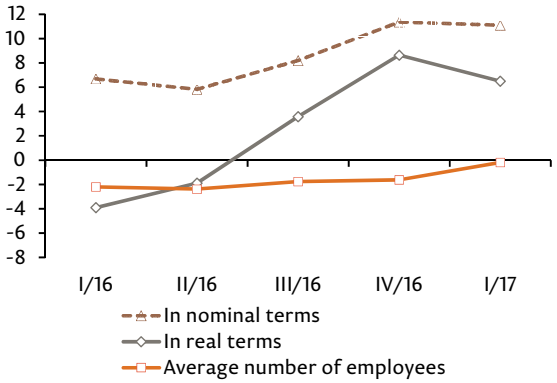


Source: NBS, NBM calculus

Chart 3.20: Evolution of the unemployment and employment rate (%)

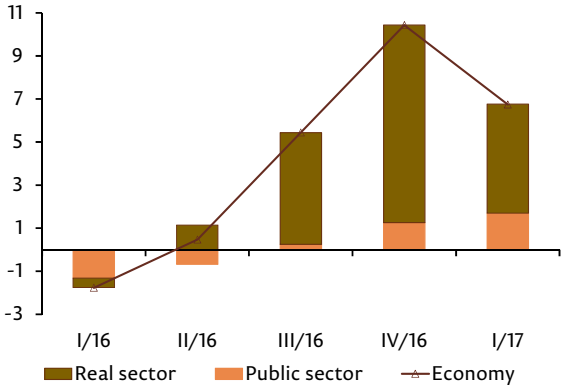
Source: NBS, NBM calculus

Chart 3.21: Wage bill in economy and average number of employees (%, versus the same period of the previous year)



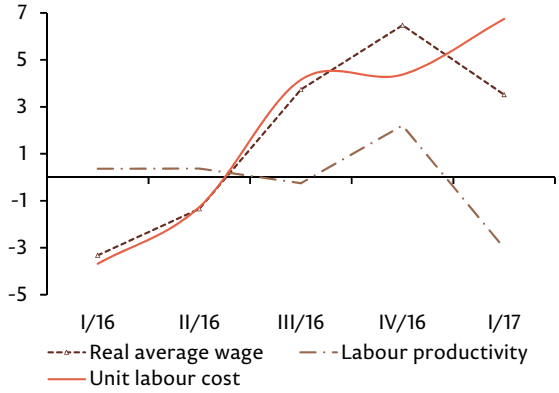
Source: NBS, NBM calculus

Chart 3.22: Real contributions of economy sectors (p.p.) to earnings growth (%, versus the same period of the previous year)



Source: NBS, NBM calculus

Chart 3.23: Average real wage and productivity in industry (%, versus the same period of the previous year)



Source: NBS, NBM calculus

the budget sector (8.0 percent), and the wage dynamic in the real sector (6.2 percent), positively contributing by 1.7 and 5.1 percentage points, respectively, to the general average wage growth per capita.

The annual growth rate of work productivity in industry accounted for -3.0 percent, by 5.2 percentage points lower than in the fourth quarter of 2016. Also, the annual dynamic of the real average wage in industry accounted for 3.5 percent, by 3.0 percentage points lower than in the fourth quarter of 2016 (Chart 3.23). Thus, the annual growth rate of labour unit cost in industry increased by about 2.4 percentage points, up to 6.7 percent.

3.3 External sector

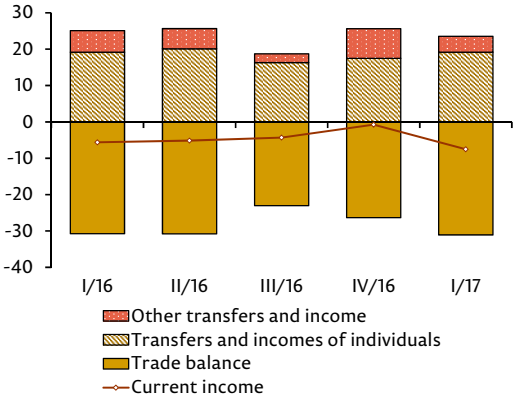
In the first quarter of 2017, the current account deficit[8] of the balance of payment[9] increased, making up a share of 7.5 percent in GDP, by 6.8 percentage points higher than in the previous quarter (Chart 3.24). The increase of balance of payment deficit occurred as a result of a negative balance of the trade balance sheet in GDP. At the same time, the components with positive contribution, transfers and revenues of individuals and other transfers and revenues recorded both growth and decrease. Thus, the component other transfers and revenue dropped by 3.7 percentage points compared with the previous quarter, while transfers and revenue of individuals increased by 1.7 percentage points as a share of GDP. The trade balance sheet deficit's share to GDP increased by 4.8 percentage points in the first quarter of 2017 compared with the fourth quarter of 2016, amounting to 31.1 percent. This growth was driven by an increase in the share of imports to GDP by 8.2 percentage points, on one hand, and by the increase of share of exports by 3.4 percentage points, on the other hand.

During the reference period, the export of goods and services increased as a share to GDP up to 50.4 percent (Chart 3.25). This development was determined by a growth of non-food products export as a share to GDP by 3.9 percentage points, up to 19.5 percent, while the service export increased as a share to GDP by 1.6 percentage points, up to 14.9 percent, and that of agri-food products export decreased by 2.1 percentage points (16.1 percent in GDP). Within the exports structure the non-food goods prevailed with 38.6 percent, agri-food products constitued 31.8 percent and services – 29.6 percent.

In the first quarter of 2017, the import of goods and services' share to GDP increased by 8.2 percentage points compared with the previous quarter, amounting to 81.7 percent. It should be noted that all import components related to GDP recorded higher values than those from the fourth quarter of 2016. Thus, non-food and agri-food products increased by 4.3 and 2.0 percentage points, respectively. As a share to GDP, these components accounted for 46.1 and 11.3 percent, respectively. Also, the share of energy resources and services increased by 1.0 percentage point. As a share to GDP, these components made up 11.1 and 13.2 percent, respectively. Within the structure of imports, the share of non-food products was of 56.4 percent, services – 16.2 percent, agri-food products – 13.9 percent and energy resources – 13.5 percent.

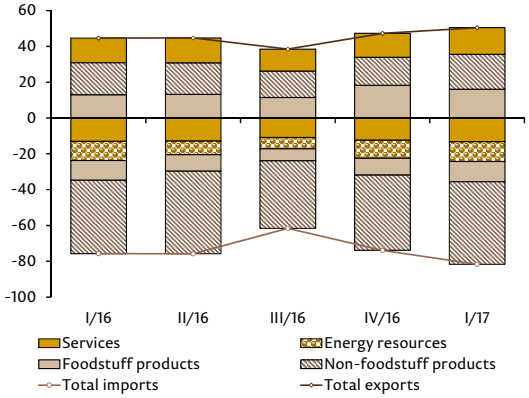
For the analyzed period, the exports disclosed in the trade balance sheet covered the respective imports to a smaller extent (61.7 percent) compared with the fourth quarter of 2016 (63.9 percent). Also, according to NBS data, the trading partners of the Republic of Moldova, such as Romania, Russia, Ukraine, Germany, Italy, Turkey,

Chart 3.24: Current account share in GDP (%)



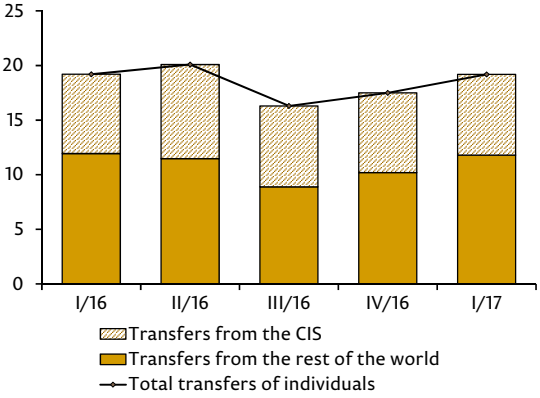
Source: NBM

Chart 3.25: Share of exports and imports in GDP (%)



Source: NBM

Chart 3.26: Share of transfers in GDP (%)

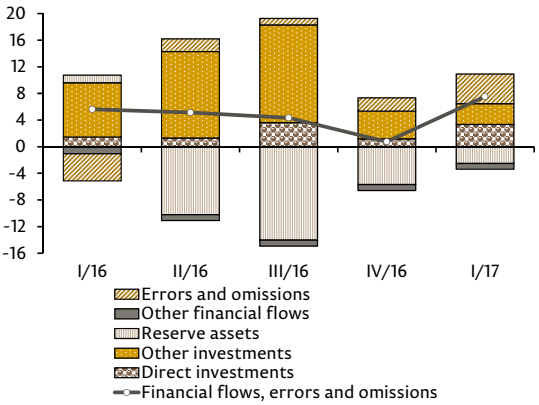


Source: NBM

[8] For the current account analysis, no standard terminology according to the IMF methodology was used. The category Total transfers of individuals discloses the information about the labour compensations and employee's transfers (current account items), other items, except for those included in the trade balance sheet, being regrouped in the category Other transfers and revenue.

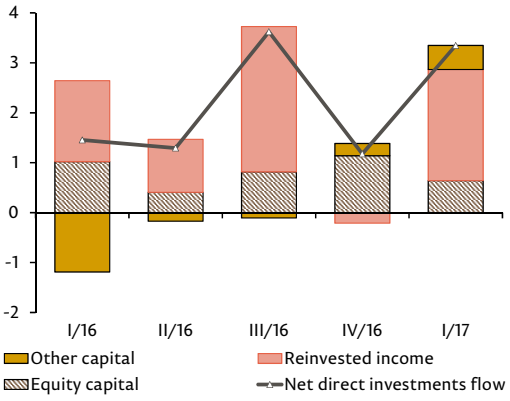
[9] Information compiled based on MBP5.

Chart 3.27: Share of financial flows in GDP (%)



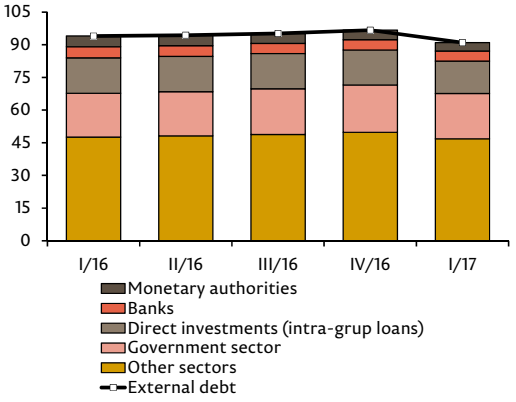
Source: NBM

Chart 3.28: Share of direct investments in GDP (%)



Source: NBM

Chart 3.29: Share of external debt in GDP (%)



Source: NBM

and Belarus held 56.8 percent of the overall trade transactions carried out to export-import operations with goods and services in the first quarter of 2017.

In the first quarter of 2017, the transfers and personal incomes of individuals working abroad increased as a share to GDP by 1.8 percentage points, compared with the previous quarter, thus amounting to 19.2 percent (Chart 3.26). The upward trend of transfers was driven by the growth of transfers from countries falling in the group "Rest of the World". Thus, in the first quarter of 2017, all funds transferred from CIS countries made a share of up to 7.4 percent in GDP, by 0.1 percentage points higher than in the fourth quarter of 2016, and those from "Rest of the World"[10] made up a share of 11.8 percent in GDP, by 1.7 percentage points higher than in the previous quarter. According to geographical distribution, the transfers from countries falling in "Rest of the World" category accounted, during the reference period, for 61.5 percent, and those from CIS countries – 38.5 percent.

In the first quarter of 2017, the financial flow invigorated. Thus, its share in GDP increased by 6.8 percentage points compared with the fourth quarter of 2016, recording a level of 7.5 percent (Chart 3.27). This financial flow growth as a share to GDP was determined by the evolution of "direct investments" and "other investments". The growth of the positive contribution of "direct investments" was driven by the evolution of "reinvested revenue" group, while that of "other investments" – by the share of trade loans to GDP. At the same time, the growth of official reserve assets influenced the decrease of financial inflow on the market (negative contribution from "reserve assets", but its contribution is considerably lower than that of those recorded during the last three quarters).

During the reference period, the direct investments in GDP recorded an upward trend, recording a level of 3.3 percent, or by 2.1 percentage points higher than in the fourth quarter of 2016. According to the structure, the growth of the direct investment share in GDP was determined by a positive contribution from "reinvested revenue". Also, similar to the recent time, it is seen a growth of "equity capital" investment in GDP; however, the dynamic is still low (Chart 3.28).

The share of the external debt to GDP[11], reached 91.0 percent in the first quarter of 2017, by 5.7 percentage points lower than in the previous quarter (Chart 3.29). All economy sectors contributed to its decrease, compared with the fourth quarter of 2016. It should be noted that this downward trend of the external debt share to GDP was driven by the increase of GDP denominated in U.S. dollars. Moreover, these evolutions did not fundamentally change the external debt structure. Thus, similar to the previous periods of time, the major share in the overall external debt was held by the economic agents with 51.4 percent, followed by the government sector – 24.6 percent and direct investments – 14.9 percent.

[10] It is about transfers received from all countries of the world, except CIS member states.

[11] GDP estimated for 2017.

Chapter 4

Monetary Policy

4.1 Monetary Policy Instruments

Interest rate policy

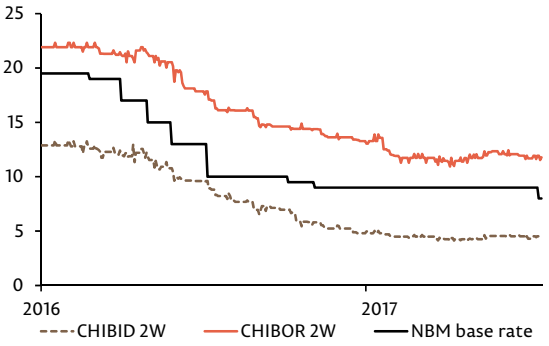
The decisions on maintaining the monetary policy rate at 9.0 percent per year in the second quarter of 2017 have been supported by the settlement of the annual inflation rate within or slightly above the range of ± 1.5 percentage points of 5.0 percent inflation target and the breath of new life in the economy's activity. Moreover, at the end of the quarter, a new decision on the monetary policy was made, according to which the monetary policy interest rate was reduced by 1.0 percentage points to 8.0 percent per year. This decision was based on the macroeconomic indicators' dynamic recorded in the last 2-3 months, outlining a slowdown of the economic activity and a reduction of inflationary pressure in the medium-term, under real moderate overvaluation of the national currency.

CHIBOR 2W yield curve kept its position during the reporting quarter, recording smooth changes in both directions. CHIBOR 2W quotation registered at the end of June was marginally higher than that recorded in the last day of the previous quarter, accounting for 11.78 percent.

The interest rates on 91-days state securities continued an upward trend during April-May, after which in June, the yield curve flattened (Chart 4.2). In the last month of the quarter, the average interest rate on 91-days state securities accounted for 7.63 percent (+1.12 percentage points compared with the value recorded in the last month of the previous quarter).

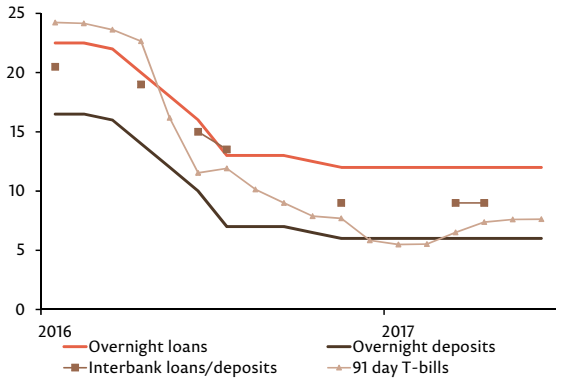
In the second quarter of 2017, the quarter average yield rate on the buying and selling operation on the secondary market of state securities accounted for 7.81 percent, increasing by 1.61 percentage points compared with the previous quarter, conditioned by the decrease of the weighted average maturity from 304 days to 212 days. The traded volume accounted for MDL 5.7 million, increasing by MDL 0.6 million, compared with the previous period. The recorded transactions were dominated by the bank-customer operations, accounting for 56.1 percent of the overall transactions.

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



Source: NBM

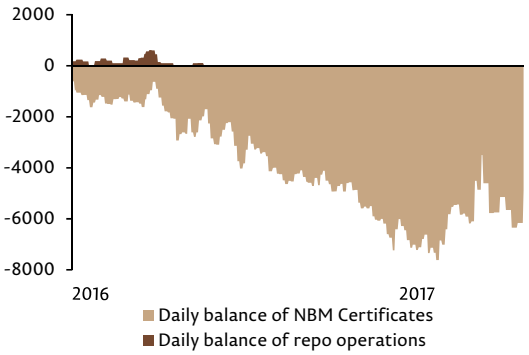
Chart 4.2: The monthly evolution of interest rates corridor (%)



Source: NBM

Monetary market operations

Chart 4.3: The daily balance of money market operations (MDL, million)



Source: NBM

The net debtor position of NBM to the banking system was maintained during the second quarter of 2017, but this value reduced compared with the previous period and the liquidity excess was absorbed through the auctions of NBM Certificates placement (NBC).

NBM carried out the auctions of NBC placement two times per week in the first two months of the quarter, reducing the frequency to one time per week at the beginning of May. The auctions took place with the announcement of the maximum interest rate equivalent to the NBM base rate. As a whole of the second quarter of 2017, the weighted average rate of liquidity absorption operations accounted for 8.95 percent annually.

The stock of NBC placement operations varied during the quarter between the minimum value of MDL 3502.9 million and maximum value of MDL 6346.9 million, being driven by the decisions of the monetary policy and currency purchase made by NBM during the reference period. The monthly average balance of NBC accounted for MDL 5552.8 million (MDL -1159.5 million compared with the first quarter of 2017) (Chart 4.3).

Lending activity

As of 30 June 2017, the credit indebtedness to the National Bank of Moldova accounted for MDL 0.25 million, being fully represented by loans granted to banks during 1992-2002 for crediting the construction of housing cooperatives.

The balance of loans granted to banks decreased by MDL 0.05 million compared with the previous quarter.

Following the evaluation of the loan portfolio of June 2017, no impairment allowances were formed for the loans.

Standing facilities

Standing facilities regime (overnight deposits and credits) set by NBM allowed banks to manage their liquidity efficiently and granted NBM more flexibility in the implementation of its own monetary policy.

During the second quarter of 2017, banks used daily the overnight deposit facility, while the credit facility was requested only in April by a single bank to supply the short-term liquidity demand.

The total volume of overnight deposits with NBM amounted in the analyzed quarter to MDL 69702.5 million, representing a daily average balance of MDL 1108.3 million, by 3.0 percent higher than in the previous quarter. The amount of overnight deposits varied between the minimum MDL 5.0 million and maximum MDL 1600.0 million.

The amount of overnight credits granted during the analyzed period was of MDL 246.0 million, indicating an average balance of MDL 2.7 million.

The interest rates for standing facilities of NBM were simultaneously decreased with the base rate by 1.0 percentage points in late quarter 2, 2017. Thus, the interest rate of overnight deposit facility was set at 5.0 percent annually, while that of the overnight credit facility – 11.0 percent annually.

Required reserves

In the second quarter of 2017, the required reserves mechanism played a leading role in the monetary control and liquidity management in the banking system.

The characteristics of the required reserves mechanism changed following the decisions made during NBM Executive Board's sessions, by increasing the required reserves ratio based on the attracted funds in MDL and non-convertible currency, as follows:

- For the required reserves' maintenance period from 8 April 2017 to 7 May 2017, the required reserves ratio was set at 37.0 percent of the base;
- Starting with the required reserves' maintenance period from 8 May 2017 – 7 June 2017, the required reserves ratio was set at 40.0 percent of the base.

The required reserves ratio from the attracted means in freely convertible currency was maintained at the level of 14.0 percent of the base.

The required reserves in MDL maintained by banks from 8 June 2017 to 7 July 2017 amounted to MDL 12137.6 million, by MDL 1641.9 million (about 15.6 percent) higher than those at the end of the previous quarter (8 March 2016 – 7 April 2017). The increase of the required reserves in MDL was mostly due to the increase of the required reserves ratio in MDL.

As of 30 June 2017, the required reserves in FCC maintained by the banks with NBM accounted for USD 62.0 million and EUR 110.8 million. The required reserves in USD increased by 0.6 percent and those in EUR – by 1.3 percent compared with 31 March 2017, due to the growth of funds attracted in these currencies.

Interbank money market

In the second quarter of 2017, due to a persistent excess of liquidity attested in the banking system, the interbank credit/deposit market was passive. Only in April was that an insignificant transaction of MDL 35.0 million registered, with a minimum market maturity and with an annual interest rate of 9.0 percent, falling into NBM rate corridor.

State deposits with the National Bank of Moldova

As of 30 June 2017, the deposit balance of the Ministry of Finance with the National Bank of Moldova accounted for MDL 528.9 million. The weighted average rate of the balance deposits was of 7.57 percent annually, and the weighted average maturity – 603 days.

Intervention on the domestic foreign exchange market

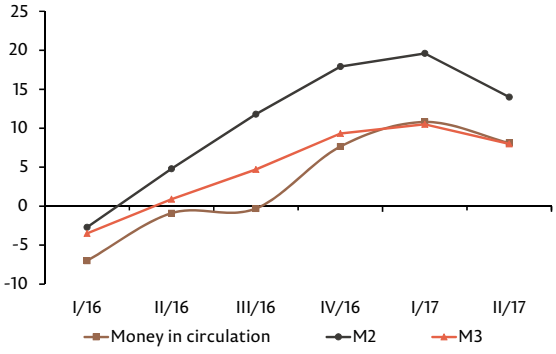
NBM intervened in the domestic foreign exchange market in April-June 2017 solely as a purchaser of foreign currency.

During the analyzed period, the volume of NBM purchase transactions carried out on the value date on the interbank foreign exchange market against MDL was of USD 86.08 million (of which USD 0.03 million represented the equivalent of EUR 0.03 million and USD 0.01 million represented the equivalent of RUB 0.50 million), including currency purchase conversions with the World Bank institutions (International Bank for Reconstruction and Development and International Development Association) amounting to USD 1.34 million.

During the reference period, NBM has not carried out swap operations.

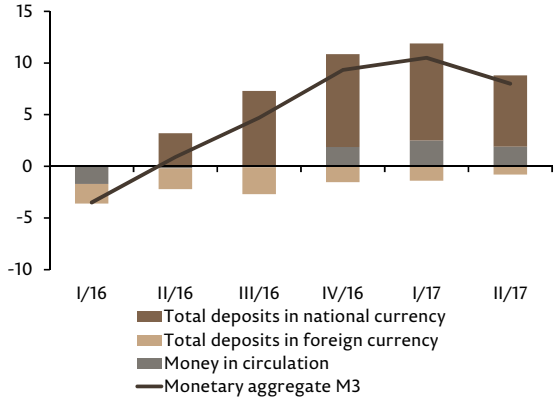
4.2 Dynamics of monetary indicators

Chart 4.4: The dynamics of monetary aggregates (%, annual growth)



Source: NBM

Chart 4.5: The dynamics of monetary aggregate M3 (%, components contribution to the annual growth)



Source: NBM

In the second quarter of 2017, the monetary aggregates showed a positive dynamic, the quarterly average in annual terms accounting for 14.0 percent for M2 (by 5.6 percentage points lower than in the first quarter of 2017) and 8.0 percent for M3 (by 2.5 percentage points lower than the growth in the previous quarter) (Chart 4.4).

Money supply

The broad money supply recorded an annual average growth by 8.0 percent during the second quarter of 2017, generated by the increase of MDL deposits and money in circulation with a simultaneous negative influence of foreign currency deposits' decrease. Thus, the evolution of the money supply M3 was due to the increase by 6.9 percentage points of balance of deposits in MDL, increase of money in circulation by 1.9 percentage points and decrease by 0.8 percentage points of balance of deposits in foreign currency (Chart 4.5).

Also, the structure of money supply M3 changed compared with the first quarter of 2017. The average quarterly share of deposits in national currency increased by 0.5 percentage points compared with the previous quarter, amounting to 42.9 percent. The share of foreign currency deposits decreased by 0.9 percentage points, making up 33.3 percent, while the share of money in circulation increased by 0.4 percentage points, reaching the average quarterly level of 23.7 percent.

At the same time, the money in circulation increased by 3.4 percent (MDL 556.7 million) compared with the previous quarter. This growth was driven by the lower cash inflow compared with cash outflow from the licensed bank cash desks. Of the total cash inflow, the largest share was held by trade with consumer goods (50.5 percent of the total cash inflow) and individuals' current and deposit accounts cash inflow (9.9 percent of the total cash inflow).

At the same time, when referring to outflows from the licensed banks cash desks, the main components had been: outflows for foreign currency purchase from individuals (32.3 percent of the total cash outflow) and cash outflow for ATMs and POS (20.7 percent of the total cash outflow).

The average growth rate of deposit balance in MDL reduced by 7.5 percentage points compared with the previous quarter, making up 17.5 percent. The deposits in foreign currency recorded an annual average decrease by 2.3 percent, by 1.3 percentage points more than in the previous quarter. The growth rate of the total deposit balance for that period dropped, on average, by 2.4 percentage points compared with the first quarter of 2017, recording an annual average rate of 8.0 percent.

Lending market[12]

In April-June 2017, the total balance of credits registered a downward trend, dropping, at the end of the quarter, to MDL 33479.0 million, decreasing by 7.9 percent compared with the end of June 2016 (Chart 4.6).

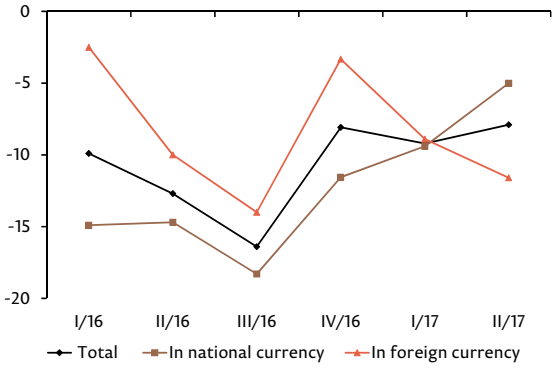
In terms of currency structure, the negative annual dynamic of loan balance was mostly due to the decrease of loans balance in both national and foreign currency. In the total loan portfolio, the loans granted in national currency held a share of 58.1 percent, while in foreign currency – 41.9 percent (Chart 4.7).

In late June 2017, the balance of loans in MDL granted by the licensed banks from the Republic of Moldova accounted for MDL 19452.2 million, by 5.0 percent less than in June 2016.

During the second quarter of 2017, the evolution of loan balance in MDL was driven by the annual decrease by 13.2 percent of loan volume granted to legal entities, accounting for MDL 11836.7 million (a 60.9 percent share in the overall MDL loans). At the same time, the volume of loans granted to individuals increased annually by 11.4 percent, amounting to MDL 7615.5 million (a 39.1 percent share in the overall MDL loans).

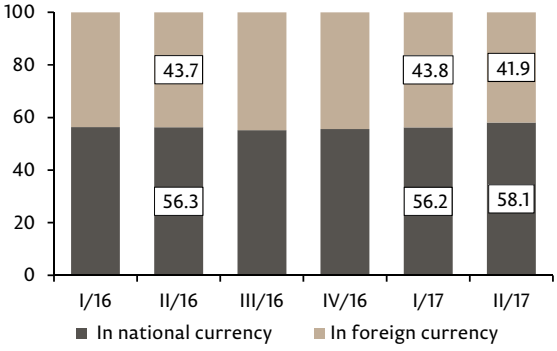
The balance of foreign currency loans, recalculated in national currency, recorded a decrease, in annual terms, by 11.6 percent in late the second quarter of 2017 compared with the same period of the previous year, making up MDL 14026.8 million. The downward trend of loans in foreign currency, recalculated in MDL was mostly driven by the appreciation of the national currency against the main reference currencies. This appreciation influenced the evolution of legal entities loans component (a 98.0 percent share in the overall foreign currency loans), the volume of which accounted for MDL 13757.3 million on 30 June 2017, by 11.6 percent lower than in late quarter 2, 2016. The loans in foreign currency granted to individuals recorded a negative annual growth rate of 13.2 percent in late quarter 2, 2017, making up MDL 269.5 million.

Chart 4.6: The evolution of loans balance (%, annual growth)



Source: NBM

Chart 4.7: The shares of loans balance (%)



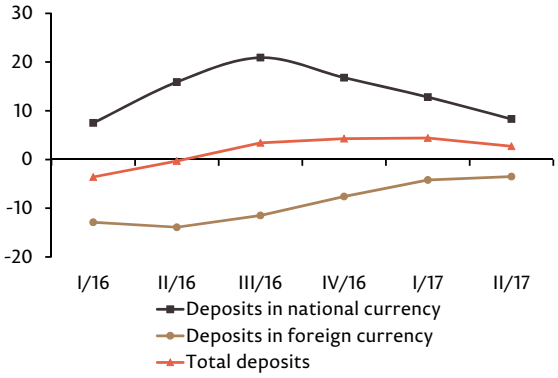
Source: NBM

[12] Data analysis was carried out based on the reports ORD01.06 "Interest rates on credit and deposit balance" submitted by the licensed banks before 14 July 2017.

The trade sector held the largest share in the structure of loan portfolio by sectors. In late reference quarter, this sector recorded an annual decrease of 10.9 percent for the loans granted in national currency and of 9.6 percent for loans in foreign currency. The share of loans targeted at this sector was 21.7 percent in national currency (-1.4 percentage points compared with June 2016) and 38.5 percent in foreign currency (+0.9 percentage points compared with June 2016).

Deposit market[13]

Chart 4.8: The evolution of deposits balance (%, annual growth)



Source: NBM

During the second quarter of 2017, the annual dynamic of the overall balance of deposits from the banking sector recorded positive values, similar to the previous quarter. Thus, the overall deposit balance faced a 2.7 percent annual increase, amounting to MDL 33011.1 million in late June 2017.

Compared with the same period of 2016, the positive dynamic of the deposit balance was influenced by an upward trend of the component in the national currency. The annual growth rate of deposits in national currency settled at 8.3 percent, by 4.5 percentage points lower than in the previous quarter. In its turn, the annual growth rate of the balance of deposits in foreign currency, recalculated in MDL, recorded an annual drop of 3.5 percent (Chart 4.8).

The balance of deposits attracted in national currency increased up to MDL 18454.4 million. The upward trend of MDL deposits during the second quarter of 2017 was mostly driven by the growth of deposits attracted from individuals, increasing up to MDL 15378.4 million (83.3 percent of the overall MDL deposit portfolio). The balance of deposits in MDL attracted from legal entities amounted to MDL 3076.0 million, while their share increased, during the last 12 months, by 6.7 percentage points, accounting for 16.7 percent in the overall deposit portfolio.

The annual dynamic of foreign currency deposit balance, recalculated in MDL, decreased by 3.5 percent, dropping to MDL 14556.7 million. This decrease occurred mostly due to the appreciation of the national currency against the main reference currencies. Thus, the balance of deposits attracted from individuals reduced by 3.8 percent, making up MDL 12662.0 million (87.0 percent in the overall deposits attracted in foreign currency). In late quarter 2, 2017, deposits attracted from legal entities recorded an annual decrease of 1.9 percent, making up MDL 1894.7 million (13.0 percent in the overall deposits attracted in foreign currency).

[13]Data analysis carried out based on the reports ORD01.06 "Interest rates related to the loan and deposit balance" submitted by the licensed banks before 14 July 2017 and not including sight deposits.

Interest rates[14]

Base rate evolution

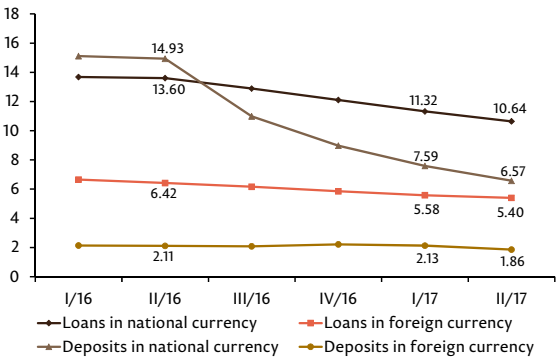
Three meetings of the Executive Board of the National Bank of Moldova on monetary policy decisions were held in the second quarter of 2017. Following the assessment of internal and external balance of risks and short and medium-term inflation forecasts, the Executive Board of NBM decided, during the meetings of 27 April 2017 and 24 May 2017, to maintain the annual base rate applied to the main monetary policy operations at 9.0 percent. Further on, at the meetings of 28 June 2017, it was decided to reduce the annual base rate applied to the main monetary policy operations by 1.0 percentage points, i.e. from 9.0 percent (a level established during the meeting of 27 October 2016) to 8.0 percent per year.

These decisions targeted the creation of a monetary climate that would reanimate the lending and saving activity and further adjust the internal economic environment to the volatility and uncertainty related to the external macroeconomic situation, aiming to anchor the inflation expectations, bringing and keeping the inflation rate close to the target of 5.0 percent on the medium-term, with a possible deviation of ± 1.5 percentage points.

Loan interest rate

During the second quarter of 2017, the average interest rate on loans granted by the licensed banks continued its downward path amounted to 10.64 percent for national currency loans (-0.68 percentage points compared with the first quarter of 2017) and 5.40 percent for foreign currency loans (-0.18 percentage points compared with the first quarter of 2017). This evolution reflects the continuation of the effect of the transmission mechanism of the consecutive base rate cuts applied to the main monetary policy operations approved by the Executive Board of the National Bank of Moldova during 2016. Moreover, the annual average interest rate related to balance of loans in national currency recorded a reduction of 2.96 percentage points, while that of loan balance in foreign currency – 1.02 percentage points compared with the second quarter of 2016 (Chart 4.9).

Chart 4.9: The average interest rates (%)



Source: NBM

The decrease of the average interest rate on balance of loans in national currency was conditioned by a decrease of the average rate on loans granted to both legal entities and individuals. The average quarterly interest rate on loans granted to legal entities decreased by 0.58 percentage points compared with the first quarter of 2017 and constituted 10.04 percent per year. In the second quarter of 2017, the average annual interest rate on loans in MDL granted to individuals was of 11.59 percent, decreasing by 0.91 percentage points compared with the previous quarter.

During the second quarter of 2017, the cost of foreign currency loans decreased due to the downward development both of the interest rate on loans granted to legal entities (by 0.18 percentage

[14] Rate analysis carried out based on the reports ORD01.06 "Interest rates related to the loan and deposit balance" submitted by the licensed banks before 14 July 2017 and not including sight deposits.

points, up to the level of 5.36 percent per year) and the interest rates granted to individuals (by 0.09 percentage points, up to the level of 7.42 percent per year).

Deposit interest rate

Following the downward trend of the base rate applied on the main monetary policy operations of NBM, the average interest rates on deposits balance continued to drop.

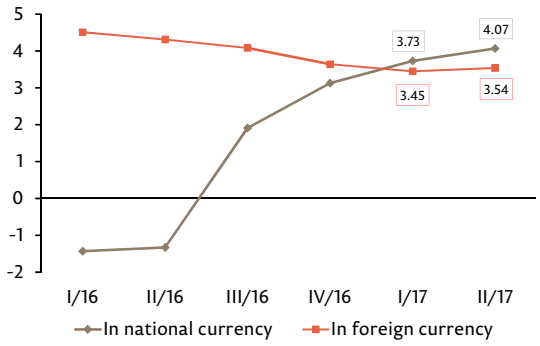
The average interest rates on deposits in MDL amounted to 6.57 percent in the second quarter of 2017, lower by 1.02 percentage points than in the previous quarter, and by 8.36 percentage points lower than in the second quarter of 2016 (Chart 4.9). The evolution of the average interest rate on deposits in MDL was driven by the decrease of the average interest rate on deposits in MDL attracted from legal entities to 5.51 percent (-1.34 percentage points compared with the previous quarter), and from individuals – to 6.77 percent (-0.91 percentage points compared with the previous quarter).

The interest rate for foreign currency deposits amounted, on average, to 1.86 percent during the reference period, by 0.27 percentage points lower than in the previous quarter. This quarter-based reduction was influenced by the decrease of the average interest rate by 0.22 percentage points (to 1.84 percent per year) on deposits attracted from legal entities and by 0.28 percentage points (to 1.86 percent per year) on deposits attracted from individuals.

Banking margin

The banking margin (the difference between the average interest rates on loans and the deposits) for operations in MDL accounted for 4.07 percentage points in the second quarter of 2017, by 0.34 percentage points higher than in the previous quarter (Chart 4.10). The banking margin on foreign currency operations had an upward trend, recording 3.54 percent, by 0.09 percentage points higher than in the first quarter of 2017. These evolutions were due to a sharper decrease of interest rates on deposits attracted by the banking system.

Chart 4.10: The evolution of banking margin (p.p.)



Source: NBM

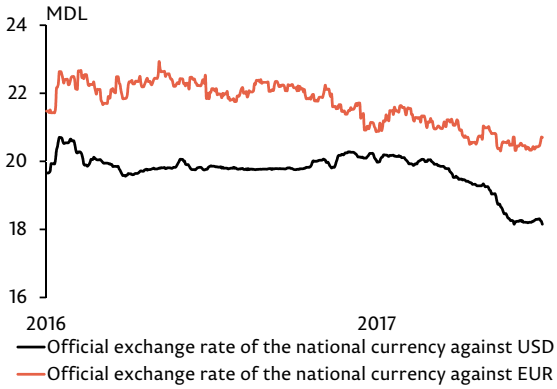
Nominal exchange rate and real effective rate

In the second quarter of 2017, the national currency kept on strengthening its position against the main foreign currencies, appreciating by 6.8 percent against the U.S. dollar and by a smaller ratio of 1.0 percent against EUR compared with the previous quarter (Chart 4.11).

On average, the Moldovan leu appreciated by 6.0 percent against U.S. dollar and by 3.1 percent against EUR in the reference quarter.

The current year was under the dominance of the regional national currency appreciation trend against U.S. dollar; this trend also covered the currencies of the trading partners holding major shares in the external trade with the Republic of Moldova. Thus, as of late quarter 2, 2017, EUR appreciated by 5.8 percent against the U.S.

Chart 4.11: The fluctuations of the official exchange rate of MDL against USD and EUR



Source: NBM

dollar, the Romanian leu and the Hungarian forint – by 5.7 percent, the Czech crown – by 8.4 percent, and the Polish zloty – by 5.4 percent etc., compared with the previous quarter (Chart 4.12).

In real terms, the Moldovan leu appreciated by 5.4 percent against the main trading partners' currency in the second quarter of 2017. This dynamic was driven especially by Romania – by 1.31 percentage points and Russian Federation – by 1.2 percentage points (Chart 4.13).

In the second quarter of 2017, most net foreign currency transfers from abroad on behalf of individuals fell into the net foreign currency supply generated by the population, which increased almost $\frac{1}{4}$, up to USD 493.1 million compared with the previous quarter. By currency structure, the most increase was signalled for net supply of Russian ruble – by 27.8 percent[15], followed by the euro net supply– by 23.3 percent[15] and U.S. dollars – by 11.5 percent (Chart 4.14).

At the same time, in the second quarter of 2017, the external trade operations intensified while the trading balance deteriorated due to a slow evolution of the export of goods, as compared with the import. Thus, the net foreign currency demand of economic agents increased, however moderately, up to 12.0 percent (USD 440.7 million) compared with the previous quarter.

These evolutions created premises for foreign currency excesses on the market, where the demand was covered in a share of 111.9 percent from the net foreign currency supply (Chart 4.15), generating appreciation pressures on Moldovan leu. A positive influence on the exchange rates had, to a certain extent, the net loan, grants, and foreign investment inflows amounting to USD 24.0 million in April-May 2017[16].

In these circumstances, NBM divided its interventions depending on the monetary policy goal, and when NBM found a real over-appreciation of the national currency, it withdrew about USD 85.0 million from the market, through purchase operations.

In terms of the monthly dynamic of the national currency against U.S. dollar, MDL exchange rate followed a gradual appreciation trend in April, intensifying in May and stabilizing in June.

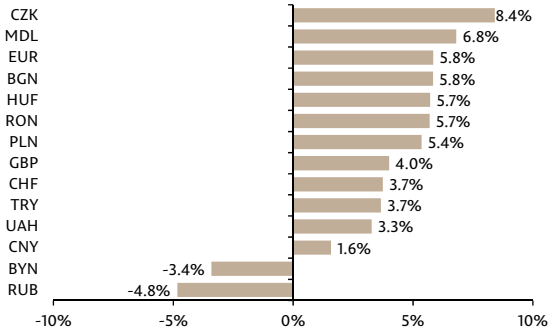
For these months, there was a specific improper demand coverage ratio with the foreign currency supply due to a still moderate relaunch of the net foreign currency supply from the economic agents, which was consistently exceeded by the net foreign currency purchases from the population.

Thus, in April, based on an excessive 116.3 percent (or by USD 19.3 million more than it was required) coverage of demand by foreign currency supply, NBM purchased USD 9.5 million from the market while the partial sterilizations of foreign currency excess were used to avoid major MDL exchange fluctuations. In late April, MDL exchange rate appreciated rapidly against USD due to the increase of foreign currency excess on the market. Within 2 consecutive weeks, this amounted to USD 29.0 million and NBM intervened with purchases of USD 10.0 million. Amid appreciation

[15] Modification calculated by excluding the exchange rate difference.

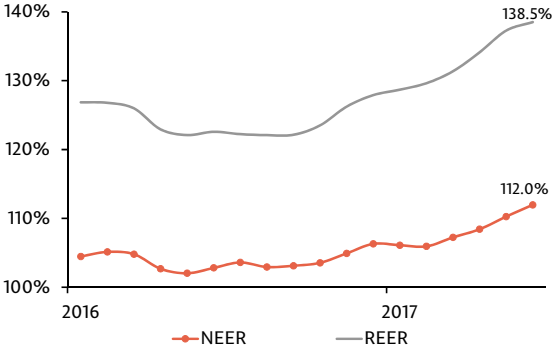
[16] Banking system inflows – preliminary data. At the moment of drafting this report, the data for June was not available.

Chart 4.12: The evolution of currencies in the region and currencies of the major trading partners of the Republic of Moldova against the U.S. dollar (30.06.2017), 31.03.2017=100%



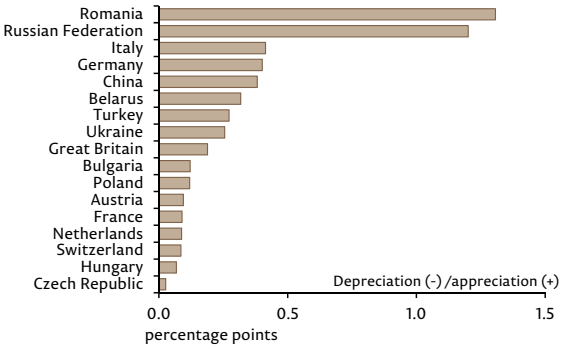
Source: NBM

Chart 4.13: The dynamics of nominal effective exchange rate (NEER) and real effective exchange rate (REER) of MDL calculated based on the major trading partners weights (Dec.2000=100%)



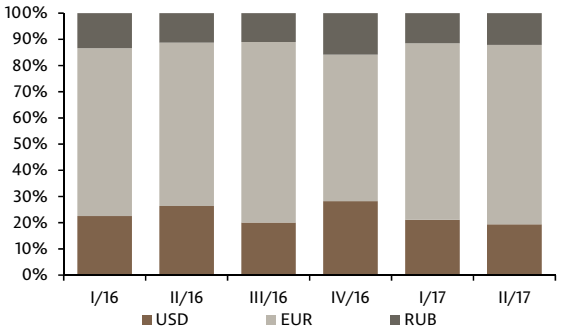
Source: NBM

Chart 4.14: The contribution of the major trading partners of the Republic of Moldova to the real effective exchange rate modification in the second quarter of 2017



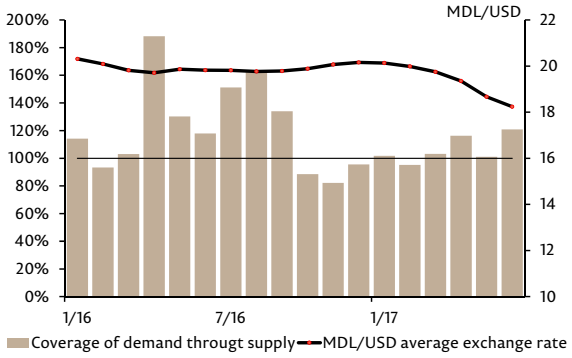
Source: NBM

Chart 4.15: The foreign currency structure of net foreign currency supply from individuals (foreign currencies are recalculated in USD at constant exchange rate)



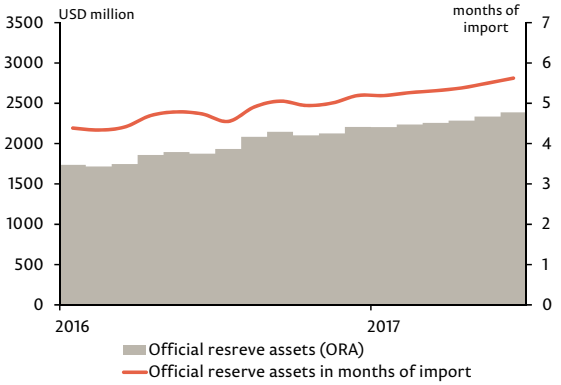
Source: NBM

Chart 4.16: The coverage rate of net demand by the net supply and the dynamics of the official exchange rate



Source: NBM

Chart 4.17: The evolution of official reserve assets expressed in months of import of goods and services (MBP6)



Source: NBM

pressures, the overall volume of purchases carried out by NBM until late May amounted to USD 36.0 million, creating premises to slowdown the appreciation rate of the national currency.

In June, the increase by 3.8 percent, up to USD 181.0 million, of the net foreign currency supply from the population compared with the previous month and the simultaneous decrease by 15.8 percent, to USD 145.3 million of the net foreign currency demand from the economic agents triggered the highest coverage ratio of 124.5 percent of the current year, and under such circumstances NBM purchased USD 39.2 million from the market. Thus, in late June, MDL slowly appreciated by 0.4 percent against USD compared with the appreciation of 5.4 percent in May and 1.1 percent in April.

A lower appreciation of only 1.0 percent of the national currency against EUR can be explained by the upward trend of EUR against USD on the foreign markets. This dynamic was triggered by under expectation economic growth of the USA in the first quarter of 2017, that fed the foreign investors' expectations related to the slowdown by the Federal Reserve System of the refunding rate, on one hand, and by the lack of a political consensus in USA that boosted the level of concern of foreign market participants related to the successful implementation of the reforms supported by the elected president. On the other hand, position of EUR on the external markets strengthened as a result of the European Central Bank's governor comments related to the economic growth of the euro area, return of inflation, and creation of premises to normalize, in the near future, the monetary policy promoted by this institution.

In late quarter 2, 2017, the balance of official reserve assets was of USD 2388.7 million, increasing by USD 132.2 million (5.9 percent) compared with the end of the first quarter of 2017 (Chart 4.16), amid foreign currency purchase interventions carried out by NBM and mostly loan disbursements, on behalf of the major development partners (equivalent of USD 39.7 million).

Thus, IMF allocated the second installment amounting to USD 8.5 million (SDRs 6.2 million) within the Extended Fund Facility (EFF) in favor of NBM and USD 5.9 million (SDRs 4.3 million) for the support the state budget. For the same purpose, the Ministry of Finance was awarded the second installment of USD 7.1 million (SDRs 5.2 million) within the Extended Credit Facility (ECF).

During the reference quarter, the World Bank institutions (IDA and IBRD) granted funds (equivalent of USD 7.5 million), mostly in the form of loans for education reform (USD 1.8 million) and for funding of the following projects: Improvement of Competition II (USD 2.9 million) and Improving Heating Supply Efficiency (USD 1.9 million).

The European Investment Bank funded the Wine Sector Restructuring Program from a loan of USD 5.6 million (EUR 5.3 million), while the Council of Europe Development Bank allocated USD 2.2 million (EUR 2.0 million) for "Social Housing Construction II" project support. At the same time, IFAD disbursed the amount of USD 1.9 million within the Inclusive Rural Economic and Climate Resilience Program IFAD VI.

As of late quarter 2, 2017, the official reserve assets continued to provide a sufficient level of coverage of imports of goods and services (5.6 months of imports[17]) (Chart 4.17).

[17]Calculated based on the forecast of import of goods and services for 2017.

Chapter 5

Medium-term inflation forecasting

5.1 Assumptions of the external environment

In the first months of this year, the major trading partners had a satisfactory evolution, which fueled the increase of the forecasted value related to their economic growth during the forecasting period. The first signs of the European Central Bank on the decrease of the monetary incentive amid gradual increase of consumer prices and presidential elections results from France led to the significant appreciation of the European single currency. The oil prices dropped significantly, after the investors lost any trust in OPEC capacity to rebalance the oil market. Also, the international raw material quotations slowed down their increasing rate due to the depreciation of the U.S. dollar and oil price decrease. At the same time, the decrease of food products stocks has contributed to maintain high quotations of these products.

In the first half of this year, the euro area economy recovered at a high pace, thanks to the incentive macroeconomic policies and growth of exports generated by the reduced parity of the European single currency and the recovery of the external demand. The first consultations on Brexit had a new phlegmatic note, welcomed by the stock exchange market and diminishing the existing uncertainties. Also, the results of the presidential elections in France confirmed the pro-European sentiment, thus scattering away the risk of macro-financial instability. According to the modification of factors, the forecasts on *the economic growth in the euro zone* increased. In the current forecasting round, it is anticipated that GDP in euro area will increase on average by 1.9 percent in 2017 and by 1.7 percent in 2018, by 0.2 percentage points more than in the previous forecasting round (Chart 5.1).

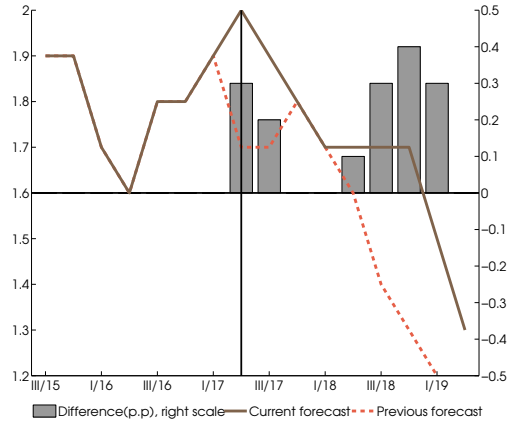
The economy of the Russian Federation recovers due to the reduction of economic sanctions imposed by the West and the stabilization of the exchange rate amid oil price boost up to USD 50 per barrel. At the same time, low or negative interest rates in advanced economies increases the investment attractiveness of emerging economies and now, the Russian Federation is in the top of favorite countries. That is why, in the current forecasting round, the evolution scenario of *GDP of the Russian Federation* shows higher values than in the previous round. On average, it is anticipated that the economy of the Russian Federation will grow by 1.3 percent in 2017 and by 1.7 percent in 2018 (Chart 5.2).

Table 5.1: The expected evolution of external variables (annual average)

	2017	2018
Economic growth in the euro area (%)	1.9	1.7
Economic growth in the Russian Federation (%)	1.3	1.7
Average annual inflation in the euro area (%)	1.5	1.4
Average annual inflation in the Russian Federation (%)	4.2	4.0
USD/EUR	1.10	1.12
RUB/USD	58.5	59.4
Urals brand oil prices (USD/barrel)	48.1	47.7
International food prices growth (%)	9.4	3.5

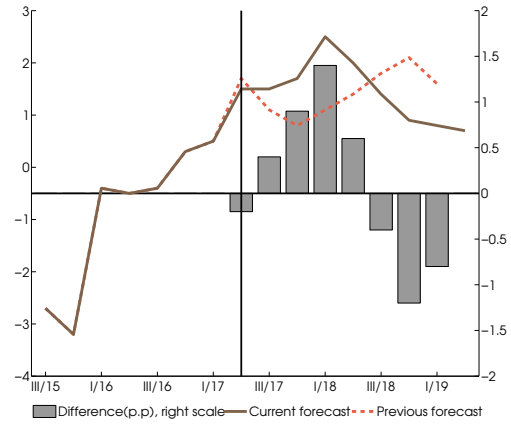
Source: Consensus Economics, Bloomberg, NBM calculus

Chart 5.1: The real GDP in the euro area (%, f.a.p.)



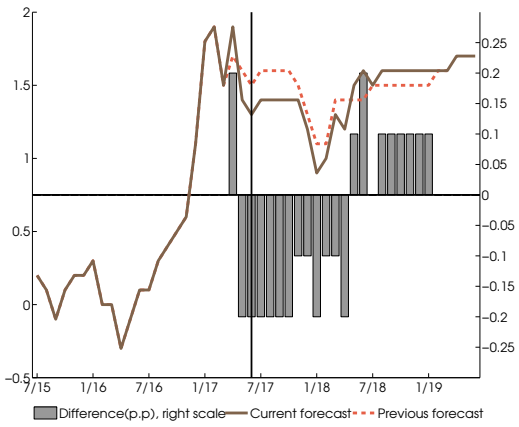
Source: Eurostat, Consensus Economics, NBM calculus

Chart 5.2: The real GDP in the Russian Federation (%, f.a.p.)



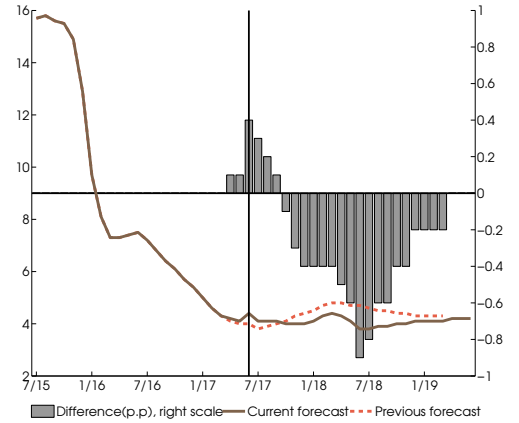
Source: Russian Federal State Statistics Service, Consensus Economics, NBM calculus

Chart 5.3: The CPI in the euro area (%, f.a.p.)



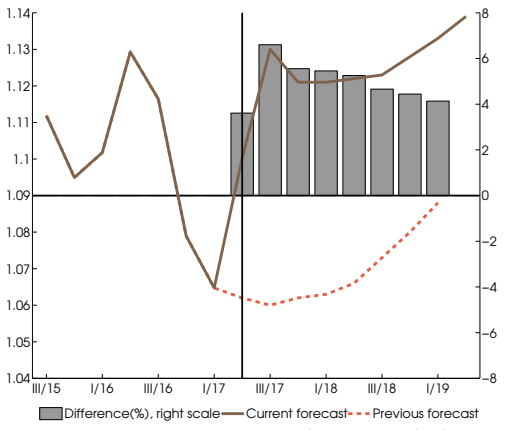
Source: Eurostat, Consensus Economics, NBM calculus

Chart 5.4: The CPI in the Russian Federation (%, f.a.p.)



Source: Russian Federal State Statistics Service, Consensus Economics, NBM calculus

Chart 5.5: The evolutionary scenario of the USD/EUR exchange rate



Source: ECB, Consensus Economics, NBM calculus

The monthly statistics of the second quarter of 2017 on the increase of consumer prices in the euro area show an instable inflation on the medium and long-term and a high sensitivity against the energy resources prices. The incentives of the monetary policy contributed greatly to the increase of the domestic demand, that propelled most prices of food, non-food products and services. However, the uncertainty related to the evolution of prices of energy resources and the recent appreciation of the European single currency diminished the forecast on *the evolution of the consumer prices in the euro area* in 2017 from 1.6 percent in the previous round to 1.5 percent in the current forecasting round. For 2018 the annual average growth forecast of consumer prices in the euro area will stay at 1.4 percent (Chart 5.3).

The evolution scenario of *the annual inflation in the Russian Federation* does not point at any major changes. In the current forecasting round, it is anticipated that the consumer prices will increase in the Russian Federation on average by 4.2 percent in 2017 and by 4.0 percent in 2018. The current forecast is based on the lack of severe inflationary pressures and concern of the Central Bank of the Russian Federation in reaching the targeted level of inflation of 4.0 percent in late this year and in the long-term (Chart 5.4).

The forecast on the *USD/EUR parity evolution* shows major changes in the current forecasting round due to the evolution recorded in the second quarter of 2017. The results of the presidential elections in France, the phlegmatic nature of the recently initiated negotiations regarding Great Britain's exit from the European Union, macroeconomic statistics indicating an ongoing recovery of the euro area economy and the first signs of the European Central Bank on the diminished monetary incentive are among the factors that contributed to the significant appreciation of the European single currency. Thus, in the current forecasting round, it is anticipated that the average USD/EUR parity will be of 1.10 in 2017 and 1.12 in 2018, while the reserves related to the stock exchange volatility will be maintained (Chart 5.5).

The decrease of oil price in the second quarter of 2017 diminished the appreciation of the Russian ruble. On the long run, the scenario on *the evolution of the Russian ruble* shows a low volatile trajectory against the forecasts on the evolution of oil prices in the long-term. Thus, in the current forecasting round it is anticipated that the RUB/USD average parity will be of 58.5 in 2017 and 59.4 in 2018 (Chart 5.6).

The cut-down of oil price in the second quarter of 2017 led to the decrease of forecasted *oil price evolution* values by over 10.0 percent. Thus, in the current forecasting round, it is anticipated that Urals oil price will amount to USD 48.1 per barrel in 2017 compared with USD 53.7 per barrel in the previous forecasting round. For 2018 the forecasted value of the average Urals oil price was reduced from USD 54.3 to USD 47.7 per barrel. It should be noted that, the lightly upward and volatile trajectory of future oil quotations follows the same trend for over a year and shows how severe the issue on oil demand and supply imbalance on the world market is (Chart 5.7).

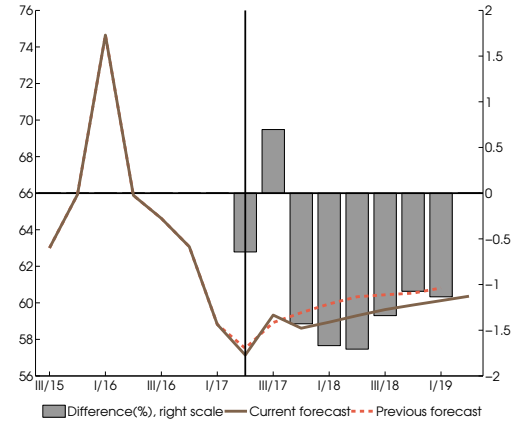
The slowdown of the growth rate on *the international prices of food products* in the second quarter of 2017 contributed to their trajectory deviation, maintaining the high quotations of food. Thus, in the current forecasting round, it is anticipated that the international prices on food will increase on average by 9.4 percent in 2017 and by 3.5 percent in 2018. The main factor that conditions the international price increase of food is the reduction of food supplies amid trade growth, even if the harvest of certain crops is relatively satisfactory (Chart 5.8).

5.2 Assumptions on regulated prices

The anticipations on the evolution of tariffs within the inflation horizon foresees the increase of waste transportation and water and sewerage services tariffs by 27.0 percent and 5.0 percent, respectively, in the third quarter of 2017. For 2018, it is anticipated that the electricity tariff will drop by 15.0 percent in the second quarter and the network gas tariff will diminish by 15.0 percent in the third quarter. For 2019, in the second quarter it is forecasted an increase by 5.0 percent of the gas, central heating, electricity, hot water supply and network and sewerage tariffs. In the third quarter, it is anticipated an increase of the urban and interurban transport by 30.0 percent and 10.0 percent, respectively.

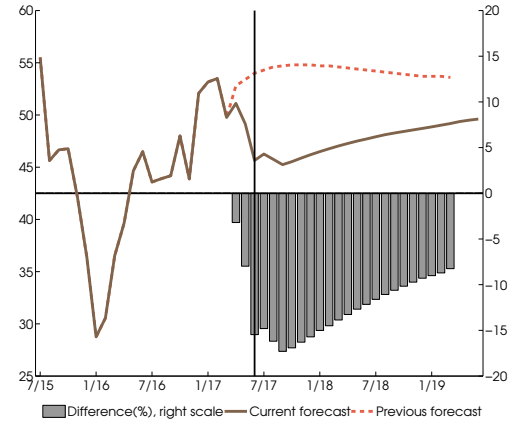
The assumptions on tariff increase have been added to the medium-term inflation forecast. However, given that these decisions are based not only from economic, but also from their social impact viewpoint, the day of adoption of new tariffs and their value are covered by a significant degree of uncertainty, which will create a high risk that might lead to recording a deviation from the medium-term inflation forecast.

Chart 5.6: The evolutionary scenario of the RUB/USD exchange rate



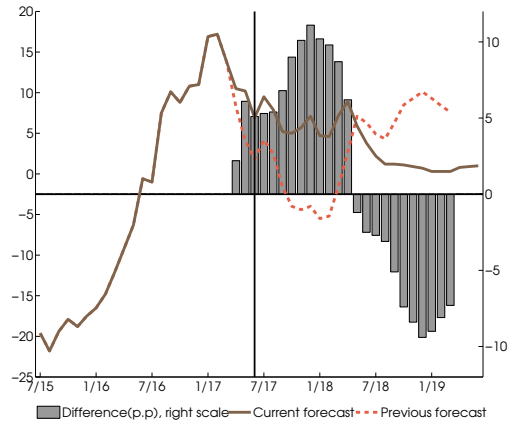
Source: Central Bank of the Russian Federation, Consensus Economics, NBM calculus

Chart 5.7: The Urals brand oil world prices (USD/barrel)



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

Chart 5.8: The world food prices (%, f.a.p.)

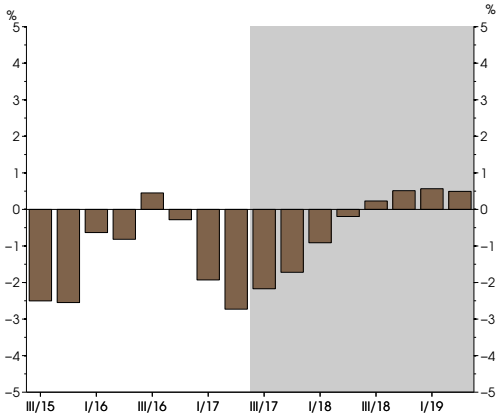


Source: FAO, Bloomberg, NBM calculus

5.3 Medium-term forecasting

Aggregate demand

Chart 5.9: The output gap forecast



Source: NBS, NBM calculus

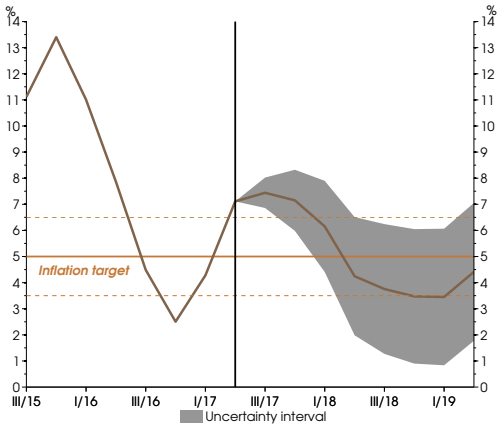
The current forecasting round predicts that *the GDP deviation* will see a slow and constant recovery for the entire forecasting period. However, it will nevertheless remain in the negative range for the first four quarters. Further, it will recover and will record minor positive values. Thus, an economic activity below its potential level during the first four quarters will cause disinflationary pressures from aggregate demand and inflationary pressures starting with the second half of 2018 and until the end of the forecasting horizon (Chart 5.9).

The slow recovery of GDP deviation was triggered by the low *external demand*. In the *euro area*, it is predicted that the economic activity will drop below its potential level for the first four forecasting quarters, further, it will maintain close to zero, thus keeping its restrictive impact on the domestic economic activity. In the *Russian Federation*, the aggregate demand will be close to its potential level.

The real monetary conditions will have a mixed impact on the demand. The real exchange rate will fuel the restrictive nature of the monetary conditions for the entire forecasting horizon. *The real interest rate* will be incentive in the first period, after which, it will fuel the restrictive nature of the monetary conditions until the end of the horizon.

Inflation

Chart 5.10: The annual rate of CPI



Source: NBS, NBM calculus

The annual inflation rate will continue to record a high level in the third quarter of 2017, after which it will rapidly drop to the lower limit of the target variation range. In the first quarter of 2018, the inflation will return to the range and will stay within it until the end of the forecasting horizon, mostly close to the lower limit. The minimum value of 3.5 percent will be recorded in the fourth quarter of 2018 and the first quarter of 2019, while the maximum value of 7.4 percent – in the third quarter of 2017 (Chart 5.10).

According to the current forecasting round, the annual average inflation rate will account for 6.5 percent this year and 4.4 percent in the following year.

The annual *core inflation rate* will record a stable level and will swing near the inflation target for the entire forecasting horizon. Even though the aggregate demand will fuel disinflationary pressures for the first half of the forecasting horizon, the supply pressures will partially diminish the effects of the demand. The contribution of the core inflation to the annual inflation rate will stay unchanged for the entire forecasting horizon (Chart 5.11).

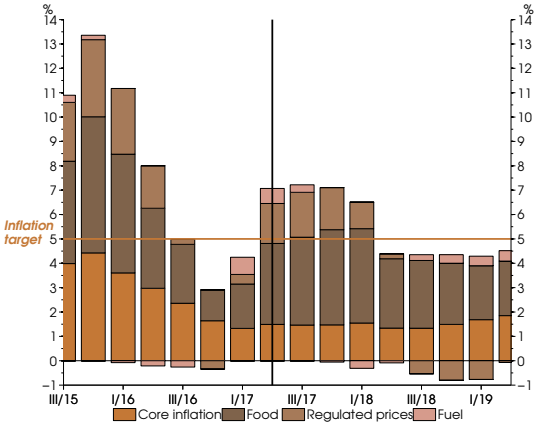
The annual *food prices rate* will continue to grow this year. Later, it will see a downward trend that will continue until the end of

the forecasting horizon. The prediction of food prices growth is conditioned by major increase of international food prices for the forecasting horizon (Chart 5.9). The contribution of food prices to the annual inflation rate will stay firm and will record an upward trend for the current year; it will drop toward the end of the forecasting horizon (Chart 5.11).

The annual *regulated prices rate* will continue to record a high level in the third quarter of 2017, but it will later decrease significantly. From the third quarter of 2018 and to the end of the forecasting horizon, the annual regulated prices rate will record negative values. This evolution's determining elements are analyzed above ***(5.2. Assumptions on regulated prices)***. It should be noted that, the contribution of the regulated prices to the annual inflation rate will keep a positive trend only for four consecutive quarters; for the rest of the forecasting horizon, it will have negative values (Chart 5.11).

The annual *fuel prices* rate will have a downward trend until the first quarter of 2018, mostly due to the smooth decline in fuel prices on the international markets. Starting with the second quarter of 2018, it will record a constant growth until the end of the forecasting period. This growth of the annual rate is conditioned by the slow boom of oil prices, and the low base effect. The contribution of fuel prices to the annual inflation rate will record a downward trend until the first quarter of 2018 and an upward trend – until the end of the forecasting horizon. The contributions to the annual rate will be negative for three consecutive quarters, beginning the fourth quarter of 2017 (Chart 5.11).

Chart 5.11: The CPI decomposition



Source: NBS, NBM calculus

Comparison of the current and previous forecasts

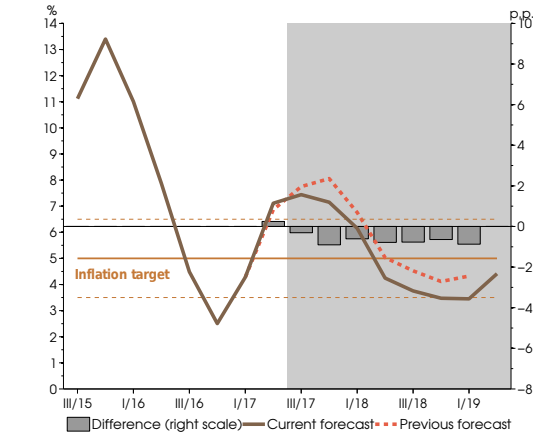
According to the current forecasting round, the forecasted *annual inflation rate* decreased for the entire forecasting horizon. Compared with the values recorded in the Inflation Report no. 2, 2017, the average annual forecasted values of the annual inflation rate are lower by 0.3 percentage points for 2017 and by 0.7 percentage points for 2018 (Chart 5.12).

The core inflation recorded a stable and significantly lower dynamic for the entire forecasting horizon, except for first and second quarters of 2019, when slightly higher values, compared with the reference report, will be recorded. This is mostly due to the reconfiguration of the aggregate demand, being lower in the current year and predominantly higher in the following year.

Compared with the previous forecasting round, the annual *food price rate* will see a predominantly higher rate for the entire forecasting horizon, and only starting with the first quarter of 2019 it will record lower values for two consecutive quarters. The reconfiguration of the forecasting rate is due to international food prices perspectives that are significantly higher for the entire forecasting horizon, compared with the previous forecast.

The annual *regulated prices rate* is slightly higher until in the first quarter of 2018 and significantly lower until the end of the forecasting horizon. The reconfiguration of the annual regulated prices rate is due to an additional increase of tariffs in the third

Chart 5.12: The annual rate of CPI



Source: NBS, NBM calculus

quarter of 2017 and a major decrease of some tariffs in the second and third quarters of 2018, respectively.

The annual *fuel prices rate* will be predominantly lower for the entire forecasting horizon, except for the last three quarters, when it will record slightly higher values. Compared with the previous report, the lower dynamic of the oil price is the main source of this difference. The higher level recorded for the last three quarters is largely conditioned by a higher imported inflation rate on fuel.

Risks and uncertainties

External sector

- **Enhanced appreciation trend of U.S. dollar and European single currency.** The recent months have seen a firm growth pattern of the international currencies in circulation, such as the U.S. dollar and the European single currency. The appreciation trend of the U.S. dollar on the medium-term is fueled by the Federal Reserve System on the gradual increase of interest rate range. This year, Fed has already operated two increases, the most recent one occurring on 15 June 2017 by 0.25 percentage points, the range making up 1.00-1.25 percent and it is assumed that the next increase will be carried out until the end of this year. The European single currency started significantly to appreciate in the second quarter of 2017 amid France's presidential election results and the first signs of ECB on the decrease of currency incentive degree in the near future. Thus, on the medium and long-term, there is a trend of appreciation of the U.S. dollar, the European single currency and other international currencies in circulation that will result in the depreciation of currencies in the emerging economies. At the same time, the reduction of the difference between the refunding rates for advanced and emerging economies will push the capital flow from the emerging economies toward the advanced ones, and this will lead to the depreciation of emerging economies' currencies.
- **Flattening of the appreciation/depreciation of the Russian ruble.** The appreciation premises of the Russian ruble in the first months of the current year have been recently scattered under oil price decrease and USA preparation of new economic sanctions against the Russian Federation. At the same time, the Central Bank of the Russian Federation gradually reduces the reference interest rate, amid the circumstance of reaching the targeted inflation level, thus pushing the investment attractiveness scores back.
- **Reduced oil prices.** Following an increase in oil prices in the first months of the current year, exceeding USD 50 per barrel, in the recent weeks they started to drop again due to the loss of investors' trust in OPEC's capacity to rebalance oil demand and supply. At the same time, USA and Canada over-exploited the shale oil wells and according to the weekly statistics, oil production sees a gradual increase. According to most specialists, the factors that dictate the decrease are

persistent and exceed in number the factors that dictate the increase. That is why, on a short and medium-term basis, it is anticipated a drop of oil prices, while on the long-term basis – a diffuse upward evolution.

- **Increase of international food prices.** Although the predictions regarding this year's harvest are mixed and there are no clear indications as to a potential shortage of some crops, the international food prices keep on going up. The factors that drive the positive growth are: reduction of stocks due to growth of trade with certain crops and consumption increase in advanced economies amid incentive macroeconomic policies.
- **Enhanced external demand.** Statistics of the first semester of this year show a significant and constant recovery of the economy of the main trading partners, which means that on the short and medium-term this will push the external trade forward, triggering relevant effects in the national economy.

Real sector

- **Uncertainties related to the 2017 and 2018 harvest.** According to the current forecasts of the State Hydrometeorological Service of the Republic of Moldova, wheat, sunflower, and corn harvest for 2017 is expected to be averagely higher than in the last years, which signals optimism in relation to the agricultural output in the current year. However, fruits and vegetables harvest still depends on the agro-meteorological conditions in the months that will follow. Thus, fruits and vegetables production of this year, the harvest of the next year and the food prices on the domestic market will largely depend on the agro-meteorological conditions in the next months and year, respectively. This information cannot be predicted, though, and the 2017 and 2018 food prices fall into the uncertainty category. Thus, given the high vulnerability of the agricultural production against the meteorological conditions, the uncertainty related to 2017 and 2018 harvest, and the uncertainty that is typical for the domestic food price dynamic still persists, although to a smaller extent than in the previous forecasting round.
- **Renewal of electricity export to Moldova from Ukraine.** A share of the electricity will be imported to Moldova from Ukraine. This practice could trigger the downward adjustment of electricity tariff for people.
- **Postponed tariff adjustment on regulated services.** Although there are preconditions on the decrease of natural gas and related services tariff within the inflation forecasting horizon, they may be delayed due to the tariff adjustment method. At the same time, some tariff reductions might be postponed for the next year, which might cause the drop of the annual inflation below the lower limit of ± 1.5 percentage points range from the 5.0 percent target in 2018.
- **Further faster recovery of the aggregate demand.** The medium-term inflation prediction is based on the modest aggregate demand that has a minor impact on prices. A

further stronger growth of the economic activity might exercise additional inflationary pressures on the core inflation and some food prices.

Monetary and public sectors

- **Excess liquidity in the banking sector.** As a result of 2016-2017 monetary issuance and NBM net interventions on the foreign exchange market (foreign currency purchase) in amount of USD 556.5 million (about MDL 10.8 billion), the banking sector accumulated excessive liquidities in the amount of MDL 7.3 billion. This excess can cause a positive short-term impact on the aggregate demand, currency exchange rate and can influence the increase of inflationary pressures.
- **Fiscal deficit.** The draft of the fiscal policy of 2017 and the 2017-2019 Medium-term State Debt Management Project foresee the growth of financial funds under the form of grants and loans from international financial institutions up to MDL 8.7 billion in 2017. The fiscal deficit will account for -9.1 percent of GDP. This will considerably influence the evolution of the fiscal sector indicators and will create additional inflationary pressures.
- **Pension reform.** Distribution of the Social Fund funds to people with small income will stimulate their power of consumption, resulting in supporting the domestic aggregate demand and imports and, thus, the depreciation pressures on the MDL exchange rate.
- **Weak lending of economy.** The loan market evolution records a pessimistic dynamic during 2017. At the same time, it should be mentioned that the minimum loan decrease level was recorded in September 2016 (-16.4 percent per year), after which it started to grow (-7.9 percent per year in June 2017). The passive approach of legal entities' lending is caused by an economic and political turmoil in the Republic of Moldova and in the region, due to the unacceptable lending conditions or high risks. The worsening of these trends might create additional disinflationary pressures; however, it pushes the banks to search for profitable alternatives that would generate revenues on the market (securities purchasing, currency operations etc.).
- **MDL/USD currency exchange trajectory.** Some consumer prices, such as those for imported goods or displayed in foreign currency, are sensitive to the currency exchange rate dynamic. Early this year, the national currency exchange rate recorded a relatively steady dynamic, in March it slightly appreciated. This trend, however, can continue for a limited time and it strongly depends on the 2017 potential harvest and money transfers from abroad. An eventual overturn of this trend in the second half of the year will result in price growth for some goods within CPI. Given the non-homogeneous price pattern against the exchange rate modification, there is a proinflationary risk related to the exchange rate evolution.
- **Situation in the banking sector.** Events related to the banking fraud, MDL depreciation, international financial

institutions’ warnings on the situation in the domestic banking sector and the negative information background shatter the trust in the national financial system. Any negative information flow shock or build-up with reference to the domestic financial and banking sector increases the business owners and people’s doubt and contributes to seeking less risky funding and savings ways.

List of Figures

1.1 The annual rate of CPI and core inflation (%) . . . 6

1.2 The annual rate of food, regulated and fuel prices (%) . . . 6

1.3 The evolution of the annual inflation (%) and subcomponents contribution (p.p.) . . . 7

1.4 The subcomponents contribution (p.p.) to the annual rate of core inflation (%) . . . 7

1.5 The components contribution (p.p.) to the annual rate of food prices (%) . . . 8

1.6 The components contribution (p.p.) to the annual rate of regulated prices (%) . . . 8

1.7 The components contributions (p.p.) to the annual growth of fuel prices (%) . . . 9

1.8 The evolution and forecast of CPI since the implementation of inflation targeting regime (%) 11

1.9 The IPPI annual rate (%) . . . 12

1.10 The IPPI annual rate (%) and the contribution of its components categorised by main branches (p.p.) . . . 12

2.1 U.S. dollar index (USDX) evolution in Fed monetary policy context . . . 13

2.2 The evolution of USD/EUR parity (monthly average) and inflation in euro area . . . 13

2.3 The evolution of RUB/USD (monthly average) under the influence of the oil price developments . . . 14

2.4 Oil production, millions barrels per day . . . 14

2.5 The annual growth rate of world prices indexes (%) . . . 15

2.6 The unemployment rate in the euro area, Italy and Russian Federation (%) . . . 15

2.7 The evolution of consumer prices in Ukraine (%) . . . 16

3.1 The contribution of demand components to GDP growth (p.p.) . . . 17

3.2 Components' contribution (p.p.) to the final consumption of households' growth (%) . . . 18

3.3 Evolution of personal disposable income (%, versus the same period of the previous year) and subcomponents' contribution (p.p.) . . . 18

3.4 The dynamics of public revenues and expenditures (%, annual growth) . . . 18

3.5 SS yield curve (%) . . . 19

3.6 The annual growth rate of investment (%) . . . 19

3.7 Structure of investments in tangible assets in the first quarter of 2017 . . . 20

3.8 Components' contribution to increasead investment in tangible assets in the first quarter of 2017 (p.p.) . . . 20
3.9 Evolution of exports annual rate (%) and contribution by categories of countries (p.p.) . . 20
3.10 Evolution of exports annual rate (%) and subcomponents contribution by groups of goods (p.p.) . . . 21
3.11 Evolution of imports annual rate (%) and subcomponents contribution by categories of countries (p.p.) . . . 21
3.12 Evolution of imports annual rate (%) and subcomponents contribution by groups of goods (p.p.) . . . 21
3.13 The evolution of foreign trade (f.a.p., USD, %) . . . 22
3.14 The contribution of economic sectors to GDP growth (p.p.) . . . 23
3.15 Evolution in real terms of industry (%, versus the same month of the previous year) . . . 23
3.16 Evolution of goods transport (%, versus the same month of the previous year) . . . 23
3.17 Evolution of domestic trade (%, versus the same month of the previous year) . . . 24
3.18 Global agricultural production (%, versus the previous year) . . . 24
3.19 Annual growth rate of employed population (%) and its formation by national economy sectors (p.p.) . . . 25
3.20 Evolution of the unemployment and employment rate (%) . . . 25
3.21 Wage bill in economy and average number of employees (%, versus the same period of the previous year) . . . 25
3.22 Real contributions of economy sectors (p.p.) to earnings growth (%, versus the same period of the previous year) . . . 26
3.23 Average real wage and productivity in industry (%, versus the same period of the previous year) . . . 26
3.24 Current account share in GDP (%) . . . 27
3.25 Share of exports and imports in GDP (%) . . . 27
3.26 Share of transfers in GDP (%) . . . 27
3.27 Share of financial flows in GDP (%) . . . 28
3.28 Share of direct investments in GDP (%) . . . 28
3.29 Share of external debt in GDP (%) . . . 28

4.1 The average monthly reference rates on interbank market and the NBM base rate (%) . . 29
4.2 The monthly evolution of interest rates corridor (%) . . . 29
4.3 The daily balance of money market operations (MDL, million) . . . 30
4.4 The dynamics of monetary aggregates (%, annual growth) . . . 32

4.5 The dynamics of monetary aggregate M3 (%, components contribution to the annual growth) 32
4.6 The evolution of loans balance (%, annual growth) 33
4.7 The shares of loans balance (%) 33
4.8 The evolution of deposits balance (%, annual growth) 34
4.9 The average interest rates (%) 35
4.10 The evolution of banking margin (p.p.) 36
4.11 The fluctuations of the official exchange rate of MDL against USD and EUR 36
4.12 The evolution of currencies in the region and currencies of the major trading partners of the Republic of Moldova against the U.S. dollar (30.06.2017), 31.03.2017=100% 37
4.13 The dynamics of nominal effective exchange rate (NEER) and real effective exchange rate (REER) of MDL calculated based on the major trading partners weights (Dec.2000=100%) 37
4.14 The contribution of the major trading partners of the Republic of Moldova to the real effective exchange rate modification in the second quarter of 2017 37
4.15 The foreign currency structure of net foreign currency supply from individuals (foreign currencies are recalculated in USD at constant exchange rate) 38
4.16 The coverage rate of net demand by the net supply and the dynamics of the official exchange rate 38
4.17 The evolution of official reserve assets expressed in months of import of goods and services (MBP6) 38

5.1 The real GDP in the euro area (%, f.a.p.) 39
5.2 The real GDP in the Russian Federation (%, f.a.p.) 39
5.3 The CPI in the euro area (%, f.a.p.) 40
5.4 The CPI in the Russian Federation (%, f.a.p.) 40
5.5 The evolutionary scenario of the USD/EUR exchange rate 40
5.6 The evolutionary scenario of the RUB/USD exchange rate 41
5.7 The Urals brand oil world prices (USD/barrel) 41
5.8 The world food prices (%, f.a.p.) 41
5.9 The output gap forecast 42
5.10 The annual rate of CPI 42
5.11 The CPI decomposition 43
5.12 The annual rate of CPI 43

List of Tables

1.1 The evolution and forecast of CPI and its components 11

2.1 The evolution of GDP, CPI and IPI in the selected economies(%) 15

5.1 The expected evolution of external variables (annual average) 39