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# Inflation Report no. 3, 2012

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## Summary

### External environment

The global economic downturn continued to be determined in the second quarter of 2012 by the euro area sovereign debt crisis and by the uncertainties in the financial markets. The decrease in world oil prices and commodity prices convinced the financial markets on the impending reduction of global demand and determined many advanced economies to loosen their monetary policy in order to sustain their national economies. In the second quarter of 2012, the Euro has depreciated significantly against major international currencies, following the publication of negative statistics in the euro area and delayed firm decisions of granting new loans to countries facing sovereign debt crisis. At the same time, many emerging economies have grown below expectations in the first quarter of this year, due to reduced industrial output, amid lower volume of goods exported to developed economies. High volatility in financial markets has increased the uncertainties about the global economy, which resulted in a downward revision of the forecasts for 2012.

### Inflation

The annual rate of inflation measured by CPI constituted 4.1 percent in the second quarter of 2012, thus continuing the downward trend started at the end of the previous year. The inflation development was mainly determined by the gradual decrease of pressure from food prices amid their decrease on the international market and a good harvest in 2011. At the same time, the contributions from core inflation and regulated prices were below the previous quarter, due to weakening domestic demand and the gradual absorption of the effects of increases in gas and heating tariffs from the beginning of the previous year. The average annual rate of inflation during the aforementioned period was below the level projected in the April round of forecasting. This deviation was determined by the changes in the anticipated trends of oil prices and the reduction over the expectations of food prices on foreign markets, and also due to the adoption of the new electricity tariff later than expected.

Similarly, the annual core inflation rate registered a downward trajectory during the second quarter of 2012 and decreased to the level of 4.1 percent in June. After a period of more than two years, the annual rate of core inflation has exceeded for the third month in a row the annual rate of overall inflation. In the second quarter of 2012, the annual rate of industrial production price index was 5.8 percent, down by 1.4 percentage points from the previous quarter.

## Economic developments

In the first quarter of 2012, the tendency of economic activity mitigation reported in the second half of last year has emphasized. The annual rate of GDP decreased during the reference period to 1.0 percent, being significantly below the value of 6.4 percent recorded in 2011. The modest evolution of the local economy is mainly due to the uncertainty in the euro area resulted in a slowdown in remittances and exports growth.

Private consumption grew by only 2.7 percent as compared to the value of 8.5 percent recorded in 2011, due to the slowdown of its financing sources growth. At the same time, the modest economic performance of the euro area determined the exports increase by only 8.2 percent.

Gross fixed capital formation recorded a slight increase of only 1.4 percent. The slowdown in domestic demand and exports resulted in a more modest evolution of imports. Final consumption of public administration has declined by 1.6 percent in the reporting period. The attenuation of the annual GDP growth in the first quarter of 2012 was mainly determined by the equal negative contributions from the industry and net taxes on products, and the slowdown in the growth rate of gross value added of the services. An acceleration of the growth rate was recorded only in the construction sector.

The labor market in the first quarter of 2012 was characterized by a remediation as compared to the same period last year. At the same time, the seasonally adjusted unemployment rate shows stabilization as compared to the fourth quarter of 2011. The net real wage in the economy accelerated its annual growth rate from 2.1 percent in April 2012 to 4.3 percent in May 2012, the trend found in all economic sectors.

## Monetary policy

During the second quarter of 2012, the NBM adopted three decisions to maintain the monetary policy interest rate at the level of 4.50 percent annually. The major argument of those decisions was the strengthening of the disinflation trend in the Republic of Moldova.

At the same time, to ensure adequate monetary conditions to maintain price stability, the National Bank of Moldova continued to manage firmly the liquidity surplus in the money market through sterilization operations.

During the second quarter of 2012, the NBM intervened in the foreign exchange market as a buyer of foreign currency in the context of the monetary policy promoted by the NBM and to ensure the consolidation of foreign exchange reserves.

After a substantial growth in 2011 of the monetary indicators, due to economic restoration after the crisis, in 2012 the growth rates have slowed down and in the second quarter of 2012 they recorded a pronounced downward dynamic. Noting a decline in growth rates of monetary aggregates, the quarterly average in annual terms recorded values of 11.7 percent for M2 and 8.7 percent for M3.

The average interest rates charged by commercial banks during the second quarter of 2012 recorded a stable evolution, registering insignificant increases or decreases. At the end of June 2012, the average interest rate on new loans in national currency recorded a new historical minimum of 13.69 percent, and those in foreign currency - 7.92 percent. In turn, the returns on bank term investments showed values higher than those recorded in the previous quarter for placements in national currency and below the previously recorded levels for those in foreign currency.

## Medium-term inflation forecasting

According to the current projection of the baseline scenario, the annual inflation rate will be placed at the level of 3.9 percent at the end of 2012 and at the end of the next year.

Throughout the forecast period, the values are projected onto a trajectory placed within the tolerance range of ± 1.5 percentage points from the 5.0 percent target.

The quarterly dynamic of the output gap is expected to be negative for the years 2012-2013, with a slight return to positive values in the first quarters of 2014. The deficiency of demand is expected to be relatively pronounced by the end of 2012, indicating increased disinflationary pressures from aggregate demand. The slowdown in the economic growth will lead to lack of inflationary pressures from aggregate demand, therefore the inflationary pressures will arise from supply-side during the forecast period.

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