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Inflation Report no. 2, 2014

Inflation Report no.2 May 2014 [1]

Summary

Inflation development

In the first quarter of 2014, the annual rate of inflation constituted 5.4 percent, by 0.5 percentage points higher than the previous quarter. The CPI annual rate increase was driven primarily by augmented pressure from core inflation and food prices due to of the national currency's depreciation and some changes made in the structure of the CPI in the current year. Both the annual rate of inflation and that of core inflation were in the range of ± 1.5 percentage points from the target of 5.0 percent stipulated in the Medium-term strategy on monetary policy of the National Bank of Moldova. Contributions from regulated prices and fuel prices were basically similar to the previous quarter. Annual inflation rate development in the first quarter of 2014 was by 0.3 percentage points lower than it was anticipated in the projection (5.7 percent) publiched in the Inflation Report no. 1, 2014.

External environment

In the first months of 2014, the global economy has strengthened and it expected to continue the same trajectory, the basic impulse is generated by advanced economies. At the same time, emerging economies evolve unsatisfactory, being affected by less favorable external financial environment. The low level of inflation in some economies, caused by recent decreases in international prices of raw materials, although it shows a weak demand, could be the basis for actions to stimulate these economies. At the same time, the geopolitical risks reappeared, which determine strong volatility of key economic indicators and which could cause significant turbulence in the coming quarters. It also continues the depreciation of currencies of emerging economies amid monetary policies of FRS and the region pressures are more pronounced due to the worsening Ukrainian conflict.

Economic developments

The economic growth was pronounced in the fourth quarter of 2013 and GDP increased by 11.2 percent compared to the fourth quarter of 2012. Similarly to the third quarter of 2013, this development was mainly due to the positive effects in the agricultural sector and their impact on other related sectors, such as manufacturing, which indicated a reduced sustainability of this development on medium-term. At the same time, positive developments in economic activity was favored to some extend by currency depreciation trend during 2013 against the currencies of major trading partners. In the fourth quarter of 2013 household consumption and gross fixed capital formation recorded increases of 5.0 and 3.6 percent, respectively, while government consumption recorded a contraction of 0.2 percent. In the fourth quarter of 2013, exports of goods and services increased by 16.0 percent, which was enough to neutralize the negative contribution of

the increase in imports by 6.1 percent in the reporting period. Gross value added in agriculture and industry increased by 28.9 and 7.4 percent, respectively, compared to the fourth quarter of 2012. Annual rate of trade and construction accelerated to values of 10.3 and 16.0 percent respectively. In the fourth quarter of 2013 was registered an increase in employment of 2.4 percent and a decrease in the unemployment rate to 4.1 percent.

Monetary policy

In the first quarter of 2014, there were three meetings of the Council of Administration of the National Bank of Moldova on monetary policy decisions. As a result of assessing the balance of internal and external risks, which could be faced by the Moldovan economy and inflation forecasts in the short and medium terms, there were issued three decisions to maintain the base rate at the level of 3.50 percent (level set at the meeting of April 25, 2013). During the reporting period, monetary policy was oriented towards maintaining the incentive nature of the real economy and keeping the inflation within the range of ± 1.5 percentage points from the target of 5.0 percent.

Growth rates of monetary indicators have started to diminish as from the beginning of 2014 compared to the end of 2013. Thus, in the first quarter of 2014, the growth rate of monetary aggregates remained high, the quarterly average in annual terms of M2 constituted 26.5 percent (by 2.8 percentage points below the growth in the fourth quarter of 2013) and 25.1 percent for M3 (by 1.1 percentage points less than in the fourth quarter of 2013).

During the first quarter of 2014, the average annual interest rate of credits balance granted to private sector decreased both in national currency (by 0.01 percentage points) and foreign currency (by 0.18 percentage points) compared to the end of the previous quarter, recording the level of 11.51 percent in national currency and 7.56 percent in foreign currency. At the end of the first quarter of 2014, the average interest rate of loans in national currency was 7.77 percent, decreasing by 1.54 percentage points compared to the level of December 2013. The average interest rate of loans in foreign currency reached the average level of 4.66 percent in March 2014, decreasing by 0.06 percentage points compared to December 2013.

Medium-term inflation forecasting

According to the current projection, the annual average CPI inflation is accounting for a level of 5.2 percent for 2014, by 0.2 percentage points lower compared to the values projected in the Inflation Report no.1, 2014. For 2015, inflation is projected to record the level of 4.3 percent, or by 0.5 percentage points lower compared to the previous report. Current projection sets the annual inflation rate in the range of ± 1.5 percentage points from the inflation target of 5.0 percent annually throughout the forecasting horizon.

The contribution of core inflation to the annual inflation rate will record a downward trend, but remaining significant throughout the forecasting period. Thus, the average annual core inflation will be 5.1 percent and 3.6 percent for 2014 and 2015, respectively. The downward trend in core inflation contribution to the annual inflation rate is due to a negative level of aggregate demand for the next eight quarters.

Downward revision of the forecast for food prices on the international markets compared to the scenario of the Inflation Report no.1, 2014, is one of the main factors that led to slower annual growth of domestic food prices compared to the previous projection.

According to the current round of forecasting, the output gap is expected to be negative for the entire forecasting horizon. Thus, according to the scenario, the output gap will record negative values from the first quarter of forecasting horizon, recording a minimum value in the third quarter of this year. In the

second half of the forecasting horizon, the aggregate demand will record a slow return to its potential level. An economic activity below its potential level in the long term will cause disinflationary pressures.

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