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Inflation Report no. 4, 2014

Inflation Report no.4, November 2014 [1]

Summary

Inflation development

In the third quarter of 2014, the annual rate of inflation was 5.1 percent, by 0.1 percentage points lower than in the previous quarter. Its downward development was determined by the mitigation of pressures from food prices. The impact of regulated prices and core inflation was similar to that of the previous quarter. However, i following the depreciation of the national currency, the core inflation increased up to the value of 5.8 percent by the end of the reporting period. The moderate domestic demand continued to have a modest impact on the prices growth in the third quarter of 2014. Fuel prices contribution increased in the third quarter of 2014, as a result of the military conflict in Eastern Ukraine that has reduced the coal supply on the market. Both the annual inflation rate and the core inflation continued to be within the range of ± 1.5 percentage points from the 5.0 percent target, according to the Medium-term monetary policy strategy of the National Bank. The annual inflation rate in the third quarter of 2014 was by 0.2 percentage points higher than it was anticipated in the projection (4.9 percent) published in the Inflation Report no. 3, 2014.

External environment

The world economy is going through a difficult balancing period. Many economies still face the inheritances of the global financial crisis – low interest rates correlated with low inflation level and high unemployment rates. At the same time, the prospects are somber; the forecasts on global economic growth are gradually reduced, which affects the confidence and the demand, respectively. The gap between the growth of advanced and emerging economies continue to deepen, which creates confusing signals concerning the global demand. Another recent phenomenon in the world economy is the significant decrease in the prices of raw materials, given the occurrence of excess supply. At the same time, the prices decrease is supported by the appreciation of the U.S. dollar. In recent months, the currency markets were significantly disturbed by the divergent monetary policies of the European Central Bank, Bank of Japan, the Federal Reserve System and Bank of England.

Economic developments

In the second quarter of 2014, the economy of the Republic of Moldova recorded a more pronounced dynamics, GDP increased by 4.2 percent compared to the similar period of the previous year. The acceleration of the economic activity in the second quarter of 2014 was mainly determined by the external demand. Thus, the exports increased by 10.0 percent, mainly due to the exports growth in the European Union' countries. The domestic demand continued to be modest, so that the household consumption recorded an annual growth rate of only 1.9 percent. The investment contribution had a negative impact on the GDP dynamics in the second quarter of 2014, exclusively due the dynamics of the inventories component. The gross fixed capital formation increased by 7.6 percent compared to the same period of 2013.

The modest domestic demand generated a negligible dynamics of imports, increasing by only 0.1 percent in the second quarter of 2014. The economic developments were generated, to some extent, by the depreciation of the national currency during the reporting period against the currencies of major trading partners. However, the GDP annual dynamics in the first half of 2014 (3.9 percent) was significantly lower than the GDP dynamics in the previous year (8.9 percent). This dynamics was determined by the disappearance of the imposing effect of agricultural growth of the previous year as well as further slowdown of the domestic demand. The evolution of the unemployment rate and employed population shows an improvement on the labor market of the Republic of Moldova in the second quarter of 2014 compared to the similar period of the previous year.

Monetary policy

In the third 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 limiting the disinflationary pressures, keeping the inflation within the range of ± 1.5 percentage points from the 5.0 percent target.

The growth rates of the monetary indicators have started to decrease since the beginning of 2014. Thus, in the third quarter of 2014, the growth rate of monetary aggregates approached the values recorded in 2011 and 2012, the quarterly average in annual terms of M2 constituted 12.2 percent (by 9.9 percentage points less than in the second quarter of 2014) and that of M3 amounted to 16.1 percent (by 7.1 percentage points less than in the previous quarter).

During the third quarter of 2014, the average annual interest rate of loans balance granted to private sector decreased both in national currency (by 0.48 percentage points) and in foreign currency (by 0.26 percentage points) compared to the previous quarter, amounting to 10.85 percent in national currency and to 7.40 percent in foreign currency. The average interest rate of deposits in MDL recorded a level of 7.69 percent in the third quarter of 2014, by 0.04 percentage points higher than in the previous quarter. The interest rate of deposits in foreign currency amounted to an average of 4.58 percent, decreasing by 0.07 percentage points compared to the previous quarter.

Medium-term inflation forecasting

According to the current projection, the annual growth rate of CPI will record the level of 4.9 for this year and 4.6 percent in 2015, the same trend of variation in the proximity of the inflation target being registered for the first three quarters of 2016. The annual inflation rate will fall within the range of the inflation target for the entire forecasting period. Although inflation is projected to be tolerable, it will be preponderantly situated in the lower range of variation. The minimum value of 3.6 percent will be recorded in the first quarter of 2015. At the same time, the balance of risks is dominated by disinflationary factors throughout the projection horizon.

The contribution of **core inflation** to the annual inflation rate shows a downward trend during the entire forecasting period, but higher compared to the contribution recorded in the previous report due to a higher domestic demand developments.

The increased likelihood of the unfavourable agro meteorological conditions for the next year will cause an increase of the contribution of **food prices** to the formation of the annual inflation rate, despite the food

prices reduction on the international markets.

The **regulated prices** evolution will be similar to that published in the Inflation Report no.3, 2014 and will maintain their enhanced contribution to the CPI.

According to the current round of forecasting, the output gap recorded an enhanced volatility throughout the entire forecasting period. The output gap for the second half of this year will record a positive level, due to the persistent economic growth that was recorded in the first two quarters of this year and the simulative nature of the monetary policy. As from the first quarter of 2015, the output gap will turn negative and will record negative values for two consecutive quarters, reaching the minimum value in the first quarter of the next year. The output gap reorientation will primarily occur due to the decline in growth of the consumption funding sources. The main negative contribution is assumed to be the decrease in the remittances, due to reduced growth of economic activity in the major source countries.

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