



# Monetary Policy Report

No. 4, November 2010



**Note**

*Monetary Policy Report no. 4, November 2010 was prepared bearing on the most recent statistical data compiled by the National Bank of Moldova, National Bureau of Statistics, Ministry of Economy and Ministry of Finance.*

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

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



## LIST OF ACRONYMS

ANRE	National Agency for Energy Regulation
NBM	National Bank of Moldova
NBS	National Bureau of Statistics of the Republic of Moldova
NBC	Certificates issued by the National Bank of Moldova
MTEF	Medium-term expenditure framework
CHIBID	Average interest rate at which the contributors banks are available to borrow funds in MDL from other banks, on the interbank monetary market
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
SDR	Special drawing rights
EUR	Common European Currency
IMF	International Monetary Fund
CPI	Consumer Price Index
PPI	Producer Price Index
MDL	Moldovan Lei
NEER	Nominal effective exchange rate of the national currency
OPEC	Organization of the Petroleum Exporting Countries
GDP	Gross Domestic Product
REER	Real effective exchange rate of the national currency
REPO	Sale and Repurchase Agreement
RUB	Russian rouble
USA	United States of America
EU	European Union
USD	US Dollar
SS	State Securities
FCC	Freely convertible currencies



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## Summary

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In the first quarter of 2010, the world economy continued its recovery process. According to the International Monetary Fund estimates (IMF), in the first and second quarters of the year, the world economy grew at an annual rate of 4.7 and 4.9 percent respectively. Based on data from the first quarter of this year, the annual growth rate of world economy is expected to be 4.8 percent in 2010.

The recovery process remains to be uneven, each region registering its growth rate. While in the advanced economies, the recovery process will further depend on the public debt, high unemployment, maintenance of difficult conditions in terms of credit, and volatility in foreign exchange markets, the outlook for emerging countries is considerably better. However, the advanced economies would grow by 2.7 percent, while for the emerging and developing economies the new forecast indicates an advance of 7.1 percent.

However, the most recent macroeconomic indicators, published during July – September 2010, suggest a decrease in the global economic activity rate, offering a possible further deceleration in global growth during the second quarter of 2010. In the most developed economies, the recovery is tempered by unfavorable conditions in the labor market, mortgage decline, and difficulties in financing fiscal deficits. The growth in emerging economies remained generally robust, but the short-term indicators suggest a slowdown of economic growth.

In the upcoming period, the inflationary pressures remain low, mainly in the developed economies. The inflation in the advanced countries will reach 1.4 percent in 2010 and in emerging countries will reach 6.2 percent.

### **Dynamics of the inflationary process**

In the third quarter of 2010, the annual rate of inflation measured by the CPI showed a slight upward trend, increasing from 7.6 percent in July to 8.0 percent in September, while the annual core inflation rate experienced a declining growth in the reference period (from 5.1 percent in July to 4.8 percent in September 2010). The significant difference between the rate of CPI inflation and core inflation rate shows the significant contribution of the non-monetary factors in prices increase in Moldova.

To the annual inflation rate formation in September 2010, the most had contributed the regulated prices as a result of changes in tariffs for gas, electricity and heating, conducted in January and May. At the same time, a major contribution has been exerted by food prices, as a result of weather deviations from the norm during the year and food price fluctuations on the world market. The oil prices fluctuations in the world market have determined the increase in fuel prices. The increase in core inflation was mainly influenced by the developments in the foreign exchange market in the first quarter of this year, by the increases in indirect taxes from the beginning of the year, and by the second-round effects resulting from higher prices of services with regulated prices.

### **Macroeconomic situation**

In the first half of this year, it is recorded a pronounced recovery of the Moldovan economy, after the severe decline during 2009, following the global economic crisis. Thus, the gross domestic product in the first semester of 2010 rose by 5.6 percent compared to the same period last year. Household consumption and gross capital formation have been the engines of the economic growth in the second quarter of 2010. The export growth had a modest contribution to the positive evolution of GDP in this period. The significant increase in imports in the second quarter of 2010 had a considerable impediment to the GDP growth in Moldova, a significant portion of domestic demand being directed towards goods and services from outside, to the detriment of those produced by the branches of national economy. The entry of the economy in the recovery phase is confirmed by positive developments in all sectors, and after a long period of decline, in the construction sector.

Operational data on consumption of goods and services, industrial production and transport of goods for July, August, and September, and the information on foreign trade for July and August outline the prerequisites for continuing recovery in economic activity in the third quarter of 2010.

In the second quarter of 2010, it is recorded a deterioration in the labor market situation in Moldova, so that the unemployment rate on country-level exceeded by 0.9 percentage points the value recorded in the previous year due to reduced flexibility of the labor market in Moldova.

### **Macroeconomic and inflation forecast on medium term**

According to the NBM estimates, the level of GDP exceeded the minimum level of recession and starting with the end of 2009 has had an upward trend, which was visible in the first two quarters of this year. However, the level of the economic activity is still below its potential, which created disinflationary pressures that are still persistent.

Compared with the Monetary Policy Report no.3, 2010, the economic growth will be higher by about 1.6 percentage points for this year and by 0.1 percentage points higher for the next year. Thus, the GDP growth in 2010 will be 5.0 percent and 3.4 percent in 2011. Therefore, as in the previous forecast, potentially reaching the level of economic activity will be outside the horizon of two years.

The annual rate of CPI inflation at the end of 2010 will record the level of 7.8 percent, which is 0.4 percentage points less than the amount previously projected. The reduction of the forecasted inflation rate for 2010 is due to inflationary pressures, which were lower than previously projected.

The inflationary pressures in 2011 will have a nature and intensity similar to those of 2010. Towards the end of the forecast period (2012), the annual inflation rate will reach close to a long-term sustainable level of 5.0 percent. The core inflation at the end of this year will reach 4.0 percent. During 2011, it will drop to 2.1 percent, which will accelerate to a level of approx. 4.0 percent at the end of 2012.

The risks relating to external environment evolution are generated by signs of recovery in the world economy, which could transpose into price fluctuations on oil and natural gas. The food products have recorded a considerable growth pace in the recent years. All these external factors could therefore cause disruptions in the evolution of inflation.

### **Monetary policy decision**

Analyzing the medium-term inflation projections, the Council of administration of the NBM decided in the meeting of October 28, 2010 to maintain the base rate at 7.0 percent. The base rate remained unchanged throughout the second and third quarter of 2010.

## I. Macroeconomic developments

### External environment

The process of revival of the global economy continues and according to the estimates of the Monetary Fund (IMF) in the second quarter of this year, the world economy grew at an annual rate of 4.9 percent, with higher developments than the ones projected in July. However, the pace of economic recovery varies from one region to another: advanced economies grew at an annual rate of 2.9 percent, while emerging economies have advanced at a rate of 8.1 percent. In this context, the IMF increased its forecast for global economic development in 2010, from 4.6 percent (July 2010 report)<sup>1</sup> to 4.8 percent (October 2010 report)<sup>2</sup> compared to the previous year. Developed economies would grow in 2010 by 2.7 percent, while for the emerging and developing economies, the new forecast indicates an advance of 7.1 percent.

However, the most recent macroeconomic indicators, published during July – September 2010, suggest the loss rate of international economic activity, thus providing a possible further deceleration in global growth during the second semester of 2010. In most developed economies, the recovery is tempered by unfavorable conditions in the labor market, by the decline in mortgage credits and by the difficulties related to fiscal deficits financing. The economic growth in emerging economies remained generally robust, but short-term indicators suggest a slowdown of economic growth. Difficulties in the state bonds markets and austerity programs introduced in the recent months have greatly increased the pressure on public finances and private consumption, resulting in a loss of confidence in the markets and causing significant decrease in the budget of the states in recession, which will slow down the process of recovery.

International Monetary Fund (IMF) forecasts a global economic deceleration on short term, this process will be seen both in the developed and emerging economies. Among the main risk factors regarding the global economy evolution on the short-term, the IMF stated: attenuation of stock recovery rate by the companies, the withdrawal of budgetary stimulus programs, uncertainties on the financial markets (public finance crisis, financing banks, and non-termination of the financial system reform, global unemployment increase).

However, the IMF notes that the sustainable economic recovery is dependent on the two balancing processes: between the government and private demand in the developed countries and between the foreign and domestic demand in the emerging and developing economies. These processes involve a number of challenges such as budgetary, financial, and structural. The main challenges for the developed economies are: financial system reform, consolidation of the consumers' financial situation, public debt stabilization and reduction. Thus, the macroeconomic policies in these countries should be aimed at reviving the private demand, financial sector reform, and budgetary consolidation. On the other hand, for the emerging economies, the main macroeconomic challenge is the dependence on the demand from developed economies.

The process of global economic recovery will continue, while tensions and vulnerabilities will be present. World trade grows faster than in the pre-crisis periods. This growth is differentiated according to geographical areas and product categories as a result of the accentuation of the global trade imbalances, volatile capital flows, exchange rate developments and issues related to supply and accumulation of official reserves.

According to the IMF report, the stable economic growth depends on the measures necessary to restore the balance of global trade. These measures involve ensuring the stability of domestic demand in developed countries that will contribute to fiscal consolidation, the increase in net exports of countries with essential trade deficits and reduction of net exports of emerging countries in Asia. Although the net exports will be

<sup>1</sup> World Economic Outlook (WEO) July 2010

<sup>2</sup> World Economic Outlook (WEO) October 2010



reduced, this measure allows to consolidate the domestic demand that will sustain the growth pace in Asian countries.

The forecast regarding the inflation marks a slight increase for both 2010 and 2011. The consumer price index in advanced countries will reach the level of 1.4 percent in 2010, while in emerging countries it will reach 6.2 percent. However, the still weak capacity utilization rates of production will limit the inflationary pressures.

### *Euro zone*

Economic analysis shows that after a sharp decline, the economic activity in the euro zone has recorded an increase starting with the second half of 2009. In the second quarter of 2010, in accordance with the second estimate of Eurostat, the EU and the euro zone's real GDP recorded an increase compared to the same period of the previous year by 2.0 and 1.9 percent respectively. The available information indicates a sustainable growth of domestic demand, partly due to strong intensification of investments, net exports (the recovery process motor) and stocks that also contributed to the economic expansion.

The momentum in the second quarter of 2010 will partly be reflect in the second half of 2010. According to the expectations, the real GDP of the euro zone will grow in 2010 and 2011 by 1.7 and 1.5 percent respectively. Official statistical data show uneven recovery in the economies of member countries. For example, the German economy, the biggest euro zone economy, rose in the second quarter of 2010 by 3.7 percent compared to the same period of 2009. At the same time, the difficulties regarding the financing of fiscal deficits and austerity programs introduced in recent months in Greece and Spain have adversely affected these economies recover. The austerity measures, practiced in many European countries, become nowadays a debate subject in the United Kingdom as well. These measures include reduction of social benefits and wages in the public sector and taxes increase. The lack of uniformity reflects the differences between production structures and scale of the problems of adaptation and rebalancing that continue to take place in the euro zone and the EU in general.

As regards the price developments, according to the preliminary estimates of Eurostat, the annual rate of inflation in the euro area has insignificantly increased from 1.6 percent in August 2010 to 1.8 percent in September 2010. After reaching this level, the total inflation is projected to rise slightly until the end of 2010, largely due to the developments in commodity prices.

### *United States of America*

In the United States of America, the world's largest economy, the U.S. Bureau of Economic Analysis has estimated the GDP growth in the second quarter of 2010 to 3.0 percent in real terms than during the previous year. The economic growth in the second quarter of this year reflected on the one hand, the expenditures growth of consumption of households, which constitute two thirds of the U.S. economic activity and increased by 1.7 percent during the analyzed period. However, in the context of lower consumer confidence and the persistence of unfavorable labor market, household consumption expenditure continued to report a modest increase during the first semester of 2010.

On the other hand, the economic growth was limited by the reduction of regional and local government expenditures, and by the significant negative contribution of net exports, the import growth being faster than that of exports.

It is anticipated that the U.S. economic recovery will continue at a moderate pace. According to the expectations, the U.S. real GDP would grow by 2.6 percent in 2010. In general, the recovery is likely to achieve a relatively modest level compared to historical values. Unfavorable conditions in the labor market, modest income growth, further adjustment of population balances, and the slow depreciation of real estate assets could limit the U.S. economic growth on short term.

As regards the price developments, the annual CPI inflation rose from 0.1 percent in August 2010 to 1.1 percent in September 2010. The increase in inflation was due in most part, to food price increases. It is



anticipated that the inflation will remain moderate in the short term, reflecting a modest increase in wages and slowing the process of “healing” of the labor market.

### ***Romania***

The strong recession in 2009 continues to have negative effects on the Romanian economy this year. The macroeconomic indicators published during August - September confirmed the economic downturn. Gross domestic product estimated for the second semester of 2010 was down by 1.5 percent in real terms compared to the respective period of the last year, the trend is maintained until the end of 2010. The downturn in economic activity, inflation, unemployment, budget deficits are some of the factors that will significantly impact the economy of a possible decline to 1.9 percent this year, the largest of emerging Europe (according to IMF forecasts).

The economic crisis had a negative impact on all areas of activity, but the most affected sector was construction, which significantly reduced the volume of activity (to 12.0 percent) in the first half of 2010 compared with the same period of 2009. However, industry was the only branch that has recorded a significant increase of 5.1 percent and could be the main factor supporting the economic growth in 2011, particularly on the external demand.

The net exports contributed to the positive effect on GDP, due to faster increase in exports of goods and services compared to the volume of imports. At the same time, the inflation increase pressures by the end of 2010 are due to the increase in value added tax by 5.0 percentage points and the slight depreciation of the Romanian Leu.

### ***Russian Federation***

The economic development of the Russian Federation in the first half of this year recorded positive trends. Thus, after the recession of 2009 there has been seen an increase in production in most economic activities, the stabilization of domestic demand and an increase in investment in fixed capital. In the second semester of 2010, the GDP grew by 5.2 percent compared to the same period last year, while during January to March it was recorded an increase of 3.1 percent. At the same time, the economic downturn was mentioned in the Economic Development Report, published in September 2010 by the Russian Federation Ministry of Economic Development. Thus, the GDP in August (the second consecutive month) fell by 0.4 percent compared to the previous month.

However, restoring the international market oil prices, increase of revenues from raw material exports, continued growth in investment and stimulating the domestic consumption are factors that would contribute to the increase of the Russian economy by 4.0 percent in 2010 (according to the IMF forecasts). At the same time, the severe drought could have a major impact on economic development. The most affected sector is the agro-industrial complex: the reduction in food can cause reduction in grain exports and increase in imports of food. These natural factors may become an impetus for higher inflation and slowing the GDP growth.

### ***Ukraine***

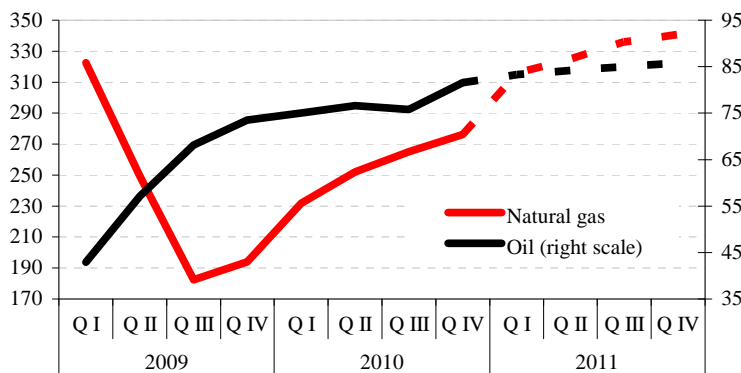
The recession has been particularly strong in Ukraine, which considerably reduced the real growth rate from 2.1 percent in 2008 to minus 15.1 percent in 2009. The depth of the crisis was demonstrated by the stagnation, of almost all sectors of the economy and by the significant increase of budget deficit. However, at the end of 2009, a modest increase was recorded, which still continues. Thus, in the second semester of 2010, a positive growth of real GDP of 5.9 percent was recorded as compared to the same period last year. Available data shows that the economic recovery was driven by the industrial production growth (14.7 percent), by the increase of exports and increase of domestic demand.

## Evolution of gas and oil prices

Despite the attenuation of growth rate of world economy in the third quarter of 2010, the demand for oil from countries in Asia and the U.S. showed an upward trend, which contributed to the increase of “futures” quotes on oil.

The evolution of oil prices has been caused, in particular, by the pessimistic expectations of rising oil demand in the context of economic revival in a number of countries and the ongoing development of the Chinese economy. Also, the oil market was influenced by the exchange rate depreciation of U.S. dollar against the major world currencies, affecting the prices of petroleum products denominated in U.S. dollars and thus contributing to increasing the attractiveness of the property market for speculative and investment capital.

**Chart no. 1.1. Evolution and forecast of natural gas (USD/1000 m<sup>3</sup>) and oil prices (USD per barrel)<sup>1</sup>**



<sup>1</sup> Source: NBM, Energy Information Administration (U.S. government's official statistics), <http://tonto.eia.doe.gov/dnav/pet/hist/wepcuralsw.htm>

Also, it should be mentioned that during the three quarters of this year, the dynamics of oil prices has fluctuated around the average price during the analyzed period, representing U.S. \$ 75.6 per barrel<sup>3</sup>, increasing by 14.2 percent compared with the same period last year.

In the third quarter of 2010, the quotations in world oil prices reached an average value of U.S. \$ 75.7 per barrel, increasing by 11.4 percent compared to the same period last year.

Nowadays, the oil prices record stability at about U.S. \$ 80.0 a barrel<sup>4</sup>.

During 2010-2011, the oil price will fall within U.S. \$ 80.0 - 86.0 per barrel.

Thus, it is expected that in the second half of 2010, the global economic recovery will continue, with resultant increase in consumption of petroleum products and therefore will lead to a slight increase in prices. Besides those mentioned, the International Energy Agency has recently revised its forecasts for oil demand for 2010, and declared that it will increase by 0.3 percent compared with the data shown in the previous report submitted in September 2010, reaching a value of 86.9 million barrels per day<sup>5</sup>.

According to data announced by the ANRE, the purchase price of natural gas in the fourth quarter of 2010 will be about U.S. dollars 270.0 per 1000 cubic meters, up by 2.0 percent compared to the third quarter of 2010.

We anticipate that in 2011, the average price of gas will increase, because started with the respective year the reduction factor will be applied to imported gas price formation.

## Inflation

In the third quarter of 2010, the annual rate of inflation measured by the CPI showed an upward trend, increasing from 7.6 percent in July to 8.0 percent in September. Thus, the annual rate of inflation is in line with the projection published in the last Monetary Policy Report (August 2010). Compared with the second quarter of 2010, there is an annual pace of CPI stability as a result of lack of inflationary or deflationary pressures considerably during the third quarter of 2010.

The annual rate of core inflation has experienced a declining growth in the reference period. Thus, it dropped from 5.1 percent in July to 4.8 percent in September. Significant difference between the rate of CPI

<sup>3</sup> Urals brand

<sup>4</sup> [http://www.opec.org/opec\\_web/static\\_files\\_project/media/downloads/publications/MOMR\\_October\\_2010.pdf](http://www.opec.org/opec_web/static_files_project/media/downloads/publications/MOMR_October_2010.pdf)

<sup>5</sup> <http://omrpublic.iea.org/currentissues/high.pdf>

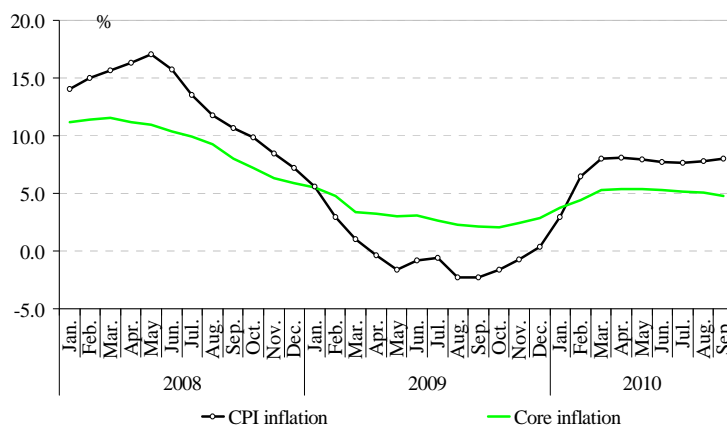
inflation and core inflation rate (3.2 percentage points in September 2010) reveals the significant contribution of non-monetary factors in rising prices in Moldova.

In this regard, the impressive contributions have been exercised by regulated prices<sup>6</sup>, prices for fuel and food prices, development of which is influenced by factors such as prices of goods on world markets, climatic conditions, etc., factors that cannot be controlled or anticipated by the monetary policy actions of the National Bank of Moldova.

Thus, to the formation of the annual inflation rate in September 2010, the most has contributed the following: regulated prices (2.5 percentage points) as a result of changes in tariffs for services with regulated prices (gas, electricity, heating) made in January and May. At the same time, a major contribution (2.4 percentage points) was exerted by food prices as a result of weather deviations from the norm during the year and food price fluctuations on the world market. Fluctuations of oil prices in the world market led to higher fuel prices that have contributed to annual inflation formation by 1.1 percentage points. The increase in core inflation has contributed by 2.1 percentage points to CPI inflation rate formation.

Within the components structure, in September 2010, the largest increase, compared to September 2009 (11.1 percent) was recorded for services, followed by prices for foodstuff products (7.1 percent), while non-foodstuff products prices recorded an increase of 6.8 percent. Since the beginning of the year, the consumer price index rose by 4.5 percent, foodstuff products prices - by 0.6 percent, non-foodstuff products - by 4.6 percent and prices of services - by 9.4 percent.

Chart no. 1.2. The annual rate of CPI and core inflation



Source: NBS

*Core inflation index<sup>7</sup>*

In the third quarter of 2010, the annual rate of core inflation continued the downward trend started in the previous quarter, so it fell from 5.1 percent in July to 4.8 percent in September 2010 (chart no. 1.2.).

Prices increase in annual terms of goods related to core inflation was mainly influenced by developments in the foreign exchange market in the first half of 2010. Thus, the average nominal exchange rate of MDL against U.S. dollar in June has depreciated by 8.1 percent compared to December 2009. In the third quarter, this trend

was reversed, the MDL appreciated by about 5.1 percent in September compared to June, so that the inflationary pressures in the exchange rate have lost significant intensity, which explains the reduction rate of core inflation in this period.

At the same time, the annual rate of core inflation, especially of services for this component was influenced by second-round effects that occurred after increases in utility tariffs in January and May, but also to a certain extent by the increase in food prices. Increases in indirect taxes made earlier this year were another factor that contributed to the annual rate of core inflation.

Within the structure, the most significant increases were registered for public catering services and medicines, which prices in September rose by 12.0 and 10.9 percent respectively compared to the same period last year.

<sup>6</sup> Decomposition of CPI inflation in these components is made based on the internal methodology of the NBM. Components of CPI inflation are: (1) core inflation (2) food prices (3) regulated prices (4) fuel prices

<sup>7</sup> Index calculated by the method of exclusion (there were excluded food, fuel, products and services with administered prices), based on the CPI calculated by the National Bureau of Statistics of the Republic of Moldova.

*Food prices*

In the third quarter of 2010, the annual rate increase in food prices has increased. Thus, in September 2010 its value amounted to 7.1 percent from 5.3 percent, value recorded in June of this year.

The increase of food prices in annual terms in the reference period was determined primarily by higher prices of milling and bakery products – by 5.6 percent, vegetables - by 22.9 percent, sugar - by 45.8 percent, milk and dairy products - by 8.7 percent.

Prices increases in milling and bakery have been influenced by the increase in world prices, and heavy rains during the harvest period, which affected the quality and volume of wheat harvest. Prices for vegetables have been influenced by the considerable increase in the price of tomatoes and garlic (with 112.9 and 50.3 percent, respectively). This prices increase was conditioned by lower production volume, following the registration of adverse weather conditions for such crops. The increase in sugar prices has been registered as the effect of price increases in the fourth quarter of 2009 and first quarter of 2010. It should be mentioned that the increase in prices for milk and dairy products is due to increases recorded in the second and third quarter of 2010.

Negative contributions to food inflation have been exercised by lower prices for potatoes - by 20.3 percent, meat, and meat products - by 2.0 percent, as a result of increases in respective production volume.

Besides the internal factors, the increase in food prices has been driven by global food price increase, thus the last ones increasing by about 6.4 percent in September 2010 as compared to the same period last year.

*Regulated prices*

Regulated prices have a relatively constant evolution during the third quarter of 2010, due to the fact that during this period no changes were made to service tariffs. However, the annual rate of prices for regulated services amounted to 16.3 percent in September. This value is a consequence of changes in tariffs made in January and May, to cover the actual costs and full payment of the payments for the purchase of the energy resources from the suppliers.

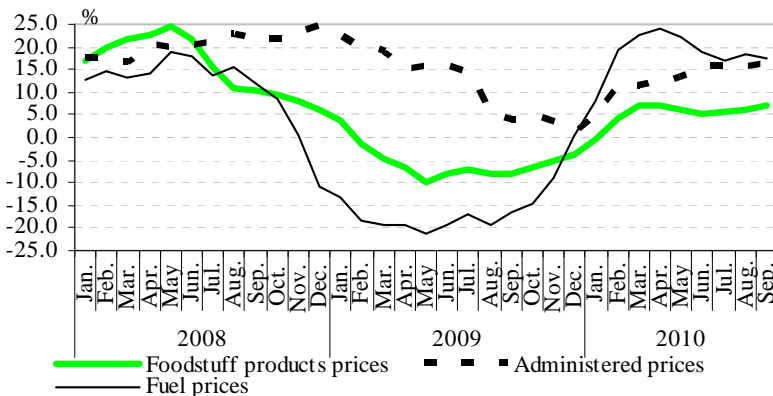
The largest contribution to the annual rate of regulated prices in September comes from electricity price increase - by 20.4 percent compared to September 2009 as a result of the tariff increase in January. This is followed by the contribution from higher prices for natural gas in centralized pipelines and heating by 21.6 and 25.3 percent respectively, as compared to the same period last year. Significant contributions have been generated by urban transport services increases by 24.3 percent and payment for housing – by 11.4 percent.

*Fuel prices*

In the third quarter of 2010, the annual growth of fuel prices has followed a relatively stable path after the downward tendency recorded in the previous quarter (chart no. 1.3). Thus, in September 2010, the fuel price growth rate constituted 17.5 percent compared to the same period last year.

The slowdown in price increases for fuel during this period was due to the attenuation of quotations increase of oil prices on international exchanges and Platt's quotations prices for oil products during the analyzed period, that have not created prerequisites for the increase in import prices of petroleum products on the domestic market. Another factor that

*Chart no. 1.3. The annual rate of inflation subcomponents*



Source: NBS

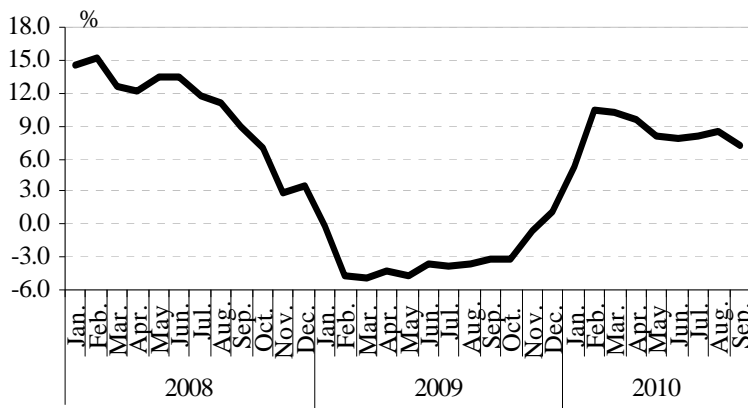
influenced the attenuation of fuel prices increase on the domestic market constituted the appreciation of the domestic currency against the U.S. dollar in the corresponding period. However, the price of Urals oil has reached the weekly values over U.S. \$ 80.0 a barrel in August, and the average monthly value in September (U.S. \$ 77.1 a barrel) constituted 13.0 percent more than during the previous year. Also, it should be mentioned that in September the price of liquefied gas increased by 7.2 percent compared with the last increase, due to an increased purchase price of liquefied gas in Ukraine.

Within the sub-components structure, prices for gas from cylinders were by 28.2 percent higher in September than in the same period last year. Fuel prices have increased by 19.7 percent, while the coal price of land rose by 10.4 percent compared to September 2009.

**Industrial production price index**

In the third quarter of 2010, the annual rate of industrial producer price index was characterized by an increase from 7.7 percent in July to 8.5 percent in August and in September dropped to 7.2 percent.

Chart no. 1.4. The annual rate of PPI



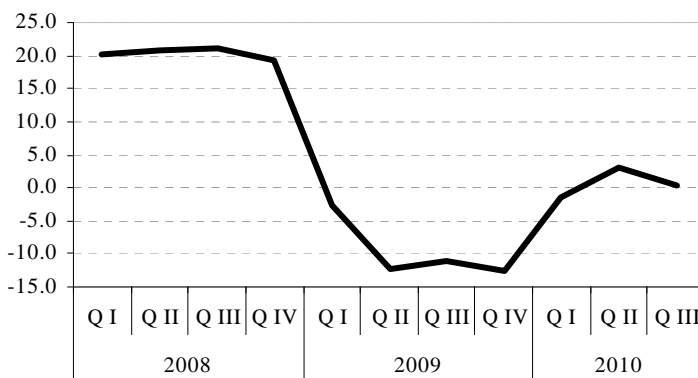
Source: NBS

Within the structure, in September there was recorded a decrease in prices in mining and quarrying by 0.5 percent compared with the same month last year, and in manufacturing and in energy sector there was recorded an increase of 5.2 and 18.2 percent respectively compared with September 2009. Compared with August 2010, prices in the industry as a whole fell by 0.3 percent. This price reduction is due to price reduction in manufacturing by 0.4 percent.

Prices increase in annual terms for industrial production was driven by higher prices for raw materials and food products in international markets and by the exchange rate of MDL against the currencies of major trading partners of Moldova.

**Construction prices**

Chart no. 1.5. Evolution of construction price index (% , compared to the same period last year)



Source: NBS

In the second and third quarter of 2010, the growth rate of construction price has returned to the positive path after a period of more than a year when had negative values as a result of the economic crisis which had a severe impact on the construction sector Republic of Moldova. According to the National Bureau of Statistics, prices of construction and assembly in the third quarter of 2010 increased by 0.4 percent compared with same period of 2009.

Within the components structure, in the third quarter of 2010, the highest growth in compared to the third quarter of 2009 was recorded in housing (by 1.4 percent), construction of objects of socio – cultural purpose (by 2.6 percent), electrical power (by 2.5 percent), and telecommunications (by 12.8 percent).

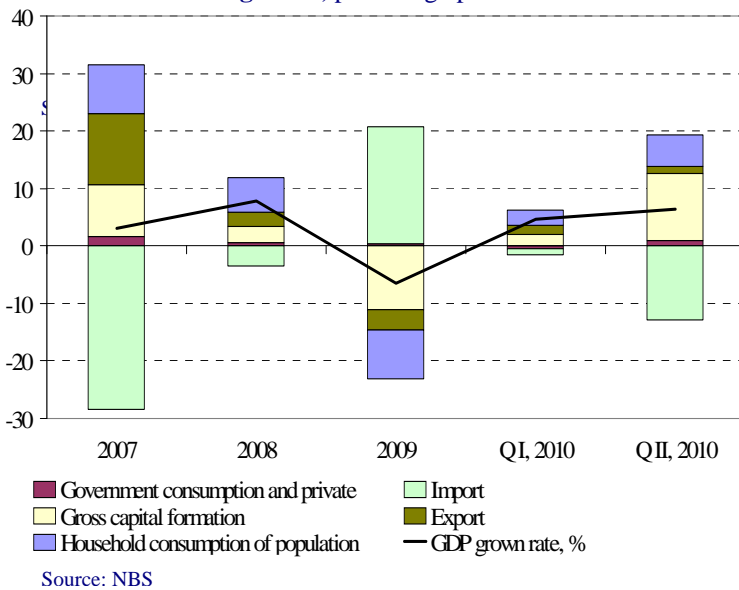


**Real sector**

**Gross domestic product**

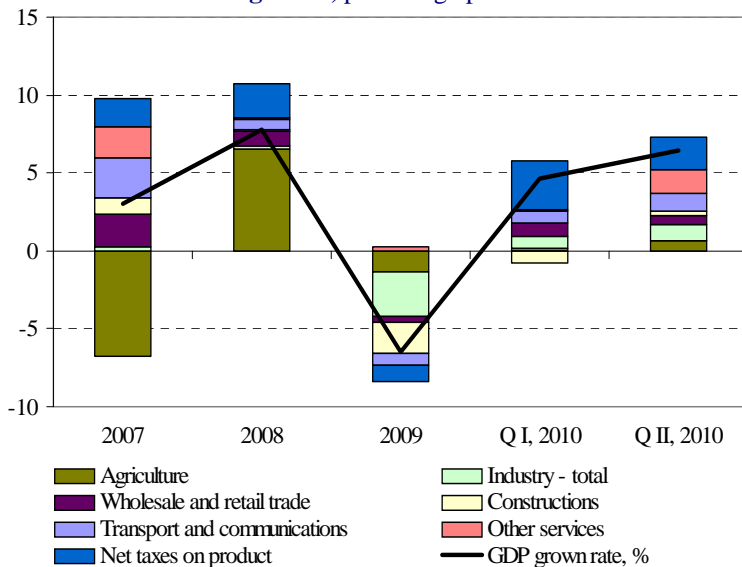
The National Bureau of Statistics data on national accounts show a pronounced recovery of the Moldovan economy in the first half of this year after severe decline recorded during 2009, following the global economic crisis. Thus, the gross domestic product in the first semester of 2010 rose by 5.6 percent compared to the same period last year. Quarterly evolution of this indicator shows a sharp recovery in economic activity in the second quarter of 2010, during which there was an increase of 6.4 percent versus 4.7 percent increase recorded in the first quarter of 2010 compared to same period of 2009. Taking into account that, in the first half of 2009, GDP declined by 7.8 percent, the significant recorded growth during the first half of this year shows more than a return to the level up to the economic crisis, thus Moldova economy has not yet reached its potential.

**Chart no. 1.6. Contribution of demand components to GDP growth, percentage points**



economic agents expectations and their access to funding, have determined the increase of gross fixed capital formation by 13.7 percent in the second quarter of 2010 compared to the same period last year.

**Chart no. 1.7. Contribution of economy sectors to the GDP growth, percentage points**

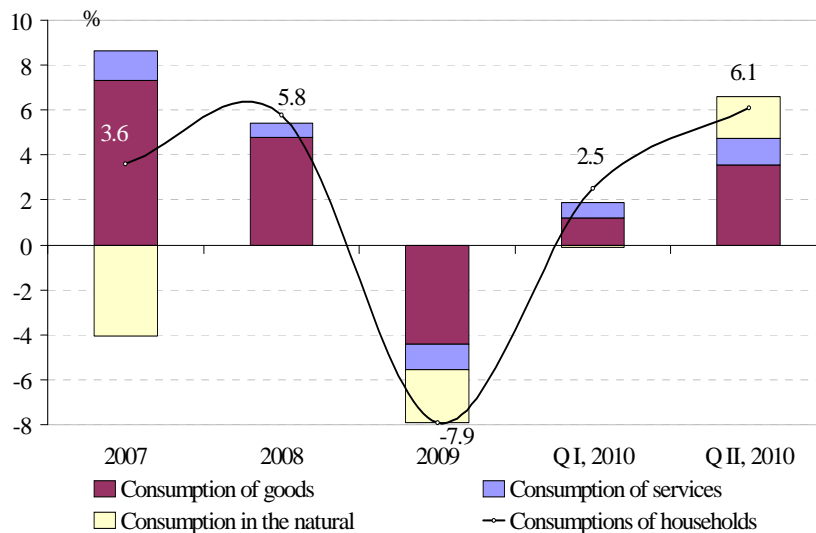


In terms of uses (chart no. 1.6.), the household consumption and gross capital formation constituted the engines of the economic growth in the second quarter of 2010. In this respect, it is clear that the positive evolution of GDP was mainly due to the domestic demand. Household consumption registered an increase of 6.1 percent, following the restoration of people's expectations about the national economy development by the signals from both outside and inside, about a possible end of the economic crisis, which encourages the consumption at the expense of savings. On the other hand, household consumption growth is driven by the increase of its funding sources, as a result of increased volume of remittances and credit recovery granted to population. Similar causes, i.e. restoration of economic agents expectations and their access to funding, have determined the increase of gross fixed capital formation by 13.7 percent in the second quarter of 2010 compared to the same period last year. Another factor that contributed to the increase of the economic activity in the analyzed period constituted the increase of 3.4 percent in final consumption of public administration. Despite signals of economic recovery of Moldova's main trading partners, the export growth was only of 3.4 percent and, contrary to expectations, had a modest contribution to the positive evolution of GDP in this period. The increase in imports by 18.9 percent in the second quarter of 2010, due to the increase of domestic demand and to the reduction of competitiveness of domestic products against those from outside, constituting a significant impediment to the GDP growth in Moldova, so that the negative contribution of this component has eroded most of the positive

contribution of the mentioned above factors. In other words, a significant portion of domestic demand was focused on outside goods and services at the expense of those produced by the branches of national economy.

By categories of resources (chart no. 1.7), the positive developments in all sectors have confirmed the economy recovery phase. The increase of net taxes on products by 13.5 percent continued to have a significant contribution to the GDP growth during this period, but this influence has a lower intensity compared with the previous period, which is a positive factor since the largest contribution comes from the gross value added growth in sectors of the economy, which grew by 5.1 percent in the analyzed period. In the second quarter of 2010, services' contribution to GDP growth is higher than the contribution of assets.

**Chart no. 1.8. Contribution of final consumption of households (percentage points)**



Source: NBS

Under these conditions, unlike the development in the first quarter of 2010, the services as a whole return on the positive path in the second quarter of 2010, registering an increase of 5.2 percent compared to the same period last year. The significant contributions are generated by the development of trade, transport, communications, and “other services” component, which in this period increased by 4.1, 9.7, and 4.5 percent respectively. After a long period of decline, the construction sector shows a positive development in this sector, and the gross value added in this sector increased by 5.4 percent in the second quarter of 2010 compared to the previous year. The value added tax of goods increased by 8.0 percent in this period,

*Household final consumption*

due to similar developments in agriculture and industry, which grew in the reference period by 7.8 and 8.2 percent respectively. The driving force in increasing the value added continues to be the manufacturing industry, which increased by 10.0 percent in the second quarter of 2010 as compared to the second quarter of 2009.

After a considerable decline during 2009 (7.9 percent), following the economic crisis in the second quarter of 2010, the household consumption continued the trend started in the first quarter of 2010, registering a growth of 6.1 percent compared to the same period of the previous year as a result of restoring people's expectations regarding the development of national economy.

The consumption of goods increase of 5.8 percent in the second quarter of 2010, compared to the same period last year, is due to the decisive impact of non-food retail sales increase of 10.1 percent, whose share in total sales is 66.5 percent. Similarly, the spending for services procurement from the account of individual budget registered a growth in real terms of 4.5 percent. The final consumption of goods and services in natural form recorded acceleration tendencies, increasing by 17.9 percent in the second quarter of 2010 compared to the same period last year. The respective growth was made despite the fact that in the first half of this year the average trading prices of agricultural products of the agricultural enterprises increased by 18.4 percent.

Household consumption growth was driven by the increase of the main sources of its funding<sup>8</sup>, so that in the second quarter of 2010 increased by 7.0 percent in real terms<sup>9</sup> versus the same period of 2009. Considerable contributions to the main funding sources increase were generated by the growth in real terms of the volume of transfers from abroad and lending to households by 11.8 percent and 168.3 percent, respectively. The amplification of positive dynamics of credit growth has originally the recovery of foreign trade, which has fueled the demand for loans in foreign currency for financing the import operations. A positive contribution of lower intensity was generated by the increase of 4.3 percent in social transfers. On the other hand, the total cost of jobs declined by 2.7 percent, contributing negatively to the dynamic of consumption financing sources.

*Gross capital formation*

In the second quarter of 2010, the gross capital formation recorded a 71.3 percent increase against the corresponding period last year. This strong growth is another sign of revival of economic activity along with household consumption recovery.

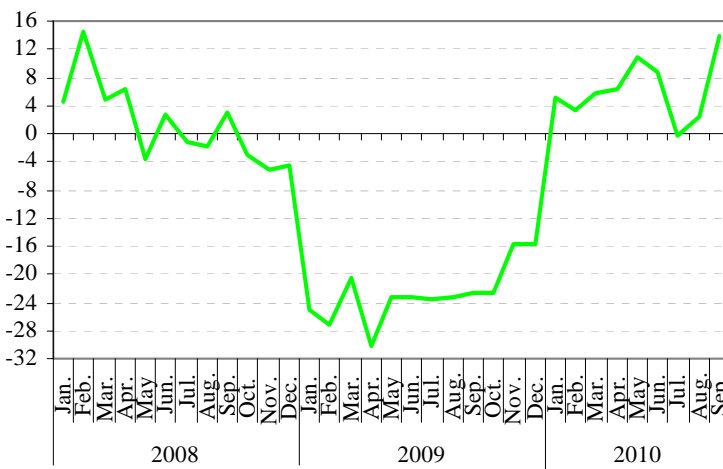
Gross fixed capital formation increased in real terms by 13.7 percent in the second quarter of 2010 compared with second quarter of 2009. The growth rate in gross fixed capital formation was mostly conditioned by the increase of capital investment in real terms with 13.7 percent, which share represents 80.8 percent of this. To the increase in gross fixed capital formation to a certain extent has contributed the increase of expenditures on capital repairs of fixed assets and expenditures for development and procurement of programs and databases with 18.4 and 15.5 percent respectively. Negative contributions to the evolution of this index were generated by reducing the amount of capital stock growth in cattle and equipment procurement and inventory of budgetary institutions by 25.3 and 13.4 percent respectively. The contribution of gross fixed capital formation to the gross fixed capital formation in the second quarter of 2010 constituted 16.9 percentage points.

Changes in inventories in the second quarter of 2010 showed a positive trend, so its contribution to growth of gross capital formation constituted 54.4 percentage points.

**Industrial production**

In January-September 2010, according to data provided by the National Bureau of Statistics, the industrial

*Chart no. 1.9. Evolution in real terms of industrial production* (% , compared to the same period last year)



Source: NBS

production in all forms of property has increased in real terms by 6.3 percent compared to the same period a year earlier, while in September 2010 compared with September 2009 this indicator has marked an increase of 13.9 percent.

The increase of industrial production volume, compared with January-September 2009, was caused by the increase in manufacturing production by 7.5 percent, while the production volume in the energy sector has remained constant as compared to the previous period.

The increase in manufacturing production was due to the increase in industrial production in the following activities: “food and beverages”, “manufacture of wearing apparel, fur

<sup>8</sup> Main funding sources are approximated by the sum of the payroll, social transfers, transfers from abroad in the form of remittances from workers abroad  
<sup>9</sup> In 2000 prices



preparation and dyeing”, “tobacco products”, “production of leather, leather products and footwear” and “chemical industry”, which have contributed to the increase of industrial production by 2.9, 1.0, 0.8, 0.5 and 0.5 percentage points, respectively.

At the same time, during the analyzed period, as compared to the same period of 2009, there were reductions in production volume in the following components: “manufacture of vegetable and animal oils and fats”, “production of other non-metallic mineral products”, “manufacture of fabricated metal products, except machinery and equipment” and “production of rubber and plastic products”, which have reduced the annual rate of overall production index by 0.5, 0.4, 0.4 and 0.3 percent respectively.

**Agricultural production**

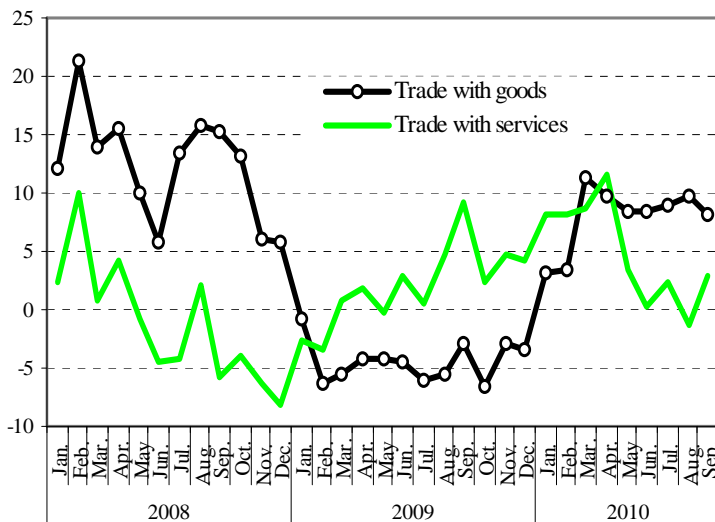
Global agricultural production in all categories increased by 8.7 percent during January-September 2010, as compared to the same period last year. This evolution was due to the increase in livestock production by 15.5 percent and vegetable production by 4.4 percent.

In the first nine months of 2010, the state of the livestock sector has been driven by positive growth trends of animal production in the most types of products. Thus, cattle and poultry production increase was due to an increase of 58.0 percent of the volume of pig production and of 25.0 percent of poultry production, which was generated by both the average flock growth and productivity of pigs and poultry. Also, during January-September 2010, the production of eggs increased by 12.4 percent compared to the same period last year as a result of the increase in egg production in households and agricultural enterprises with 14.3 and 9.6 percent, respectively. The increase in milk production by 2.6 percent took place exclusively due to the increase of production in households by 2.9 percent while the milk production in farms decreased by 7.2 percent.

According to the information provided by the State Hydro meteorological Service, the summer months were characterized by favorable weather conditions for developing certain crops. Rainy weather and relatively high air humidity (80.0 percent and more) in the second half of June - the first half of July have created conditions less favorable for harvest ripening of autumn crops and orchards, have also contributed to the development of diseases in agricultural plantations, have complicated reaping of the cereals. At the same time, these weather conditions were favorable for growth and development of corn, sunflower, and forage. In September, the households have harvested sunflower, corn, sugar beet, grapes, fruits, and vegetables. In addition, some households have sowed winter crops in optimal terms.

**Domestic trade in goods and services**

*Chart no. 1.10. Evolution of domestic trade*  
(%, compared to the same period last year)



Source: NBS

According to data provided by the National Bureau of Statistics, during the last months of this year the retail trade registered an increase in real terms compared to values recorded in 2009, unlike the trade in services that has been more unstable, recording both positive and negative values. In January-September 2010, the commercial units traded goods by 8.2 percent more than in the same period of 2009, this increase being largely due to the increase of non-foodstuff products sales by 10.1 percent and of foodstuff products by 3.5 percent.

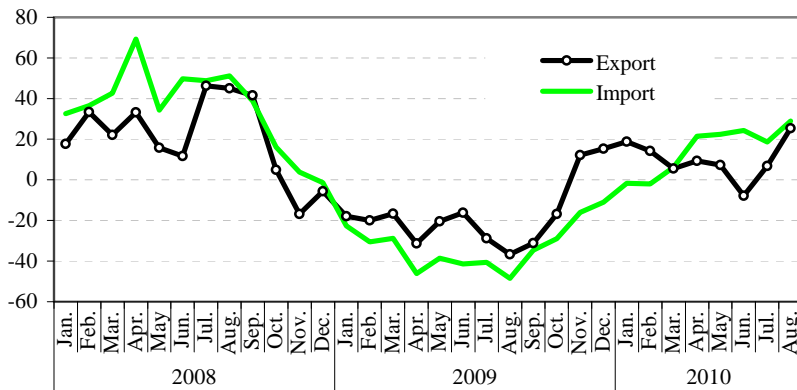
Thus, during the third quarter of 2010, the values of retail sales constituted by 8.9, 9.7, and 8.1 percent respectively, more than in the same quarter of the previous year. Unlike the trade in

goods, which recorded a steady growth of around 9.0 percent starting with March 2010, the annual growth rate of trade in services is uneven. Although throughout the second quarter of 2010, a downward trend has been recorded (from 11.6 in April to 0.2 in June), in the third quarter the pace of trade in services has recovered slightly, fluctuating around the average of 1.3 percent. However, from the beginning of the year until September, the officially registered units have provided paid services to the population by 5.0 percent more than in January-September 2009, which is largely due to higher volume of services to households in Chisinau and Balti.

**Foreign trade**

With the recovery in demand from key external partners of the Republic of Moldova, the exports of domestic products in the third quarter of 2010 have substantially increased, recording in August the highest growth over the past two years (25.3 percent more compared to August 2009), which reinforces the tendency of recovery in external demand. Since the beginning of the year until August 2010, the exports increased by 9.2 percent compared to January to August 2009, largely due to significant increases in exports of “raw inedible materials, except fuels”, “beverages and tobacco” and “vehicles and transport equipment”

*Chart no. 1.11. Evolution of foreign trade*  
(%, compared to the same period last year)

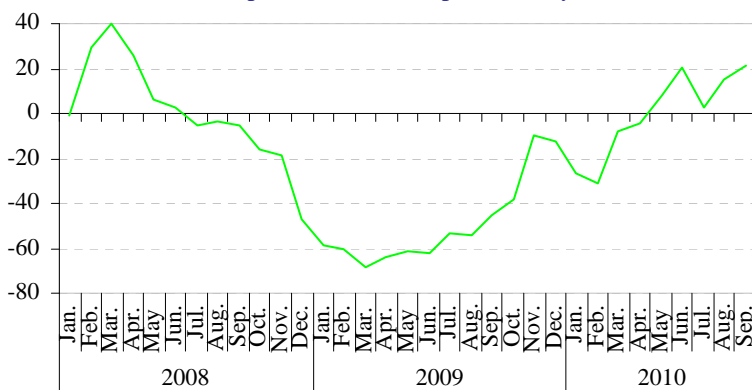


Source: NBS

which accounted for higher values of 38.6, 20.0, and 18.2 percent respectively. At the same time, the demand for “oils, fats and waxes of animals or plants” and the “food and livestock” decreased by 30.1 and 4.5 percent respectively in January-August 2010 compared to the same period previous year. However, in the third quarter of 2010, a growth in imports was recorded, maintaining the upward trend begun in the mid of 2009. Thus in August 2010, the imports increased by 28.9 percent compared to the same month last year, registering the highest level in over two years, which indicates the national economic recovery.

From the beginning of the year until August, the imports increased by 14.8 percent compared to January - August 2009 due to the increase in demand for “vehicles and transport equipment”, “food and livestock”, “manufactured goods classified mainly by raw material” and “chemicals and derivatives unspecified elsewhere” by 24.4, 22.8, 18.5 and 16.8 percent respectively compared to the same period last year.

*Chart no. 1.12 Volume of transported goods*  
(%, compared to the same period last year)



Source: NBS

**Goods transport**

The annual rate of goods shipped in the third quarter of 2010 had an upward trend, so that it rose from 2.9 percent in July to 21.4 percent in September, which favored the recovery of economic activity in this sector, so that the volume of goods transported from the beginning of this year until September was by 1.8 percent higher than in January-September 2009, despite the considerable decline from the beginning of this year.

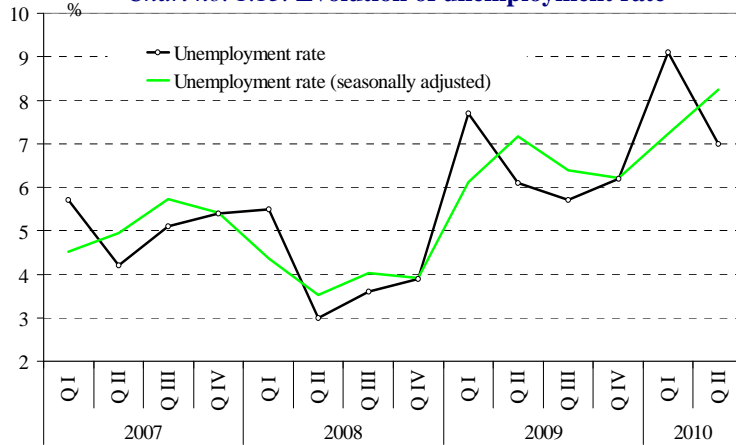
**Labor market**

*Workforce*

In the second quarter of 2010, the indicators provided by the NBS show deterioration in the labor market situation in Moldova compared with the second quarter of 2009. Thus, the economically active population declined by 0.6 percent compared to the same period last year, which is determined mainly by the decrease

of population employed in non-agricultural sector. Employment in this period declined by 1.6 percent compared to the second quarter of 2009. Within the structure of the active population, the employment share fell from 93.9 to 93.0 percent. Country unemployment rate registered a value of 7.0 percent, 0.9 percentage points higher than in the same period last year. Seasonally adjusted data confirm this trend, so the unemployment rate in these conditions was 8.2 percent as compared to 7.2 percent in the first quarter of 2010 and as compared to 3.5 percent in the second quarter of 2008 (before the economic crisis) (chart no. 1.13). The situation in the labor market denotes a delay of

**Chart no. 1.13. Evolution of unemployment rate**



Source: NBS, NBM calculations

the process of creating new jobs in Moldova's economy with the recovery of the economic activity in Moldova recorded in the first half of 2010.

The information contained in the Beveridge curve reveals a

substantial increase in the number of registered unemployed in the second quarter of 2010, compared to the first quarter of 2010, of approximately 8.3 thousand persons, while the number of vacancies fell by 2500 jobs. This shows a lack of flexibility in the labor market in Moldova, but also a significant gap between the professional qualifications of the unemployed and the professional requirements related to available jobs. Another reason for this situation lies in the unwillingness of the unemployed to accept the available options because of low wages.

**Chart no. 1.14. Beveridge curve (seasonally adjusted, thousands)**



Source: NBS, NBM calculations

the second quarter of 2010, retaining the same value compared to the same period last year. The percentage of persons employed in “public administration, education, health, and welfare” constituted 19.7 percent in the second quarter of 2010, similar to that of the same period last year.

The number of persons employed in trade and industry fell by 5.9 and 4.3 percent, respectively, compared to the second quarter of 2009, so that the share in these sectors has become 17.6 and 11.7 percent, respectively. Transport and communications sector has the lowest concentration of employment, in the second quarter of 2010 its share constituted 5.2 percent. Excluding the seasonal factor, we could mention an almost steady stability in dynamic distribution of employed persons by economic activity.

**Income and expenditure**

According to the information provided by the NBS in the second quarter of 2010, the disposable income per person has increased in nominal terms by 10.8 percent compared to the same period of 2009. The most significant source of income remain to be the wage payments, which contribution is 42.2 percent of total available income decreasing by 2.4 percentage points compared to the second quarter of 2009. The income from social benefits contributed to household income at a rate of 18.7 percent (0.4 percentage points more than the same period of 2009). Another important source of household income formation is the money transfers from abroad, contributing by 15.8 percent, or 1.4 percentage points less than in the second quarter of 2009. The average monthly consumption expenditure of the population in the second quarter of 2010 marked an increase in nominal terms by 10.6 percent compared to the same period of 2009. The most of the expenditure was intended to cover the needs of food consumption, constituting 40.6 percent and by 0.6 percentage points less than in the second quarter of 2009. To maintain a home a person spends in average 18.7 percent of total consumption expenditure, constituting 1.4 percentage points more than the same period last year.

For shoes, clothing, and health spending, a person uses in average 10.0 percent and 6.5 percent of its total consumption expenditure.

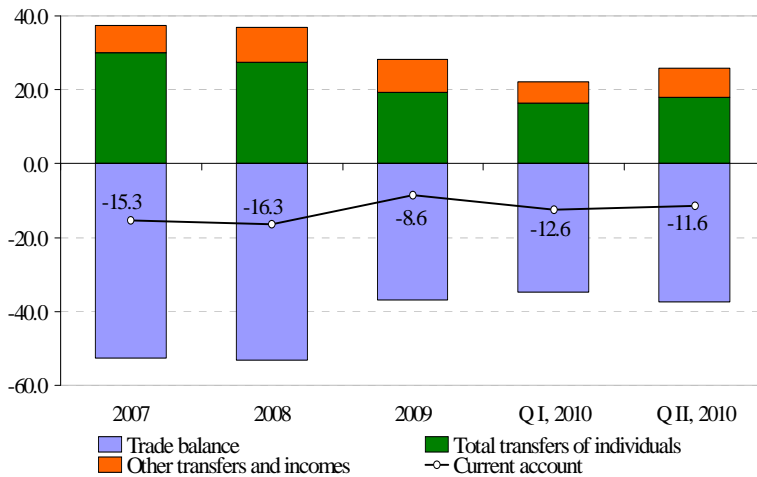
In January-August 2010, the average nominal wages in the economy increased by 7.4 percent compared to the same period last year. According to the information provided by the NBS, in January-August 2010 the average wage in the public sector registered an increase of 8.3 percent and in the real sector an increase of 7.1 percent compared with the same period last year.

During the analyzed period it is recorded an increase in the most sectors in wages as compared to the same period last year, the most pronounced being in education (15.6 percent) and agriculture (9.3 percent). The wages in industry and trade rose by 6.1 and 5.8 percent, while wages in the construction sector registered a slight increase (0.2 percent) compared to the same period previous year. Wage reductions were recorded in public administration (1.2 percent) due to severe measures to reduce government expenditure. The financial sector remains the most attractive field, with the highest wages, while the lowest wages prevailing in the agricultural sector.

**External sector of the economy**

The first half of 2010 was marked by gradual recovery of the national economy after the recession, as reported positive developments in several branches of the real sector. The indicators recently calculated show increases in household final consumption, thus stimulating the increase

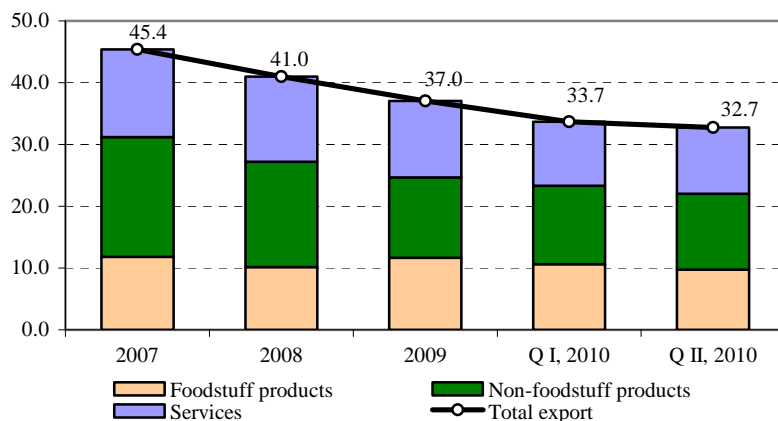
**Chart no. 1.15. Share of the current account in GDP**  
(seasonally adjusted data), %



Source: NBM

most pronounced being in education (15.6 percent) and agriculture (9.3 percent). The wages in industry and trade rose by 6.1 and 5.8 percent, while wages in the construction sector registered a slight increase (0.2 percent) compared to the same period previous year. Wage reductions were recorded in public administration (1.2 percent) due to severe measures to reduce government expenditure.

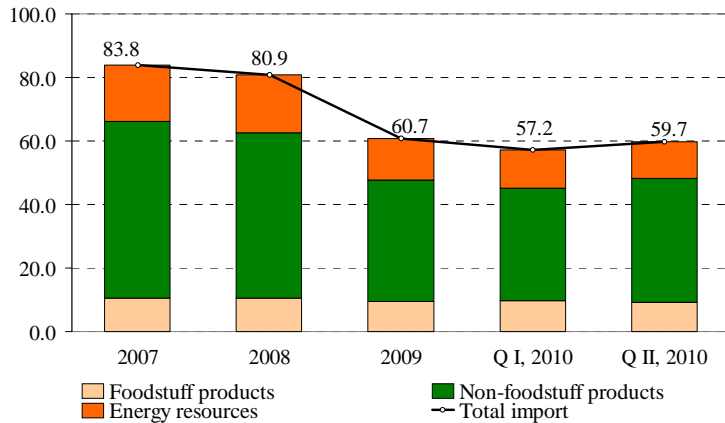
**Chart no. 1.16. Share of exports in GDP**  
(seasonally adjusted data), %



Source: NBM

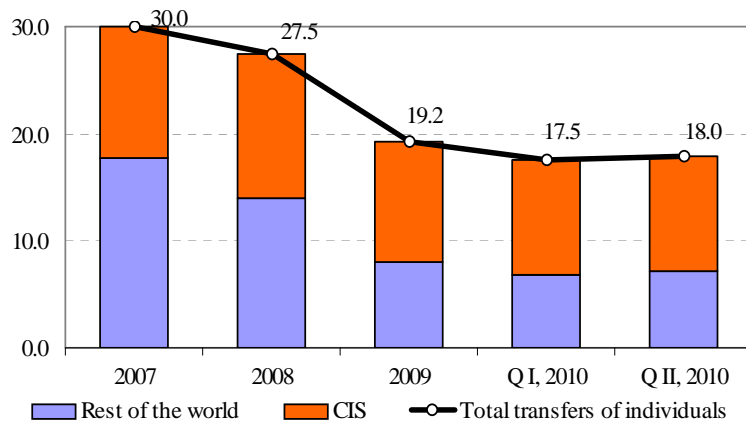
of domestic production and foreign trade in goods and services.

**Chart no. 1.17. Share of imports in GDP**  
(seasonally adjusted data), %



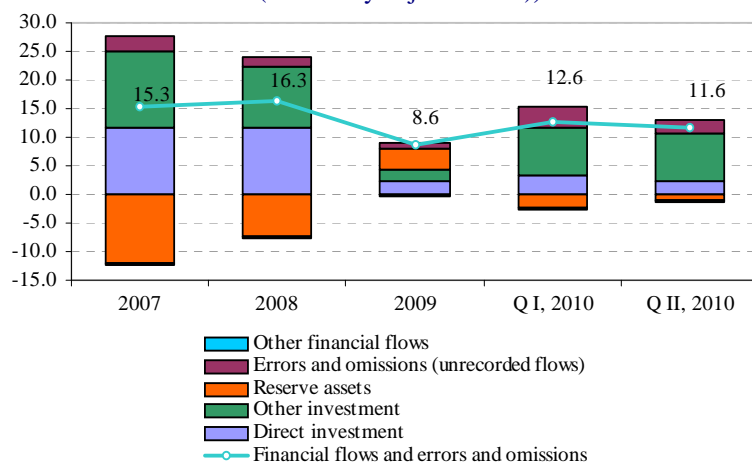
Source: NBS

**Chart no. 1.18. Transfers share in GDP**  
(seasonally adjusted data), %



Source: NBM

**Chart no. 1.19. Share in GDP of the movement of financial flows**  
(seasonally adjusted data), %



Source: NBM

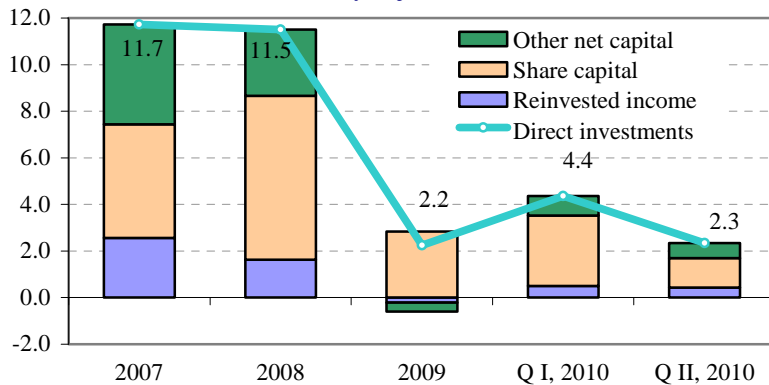
In 2009 there was registered a significant decrease of the current account deficit, driven by pessimistic expectations of the population in terms of further development of national economy and led to lower imports. Thus, the current account deficit declined to 8.6 percent of GDP in 2009. In the first two quarters of this year, we can talk about a stabilization of the deficit of about 12.1 percent of GDP (chart no. 1.15)<sup>10</sup> compared with the fluctuations in the last two years. The current account deficit is due to negative balance of trade, based on the increased volume of imports compared to the exports of the national economy. The share of exports in GDP had a downward trajectory in the recent years, recording for the second quarter of 2010 the value of 32.7 percent, about 12.7 percentage points less than in 2007. Within the structure of exports, this decline was driven by the share of nonfood products and by the share of net services in GDP (chart no. 1.16.). According to the NBS, in the first half of 2010 the share of imports in GDP has remained on average at about 58.5 percent, decreasing slightly compared with 2009, when recording a share of 60.7 percent of GDP (chart no. 1.17.). The evolution of imports in GDP was largely determined by the movement within the structure of non-food products and energy resources, the share of food products maintaining at a constant level in recent years. The share of individuals' transfers consistently decreased in 2009, registering 19.2 percent of GDP, by about 8.3 percentage points less than in 2008. This decrease was largely conditioned by the decrease in transfers to individuals in the world (excluding CIS states). Maintaining the trend of previous year, the employee transfers from abroad in the first quarter of this year remained almost constant at a level of about 17.5 percent of GDP for the first quarter of 2010 and about 18.0 percent for the second quarter of 2010 (chart no. 1.18.).

These transfers are particularly important for

<sup>10</sup> For the analysis of the current account was not used the standard terminology according to the IMF methodology. The category *Total transfers of individuals* includes compensation for labor and employee transfers (current account items), the remaining items except those included in the *Trade balance* being grouped in the category *Other transfers and other income*.

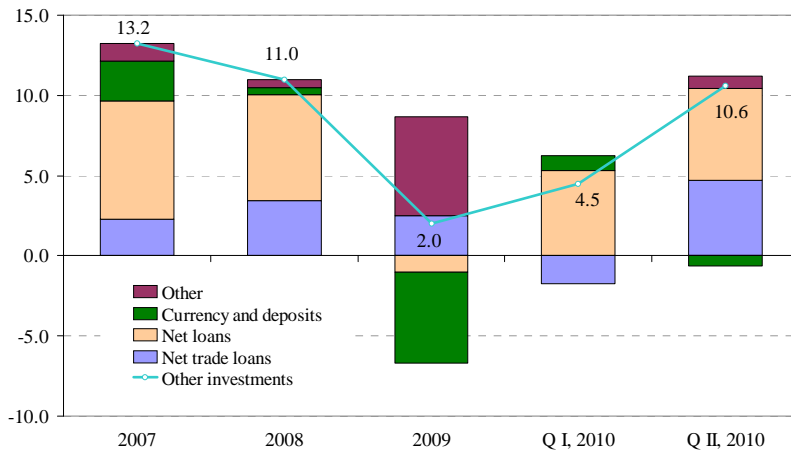


**Chart no. 1.20. Direct investment share in GDP**  
(seasonally adjusted data), %



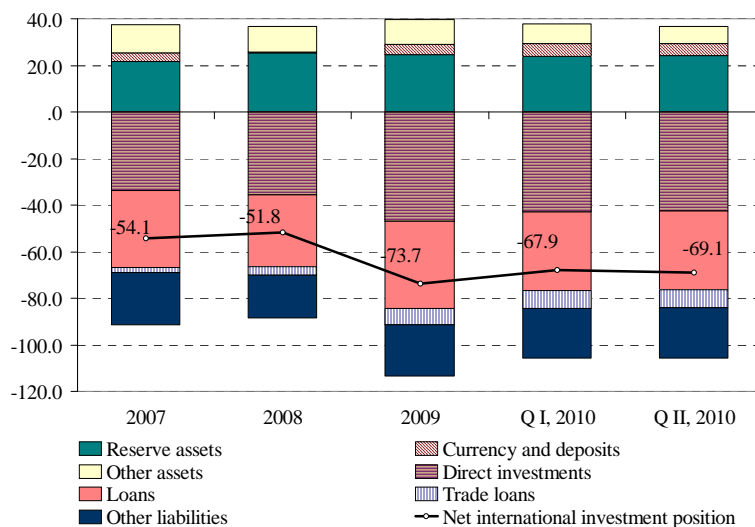
Source: NBM

**Chart no. 1.21. Other investments share in GDP**  
(seasonally adjusted data), %



Source: NBM

**Chart no.1.22. PII Share (in structure) in GDP**  
(seasonally adjusted data), %



Source: NBM

the national economy, contributing in part to cover the trade deficit. Analyzing the transfers of individuals by geographical area of origin of funds, it can be pointed out that the share of GDP of funds that come from the CIS countries are exceeding by about 3.5 percentage points the share of transfers from the rest of the world.

Examining the evolution of the share in GDP of the movement of financial flows, it is found a surplus in capital balance, which helps to offset the current account deficit and balance of payments. In the second quarter of 2010, the capital and financial account balance has turned into a surplus of USD 153.0 million, being determined largely by the item “other investments”, which totaled USD 141.04 million. Positive contribution is due to significant share of other investments of 8.6 percent within the structure of financial flows.

The share of direct investment in GDP in the second quarter of 2010 constituted 2.3 percent, about the level of 2009 (chart no. 1.20.). In the second quarter of 2010, the share of all components of direct investment decreased compared to the first quarter of this year. At the same time, for the first quarter of 2010, the component “other net capital” returned on the positive path after recording minus 0.6 percent in 2009. Foreign direct investment in the form of share capital has been directed mainly to the financial activities sector (25.8 percent), manufacturing (21.1 percent), and wholesale and retail trade (21.0 percent).

The share of GDP of net loans had an upward trend during the first two quarters, registering an average share of about 5.5 percent of GDP. Most of net loans were directed to banking and governmental sector. For the second quarter of 2010, the share of GDP of other investments of about 10.6 percent returned to the levels similar the ones recorded before the period of crisis, being 5 times higher than in 2009. The positive evolutions of net loans and net trade credits have contributed to this increase (chart no. 1.21.). Although in the first

quarter of 2010, net trade credits have recorded negative values, for the analyzed period they have reached



4.7 percent of GDP on the account of receipt of loans from foreign partners and reimbursement of loans from non-residents. In the second quarter of 2010, the share of international investment position (PII) in GDP was net debtor and constituted 69.1 percent (chart no. 1.22.). Among our country's assets held abroad, the share of reserve assets to GDP has recorded the highest values, accounting for 24.3 percent in the second quarter of 2010. Net debtor position is due to large shares held by foreign direct investment stocks - 42.6 percent and loans - 33.5 percent. During the analyzed period, the loans stock had small fluctuations, oscillating around the average rate of 33.7 percent in GDP and the share of direct foreign investment is declining, while in 2009 recorded the maximum of 47.1 percent.

### **Budget execution**

According to the information provided by the Ministry of Finance, during January-September 2010 about 19111.7 million lei revenues have been accrued in the government budget, which represents 14.7 percent more than during the previous year. Tax revenues continue to hold the major share (84.2 percent) in government revenues; the major sources of tax revenues remaining to be the domestic goods and services, which registered an increase of 23.0 percent compared with the same period of previous year; state compulsory social security contributions, which registered a modest growth of 4.9 percent compared to the same period of 2009 and income taxes, which rose by 3.8 percent compared to January-September 2009. As a result of amending these indicators, the tax revenues have registered a higher value of 14.6 percent than the previous year.

At the expense of the national public budget in January-September 2010 were incurred expenses totaling 20608.1 million, which represents 6.2 percent more compared to the same period last year. The increase in expenditures was mainly caused by increased spending on insurance, welfare (by 11.3 percent) and education (17.9 percent).

Government budget execution has resulted in a deficit of 1496.4 million lei, which represents 54.4 percent of the value recorded in the same period last year.

### ***State debt***

On 30 September 2010, the debt structure of the Republic of Moldova was represented by the domestic state debt in proportion of 29.2 percent and by the external state debt in proportion of 70.8 percent. Domestic state debt has increased by 310.7 million lei compared to the situation at the beginning of the year and constituted 5415.6 million lei. The internal debt modification occurred at the expense of the increase of SS auction issuance and SS redemption placed by subscription. The balance of external debt amounted to 13147.1 million lei, the equivalent of U.S. \$ 1094.1 million, increasing by about U.S. \$ 320.5 million compared with the balance of January 1, 2010.

## II. Promotion of the monetary policy

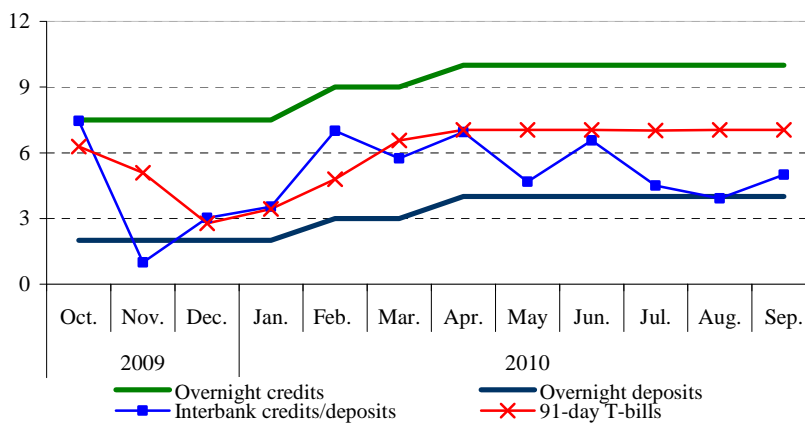
### Monetary Policy Instruments

During the third quarter of 2010, the National Bank of Moldova has kept its current money market conditions, using the monetary policy instruments to ensure achieving the objectives set out in the medium term monetary policy strategy for 2010-2012, for providing and maintaining price stability.

#### Interest Rates Policy

During the third quarter of 2010, the National Bank of Moldova has maintained the conduct of monetary policy prudent by keeping the monetary policy rates at the same level and has firmly managed the excess of liquidity from the banking system through sterilization operations. Thus, the NBM, through the decisions of the three meetings of the Council of administration held in the reporting quarter, considered the level of interest rates at its monetary regulation instruments appropriate, keeping them the sixth consecutive month at the same level (7.0 percent - the rate base, 4.0 and 10.0 percent - the interest rates attached to the deposit facility, and overnight credit respectively).

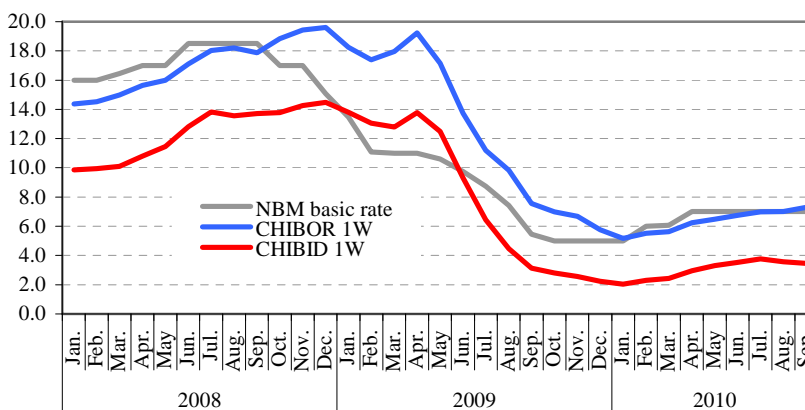
Chart no. 2.1. Monthly evolution of interest rate corridor, %



Source: NBM

percent annually (below the lower limit of the interest rate range) and increased in September by 5.0 percent annually.

Chart no. 2.2. Average monthly reference rate in the interbank market and the base rate of the NBM (%)



Source: NBM

no. 2.2).

In the context of maintaining the base rate at the same level, state securities (SS) yields of 91 days recorded values of around 7.0 percent annually the second consecutive quarter. At the same time, the evolution of the average rate on the credit market/interbank deposits was uneven due to the small number of transactions (in July and September was recorded only one transaction) and maturities that differ from one month to another: the average interest rate decreased in July by 4.50 percent annually, and in August – by 3.92 percent annually.

It should be mentioned that in all three months of the quarter, the interbank interest rates were placed at the lower limit of the interest rate range, below the base rate of the NBM (chart no. 2.1).

CHIBOR interbank reference rate of one week (1W) during the reporting quarter recorded an insignificant increase, positioning itself in the first two months of the quarter in close vicinity of the base rate (6.94, 6.99 and 7.01 percent), and in May September recording values between 7.27 and 7.30 percent annually (chart





## ***Open Market Operations***

### ***NBM Certificates-selling operations***

During the third quarter of 2010, the excess liquidity in the banking system remained high and was drained by using the NBM certificates. The National Bank of Moldova has conducted two weekly auctions.

In the 27 auctions for the sale of CBN with the announcement of the maximum rate of interest equivalent to the base rate, the NBM has fully accepted the banks offers. The issued CBN had mainly maturity of 7 days, except for a few auctions conducted at the end of August with a maturity of 6 to 8 days.

Over the period of July to September 2010, the daily balance of sterilization operations has evolved from the minimum of 2585.4 million lei to the maximum of 3761.4 million lei, recorded at the end of the quarter, which is also the maximum from the beginning of the year.

Quarterly average balance of sterilizations constituted 3247.1 million lei, down by 187.1 million lei, or by 5.4 percent below the level recorded in the second quarter of 2010.

During the reporting period, the banks submitted requests only with the maximum rate announced by the NBM. Thus, the average interest rate on CBN issued by the NBM in the third quarter of 2010 has been of 7.0 percent annually.

### ***State securities (SS) REPO-buying operations***

During the third quarter of 2010, according the schedule posted on the official web site, the National Bank of Moldova announced weekly auctions for cash payment operations within seven days – state securities REPO-buying operations at the fixed rate (the NBM basic rate); requests from banks were not recorded.

### ***Lending activity***

Under the conditions of credit agreements between the National Bank of Moldova and the licensed banks, concluded in May-August 2009 and in April 2010 (according to which banks were opened credit lines to credit the economic agents from the real sector of economy), in the third quarter of 2010, the National Bank of Moldova has granted loans to banks in the amount of 70.8 million. The amount of reimbursed loans constituted 41.8 million lei during the analyzed period.

Thus, on September 30, 2010, the licensed banks creditor debt to the National Bank of Moldova amounted to 1170.6 million lei, increasing by 29.0 million lei, or about 2.5 percent versus the previous quarter.

In the reference quarter, within the pledge structure, that assures the credit debt and relating interests of the banks to the NBM no changes have occurred. On September 30, 2010, the pledge was represented of state securities, required reserves in Moldovan lei and required reserves in freely convertible currency held by banks in the NBM.

### ***Standing facilities***

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

In the third quarter of 2010, the average daily balance of overnight deposits was 295.7 million lei, decreasing by 113.1 million lei, or 27.7 percent compared to the second quarter of 2010.

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

### ***Required reserves***

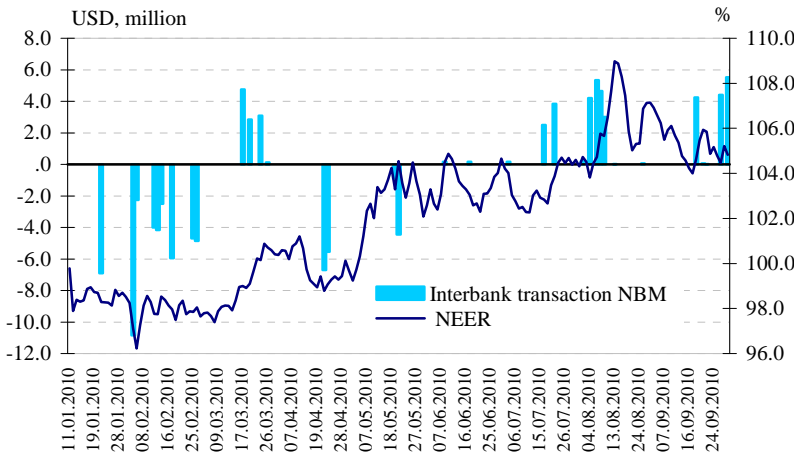
The amount of required reserves maintained by banks in MDL, in the tracking period of attracted funds 6 to 20 September 2010, maintained by banks during September 21 to October 5, 2010, constituted 1223.5 million lei, increasing by 47.5 million lei, or 4.0 percent compared to the tracking period of June 6 to 20, 2010, maintained by banks in the period of June 21 to July 5, 2010. The amount of bank reserves held in

U.S. dollars and Euros at September 30, 2010 were respectively USD 43.7 million and EUR 51.5 million, increasing by USD 1.6 million (3.8 percent) and by EUR 2.8 million (5.8 percent) compared to June 30, 2010.

The evolution of the required reserves both in MDL and in freely convertible currency was determined by the change of the balance of the attracted funds subject to reservation.

**Internal foreign exchange market interventions**

**Chart no. 2.3. Evolution of nominal effective exchange rate of the national currency (NEER) and the daily transaction NBM**



Source: NBM

equivalent of U.S. dollars 35.04 million.

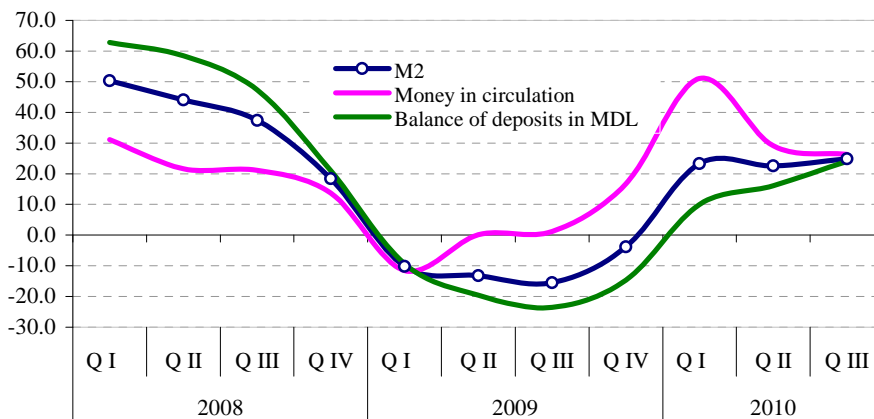
**Dynamics of monetary indicators**

Monetary indicators during the third quarter of 2010 showed an increase with a higher speed compared to the previous quarters of this year. In annual terms, the growth of these aggregates had an upward dynamic, reflecting the impact of monetary policies pursued in 2009, and a gradual recovery of the national economy.

**Money supply**

The money supply in MDL - M2 registered a growth of 5.6 percent compared to the second quarter of 2010, due to the positive dynamics of its components. Thus, the balance of deposits in MDL increased by 6.6 percent, the highest increase being recorded in September 2010, and the money in circulation increased by 4.1 percent. The weights of M2 components have changed insignificantly, the increase being characteristic for the deposits in MDL - up to 60.2 percent, to the detriment of money in circulation - 39.8 percent.

**Chart no. 2.4. Evolution of the components of M2 monetary aggregate (annual increase, %)**



Source: NBM

The M2 monetary aggregate grew by 24.9 percent annually, due to the increase of money in circulation by 26.3 percent and deposits in lei - 24.1 percent (chart no. 2.4). The positive evolution of money in

circulation increased by 4.1 percent. The weights of M2 components have changed insignificantly, the increase being characteristic for the deposits in MDL - up to 60.2 percent, to the detriment of money in circulation - 39.8 percent.

circulation (M0 monetary aggregate)<sup>1</sup> at the end of the third quarter of 2010, by 4.1 percent is the highest compared with increase in the second quarter of 3.6 percent and with the decrease of 4.0 percent in first quarter of 2010.

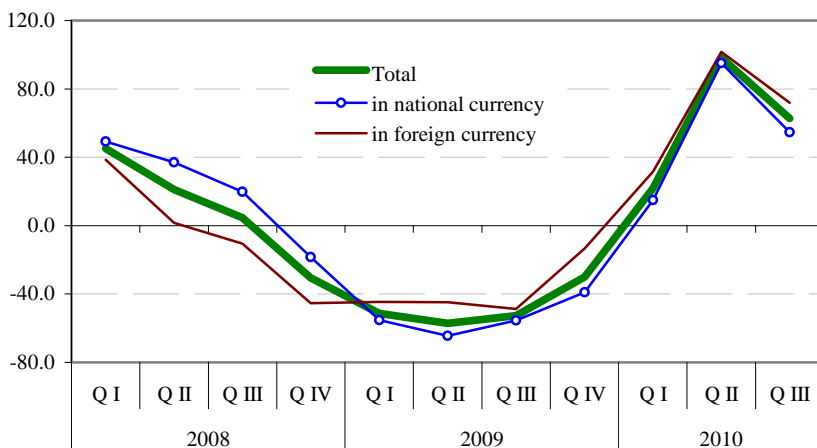
The revival of the economic activity and of the lending process has determined the increase of money multiplication in the economy, and respectively, the increase of deposits in national currency, directly contributing to the increase of M2 monetary aggregate in this period. Towards the end of the third quarter of 2010, the share of sight deposits in the total of deposits in national currency constituted 38.0 percent, increasing by 1.9 percentage points compared to the previous quarter. Within the structure of deposits in MDL, the sight deposits increased by 12.4 percent due to the increase of 18.3 percent of deposit of legal entities offset by the reduction of 2.9 percent of individuals' deposits, while the term deposits have increased by 3.4 percent following the positive development of legal entities deposits by 18.4 percent and those of individuals - by 0.9 percent compared to the second quarter of 2010.

During the third quarter of 2010, the *money supply (M3)*<sup>2</sup> increased by 5.5 percent compared to the previous period, exceeding the increases recorded in the second quarter of 2010, when in the first quarter this monetary indicator has been on decline. The evolution of M3 monetary aggregate was determined by the upward dynamics of all components: money in circulation, deposits in MDL, deposits in foreign currency. It should be mentioned that the deposits expressed in MDL have reversed the trend of reduction recorded in the first two quarters of 2010 and increased by 5.3 percent compared to the second quarter of 2010. Expressed in U.S. dollars, the deposits in foreign currency increased by 12.5 percent compared with the reductions of 6.1 and 3.1 in II and I quarters, respectively. At the same time, the share of the deposits in foreign currency in the total deposits declined from 46.2 percent at the end of the second quarter to 45.9 percent at the end of the third quarter of 2010. The modification of the share of the deposits in foreign currency in total deposits represents a positive signal to improve the monetary transmission mechanism of monetary policy.

**Credit market**

In the third quarter of 2010, the loan dynamics showed lower growth, recording an annual growth rate of 62.6 percent, reaching a value of 5796.4 million lei (chart no. 2.5). The volume of credits in the reporting quarter decreased by 5.9 percent compared to the second quarter of 2010, in the context of a pronounced economic recovery.

Chart no. 2.5. Evolution of new credits(annual increase, %)



Source: NBM

Within the structure of new loans, the increase was registered in both components: in the national currency and foreign currency. Thus, the volume of new loans in MDL recorded a growth of 54.7 percent compared to the third quarter of 2009 (reaching 2970.9 million lei). In terms of maturity structure of loans, the new loans with the term of over 12 months held the major share.

Analyzing the new loans in national currency, in terms of the two customers sectors, it can be seen an increase in the loans granted to legal entities - by 35.2 percent compared

<sup>1</sup> The money in circulation is the cash outside the banking sector

<sup>2</sup> Money supply M3 includes money supply M2 and deposits in foreign currency of residents expressed in U.S. dollars

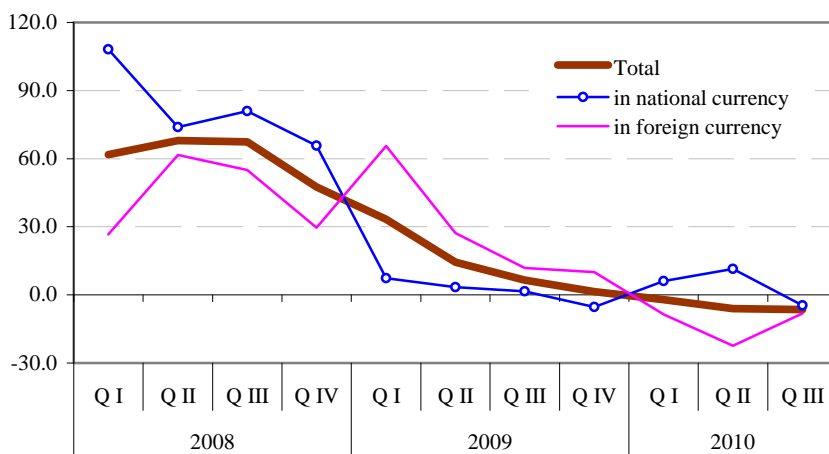
with the same period last year. While, new loans granted to households continued their upward trend with accelerated pace, noting an impressive growth of 3.1 times compared to the third quarter of 2009.

The dynamics of the new loans in foreign currency has been similar to the dynamics of the loans in MDL, increasing by 72.0 percent as compared to the third quarter of 2009. The evolution of credits in foreign currency was due to the increase of 75.1 percent of credits granted to legal entities to finance the foreign trade operations. However, the lending to individuals had an inverse trend, decreasing by 9.7 percent.

**Deposits market**

The annual growth rates of new attracted term deposits had a descending trend since the third quarter of 2008, this year being recorded negative annual changes. Thus, in the third quarter of 2010, the new attracted

**Chart no. 2.6. Quarterly evolution of new attracted deposits (annual increase, %)**



Source: NBM

term deposits fell by 6.4 percent compared to the same period last year, noting the level of 8985.0 million lei (chart no. 2.6).

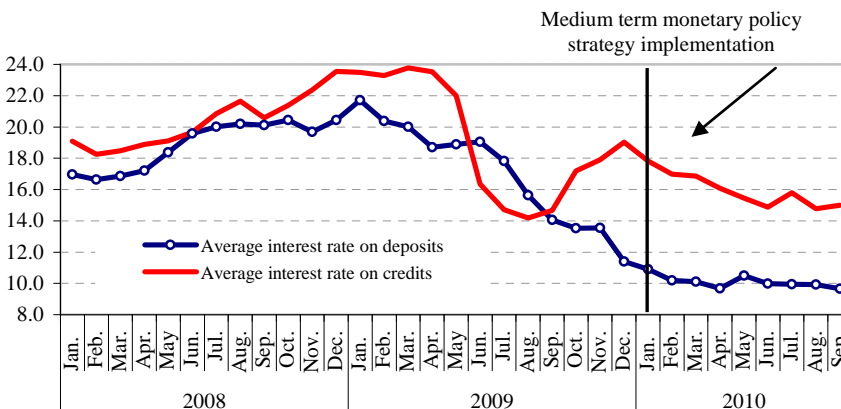
The decrease occurred on the account of the growth reduction of both components: the deposits in foreign currency - by 8.1 percent compared to the third quarter of 2009 (up to the level of 4498.1 million lei) and deposits in lei - 4.6 percent (up to the level of 4486.9 million lei). As for the term deposits in MDL, the reduction occurred on both customer segments. The reduction of term deposits in foreign currency was due to the reduction of

placements in foreign currency of individuals by 10.2 percent, partially offset by the positive dynamics of deposits of legal persons, whose growth was 25.1 percent. It should be mentioned that the term deposits in foreign currency were the only ones that have demonstrated a positive trend in the third quarter of 2010 compared with the same period of 2009.

The downward trend of the new attracted term deposits did not affect negatively the dynamics of the balance of deposits. Thus, the total balance of deposits increased in annual terms by 14.7 percent, following the growth of sight deposits by 21.0 percent and of term deposits - by 12.0 percent. This fact was

conditioned by the positive changes in the individuals and legal entities deposits.

**Chart no. 2.7. The average interest rate on new attracted term deposits and on new deposits granted from 6 to 12 months in MDL (%)**



Source: NBM

**Interest rates and monetary policy transmission mechanism**

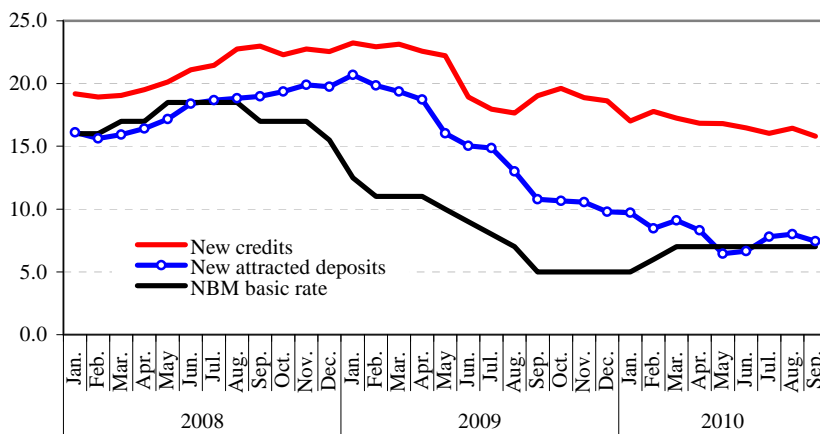
According to the provisions of the Monetary Policy Strategy of the National Bank of Moldova for 2010-2012, there are quarterly published monetary policy reports containing an analysis of the macroeconomic situation and a medium term forecast of inflation and of the main macroeconomic

indicators. At the same time, there are monthly meetings of the Council of Administration of the NBM, where it is evaluated the current macroeconomic trends and medium term forecasts of macroeconomic indicators. In addition, the inflation outlook on short and medium term is considered in terms of possible uncertainties and challenges that may arise in the future. Due to the drawn forecasts, the Council of administration of the NBM decided not to alter the base rate, maintaining a level of 7.0 percent throughout the third quarter of 2010.

This was done in order to maintain appropriate monetary conditions for price stability and to sustain the upward evolution of the national economy. In addition, the NBM continued to manage the liquidity excess held through money market sterilization operations.

Under these conditions, the evolution of deposits in lei attracted with terms from 6 to 12 months and continued the reduction outlined in the previous quarter. Loans granted in MDL attracted with the same terms, has showed only in August a reduction in interest rates (chart no. 2.7).

Chart no. 2.8. Average interest rates in MDL, %



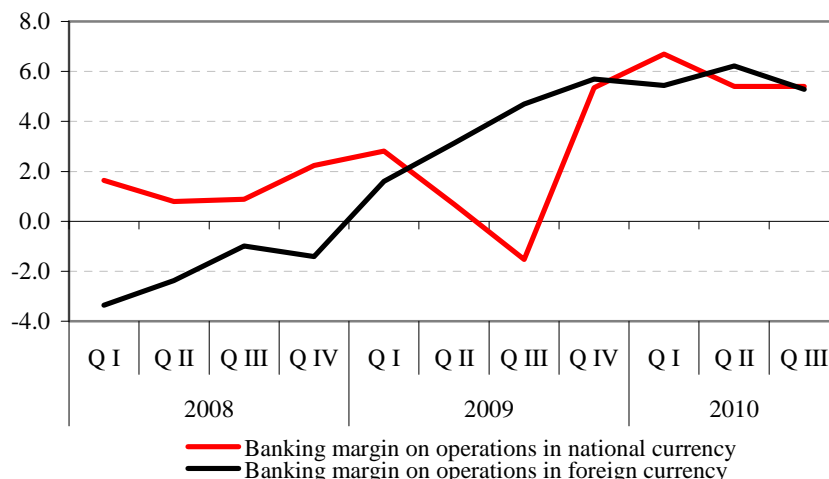
Source: NBM

Quarterly values of the interest rates on term deposits in MDL show an increase of 0.72 percentage points, compared to the second quarter of 2010, and accounted for 7.73 percent. Quarterly average yield on loans in national currency stood at the level of 16.07 percent, by 0.63 percentage points less than the previous quarter (chart no. 2.8).

The banking margin (the difference between the average rates on loans and deposits) was affected by higher rates on new attracted deposits, combined with the reduced rates on new loans.

It should be mentioned that the margin on foreign currency transactions with terms of 6 to 12 months decreased from 6.22 to 5.29 percentage points compared to the second quarter of 2010, while on national

Chart no. 2.9. Evolution of banking margin in operations from 6 to 12 months (percentage points)



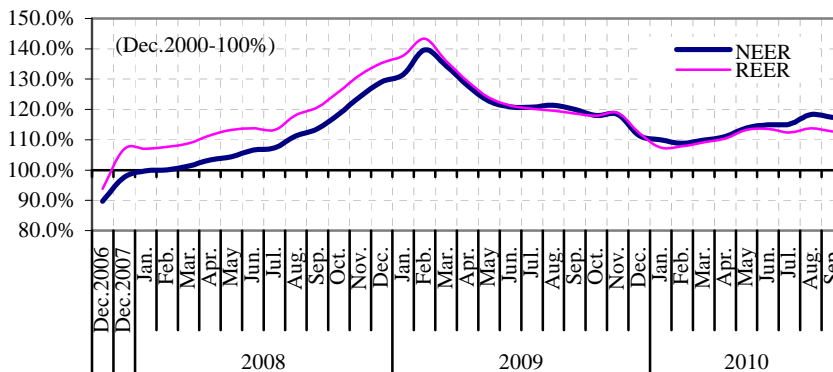
currency transactions remained in the third quarter of 2010 at the second quarter of 2010 - by 5.4 percentage points (chart no. 2.9). The evolution of increasing the interest margin was mitigated under a relative stabilization of the economic situation, which contributed in part to a relative cheaper of new granted loans.

However, based on the national economy trends, the level of liquidity and increased demand for money, in the third quarter of 2010 it is expected to reduce the interest rates on new loans and to increase the interest rates on new deposits

attracted in national currency and respectively to reduce the banking margin.

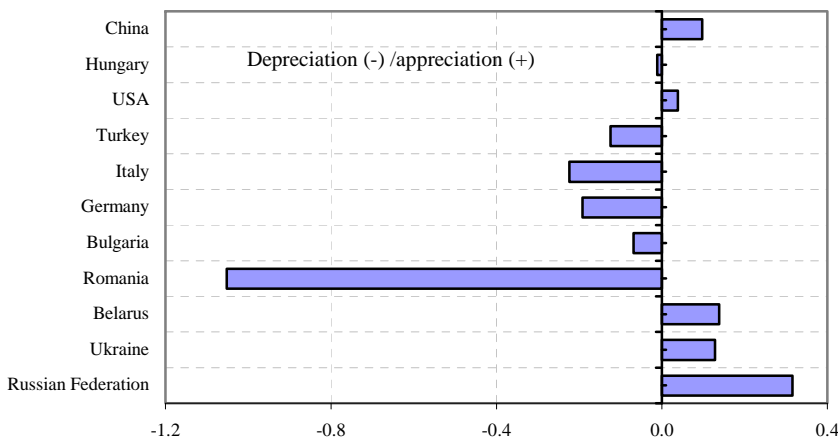


**Chart no. 2.10. Real and nominal effective exchange rate dynamics of the national currency calculated based on the share of the major trading partners**



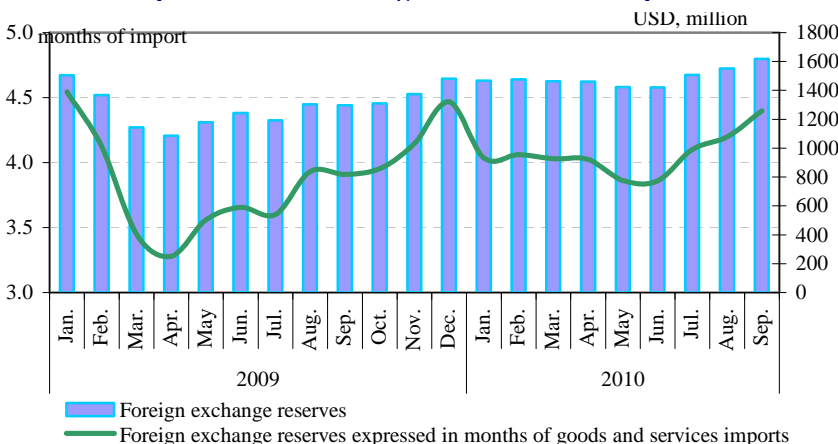
Source: NBM

**Chart no. 2.11. Contribution of major trading partners of Moldova to the real effective appreciation during the third quarter of 2010**



Source: NBM

**Chart no. 2.12. Evolution of foreign exchange reserves expressed in months of goods and services imports**



Source: NBM

**Foreign exchange market (the exchange rate, real effective rate)**

During the third quarter of 2010, *the official nominal exchange rate of the national currency against the U.S. dollar* appreciated by 6.4 percent and against the euro - has depreciated by 4.4 percent. At the same time, *the real effective exchange rate of the national currency (REER)* calculated versus December 2000 under the weight of major trading partners, has depreciated by 0.9 percentage points (chart no. 2.10). REER depreciation was due to the appreciation of the Euro and the Romanian leu, which hold significant shares in foreign trade. Thus, the contribution to the real effective depreciation of Romania constituted 62.9 percent, while of Germany and Italy - 24.9 percent (chart no. 2.11).

The *nominal effective exchange rate of the national currency (NEER)*<sup>3</sup> appreciated by 2.4 percentage points.

During third quarter of 2010, the foreign exchange reserves increased by USD 197.5 million, or by 13.9 percent, from USD 1421.8 million at June 30, 2010 to USD 1619.3 million at September 30, 2010, which covers 4.4 months of imports<sup>4</sup> (chart no. 2.12).

The growth of foreign reserves was mainly conditioned by the IMF tranche grant of SDR 40.0 million (U.S. dollars 60.7 million) for the Ministry of Finance under the Extended Credit Mechanism Program and NBM of the tranche of SDR 20.0 million (USD 30.3 million) under the Extended Financing Mechanism Program.

<sup>3</sup> Calculated compared to December 2010

<sup>4</sup> According to the imports of goods and services forecast for 2010.

**Fulfilling the provisions of the Memorandum of Economic and Financial Policies and consistency of the monetary program of the IMF with the monetary policy of the NBM**

On September 30, 2010, the NBM has met the performance criteria set in the monetary program for the third quarter of 2010 as follows: net domestic assets (-345.6 million), the monetary base (-330.6 million)

and net international reserves (U.S. \$ 28.4 million). Achieving the limits set by the IMF for the monetary base was carried out by monetary policy decisions aimed at sterilizing the liquidity excess in terms of purchasing foreign currency from banks amounting to U.S. \$ 35.0 million.

*Table no. 2.1. Achievement of the monetary program (million, lei)*

	<b>Effective on 30.09.2010</b>	<b>Ceiling for 30.09.2010</b>	<b>Difference versus the ceiling</b>	<b>Difference (%)</b>
<b>Net domestic assets</b>	-7006.6	-6661.0	-345.6	-2.0
<b>Net International Reserves (million, USD)</b>	1464.4	1436.0*	28.4	5.6
<b>Monetary Base</b>	10999.4	11330.0	-330.6	-2.9

According to the adjustments made in accordance with p. 25 of Technical Memorandum of Understanding

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### **III. Macroeconomic Forecast on medium term**

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#### **External environment**

In the third quarter of 2010, the global economic recovery continued its consolidation path. The economic recovery in countries with advanced economy recorded a moderate growth rate as a result of unfavorable conditions in the labor market, the decline in mortgage loans and the difficulties related to financing fiscal deficits. The economic growth in the emerging economies remained generally robust, but short-term indicators suggest a slowdown of the economic growth. Despite the difficulties in the state bonds market and austerity programs, which will result in slowing down the economic recovery process, it is expected that in 2010 the annual growth rate of world economy will be 4.8 percent compared to the previous year. The developed economies would grow by 2.7 percent, while for the emerging and developing economies the new forecasts indicate an advance of 7.1 percent.

Moldova's partner economies in the medium-term macroeconomic forecasting will continue to recover and grow. The euro zone will register a growth of 1.7 percent in 2010 and 1.5 percent in 2011. The trajectory of real growth rate of GDP in the Russian Federation in the current year will reach 4.9 percent and the next year this indicator will be 4.4 percent. Russian Federation and the euro zone are currently below their potential economic pressures resulting from the lack of demand in coming years.

Romania's gross domestic product estimated for the second quarter of 2010 decreased by 1.5 percent in real terms compared to the same period last year, the trend maintaining until the end of 2010. Downturn in economic activity, inflation, unemployment, budget deficit - are some of the factors that will significantly influence the economy of a possible decline to 1.9 percent this year, the largest part of emerging Europe (according to IMF forecasts).

In the euro zone, the inflation rate for 2010 and 2011 will constitute 1.5 and 1.6 percent respectively. In the Russian Federation, the inflation rate will be below 7.5 percent over the next two years.

According to the forecasts, oil price developments will be determined, in particular, by the expectations for oil demand growth in the context of economic revival in a number of countries and the ongoing development of the Chinese economy. In addition, the oil market dynamics will be influenced by the exchange rate of U.S. dollar against major world currencies, affecting the prices of petroleum products denominated in U.S. dollars. Thus, the oil price over the forecast period will be within the range of values USD 80.9 - 88.6 per barrel, being an upward trajectory. Prices for imported natural gas will increase in line with the increase of oil prices.

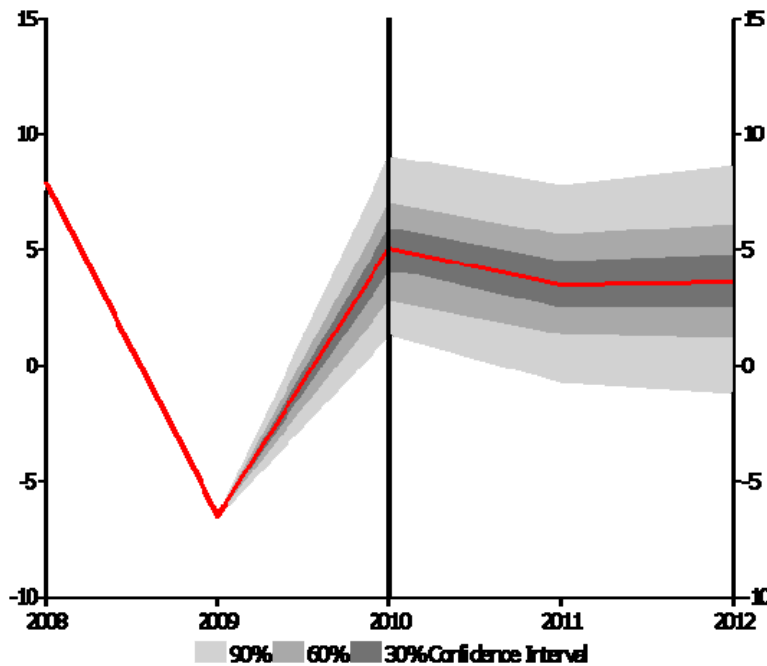
#### **Prospects for the real sector**

According to the NBM estimates, the GDP has exceeded the minimum level of the recession and, starting with the end of 2009 has a growing trend, which was visible during the first two quarters of this year (according to the NBS). However, the negative effect of the decline experienced in 2009 is still felt today by an economic activity lower its potential level. The capacities of the national economy are under-utilized and the GDP deviation is negative. As a result, the disinflationary pressures remain persistent. Compared with the projection of the Monetary Policy Report no. 3, the economic growth is approx. by 1.6 percentage points higher for 2010 and by 0.1 percentage points higher for the next year. For 2012, the economic growth will be by around 0.7 percentage points lower.

Positive differences of data of the current round for forecasting takes into account the revaluation of the cyclical positioning of the aggregate demand to more favorable levels of the growth process due to the NBS publication of data on the real GDP growth for the first quarter of 4.7 percent 6.4 percent for the second quarter of this year. This has determined the projection change both for the forecast period and for the re-estimation period for 2008-2009 on quarterly values of the reconciled GDP. Just as in the previous forecast,



Chart no 3.1. Annual rate of real GDP forecast (%)



potentially reaching the level of economic activity will be outside the horizon, but the shrinking pace of the GDP deviation is higher in the current projection.

According to data on the public budget execution, the fiscal policy momentum on the real sector was reviewed. In 2010, the degree of fiscal expansion has been revised in the direction of increase and for the rest of the forecast period the impact of fiscal policy will be more severe.

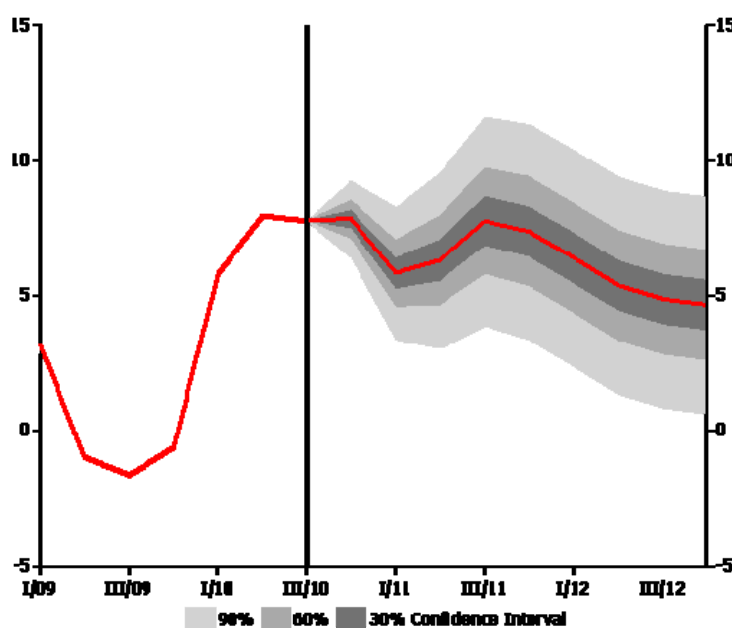
### Inflation outlook

Basic scenario of the current projection places the annual inflation rate at the end of this year to the level of 7.8 percent or 0.4 percentage points less than the Monetary Policy

Report no. 3. This discrepancy is due to lower inflationary pressures in 2010 than was assumed previously. For the next year, the annual inflation rate will record lower values - by 0.2 percentage points at the end of the year. The inflationary pressures for the next year will be largely due to regulated price increases as a result of developments in world energy prices and to the elimination of the reduction coefficient for the imported natural gas prices, and the value at the end of 2011 will be 7.3 percent according to the basic scenario. During 2012, the annual inflation rate will reach close to a long-term sustainable level of 5.0

percent.

Chart no 3.2. Annual rate of CPI forecast (%)



The core inflation at the end of 2010 will be around the level of 4.0 percent, and at the end of the forecasting horizon will register values around 3.9 percent. The deceleration in question is attributable to the dissipation of the second-round effects from supply part and will be due to the persistence of aggregate demand.

The projection of regulated prices for the current year was revised in the direction of decrease, but the price developments for food and petroleum products were revised in opposite direction, thus there have been assumed higher growth than previously estimated. Evolution of prices increases in food and oil

products is the result of “futures” price increases on the international markets for the products listed above.

The maximum contribution to the formation of the annual rate of inflation and achievement of the level of 7.8 percent in the fourth quarter of this year compared to the previous year, will be due to the growth in regulated prices and food prices, which will register an increase compared with the values projected in the

Monetary Policy Report no. 3. At the end of the next year, the annual inflation rate will recorded values of 7.3 percent and the greatest contribution will be from food prices and regulated prices, and the difference of 0.2 percentage points lower compared with the previous report will be due to the evolutions of appreciated national currency.

Natural gas prices will have a consistent upward trend in accord with the oil prices and the future evolution of gas prices takes into account the elimination of the adjustment coefficient, after which the import price of natural gas will reach the average European price.

Currently, the only inflation influence factors are form the supply side, while the economic activity is below its potential and the inflation does not create preconditions for the entire forecast period.

### **Risks and uncertainties**

In the context of many internally and externally uncertainty factors that will rebound upon the development of national economy and which were not considered in the projection of inflation for the forecast period, we can assume that these factors will affect the price levels, thus deviating the inflation from the forecasted one.

Although the uncertainties related to the external environment remains to be further increased, the influence of internal risk factors will prevail in the coming quarters taking into account the political developments. Thus, in these conditions it is difficult to estimate the regulated prices, and respectively, their adjustment period and the period of rebalancing of tariffs for telecommunication services.

As regards the external environment, it is not known with certainty its impact on the future evolution of the volume of remittances, taking into account a number of adverse events that occurred in several countries such as Spain, Greece, Ireland, Portugal (which are facing severe fiscal austerity programs), countries that are important sources of funds transferred by individuals in Moldova.

In addition, the global economy recorded signs of recovery, which could transpose into fluctuations in the prices of oil and natural gas. Consequently, they may cause disturbance in the evolution of inflation level.

At the same time, in case of manifestation of adverse weather conditions (frost, drought) across the country, agricultural production could be affected in the next year and the effect of such events can hardly be quantified on the evolution of food prices for 2011.