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Monetary Policy

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Inflation Report no. 3, 2014

Inflation Report no.3 August 2014 [1]

Summary

Inflation development

In the second quarter of 2014, the average annual rate of inflation was 5.2 percent, by 0.2 percentage points lower than in the previous quarter. Its downward development was due to reduced pressures from food prices and reduced contribution of regulated prices. At the same time, although marginally, the core inflation contribution continued to increase as a result of the national currency's depreciation tendency. Fuel prices contribution was almost similar to the one registered in the previous quarter. Both the annual inflation rate and the core inflation continued to be within the range of ± 1.5 percentage points from the 5.0 percent target, according to the Medium-term monetary policy strategy of the National Bank of Moldova. The annual inflation rate in the second quarter of 2014 was by 0.4 percentage points lower than it was anticipated in the projection (5.6 percent) published in the Inflation Report no. 2, 2014.

External environment

Macroeconomic global events in the second quarter of 2014 were largely predictable, international markets registering a reduced volatility. As in the previous quarter, attention has been granted to the monetary policies of the Fed and the European Central Bank, which guided the development trend of the USD/EUR parity. Thus, the ECB's decision to reduce the interest rates by 0.1 percentage points (down to 0.15 percent) was the most significant event in the second quarter of 2014. Overall, advanced economies continued to expand in the analysed period, while the emerging economies continued to face somewhat severe slowdown in the economic activity.

Economic developments

In the first quarter of 2014, the dynamics of the economic activity was significantly more modest compared to the previous year, so that GDP grew by only 3.6 percent compared to the same period of the previous year. This slowdown was due to the disappearance of the imposing effect of agricultural growth from the previous year and due to the further slowdown in domestic demand. However, the pronounced growth of agriculture in the previous year has created the conditions for increasing the gross value added in industry in the first quarter of 2014. The positive evolution of economic activity was boosted to some extent by the depreciation trend of the national currency during the current year against the currencies of major trading partners. In the first quarter of 2014, household consumption grew by only 0.6 percent, while government consumption contracted by 0.3 percent. At the same time, gross fixed capital formation increased by 8.6 percent. The modest domestic demand led to a contraction in imports by 0.5 percent. The decrease in demand from Eastern trading partners resulted in an increase in exports of only 3.4 percent. The dynamics of the unemployment rate and employed population shows an improvement on the labor market of the Republic of Moldova in the first quarter of 2014 compared to the same period of the previous year.

Operational data for April and May on industrial production, foreign and domestic trade outlines further slowdown in economic activity in the second quarter of 2014.

Monetary policy

In the second quarter of 2014, there were three meetings of the Council of Administration of the National Bank on monetary policy. As a result of assessing the balance of internal and external risks, which could be faced by the Moldovan economy and inflation forecasts in the short and medium terms, there were issued three decisions to maintain the base rate at the level of 3.50 percent (level set at the meeting of April 25, 2013). During the reporting period, monetary policy was oriented towards maintaining the incentive nature of the real economy and keeping the inflation within the range of ± 1.5 percentage points from the 5.0 percent target. Since the beginning of 2014, growth rates of monetary indicators have reduced. However, the growth rate of monetary aggregates remained at a high level, the quarterly average in annual terms of M2 constituted 22.1 percent (by 4.4 percentage points less than in the first quarter of 2014) and that of M3 accounted for 23.3 percent (by 1.8 percentage points less than in the first quarter of 2014). During the second quarter of 2014, the average annual interest rate of loans balance granted to private sector decreased both in national currency (by 0.38 percentage points) and in foreign currency (by 0.03 percentage points) compared to the end of the previous quarter, recording values of 11.13 percent in national currency and 7.53 percent in foreign currency. The average interest rate of deposits in MDL recorded a level of 7.64 percent at the end of the quarter, by 0.13 percentage points lower than the level recorded in March 2014. The interest rate of deposits in foreign currency amounted to an average of 4.64 percent in June 2014, decreasing by 0.02 percentage points compared to March 2014.

Medium-term inflation forecasting

According to the current projection, if the assumptions will come true, the annual rate of CPI will record the level of 4.7 percent for this year and 3.5 percent in 2015. The annual inflation rate will leave the range of variation from the inflation target for two consecutive quarters, starting with the first quarter of 2015, when it will record a minimum level of 2.8 percent. The balance of risks is dominated by disinflationary factors throughout the projection horizon.

The contribution of core inflation to the annual inflation rate will be halved by the end of the forecasting horizon. The diminishing core inflation’s contribution is mainly due to the considerable deficit in aggregate demand.

The decrease of international food prices by the end of 2015 and favorable agro meteorological conditions registered this year will cause a decrease of the contribution of food prices to the formation of the annual inflation rate.

According to the current round of forecasting, the output gap will remain negative during the entire forecasting period. In comparison with the forecast published in the Inflation Report no.2, 2014, the aggregate demand’s decrease has been also influenced by the external demand contribution, especially from the Russian Federation. The output gap’s decrease attenuation will be possible to be mitigated during the current and next years as a result of a stimulating monetary policy. The stimulating impact of real monetary conditions will be primarily determined by the real effective exchange rate. Low real interest rates will also contribute to the stimulation of the aggregate demand.

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