

Monetary and Foreign Exchange Policy of the National Bank of Moldova for 2006

NBM Monetary and Foreign Exchange Policy Strategy and Objectives

Under the scope of the Law on the National Bank of Moldova no. 548-XIII of 21 July 1995, the National Bank of Moldova, in cooperation with the Government of the Republic of Moldova, establishes and promotes the monetary and foreign exchange policy as integral part of the single economic policy of the state. Since the introduction of the national currency in 1993 NBM has promoted a monetary and foreign exchange policy aimed at achieving the stability of the national currency by ensuring the relevant degree of national economy monetization.

The monetary and foreign exchange policy promoted by NBM provides the establishment of quantitative targets of money supply in economy. The strategy of the NBM policy is based on the use of reserve money as operational target and of broad money as intermediate target.

In 2006 the National Bank of Moldova shall further implement a relevant monetary and foreign exchange policy aimed at achieving the NBM's main objective – the realisation and maintenance of the stability of the national currency by establishing the monetary, credit and foreign exchange market conditions based on market economy principles.

I. Macroeconomic Trends, Banking System and 2005 Monetary Policy Assessment

Macroeconomic Situation

Gross Domestic Product (GDP) in January – September 2005 increased by 8.4% in real terms as compared to the relevant period of the previous year and amounted to 28712.2 million lei in current prices. GDP growth was conditioned by the 7.7%-enlargement from the previous year of gross added value, including by 8.1% - from services, by 9.9% - in the agricultural sector and by 4.5% - within industry.

GDP structure was similar to those in previous years: services accounted for the largest share of 54.9%; industry – for 14.8%; agriculture – for 17.4%; net taxes on products and imports – for 14.8%; and indirectly measured services rendered by financial intermediaries – minus 1.9%.

The weight of final consumption accounted for 106.2% of GDP; of gross capital formation – for 27.5%; and of net exports – minus 33.7%.

The current account of the balance of payments over the first nine months of 2005 denoted a negative balance of US\$ 98.3 million. The deficit from external trade with goods and services increased from the relevant period of the previous year by 51.1% and amounted to US\$ 769.2 million. Exports of goods and services grew from January-September 2004 by 9.7% and imports – by 29.3%.

Inflation in January-November 2005 accounted for 8.5%: prices for foodstuffs rose by 6.3%; for non-food articles – by 13.7%; and for services rendered to the population – by 6.2%.

State budget revenues during the first 10 months of 2005 amounted to 7268.7 million lei, accounting for 103.8% of relevant provisions. State budget expenditures amounted to 6284.9 million lei, accounting for 83.6% of provisions for October-end 2005.

State internal debt as by 3rd quarter - end of 2005 amounted to 3736.2 million lei; public external direct and guaranteed debt totalled US\$ 783.6 million.

Foreign Exchange Market

During the first 11 months of 2005 the evolution of the main foreign exchange market indicators was foremost impacted by: (1) the seasonal character of forex inflows and outflows from international trade; (2) abating of growth rate of net foreign exchange supply from individuals; (3) the appreciation trend of the exchange rate of US\$ against Euro in the international market; (4) the enlargement of deposits in foreign currency within the time-period denoting the largest net inflow of foreign currency, which determined the reduction of foreign currency supply in the domestic forex market.

The nominal official exchange rate of the national currency against US\$ in January to November 2005 depreciated by 2.9%, as compared to the 5.6%-appreciation registered in the similar period of 2004.

The real effective exchange rate of the national currency (estimated in comparison with the December 2000 considering the inflation in Moldova's main trade partners and monthly average exchange rate changes) constituted 95.5% in November, appreciating by 3.0 p.p. as compared to December 2004 (92.5%).

In the international markets, from January to November 2005, US\$ appreciated against Euro by 13.2% - from US\$ 1.3607 for Euro as at December-end 2004 to US\$ 1.1816 for Euro as at November-end 2005.

Over the first 11 months of 2005 the growth of net foreign currency supply by individuals accounted for 41.3% as compared to 69.5% in the similar period of 2004.

On the background of depreciation trends of the national currency against US\$, in January – November 2005, net balance-sheet assets in foreign currency of commercial banks rose by US\$ 80.2 million as compared to the US\$ 69.5 million - increase of the relevant indicator in the similar period of 2004. Such augmentation of foreign currency assets contributed to the reduction of foreign exchange supply in the domestic foreign exchange market.

Over the first 11 months of 2005, with the view to smoothing down excess fluctuations of the official nominal exchange rate of the national currency against US\$, the NBM intervened in the domestic forex market by using of the following instruments: buying / selling transactions of US\$ in net value of US\$ 149.3 million (including forward transactions in an amount of US\$ 5.35 million); and reversible instruments in form of (selling) swaps in a value of US\$ 15.03 million.

Within the structure of total selling/buying turnover in the domestic forex market over January to November 2005, transactions in US\$ accounted for 71.6%; in Euro – for 24.1%; in Russian Roubles – for 3.8%; and in other non-convertible currencies – for 0.5%. In the reported period the US\$ weight in the domestic foreign exchange market reduced by 4.2 p.p. and the Euro weight increased by 3.6 p.p. as compared to the similar period of 2004.

International reserves increased by US\$ 98.0 million: from US\$ 470.3 million as at end of 2004 to US\$ 568.3¹ million as at end of November 2005 (which, in estimate terms, cover 2.6 import-months).

Payments System

Over 2005 the National Bank of Moldova revised the concept associated with the usage of non-cash payment instruments and identified the need to improve the existent procedures and mechanisms and to elaborate a new legal framework related to thereof.

Under this scope, the Council of Administration of the National Bank of Moldova approved new regulations in the field of payments system, which explicitly define the payment instruments and documents used to conduct non-cash payments.

¹ As in accordance with the IMF methodology related to Special Data Distribution System (SDDS)

Banking System

The consolidation of the banking system continued in January – November 2005. Tier I capital of banks increased over this period by 382.9 million lei, or by 15.7% and amounted to 2817.0 million, thus exercising a positive impact upon banks' financial stability and the capacity of thereof to absorb risks associated with financial operations.

Total assets of the banking sector over January to November 2005 amounted to 16805.6 million lei, registering an increase of 26.4% or by 3510.1 million lei. Within total assets, net credits held the largest weight of 55.1%.

The better quality of the credit portfolio over the reported period² following the consolidation of internal control systems and the improvement of internal procedures related to credit provision and supervision has lead to the reduction from 2004-end of the weight of unfavourable credits (substandard, doubtful and compromised) by 2.1 p.p. down to the level of 4.8% and of credit loss provisions by 1.0 p.p. down to 4.9% of credit portfolio as of 30 November 2005.

Dynamics of monetary aggregates

Over the first eleven months of 2005 reserve money increased by 8.4% or by 448.8 million lei as compared to 31 December 2004 and amounted to 5761.9 million lei. The reduction by 8.8% of banking reserves over the reported period was mainly conditioned by the lessening of funds in commercial banks' correspondent accounts with the National Bank of Moldova, determined also by sterilisation of excess liquidity in the banking system. The balance of NBM's certificates in circulation as at November-end totalled 413.8 million lei; the balance of deposits accepted by the National Bank amounted to 647.5 million.

Over the first 11 months of 2005 broad money M2 (currency in circulation + MDL deposits + money market instruments) rose by 27.0% or by 2200.0 million lei and amounted to 10337.0 million lei as of 30 November 2005. Within the M2 structure, MDL deposits expanded by 36.3% and currency in circulation – by 16.0%.

Broad money M3 enlarged from January to November 2005 by 26.0%, including the total balance of deposits – by 30.6%. The growth of deposits in national currency accounted for 36.3%, while that of deposits in foreign currency (expressed in MDL) – for 23.7%. The population's consolidated confidence in the national currency conditioned the augmentation by 52.6% of individuals' deposits in national currency.

The value of newly attracted deposits broadened by 3367.1 million lei as compared to the similar period of 2004 and amounted to 9309.8 million lei: deposits in national currency rose by 62.4% and those in foreign currency – by 50.9%. The weighted average interest rate on deposits in national currency reduced by 1.7 p.p. and constituted 13.4%; the one on deposits in foreign currency increased by 0.2 p.p. and constituted 5.1%.

The balance of credits to economy rose in January to November 2005 by 2222.9 million lei (or 30.0%) as compared to the value as of 31 December 2004 and totalled 9622.2 million lei.

The superior increase of the demand for new credits in national currency as compared to that for credits in foreign currency has been also determined by the reduction by 1.8 p.p. of the weighted average interest rate (computed for the time-period of January to November) as against 0.3 p.p. of the relevant interest on credits in foreign currency, which accounted, respectively, for 19.2% and 11.1%.

² Data are submitted on quarterly basis

Use of Monetary Policy Instruments

Over the first eleven months of 2005 the National Bank of Moldova reduced twice the interest rates on its instruments of monetary regulation. Thus, at November-end 2005, the rate applied on 2-month state securities (SS) REPO-buying operations accounted for 12.5%; the interest corridor varied within 2.0% per year on overnight deposits and 15.0% per year on overnight credits. Over 2005, the National Bank was further establishing the base rate on long-term credits (more than 5 years) to service long-term credits extended to banks; at November-end this rate accounted for 10.5% per year.

Money supply, supplemented on the account of NBM interventions in the foreign exchange market, was balanced following the expansion of *sterilisation operations*.

With the view to conducting more efficient excess liquidity sterilisation, the National Bank has implemented a new instrument – Certificates of the NBM (NBC), which, in common with the attraction of deposits from commercial banks, constituted the main operations used to sterilise the excess liquidity in the banking system.

The value of sterilisation operations performed by the National Bank of Moldova from January to November 2005 amounted to 8153.3 million lei. The average monthly interest rates on sterilisation operations reduced over the year from 6.66% in January to 3.77% in November.

Sales of NBM Certificates. Over the first 11 months of 2005 the National Bank of Moldova conducted placement auctions of NBM Certificates, at which offered for sale 28-day NBC's in a total amount of 4295.0 million lei. Bids by participants totalled 5965.0 million lei; the effective value amounted to 4018.8 million lei. The average interest rate in January to November 2005 accounted for 3.11% per year.

Deposit operations. The value of deposit auctions conducted by the National Bank of Moldova from January to November 2005 amounted to 4290.0 million lei. The integral value of commercial banks' demand totalled 6510.5 million lei; the value of accepted bids constituted 4134.5 million lei. The average weighted term of accepted deposits was 47 days. The average weighted interest rate in January to November 2005 accounted for 3.52% per year.

Required reserves. In April 2005 the transition period to establishment of required reserves separately in MDL and free convertible currency initiated by the National Bank in July 2004 was completed.

Government debt to the National Bank of Moldova. Within the structure of domestic public debt, the Government debt to the National Bank held the largest weight, amounting as at November-end to 2611.0 million lei, including debt on loans – 2211.0 million lei, and debt in form of state securities in the NBM's portfolio – 400.0 million lei.

Over 2005 the National Bank of Moldova did not extend any new credit to the State. The Government debt to the National Bank as of 30 November 2005 reduced by 127.0 million lei as compared to the end of 2004.

II. Monetary and Foreign Exchange Policy for 2006

The monetary and foreign exchange policy of the National Bank of Moldova, including the main activities to be followed with the view to fulfil the NBM's basic attributions for 2006 are worked out based on the Law on the National Bank of Moldova. The framework applied for the elaboration of the monetary and foreign exchange Policy of the National Bank of Moldova for 2006 included: 1) the forecast of economic development of the Republic of Moldova provided within the Framework of medium-term expenditures for the years 2006-2008, Poverty Reduction and Growth Facility (PRGF) that provides the GDP 6.5%-increase in 2006; 2) the Law on the State Budget for 2006; 3) the Strategy of the Government of the Republic of Moldova and the National Bank of Moldova on the development of the financial sector of the Republic of Moldova over the years 2005-2010.

The monetary and foreign exchange policy of the National Bank of Moldova for 2006 is worked out based on the following considerations:

- inflation target shall be observed within 8.0% - 10.0% per year;
- population's saving and consumption trends shall be similar to those in 2005;
- the net supply of foreign currency in the foreign exchange market shall be similar to that in 2005;
- state external debt shall be served as in accordance with the Law on the State Budget for 2006 and NBM shall repay IMF credits (US\$ 25.7 million);

The NBM's forecast of monetary indicators for 2006 provides as follows:

- a) reserve money shall increase maximum by 20.0%;
- b) broad money M2 shall increase maximum by around 40.0%;
- c) monetization level M2 (ratio of broad money M2 to GDP) is expected to account for around 35% as at end of 2006;
- d) required reserves shall conform to the dynamics of macroeconomic condition of the state.

The Government's debt to NBM shall stay within the limits of 2492.2 million lei as at the end of 2006.

Monetary Policy

To execute the monetary Policy for 2006, the National Bank of Moldova shall apply all the instruments of banks' liquidity management, including as instruments of excess liquidity sterilisation: Certificates of the National Bank; deposits placed with the National Bank; sales of state securities from the NBM portfolio and SS selling REPOs; as well as the intraday credit, which shall be implemented under the scope of maintaining banks' liquidity along with SS buying REPOs and overnight credits / deposits.

The National Bank of Moldova shall further promote the interest rates policy through application of the corridor method, where the interest on overnight credits shall be the highest rate and the interest on overnight deposits – the lowest one. The rate on 2-month SS purchasing REPOs shall be considered as the base NBM rate to be used as pillar for the determination of interest rates on other instruments included in the rates' corridor. With the view to developing the interbank money market of the Republic of Moldova, the National Bank shall further publish the CHIBOR (Chisinau Interbank Offered Rate) and CHIBID (Chisinau Interbank Bid Rate) reference rates on the official web site of the National Bank of Moldova.

Foreign Exchange Policy

The foreign exchange Policy of the National Bank of Moldova for 2006 provides the further free floating exchange rate regime of the national currency and the establishment of the official exchange rate of Moldovan Leu against US\$ based on prevailing exchange rates in the forex market.

Within this context, the NBM shall have the right to make foreign exchange interventions, if needed, to smooth down excessive fluctuations of the official exchange rate. Instruments of the foreign exchange policy shall include: direct interventions in the forex market, inclusive forward transactions; as well as reversible forex swaps.

The foreign exchange Policy of the National Bank of Moldova for 2006 shall be continuously directed towards the maintenance of international foreign exchange reserves at a level acceptable to cover 3 import-months at least. NBM shall place its foreign exchange assets in investment instruments that comply with security and liquidity requirements.

Payments System

As in accordance with the Strategy of the Government of the Republic of Moldova and the National Bank of Moldova on the development of the financial sector of the Republic of Moldova over the years 2005 – 2010, in 2006 it is provided to conclude the implementation of the new generation automated system of interbank payments.

This system is aimed at ensuring the compliance of the interbank payments system of the Republic of Moldova with international practices and standards, as well as at speeding up and enhancing the performance of non-cash payments.

The automated interbank payment system shall include the real time gross settlement system provided for urgent and large-value payments and the net settlement clearing system for small-value payments.

Banking Supervision

With the view to maintaining the financial stability of the banking system, thus contributing to the enlargement of the system's capacity to intermediate capital flows for purposes of increasing the volume of domestic and external investments in different economic branches, the National Bank of Moldova shall concentrate its effort for sustainable development of the banking sector, paying due consideration to international best practices. To achieve this target, the National Bank shall further undertake relevant measures to execute the provisions of the Poverty Reduction and Growth Facility Strategy, the Strategy of the Government of the Republic of Moldova and the National Bank of Moldova on the development of the banking sector of the Republic of Moldova in the years 2005-2010, the Actions Plan –Republic of Moldova – European Union, which was worked out based on recommendations exposed within the Financial Sector Assessment Program.

Under the scope of above-mentioned, the NBM's activity shall emphasise as follows:

- a) the promotion of banks' capacity to assess and manage risks related to different forms of banking activity, as well as the capacity to adequately cover these risks with own capital;
- b) the development of banks' internal control procedures, methods related to assets' and liabilities' management, as well as procedures for due verification and assessment of thereof, including procedures and policies related to the identification, monitoring and management of country and market risks;
- c) the promotion of policies related to the identification of owners exercising significant impact upon bank's management and activity, with the view to determining the structure of owners and the origins of means paid in bank's capital;
- d) the promotion of policies related to the acceptance as shareholders of persons conducting activities conducive to establishment of relevant premises for a prudent functioning of the bank and the non-admittance of further increase of significant interests of shareholders exercising negative impact upon bank's activity.

Note: The National Bank of Moldova reserves the right to review the monetary and foreign exchange Policy for 2006 in event the current State economic and financial policies provide certain modifications at macroeconomic level that affect the monetary and foreign exchange policy, as well as if international financial institutions resume the financing of the Republic of Moldova.