NEWSLETTER
GET MOLDOVA
Issue No. 49 | September - October 2018

Monetary policy normalisation and its impact on Moldova

In response to the international financial crisis in 2007/2008, central banks in advanced economies reacted heavily and cut their policy rates to unprecedented low levels. This ultra accommodative policy had its intended impact, but now it poses severe risks of asset bubbles. Thus, leading central banks have started to normalise their policy.

This policy normalisation is negatively affecting several emerging countries such as Argentina and Turkey, but so far, no impact was observed on Moldova for two main reasons. First, Moldova has a low level of external short-term debt; there is practically no "hot money" in the country. Second, macroeconomic management has been very prudent in the last two years or so.

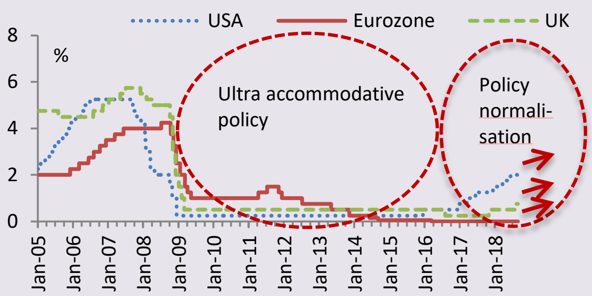
Despite the lack of impact so far, some caution is advisable. In particular, we favour a continuation of the built up of foreign exchange reserves and of a prudent fiscal policy.

Ultra accommodative policy in advanced economies

In the context of the international financial crisis in 2007/2008, central banks in advanced economies took severe measures. The Federal Reserve Bank (Fed) as well as the European Central Bank (ECB) cut policy rates to unprecedented low levels. Additionally, they injected huge amounts of liquidity into the markets, which was mirrored by a huge increase of their balance sheets.

This ultra accommodative policy had the intended impact on GDP, unemployment, inflation and on financial indicators. However, a continuation of this policy entails a serious risk of asset price bubbles. Thus, it is time to normalise monetary policy. The Fed and Bank of England already started raising interest rates and the ECB will follow suit by the end of 2019.

Key central bank interest rates



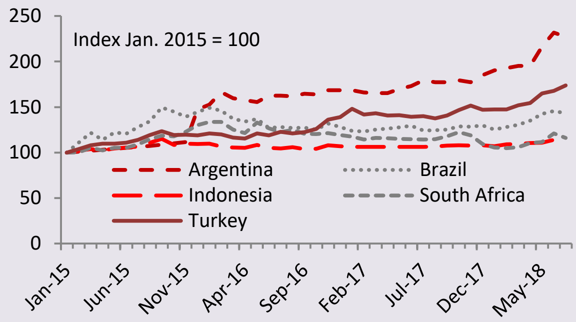
Source: HSH Nordbank

Impact on selected emerging markets

Monetary policy normalisation in advanced economies has led to higher interest rates and sizeable depreciations in emerging markets.

Higher interest rates in advanced economies make investment in advanced economies more attractive, which makes private investors shift funds from emerging markets to advanced economies. This in turn leads to a depreciation of emerging markets currencies, as shown in the chart below.

Major emerging markets currencies against the US dollar



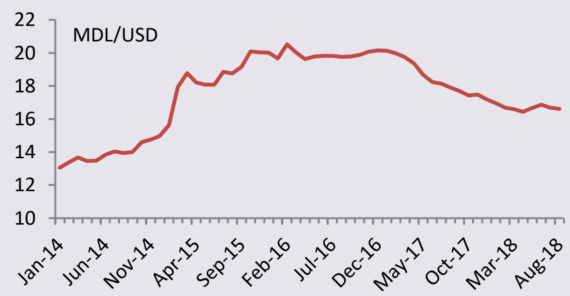
Source: IMF

There was a particular strong impact on Argentina, Turkey and Brazil. These countries also had to increase policy rates to keep inflation at bay.

Impact on Moldova so far

In Moldova no negative impact on policy rates can be observed so far. The National Bank of Moldova was even able to reduce the base rate from a peak of 19.5% in January 2016 to currently 6.5%. At the same time, there was a strong appreciation of the Moldovan Leu of 17.5% against the US dollar since January 2017.

Exchange rate of the Moldovan Leu



Source: NBM

Expected future impact on Moldova

To assess possible future risks, we look at selected risk factors. These are public debt, corporate debt, the banking sector, the current account deficit and foreign exchange reserves.

Public debt. There is a traditionally low level of public debt in Moldova; in 2017 it amounted to 33% of GDP. Only 21% of the debt is short-term. At the same time 81% of the external debt is with international financial institutions (IFIs).

Moldova doesn't issue Eurobonds and the participation of foreigners in local debt markets is very limited (no "hot money"). Thus, we see only a limited risk related to public debt.

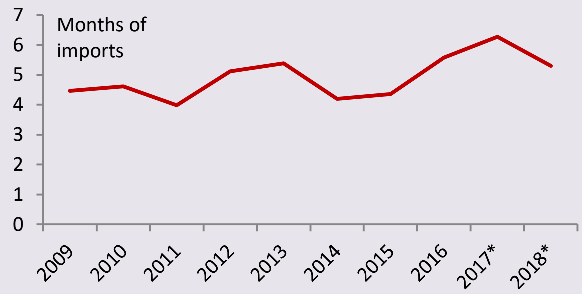
Corporate debt. In 2017 the short-term external debt of the corporate sector amounted to almost 14% of GDP. In international comparison this is a sizeable share. However, most of this short-term debt consists of trade credits (12.5% of GDP), which are not a major source of concern as firms can repay them after selling the imported goods. Corporate debt is, therefore, also not critical.

Banking sector. The banking sector has at the moment a very high capital adequacy ratio of 27%. The regulatory minimum lies between 13.5 to 16.25%. This high ratio can act as buffer. We see little risk here.

Current account deficit. In 2017 the deficit amounted to ca. 6.5% of GDP, which is per se a risk factor. However, the deficit is to a large extent financed by FDI (2.1% of GDP) and by IFIs (1.3% of GDP in public and a significant amount in private sector). Since these are rather stable capital inflows, we see a moderate risk related to current account deficit.

Foreign exchange reserves. As of today, FX reserves amount to USD 2.97 bn, equivalent to 5.3 months of import coverage and 152% of short-term external liabilities. Given this considerable (but not huge) level of FX reserves, we see no related risk.

Foreign exchange reserve assets



*Source: World Bank, IMF; *own calculation, own estimate*

Conclusions and policy implications

Since 2017, the Moldovan Leu appreciated versus the US dollar and the policy rates have decreased. Thus, so far, the normalisation of monetary policy in advanced economies had no impact on Moldova.

The main reason for the lack of impact is Moldova's limited integration in global financial markets and the high share of IFIs in external debt. But also a prudent macroeconomic policy and the recent clean-up of the banking sector contributed to the lack of impact.

Assuming a continuation of the current prudent macroeconomic policy, no shock is to be expected on Moldova. However, eventually some impact will be felt, especially on interest rates.

We recommend the authorities to remain cautious, to further accumulate FX reserves as potential buffer and to stick to a cautious fiscal policy with appropriate budget deficits.

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A more comprehensive analysis is provided by our Policy Study PS/01/2018 "Monetary policy normalisation in advanced economies and the impact on Moldova"

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The German Economic Team advises the Government of Moldova on economic policy issues since 2010. It is funded by the German Federal Ministry for Economic Affairs and Energy and implemented by the consulting firm Berlin Economics.

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