POLICY BRIEFING 03|2022

German Economic Team

MOLDOVA

Inflation in Moldova. Economic implications and policy response

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Outline

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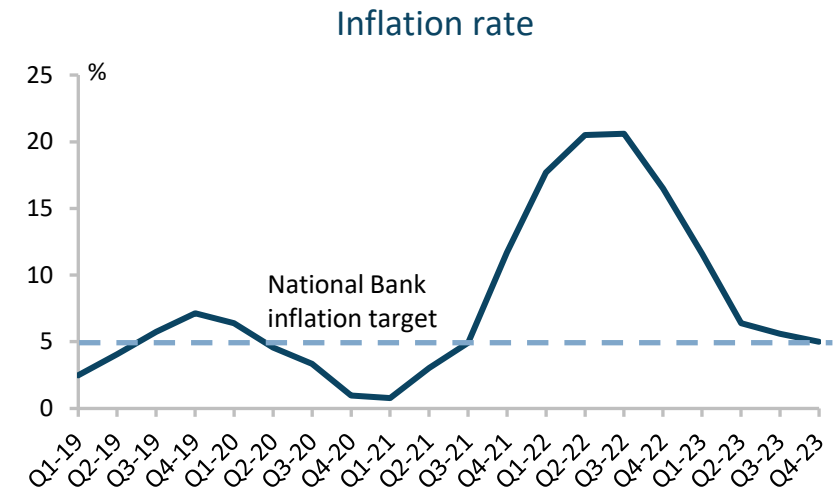
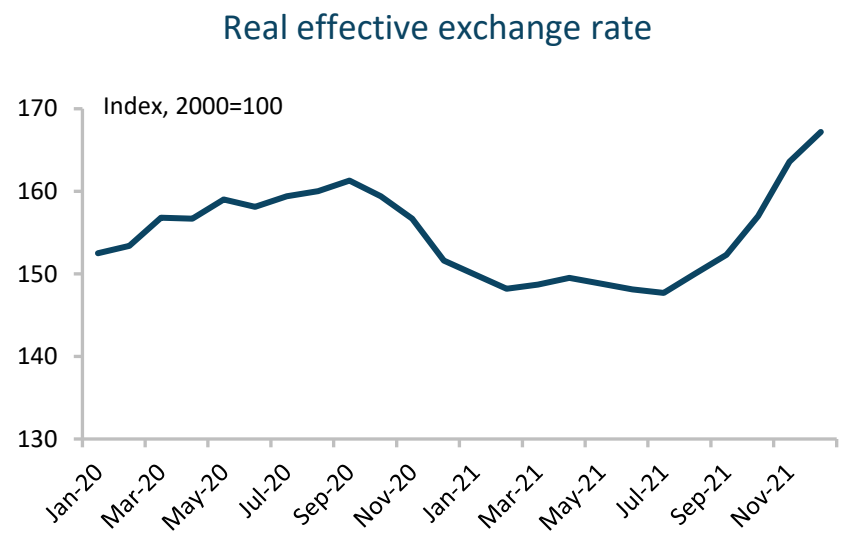
1. Inflation in Moldova and economic implications



Source: National Bank of Moldova, note: average quarterly inflation



Source: National Bank of Moldova

Inflation

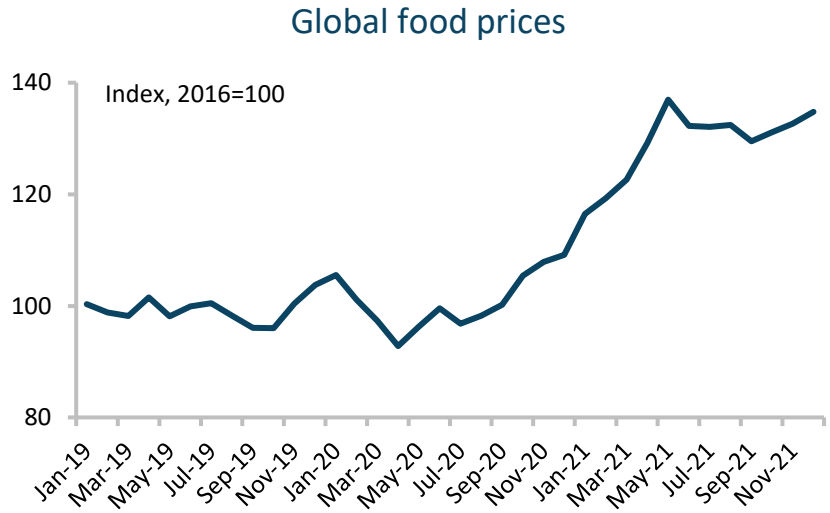
- High inflation (CPI) in MDA throughout 2022
- Strong negative impact on low-income households; social issue
- Negative effect on employees and pensioners, but not necessarily for companies; distributional effect of inflation

Real effective exchange rate

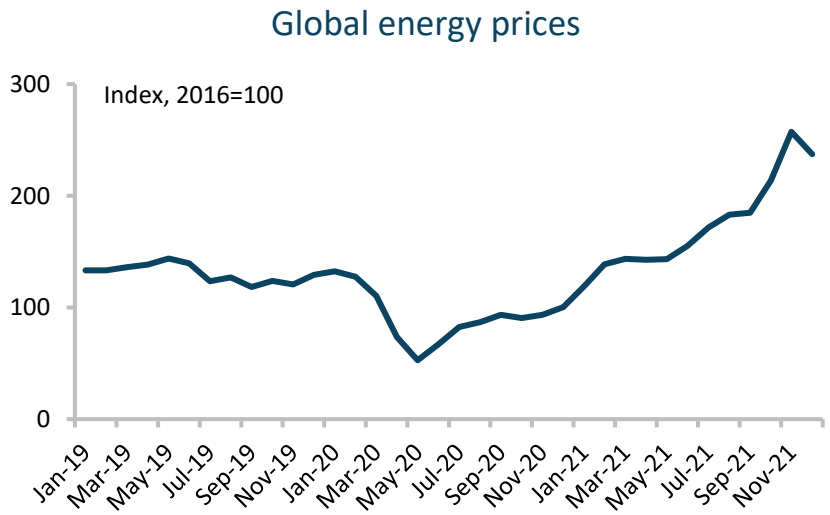
- Inflation contributes to real appreciation of Leu
- Implication: MDA products become more expensive in international comparison
- Bad for exports and for the economy
- Leads to higher imports and higher trade deficit

➢ **High inflation with negative economic, social and distributional effects**

2. Why high inflation in Moldova? Food and energy prices



Source: IMF



Source: IMF

Food prices

- Global increase in food prices: IMF Food Price Index increased by 23.5% in 2021
- Drivers: higher input prices, especially fertilizer and fuel

Energy prices

- Energy prices (crude oil, natural gas, coal) increased internationally
- Driven by high global demand due to pandemic recovery

➢ **Strong increase in global prices for food and energy**

2. Why high inflation in Moldova? Consumer basket

Share of food and energy in consumer price index

Product group (in %)	Moldova	Germany	Eurozone
Food and drinks	36.6	9.4	17.3
Energy	6.1	5.6	5.9
Electricity	3.3	2.6	2.9
Gas	1.9	2.5	1.9
District heating	1.0	0.5	3.3

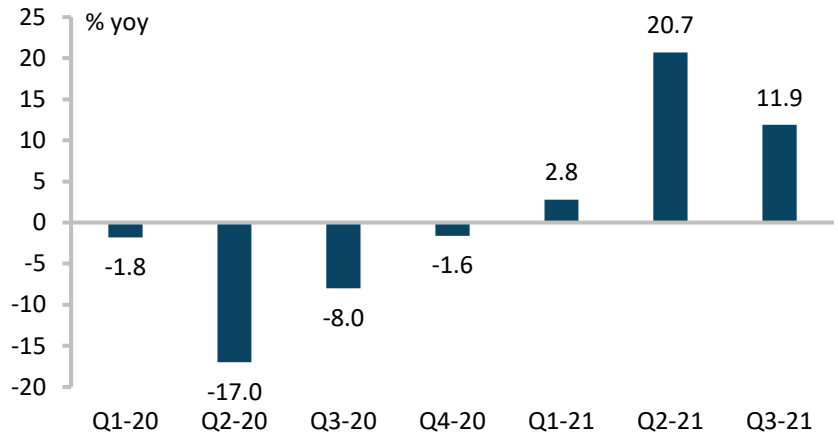
Sources: National Bureau of Statistics Moldova, Federal Statistical Office of Germany, Eurostat

- MDA: high share of food in CPI basket, as in most countries at the GDP/capita level of MDA
- Thus: food supply shock translates into higher inflation in MDA than in many other countries
- On top: very strong energy price shock in MDA; gas prices increased by 81.7%
- But: share of energy in consumer basket not higher than in other countries

➢ **Inflation higher in MDA due to structure of consumer price index**

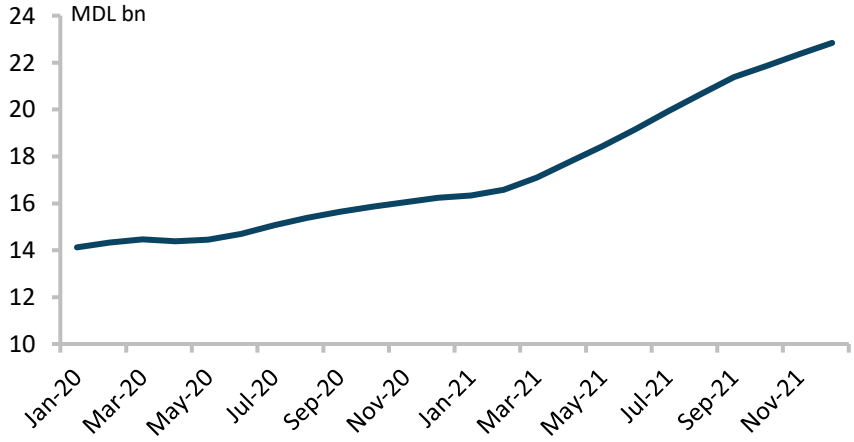
2. Why high inflation in Moldova? Strong consumption

Quarterly private consumption



Source: National Bureau of Statistics

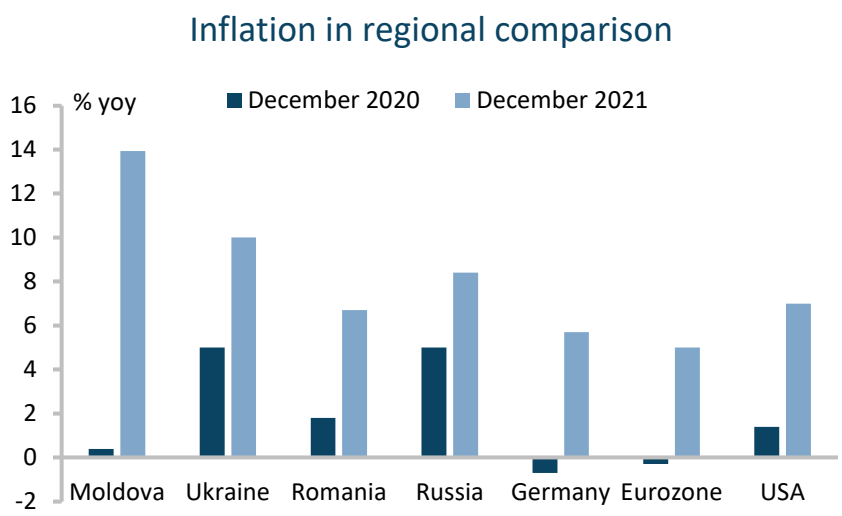
Outstanding consumer loans



Source: National Bank of Moldova

- Strong private consumption also contributed to inflation
- This demand factor comes on top of supply factors (food and energy prices)
- Reasons for high consumption:
  - strong economy (ca. 8% growth in 2021)
  - higher wages
  - higher remittances
- But also: strong increase of consumer loans on the back of wide liquidity

3. Inflation in Moldova in regional comparison



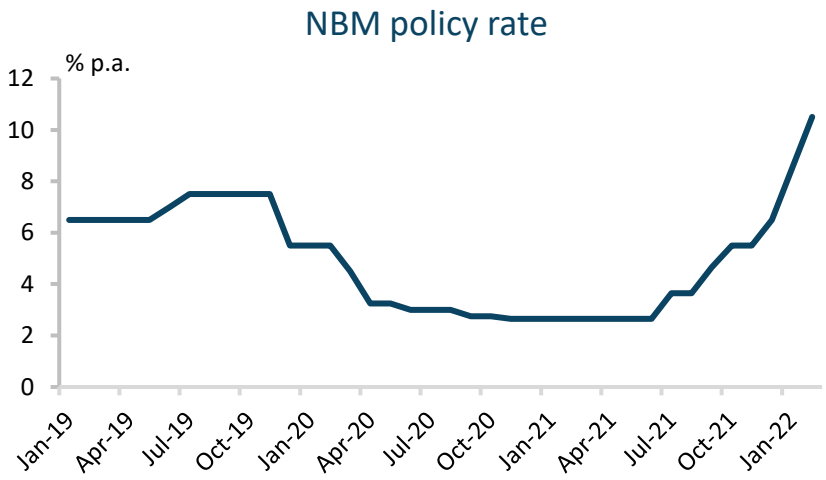
Source: National Bank of Moldova, National Bank of Ukraine, Eurostat, U.S. Bureau of Labor Statistics

- Practically all countries currently face high inflation: Eurozone (including DEU), USA, but also UKR and ROU
- Thus: inflation is a global problem; not a specific problem of MDA
- At the same time: inflation in MDA somewhat higher than in other countries
- Reason: combination of 3 factors in MDA
  - Supply side: higher global food and energy prices
  - Large share of food in consumer basket
  - Demand side: strong consumption fueled by consumer loans

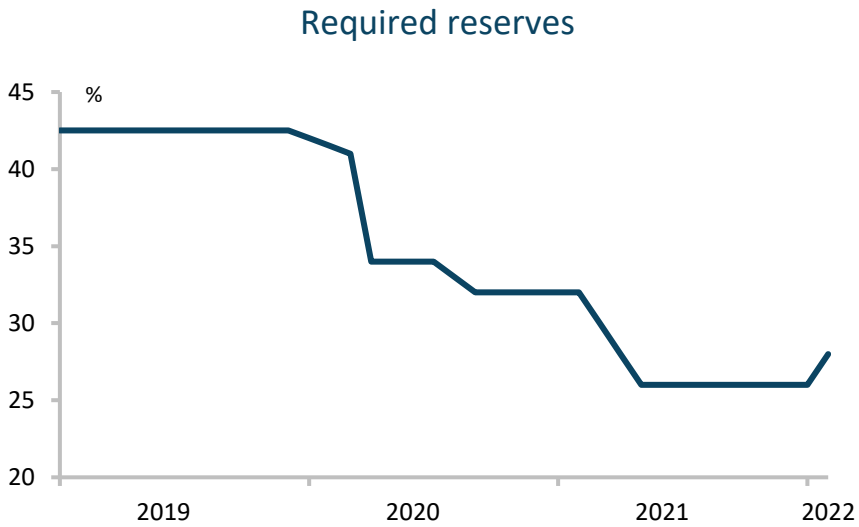
➢ **High inflation in MDA can be explained with standard analysis**

➢ **Diagnosis clear, what about the therapy?**

4. What to do? Monetary policy



Source: National Bank of Moldova



Source: National Bank of Molova; note: as a share of all deposits in MDL

- In general: NBM can only influence demand factors such as liquidity, not supply factors such as food and energy prices
- Action so far: tightening of monetary policy to contain aggregate demand
- Concrete: higher policy rates and higher reserve requirements on Leu deposits
- Outlook: real policy rate is still negative
- Policy rate of 10.5% compared to an inflation rate of 16.6% (Jan-22); thus, further steps might be necessary
- Negative effect on economic growth
- But: tightening is necessary, to avoid high inflation expectations and thus high inflation for many years

➢ **Thus: appropriate policy of NBM**

4. What to do? Fiscal policy

- Monetary policy has supported the economy throughout the COVID crisis
- Thus: strong contribution to limit the negative effect of COVID
- However, now monetary policy has to be tightened, with negative effect on growth
- What to do? Support from fiscal policy
- E.g.: investments in infrastructure, which are badly needed
- In particular: investment into energy, good in short and long term
- Support of low-income households
  - To avoid poverty
  - Important: no strong contribution to imports and higher trade deficit, because low-income households tend to consume domestic products
  - Thus: expansive fiscal policy with limited effect on imports
- To be avoided: non-targeted measures

5. What not to do? Price controls

- Current discussion: stronger control of companies to check whether price increases are justified; possibility to introduce price controls or similar measures
- Justification for such measures: “lack of competition in many product markets; companies with market power contributed to inflation by increasing prices very hard”
- Our position:
  - Lack of competition is not new and certainly not the reason for high inflation
  - Example: price for vegetables (legumes) increased very strongly (44%), however it is difficult to see how such a price increase should have been orchestrated by a few companies with strong market position
  - Thus: any pressure on companies to reduce prices will not solve the problem, but create an additional problem, i.e. worsening of business climate

5. What not to do? Unfounded critique of NBM

- Clear: nobody likes high interest rates
- Thus: easy to criticize the NBM on this point
- But: such critique makes things only worse
- It contributes to uncertainty and to inflation expectations, thus making it more difficult for the NBM to fight inflation
- Implication: any critique on monitory tightening is not only unfounded, but counterproductive and aggravates the problem

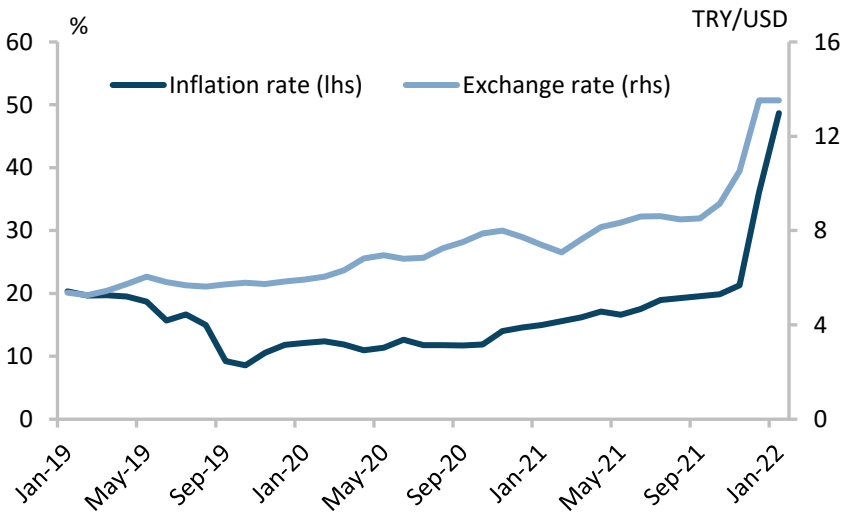
6. International experience

Inflation and policy rates in peer countries

	Inflation (CPI, %)	Policy rate (% p.a.)
Moldova	**16.6**	**10.5**
Ukraine	10.0	10.0
Belarus	10.4	9.25
Georgia	13.9	10.5
Armenia	7.1	8.0

Sources: NBM, NBU, NBRB, NBG, CBA

Inflation and exchange rate in Turkey



Source: Central Bank of the Republic of Turkey

- Practically all peer countries increased policy rates to combat inflation; standard approach
- Exemption: TUR often reluctant to raise policy rates, due to political interference
- Result in TUR: long-term problem with inflation, weak exchange rate
  - Inflation rate Jan-22: 48.7%
  - Deprecation in 2021: 43%

➢ **NBM applies best international practice to combat inflation**

➢ **This policy should be kept**

7. Conclusions

- Inflation in MDA is a serious issue, no question about it
- High policy rates to tighten liquidity do constrain economic growth in the short term, but they are necessary to reduce inflation
- This is clearly shown by international experience
- TUR approach to keep low policy rates despite high inflation has completely failed
- While combating inflation is mainly a task for the NBM, gov and parliament can implement measures to reduce the negative impact of inflation
- Fiscal policy:
  - Infrastructure projects
  - Protection of low-income households within a targeted approach
- At the same time, gov and parliament should avoid mistakes such as
  - Price controls; this would only worsen the business climate
  - Critique of monetary tightening: this does not solve, but aggravate the problem

About the German Economic Team

Financed by the Federal Ministry for Economic Affairs and Climate Action, the German Economic Team (GET) advises the governments of Ukraine, Belarus, Moldova, Kosovo, Armenia, Georgia and Uzbekistan on economic policy matters. Berlin Economics has been commissioned with the implementation of the consultancy.

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