

**Session II: Monetary and Exchange Rate Policy in Economies with  
Newly Independent Currencies: Lessons from Recent History**

**Mr. Leonid Talmaci  
Governor, National Bank of Moldova**

**CONTENTS**

1. Implementation of the anti-inflationary policy: requisites and results
2. Monetary policy: contents and instruments
  - 2.1 Essence of the monetary policy
  - 2.2 Instruments of the monetary policy
    - 2.2.1 Required reserves
    - 2.2.2 Interest rate
    - 2.2.3 Financing of the state budget deficit
    - 2.2.4 State securities
    - 2.2.5 National Bank's net foreign assets
    - 2.2.6 Dynamics of money aggregates
3. Foreign exchange policy
4. Banking supervision and regulation of banking activity

Conclusions

## 1. IMPLEMENTATION OF THE ANTI-INFLATIONARY POLICY: REQUISITES AND RESULTS

On 27 August 1991 the Republic of Moldova has proclaimed its independence. A few months before, on 4 June 1991, the National Bank of Moldova was set up on the basis of the Republican Office of the State Bank of the USSR. On 11 June 1991 the Parliament of the Republic adopted the Law on the State National Bank of Moldova and on the 12 June — the Law on banks and Banking Activity. These Laws have provided the legal basis for the NBM's activity and for the operation of the country's banking system. It was stated that "the National Bank of Moldova, as the sole issuing authority of the state, is responsible for the formulation and implementation in the Republic of Moldova of the monetary, credit, foreign exchange and banking supervision policies". The NBM was declared independent from the bodies of the state executive power and responsible only to the Parliament. Thus, all conditions for a successful implementation of the monetary, credit and foreign exchange policies with the view to achieving the main objective of the NBM — stability of prices and exchange rate, seemed to have been set.

Yet, neither in 1991, nor in 1992, nor in 1993 the objective was not attained. In 1991 prices raised twice, in 1992 — by almost 18 times and in 1993 — by 27 times. The exchange rate increased from 57 Rubles for 1 USD in December 1991 to 415 Rubles for 1 USD in December 1992, i.e. by more than 7.3 times. In 1993 the Ruble devaluated by 9 more times.

In 1991—1993 the adopted laws, decisions and measures on macroeconomic financial stability did not bring the expected results. The point is, that still belonging to the "Ruble zone", we were not able to guard our economy from unfavorable environment in the monetary, credit and foreign exchange sectors of the other Ruble states. In such a situation, the economic state of the Republic of Moldova was determined not only by the own economic policy, but mostly, by the processes, more often negative, developing in the "Ruble zone".

The implementation of a more effective economic policy required the monetary, credit and financial independence of Moldova. The introduction of the national currency was to be the first step to this independence. Yet ... we were quite aware that the very introduction of the national currency was not as important as the maintenance of its stability. This statement gives rise to a very serious issue — the correspondence between the target of the NBM's monetary policy on the one hand and the target of the overall economic stability — on the other hand. In fact, this is the issue about the contribution of the NBM and of the banking system to the overall economic stability of the country.

Our approach to the matter is very simple. The contribution of the National Bank of Moldova to the achievement of general economic

stability is the stability of the national currency. Our task is to ensure the economy with stable, from the value point of view, money, to make the investors, both foreign and local, be sure about their profit, in despite of inflation and devaluation.

On 29 November 1993 Moldova has introduced the national currency — the Moldovan Leu. Since then, that is four years and a half, the currency has been relatively stable. Let me bring some figures (see diagram 1, table 1). If in 1993 the inflation amounted to more than 2000%, in 1994 — only 104.6%, in 1995 — 23.8%, in 1996 — 15.1% and in 1997 — 11.2%. The target of the NBM's policy for 1998 is to maintain the inflation rate up to 7%. We consider this target quite real. Still, under current circumstances, when the market and the economy of Moldova are not balanced yet, "economic surprises" are possible. I mean here administrative interference in the process of prices setting, centralized influence on different tariffs, etc. Thus, for example, in 1997 the Government of Moldova adopted the decision on the increase of tariffs for communal services, heating and energy. As a result (see table 1), the inflation in June constituted 2%, as compared to May — only 0.6%. When the Parliament of Moldova suspended this governmental decision, the deflation in July constituted -1%. It is obvious that in conditions when the tariffs for communal services, heating and energy do not compensate production expenditures, we cannot stand against these tariffs' increase. Yet, such an increase should be done gradually, smoothly, without sudden rises and fluctuations. Anyway this is only one face of the problem. We need to perform the reorganization and the demonopolisation of the economy's relevant fields and sectors and to carry out general economic reforms.

The exchange rate of the MDL has stayed relatively stable since the currency introduction. Since December 1993 the MDL has devaluated by 21.3%; taking into consideration the inflation rate we can speak about the rise of the real exchange rate.

All facts stated above — the decrease of the inflation rate, the relative stability of the MDL — did not come from the blue. This is the result of the credit, monetary and foreign exchange policies conducted by the National Bank of Moldova.

Before going into details speaking about the policy, let me stop for a moment on one issue, without which the implementation of the monetary policy would have been impossible. This is the legislation and the independence of the National Bank of Moldova.

As stated, the Law on the State (National) Bank of Moldova and the Law on Banks and Banking Activity were adopted immediately after the formation of the National Bank of Moldova. During the implementation of economic reforms and of targets set before the NBM and the commercial banks of the republic, the banking legislation had to

be significantly modified. As a result, on 21 July 1995, the Parliament adopted two practically new laws — the Law on the National Bank of Moldova and the Law on Financial Institutions. As foreign experts say, these are ones of the most progressive laws on central banks and financial institutions in the CIS region. A great assistance in the formulation of these laws was provided by the IMF experts. It is due to them, that many of stipulations of the above mentioned laws fully correspond to international standards. The legislation states, that "the principle objective of the National Bank is to achieve and maintain the stability of the national currency", to formulate and to promote the state monetary and foreign exchange policies, to act as the bank of the state, the bank of banks, as the sole issuer of domestic currency, to license, supervise and regulate the activity of financial institutions, to hold and manage foreign exchange reserves of the Republic, etc.

It is very important that the Laws stipulate the independence of the NBM not only from the bodies of the state executive power, but also before the Parliament. It is stated only that the National Bank of Moldova is responsible to the Parliament. Yet, this stipulation is not to be absolutised. Many articles of the Law on the National Bank of Moldova state, that the NBM cooperates with the Government in pursuing its objectives, provides information as requested by economic and financial entities of the Government with respect to monetary and financial matters, assesses the economic and financial conditions of the state, describes and explains to the Parliament and the Government the monetary and foreign exchange policies for the next year.

Let me underline, that the independence of the National Bank is very important not only by its nature, i.e. this is not the end in itself. This independence is a must for the formulation and the implementation of independent monetary, credit and foreign exchange policies, for the definition of instruments and measures to achieve the NBM's objective — the stability of the national currency.

So, we have here, in Moldova, almost all the conditions for the implementation of effective monetary, credit and foreign exchange policies. The political independence of the country is achieved, an independent national currency is introduced, a new banking legislation is elaborated and approved by the Parliament, etc.

## 2. MONETARY POLICY: CONTENTS AND INSTRUMENTS

### 2.1 Essence of the monetary policy

What is the essence and the mechanism of the NBM's policy working out and implementation? The main objective of the National Bank is, as stated before, the stability of the national currency, more specifically — the relative stability of the general prices' level on the background of a relative low inflation rate and a relative stability of the exchange rate. I think, everybody knows the statement "the inflation is everywhere and everywhere a monetary phenomenon". Furthermore, it means, that, notwithstanding the reason for prices to jump, the inflation rise can be supported only by the increase of the money supply. Within this context, the target of inflation control comes to the regulation of the money supply increase, more specifically, to the correspondence between the money supply increase and the GDP dynamics (taking into account the foreign exchange reserves and the situation of the payments balance).

I should mention, that theoretically, the Central Bank does not have instruments to directly influence the volume and the dynamics of the money supply. This is achieved through regulation of reserve money or, in other words, of "reserve money". This situation can be explained as follows (slide 2). According to the quantity theory of money, Money Demand ( $M^D$ ) is directly proportional to the real production Volume ( $Y$ ) and the Prices' level ( $P$ ) and inversely proportional to the money Velocity ( $V$ ), i.e.:

$$M^D \equiv \frac{P \times Y}{V}; \quad (1.)$$

where:  $M^D$  — money demand  
P — prices' level  
Y — real production volume  
V — money velocity.

On the other hand, the Money Supply in circulation  $M^S$  is directly proportional to the multiplier ( $m$ ) and the volume of reserve money ( $B$ ), i.e.:

$$M^S \equiv m \times B, \quad (2.)$$

where:  $M^S$  — money supply  
m — multiplier  
B — monetary basis or reserve money.

The anti-inflationary policy should be directed towards the market balance, i.e.:

$$M^D = M^S \quad (3.)$$

Thus,

$$\frac{P \times Y}{V} = m \times B \quad (4.) \quad \text{or} \quad P = \frac{V \times m \times B}{Y} \quad (5.)$$

Making some modifications with the condition that  $V$ ,  $m$ ,  $Y$  are constant values, we have the following:

$$\frac{\Delta P}{P} = \frac{\Delta B}{B} \quad (6.),$$

where:  $\frac{\Delta P}{P}$  - inflation rate, and

$\frac{\Delta B}{B}$  - modification of the reserve money volume.

Of course, in reality, especially in transition economies, the money velocity, the multiplier and the production volume are not constant values. That is why this fact should be taken into consideration when determining the influence of reserve money modification on inflation dynamics.

On the other hand, proceeding from the NBM balance sheet, the reserve money ( $B^S$ ) can be calculated as follows:

$$B^S \equiv \text{NFA} + \text{NDA} \equiv \text{NFA} + \text{NCG} + \text{CB} + \text{OIN}, \quad (7.)$$

where: NFA - net foreign assets,  
 NDA - net domestic assets,  
 NCG - net claims on the government,  
 CB - credits to banks,  
 OIN - other items (net).

Here we came close to the factors with direct influence on the volume of reserve money and, ultimately, on the money supply and, finally, on the inflation level.

These are: - Net Foreign Assets;  
 - Net Claims on the Government;  
 - Credits to Banks.

The modifications of the multiplier, (see identity (2), slide 2), of the money velocity and of the production volume (see identity (1), slide 2) should be also taken into consideration and forecast. The reserves requirements or the norm of required reserves is to added too. These factors do not affect the volume of reserve money, but have an important role in the influence of monetary basis modifications on the money supply dynamics.

With the view to ensuring the stability of the national currency, it is the NBM's monetary policy that reserve money should be influenced through the regulation of net foreign assets, claims on the government, volume of credits to banks and required reserves.

Not having the possibility to demonstrate the process of the monetary policy implementation during the whole period following the introduction of the Moldovan Leu, let me bring a number of examples when these instruments were used the most. But before this, I would like to mention the following. Till the beginning of 1993 the National bank of Moldova did not have any foreign assets. Due to this, in order to carry out the vested general functions – the stability of the general prices' level and of the exchange rate – in conditions of continuous economic recession and deficit of the balance of payments, the necessity to set up foreign reserves in a sufficient volume became very urgent. Now these reserves exceed 350 mil USD. Second, the organizational aspects of the monetary policy elaboration and realization. The highest management authority of the National Bank of Moldova is the Council of Administration of the NBM. This Council has the power to establish the monetary policy, its main parameters and instruments for implementation. The Bank has set also a Monetary Committee, headed by the First Vice Governor of the NBM and convened each Tuesday. This Committee receives proposals from the Departments and Directions of the NBM on the basis of which establishes the monetary, credit and foreign exchange policies for the current week, till the end of the month and of the quarter and ultimately submit the documents to the Council of Administration for approval. The Monetary Committee examines also all the matters regarding the functioning of both primary and secondary state securities markets. Besides, the Bank holds credit auctions twice per month and state securities auctions every week. The volumes of these auctions are determined by the Monetary Committee's meetings and approved by the Council of Administration. Credit auctions and state securities auctions are held in fully correspondence with the market principles and exclude any administrative interference.

## 2.2. Instruments of the monetary policy

### 2.2.1. Required Reserves

One of the instruments used by the National Bank in the carrying out of its monetary policy is required reserves. As mentioned before, they do not influence directly the reserve money and the money supply. This is achieved through the influence on the commercial banks' possibilities to perform different operations, especially credit and foreign exchange ones. The norm of required reserves was changed in January 1994, when it increased from 20% to 28%. This was the result of the active acquisition by the commercial banks of the foreign exchange after the introduction of the MDL either for their portfolios, or on the clients' order. Because of this, the insignificant foreign exchange reserves of the NBM were put at stake. The increase of required reserves contributed to the decrease of the commercial banks' possibilities and ultimately reduced the speculated foreign exchange demand.

In June 1994 required reserves decreased to 20% following the season increase of credit demand. The NBM found itself before a dilemma: to carry out the credit emission that could have caused the inflation raise, or to decrease required reserves. The Bank decided to take the second variant. Realizing, that required reserves is in a certain way a kind of tax on the activity of commercial banks and using new, more efficient and operative financial instruments and following the IMF recommendations, the NBM continued further to decrease the required reserves to 12% and then — to 8%. Now required reserves constitute 8% of the amount of means attracted by commercial banks, irrespective of their term. Besides, the NBM remunerates, in accordance with the Law on the National Bank of Moldova, the portion of required reserves balances that exceeds 5% of the liabilities on which required reserves are based. This norm is valid also for deposits in foreign exchange.

### 2.2.2. Interest Rate

Another instrument of the NBM's monetary policy is the refinancing rate. This rate expresses the cost of money and play an important role in the demand for NBM's credits; thus, it influences reserves money and the money supply. Yet, the NBM does not set the refinancing rate in a centralized manner. The rate is influenced by the volume of credit auctions, that serve as main instrument for the distribution of the NBM's credits among the commercial banks. In 1997 the NBM distributed through credit auctions 80% of its credits. This figure speaks for the market character of the monetary and credit policies carried out by the NBM. The essence of the interest rate as instrument of the monetary and credit policies is as follows: in conditions when the inflationary processes deepen and the real inflation rate is



higher than the one expected at the beginning of the year, the volume of credits put at auction by the NBM reduces. On the other hand, if the demand for the NBM's credits rises and the inflation corresponds to the monetary policy objectives, the NBM may increase the number of credit auctions.

So, an efficient management of reserve money and money supply assumes a correct determination of credit auctions' volume. This is done by the Monetary Committee by confronting the real inflation level with the programmed one taking into consideration the credit reimbursement. Yet, in conditions of inflation growth, this instrument should be used with great caution, as the required in this case decrease of credit auctions' volume shall result in the increase of the interest rate, that would be a bad signal for the economy.

Since the introduction of the MDL the refinancing rate has been steadily, although with different tempos, decreasing (table 3, diagram 3). As you can see on the slide, starting with the second half of 1994, this decrease was quite smooth. The high interest rate in the first half of 1994 is explained by the average monthly inflation level of 33.4% during September 1993 - February 1994, i.e. there were high inflationary expectations. On the other hand, due to the increase of required reserves, the commercial banks felt a certain shortage of financial resources for the economy crediting, while the demand for credits was at a high level. In February 1994 the refinancing rate reached the highest level - 377%. It is significant, that from February 1994 to June 1995 the interest rate decreased from 377% to 27%, while from July 1995 to December 1997 - from 24.4% to 16%. Considering the inflation dynamics stated before, we can speak about a certain balance on the monetary market of Moldova starting from 1995. Due to favorable economic conditions as a result of this balance and to measures undertaken by the Government in 1997 the production recession was stopped (the real GDP increased by 1.3%, the rural economy volume - by 11%, the industrial recession was stopped, etc.).

Credit auctions are an important, but not the sole instrument of the NBM's credit policy. The objective of this policy is the satisfaction of temporary demand for money by commercial banks. Recently the NBM started to use other instruments, like: the Lombard credit, REPO and operations with state securities. Credit auctions are expected to be replaced in the near future by these monetary policy instruments that are more efficient and flexible.

### 2.2.3. Financing of the state budget deficit

The financing of the state budget deficit by the National Bank of Moldova brings to the increase of reserve money and ultimately, to the increase of money supply, so, this is an inflationary factor. During the

year, the NBM was crediting the state management bodies, proceeding first of all, from the Law on the Budget, and second, from the monetary policy of the NBM for the current year. Since 1994 the volume of the NBM's means for the state budget deficit financing has decreased. Since 1996 the NBM has not granted direct credits to the Ministry of Finance and has financed it through acquisition of state securities. The NBM's monetary policy for 1998 does not provide the state budget financing. The budget shall be covered with proceeds from state securities realization, commercial banks' resources and foreign loans. During the year the NBM could not grant credits to the Ministry of Finance in a volume less than the one provided by the Law on the Budget and the NBM's policy for the current year, even if the real inflation exceeded the expected level. In such cases, the NBM compensates the negative influence of state expenditures on prices' dynamics and on the exchange rate by using instruments of its monetary policy, i.e. the NBM performs the sterilization of the money supply surplus.

The budget deficit entails not only the financing of the social sector's current expenditures. To a considerable extent it is conditioned by the expenses of the production sector, that depend both on objective and subjective factors. The NBM's participation in the crediting of the state budget deficit contributes to the maintenance of the non-effective structure of the Moldovan economy, while the NBM's objective is to contribute to the structural reorganization, to the assistance of efficient enterprises and sectors of the national economy. Such a contribution can be made only through market mechanisms of credit and financial resources distribution and not in a centralized manner.

#### 2.2.4. State Securities

In 1997 the NBM included in the arsenal of its instruments for monetary and credit regulation the open market operations, that differ from the other instruments on the flexibility, power of influence and high marketing.

Open market operations are performed on the NBM's initiative and, unlike required reserves, not on a compulsory basis, but in conditions of banks' voluntary participation. These operations may be performed as often as needed and in any volume. Due to this, they are an useful method to stabilize the reserve money and to sterilize the money supply surplus.

Open market operations may take any form of state securities acquisition and selling or conclusion of state securities selling and repurchase agreements (REPO).

Since the beginning of these operations performance (August 1997), the NBM was holding mainly selling auctions of SS from its own portfolio and operations for SS selling with further repurchase (REPO).

One deterrent to the implementation of open market operations in 1997 was the transaction tax in the amount of 0.3% of the transaction's volume (to be paid by the purchaser), as this tax constituted a significant figure in the short term T-Bills profit.

Since January 1998 this tax has been abolished. Realizing the importance of open market operations for the influence on the interest rate and on the liquidity management, the NBM is planning to gradually replace till the end of 1998 the credit auctions with open market operations.

In order to ensure the implementation of open market operations, the National Bank is working now on the required infrastructure.

The most important part of this work is the collaboration with the Ministry of Finance on the formation of a liquid and efficient state securities market.

The NBM acts as fiscal agent of the state in the placement of dematerialized state securities. In this position, using the auction system, the NBM has significantly increased the SS selling through different market methods and covered the whole spectrum of the monetary market (T-Bills with the maturity of 28, 91, 182, 364 days).

Until the beginning of 1998 the issued and circulating dematerialized state securities amounted to 673 mil MDL, that is by 563 mil MDL, or by 6 times more than at the beginning of 1996. The effective profitability of 91-days T-Bills decreased from 51.7% to 28.17% (data as at the first auction of 1996 and at the first auction of 1998) and came close to the inflation level, the refinancing rate and the interbank credit rate.

#### 2.2.5. NBM's Net Foreign Assets

Another instrument of the NBM's monetary policy, besides required reserves, interest rate, operations with state securities, state budget deficit crediting, is the purchase-selling of foreign exchange. In conditions when the real inflation exceeds the expected one, the NBM sells foreign exchange and, in such a way, sterilizes the money supply surplus. On the other hand, when the net foreign assets are smaller than the foreseen by the program, the NBM replenishes its foreign exchange reserves by purchasing foreign exchange. In reality this picture is more complicated. It can happen, the levels of inflation, money supply and

reserve money are higher than the foreseen ones while the volume of net foreign assets is smaller than the one provided by the monetary policy. In this case, the National Bank uses other instruments, like state securities selling.

#### 2.2.6. Monetary Aggregates Dynamics

The use of monetary policy instruments has a quantitative reflection in the dynamics of monetary aggregates. Considering real data of such indices like reserve money, money supply, money in circulation, total volume of deposits, both in foreign and domestic currencies, we can say that during 1993 — 1997 these indices significantly increased. As compared to 1993, the growth of reserve money constituted 468%, of money supply — 550%, of money in circulation — 814%, of deposits in MDL — 435%, of deposits in foreign exchange — 344%; the total volume of deposits increased by 4.14 times (see table 4). The GDP increased by 4.6 times. Thus, the main monetary aggregate's increase exceeded the GDP growth. Yet, the inflation level decreased from 2700% in 1993 to 11.2% in 1997. This decrease is due to the fact that the MDL stability is secured not only with the production coverage, but also with foreign exchange reserves. To confirm this, let me remind you about the situation in Moscow in the autumn of 1995, known as "the black Tuesday". At that time, following the sudden rise of the USD on the Russian forex market, in Moldova started a speculative demand for foreign exchange that resulted in the decrease of the exchange rate of the MDL and the increase of the inflation rate. With the view to bringing the MDL exchange rate and the inflation down to the previous levels, the NBM had to resort to forex interventions in a total ultimate amount of 12 mil USD. As a result, we managed in a short time to hold up the speculative demand and to restore the MDL exchange rate and the inflation level.

In conclusion: first, the fact that the increase of money supply exceeds the GDP growth means that the monetization of the Moldovan economy is coming up. If in 1994 the monetization level constituted 14.3%, in 1997 it was 18.9% (see table 5). Of course it is early to compare ourselves with developed countries, but the most important is that the monetary and foreign exchange policies carried out in Moldova accompany with money supply growth on the background of a relatively stable prices' level and exchange rate, that result in favorable conditions for the economic growth. Second, statements about intensification of our economy's dollarization are unfounded. During the whole period from 1993 to 1997 (except 1994 and 1995) the increase of deposits in MDL exceeded the increase of deposits in foreign exchange. If at the end of 1993 foreign exchange reserves constituted 15.2% of the money supply, in December 1997 — 9.5%. It means that the public and the economic

agents put trust in the national currency and ultimately in the NBM's policy.

The comparison of credits to commercial banks with credits to economy is another revealing factor. In 1994 the weight of NBM's credits in the total commercial banks' provision of crediting of the economy constituted 41.1%, while in 1997 — only 18.2%. This difference proves the strengthening of the banking system financial situation, the reducing need by commercial banks for NBM's credits and these banks' capacity to credit the economic agents from their own resources.

Let me stop now on the issue of cash in circulation. On 29 November 1993 when the national currency was introduced, we put into circulation an amount of 75 mil MDL. Now this amount comes to 1 bln MDL. The liquidity coefficient that represents the ratio between the cash in circulation and the deposits' volume, exceeds 1, i.e. cash constitutes more than half of the money supply. In a balanced market economy the economic agents and the natural persons may choose the forms of deposits and payment by themselves. The law in effect here is the so called "price of alternative". The economic agents, for example, decide by themselves how to keep the money — on a bank account or in cash and how to make the payments — in cash or by transfer. In our case, and I think in other countries in transition too, the significant weight of cash in circulation is determined by other factors. This is the largely used "barter" with the view to hiding the income from taxation. In such a situation, the Government of the Republic of Moldova together with the National Bank of Moldova works out and implements different measures to regulate the cash in circulation in order to reduce the cash volume, to improve the manners of payment and to strengthen the payment discipline.

### 3. THE FOREIGN EXCHANGE POLICY

The objective of the foreign exchange policy is to satisfy, in conditions of a stable exchange rate, the demand for foreign exchange by state management authorities and economic agents for them to repay their foreign liabilities and by natural persons. So, the objective provides a balanced foreign exchange market, i.e. the correlation between foreign exchange demand and supply.

As already mentioned, at the moment of the national currency introduction, the amount of the NBM's foreign exchange reserves was insignificant — about 40 mil USD.

In order to achieve the main objective — the stability of the national currency, the National Bank of Moldova had to replenish its foreign exchange reserves up to the necessary level (to cover the 3-months import).

Since the introduction of the national currency (see table 6, diagram 6), the level of gross foreign exchange reserves has increased to 365 mil USD. This amount covers the volume of 3-months import. One significant feature is the "—" sign of the NBM's net foreign assets. It means, the National Bank can pay off its whole debt to foreign creditors and shall have after this an amount of foreign exchange reserves.

Now the foreign exchange market includes the Interbank Foreign Currency Exchange, the Interbank foreign exchange market and independent exchange offices.

In Moldova there is an opinion, that the NBM's policy aimed at the stability of the national currency, put the Moldovan exporters in the position of hostages and has a negative influence on the country's export potential. Many managers of export companies consider that the NBM's foreign exchange policy should be based on exporters' interests.

According to them, in the majority of European countries the exchange rate of the national currency has a decreasing tendency as against the USD and this is a natural phenomenon for countries in transition. The fact that Moldova has a deficit of the balance of payments is, yet, forgotten.

Under such circumstances exporters are interested in a low exchange rate of the MDL, while importers — in a low exchange rate of the USD. However, the procedure of exchange rate determination excludes the centralized fixing. The rate is set on a everyday basis at the sessions of Interbank Foreign Currency Exchange at the balance point between foreign exchange demand and supply.

The fact, that the MDL exchange rate is relatively stable (see diagram 7) shows the balance reached on the forex market between the foreign exchange demand and supply. The NBM's target is not to allow sudden oscillations of the MDL exchange rate.

Criticizing the foreign exchange policy of the National Bank, exporters consider that the exchange rate of the Moldovan currency should be pegged to the inflation rate. In 1997 the exchange rate of the MDL practically did not change, the inflation constituted 11.2%. If the exchange rate would have been pegged to the inflation rate, it would have constituted at the end of 1997 more than 5 MDL for 1 USD. As a result, prices for import and the deficit of the balance of payments would have significantly increased, and the repayment of the state foreign debt

would have been negatively influenced. The ultimate increase of the production cost would have resulted in a further prices' rise.

Thus, strengthening the exchange rate of the national currency, the National Bank accomplishes important economic strategic tasks. The NBM maintains the regime of a floating rate, that, as a matter of fact, is determined by the demand and supply on the forex market. Applying indirect instruments, through interventions, the NBM does not allow sudden oscillations of the rate.

Taking into consideration that the NBM's share on the forex market constitutes only 4% of total transactions, selling and purchasing, we can say that the forex market is practically self-regulated.

Following the success in financial stabilization, the Republic of Moldova accepted in July 1995 the provisions of Art. VIII, p. 2, 3 and 4 of IMF Articles of Agreement. It means, the Moldovan Leu is a free convertible currency and provides:

- minimization of national currency risk in conditions of its stability;
- no restrictions on current import-export operations;
- full access to foreign exchange, freedom to hold and intermediate foreign exchange;
- no surrender requirements on export proceeds;
- no restriction on repatriation of profits for foreign investors;
- no restrictions on interest payments of foreign loans.

Economic agents have now the freedom to buy and sell foreign exchange for all payments related to current account operations and for some other capital account operations.

Non-residents that hold foreign exchange on the accounts of authorized banks of the Republic of Moldova are allowed to freely transfer this foreign exchange abroad or to sell it on the local market through the authorized banks. Sources of foreign exchange are not subject to examination. Non-residents that hold on their accounts MDL gained from operations with residents of the Republic of Moldova can convert it to any other foreign exchange and repatriate the means. Regarding the import agreements payment, importers have full access to foreign exchange and can perform payments upon receiving the goods or in advance, provided that the goods import be secured within 90 days.

The state foreign exchange reserves and the stability of the national currency, the recognition of the MDL as a free convertible currency created a favorable environment for foreign investors. The overall direct investments during 1993 - 1997 increased by more than 11 times and amounted to 152.5 mil USD.

An attractive signal for foreign investors is the legal basis for foreign investments. The Moldovan legislation allows the use of indirect investment mechanisms, like securities or investment funds.

Enterprises may belong 100% to owners. Companies with limited liability or joint stock companies may belong to or be managed by non-residents. At the moment we have the following laws that regulate foreign investments:

- Law on Foreign Economic Activity;
- Law on Foreign Investments;
- Law on Enterprises and Business Undertakings;
- Law on Property;
- Law on Joint Stock Companies;
- Law on Joint Ventures;
- Regulation on Foreign Exchange Regulation in the Republic of Moldova.

The foreign stake in the statutory fund of 1263 joint ventures currently activating on the territory of Moldova amount to more than 120 mil USD.

The repatriation of foreign exchange profit is one of the important aspects of the foreign exchange policy.

The balance on the forex market shows the balance between the foreign exchange demand and supply. Repatriation serves as one source of income. Economic agents should repatriate their export proceeds within 180 days from the customs declaration date. The control on the repatriation of money means on the accounts of economic agents is done in accordance with the Decree of the President of the Republic of Moldova and with normative acts of the Government and of the National Bank of Moldova adopted during 1995-1996.

The repatriation of export proceeds amounted:

- in 1994 - to 89.9% out of the export amount;



- in 1995 - to 81.9% out of the export amount;
- in 1996 - to 89.3% out of the export amount;
- in the first half of 1997 - to 91% out of the export amount.

The amount of penal sanctions to the state budget constituted 0.6% out of the non-repatriated amount.

To further development the control on export proceeds' repatriation, the NBM took part in the elaboration of the Law on Regulation of Repatriation of Export Proceeds in form of money means, goods or services, approved by the Parliament of the Republic of Moldova on 29 January 1998.

#### 4. BANKING SUPERVISION AND REGULATION OF BANKING ACTIVITY

The stability of the national currency secured by the anti-inflationary monetary and foreign exchange policies constitutes the main objective of the NBM. Another important target of the NBM's activity is a stable financial situation of commercial banks and of the banking system of the country.

To achieve this, concrete steps are taken to implement the Basle principles on Banking Supervision.

The introduction of these principles started at the end of 1995 with the modification of the banking legislation. As stated before, the new legislation provides modern elements aimed to the strengthening of the NBM's role in the holding of the monetary, credit and foreign exchange markets with the view to ensuring favorable conditions for the economic growth and stability of the financial sector.

At the same time, the new legislation grants equal conditions to all financial institutions and secures their legal, operational, financial and administrative independence.

Since 1996 private or legal entities have been required to be issued banking licenses and permissions to hold significant share in the capital of banks. These requirements secure the capital investing in commercial banks only by those economic agents that have sufficient proper means and are stable from the financial point of view.

According to the requirements for banks' managers, management functions could be performed only by persons of recognized integrity and professional experience.

The banks' financial stability directly depends on their capital investment. Hence, the NBM's policy is aimed to the stimulation of a constant growth of the commercial banks' capital. Beginning with 01.01.98 all the commercial banks should have the minimal required capital in the amount of 8 mil MDL or 1260 thou SDR (1696 thou USD) and the capital sufficiency of 8%.

To prevent the credit risk, the NBM worked out a number of requirements that provide restrictions on granting of large credits, credits to affiliated persons, credits to the banks' employees. The banks are required to set up risk funds to cover losses from credit granting.

Requirements on banks' current and long term liquidity secure the banks' capacity to pay off their liabilities in due time.

Requirements on banks' liquidity allows to determine the short and long term coverage of the Banks' liabilities with liquid assets.

The stability of the banks' financial state greatly depends on the information used by the bank's administration for the performance of financial and banking activity. This information is basic also for banking supervision and regulation of the banking sector. Following the implementation of new accounting principles, the NBM improved the system of banks' financial reporting. This system fully satisfies the shareholders', depositors', creditors' and public's demand for information.

Now the NBM is preparing the implementation of a number of prudential regulations in the fields of internal control, of shares in the capital of managed entities, etc.

Employees of the NBM engaged in the banking supervision and of commercial banks engaged in the risk management benefit from training courses. New methods of analysis and of accounting report are in process of elaboration.

## CONCLUSIONS

The immensity obviously cannot be bounded. All the aspects and directions of the NBM's activity are connected, in a way or another, with the monetary policy. The main characteristics of this policy in conditions of a transition economy is the aim towards the stability of the national currency and the use of indirect market instruments to achieve this target. To correctly determine the objective and to work out the relevant instruments is not enough for a successful implementation of the anti-inflationary policy. This process requires a legislative basis and

independence before the state legislative and executive bodies. The new accounting and reporting forms are important, too. We have already attained some success, but lots remain to be done. We realize that the achievement and the long term financial macroeconomic stability (the relative stability of the general level of prices and of the exchange rate) is not possible with the use of monetary means only. Economic reforms are to be activated, the structural reorganization and the reorganization of economy's sectors and branches are to be carried out, etc. In our point of view, the financial stability reached in Moldova gives all necessary possibilities and conditions for this.

*L. Tolmachev*

## Dynamics of inflation

Tab. 1

	1993	1994	1995	1996	1997
Jan	55.7	18.9	2.9	3.5	1.9
Feb	27.0	21.6	2.3	2.5	1.4
Mar	26.2	10.0	0.7	1.1	1.0
Q1	149.5	59.0	6.0	7.3	4.4
Apr	14.7	5.0	0.6	1.1	0.8
Mai	10.6	2.7	0.4	0.8	0.6
Jun	33.6	2.7	0.2	0.1	2.0
Q2	69.5	10.7	1.2	2.0	3.4
Jul	37.9	2.2	0.2	0.1	-1.0
Aug	23.2	-0.1	0.2	-0.3	-0.8
Sep	39.3	2.5	2.6	1.5	1.2
Q3	136.7	4.7	3.0	1.3	-0.6
Oct	43.5	4.2	2.7	1.6	0.9
Nov	22.7	3.5	6.0	1.4	1.1
Dec	59.2	2.9	2.9	0.8	1.5
Q4	180.3	11.0	12.0	3.8	3.5
Annual	2702.2	104.6	23.8	15.1	11.2

Slide 2

$$M^D \equiv \frac{P \times y}{V} \quad (1.)$$

$$M^S \equiv m \times B \quad (2.)$$

$$M^D = M^S \quad (3.)$$

$$\frac{P \times y}{V} = m \times B \quad (4.)$$

$$P = \frac{V \times m \times B}{y} \quad (5.)$$

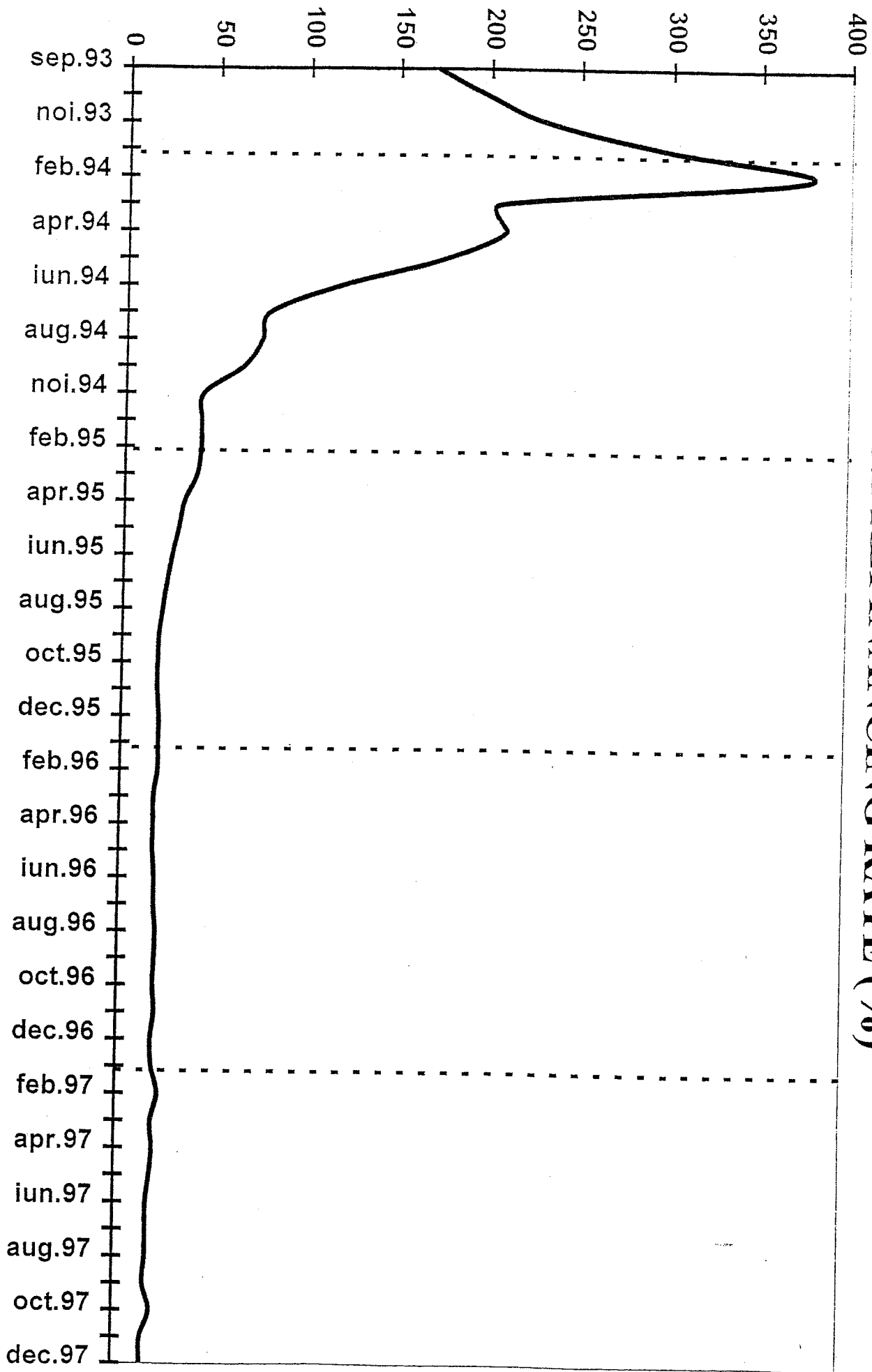
$$\frac{\Delta P}{P} = \frac{\Delta B}{B} \quad (6.)$$

$$B^S \equiv NFA + NDA \equiv NFA + NCG + CB + OIN \quad (7.)$$

## AVERAGE REFINANCING RATE (%)

Tab. 3

	1994	1995	1996	1997
January	298.5	42.0	21.0	20.0
February	377.0	42.0	21.0	23.5
March	205.0	40.0	19.0	20.2
April	209.0	33.3	19.0	21.0
May	174.8	30.4	19.0	20.0
June	118.0	27.0	20.0	18.0
July	79.0	24.4	20.0	18.0
August	75.0	22.3	21.0	18.0
September	65.0	20.4	20.8	17.0
October	65.0	20.0	20.3	20.7
November	43.0	20.0	21.0	16.0
December	42.0	21.0	19.5	16.0



**AVERAGE REFINANCING RATE (%)**

*Moldova*

# Dynamics of Monetary Aggregates (mln. USD)

TAB. 4

	1993	1997	Increase of lei equivalent (%)	Increase of dollar equivalent (%)
<b>Reserve Money</b>	<b>65.1</b>	<b>240.4</b>	<b>463.3</b>	<b>369.1</b>
Currency in circulation	32.1	208.1	814.1	648.5
<b>Broad Money</b>	<b>93.9</b>	<b>411.7</b>	<b>550.6</b>	<b>438.6</b>
Deposits in national currency	47.5	164.3	434.6	346.2
Deposits in foreign currency	14.3	39.2	344.2	274.2
Deposits (total)	61.8	203.6	413.7	329.5
Gross Domestic Product	594.2	2175.6	459.6	366.1
Monetization	15.8	18.9		
Dollarization	15.2	9.5		



# Monetization

TAB. 5

	1994	1995	1996	1997
GDP (nominal, mln \$)	1236.5	1697.3	1935.5	2178.6
Broad Money (mln. \$)	176.4	276.3	307.1	411.6
Monetization (%)	14.3	16.3	15.9	18.9

**MOLDOVA**

**Foreign Reserves in mln. USD**

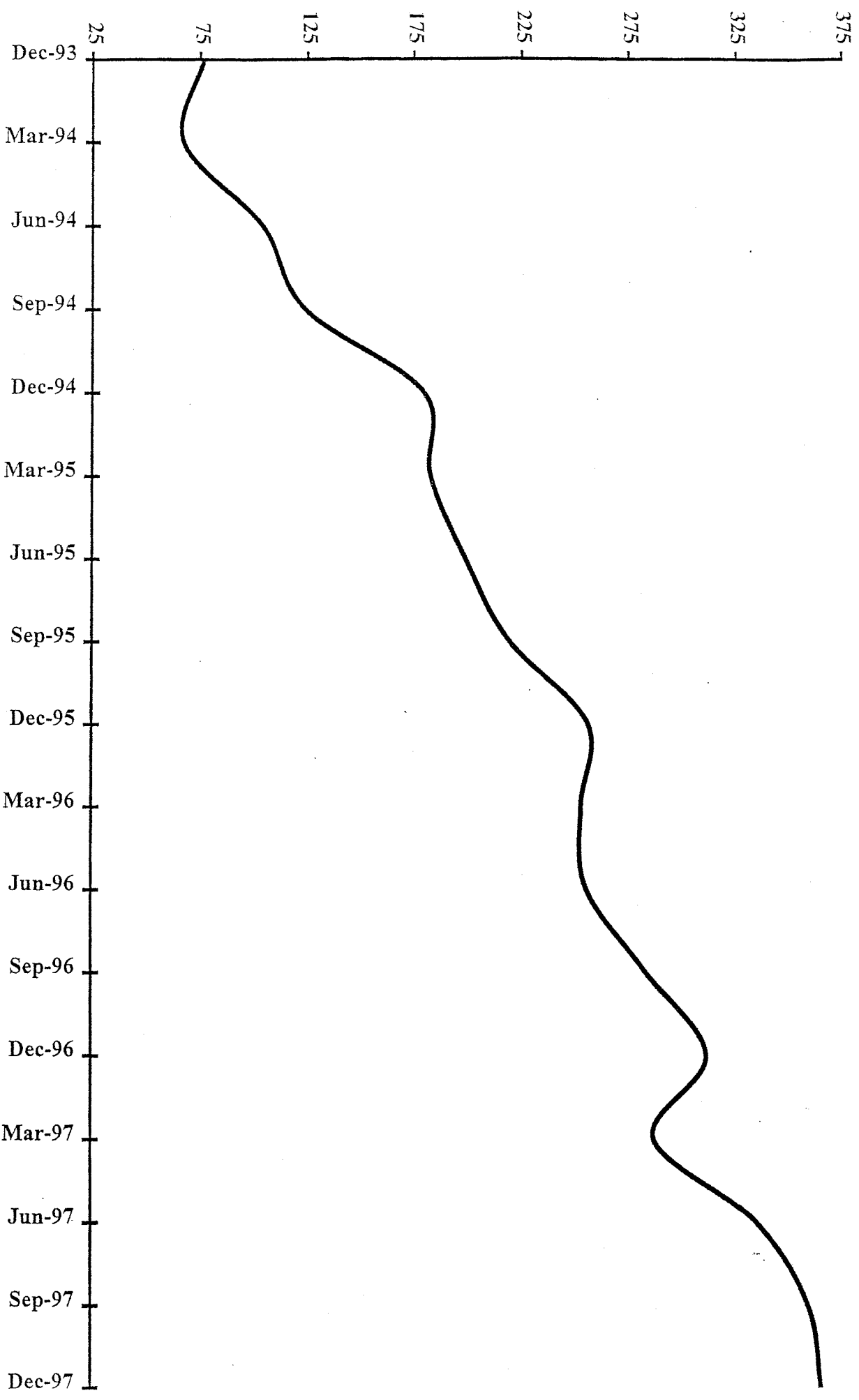
Tab. 6

	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>
<b>Q1</b>	67.1	183	253.4	287.5
<b>Q2</b>	104.1	199.1	255.7	335.3
<b>Q3</b>	124.2	219.5	283.7	359.6
<b>Q4</b>	179.8	256.5	311.9	365.7

Grat. 6

MOLDOVA

Foreign Reserves  
mln. USD



Grat. 7  
USD

# Exchange rate USD / MDL

MOLDOVA

