

2. National currency: successful story?

On November 29, 1998 the country will mark the 5th anniversary of the introduction of national currency – Moldovan leu. At this point, it is a good opportunity to assess what the achievements are and how it all went from the very beginning. Of course, the main conclusions remain to be drawn by the National Bank of Moldova (NBM), which played the major part in this act, but nevertheless, an attempt will be made here to draw such an analysis from an independent point of view.

So, was it a successful story? From one prospective the obvious answer is: yes, it was. It was the most important achievement of this country so far in terms of reforming its economy. But from another point of view the answer would be no, it wasn't, because this was practically the *only* achievement, along with failures and delays in implementing the reforms in the real sector of economy. And it has become clear for a year now, that, having a stable currency and a low inflation rate does not implicitly guarantee the success of the economic reforms in general, and the establishment of an attractive investment environment in particular. Moreover, it's not sustainable only by itself. And this was clearly proved by the destabilization in the foreign exchange market which happened in October-November 1998.

Yes, Moldova did have a stable leu and a low inflation, backed by a tight and successful monetary policy implemented by the central bank, but it could not last forever under a blockage of structural reforms in the economy, which generated a persistent huge budget deficit along with a high current account deficit and rapid accumulation of foreign debt. And it all blew up, under the stress of the financial crisis in Russia, at the beginning of November 1998 when it became obvious that such a stability can not be entirely at the expense of the central bank's foreign exchange reserves, which fell dramatically, since NBM was the only source of hard currency in the country. The National Bank obviously could not fulfill a wide range of objectives at the same time: trying to give a hand to the Government by providing direct loans for covering the budget deficit, providing hard currency for servicing the country's foreign debt, and ultimately selling foreign exchange to commercial banks through the Interbank Currency Exchange or directly.

What were the results in the end?

- The same huge budget deficit, generating increasing arrears to the social sphere, pensioners, and employees, with an inability of the state to maintain borrowing in the domestic market to cover current expenditures, including servicing of already issued securities.
- The same enormous trade and respectively current account deficits, resulting mainly from the dramatic decrease of exports caused by the Russian crisis, and at the same time hardly diminishing imports, caused among others by the less elastic energy component. No dynamism in non-CIS exports.
- The increasing huge burden of foreign debt, which demands more than \$200m both in 1998 and in 1999 needed for repayment of interest and principal.
- And... less than \$200m of central bank's foreign exchange reserves, dropping from the \$366m figure at the beginning of 1998.

This dead end must have been foreseen by the Government and Parliament, which should have been more active in implementing the economic reforms in the real sector, and not counting on miracles to happen. The country showed a bright start at the beginning of

1996, when successful monetary policy laid the much needed path for a more active continuation of reforms in the real economy. However, regretfully this chance was lost – no correct conclusions being made and no notable results achieved, in spite of significant additional external financing received also in 1997 resulted from sales of T-Bills, Eurobonds, MIG jets (apart from the World Bank disbursements).

And the NBM, on seeing that, should have tried to assess in a more realistic way the major dangers which were approaching and to ease the significant pressure on the exchange rate, which was backed by foreign exchange reserves. If the NBM limited its interventions in the foreign exchange market at the beginning of the 1998, when it became quite clear that the economic situation did not improve at all, then it would have managed to keep more than half of its net reserves. Of course, this decision would have led immediately to a depreciation of the national currency, as it happened in November, but it wouldn't have been so dramatic, and the impact of Russian crisis would have never been so harmful.

Now, let's see first how it all began... What was the monetary policy in Moldova before the introduction of the national currency? Actually, it was a very weak policy at that stance. But let us follow the historical background.

Ruble zone. Moldova, like other post-communist economies, joined the transition process having a high rate of inflation and massively decreasing production. After the surge in administered prices in early 1992, sharp price increases followed, leading to hyperinflation. Thus, the level of inflation was 1280% in 1992. In such environment the so needed budget deficit reduction was not done. Moreover, this deficit was financed by extensive money printing, as well as preferential centralized loans, which ultimately generated a non-productive consumption, since frequently the loans were absorbed by inefficient state enterprises which should have been either restructured or bankrupted.

The Government did not have the needed resolution (and experience) to perform the radical reforms, combining the transition to a market economy and the hyperinflationary environment. In these circumstances the country needed a stable monetary system, as well as sound banking system.

The currency stabilization environment had to be built up from scratch, since in 1991, when Moldova became an independent state, the foreign exchange and gold reserves were zero, and there was neither a foreign exchange market, nor even a central bank of the state.

As in all other former Soviet republics, in Moldova the Soviet ruble banknote was in circulation. The exchange rate of the ruble against major currencies was set at the auctions of the Moscow Interbank Currency Exchange. Referring to the banking system, only the republican central bank (a branch of the former USSR Gosbank) existed in Moldova, plus several state specialized banks for savings accumulation, budget servicing, agriculture and industry financing. They were receiving financing from the central bank for granting directed credits. Hard currency flows were subject to a strict control, the circulation of hard currencies was banned.

At the beginning of June 1991, Parliament approved the banking laws, which set the legal basis for the 2-tier banking system in Moldova – the central bank and commercial banks. On June 4, 1991 the National Bank of Moldova (NBM) was established. The NBM is independent from the Government and reports only to the Parliament. It is the sole money issuance authority of the state, drawing up and implementing monetary, credit, and foreign exchange policies, setting the regulatory framework for commercial banks and supervising their activity. The first five commercial banks were in fact the former state specialized banks afterwards privatized into joint-stock companies.

Because Moldova continued to remain in the ruble zone, the NBM could not protect the extremely vulnerable national economy from external shocks coming from neighboring countries. The economic policy was not efficient, being constantly altered by negative processes taking place in the former Soviet countries (FSU).

Introduction of coupon. When the inflation in neighboring republics exceeded the inflation in Moldova, and some of them started issuing localized currencies (such as Russian ruble in Russia, which took the place of the Soviet ruble), it has become clear that in order to avoid the total chaos and invasion of Soviet rubles from the entire ruble zone, the domestic market must have been somehow protected. Thus, on June 10, 1992 the NBM put in circulation Moldovan coupons (denomination of 50, 200 and 1000), which were equivalent to Soviet type rubles, and circulated in parallel. By end-June 1993 the coupons accounted for 80% of cash in circulation. The official exchange rate of coupon against US dollar remained the same as of ruble, fixed by Russia.

On July 24, 1998, the Central Bank of Russia decided to ban the circulation of Soviet bank notes on the territory of Russian Federation. The next day, NBM also decided to withdraw Soviet rubles from circulation in Moldova. But it took out only the bank notes with nominal values of more than 100, due to lack of small denominated coupons.

From August 9, 1993, the NBM started an independent weekly quotation of the Moldovan ruble against main currencies, including other rubles of the FSU area, using the cross-rate through the Russian ruble. This greatly contributed to shrinkage of the currency black market.

In the period January-November 1993, the exchange rate of Moldovan coupon against US dollar depreciated by more than nine times. The NBM supported this depreciation policy due to the negative trade balance between Moldova and Russia and import of inflation from the ruble zone.

In October 1993 the Moldovan Interbank Currency Exchange was founded by seven commercial banks as a closed joint stock company. The NBM had only a supervision role. Weekly trading auctions were held at this Bourse, and the exchange rate, was set at the equilibrium point of supply and demand, afterwards automatically becoming the NBM's reference rate for the next day. During the first several weeks of the Bourse's activity, the NBM was the only seller of hard currency in the market, but afterwards the situation became more balanced.

Significantly, after the first few weeks of the Bourse's existence, the exchange rates set at the Bourse, exchange bureaus and street markets have exhibited a high degree of convergence – the unification of exchange rates was achieved *de facto*. This suggests that the markets were broadly competitive.

An important aspect of the NBM's activity at that time was the commencing of collaboration with international financial organizations. On May 5, 1992 Moldova became a member of the EBRD, and on August 12, 1992 Moldova joined the IMF together with the IBRD and IDA. In February 1993 Moldova received its first loan from the IMF for financing the trade deficit (\$4.56m), and shortly after, in March 1993, the first loan from IBRD followed (\$26m) for critical imports.

At that time preparations for the introduction of the national currency started.

In spring 1993 when the fast collapse of Russian ruble became obvious, which was due primarily to expansionary monetary and fiscal policy and huge political instability, some countries of FSU decided to introduce national currencies. The first countries to introduce

currencies were the Baltic States, later, Kyrgyzstan and Moldova followed.

The biggest problem was the type of exchange regime that would be the most appropriate for Moldova. A fixed exchange rate or a pegged regime could at a larger extent expose the economy to shocks, besides the country had no gold of significant hard currency reserves. Thus, Moldova adopted a floating currency regime, or in more exact terms – a managed floating regime.

Introduction of leu. Moldova introduced its national currency, the Moldovan leu, on November 29, 1993. The conversion rate was set to 1 leu for 1000 Moldovan rubles or coupons.

The main task of this extremely important step was to insulate the Moldovan economy from the continued instability of the ruble area. The program of financial stabilization and structural reforms, adopted along with the introduction of the leu, was supported by the IMF through stand-by arrangements. This program, which covered the period through March 1995, was designed to secure a stable leu through the adoption of tight financial policies. The program also sought to advance economic restructuring through the liberalization of domestic and international trade and payments systems and the introduction of key structural reforms. In addition to IMF support, the program was supported by other bilateral and multilateral donors, including the World Bank.

Apart from financial aid, Moldova has received significant and very efficient technical assistance from IMF, continuously provided since 1992. Consequently, NBM became a modern central bank, with qualified staff and equipped according to Western standards. Considerable assistance was provided in the following fields: compilation of monetary statistics, reorganization of payments system, foreign exchange market mechanisms, balance of payments statistics, new accounting system, as well as banking supervision, legal and regulatory issues.

Monetary policy instruments. With the introduction of the Moldovan leu a tight monetary policy was implemented, which proved to be one of the most successful (along with the one of the Baltic States) in the FSU. Briefly it can be described as follows: each year NBM draws the monetary-credit program, based on monetary aggregates, including the following policy goals: Net Foreign Assets (foreign exchange reserves and liabilities), and Net Domestic Assets (ceilings on lending to the Government, to commercial banks, and banks' lending to the economy, as well as targets for cash in circulation, banks' reserves, and deposits). Among the applied instruments of monetary policy there are: reserve requirements, refinancing auctions, interventions in the foreign exchange market, and open market operations with securities. The last one is most recommended, but it started to be utilized only after August 1997, when the securities market was sufficiently developed.

Starting 1995, the budget deficit is covered mainly by issuance of state securities (Treasury bills and bonds) and not only by direct lending from the central bank. Thus, the needed budget funds are attracted from the financial market, avoiding additional money issuance by NBM. The volume of T-Bills to be issued annually is forecasted in the Budget Law, approved by the Parliament. The NBM is the state's fiscal agent which puts state securities in circulation through organizing auctions and negotiating directly with commercial banks, which act as dealers in the primary market. Foreign investors may participate at auctions without any restrictions.

On March 14, 1995, the NBM organized the first T-Bill auction (3-month maturity), where banks acted as buyers. Since August 1995, auctions started to be held once in two weeks according to the pre-published schedule. In 1995, the supply of state T-Bills was bigger than the demand, mainly due to the following reasons: Ministry of Finance was trying to sell

big amounts of securities, and secondly these securities were not known in the financial market. The volume of issued state securities had a continuous and fast increase, until in 1998 the Government realized that this “pyramidal” practice can not continue any longer, since the budget deficit has not been reduced, and moreover, the proceeds from newly issued bills and bonds did not even cover the amounts needed for securities redemption (1998 evolutions are described a bit further). During 1995-1997 interest rates on state securities gradually decreased following the reduction of inflation, but they were often high enough (also comparing with deposit rates) to allow commercial banks to use available funds for buying T-Bills and getting easy and guaranteed profits, instead of crediting the economy.

The main successes of the monetary policy were stabilization of the national currency and of the inflation rate.

Inflation. The rate of inflation decreased sharply in 1994. If in 1993 annual inflation was more than 2000%, then at the end of in 1994 it came down to 105%, in 1995 it was already 23.8% (IMF target - 15%), in 1996 – 15.1% (target 15%), in 1997 – 11.2% (target 10%). Referring to the average monthly rate of inflation: in 1993 it was 33.9%, in 1994 – 6.2%, in 1995 – 1.8%, in 1996 – 1.8% and in 1997 – 0.9%.

In Moldova, the inflation is characterized by two main factors: monetary factor (as in Western economies) and the non-monetary one. Generally speaking, if the financial market is balanced, than any changes in the monetary supply would affect the inflation without adequate economic variances. However, the Moldovan financial market has not become yet a balanced one. That is why, having an adequate volume of broad money, or an adequate monetary policy of the central bank, does not implicitly mean the total control over the inflation, since the inflation rate could go up influenced by indirect, non-monetary factors, such as administrative increases in prices and tariffs (housing services, transport, energy etc.), or some seasonal tendencies.

Credit allocation. Before 1993 the central bank was providing directed and centralized loans in the amounts requested by the Government. Since August 1993, when the first refinancing auction took place, the main type of credit allocation were credit auctions held at the NBM, where only banks which fulfilled NBM’s requirements could take part in. The approved policy guidelines for 1994 specified that 80% of the central bank’s credit (and for 1995 – 90%) must go through credit auctions (the remaining part was distributed according to Parliament decisions), and these conditions were fulfilled, though few believed back in 1992 that the economy could do well without preferential loans. But it indeed managed well. Market method of granting loans to banks at the auctions proved substantially more efficient. The refinancing rate was equal to the interest rate set at the auctions according to the supply and demand.

In 1994 NBM’s preferential credits (direct loans at low interest rate granted to some economic agents, mainly state enterprises) have been phased out. However, the Government itself continued to provide state guarantees for commercial banks’ loans to some economic agents. On the other hand, NBM continued to provide direct loans to the Ministry of Finance, however, starting with the issuance of state T-Bills in 1995, these credits are granted by the NBM exclusively against state’s T-Bills. The NBM and Ministry of Finance have been working out the possibility of converting old (from 1992) NBM’s loans to Government into state securities, but no securitization of this debt was effected so far, and it’s only being continuously prolonged.

The annual refinancing rate established at credit auctions increased significantly through late 1993 reaching a peak of 377 percent in February 1994. Then, as inflation declined, the auction rate dropped to yearly 42% by end-1994, reducing further to 21% by end-1995. The decrease of inflation rate has had a positive effect on NBM refinancing rate, which beginning with January 1994 became positive in real terms. During 1996 the refinancing rate fluctuated insignificantly around 19-21%, going down to 16% by end-1997.

Real refinancing rate rose significantly in 1994 and peaked by mid-1994 (which brought the first symptoms of suffocating economy and urged NBM to start a decrease in interest rates). Real interest rates in the banking system always remained quite high. Among reasons for this are, on the one hand, high systemic risk, driven by the weakness of court and legal environment (for instance lack of legal basis for land collateral and mortgage loans), and on the other hand, lack of serious competition between banks, as well as their undercapitalization.

The volume of credits auctioned was determined so as to achieve targeted levels of the central bank's NDA, taking into account indicative targets for reserve money and broad money. These targets are consistent with performance criteria under arrangements with the IMF.

The refinancing rate set at the credit auctions has been the key reference rate of NBM. Since August 1997 a new instrument started to be applied – the Lombard facility. The Lombard rate was determined at the level of interest rate on 28-day state securities plus a constant margin (5% or higher). In September 1997 NBM approved the regulations on open market operations – Repo agreements, i.e. selling of state securities with their further repurchase at a specific date at an agreed price. Commercial banks act as primary dealers in these operations.

Monetary aggregates. Reserve money and the money supply increased in 1994 by 128% and 116%, respectively, compared with 320% and 393% in 1993. Tight financial conditions also resulted in a decline in the growth of bank deposits, which increased by 77% in 1994 compared to 212% in 1993. The share of foreign currency deposits in total deposits declined to about 10% at the end of 1994, down from 15 percent at the end of 1993. This reflected an increase in confidence in the leu (supported by the stable exchange rate and the rapid decline in inflation) and the increasing reliance on foreign currency deposits to finance current transactions rather than as a store of value.

During 1995 monetary supply (M_3) increased by 65.2%, because of the increase of cash in circulation (M_0) by 85%. Cash constituted more than 50% of the monetary supply. Deposits in foreign exchange went up by 84%, while deposits in lei – by 38%. Total deposits amounted to 140m lei, or more than \$30m.

In 1996 monetary supply grew by 12.8%. Cash in circulation and sight deposits (M_1) constituted 65.5%, showing a 2.3% decrease over previous year. The volume of time deposits and foreign exchange deposits (quasy money) grew up respectively, reaching a share of 34.5% of M_3 .

During 1997 broad money increased by 34%. It happened mainly due to the growth of cash in circulation by 33%, which in 1996 was by 14.4%. Deposits constituted already 49.4% of the broad money, and the biggest share of them was in national currency, which actually proved the confidence of households and economic agents in leu, and its stability.

The National Bank, as the central bank, sets commercial banks' reserve requirement according to the implemented monetary policy. A more aggressive utilization of this instrument took place in 1994. Till February 1, 1994 mandatory reserves for sight deposits was equal to 20% of the total attracted funds, while for the time deposits the requirement was lower (15% and less). Then, in order to limit the money in circulation, NBM raised the

reserve requirement up to 28%. And from June 1, 1994, seeing that the level of inflation has decreased, NBM lowered the reserve requirement back to 20%. From December 16, 1994 NBM set a unique reserve requirement for all deposits equal to 12%. From October 1, 1995 it was set at 8%. In 1996 NBM transposed the reserve requirement (8%) to the foreign exchange deposits. The situation changed dramatically in the last quarter of 1998, but this aspect will be analyzed in the "Latest developments" subsection below.

Exchange rate. The initial exchange rate of the leu was set at 3.85 lei per 1 US dollar. Further on, the official rate was fixed at the sessions of the Moldovan Interbank Currency Exchange. Official rate applies to foreign exchange transactions carried out by the NBM, including external debt service, and is used for accounting and tax valuation purposes.

From October 14, 1993, the fixing sessions of the Chişinău Bourse were held on a weekly basis, and starting December 10, 1993 they were held twice a week. Since January 1, 1994 – thrice a week. Already in 1995 the NBM introduced daily quoting (from February 1, 1995) of the USD, RUR, ROL and DEM.

Due to the fact that the lag between exchange rates in the cash and non-cash markets was expanding, in December 1993 the NBM made several interventions at the exchange bureaus, buying US dollars and after a while selling them back. Thus, the nominal exchange rate was at first even appreciating, reaching 3.665 lei per USD during 20-25 January 1994. Afterwards the rate started to slowly depreciate. Relatively high interventions were made by the NBM in 1994, mainly in the cash market. Because of panic among population, and increased demand for hard currency in spring 1994, the exchange bureaus raised sharply the exchange rate in April 1994, so that the NBM decided to make a massive intervention and sold around one million USD in cash (quite a lot for that time). Then, after a short stabilization, another hit followed, and NBM sold in May another 700 thousand dollars cash to the exchange bureaus. Interventions proved to be quite successful and the central bank afterwards bought the foreign exchange back, at a convenient rate. This was a good example of how the NBM stood the speculations in the foreign exchange market.

During 1993 the coupon depreciated by 900%, while already in 1994 the Moldovan leu depreciated against the US dollar only by 13%. Further on leu showed a remarkable stability, and the yearly nominal depreciation index was: 5.4% in 1995, 2.6% in 1996, and 0.23% in 1997. The stable exchange rate was used as a second anchor (apart from the tight monetary policy) for keeping the inflation in place. However, over a medium and long-term period, only one anchor, i.e. monetary policy, should be sufficient.

Along with the reduction of inflation, the Moldovan leu started to appreciate in real terms against the Russian ruble, Ukrainian karbovanets, US dollar and other currencies. Thus, the real exchange rate index indicated an appreciation of leu against US dollar by about 78% in 1994, by 16.6% in 1995, 12.1% in 1996, and 11% in 1997.

As it can be seen, in real terms there was a sharp appreciation of the leu over this period. Moreover, overvaluation of the leu, in the presence of huge and rising Balance of Payments disequilibrium (current account to GDP ratio was 15.8% in 1997), encouraged organized speculative drive against the leu. The nominal *effective* exchange rate showed in 1997 an appreciation of Moldovan leu by 36% against currencies of the main trading partners of Moldova – Russia, Ukraine, Belarus, Romania, Bulgaria, Germany and Italy. The real effective rate, which also takes into account the inflation in Moldova and the above countries, indicated an appreciation by 16%. This evolution of the national currency has generated many objections (especially in 1997) from the exporters' side, which claimed that an overvalued value of leu made Moldovan exported goods too expensive, thus deteriorating

their competitiveness. At the same time, it was believed that a devaluation of leu would cut the massive imports, especially of commodity goods. But, on the other hand, NBM claimed that the devaluation would not solve this problem, since almost one third of imports were energy resources. Besides, it was stressed that a depreciation would cause problems to the Government in terms of external debt service, and also would cause the reduction of households' real incomes.

Analyzing the path of the exchange rate during 1994-1997, it may be seen that there were some common tendencies generated by seasonal fluctuations of the supply and demand for hard currency in the forex market. They are explained by the seasonal character of Moldova's economy, which is strongly relying on the agriculture sector. In spring NBM usually sold hard currency due to the high demand from economic agents related to the procurement of fuel etc. needed for the sowing period. Then, later in the year, when the production is harvested and exported, there are inflows of hard currency sold in the market, and bought by the NBM for completing its reserves. Before the beginning of winter preparations are being made (energy imports) which contribute again to an increase in demand for foreign exchange etc.

During 1994-1997 NBM has been intervening on the foreign exchange market for attenuating sharp exchange rate fluctuations, according to the goals of the monetary policy. However, in spite of the relatively reduced scale of its interventions (with some exceptions), the NBM always had a notable psychological influence on the participants of the forex market. It is explained by the fact that, having significant foreign exchange reserves, NBM could virtually satisfy almost any demand on the small Moldova's currency market. Thus, the exchange rate was closely supervised by the central bank, while commercial banks and economic agents were monitoring NBM's interventions in the market, which could implicitly reshuffle the exchange rate, thus causing them losses.

Foreign exchange regime. The NBM has been gradually implementing a policy of foreign exchange market liberalization. Since 1992 positive changes in currency regulations emerged: till May 1992 mandatory sale of hard currency constituted 50% of the proceeds from production activity and 60% in case of intermediaries. Thereafter the surrender requirement has been gradually unified, accounting for 35% by end-1993. Moreover, while in 1993 exports proceeds have been sold to the NBM, starting January 1994 they are sold to commercial banks. Complying with the surrender requirement, till the end of 1993 economic entities sold \$11.4m which completed the NBM's foreign exchange reserves, that at the end of 1993 stood at \$77m. On January 17, 1994 NBM approved the new Regulation on Currency Control, which authorized buying of hard currency for current account operations. From November 15, 1994 the surrender requirement was cancelled, thus economic agents being able to freely dispose of their export earnings, kept with banks. This was a strong evidence of leu's stability.

The building up of reserves evolved further. Thus, at the end of 1994 gross reserves already reached \$180m, 1995 - \$256m, 1996 - \$314m. At end-1997 gross reserves reached - \$366m (covering 3.1 months of imports of goods and services), out of which \$132m represented net reserves. Increase of reserves was mainly due to NBM's interventions in the foreign exchange market (where there was a higher supply of foreign exchange, resulted from exports, foreign investments, and foreign loans), and also due to a successful management of the reserve portfolio done by central bank's dealers (placements on deposits with foreign banks, Repos, investments in US Treasury securities and others).

Rules of export-import of hard currency in Moldova have been simplified, while quite liberal regulations have been set regarding keeping hard currency on deposits with Moldovan banks. These actions led to a growing confidence in leu from population and economic entities. Consequently, the exchange rate of leu has stabilized, the volume of lei deposits with banks increased, while the “street” activities and black currency market phenomena have practically wiped out.

The above mentioned measures and results obtained served as a good reason for the NBM to accept on June 30, 1995 the Article VIII, sections 2, 3, 4 of the IMF Articles of Agreement. This represented *de jure* the convertibility of Moldovan leu for current account operations, and for some capital account operations. As a result, any resident or non-resident individual or legal entity have been allowed to exchange with no limits lei into hard currencies (and some non-convertible currencies, for instance of FSU countries) and *vice-versa*. Foreign investors were granted the right to freely repatriate capital to their country of origin. Any economic agent of Moldova can buy hard currency amounts for import operations, without limitations, through Moldovan commercial banks. Economic entities have been allowed, in cases when they received loans from abroad, registered at the NBM, to buy hard currency in the local market for servicing these loans. Residents, working abroad, can freely transfer their earnings to relatives in Moldova. However, individuals residents of Moldova are not allowed to transfer abroad the money from their hard currency accounts with local banks, with a few exceptions such as for medical care, studies and other.

The stability of the exchange rates of commercial banks was proving that the domestic foreign exchange market was stabilized due to the fact that commercial banks started to work independently in cash supplying. Moreover, it should be noted that since 1994 the exchange rates set by commercial banks for transfers and the rates set by the exchange bureaus for cash transactions did not differ much from the official rate. This meant that the foreign exchange market in Moldova was fairly developed, hard currency was widely accessible, and the situation had a sustainable stability.

Generally speaking, to the establishment and stabilization of Moldovan foreign exchange market contributed: instituting of the Interbank Currency Exchange, creation of the securities market, NBM's Clearing Center, as well as the activity of a large number of foreign exchange bureaus, which together with commercial banks, are providing currency exchange services in Moldova.

A particular importance for Moldova had the long-term financial assistance received from the IMF and World Bank during 1993-1997. In total IMF made available \$242m, through CCF, STF, Stand-by and EFF facilities - for balance of payments support, national currency support, and structural adjustment. The World Bank provided \$265m, for financing critical imports, export promotion, financing budget deficit, private sector development, and also structural adjustment. Moldova also received considerable loans from donor countries, European Community, and private banks.

However, in mid-1997 IMF stopped the disbursements under the Extended Fund Facility. One of the main reasons was the slow progress in curbing the fiscal deficit in 1997. Other important factors were over limit deficit financing from the central bank, as well as internal payments and external debt arrears. Missed IMF targets had a knock-out effect to World Bank funding and disbursements from SAL2 also ceased. Instead of reducing the deficit, the authorities (in absence of multilateral funding, and reluctance of NBM to extend unlimited credit to the Government) have increasingly resorted to private borrowing – launch of Moldovan Eurobonds and encouraging foreign investors to buy domestic T-Bills. This

ultimately led to the expansion of crisis in the financial sphere (because the budget deficit still has not been reduced), which was strongly catalyzed by the Russian crisis later in August 1998.

Latest evolutions in 1998. The situation on the Moldovan financial market during 1998 remained relatively stable, except for the period influenced by Russian financial crisis, which started at mid-August 1998. The Russian crisis along with serious undermining of Moldovan exports, had also a major negative impact on local financial market. The majority of foreign portfolio investors withdrew their capitals invested in State Treasury Bills (total foreign investments in state securities had reached around \$30m, i.e. one third of the total). At the same time, starting end-August people began converting their lei deposits with commercial banks into hard currency ones, some entirely withdrawing their funds from the banking system.

These actions were particularly driven by the events happened on “black Friday” – September 4, 1998 – when many exchange bureaus in Chişinău, supported by one commercial bank tried irresponsible speculative actions against the leu (under conditions of temporary shortage of cash hard currency in the market), raising the US dollar selling rate to 6-7 lei per 1 US\$. Moreover, they violated several regulations, changing the rates several times a day and fixing much higher spreads comparing to the 10% allowed ones. Energetic steps taken by the NBM, which helped commercial banks, selling them several millions of US dollars in cash on Saturday, plus inspections and massive withdrawal of licenses of exchange bureaus (along with tightening of buying-selling spread), helped to calm the situation, and starting Monday, September 7, the dollar selling rates have fallen back to 4.9 lei/\$.

At that time NBM decided to limit hard currency interventions, keeping them at lowest possible level, obviously driven by the decision to protect its diminishing FX reserves. This, in its turn kept the demand for dollars in the market. The NBM has been selling hard currency during all the sessions of the Interbank Currency Exchange in September-October, and the official exchange rate was firmly depreciating:

At October 8 the official exchange rate reached for the first time 5.00 lei per 1USD.

At October 29 the official exchange rate reached the level of 6.00 lei per 1USD.

At November 7 the official exchange rate reached the level of 7.01 lei per 1USD, and then leu continued to depreciate, approaching 10 lei/1USD by end-November.

The National Bank had an opportunity to consider the IMF warning, expressed on October 14, 1998 and stop selling hard currency in the interbank market. But NBM's management decided to make another attempt to stabilize the leu, using one of the pivots of monetary policy – mandatory reserves of commercial banks at the central bank. Thus, on October 14, 1998 NBM's Administrative Council adopted a decision to raise the reserve requirement from 8% to 25% starting October 25, which generated a lot of arguments (and a part of them quite sensible) against it, coming from commercial banks.

Obviously NBM counted on the fact that, lacking cash lei, the banks would start selling hard currency at the Interbank Bourse in order to get cash lei. The NBM's goal was to diminish banks' growing demand for hard currency, by diminishing their liquidity in national currency, and thus stabilizing Moldovan leu and stopping the decrease of official foreign exchange reserves. But it did not happen that way. A number of banks indeed started to accumulate the required reserves at the NBM, but till the end of October no bank managed to accomplish this task (the deadline being set for November 5, 1998).

Starting November 2, 1998 the NBM decided to temporary withdraw from selling hard currency at the Interbank Currency Exchange (also reducing the reserve requirement to 15%, though provided that 10% of banks' total assets must be in the form of state securities).

It was a long way to this wise decision, which should have been done already somewhere in the first quarter of 1998. Now, the official exchange rate is being set as a weighted average of rates of the banks' foreign exchange transactions. Thus, banks are put in the position to find all by themselves the equilibrium point of the supply and demand for hard currency in the market. And it seems that they manage to do the job. Banks even agreed between themselves to cancel the results of Bourse transactions if the exchange rate of leu falls beyond 10%.

Of course, central bank's decision to stop the interventions generated a considerable initial increase in the price of dollar because of the shortage of dollars which are not coming from the NBM reserves anymore. And the one transaction that took place on November 2 was a proof to this, though a pale one, since the volume of transaction was very insignificant, and the surprisingly high price of 10 lei per 1USD put the NBM *en garde*. Consequently, the results of the Bourse trading where canceled, and the official rate remained at the previous level of 6.40 lei/1USD. However, it was clear that the rate may well be at around 7-8 lei per 1USD at the initial stage, and later much will depend on the inflows of hard currency into the country, either in the form of foreign investment, or repatriation of currency as a result of export operations.

This higher nominal depreciation of Moldovan leu, along with very low level of inflation rate led to a depreciation in real terms, which happened for the first time since the introduction of the national currency. The real exchange rate index indicated in October 1998 a real depreciation of Moldovan leu against US dollar by about 15%, comparing to the level of December 1997 (calculated on monthly basis). This is believed to be a good evolution of the exchange rate, which exporters now should not be complying about. Will they be able to take advantage of this remains to be seen.

The influence of present leu depreciation on the prices remains to be calculated, but it is clear that the major impact it will have on imported goods, while the prices of domestic products most likely will not raise more than 30% (depending on the import component in their production). Besides, since the majority of households have incomes in lei, which will not change much, it is believed that this will keep the domestic inflation in check.

An interesting aspect relates to the domestic interest rates. In order to maintain the present deposits and even to attract others the banks will have now to increase substantially the interest rates on lei deposits, which should be correlated with the depreciation of leu. Nevertheless the dollarization of the banks' funds will continue, at least till a mere stabilization of the exchange rate.

An alarming trend represent massive sales of hard currency of the NBM at the Moldovan Interbank Foreign Currency Exchange in 1998. In previous years NBM's transactions at the Bourse had a seasonality evolution, while during the period January-October 1998 NBM just sold considerable amounts of hard currency – almost \$123m. Stubborn decision of the Bank's management to defend the leu at all costs (which actually have been quite high) resulted in the end in draining of all own foreign exchange reserves of the NBM, thus at the end of October its net reserves turned into a negative value, while the gross reserves dropped to less than \$200m from \$366m at the beginning of the year.

Another critical aspect within the context of the official foreign exchange reserves reduction is linked with the need to service external debt, which implies transfer of big amounts in hard currency for the repayment of principal and interest. In 1998 Moldova has to repay more than \$215m for foreign debt servicing (including almost \$70m paid by the NBM to IMF). And all this is happening under an aggravating factor such as the considerable current account deficit of the balance of payments.

Since the country did not receive any loans from IMF and World Bank for almost an year, the NBM had to finance out of its reserves the repayment of principal and interest for the loans received from international finance institutions, foreign banks and others. Moreover, there are \$30m waiting to be fully redeemed in 1998 – the first Moldova's private placement through Merrill Lynch, i.e. the Eurobond, which was issued in 1996 for two years with a possibility to be prolonged till 1999. Of course, after the Russian "lesson" no one is willing to prolong these securities anymore. Thus, Moldova must have tough negotiations regarding a possible restructuring of the Eurobond debt.

The last IMF mission that visited Moldova in November reached a provisional agreement with the Government and NBM on a new program of economic policies, which if approved by the IMF Executive Board and successfully implemented by Moldova, will lead to the disbursement of the next \$35m tranche of the EFF, thus re-opening financing from the World Bank and other donors and creditors, including debt rescheduling.

In 1998 inflation rate showed a significant shrink comparing to previous years. In March, June, July, August deflation was observed, thus bringing the cumulative level of inflation for the period January-October 1998 to only 0.97%. However, taking into account the recent price increases, it becomes clear that the projected figure of annual inflation of 7-10% (NBM target) will not be achieved, and inflation rate would probably be somewhere at 13%.

Referring to the deflation phenomenon observed in summer 1998 it should be mentioned that it has mainly a pure monetary nature: the cash in circulation has shrunk considerably during 1998 – by about ¼. This happened due to massive withdrawal of lei from the circulation resulted from sales of hard currency done by the NBM at the Bourse out of its foreign exchange reserves.

The evolution of broad money did not follow exactly the same path as cash in circulation did, due to the fluctuations in the deposits base, both in local currency and in US dollars. The confidence of economic agents and the population in banks remained high during first half of the year, though it was quite affected by Russian crisis in autumn. While during the first half of the year people preferred high yields ensured by lei deposits with the banks, in autumn they started largely converting them in hard currency deposits.

As of end-September 1998 broad money has diminished by 13.2% (i.e. by 254m lei) comparing to the end-1997, and reached 1668m lei. This decrease is largely due in September when it diminished by 259m lei. The reduction of the broad money was conditioned by the decrease of base money – cash in circulation reduced by 23% and banks' reserves - by 32%. Deposits in lei fell by 19% at end-September, comparing to end-1997, while foreign exchange deposits grew (in lei equivalent) by 57.2%. Continuous dollarization of the banks' deposits had taken place.

Government's internal (and external) debt was accumulating further. Ministry of Finance, using also NBM's short term loans, continued to redeem previously issued state securities. Starting with June 1998 the share of traded securities in the total offer has decreased dramatically – from 80% in May, to 56% in June, further dropping to the level of

about 30% in October (out of these securities sold in October, almost 80% were 7-day and 14-day securities, which were launched into circulation on September 8, 1998).

Consequently, the Ministry of Finance faced the problem of shortage of funds needed for redeeming already issued securities, and any attempt to sell more bills would have led immediately to a critical increase in interest rates, which already reached almost 40% right after the Russian crisis began (luckily, a dangerous increase in interest rates was avoided).

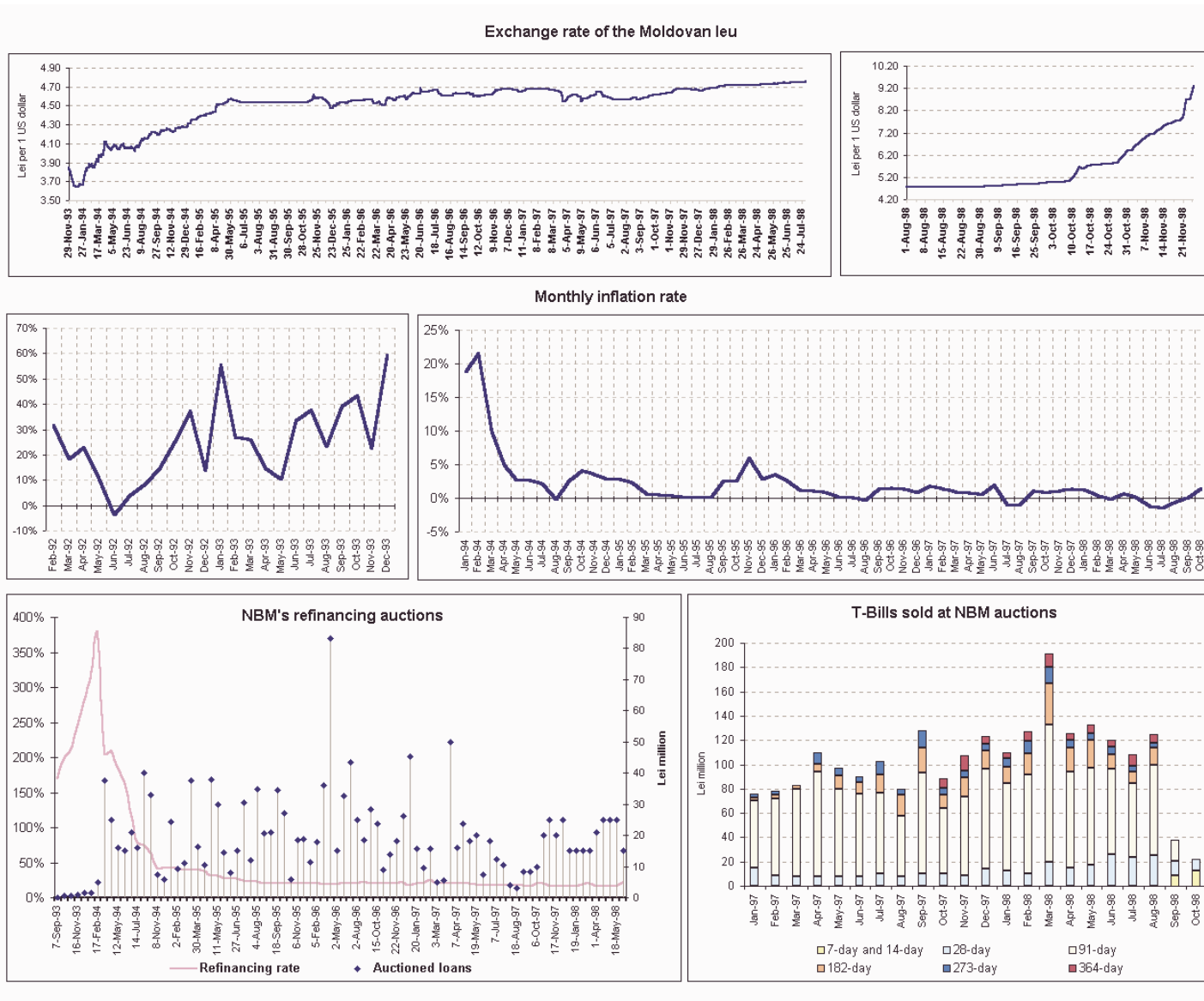
And the situation was expected to be such, because of heavy borrowing from the internal market done earlier by the Ministry of Finance for covering budget deficit. It became clear that increasing the amounts of t-bills sold on the primary market cannot last forever, and the first thing to blow could be the interest rate. What happened in Russia was from this prospective a good lesson for the Moldovan Government, showing that there is only one way to avoid the crisis – selling state securities only in the amounts needed for servicing the ones issued before, finding ways to reduce the budget deficit by cutting the spending, since finding sources for its financing has become impossible.

During the first half of 1998 nine refinancing auctions were held at which were sold 171m lei of credit resources, comparing to the 205m lei auctioned at the same period of last year. The NBM's annual refinancing rate has declined slowly to 16% in May 1998, however at the auction held on June 15, 1998 it jumped to 22.5%. This was a normal response under the circumstance of continuous increases of interest rates on T-Bills.

It should be mentioned, that this was the last refinancing auction, because afterwards these auctions were totally replaced by the Lombard facility and open market operations - Repo agreements. Consequently, large discrepancy between the refinancing rate and T-Bills interest rates was cleared. This discrepancy earlier allowed banks to buy cheap credit resources at credit auctions and then use them for buying T-Bills (i.e. financing state budget deficit), thus getting easy and risk-free profits.

During June-September 1998 banks received credits worth 202m lei (Repos – 84.4m lei, and Lombard facilities – 117.4m lei). Banks' overall credits to the economy topped at 1130m lei. The lowest volume of loans was granted in the month of September 1998 (55m lei). This happened because of the reduction of temporary available funds of commercial banks, which engaged in buying hard currency in the market, as well as reluctance of economic agents to take loans.

Overall, assessing the financial situation in Moldova, especially in the context of the crisis in Russia, it is clear that the internal stability on the financial market was maintained till November 1998 on the account of NBM's hard currency reserves, which supported the leu and eluded a default of the country in terms of foreign debt servicing. Among other factors which helped to avoid a major crisis after August 1998 were: a more or less stable banking system, relatively low level of country's private commercial debt, and relatively limited participation of foreign investors in buying state securities. Still, on the other hand, there were a number of persisting critical problems, such as: huge budget deficit, large current account deficit, high level of foreign debt, lack of external financing and others. Thus, in order to make the macroeconomic stability lasting it is obvious that the Government must optimize spending, reduce the imports, and foster the exports, by fully implementing long-awaited reforms in the real sector of the economy, backed by the international financial institutions.



2. National currency: successful story?

