NEWSLETTER
Issue No. 29 | May – June 2015

# Devaluation of the Moldovan Leu, but no overshooting

**In 2014 the Moldovan Leu devalued by 16.3% against the US dollar. As all major currencies in the region heavily depreciated, this adjustment was necessary to restore the international competitiveness of Moldovan products. But at the start of 2015, a combination of political instability and major problems in the banking sector led to a speculative attack on the currency, with the exchange rate peaking at almost 21 MDL/USD on 18 February.**

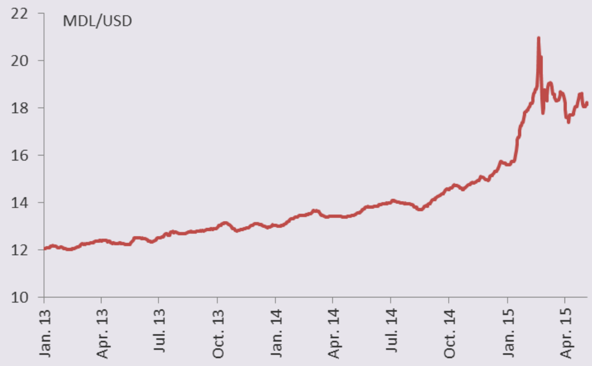
**The National Bank of Moldova reacted strongly to this pressure with a combination of instruments, mainly consisting of a very tight monetary policy and interventions at the foreign exchange market. So far, these measures were successful in avoiding a harmful overshooting of the currency, which would have further destabilised the banking sector and contributed to high inflation.**

**Despite this successful stabilisation, the situation is far from being calm, mainly because of the recent fraudulent schemes involving three commercial banks. In order to restore stability, the National Bank needs to improve banking regulation and supervision; this can only be achieved by increasing the independency of the National Bank.**

### Recent pressure on the Moldovan Leu

In 2013 the Moldovan Leu was rather stable; its value fluctuated mainly between 12-13 MDL/USD. During 2014 the currency devalued by 16.3% and the end of year value was 15.4 MDL/USD. However, at the start of 2015, the Leu came under severe pressure, with its value peaking at almost 21 MDL/USD on 18 February. Afterwards, the value stabilised at around 18 MDL/USD.

**Exchange rate developments**




*Source: National Bank of Moldova*

### Three main reasons for the pressure on the Leu

Three main developments contributed to this pressure: the depreciation of regional currencies, problems in the banking sector and political uncertainty. First, Moldova's main trading partners' currencies lost in value making a depreciation necessary to restore the economy's external competitiveness. However, the depreciation between mid-January and mid-February vis-à-vis the US dollar amounted to 31%; a pace that cannot be explained by fundamentals and is almost certainly related to a panic in the foreign exchange market.

The second cause is related to problems in the banking sector that culminated in November 2014 when the National Bank of Moldova (NBM) took control of three commercial banks under suspicion of major illegal lending activities. As these banks' assets constituted 32% of total bank assets, this caused a massive deterioration in banks' trust among each other and, more generally, in the stability of the value of the domestic currency. In the following weeks the interbank market collapsed and bank deposits denominated in the local currency started to be converted into foreign currency denominated deposits, thus creating a huge pressure on the Leu.

Third, the political uncertainty regarding the future alignment of the country surrounding the election in late November 2014 contributed to both the flight out of the currency and the banking sector's instability.

### The reaction by the National Bank

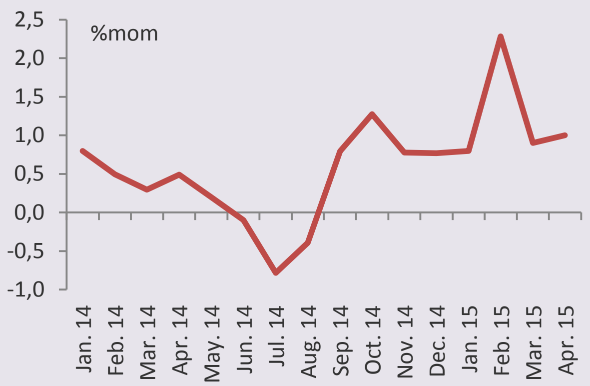
The NBM addressed the pressure with a number of drastic measures: It increased its main policy rate from 3.5% to 13.5% between 11 December 2014 to 17 February 2015. Furthermore, it increased reserve requirements on domestic currency deposits from 14% to 18% and the interest rate paid on those reserves from 0.5% to 10.5%. Last, it sold foreign currency reserves worth USD 900 m, which constituted one third of its total reserves.

The objective of these measures was clear: By raising the interest rate on domestic currency holdings and by raising the minimum reserve requirement for domestic currency deposits - while keeping reserve requirements on foreign currency deposits unchanged-, the central bank created demand for the

Leu at a time when agents took every chance to sell it. Furthermore, by selling large amounts of foreign currency, the NBM signalled to speculators that it would defend the value of the currency so that expectations of further slides in its value were not safe bets and would not become a self-fulfilling prophecy, thereby reducing speculative sales of Leu.

Another closely related objective of the restrictive monetary policy stance was the acceleration of inflation which currently violates the NBM's target rate of 5%. In an economy as open as the Moldovan one (imports to GDP ratio of 80%), a severe depreciation necessarily results in a jump in consumer prices through its effect on the price of imported goods. In fact, consumer price inflation hiked in February 2015.

**Consumer price inflation dynamics**




*Source: National Bureau of Statistics of Moldova*

### The impact of the NBM's reaction

The immediate impact was a quick stabilisation of the Leu, both in terms of its value against the US dollar and in terms of inflation. The exchange rate returned to its pre-crisis level since mid-February while the inflation rate declined strongly in March**.** Thus, the measures of the NBM, supported by the end of political uncertainty, so far worked. Most notably, by having taken control over liquidity in the domestic financial market, the NBM has a chance of permanently taking control of those financial markets which was lacking previously. The ability to influence market liquidity is a pre-requisite for influencing bank lending and thereby the business cycle and inflation. The restrictive policy, although designed to address a short-run market panic, can well be expected to increase the NBM's future credibility and its effectiveness in controlling inflation.

### Conclusions

The restrictive monetary policy in reaction to the market panic was so far successful in avoiding a de-stabilising overshooting of the currency. As with most economic measures, higher interests rates also have a negative side, they hurt business. However, the NBM needed to restore stability and only when it is sure this has been achieved it will be able to reduce interest rates again. Thus, the criticism of the current policy stance is in our view not well founded.

After this successful story regarding monetary and exchange rate policy, the NBM urgently needs to tackle the huge problems in the banking sector. A precondition for achieving any success in this field is the increase in the independency of the NBM regarding banking regulation and supervision.

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Note:
An extensive analysis of the subject can be found in the Policy Briefing PB/02/2015 "Devaluation of the Moldovan Leu, but no overshooting"
Download: www.get-moldova.de

**German Economic Team Moldova (GET Moldova)**
GET Moldova maintains a dialogue on economic policy with decision-makers of the Moldovan government since 2010. It is funded by the Federal Ministry of Economic Affairs and Energy (BMWi) within the framework of the successor of the TRANSFORM programme of the German government.

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