INFLATION REPORT

November 2023

Summary

Developments in inflation and its determinants

The annual CPI inflation rate remained on a downward path in Q3, falling to 8.83 percent in September (-1.42 percentage points versus June and -7.54 percentage points versus December 2022). In September, the indicator stood marginally (by 0.1 percentage points) below the projection in the previous *Inflation Report*. The decisive contribution to disinflation in Q3 was made by food prices (for both processed and unprocessed items), the dynamics of which reflected the relatively large crops domestically and internationally, as well as the entry into force of the measure to cap the mark-ups on basic food products. Stronger pressures on inflation compared to the latest *Report* came from fuels, with the Brent price following an upward path starting with July. In addition, administered prices also exerted an inflationary impact, with medicine prices surging in August. The average annual inflation rate, a measure with inherently higher persistence, declined further, with the indicator calculated based on the national methodology falling to 12.6 percent in September (from the 15.3 percent peak seen in March). The indicator calculated in accordance with the harmonised structure (HICP) saw a similar qualitative evolution, posting a correction to 11.4 percent after a 13.2 percent peak also recorded in March. The gap with the European average remained unchanged from the previous quarter, while Romania continued to fare better than most of the countries in the region in terms of average HICP inflation.

After the peak reached in February (15.06 percent), the annual adjusted CORE2 inflation rate followed a steady downward path, receding by 2.2 percentage points in July-September versus Q2 to 11.3 percent. Favourable developments came solely from the food segment, with the annual dynamics of the other core inflation components (non-food and market services prices) stepping up this time too. Looking at the underlying inflationary pressures, the output gap remained in the positive territory, although on a decrease during Q3, while, in turn, the import price inflation followed a downward path and short-term inflation expectations of all main categories of economic agents declined in Q3. Hence, the further upward trend in the annual growth rate of non-food prices seems to be rather the effect of hikes in prices of specific products in this basket. As for market services, apart from the significant influence exerted by the pick-up in the prices of telephony services, the pressure of wage costs has remained relevant, given that the average gross wage in the market services sector continued to report double-digit annual increases.

The annual dynamics of unit labour costs economy-wide picked up again in 2023 Q2 to reach 17.2 percent (+4.6 percentage points versus the previous quarter), on account of all economic sectors (industry, construction, services). The increase in compensation per employee stepped up further to 20.7 percent (+4 percentage points from 2023 Q1), thus leading to a larger gap with labour productivity growth rate (3 percent, -0.6 percentage points compared to the previous quarter) and, implicitly, to higher odds for inflationary pressures from labour costs to build up. In industry, the annual dynamics of unit wage costs remained particularly fast in 2023 Q2 (24.2 percent, visibly above those recorded in the other economic sectors), followed, however, by a slight moderation to 21.7 percent in July-August. Energy-intensive industries contributed to this deceleration, while sub-sectors such as furniture industry, the manufacture of other transport equipment, machinery and equipment, the manufacture of wood and light industry continued to see substantial rises in unit wage costs (between 25 percent and 55 percent in annual terms).

Monetary policy since the release of the previous *Inflation Report*

In its meeting of 7 August 2023, the NBR Board decided to keep the monetary policy rate at 7.00 percent per annum. The interest rates on standing facilities were also left unchanged at 6.00 percent per annum (the deposit facility rate) and at 8.00 percent per annum (the lending facility rate). In 2023 Q2, the annual inflation rate saw a considerably faster decrease, in line with expectations, falling from 14.53 percent in March to 10.25 percent in June. The decline continued to be driven mainly by energy and fuel price dynamics, which followed a steeper downtrend, under the impact of base effects, developments in crude oil prices and capping schemes for electricity and natural gas prices. At the same time, the annual adjusted CORE2 inflation rate continued to decrease gradually, reaching 13.5 percent in June from 14.6 percent in March amid stronger disinflationary base effects, falling prices of commodities, primarily agri-food items, and the downward adjustment of short-term inflation expectations. The impact of these factors surpassed the opposite influences that continued to come from the gradual pass-through of higher corporate costs, including wage costs, into consumer prices, as well as from the preserved profit margins, in the context of still robust consumer demand, but also from the hike in the prices of some imported goods. The updated forecast reconfirmed the outlook for a further fall in the annual inflation rate over the next two years, on a somewhat higher-than-previously-anticipated path only in the medium segment of the horizon.

Major uncertainties and risks were associated with the future fiscal and income policy stance, given the characteristics of the budget execution in the first six months of the year and the recent pay rises in the public sector, but also the fiscal package to be adopted in order to carry on the budget consolidation, whose final configuration was yet unknown. Moreover, sizeable uncertainties and risks to the outlook for economic activity, hence to medium-term inflation developments, continued to arise from the war in Ukraine and the associated sanctions, as well as from the absorption of EU funds, especially those under the Next Generation EU programme, which is conditional on fulfilling strict milestones and targets. This is essential for carrying out the necessary structural reforms, energy transition included, and for counterbalancing, at least in

part, the contractionary impact of supply-side shocks, compounded by the tightening of economic and financial conditions worldwide. The Fed's and the ECB's monetary policy decisions, as well as the stance of central banks in the region also continued to be relevant.

Subsequently, the annual inflation rate continued to decline in the first two months of 2023 Q3 overall, in line with forecasts, going down from 10.25 percent in June to 9.43 percent in August, amid the deceleration in the growth rate of food prices and the further drop in energy price dynamics, only partly counterbalanced, in terms of impact, by the hike in fuel and medicine prices. At the same time, the annual adjusted CORE2 inflation rate saw a faster decrease, falling slightly below the forecast to reach 12 percent in August from 13.5 percent in June. The developments were mainly ascribable to disinflationary base effects, declining prices of commodities, primarily agri-food items, and to the measure to cap the mark-ups on basic food products. However, they also reflected a mitigation of the opposite influences coming from the gradual pass-through of higher corporate costs, especially wage costs, into consumer prices, given the resilience of demand in certain segments, as well as from the movements in import prices. In turn, based on the data available at that time, economic growth sped up in 2023 Q2 to 0.9 percent from 0.5 percent in the previous three months (quarterly change), above forecasts, which made it likely for excess aggregate demand to stop its contractionary trend over that period. Concurrently, in annual terms however, GDP growth continued to decrease more than expected in Q2 to reach values close to 1 percent from 2.4 percent in the first three months of the year. The decline was driven by household consumption, whereas gross fixed capital formation saw a slight re-acceleration in its double-digit annual growth, and net exports exerted a larger expansionary impact, given the widening of the positive differential between the dynamics of exports of goods and services, in terms of volume, and those of imports. Against this background, trade deficit and current account deficit continued to narrow substantially in 2023 Q2 versus 2022 Q2.

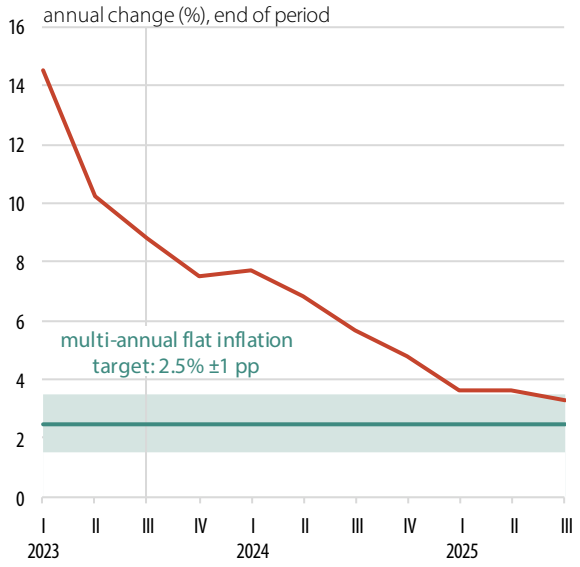
At the time of the NBR Board meeting of 5 October 2023, the latest assessments showed that the annual inflation rate would continue to fall until end-2023, in line with the latest medium-term forecast (August 2023), primarily under the influence of base effects and the downward corrections of some commodity prices, as well as amid the plentiful crop domestically and the temporary cap on the mark-ups on basic food products.

Based on the available data and assessments at that moment, as well as in light of the very elevated uncertainty, the NBR Board decided to keep the monetary policy rate at 7.00 percent per annum. The interest rates on standing facilities were also left unchanged at 6.00 percent per annum (the deposit facility rate) and at 8.00 percent per annum (the lending facility rate). Furthermore, the NBR Board decided to keep the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

Inflation outlook

The global economy continues its recovery from the pandemic shock and the multiple adverse effects of Russia's invasion of Ukraine. Nonetheless, both in the European Union and Romania, the pace of economic recovery has recently seen a slowdown, which is expected to persist in the immediately forthcoming period. Subsequent to the release of the August 2023 *Inflation Report*, the world's major central banks continued to tighten monetary conditions, with indirect effects on economic activity. Concurrently, the intensity of the war in Ukraine remained high, while new sources of risks, with many potential consequences, including in economic terms, emerged in the Middle East. Even though the correction trend of previous shocks remained the overall driver in commodity markets, the risk of reversals in recent favourable developments cannot be completely ruled out. For example, oil prices, an extremely sensitive barometer of the economic situation, have recently witnessed wide swings. As a result of all the above, volatility increased in global money and capital markets, fuelled also by investors' worsening risk appetite. While headline inflation in the euro area is foreseen to decline further in the future, benefiting from the easing of pressures on commodity costs and the gradual pass-through of monetary policy decisions, the pace of this correction appears to be slower than anticipated in the previous *Inflation Report*. Hence, as regards both economic activity and inflation, the overall picture is still beset with fragility and many uncertainties. At a time of multiple global crises that may induce far-reaching adverse consequences and, even more so, may have overlapping effects, the major sources of risks and uncertainties continue to be primarily of a geopolitical nature. Moreover, in a context marked by an across-the-board economic slowdown, the introduction on the domestic front of a significant fiscal consolidation package, whose effects on economic activity are also countercyclical, calls for caution in assessing all possible implications.

Inflation forecast



Source: NIS, NBR projection

In addition to the emerged strong tensions in the Middle East, the newness of which makes it difficult, however, for now to accurately assess their economic effects, the baseline scenario assumptions further mirror the persistent unfolding and adversity of the warfare in Ukraine. Despite the widespread, orderly decoupling of European countries from the imports of Russian energy resources ever since last year, the Middle East conflict has generated, at an incipient stage so far, some trend reversals in the price of gas traded in Europe. At the same time, there is the risk that the recent tensions will also affect the volume of Europe's gas imports from this area. In the event of such risks materialising, they could prevent a full recovery of the EU economies, including that of Romania, which are still rebounding from the losses triggered by the crises in the recent past.

In Romania, subsequent to the increased resilience of economic activity at end-2022, with annual GDP growth rates of more than 4 percent, the latest set of official statistical data points to a contraction of the economy in 2023 Q1, followed, however, by a rebound in Q2. However, annual GDP growth decelerated to 1 percent this quarter. Moreover, the most recent sectoral developments confirm the slowdown trend, so that for the latter half of the year the overall performance is seen to remain lower than that projected in the latest *Inflation Report*. These developments reflect the simultaneous moderation in European trading partners' economies, influenced by Germany's dynamics well below expectations, on the one hand, and the constraints from previous supply-side shocks, as well as from monetary policy normalisation, on the other hand. Conversely, in Romania, the effects of fiscal consolidation will be visible, however, during 2024 in particular. Given the unfavourable performance since the turn of the year, including the first-quarter temporary contraction in household consumption, GDP dynamics were reassessed to values close to 2 percent for 2023 as a whole. Linked with these developments, the positive output gap was revised downwards for 2023 Q1 and upwards for 2023 Q2, before nearing the value estimated in the August 2023 *Inflation Report* for the end of this year. Given the expected step-up in fiscal consolidation, the output gap is projected to adjust at a relatively fast tempo in 2024 and even to turn marginally negative at the end of next year.

Despite the overall lacklustre economic picture in 2023 H1, the dynamics of gross fixed capital formation continued its remarkable performance, recording annual rates of increase close to 10 percent, well above those of GDP. Over the medium term, the buoyant investment is seen boosting potential GDP growth as well, yet this is strictly conditional on the assumption that EU funds allocated to Romania will be absorbed at a sustained pace. As most of these funds target investment, gross fixed capital formation is anticipated to see both its dynamics and its contribution to economic growth exceed those of household consumption this year. However, as households recover and subsequently strengthen their purchasing power, *inter alia* as a result of ongoing disinflation, private consumption will become again the main driver of economic growth over the medium term. Aside from EU funds, foreign direct investment will remain another source of investment financing, after recording already notable dynamics in the past two years, which have persisted into 2023 as well. Nevertheless, in the medium term, direct investment will see a downward correction, reflecting, with a specific lag, both the slowing economic activity and investors' fundamental uncertainty, which further runs high in the present intricate global environment.

On the external front, the favourable developments in the current account deficit January through August 2023 reconfirm that, in this business cycle, the variable already peaked at 9.1 percent of GDP at the end of 2022. This year, the correction of the indicator, which was larger than anticipated in the previous *Report*, was chiefly spurred by a reversal of terms of trade, but also by the slowing economic activity, with a direct impact on the volume of imports of goods. In addition, the services component, the surplus of which persisted and even increased also during the pandemic period, enhanced further its favourable contribution this year, helping significantly to narrow the external deficit. Looking ahead, a consolidation of the trade deficit correction will be fostered by the future rebound of trading

partners' economies in Europe, as well as by the medium-term convergence of Romania's public deficit towards its committed targets under the excessive deficit procedure. Lower fiscal deficits, with a potential favourable impact also on the current account deficit, would also ensure a better composition of its financing from stable, non-debt-creating external sources. Conversely, addressing the persistent structural problems, which partly explain the still high current account deficit in Romania, including in a regional comparison, would imply the implementation of investment and structural adjustment programmes that benefit from large sources of financing from EU funds in the medium term.

The updated baseline scenario reconfirms the 7.5 percent forecast for the annual CPI inflation rate at end-2023. Looking at the breakdown, larger-than-expected food price corrections implied annual inflation rates that were revised downwards for the adjusted CORE2 and the VFE indices. At the same time, however, the recent surge in oil prices, as well as a number of unforeseen increases in medicine prices, caused an upward revision of the contribution of fuel prices and administered prices to inflation. Looking ahead, CPI inflation will stick to its downward path, with a temporary halt to this trend at the beginning of next year. At that time, VAT rate increases are to be implemented from 9 percent to 19 percent for sugary foods and from 5 percent to 19 percent for a number of recreational and sporting activities. Also as of 1 January 2024, the excise duty on fuels is assumed to return to a higher level, after it was capped to the minimum level Europe-wide in 2023. Specifically, the annual CPI inflation rate will temporarily grow to 7.7 percent in March 2024, before resuming its downward path to stand at 4.8 percent at end-2024 and 3.3 percent at the end of 2025 Q3, within the variation band of the target (2.5 percent ±1 percentage point). For the end of next year, the projected value is 0.4 percentage points higher than that shown in the previous *Report*, mainly as a result of the authorities' decision to raise a number of taxes and charges. In the absence of these increases, the annual CPI inflation rate would stand at 3.9 percent at end-2024, 0.1 percentage points below the indicator at constant taxes shown in the previous *Report*.

Both for the end of this year and further ahead, the adjusted CORE2 index will be the main driver of the annual headline inflation rate. Implicitly, the contribution of exogenous components to headline inflation will shrink significantly, benefiting from favourable base effects induced by the normalisation of global value chain functioning, which will entail a broad-based correction of commodity prices as well. The annual adjusted CORE 2 inflation will follow a steadily downward track, given the pronounced closing of the output gap, hence its shift into negative territory at end-2024, gradually lower inflation expectations and abating pressures from import prices. However, core inflation will outpace headline inflation throughout the projection interval, given the ongoing strong unit labour cost pressures (with expected double-digit annual growth rates in both 2023 and 2024). In this regard, relevant are the high wage increases in the private sector (driven by the skilled labour shortage, the announced hikes in the minimum wage, but also by a demonstration effect of public sector pay rises), on the one hand, and the expected slowdown in economic activity, thus depressing labour productivity, on the other hand. Specifically, the forecast of the annual adjusted CORE2 inflation rate was revised downwards for December 2023 to 9.1 percent (against 9.9 percent previously), amid the recent favourable developments

in food prices, and upwards for December 2024 to 5.2 percent (versus 5 percent previously), *inter alia* as a result of an additional estimated contribution of 0.3 percentage points to inflation coming from the hikes in taxes and charges to be implemented at the beginning of next year. In 2025, given the fading away of the effects of higher taxes and charges in 2024 and the more favourable dynamics of most of its underlying factors (primarily the output gap and import prices), adjusted CORE2 inflation is expected to re-enter the variation band of the target in 2025 Q3 (3.4 percent).

The NBR's monetary policy stance aims to bring the annual inflation rate back in line with the 2.5 percent ±1 percentage point flat target on a lasting basis, *inter alia* via the anchoring of inflation expectations over the medium term, in a manner conducive to achieving sustainable economic growth.

Since the previous *Inflation Report*, a number of risk factors from those identified have materialised, in particular the fiscal consolidation package enacted by the authorities. Concurrently, new risk sources have emerged, those associated with geopolitical tensions in the Middle East being perhaps the most relevant in terms of potential adverse effects. At this junction, the assessed balance of risks suggests possible upward deviations of inflation from its path in the baseline scenario.

Although the authorities have recently adopted a package of measures aimed at achieving medium-term fiscal sustainability, the current assessments, including those made by the authorities, suggest that these measures are insufficient for Romania to meet the deficit targets under the excessive deficit procedure. Moreover, the predictability and thus the efficiency of the entire fiscal adjustment process hinge on the authorities' transparency with regard to both the additional measures adopted over the short term and those that would allow fulfilling the targets beyond 2024. Specifically, high uncertainty stems from the absence so far of the first budget revision. Over the medium term, the risks relate to the mix of possible new fiscal consolidation measures imposed by the targets under the excessive deficit procedure and the expansionary measures, particularly relevant in 2024, given the busy electoral calendar. The composition of the set of additional measures that the authorities could envisage is important as well. Of these, the measures to raise taxes and charges would entail additional inflationary pressures as early as the first month of their implementation, causing CPI inflation to deviate from its path in the baseline scenario. Furthermore, the dosage and implementation timing of the fiscal measures are important due to their cumulative impact on economic activity, since it is preferable to have a balance between revenue-enhancing and cost-cutting measures. In the literature and international practice, a fiscal correction made primarily by compressing public expenditure is preferable, given the less restrictive effects on both inflation and economic activity. In particular, substantial uncertainties are associated with the new laws on pensions and wages in the public sector, which are also milestones for the fourth payment request under the National Recovery and Resilience Plan. In the specific case of Romania, which is still under the excessive deficit procedure, the correlation between the pace of fiscal consolidation and the amount of EU funds allocated is one of the issues recently reiterated by both the Romanian authorities and the officials of international institutions. In this vein,

high risks are associated with the possibility of failing to make full use of the available funds, leading to an incomplete implementation of structural reforms, but also of the investment programmes committed by Romania over the medium term.

Externally, the multifaceted effects, especially the economic ones, of the war in Ukraine remain a sizeable source of risks and uncertainty. Recently to these have added the geopolitical tensions in the Middle East. Until the completion of this *Report*, the economic effects of these disruptions have been contained. Moreover, given Romania's low trade exposure to both countries directly involved and those close to the warzone, direct effects on its economy of a possible protraction of disruptions are foreseen to remain moderate. Instead, it is the energy markets that could most quickly experience the effects of this conflict. Specifically, there is a higher likelihood of disruptions in the supply of oil and gas, particularly if the crisis affected production in Iran or Iraq. At the same time, this could generally put a strain on markets. Thus, the oil supply shock could dampen economic activity in energy-importing countries, but, generally, it would also dent the smooth functioning of the global economy. Apart from negatively influencing economic activity, higher energy prices would further complicate the disinflationary effort of central banks around the world, by extending the timeframe during which inflation would remain above the targets. Ultimately, this would also affect economic agents' perception as to when the imbalances would be corrected, and could thus lead them to display suboptimal economic behaviours.

Monetary policy decision

Given the outlook for a further decline in the annual inflation rate over the next two years, albeit on a higher path in 2024 than previously projected, yet slightly lower subsequently, and considering the associated risks and uncertainties, the NBR Board decided in its meeting of 8 November 2023 to keep the monetary policy rate at 7.00 percent. Moreover, it decided to leave unchanged the lending (Lombard) facility rate at 8.00 percent and the deposit facility rate at 6.00 percent. Furthermore, the NBR Board decided to keep the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.