NATIONAL BANK OF ROMANIA

INFLATION REPORT

May 2013

Year IX, No. 32
New Series

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N O T E

Some of the data are still provisional and will be updated as appropriate in the subsequent issues. Following the change in the base year from 2005 to 2010, historical data series have been recalculated for several statistical indicators released by the NIS (e.g. labour productivity, industrial producer prices, agricultural producer prices).

The source of statistical data used in charts and tables was mentioned only when they were provided by other institutions.

National Bank of Romania
25, Lipscani St., 030031 Bucharest – Romania
Phone: 40 21/312 43 75; fax: 40 21/314 97 52

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Foreword

In August 2005, the National Bank of Romania adopted a new monetary policy strategy, i.e. inflation targeting. This regime is based primarily on the anchoring of inflation expectations to the inflation target announced by the central bank and therefore on efficient communication with the public. Inflation Report is the main means of communication.

To this end, the National Bank of Romania revised both the structure and the frequency of Inflation Report which has become a quarterly publication in accordance with the frequency of the forecast cycle. Apart from the information on economic and monetary developments, and on the rationale behind the monetary policy decisions in the reviewed period, the quarterly report includes the NBR projection on inflation rate developments on an eight-quarter time horizon and the associated risks and uncertainties, as well as a section dedicated to monetary policy assessment.

The analysis in the Inflation Report is based upon the latest statistical data available at the date of drafting the paper, so that the reference periods of indicators herein may vary.

Inflation Report *was approved by the NBR Board in its meeting of 2 May 2013 and includes data available until 26 April 2013.*

All issues of this publication are available in hard copy, as well as on the NBR website (http://www.bnr.ro).

Abbreviations

ANRE	Romanian Energy Regulatory Authority
CPI	Consumer Price Index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
ESI	Economic Sentiment Indicator
EU	European Union
Eurostat	Statistical Office of the European Union
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
OPEC	Organization of the Petroleum Exporting Countries
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
VFE	vegetables, fruit, eggs
1W	one week
1M	one month
3M	3 months
6M	6 months
12M	12 months

Contents

SUMMARY

Developments in inflation and its determinants

At end-2013 Q1, the annual CPI inflation rate stood at 5.25 percent, still above the target band set at a flat 2.5 percent ±1 percentage point as of 2013. Although it was 0.3 percentage points higher than at end-2012, the 12-month CPI inflation rate deviated in March by merely 0.06 percentage points from the NBR's forecast in the February Inflation Report.

As anticipated in the previous Inflation Reports, the temporary, modest acceleration in the annual growth rate of consumer prices in 2013 Q1 was triggered by supply-side factors. The main adverse effects stemmed from the electricity price hike in January, the pick-up in excise duties owing to the change in the reference exchange rate used for their calculation, and from the short-lived rise in the international crude oil prices in January and February. Their impact on the annual CPI inflation rate was mitigated by the favourable base effects associated with the dynamics of volatile food prices (VFE[1]) and fuel prices.

Furthermore, the increase in CPI inflation in Q1 was slowed down by the annual adjusted CORE2 inflation rate[2] declining 0.2 percentage points from end-2012 to 3 percent. The return of core inflation to a downtrend was due to: the effect on import prices and market services prices of the appreciating leu against the euro, the gradual fading-out of the impact of the poor agricultural crops in the previous year on processed food prices, and the persistent negative output gap in Q1, with the above-mentioned factors having gradual favourable effects on inflation expectations.

January through February 2013, unit labour costs in industry went marginally down in annual terms, after having risen for seven quarters in a row. Behind the moderation of their annual change stood the slower growth of the average gross wage and the faster labour productivity dynamics posted by this sector in the first two months of the year. The sustainability of this trend change and its becoming broadly based across the economy are of the essence for the consolidation of the prospects for the inflation rate to return inside the target band over the medium term.

Monetary policy since the release of the previous Inflation Report

In its meeting on 5 February 2013, the NBR Board decided to leave the monetary policy rate unchanged at 5.25 percent per annum. The updated macroeconomic forecast anticipated the annual inflation rate returning to the upper bound of the target-band at end-2013, after a temporary acceleration in the first half of the year, chiefly as a result of significant adjustments in administered prices. The main risks associated with the new forecast referred to lingering uncertainties surrounding the developments in the external environment, carrying the potential to enhance capital flow volatility, and, domestically, to the persistence of structural rigidities across the Romanian economy, possible mismatches of wage dynamics with labour productivity dynamics, as well as to the growth rates of volatile prices and administered prices. The NBR Board's decisions were aimed at effectively anchoring inflation expectations and consolidating the prospects for the annual inflation rate to return inside the target band in the medium run in parallel with the gradual recovery of lending to the Romanian private sector.

1 Vegetables, fruit and eggs.

2 This core inflation measure excludes from the overall CPI a number of prices on which monetary policy (via aggregate demand management) has limited or no influence: administered prices, volatile prices (of vegetables, fruit, eggs and fuels), tobacco product and alcohol prices.

The statistical data released subsequent to the monetary policy decision adopted on 5 February 2013 showed the resumption of disinflation in February, after a temporary acceleration in consumer price growth in January 2013. This pointed to further favourable prospects for the annual inflation rate to return inside the target band by end-2013. However, one of the risks signalled in the February Inflation Report materialised into an increased volatility of capital flows triggered by resurgent euro area tensions stymieing investors' risk appetite. In addition, the other risk sources identified in the mentioned Report continued to be relevant. In its consistent attempt to carefully calibrate the monetary policy instruments with a view to firmly anchoring inflation expectations, ensuring price stability in the medium run under financial stability conditions, and reducing the unfavourable impact of external and domestic factors on economic recovery, the NBR Board decided in its meeting on 28 March 2013 to maintain the monetary policy rate unchanged at 5.25 percent per annum.

Inflation outlook

The forecast envisages the annual CPI inflation rate running above the ±1 percentage point variation band around the central target (set at 2.5 percent as from 2013) until 2013 Q2 and subsequently returning within the target band, where it is expected to remain until the end of the projection interval.

In 2012, real GDP saw a modest increase of 0.7 percent, after having grown at a swifter pace of 2.2 percent a year earlier. For 2013 as a whole, the GDP dynamics are projected to be somewhat higher than in 2012, spurred by domestic demand components in particular. At the same time, the balanceofpayments current account surplus recorded in January-February 2013, driven largely by the substantial cut in the goods and services trade deficit, and the expected persistence of such developments over the next months pave the way for more favourable year-on-year net export values than the levels projected in the previous Inflation Report. However, conditional on the anticipated gradual economic recovery of Romania's main trade partners, net exports are expected to further make a negative contribution to the GDP growth this year, but of a significantly lower magnitude than in 2012. As a result, the balanceofpayments current account deficit to nominal GDP ratio in both 2013 and 2014 is envisaged to post relatively lower levels than in 2012. Hence, from the current perspective, no significant corrective pressure on the leu exchange rate is expected until the projection horizon. Throughout the forecast interval, the negative output gap was revised to levels entailing relatively weaker-than-previously-projected disinflationary pressures, as a result *inter alia* of the new historical national accounts data released by the NIS. The strength of these pressures is nevertheless anticipated to abate slowly over the medium term, implying the persistence of a negative output gap at the projection horizon.

The baseline scenario of the current projection places the annual CPI inflation rate at 3.2 percent at end-2013, 0.3 percentage points below the February Inflation Report projection, and at 3.3 percent at end-2014, 0.1 percentage points above the previously-forecasted level.

The inflation forecast revisions for end-2013 and end-2014 entail reassessments of the contributions from the price dynamics of the main consumer basket items. Thus, compared to the previous round, over the entire reference interval, the contributions from fuel prices are expected to be lower, those from prices of tobacco products and alcohol are anticipated to be higher, while the contributions from administered prices have been revised only marginally upwards. In addition, the baseline scenario assumes, for 2013, a relatively more favourable impact of prices of volatile food items (VFE) and a slightly upward revised contribution from the prices included in the adjusted CORE2 index.

The current projection envisages the annual inflation rate remaining in 2013 Q2 close to the end-Q1 level of 5.3 percent, before slowing down considerably to a low of 2.4 percent in early 2014 and thereafter stabilising at values slightly above 3 percent, yet below the upper bound of the target band.

The expected maintenance of end-Q2 inflation rate at a level similar to that recorded in March 2013, despite the faster pick-up during this quarter in the prices of certain CPI components exogenous to the monetary policy influence – namely administered prices, prices of volatile food items (VFE), prices of tobacco products and alcohol –, is ascribed to the favourable developments in the 12-month inflation of fuel prices and the adjusted CORE2 inflation rate. Disinflation is seen resuming in 2013 H2, given the baseline scenario assumption of a normal agricultural year, on the back of a shift from an adverse statistical base effect to a favourable one, which is anticipated to have a beneficial influence on the price dynamics of VFE and processed food items included in the adjusted CORE2 index.

The adjusted CORE2 inflation rate is anticipated to stay on the downward path it embarked upon in 2013 Q1, bottoming out at 2.1 percent at end-2013. This component is foreseen to persist at marginally higher levels over the remaining interval and to reach 2.2 percent both at the end of 2014 and at the projection horizon, i.e. 2015 Q1. The annual core inflation rate is thus envisaged to return, in 2013 H2, to levels close to those seen before last year's adverse shocks on food prices and the leu exchange rate. Its forecasted dynamics reflect the gradual fading out of these shocks, being also underpinned by the appreciation of the leu since the turn of the year and by the steady downward adjustment of inflation expectations, amid the implementation of an adequate monetary policy stance and in the absence of adverse supply-side shocks over the next eight quarters. The persistence of a wide negative output gap is expected to further generate disinflationary pressures, albeit relatively less strong than in the previous forecasting round, given the reassessment of the magnitude of the GDP deviation from its potential. As a result of the joint effect of inflation determinants and especially under the impact of the revised output gap, the adjusted annual CORE2 inflation rate is projected to follow a path only marginally higher than that of the previous forecasting round for most of the reference period.

The projected monetary policy stance will further seek to calibrate real broad monetary conditions so as to ensure that inflation rate returns and consolidates inside the target band, while also creating the necessary prerequisites for a gradual recovery of lending to the private sector and a sustainable resumption of economic growth. To this end, special attention will further be paid to the endeavours to anchor inflation expectations to a path converging to the medium-term target.

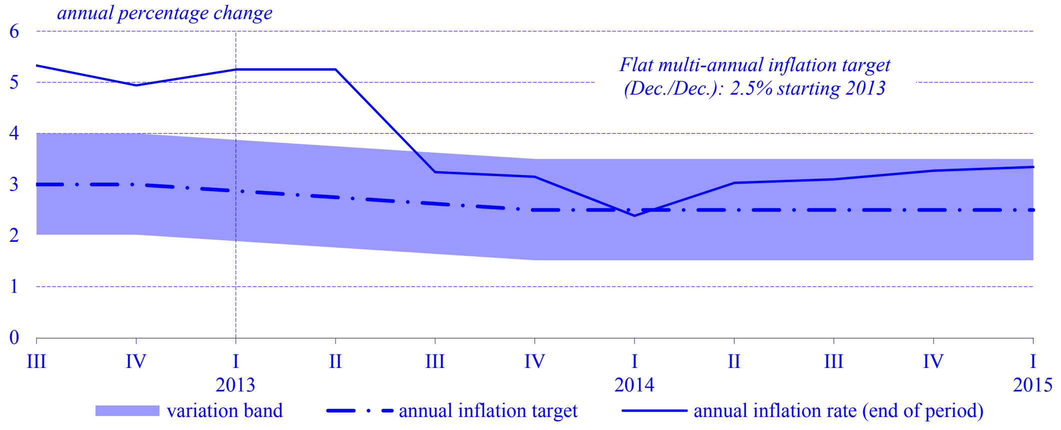
The assessment of risks associated with the current inflation rate projection points to a balance still slightly tilted to the upside, i.e. towards unfavourable deviations from the baseline scenario, yet less asymmetrical than that in the previous projection round.

Over the reference interval, relevant risks stem from the external environment that is still surrounded by uncertainties and are associated with possibly higher volatility of capital flows channelled towards the Romanian economy. The main uncertainty sources are the ongoing fragility relative to the recovery of Romania's major EU trade partners and the recent stress in the banking systems of several euro area countries, given the persistence of the sovereign debt sustainability issues in some of these economies. Against this background, frequent shifts in investor sentiment may trigger unstable capital flows between the domestic economy and the external environment. Regardless of their initial direction, inasmuch as they are large and easily reversible, the capital flows not backed by macroeconomic fundamentals can have a negative impact on financial and price stability, as well as on the sustainable economic recovery. Nevertheless, insofar as the recent favourable developments across the Romanian economy carry on, thereby shaping a lasting improvement in macroeconomic fundamentals, the risk of unstable capital flows will be lower than previously. Thus, it should be pointed out that the Cypriot crisis had limited effects on the domestic economy, despite the substantial contagion potential that might have been presumed.

The persistent structural rigidities of the Romanian economy prevent the adjustment of domestic economic factors from mitigating the consequences of adverse shocks stemming from either external or domestic sources. Consequently, any possible delay in achieving a consistent structural reform mix, such as that included in the agreement concluded by the Romanian authorities with international institutions (the EU, the IMF and the World Bank), brings about spillover risks and could even magnify the unfavourable shocks on inflation and economic growth.

Given the updated baseline scenario assumptions, the balance of risks to the developments in administered and volatile food prices over the reference period seems to be relatively in equilibrium. The future dynamics of global commodity prices continue, in this forecasting round as well, to be a relevant risk factor especially over the medium term, as global demand is expected to gain momentum at that horizon.

Inflation Forecast



Note: Variation band is ±1 percentage point around the central target.

Source: NIS, NBR projections

Monetary policy decision

With a view to effectively anchoring inflation expectations and strengthening the prospects for the annual inflation rate to return inside the variation band around the medium-term target, as the adverse effects of supply-side shocks are seen fading, the NBR Board has decided in its meeting on 2 May 2013 to keep the monetary policy rate unchanged at 5.25 percent per annum. Moreover, the NBR Board has decided to ensure adequate liquidity management in the banking system and to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. At the same time, in order to moderate interest rate volatility on the interbank money market and consolidate the transmission of the policy rate signal, the NBR Board has decided to narrow the corridor defined by interest rates on the standing facilities to ±3 percentage points. Therefore, the interest rate on the lending facility was lowered to an annual 8.25 percent from 9.25 percent, while the deposit facility rate was raised to 2.25 percent per annum versus 1.25 percent previously.

I. INFLATION DEVELOPMENTS

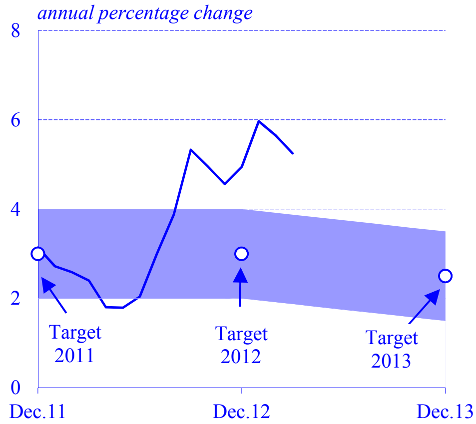
In 2013 Q1, the annual inflation rate remained outside the variation band of ±1 percentage point around the 2.5 percent central target, reaching 5.25 percent at the end of the period under review, up 0.3 percentage points against end-2012. The high level of inflation was due chiefly to the adjustment of certain administered prices and excise duties in early 2013, their impact being partly offset by favourable base effects manifest in volatile prices dynamics. The persistently negative output gap, the sharper appreciation trend of the leu versus the euro, and the lower inflation expectations also acted towards disinflation, accounting for the decrease in adjusted CORE2 inflation by 0.2 percentage points, to 3 percent.

The annual growth rate of volatile prices continued to decelerate in 2013 Q1, owing mainly to the occurrence of favourable statistical effects. Thus, the annual growth rate of VFE prices declined to 13.5 percent (-5.1 percentage points), given the developments in egg prices, which, apart from the seasonal corrections, were impacted upon by a strong base effect stemming from the 2012 Q1 increases following the implementation of EU legislation on poultry breeding conditions. A favourable base effect generated disinflation in fuel prices as well, despite the pick-up in their quarterly dynamics, on account of the higher exchange rate based on which excise duties are calculated in 2013[1] and of the upward trend in world oil prices in January and February[2].

Over the reviewed period, the highest inflationary pressure was exerted by administered prices, whose annual dynamics picked up to 10.1 percent (4 percentage points above the December 2012 level), amid the January rise in electricity prices (10.4 percent month on month), following increases in the MWh price, the cogeneration contribution and, the unit value of green certificates, respectively. The increase in prices for communal services and, the decrease in prices for heating and passenger railway transport had less impact.

The higher exchange rate based on which excise duties are calculated in 2013 fed through into consumer prices, especially via tobacco products (a 3.6 percent monthly rate in January), the other excisable goods making a modest contribution. However, in March, alcohol price movements were notably above the monthly average for the past five years, probably related to the up-front

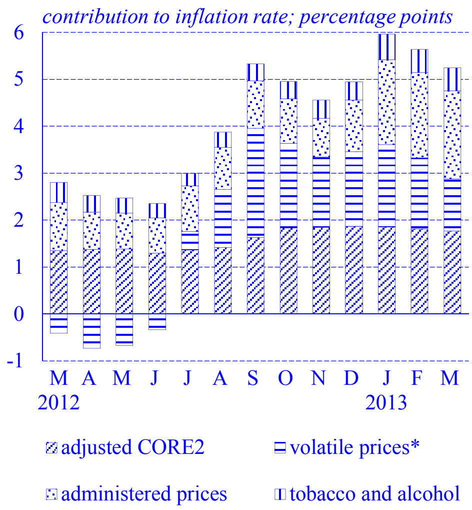
Inflation Developments



Note: Variation band is ±1 percentage point around the central target.

Source: NIS, NBR calculations

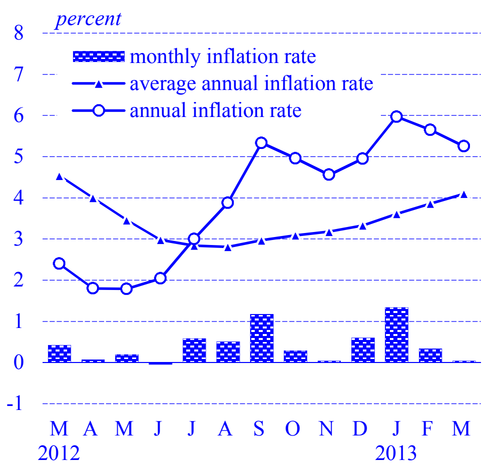
Annual Inflation Rate



*) products with volatile prices: vegetables, fruit, eggs, fuels

Source: NIS, NBR calculations

Inflation Rate



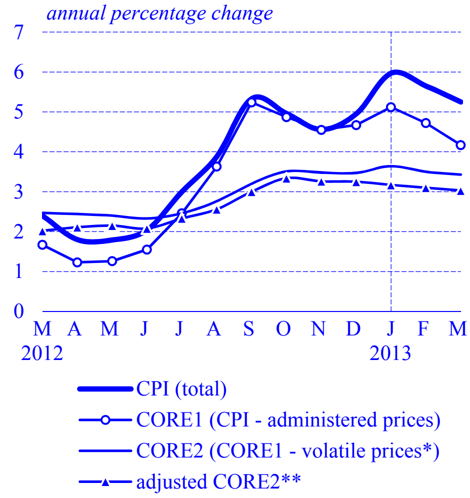
Source: NIS

[1] The exchange rate of the leu used in calculating excise duties reached RON/EUR 4.5223 versus RON/EUR 4.3001 in 2012.

[2] In February 2013, Brent crude oil prices went up to USD 116.4/barrel from USD 109.3/barrel in December 2012, where it reverted in March 2013, as the positive momentum triggered by the announcement of good economic performance in the USA and China was stalled by refineries posting a demand shortage due to maintenance operations planned March through April on their sites (according to OPEC's Monthly Oil Market Reports).

Headline Inflation and CORE Inflation

annual percentage change



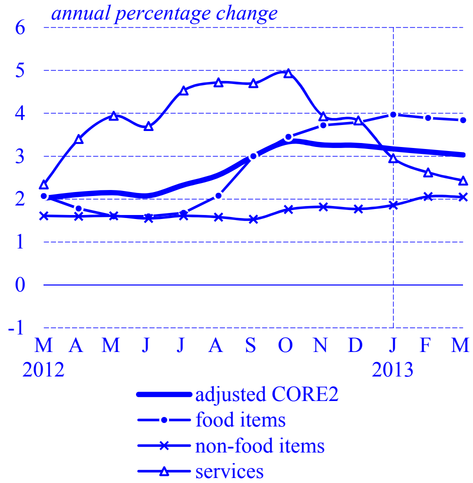
*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

Source: NIS

Adjusted CORE2 Components

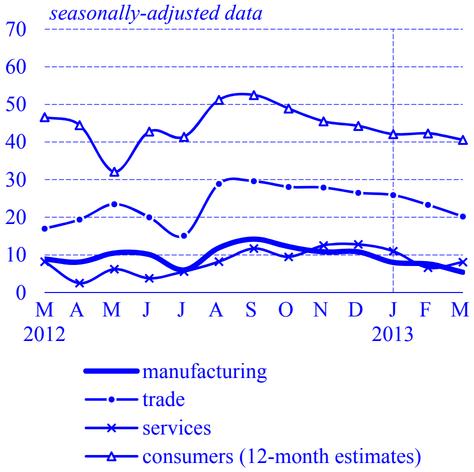
annual percentage change



Source: NIS, NBR calculations

Inflation Expectations of Economic Agents

balance of answers (%); 3-month estimates, seasonally-adjusted data



Source: EC-DG ECFIN

price adjustments made by beer producers so as to include the impact of higher excise duties to be applied as from April 2013. Under the impact of the above-mentioned factors, the annual rate of the "tobacco and alcohol" sub-group reached 10.8 percent (+4 percentage points versus end-2012).

Unlike developments in headline inflation, adjusted CORE2 inflation followed a downward path to a 3 percent annual rate in March (0.2 percentage points below the December 2012 level). Behind such a trend stood the disinflation reported on the segment of market services as a result of the appreciation of the leu versus the euro and the gradual fading out of the pressures exerted on processed food prices in the latter half of 2012, amid encouraging forecasts for the 2013 crops.

The non-food component was the sole group included in the adjusted CORE2 inflation whose annual dynamics stepped up during the first quarter (+0.3 percentage points), this development being due, however, almost entirely to one category of goods, i.e. "books, papers and magazines", owing to an unfavourable base effect. As for the other sub-groups of non-food items, the annual growth rates of prices kept unchanged or even decelerated as a result of the persistent demand deficit and the positive exchange rate developments.

The inflation expectations of economic agents (consumers, industry, construction, trade and services, banking sector) improved in 2013 Q1, with the banking analysts' estimates on inflation at end-2013 falling by 1 percentage point as compared to 2012 Q4. Given the primarily backward-looking nature of inflation expectations, the alleviation in inflationary pressures in February and March following the jump recorded in January is likely to have played the most prominent role in this change of sentiment.

The average annual HICP inflation rate continued to gain momentum during the reported period (+0.5 percentage points to 3.9 percent), the differential from the corresponding Maastricht criterion widening to 1.4 percentage points. A similar deviation was recorded vis-à-vis the EU average (1.5 percentage points), prompted by domestic developments (adjustments in certain administered prices and excise duties), as well as by the disinflation seen in most Member States following the easing of pressures exerted by energy prices.

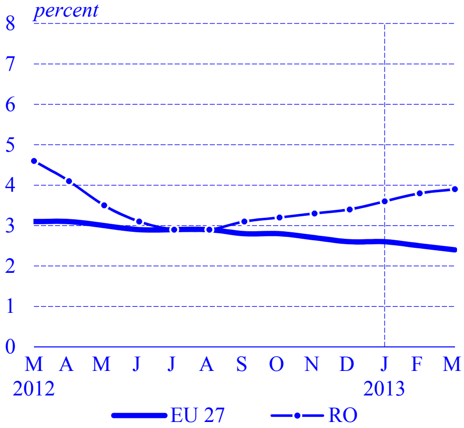
Mention should be made of the higher difference between the annual CPI and HICP inflation rates (up to 0.8 percentage points versus 0.2 percentage points in 2012 Q4) over the period under review, owing mostly to the significant difference between the weights of electricity (5.3 percent versus 2.1 percent). This discrepancy was determined by the change in the calculation methodology of the HICP weights in 2012, following the entry into force of Commission

Regulation (EU) No. 1114/2010 which takes account of national accounts data regarding household final consumption expenditure, aside from the data provided by the Household Budget Survey.

In line with the inflation targeting strategy coordinates, the NBR sets the inflation target and monitors its achievement by referring to the national definition of the consumer price index (CPI) as a benchmark.

In March 2013, the actual annual inflation rate neared the projection included in the February 2013 Inflation Report, standing merely 0.06 percentage points above that level. The explanation for this deviation lies with underestimating the annual CORE2 inflation (especially as regards the non-food component) and the adjustments in administered prices.

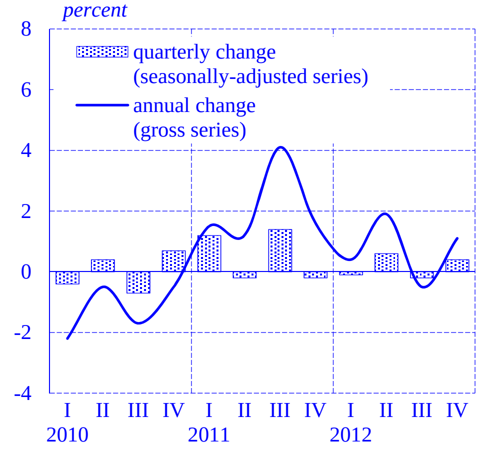
Average Annual HICP Inflation Rate



Source: Eurostat

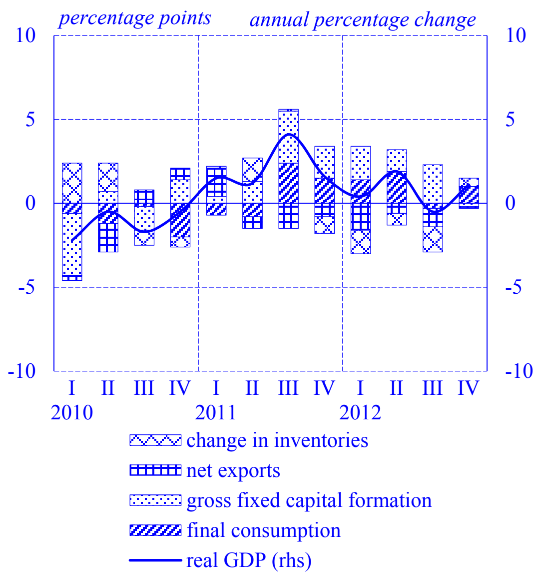
II. ECONOMIC DEVELOPMENTS

Real Gross Domestic Product



Source: NIS

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

1. Demand and supply

2012 Q4 witnessed a rebound in economic activity, as illustrated by the 1.1 percent rise in real GDP[1] following a 0.5 percent drop in the previous quarter. 2012 Q1 through Q4, real GDP dynamics fluctuated between -0.5 percent and +1.9 percent. Consequently, in 2012 as a whole, economic growth slowed down markedly against 2011, i.e. from 2.2 percent to 0.7 percent.

On the demand side, the sign reversal seen in the quarter under review by the annual growth rate of real GDP owed mainly to the faster pace of increase of domestic absorption (ascribed to consumer demand), to +1.2 percent. As regards external demand, although exports of goods and services further decreased, the net position made a clearly lower negative contribution to real GDP dynamics than in Q3 (from -1.1 percentage points to -0.1 percentage points), on the back of the steeper decline in imports of goods and services.

Economic activity also reported an upturn in quarterly terms, but the 0.4 percent advance in real GDP (versus -0.2 percent in Q3) was solely triggered by external demand (+2.4 percentage point contribution). As for domestic demand, only household final consumption posted positive dynamics, i.e. +0.4 percent, which proved however insufficient to offset the contraction in gross fixed capital formation (down 1.7 percent) and government consumption (down 10 percent), causing domestic absorption to shrink by 1.1 percent.

1.1. Demand

The resumed growth of private consumption (up 1.3 percent from -0.7 percent in Q3) was chiefly associated with the trend reversal seen by household spending, i.e. from -1.1 percent to +1.4 percent, and, to a lower extent, with the two times faster annual pace of increase of final consumption expenditure of non-profit institutions serving households (up to +5 percent). Nevertheless, available statistics suggest that the rebound in private consumption cannot be ascribed to any of the major components. On the one hand, the annual dynamics of purchases of goods and market services to households decelerated to a level close to zero given that the drop in purchases of durables gained speed and the uptrend in purchases of non-durables, food and fuels in particular, came to a halt[2]. This

[1] Unless otherwise indicated, the growth rates in this section are annual percentage changes in real terms, calculated based on unadjusted data series. Current developments refer to quarter-on-quarter changes and are calculated based on seasonally-adjusted data series.

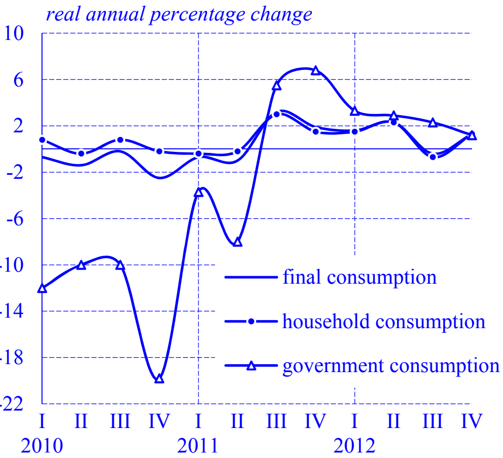
[2] Calculations based on the series of trade turnover volume indices.

is in line with the developments in the main financing sources – the slow pace of growth of household net disposable income[3] and the ongoing decline in consumer loans in terms of both flow and stock. On the other hand, the 2012 poor crops are likely to have entailed a renewed decrease in the self-consumption of agri-food items, purchases on the agri-food market, as well as in the consumption of household-processed farm and non-farm produce. Consequently, behind the upturn in household private consumption expenditure may stand only some types of services – passenger transport[4], postal and courier activities, communications, utilities, financial services, effective rents and imputed rents for owner-occupied dwellings – and/or expenses under the "non-observed economy".

Government final consumption increased at a two times slower pace, i.e. by 1.2 percent, making therefore a marginally positive contribution to real GDP dynamics.

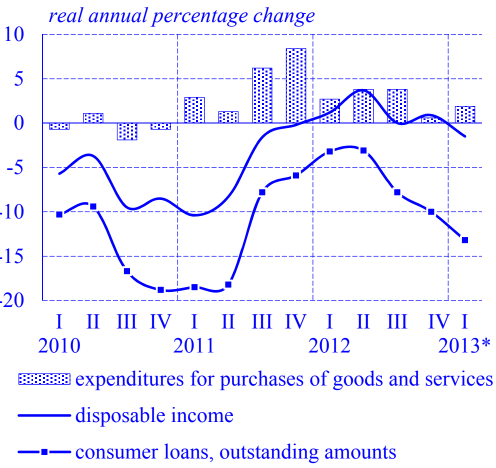
In 2012 Q4, the general government deficit stood at lei 7,602 million[5], i.e. 1.3 percent of GDP[6], well below that posted in the same year-earlier period, which amounted to lei 10,015 million[7] and accounted for 1.8 percent of GDP. The period under review saw a slacker improvement in budget execution, as the further faster negative dynamics of public expenditure[8] (-5.6 percent versus -4.8 percent in Q3) – on account of the swifter decline in the annual pace of growth of capital expenditure, i.e. -31.6 percent – was accompanied by an annual drop in budget revenues (-1.2 percent). Behind the latter stood mostly the pronounced contraction of non-tax revenues versus the same year-ago period, i.e. down 26.5 percent, which was only partly offset by the faster growth rate posted in Q4 by other receipts, particularly receipts from the tax related to use of goods, to authorisation of the use of goods or to developing activities.

Actual Final Consumption



Source: NIS

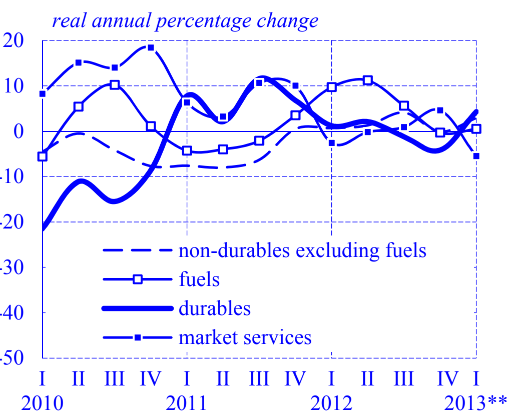
Household Consumption and Main Financing Sources



*) Jan.-Feb.

Source: NIS, MPF, NBR calculations

Purchases of Goods and Services*



*) based on data on the turnover volume of retail trade and market services to households

**) Jan.-Feb.

Source: NIS, NBR calculations

3 Approximated by the sum of incomes from wages, social transfers (state social security, unemployment benefit and health insurance) and inflows from abroad, i.e. workers' remittances and current private transfers by non-residents. In 2012 Q3 and Q4, the real annual growth rate of disposable income stood at 0 percent and +1 percent, respectively.

4 NIS data on passenger transport, according to which 2012 Q4 saw a rebound in real terms chiefly on the back of road passenger transport, hint at such a development.

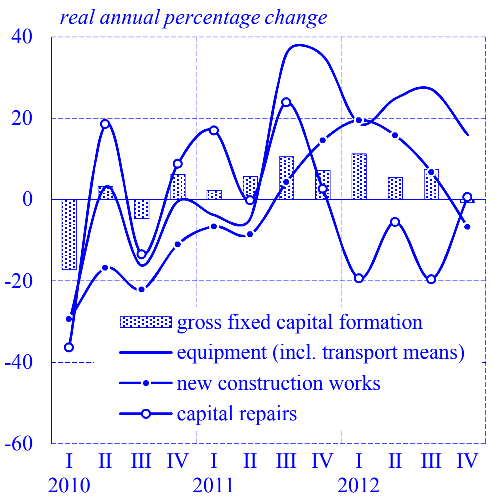
5 The preliminary data released by the MPF with respect to the general government deficit show its slight excess of the 2012 ceiling – in absolute terms – agreed with the IMF.

6 The analysis relied on the operational data relating to the December 2012 budget execution, as published by the MPF. The GDP readings released by the NIS were used for 2011 and 2012.

7 The 2011 budget execution figures were recalculated by the MPF to ensure comparability with those for 2012.

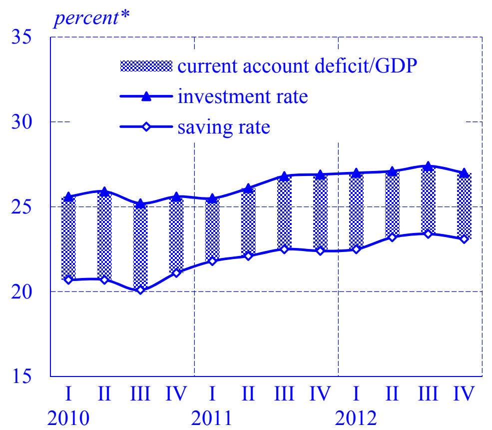
8 Percentage changes refer to the annual growth rates in real terms, unless otherwise indicated.

Investment



Source: NIS, NBR calculations

Investment Rate and Saving Rate



*) last 4 quarters' average

Note: Domestic investment rate is the ratio of gross capital formation to GDP; domestic saving rate is the difference between national gross disposable income and final consumption as a share of GDP.

Source: NIS, NBR calculations

Gross fixed capital formation performed worse than in the first three quarters of 2012, with a 0.6 percent drop in real terms in Q4 following increases that ranged between 5.4 percent and 11.3 percent.

Investment in the public sector, saw a sharp decrease, as the budget execution data indicate a more than four times steeper downward path of capital expenditure, with the decline in engineering construction works making a decisive contribution hereto.

Capital investment by households also witnessed a downturn, given that residential investment saw a renewed contraction – housing construction works (both new housing units and capital repairs) posted a faster rate of decline, to stand at -19 percent in the period under review. This downtrend was only marginally moderated by households' ongoing interest in purchasing already built houses[9], with "gross fixed capital formation" covering solely the expenditure for services related to ownership transfer in this case. Bank loans were further the main financing channel for real estate transactions, as 2012 Q4 reported a renewed increase in the stock of housing loans (up 12.8 percent, real change[10]).

By contrast, corporate investment demand remained on an uptrend, as indicated, on the one hand, by the positive, albeit clearly slowing, annual dynamics of equipment purchases (including transport means purchased by companies and institutions), i.e. 15.9 percent, and, on the other hand, by the rebound in non-residential construction works (new construction works and capital repairs), i.e. +22.7 percent. Loans further accounted for a large share of the financing sources, particularly in the case of equipment investment – the stock of loans earmarked for this purpose was 6 percent higher in real terms[10]. Net inflows of non-residents' foreign direct investment also posted a favourable development, as the euro value of such investment in the non-bank sector went up by almost 40 percent (change in the past four quarters), largely on account of the threefold increase in flows related to intra-group loans.

Turning to net external demand, the reduction in its contribution to the annual dynamics of real GDP (to -0.1 percentage points) was chiefly the result of the developments in sales of goods (a slower decline in exports concurrently with a more than four times swifter fall in imports), whereas the positive differential between the growth rate of exports of services and that of imports thereof halved, to stand at 6.7 percentage points. The ongoing downtrend followed by the EU economy[11] further impacted the

[9] According to market data, on the back of households' persistent sensitivity to the price difference between new housing units and already built ones, their investment further targeted mainly the latter, with the "First House" programme playing a significant part in this development.

[10] The calculations were based on the data supplied by the Central Credit Register.

[11] EU-27 real GDP witnessed a renewed annual contraction, i.e. -0.6 percent, whose magnitude was similar to that in Q3.

exports of goods. Nevertheless, this influence was, to a certain extent, offset by the upturn in extra-EU sales[12] – accounting for approximately one third of the total value of Romania's exports –, which added 0.6 percent in real terms (following a 3.2 percent decline in Q3) due mostly to the significant pick-up in sales of consumer goods, including motor vehicles, whose physical volume reported an almost two times swifter annual pace of increase than in Q3, to stand at +24 percent.

Imports of goods witnessed a steeper downward path (solely ascribed to the EU market) owing to volume adjustments of imports of capital goods and motor vehicles, which were larger than those seen in Q3. Purchases of intermediate goods further stood on a downtrend as well, albeit less steep than in the previous quarter (-2.7 percent compared with -3.7 percent in Q3), in line with the fall in production of final consumption goods for both external and domestic markets[13].

1.2. Supply

The 2012 Q4 outcome evinces once again the high reliance of the domestic economy's performance on the developments in agriculture. Thus, given that the dynamics of non-agricultural economic sectors were slacker than in the previous quarter, i.e. 2.8 percent cumulated growth versus 3.4 percent, the trend reversal posted by real GDP would not have been possible without the moderation in the annual rate of decline of gross value added in agriculture, by 5 percentage points, to -24.6 percent. This development caused agriculture to exert a significantly lower erosion effect on economic growth, i.e. from -3.5 percentage points to -1.5 percentage points.

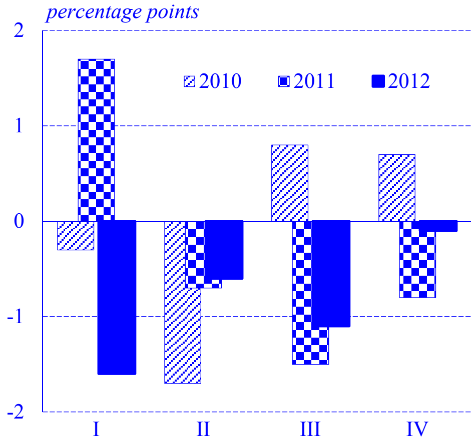
Gross value added in the services sector rose in Q4 as well (up 6.9 percent), albeit posting a 0.8 percentage point slower pace of increase than in Q3. Most components saw positive growth rates, except for financial intermediation services and real-estate transactions, i.e. -0.5 percent in each case. Information and communication services (+43.3 percent in annual terms) made again the largest contribution to the favourable performance of this sector.

Gross value added in industry kept shrinking, although at a more moderate tempo than in Q3 (-0.8 percent annual change). Nevertheless, such a trend was in contrast to the developments in the series of industrial output volume indices, which reported a two times faster annual pace of growth than in the previous quarter,

[12] The breakdown by destination market/market of origin and by group of goods of the physical volume of exports and imports is based on the series of trade balance data and international trade-related unit value indices released by the Eurostat.

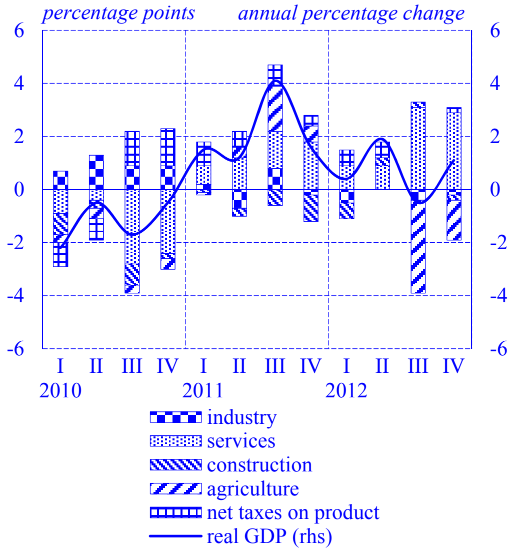
[13] The turnover volume of industrial output for the domestic market in the case of "non-durables", "durables" and "capital goods" shrank in a range between 2.1 percent and 6.6 percent versus the same year-earlier period.

Net External Demand Contribution to GDP Growth



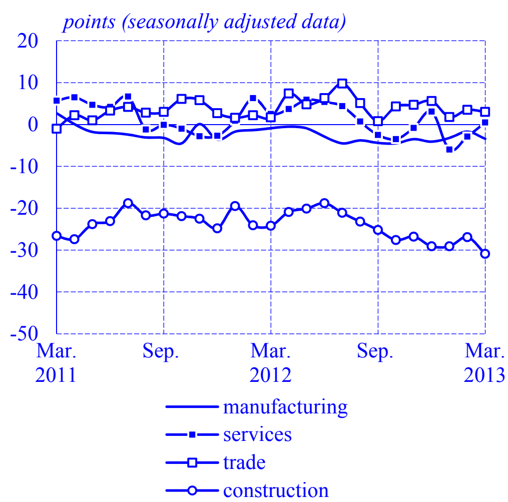
Source: NIS, NBR calculations

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

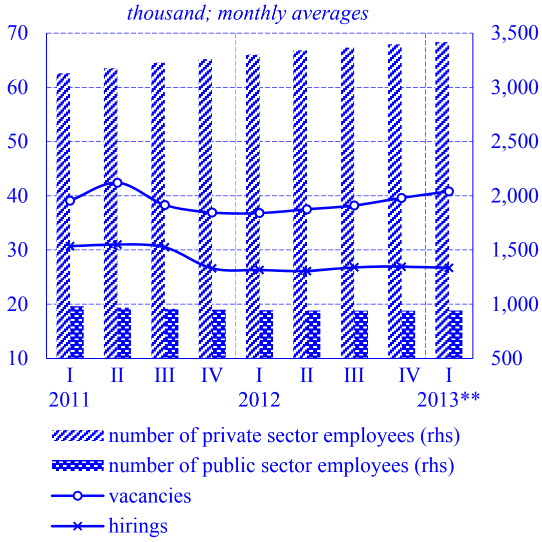
Corporate Sector: Confidence Indicators for the Next 3 Months



Source: EC-DG ECFIN

Labour Force Demand Measures*

thousand; monthly averages



*) seasonally-adjusted data

**) Jan.-Feb.

Source: NEA, NIS, NBR calculations

Unemployment Rate*

percent

*) seasonally-adjusted data

**) Jan.-Feb.

Source: NIS, NBR calculations

to 3.4 percent[14]. The explanation for this disparity could lie, on the one hand, in a potential rise in intermediate consumption and, on the other hand, in the possible downturn in some sub-sectors that are classified as industrial only from the standpoint of national accounting, i.e. relevant activities under the "non-observed economy" and the household goods industry.

The construction sector also made a negative contribution to real GDP dynamics – gross value added in this sector fell by 1.7 percent, given that the drop in residential and engineering construction works was only partly offset by the rebound in non-residential construction works, against the backdrop of the inauguration of large and modern retail stores, as well as of the launch of programmes aimed at overhauling some shopping centres.

2. Labour market

In the early 2013, labour market developments saw a slight improvement, as mirrored by the pick-up in recruitment, the uptrend posted by the registered unemployment rate coming to a halt and the slacker annual dynamics of unit labour costs. Private companies' concern for controlling wage costs translated into a slower annual growth rate of earnings, which was only partly counterbalanced by the increase in budgetary sector wages, leading, overall, to the mitigation of risks to inflation.

NEA vacancies and hiring (of unemployed) statistics and the ongoing uptrend seen by the number of employees point to strengthened labour absorption. At the same time, the excess labour supply appears to stabilise – January through February 2013, both the registered unemployment rate and the ILO unemployment rate further reported similar levels to those in 2012 Q4[15]. The short-term labour market outlook – based on the opinions of recruitment agency managers and available survey data[16] – is characterised by the persistence of the trends seen in the previous quarters, namely a relatively slow rate of job creation economy-wide, amid uneven developments across sectors. Job opportunities have been available especially in IT services, telecommunications, trade and certain manufacturing sub-sectors (the food industry, the automotive industry and related industries), whereas the construction sector, the petrochemical industry and the banking sector announced layoffs.

In January-February 2013, the average gross wage added 5.7 percent in annual terms versus 6.1 percent in 2012 Q4, under the joint impact of the divergent moves in the private and budgetary sector,

[14] The chemical and oil processing industries saw the swiftest dynamics, i.e. +12 percent and +9 percent, respectively, while the resumed increase in road transport means manufacturing (+1.6 percent) is also worth mentioning.

[15] Seasonally-adjusted statistical data.

[16] The DG ECFIN/NIS survey and the Manpower Employment Outlook Survey.

respectively. Private companies showed a cautious behaviour with respect to wage increases at the beginning of the year – gross wage growth (down 1.8 percentage points, to 2.7 percent in the private sector as a whole) decelerated in the mining, energy and private services sectors, while in manufacturing and construction it stayed virtually flat. In the budgetary sector, earnings' faster pace of growth (to 17.2 percent) owed to the final stage of their increase in December 2012, with a view to reverting to their level prior to the implementation of the mid-2010 austerity measures. The 7.1 percent hike in the minimum gross wage economy-wide, i.e. from lei 700 to lei 750, as of February 2013 had a marginal effect on the average wage growth rate.

January through February 2013, the more sluggish dynamics of the average gross wage and the rebound in labour productivity led to improved unit labour costs in industry (-0.1 percent annual pace of increase against 4 percent in 2012 Q4). In manufacturing, ULC dynamics re-entered negative territory, i.e. -0.1 percent, following seven quarters of positive readings. Nevertheless, developments across sectors continued to be mixed. Thus, unit labour costs improved in the food industry, the chemical industry, wood working and electrical equipment, while in tobacco, plastics and metallurgy they went up significantly.

Looking at consumer demand, the annual dynamics of real disposable income further favoured the resumption of disinflation. Thus, after picking up slightly (by 1 percent) in 2012 Q4, in the first two months of 2013 the real disposable income saw a 1.5 percent drop, on the back of the decline in social transfers and remittances from abroad, with wage incomes also reporting a slower growth pace.

3. Import prices and producer prices

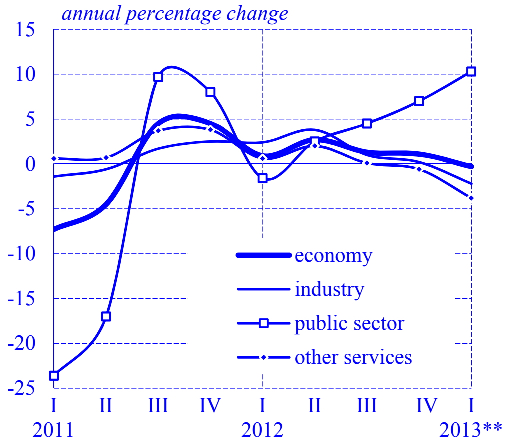
In 2012 Q4, the hike in prices of agri-food commodities both domestically and globally was the main pressure-generating factor on import prices and producer prices, its impact being only partly offset by the persistence of a significant negative output gap. There are prospects of alleviating tensions on agri-food commodity markets in 2013 Q1, but the higher utility prices for domestic producers and the rise in international fuel prices may exert new pressures.

October through December 2012, the annual unit value index of imports reverted to above par values (100.64 percent versus 99.64 percent in Q3), its adverse impact on domestic prices being moderated by the less steep depreciation path of the leu against the major currencies.

The prices of agri-food commodities further stayed on an uptrend on the back of the 2012 poor crops, leading to an annual increase in most import unit value indices of food items in the latter part

Net Real Wage*

annual percentage change



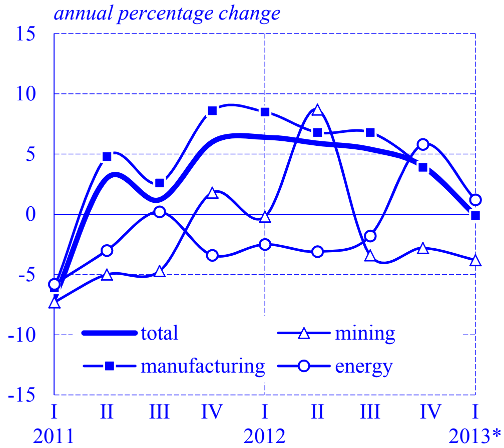
*) deflated by CPI

**) Jan.-Feb.

Source: NIS, NBR calculations

Unit Labour Cost in Industry

annual percentage change

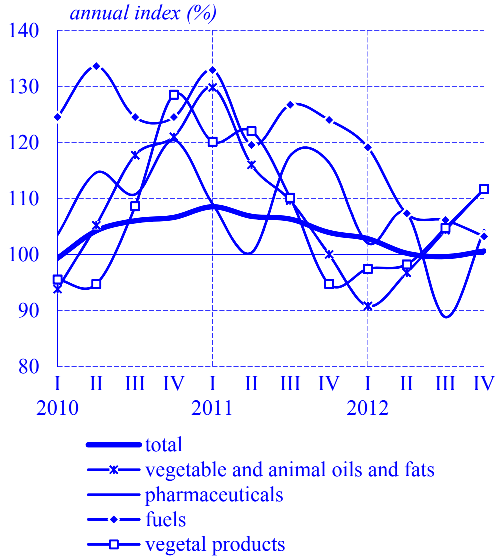


*) Jan.-Feb.

Source: NIS, NBR calculations

Major Inflationary Pressures on the Unit Value Index of Imports

annual index (%)



Source: NIS, NBR calculations

of 2012, while the opposite developments in prices of meat and fruit were solely ascribable to some base effects. As for non-food items, the swifter dynamics of pharmaceuticals were partly counterbalanced by the move in fuel prices, in line with the downward path followed by international oil prices, which owed to the negative prospects on global demand.

As regards capital goods, both the persistence of below par indices for metals and the larger imports of used cars made their contribution to the faster negative annual growth rates of transport means.

The annual dynamics of industrial producer prices for the domestic market saw a marginal change in the period under review, i.e. up 0.3 percentage points, to 5.3 percent, as the impact of costlier agri-food commodities – one of the major pressure-inducing factors mentioned in Q3 – was partly counteracted by the persistent demand deficit and the slower annual pace of depreciation of the leu versus the major currencies.

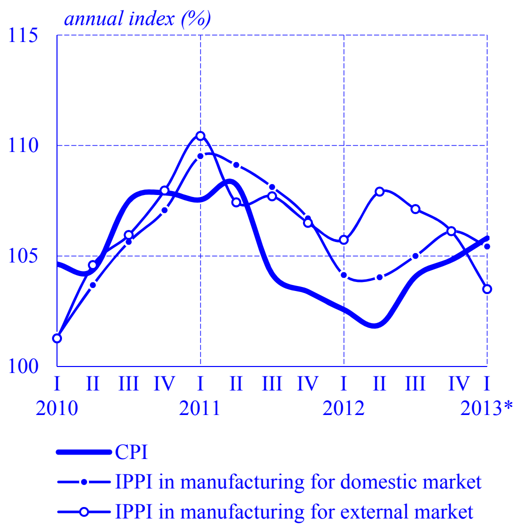
Similar to the picture seen in the previous quarter, the growth rate of producer prices for consumer goods reported the fastest increase, i.e. up 1.8 percentage points, to 8.0 percent, which was associated with the developments in the food industry, where producers further transferred higher costs of agri-food commodities into prices, possibly also following the coverage of losses generated by the subdued domestic demand via exports.

Intermediate goods witnessed a swifter annual pace of increase (up 1.3 percentage points) as well, which owed, however, mostly to a base effect in metallurgy. The current developments in the above-mentioned sub-sector showed a drop in the prices of metal products (occasionally to stand below the cost of the commodities used for their manufacturing), against the backdrop of the increasingly weaker demand[17]. Under the circumstances, some important manufacturers (ArcelorMittal, Mechel) decided to temporarily halt the activity of some plants.

Energy producer prices were the only group to post a lower annual growth rate, i.e. down 1.6 percentage points, to 4.8 percent, solely on the back of hydrocarbon processing. Behind this decrease stood the lower imported oil prices and the slacker pace of depreciation of the domestic currency versus the US dollar.

Given the poor crops, in 2012 Q4 agricultural producer prices remained on an uptrend (posting a 27.8 percent annual growth rate), which impacted both segments, particularly the vegetal production.

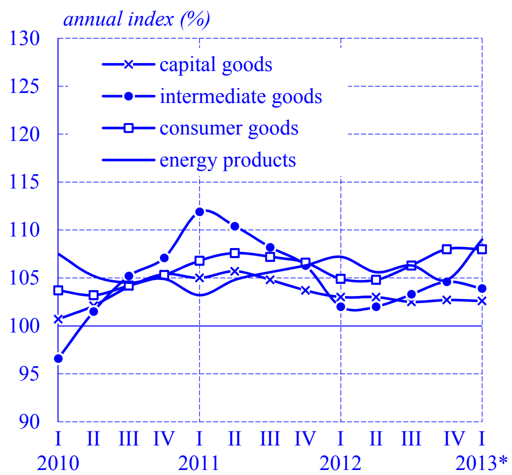
Consumer Prices and Industrial Producer Prices



*) Jan.-Feb.

Source: NIS

Industrial Producer Prices for Domestic Market by Industrial Products Group



*) Jan.-Feb.

Source: NIS

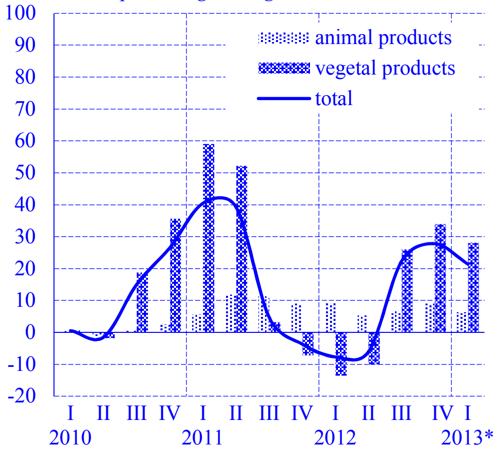
[17] In 2012 Q4, the turnover volume in metallurgy for the domestic market saw a 14.5 percent annual decline.

Breeders were further hit by the high costs of fodder, which translated however in the swifter annual dynamics of pork and beef prices only. The lower prices of mutton and poultry than in the same year-ago period were probably the result of the higher number of slaughtered livestock in the former case and of the increased recourse to self-produced fodder in the latter, following the vertical integration made by some poultry producers.

In 2013 Q1, the upward path followed by the international oil price – owing to the improved outlook for demand for the current year – may induce pressures on the prices of imported goods. In the opposite direction may act the considerable softening of the depreciation trend of the leu versus the major currencies, coupled with the favourable developments in some international commodity markets, namely a severe drop in the price of metals (as a result of high stocks and weak demand) and an incipient downtrend of agricultural producer prices amid the optimistic outlook for the 2013 crops. The encouraging signs relative to the 2013 agricultural production, which have also emerged domestically, may lead to a trend reversal in the case of domestic agricultural producer prices as well. The pace of increase of industrial producer prices for the domestic market is expected to pick up, as new pressure-inducing factors have appeared: (i) the incorporation by ANRE of electricity producers' higher costs[18] into the electricity bill as of January 2013 and (ii) the 5 percent hike in gas prices for industrial consumers in February.

Agricultural Producer Prices

annual percentage change



*) Jan.-Feb.

Source: NIS

[18] Up 17 percent for Nuclearelectrica and 76 percent for Hidroelectrica, respectively.

III. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In its meetings of 5 February and 28 March 2013, the NBR Board decided to keep the monetary policy rate at 5.25 percent per annum and to extend the status-quo of the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions[1]*. At the same time, the monetary authority resumed the adequate management of banking system liquidity*[2]*, thereby supporting the drop in interbank rates and prompting longer-term market rates to return in the vicinity of the policy rate. This calibration of the monetary policy toolkit was aimed at firmly anchoring medium-term inflation expectations and consolidating the prospects for the annual inflation rate to revert to a trajectory compatible with the flat target, while also creating the necessary prerequisites for a sustainable recovery of lending to the Romanian economy.*

Behind the decisions taken in the February meeting of the NBR Board stood, on one hand, the relative worsening of the inflation outlook across the near-term forecast horizon[3], and hence the temporarily larger deviation of the projected annual inflation rate from the upper bound of the target band, on account of the stronger-than-previously-projected inflationary impact of administered prices, as well as the larger impact exerted by tobacco product prices, as a result of the one-quarter-earlier rise in specific excise duties. To this added heightened uncertainty surrounding the magnitude of upcoming administered price adjustments (given the emerging likelihood of additional adjustments in electricity prices to be implemented in 2013, apart from those already set forth in the approved deregulation calendar) and the potential impact of recent tax hikes on consumer prices, amid the ongoing fiscal consolidation.

On the other hand, the renewed pick-up in inflation was seen as temporary, as the updated quarterly forecast reconfirmed the prospects for the annual inflation rate to drop towards end-2013 to the upper bound of the target band, before re-entering and thereafter consolidating inside the band. The intermediary segment of the forecast horizon even displayed a relative improvement in the inflation outlook vis-à-vis the previous projection, underpinned by more favourable developments anticipated for the dynamics of volatile prices and especially for the annual adjusted CORE2 inflation rate. In its turn, the improved prospects for core inflation

[1] 15 percent and 20 percent respectively.

[2] The decision was taken in the January 2013 meeting of the NBR Board.

[3] Vis-à-vis the previous medium-term projection (November 2012 Inflation Report).

was backed by the downward adjustment in inflation expectations and by the downward revision of the forecasted dynamics of the leu exchange rate. Their favourable impact was mitigated only to a small extent by the marginal decrease, compared to the previous projection, in the intensity of disinflationary pressures of aggregate demand, stemming from the slight decline in the estimated size of the negative output gap. Moreover, in the given context, the balance of risks to the inflation outlook was somewhat less tilted to the upside, amid the recent improvement in investor sentiment towards the domestic financial market and the ensuing resumption in several types of capital inflows[4].

The magnitude of both the inflation bout witnessed in early 2013 and of that anticipated for 2013 Q2, revised marginally downwards in the latter case, proved to be compatible with the prospects for a resumption in disinflation in the latter part of the year. This was projected to be driven by the fading out of the adverse effects of supply-side shocks and by the expected persistence of a wide negative output gap entailing strong disinflationary pressures. However, given the risks to inflation expectations potentially induced by the short-lived inflation increase in the second quarter of the year[5], to which added the risk of a renewed flare-up in the volatility of capital flows (and hence of the RON/EUR exchange rate), amid the recent resurfacing of external market tensions generated by the worsening situation in Cyprus, the NBR Board decided in its meeting of 28 March 2013 to extend the *statu-quo* of the monetary policy rate and of the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

Nonetheless, both the recent and the near-term widening of the negative output gap appeared to be of a lower magnitude than previously forecasted, amid GDP dynamics returning into positive territory in 2012 Q4 and the further improved performance of some relevant indicators on consumer and investment demand in January 2013, implying somewhat better growth prospects over the short term. The brighter economic picture was, however, overshadowed by the protracted worsening of the growth outlook for the EU and the euro area[6], as well as by the decline – in the early months of 2013 Q1 – in the annual dynamics of narrow money (as an indicator used to gauge economic activity) and of credit to the private sector.

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4 Portfolio investment.

5 Under the impact of an unfavourable base effect and of the earlier implementation of higher excise duties levied on tobacco products.

6 The updated forecasts released by the IMF, the EC and the ECB regarding GDP developments in the EU and the euro area in 2013 were subject to yet another downward revision, with all institutions anticipating negative annual dynamics in the eurozone.

Specifically, the annual dynamics[7] of loans to the private sector went deeper into negative territory January through February 2013, averaging out at -5.3 percent from -2.2 percent in 2012 Q4, mainly on the back of the faster rate of decline of the foreign currency component (-3.1 percent versus -1.9 percent October through December 2012, based on readings expressed in euro), while the annual pace of decline of leu-denominated credit remained virtually unchanged at -0.8 percent. The breakdown by recipient largely confirms the results of the February 2013 NBR survey on lending to households and non-financial corporations, according to which banks anticipated for 2013 Q1 a fall in both corporate credit demand and household demand for housing loans, along with the tightening of lending standards in both sectors. Under the circumstances, the annual dynamics of loans to non-financial corporations remained on a downward path (-3.4 percent January through February 2013 against -0.6 percent in 2012 Q4), exclusively on account of the foreign currency component (-4.1 percent from -3.0 percent in the previous three months, based on readings expressed in euro). By contrast, leu-denominated corporate credit rose at a faster pace, i.e. 5.1 percent versus 4.9 percent in 2012 Q4. The average annual dynamics of loans to households also fell deeper into negative territory (-6.5 percent from -3.4 percent in 2012 Q4), owing primarily to the faster annual decline of consumer credit (especially in foreign currency) and to the slower growth of housing loans, attributable solely to the foreign exchange component (the leu-denominated component expanded at a considerably quicker pace).

In line with these developments, the average annual pace of decline of broad money accelerated to -4.5 percent January through February 2013, mainly on the back of the additional loss of momentum in narrow money (M1) dynamics, triggered by the contraction in leu-denominated overnight deposits and especially in currency in circulation. The annual growth rate of household time deposits (including deposits with a maturity of over two years outside broad money) also decelerated markedly, but remained in positive territory (1.5 percent against 5.3 percent in 2012 Q4), amid the more sluggish pace of increase of the real net average wage. However, the average share of time deposits in total household deposits continued to widen slightly, hinting at the further robust precautionary demand for money.

During 2013 Q1, the NBR reverted to the adequate management of banking system liquidity. In response to the tight liquidity conditions on the money market, the central bank gradually increased the ceiling on weekly repo tenders during January and February. Moreover, starting 4 March 2013, the monetary authority removed the ceiling altogether, by resuming its repo operations conducted via auctions with full allotment. Against this background, interbank rates re-embarked on a downward path, a move that was

[7] Annual changes in real terms, unless otherwise indicated.

also replicated by longer-term ROBOR rates (relevant for setting the lending rates on new business), which thus fell in the vicinity of the monetary policy rate.

2. Financial markets and monetary developments

After rising for three consecutive quarters, average interbank money market rates shrank in 2013 Q1. In addition, most lending and deposit rates on new business dropped December 2012 through February 2013. The RON/EUR exchange rate recorded a more favourable performance in the first part of the quarter under review, underpinned by the improved investor sentiment towards emerging economies, the local economy and financial market included. The annual rate of change of broad money declined further, mainly as a result of private sector credit dynamics sticking to the downward trend.

2.1. Interest rates

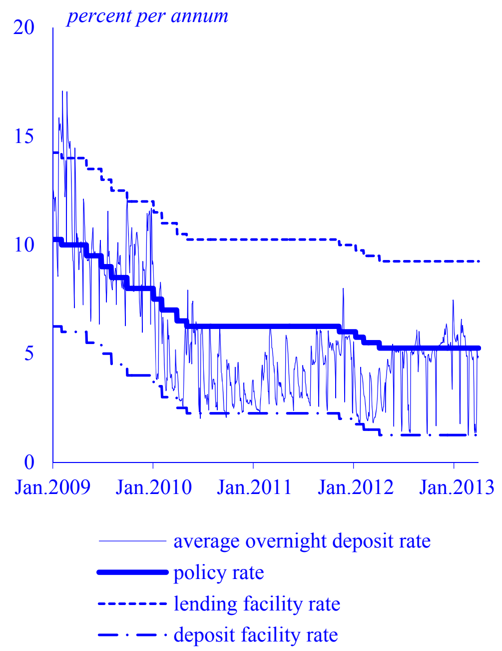
The uptrend seen in interbank money market rates during the prior three quarters came to a halt in the reported period, as their average shed 0.66 percentage points from the previous three months, to stand at 4.81 percent January through March 2013.

Overnight rates on the interbank money market followed a downward path in 2013 Q1, reflecting the improved liquidity conditions largely on account of the central bank gradually increasing the ceiling on weekly repo tenders during January and February and resuming its repo operations conducted via auctions with full allotment as of March. The autonomous liquidity factors had a similar influence, following the liquidity injections generated in the latter part of the quarter under review by transactions on the Treasury account in domestic currency, also due to MPF net redemptions of government securities during the reported period.

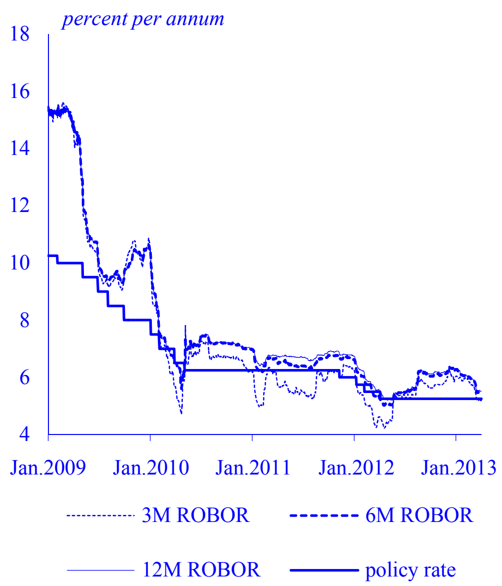
Developments in longer-term interbank rates also reflected the improvement in liquidity conditions, with 1M-12M ROBOR rates embarking in early 2013 Q1 on a slightly downward path, which steepened temporarily in the first part of March. As a result, 3M ROBOR rates returned in the vicinity of the monetary policy rate towards the end of the reported quarter, averaging out at 5.35 percent in March 2013, down 0.69 percentage points from December 2012. Average 6M and 12M ROBOR rates witnessed declines of a similar magnitude and came in at 5.62 percent and 5.64 percent respectively, thus narrowing the spread vis-à-vis the policy rate.

The maximum accepted bid rates on the primary market for government securities also stuck to the downtrend seen since the latter half of December 2012. The downward trajectory steepened temporarily in January 2013, amid non-residents' considerably keener demand for government securities in domestic currency,

Interbank Money Market Rates



Policy Rate and ROBOR Rates

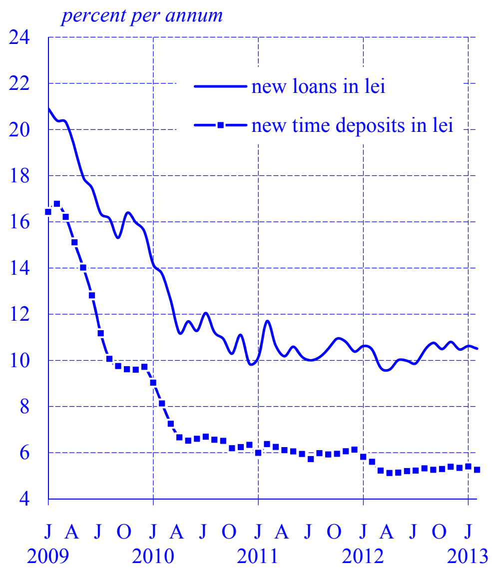


prompted mainly by the announcement of leu-denominated sovereign bonds being included into JP Morgan's local currency emerging market index starting March 2013. This context also proved beneficial in terms of extending the maturities of issued debt instruments, with treasury certificates seeing their share in newly-issued securities narrow to 26 percent from 40 percent in the previous quarter and 82 percent in 2012 Q3.

The volume of leu-denominated government securities issued during 2013 Q1 as a whole[8], i.e. lei 18.4 billion, further exceeded the announced volume[9], but also the volume of maturing debt instruments, solely on account of developments recorded in January, when the overall value of issues (accounting for two thirds of the quarterly volume) was almost double compared to these parameters. By contrast, in the closing month of the quarter, the MPF issued a volume of securities in line with the announced volume and redeemed almost half of the maturing debt.

Non-resident investors' markedly keener appetite for leu-denominated bonds issued by the MPF also fed through to the secondary market for government securities, prompting in January a steeper decline in benchmark rates[10], on one hand, and a surge in the volume of outright transactions, on the other.

Bank Rates



In line with the downward trend of interbank money market rates, average interest rates on new time deposits and new loans dropped December 2012 through February 2013 by 0.13 percentage points (to 5.26 percent) and 0.29 percentage points (to 10.51 percent) respectively. Developments in interest rates were convergent only in the case of new time deposits, whose average rate shed 0.14 percentage points (to 5.04 percent) for non-financial corporations and 0.17 percentage points (to 5.53 percent) for households. Conversely, the average lending rate on new business declined only for non-financial corporations (down 0.45 percentage points to 9.58 percent), while rising further in the case of households, albeit at a much slower pace than in the previous periods (up 0.39 percentage points to 12.64 percent).

2.2. Exchange rate and capital flows

The RON/EUR exchange rate followed a steeper downtrend in the first part of January, subsequently showing signs of stabilisation. Nevertheless, this came to a halt at the end of the first 10-day period

[8] Moreover, in January 2013, the MPF conducted a three-year EUR-denominated bond issue on the domestic market, raising a total of EUR 503 million at a 3.14 percent yield. The MPF tapped the external market in February with a 10-year USD-denominated bond issue worth USD 1.5 billion, at a 4.5 percent average yield.

[9] The ratio of the issued volume to the announced volume stood at 163 percent, slightly above the previous quarter's reading of 136 percent.

[10] Their average during the first quarter of the year stood 1 percentage point below the average for October-December 2012.

of March, when the noticeable increase in global risk aversion caused by the deteriorating situation in Cyprus prompted the exchange rates of most currencies in the region, the leu included, to temporarily re-enter an upward path.

The appreciation trend that the national currency had embarked upon in mid-December intensified in the first 10-day periods of January, as the movement was upheld by a further improvement in the global financial market sentiment and especially by investors' stronger interest in investments on the local financial market following the JP Morgan announcement of Romania's sovereign bonds being included, as from March 2013, into its local currency government bond index for emerging markets[11]. This interest was also spurred by: (i) some relevant indicators released during January, i.e. budget deficit, trade balance, current account balance[12] and international reserves, recording better developments than those expected by analysts and (ii) the outlook for the ongoing fiscal consolidation, reflected by the characteristics of the 2013 draft budget which the government adopted in January, to which added official statements on the possible abrogation of the excessive deficit procedure for Romania. Amid these developments, interbank foreign exchange market liquidity rose, with foreign currency transactions posting in January 2013 the first net surplus since April 2011, against the background of non-residents' net supply of foreign currency soaring to record highs. Therefore, in January 2013 as a whole, the nominal appreciation of the leu versus the euro was the highest since July 2007 (2.5 percent) and the average RON/EUR exchange rate saw a nine-month low. By contrast, the leu's regional peers weakened against the single currency in January.

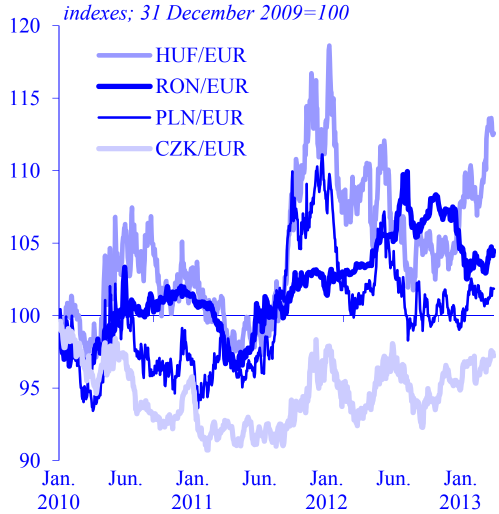
The RON/EUR exchange rate fluctuated inside a narrow band in February and in the first 10-day period of March, amid mixed domestic developments, the most significant being: (i) the considerably lower volume of non-residents' net purchases of government securities compared to the previous months, given the quasi-fading out of the effect exerted, at least on certain investor categories, by the announcements made by Barclays and JP Morgan; (ii) the slightly faster GDP growth than that anticipated by analysts (according to the flash estimate for 2012 Q4), and (iii) other relevant indicators released during the period under review posting lower-than-expected values. At the same time, this period saw a relative heightening of global risk aversion owing to the worse-than-expected performance of several macroeconomic indicators in the major euro area countries and to higher uncertainty associated with political tensions in Spain and especially with the post-election deadlock in Italy.

Key Financial Account Items (balance)

EUR million

	2012 2 mos.	2013 2 mos.
Financial account	**704**	**-88**
Direct investment	**163**	**140**
- residents abroad	-28	-23
- non-residents in Romania	192	163
Portofolio investments and financial derivatives	**1,773**	**3,205**
- residents abroad	-52	-172
- non-residents in Romania	1,825	3,378
Other capital investments	**-644**	**-2,325**
- credits and loans from the IMF	0	-620
- medium- and long-term investments	-539	-502
- short-term investments	-295	-554
- currency and short-term deposits	298	-396
- other	-107	-255
NBR's reserve assets, net ("-" increase/"+"decrease)	**-589**	**-1,108**

Exchange Rate Developments on Emerging Markets in the Region

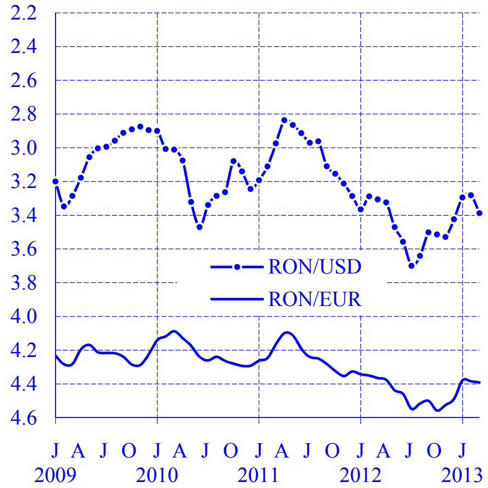


Source: NBR, ECB

11 Barclays Capital made a similar announcement in November 2012.

12 In January, the current account balance displayed a EUR 465 million surplus (as compared to a EUR 25 million deficit reported in the same year-ago period).

Nominal Exchange Rate



The further pick-up in global risk aversion, also shown by the faster decline in the EUR/USD exchange rate[13], due to a sequence of unfavourable external developments[14] culminating with tensions running high in Cyprus[15], led to a renewed, albeit short-lived, hike in the exchange rates of the currencies in the region, the RON/EUR included. However, this move ceased with the announcement of an upcoming agreement between the Eurogroup and the Cypriot authorities on the key elements necessary for a future macroeconomic adjustment programme.

Hence, January through March, the domestic currency witnessed stronger appreciation against the euro (2.2 percent in nominal terms and 4.0 percent in real terms). In relation to the US dollar, however, the leu strengthened at a slower pace than in 2012 Q4 (1.1 percent in nominal terms and 2.8 percent in real terms), given the former's appreciation on global financial markets. Looking at the average annual exchange rate dynamics in 2013 Q1, the domestic currency posted significantly slower nominal depreciation versus both currencies.

2.3. Money and credit

Money

Annual Growth Rates of M3 and Its Components

real percentage change

	2012				2013	
	I	II	III	IV	Jan.	Feb.
	quarterly average growth					
M3	6.8	8.3	2.9	-0.1	-4.5	-4.6
M1	5.9	8.5	3.4	-0.4	-6.2	-5.8
Currency in circulation	13.1	15.7	9.6	1.8	-6.1	-6.1
Overnight deposits	2.3	4.8	0.2	-1.6	-6.2	-5.6
Time deposits (maturity of up to two years)	7.7	10.2	6.4	3.5	-0.3	-0.7

Source: NIS, NBR

December 2012 through February 2013, broad money (M3) dynamics[16] followed a steeper downward path (-3.7 percent versus 0.8 percent during September-November 2012), on the back of the faster annual rate of decline of credit to the private sector. Other determinants included corporate portfolio shifts from M3 deposits to government securities and the highly likely increase in the volume of repayments on previously-accumulated debt by the private sector. A similar impact was exerted by several negative base effects, along with the statistical effect of the higher annual inflation rate, as well as that of the slower depreciation of the domestic currency against the euro in annual terms. All of these influences more than offset the favourable impact on liquidity exerted by larger structural fund disbursements[17].

[13] The appreciation of the US dollar was also bolstered by the brighter-than-expected picture painted by the US economy according to data published during the period under review.

[14] Fitch downgrading Italy's sovereign rating by one notch (with a negative outlook) and the worsening ECB staff macroeconomic projections for the euro area in 2013-2014.

[15] Sparked by the announcement of a one-off levy on ordinary citizens' bank deposits (amid discussions of a potential EU/IMF bailout) and then fuelled by the increased uncertainty generated by the Cypriot Parliament rejecting the deal and the slow-in-coming alternative solution.

[16] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2012 – February 2013.

[17] According to calculations based on press releases by the Ministry of European Funds, structural fund disbursements during the period under review exceeded those recorded in the same year-earlier period.

Similarly to the earlier period, all M3 major components contributed to the decline in the dynamics of this monetary aggregate. In particular, the dynamics of both narrow money (M1) and time deposits with a maturity of up to two years entered negative territory for the first time in the past 18 months, while the pace of decline of marketable instruments posted slightly more negative readings[18].

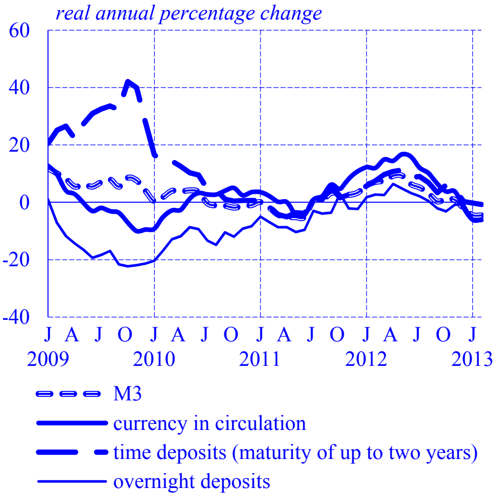
The M3 breakdown by holder reveals that the dynamics of non-financial corporations' placements went deeper into negative territory, while the rate of change of deposits held by non-MFIs slowed markedly, among the culprits being these entities' higher external debt repayments and larger holdings of leu-denominated government securities respectively. The pace of increase of M3 household deposits also slowed further, most likely owing to the slacker dynamics of the real average net wage[19], to which possibly added the larger repayments of bank loans by households. The lacklustre performance across both sectors was further ascribable exclusively to the leu-denominated component, as the growth rate of forex deposits (expressed in EUR) peaked at a 2½-year high for households and a three-year high for companies. The trend was associated with the narrowing of the trade deficit, but also with the still keen corporate demand for foreign currency in the first part of the period under review, probably warranted by the need to have the required amounts available to service their external debt. Against this background, the M3 breakdown by currency continued to worsen, as the average share of foreign currency-denominated deposits widened to a two-year high.

From the perspective of major M3 counterparts, the same as in the previous period, the decline in the dynamics of broad money reflected those of loans to the private sector and of central government net credit. These influences were partly offset by the impact of the faster dynamics of net foreign assets of the banking sector and the more sluggish growth of long-term financial liabilities.

Credit

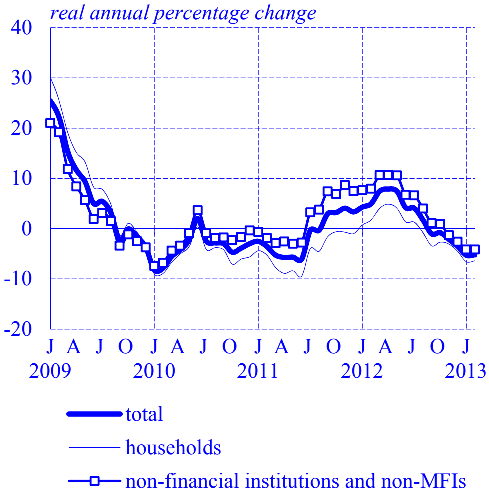
December 2012 through February 2013, the annual dynamics[20] of credit to the private sector plunged deeper into negative territory, reaching -4.7 percent from -1.3 percent during September-November 2012. The decline was manifest for both households and companies and was associated with the relative drop in the

Main Broad Money Components



Source: NIS, NBR

Credit to Private Sector by Institutional Sector



Source: NIS, NBR

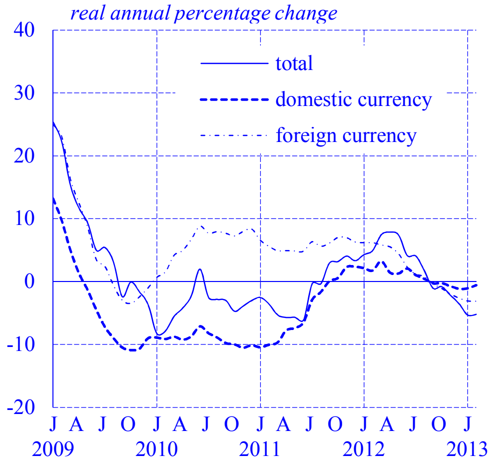
[18] The decline was further ascribable to the changed definition of money market funds.

[19] December 2012 through February 2013, the real average annual growth rate of net wage earnings economy-wide was the slowest in the past 18 months.

[20] Percentage changes refer to the average annual growth rates in real terms for December 2012 – February 2013, unless otherwise indicated.

Credit to Private Sector by Currency

real annual percentage change



Source: NIS, NBR

volume of new business to these entities[21]. The currency breakdown shows that the dynamics of forex-denominated credit posted a considerably steeper decline and hence its average share in total credit to the private sector hit an 18-month low.

The breakdown of household loans points to the persistence of the impact exerted by the end-2011 changes to the applicable regulatory framework[22]. Specifically, the growth rate of loans in domestic currency stepped up to the detriment of forex loans, while consumer credit contracted, along with the faster advance in business development loans. In turn, the pace of increase of housing loans picked up further, on the back of the extension of the "First Home" government programme.

The dynamics of credit to non-financial corporations entered negative territory, amid the worsening of banks' risk perception[23] and possibly the companies' resort to previously obtained, yet unused credit lines. The same as in the previous period, foreign currency credit contracted faster, mainly on account of the short-term component.

[21] Based on Central Credit Register data referring to loans in excess of lei 20,000 approved in the period under review compared to the year-earlier reading.

[22] NBR Regulation No. 24/2011 on loans to households.

[23] According to the latest NBR survey on lending to households and non-financial corporations, published in February 2013.

IV. INFLATION OUTLOOK

The baseline scenario of the current projection places the annual CPI inflation rate at 3.2 percent at end-2013, 0.3 percentage points below the February Inflation Report projection, and at 3.3 percent at end-2014, 0.1 percentage points above the previously-forecasted level.

The inflation forecast revisions for end-2013 and end-2014 entail reassessments of the contributions from the price dynamics of the main consumer basket items. Thus, compared to the previous round, over the entire reference interval, the contributions from fuel prices are expected to be lower, those from prices of tobacco products and alcohol are anticipated to be higher, while the contributions from administered prices have been revised only marginally upwards. In addition, the baseline scenario assumes, for 2013, a relatively more favourable impact of prices of volatile food items (VFE) and a slightly upward revised contribution from the prices included in the adjusted CORE2 index.

The current projection envisages the annual inflation rate remaining in 2013 Q2 close to the end-Q1 level of 5.3 percent, before slowing down considerably to a low of 2.4 percent in early 2014 and thereafter stabilising at values slightly above 3 percent, yet below the upper bound of the target band.

The expected maintenance of end-Q2 inflation rate at a level similar to that recorded in March 2013, despite the faster pick-up during this quarter in the prices of certain CPI components exogenous to the monetary policy influence – namely administered prices, prices of volatile food items (VFE), prices of tobacco products and alcohol –, is ascribed to the favourable developments in the 12-month inflation of fuel prices and the adjusted CORE2 inflation rate. Disinflation is seen resuming in 2013 H2, given the baseline scenario assumption of a normal agricultural year, on the back of a shift from an adverse statistical base effect to a favourable one, which is anticipated to have a beneficial influence on the price dynamics of VFE and processed food items included in the adjusted CORE2 index.

The adjusted CORE2 inflation rate is anticipated to stay on the downward path it embarked upon in 2013 Q1, bottoming out at 2.1 percent at end-2013. This component is foreseen to persist at marginally higher levels over the remaining interval and to reach 2.2 percent both at the end of 2014 and at the projection horizon, i.e. 2015 Q1. The annual core inflation rate is thus envisaged to return, in 2013 H2, to levels close to those seen before last year's adverse shocks on food prices and the leu exchange rate. Its forecasted dynamics reflect the gradual fading out of these shocks, being also underpinned by the appreciation of the leu since the turn of the year and by the steady downward adjustment of inflation expectations, amid the implementation of an adequate *monetary policy stance and in the absence of adverse supply-side shocks over the next eight quarters. The persistence of a wide negative output gap is expected to further generate disinflationary pressures, albeit relatively less strong than in the previous forecasting round, given the reassessment of the magnitude of the GDP deviation from its potential. As a result of the joint effect of inflation determinants and especially under the impact of the revised output gap, the adjusted annual CORE2 inflation rate is projected to follow a path only marginally higher than that of the previous forecasting round for most of the reference period.*

The projected monetary policy stance will further seek to calibrate real broad monetary conditions so as to ensure that inflation rate returns and consolidates inside the target band, while also creating the necessary prerequisites for a gradual recovery of lending to the private sector and a sustainable resumption of economic growth. To this end, special attention will further be paid to the endeavours to anchor inflation expectations to a path converging to the medium-term target.

The assessment of risks associated with the current inflation rate projection points to a balance still slightly tilted to the upside, i.e. towards unfavourable deviations from the baseline scenario, yet less asymmetrical than that in the previous projection round.

Over the reference interval, relevant risks stem from the external environment that is still surrounded by uncertainties and are associated with possibly higher volatility of capital flows channelled towards the Romanian economy. The main uncertainty sources are the ongoing fragility relative to the recovery of Romania's major EU trade partners and the recent stress in the banking systems of several euro area countries, given the persistence of the sovereign debt sustainability issues in some of these economies. Against this background, frequent shifts in investor sentiment may trigger unstable capital flows between the domestic economy and the external environment. Regardless of their initial direction, inasmuch as they are large and easily reversible, the capital flows not backed by macroeconomic fundamentals can have a negative impact on financial and price stability, as well as on the sustainable economic recovery. Nevertheless, insofar as the recent favourable developments across the Romanian economy carry on, thereby shaping a lasting improvement in macroeconomic fundamentals, the risk of unstable capital flows will be lower than previously. Thus, it should be pointed out that the Cypriot crisis had limited effects on the domestic economy, despite the substantial contagion potential that might have been presumed.

The persistent structural rigidities of the Romanian economy prevent the adjustment of domestic economic factors from mitigating the consequences of adverse shocks stemming from either external or domestic sources. Consequently, any possible delay in achieving a consistent structural reform mix, such as that included in the agreement concluded by the Romanian authorities *with international institutions (the EU, the IMF and the World Bank), brings about spillover risks and could even magnify the unfavourable shocks on inflation and economic growth.*

Given the updated baseline scenario assumptions, the balance of risks to the developments in administered and volatile food prices over the reference period seems to be relatively in equilibrium. The future dynamics of global commodity prices continue, in this forecasting round as well, to be a relevant risk factor especially over the medium term, as global demand is expected to gain momentum at that horizon.

1. Baseline scenario

1.1. External assumptions

The economic growth scenario for Romania's main trade partners[1] foresees the annual dynamics of the real effective EU GDP[2] at almost nil in 2013, being revised downwards by 0.4 percentage points against the February 2013 Inflation Report, before reaching 1.5 percent in 2014, a level left unchanged from the previous forecasting round. The persistently adverse effects on lending in the EU, together with the ongoing fiscal consolidation and the balance sheet adjustment driven by the still high private sector indebtedness, are assumed to contain EU economic activity throughout 2013. For 2014, in view of the gradual easing of bank financing availability, the phased improvement in labour market conditions and an expected rebound in global demand for euro area exports, investment is seen to become the main driver of economic growth. Overall, the forecasted recovery remains, however, weak, judging by historical standards, against the backdrop of lingering uncertainties surrounding the successful resolution of the sovereign debt crisis and the restoration of financial and banking stability in Europe. Under the circumstances, the deviation of the effective EU GDP from its potential, the relevant measure to approximate the impact of external demand within the model, is revised to more negative levels than in the previous forecasting round over the entire projection interval.

Expectations on the Developments in External Variables

annual average

	2013	2014
Oil price (USD/barrel)	104.0	97.7
USD/EUR exchange rate	1.30	1.28
3M EURIBOR interest rate (% p.a.)	0.22	0.33
Effective EU economic growth (%)	0.04	1.53
Annual inflation rate in the euro area (%)	1.74	1.70

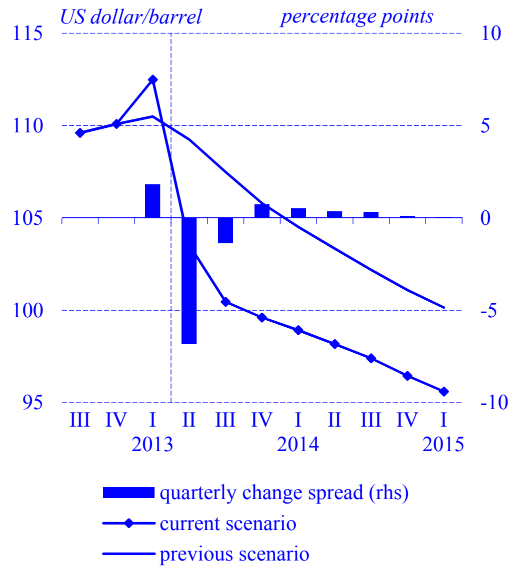
Source: NBR assumptions based on data provided by European Commission, Consensus Economics and futures prices

The average annual rise in the Harmonised Index of Consumer Prices (HICP) across the euro area is foreseen to slow from 2.5 percent in 2012 and stick to 1.7 percent in 2013 and 2014, a path revised downwards by 0.11 percentage points and 0.22 percentage points respectively. This is still ascribable to the slower dynamics of energy and, to some extent, food prices, following the fading out of the impact of their prior increases and in the absence of significant adverse supply-side shocks over the forecast interval. Compared to

1 EU-27 excluding Romania.

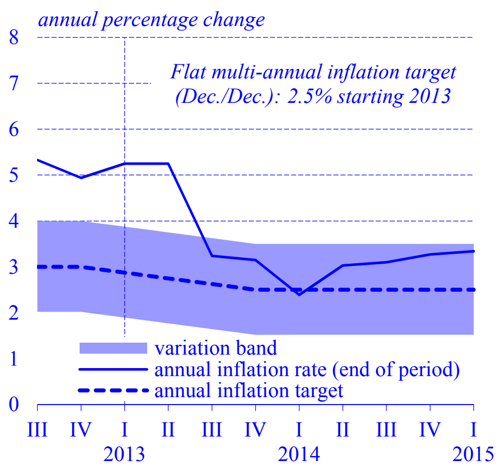
2 Effective indicator based on Romania's exports breakdown by EU country. For details on this indicator, see the box entitled "Incorporation of an effective external demand measure, i.e. effective EU GDP, into the model" in the November 2012 Inflation Report, p. 35.

Brent Oil Price Scenario



Source: Energy Information Administration, NBR assumptions based on Bloomberg data

Inflation Forecast



Note: Variation band is ±1 percentage point around the central target.

Source: NIS, NBR projections

the previous forecasting round, the downward revision of inflation for 2013-2014 stems from the deepening external output gap and the fading away of previous substantial hikes in commodity prices and indirect taxes in some euro area countries.

The path of the 3M EURIBOR rate is seen falling to historical lows, reflecting the ECB's monetary policy measures aimed at supporting the economic recovery. Thus, the current scenario foresees the EURIBOR rate declining during 2013, before edging slightly up in 2014, when the euro zone economy is expected to record positive growth.

As for the USD/EUR exchange rate, the euro is assumed to depreciate slightly versus the US dollar throughout the projection interval before reaching 1.27 USD/EUR at the end of this period[3]. The marginal upward revision of the exchange rate path for 2014 compared to the previous projection round is accounted for by the gradual recovery of economic sentiment regarding the economic outlook for the euro area.

The projection for the international Brent oil price is based on futures prices[4] and foresees its recent downtrend to continue[5] over the entire forecast interval, amid weak global demand and expected changes in the composition of the energy consumption basket to the detriment of oil. The current trajectory is revised downwards compared to the previous forecasting round, with a faster-than-previously-projected pace of quarter-on-quarter decline in oil prices at the beginning of the projection interval.

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 3.2 percent at end-2013 and at 3.3 percent at end-2014, i.e. inside the variation band around the central target[6]. The level projected for end-2013 was revised downwards by 0.3 percentage points compared to the February 2013 Inflation Report, as a result of the anticipated lower contributions from volatile food prices (VFE) and particularly from fuel prices. In contrast, the projected dynamics of alcohol and tobacco product prices and the adjusted CORE2 inflation are anticipated to make higher contributions, yet with a smaller magnitude compared to the former ones. The level forecasted for 2014 was revised upwards by 0.1 percentage points due to the larger cumulative contributions of administered prices and alcohol and tobacco product prices, whereas fuel prices are seen to have a slightly lower contribution

[3] Source: Consensus Economics.

[4] Source: Bloomberg.

[5] Assuming no escalation in geopolitical risks facing the Middle East.

[6] As from 2013, the NBR adopted a flat multi-annual inflation target of 2.5 percent ±1 percentage point.

to the annual dynamics of consumer prices[7].

The expected maintenance of end-Q2 inflation rate at a level similar to that recorded in March 2013, despite the faster pick-up during this quarter in the prices of certain CPI components exogenous to the monetary policy influence – namely administered prices, prices of volatile food items (VFE), prices of tobacco products and alcohol –, is ascribed to the favourable developments in the 12-month inflation of fuel prices and the adjusted CORE2 inflation rate. The baseline scenario underlying the macroeconomic projection relies on the assumption of normal agricultural crops in 2013 and 2014. In this context, the annual CPI inflation rate is expected to decelerate sharply starting mid-2013, mainly due to the favourable developments, as compared with 2012, in the prices of VFE and processed food items included in the adjusted CORE2 index. The decelerating dynamics of administered prices at end-2013 are also estimated to support CPI disinflation.

The annual adjusted CORE2 inflation rate is anticipated to stay on the downward path it embarked upon in 2013 Q1[8] until the end of 2013, when it is expected to stand at 2.1 percent, a level only marginally below that projected to be reached at end-2014 (2.2 percent). The disinflation envisaged for the adjusted CORE2 index is anticipated to occur against the background of the fading-out of the impact of higher prices for processed food items seen in 2012 H2 – given the assumption of normal agricultural years in 2013 and 2014 – and of the downtrend in inflation expectations of economic agents[9], underpinned by the high persistence of the negative output gap throughout the forecast interval.

The adjusted annual CORE2 inflation rate is projected to follow a path only marginally higher than that in the previous Inflation Report for most of the projection interval, being revised upwards by 0.1 percentage points at end-2013, whereas the level forecasted for end-2014 reconfirms the previous projection. The slightly higher inflationary pressures on the part of adjusted CORE2 index are seen to be generated by the lower projected levels of the negative

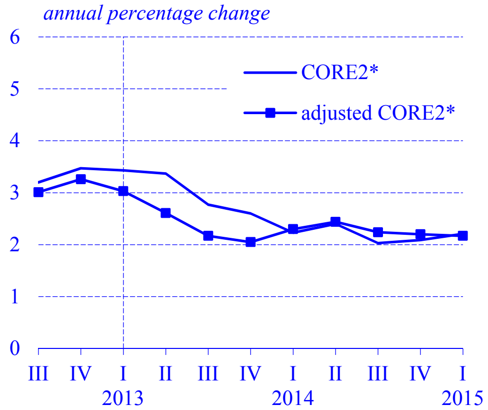
Annual Inflation Rate in the Baseline Scenario

annual percentage change (end of period)

	2013			2014				2015
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Target			2.5				2.5	
Forecast	5.3	3.2	3.2	2.4	3.0	3.1	3.3	3.3

Annual CORE2 Inflation and Annual Adjusted CORE2 Inflation

annual percentage change



*) end of period

Source: NIS, NBR projections

[7] The weights used to calculate the contributions of CPI components to the annual dynamics of consumer prices correspond to the values released by the NIS in February 2013, subsequently to the publication of the February 2013 Inflation Report. As compared with the weights used in the previous forecasting round, the current ones reveal the higher importance of administered prices, concomitantly with a slight decrease in the shares of other CPI components. Thus, the share of CPI components exogenous to the monetary policy influence – namely administered prices, prices of volatile food items (VFE), prices of fuels and prices of tobacco products and alcohol – increased by about 0.3 percentage points, due solely to the higher share of administered prices, whereas the share of adjusted CORE2 index dropped by the same figure.

[8] Starting from 3.17 percent in January and decreasing to 3.03 percent in March. For further details, see Chapter I. Inflation developments.

[9] The absence of anticipated significant supply-side shocks over the following quarters of the reference period, as well as the maintenance of an adequate monetary policy stance will have a beneficial influence on the path of economic agents' inflation expectations, which is envisaged to go down steadily throughout the forecast interval.

output gap[10] and the economic agents' inflation expectations, which are seen heading downwards, yet posting marginally higher levels than in the previous round. The slower-than-projected processed food price dynamics[11] for 2013 H1 helps to alleviate these pressures. Although the inflationary pressures from the adverse supply-side shocks have abated ever since the end of 2012, the substantial hikes in some administered prices (electricity prices for household end-users in particular) in early 2013 were reflected also by higher inflation expectations throughout the forecast interval. As compared to the previous round, import prices have a less favourable contribution to core inflation only in the first part of the forecast interval, against the background of the persistent effects generated by import price increases[12] recorded at end-2012, partly as a result of the less favourable dynamics of the nominal effective exchange rate of the leu in the same period[13]. In the latter part of the interval, import price dynamics are seen to follow a lower path, due particularly to an exogenous scenario envisaging a relative alleviation of the relevant external price dynamics in the current projection round.

The annual alcohol and tobacco product price inflation path was primarily projected based on the calendar included in the 2013 Tax Code for the change in excise duties on these products and by using the updated reference exchange rate (to the projected levels) to calculate their lei equivalent. The new Tax Code stipulates an additional increase in the excise duties on "beer" as of April 2013, as well as the front-loading of the changes in the excise duties on tobacco products from July to April. These changes are not expected to have an additional inflationary impact on the annual inflation rate[14], as they were known when the previous Inflation Report was published. Nevertheless, the expected contribution of

[10] For further details, see Section 1.3. Demand pressures in the current period and over the projection interval.

[11] Due mainly to the faster-than-expected alleviation of inflationary pressures from adverse supply-side shocks which pushed up processed food prices in 2012 H2.

[12] The unit value index of imports of consumer goods (excluding motor vehicles and fuels) increased by 1.3 percent in 2012 Q4 versus Q3 as compared with the previously projected 0.3 percent (determined by extrapolating the dynamics seen in October to the entire quarter), against the background of relatively high effective external inflation rates at end-2012. The unit value index is calculated by Eurostat on a monthly basis starting from the EUR-denominated values of foreign trade in goods and services. It provides, alongside the movements in the nominal exchange rate of the leu, insight on the developments in import prices of consumer goods included in the adjusted CORE2 index basket.

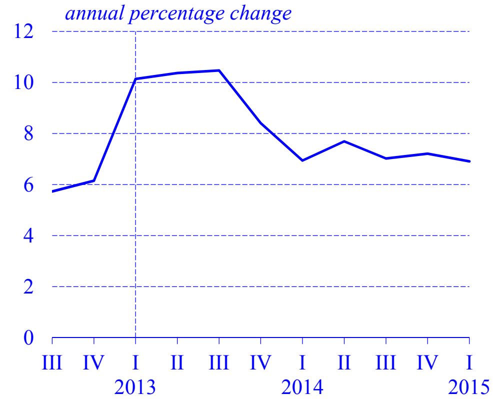
[13] The quantitative analyses made by the central bank staff based on econometric estimates revealed an asymmetry with regard to the impact of the nominal exchange rate movements on import price dynamics, i.e. the domestic currency depreciation versus major currencies passes through to consumer prices to a larger extent than the appreciation.

[14] One of the assumptions is that the expected hikes in the excise duty on tobacco will have no second-round effects passed through to the prices of other categories of products, considering that such hikes are pre-announced (according to the Tax Code) and they also affect relatively limited consumer groups.

the “tobacco and alcohol” sub-group to the annual CPI inflation rate is foreseen to be of 0.5 percentage points at end-2013 and of 0.1 percentage points at end-2014. Both figures are 0.1 percentage point higher than in the previous projection, particularly owing to the higher-than-anticipated inflation rates recorded in early 2013.

Similarly to the previous forecasting round, the scenario on administered price developments takes into account both the information released by the Romanian Energy Regulatory Authority (ANRE)[15] and the latest developments in different categories of administered prices. The annual dynamics of administered prices are projected to stand at 8.4 percent in December 2013 and at 7.2 percent at end-2014, i.e. below the levels foreseen in the previous forecasting round. However, the contribution of administered prices to the annual CPI inflation at the end of the two years of the projection interval was revised slightly upwards[16] versus the previous round, on the back of the 0.7 percentage point rise in the share of goods and services with administered prices in total CPI basket. Specifically, prices of electricity and water, sewerage and waste disposal services saw their shares in the CPI basket increasing to a relatively lower extent than prices of natural gas and the other sub-components of products with administered prices[17]. Given that the assumptions underlying the hikes in different categories of administered prices in the latter part of 2013 remained unchanged versus the February projection and that the prices of electricity, water, sewerage and waste disposal services were higher in 2013 Q1, the downward revision of the scenario of administered prices is solely due to the relative decline in the share of sub-components with stronger annual dynamics, along with the relatively increased importance of those which kept unchanged their rate of increase.

Administered Prices Annual Inflation*

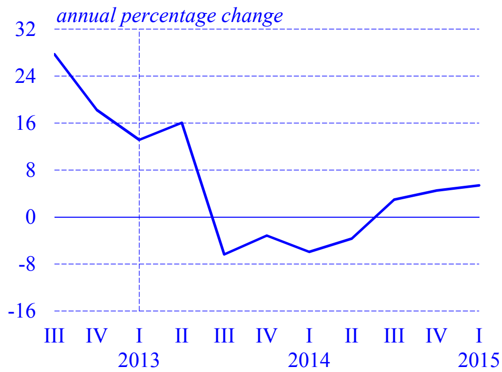


*) end of period

Source: NIS, NBR projections

Assuming normal agricultural crops in 2013 and 2014, the annual dynamics of VFE prices are expected to follow a disinflationary trajectory starting with mid-2013, against the backdrop of the phasing-out of the unfavourable impact exerted by the 2012 poor agricultural crops and, implicitly, of an emerging favourable statistical base effect. The VFE price contribution to the annual CPI inflation rate at the end of the period is of -0.2 percentage points at end-2013, 0.2 percentage points lower than in the previous round (largely due to some more favourable developments recorded in the early months of the year). For 2014, the anticipated contribution remains unchanged at about 0.3 percentage points, the same as in the previous Inflation Report.

Vegetables, Fruit and Eggs Prices Annual Inflation*



*) end of period

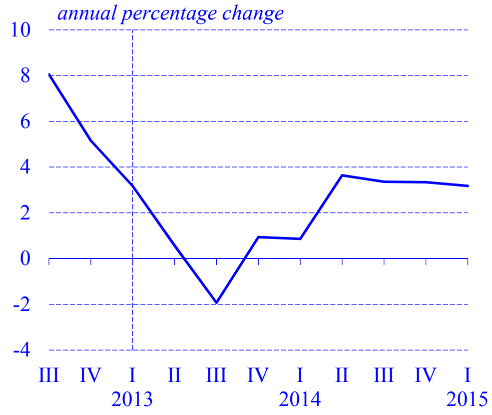
Source: NIS, NBR projections

15 Additional information on the stages of electricity and natural gas market liberalisation in compliance with the Memorandum approved by the Government of Romania are available on the ANRE website at: http://www.anre.ro/documente.php?id=868 and http://www.anre.ro/documente.php?id=695.

16 Up by 0.02 percentage points at end-2013 and by 0.04 percentage points at end-2014.

17 The shares of electricity and water, sewerage and waste disposal services in the CPI basket rose from 5.2 percent to 5.28 percent and from 2.67 percent to 2.77 percent respectively, to a lower extent than the natural gas and the remaining sub-components whose share moved ahead from 3.28 percent to 3.46 percent and from 6.45 percent to 6.81 percent respectively.

Fuel Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

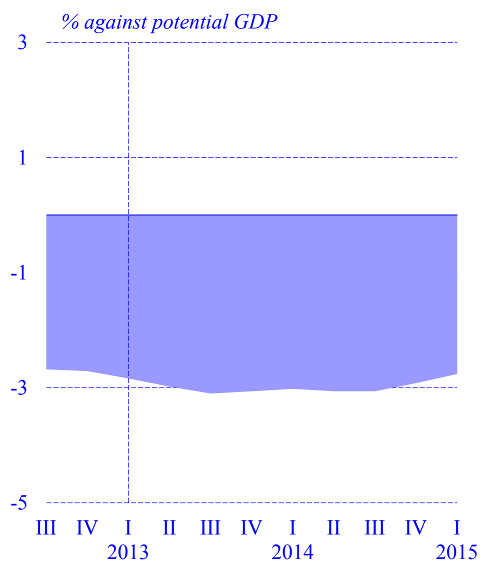
Components' Contribution to Annual Inflation Rate*

percentage points

	2013	2014
Administered prices	1.5	1.3
Fuels	0.1	0.3
VFE prices	-0.2	0.3
Adjusted CORE2	1.2	1.3
Tobacco products and alcohol	0.5	0.1

** end of period; contributions based on 2-decimal data add up to CPI inflation*

GDP Deviation



Source: NIS, NBR projections

The annual growth rate of fuel prices is projected to stand at 0.9 percent at end-2013, 3.3 percentage points lower than in the previous forecasting round and at 3.3 percent at end-2014, a level similar to that previously expected.

Behind the reconfiguration of the fuel inflation path stand the significantly lower level of this component in 2013 Q2[18], the projected EUR/USD exchange rate developments with a more favourable impact on the RON/USD exchange rate, as well as the stronger deceleration of the Brent oil price anticipated in the first part of the projection interval compared with the previous projection. An adverse impact, yet of a lower magnitude, had the marginal upward revision of economic agents' inflation expectations, which also had an impact on this category of prices.

On the whole, the cumulative contribution of components exogenous to the monetary policy influence – namely administered prices, prices of volatile food items (VFE), prices of fuels and prices of tobacco products and alcohol – to the annual CPI inflation rate stands at 1.9 percentage points at end-2013 and at 2 percentage points at end-2014.

1.3. Demand pressures in the current period and over the projection interval[19]

Output gap

In 2013 Q1, real GDP is expected to further witness a positive growth compared with the previous quarter, when a 0.4 percent increase was reported. As compared with the previous forecasting round, the dynamics of real GDP for 2012 was revised upwards based on the latest national account data series released by the NIS. This entailed GDP growth rates higher than those previously projected for end-2012, as well as the upward revision of the forecast for 2013 Q1. The annual growth rate of real GDP is foreseen to remain in positive territory in Q1, at a value similar to that recorded in the previous quarter.

Given the persistence of a slightly positive contribution of the capital stock and total factor productivity during the projection interval and in the context of the recently improved contribution of labour, whose impact on growth in the following years is expected to be positive, potential GDP growth for 2013 is foreseen to be similar to that reported in the previous year, while it is anticipated to improve moderately in 2014. The potential GDP growth is forecasted under the assumptions of a gradual strengthening of investor confidence in the national economy, against the background of a similar regional trend, with positive effects on the capital flow dynamics,

[18] Mainly due to more favourable anticipated dynamics of the world Brent oil price in this quarter.

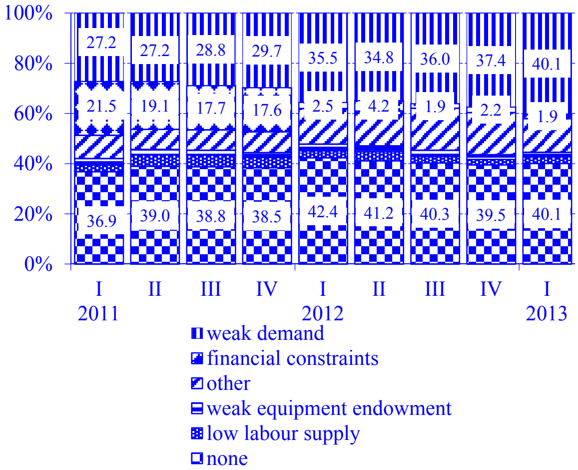
[19] Unless otherwise indicated, percentage changes are calculated based on seasonally-adjusted data series. Source: NBR, MPF, NIS, Eurostat, EC-DG ECFIN and Bloomberg.

as well as on the efficiency of the production factors. The moderate increase in the capital stock during the projection interval is seen as the result of the anticipated rise in gross fixed capital formation[20]. Moreover, in the context of an expected employment growth, labour is projected to make a slightly positive contribution to potential GDP dynamics. The advance of total factor productivity during the projection interval is anticipated to further witness positive values, yet markedly lower than in the period prior to the onset of the economic crisis. This development is supported by the slow easing of constraints on the expenditures for production capacity revamping, including in the context of a gradual improvement of the absorption rate of EU structural and cohesion funds.

The assessment of the negative output gap in 2013 Q1 shows a marginal widening from the previous quarter, entailing, *ceteris paribus*, slightly stronger disinflationary pressures from aggregate demand. However, compared with the previous forecasting round, in the context of the revision of the seasonally-adjusted real GDP historical data series by the NIS, the GDP deviation in 2012 Q4 is assessed to be less negative, under the joint effect of the reassessment of GDP deviation[21] determinants and of the short-term GDP forecast error. The change in the negative output gap in 2013 Q1, compared with the previous quarter, stems from its relatively high persistence, the strong impact of the external demand deficit, as well as from the pro-cyclical nature of the discretionary component of fiscal policy (approximated by the fiscal impulse)[22], whose contributions were partly offset by the stimulative effect of the real exchange rate via the net export channel.

The widening of the negative output gap in 2013 Q1 is only partly supported by the evolution of other indicators correlated with the cyclical position of the economy. Thus, signals that indicate a further increase of the negative output gap come from the larger share of respondents citing "insufficient demand" as a factor limiting industrial production and from the ILO unemployment rate that exceeded slightly the medium-term trend. Opposite signals come from the capacity utilisation rate in industry, which

Factors Limiting the Industry Production



Source: EC-DG ECFIN

20 Among the contributions of the determinants to potential GDP, the changes in the annual dynamics of gross fixed capital formation are only marginally reflected in the annual dynamics of the capital stock due to the major scale differences in gross fixed capital formation and the capital stock.

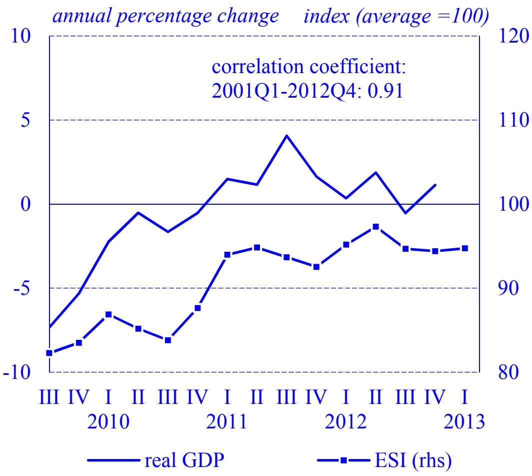
21 Given the need to include a wide range of information, analyses or data revisions, the reassessment of the GDP trend and the cyclical components is a recurrent process. In fact, during the previous forecasting round, the dynamics of potential GDP and the output gap were revised under a comprehensive process intended to reassess the historical evolution of these components. The process was aimed at incorporating the results of some NBR analyses regarding potential GDP dynamics following the onset of the global financial crisis. Further details on the reassessment of potential GDP dynamics and of the GDP cyclical component, carried out during the previous forecasting round, can be found in the box titled "Reassessment of potential GDP dynamics and GDP deviation" in the February 2013 Inflation Report, p. 38.

22 The more pronounced pro-cyclical nature of the fiscal impulse in 2013 Q1, compared with the other quarters, is generated by the seasonal pattern of the evolution of revenues and expenditure of the general government budget, as they determine a better budget performance usually recorded in this quarter.

outran the medium-term trend, and from the positive dynamics of industrial output.

During the projection interval, the negative output gap is foreseen to persist and to post a slightly narrowing trajectory over the largest part of the projection interval, which implies relatively less strong disinflationary pressures. The closing of the negative output gap throughout the projection interval is favoured by both external demand, along with the gradual recovery of EU economic activity, and the real broad monetary conditions. Compared with the February 2013 Inflation Report, the demand deficit stands at lower levels, suggesting, in relative terms, less ample disinflationary pressures on adjusted CORE2 inflation. Apart from the upward revision of the seasonally-adjusted real GDP historical data series by the NIS, to the reassessment of the output gap to less negative values than those released previously throughout the projection interval contribute the more stimulative real broad monetary conditions and the existence of a positive residual. This residual is ascribed to certain influences, such as the incidental ones captured by the exogenous forecasts and which are not explained by the factors with systematic influence included in the model for analysis and medium-term forecast or those triggered by the efforts to increase the absorption rate of the EU structural and cohesion funds. Compared to the previous round, external demand, as well as the discretionary component of the fiscal policy, are expected to act towards the widening of the negative output gap: the former is proxied by the deviation of real effective EU GDP from its potential, whose impact on domestic economic activity is more restrictive during the entire projection interval, following the revision of this deviation to substantially more negative values[23], while the latter is measured by the fiscal impulse, whose impact is more restrictive in comparative terms, particularly in 2014.

Economic Sentiment Indicator*
and Economic Growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

Aggregate demand components

In 2013 Q1, the positive quarterly growth of the actual final consumption of households is expected to accelerate slightly, causing the negative deviation from its medium-term trend to narrow. The faster growth of this component is supported by the 1.9 percent rise in retail trade turnover, except motor vehicles and motorcycles, in January-February from the 2012 Q4 average, as well as by the slight recovery in consumer confidence (up 2.3 points). On the other hand, some other coincident indicators relevant for the evolution of the actual individual consumption of households give opposite signals: real wage dropped by 3.7 percent in January-February from the previous quarter average, while the flow of new consumer loans contracted markedly in real terms (-29.7 percent in January-February from the previous quarter average). The actual collective consumption of general government is anticipated to witness a stalemate in 2013 Q1, supporting fiscal consolidation. According to the latest data released by the Ministry of Public

[23] For further details, see Section 1.1. External assumptions.

Finance, the general government deficit stood at 0.67 percent of GDP (cash-based methodology) in March 2013, only marginally higher than in the same period of 2013 (0.58 percent). Given the decline in government consumption in the previous quarters, the deviation from the medium-term trend is seen as negative.

The positive dynamics of individual consumption of households are envisaged to carry on in both years of the projection interval. This growth is foreseen to be driven by the projected higher employment in the private sector and, indirectly, by the gradual improvement in labour productivity, with a favourable impact on wage dynamics. Given the projected significant slowdown in the annual CPI inflation rate starting with mid-2013, these developments are anticipated to lead to the faster rate of increase of real disposable income of households, with a favourable impact on consumer spending. On the other hand, the dynamics of this component are further seen as subject to the constraints which affect both demand and supply of loans and prove to be highly persistent. The actual collective consumption of general government is expected to follow a path that implies the consolidation of its dynamics over the projection interval, namely the anticipation of a drop in this component in 2013 and its re-entering positive territory in 2014.

The quarterly dynamics of gross fixed capital formation are forecasted to re-enter positive territory in 2013 Q1. The real economy signals correlated with the short-term developments of the two investment components (construction and investment in equipment) are mixed and, overall, they indicate only a slight increase in this component. Specifically, January through February, the construction works index fell by 1.8 percent compared with the previous quarter average while new building permits moved up 13 percent. Similarly, the turnover volume of capital goods industry decreased in January-February by 2.6 percent from the 2012 Q4 average, even though capital goods production rose by 4.6 percent during the same period. In the context of unfavourable developments in gross fixed capital formation in 2012 Q4, followed by a slight rebound in 2013 Q1, the deviation from its medium-term trend is seen as somewhat negative.

Gross fixed capital formation is envisaged to witness, during the projection interval, a strengthening in the positive dynamics expected for 2013 Q1. The projected dynamics are based on a set of favourable assumptions that takes into consideration a higher employment rate and positive dynamics of FDI flows, against the background of a rebound, albeit slow, in exports and, later, of a higher rate of absorption of EU funds. The persistent constraints associated with the international lending conditions put a damper on the fast-paced recovery of gross fixed capital formation. Overall, the growth rate of this component is expected to stay in positive territory in both years of the projection interval, gaining momentum in 2014 compared with the current year, yet posting significantly lower levels compared with the period prior to the onset of the financial crisis.

In 2013 Q1, exports are foreseen to post an increase (following the decline reported in 2012), based on the projection taking into account balance-of-payments data on exports in the first two months of 2013[24], correlated with the good performance of industrial output (up 1.9 percent in January-February compared with the 2012 Q4 average). Imports are also expected to witness a quarterly increase, amid high import content of exports and their projected good performance[25], as well as the real exchange rate dynamics. Following the above-mentioned developments, the deviations of exports and imports from the medium-term trend are foreseen to remain negative, yet declining compared with the previous periods.

The good performance of exports of goods and services in early 2013 relative to "machinery and transport equipment" and "chemicals and related products" is foreseen to continue in the quarters ahead. This assessment takes into consideration both the longer-term nature of contracts in these industrial sectors, as well as the expected positive dynamics of external demand for such products, given that these categories of goods are exported mainly to non-EU emerging economies. Based on these developments and the anticipated relative improvement in external competitiveness, as a result of the faster fall in unit labour costs compared to that foreseen for trading partners, exports are projected to grow during the current year, after having recorded a significant decline in 2012. Nevertheless, the cautious forecasts regarding the rebound in external demand for Romanian exports entail, over the projection interval, an annual growth rate of exports slightly lower than that of real imports, the latter being supported *inter alia* by a faster rebound in domestic demand. Given the breakdown by categories of goods and services of the Romanian exports and imports, as well as the envisaged maintenance of export prices of Romanian goods[26] at comfortable levels in 2013 and 2014, the balance-of-payments current account deficit is projected to narrow compared with 2012. In this context, the current scenario does not foresee any significant corrective pressures on the exchange rate of the leu until the projection horizon.

[24] The positive growth of exports is supported mainly by the favourable performance of "machinery and transport equipment" (up 9.7 percent year on year in January-February 2013 and holding a 42.4 percent share in total exports) and "chemicals and related products" (up 25.8 percent during the same period and posting a 6.7 percent share in total exports).

[25] The partial balance-of-payments data expressed in euro are indicative of the increase in both exports and imports (5.1 percent and 2 percent respectively in January-February compared with the 2012 Q4 average).

[26] The significantly higher growth rates of the export deflator compared to those of the import deflator recorded in the latter half of 2012 are most likely to generate higher average annual dynamics for the export deflator in 2013, due to the carry-over statistical effect. From a methodological standpoint, the annual average growth rates of GDP and its components (in the case of both volume and price indices) are impacted by current year developments as well as by those recorded in the previous year (persistent carry-over statistical effects generated by the effective developments of the indicator in 2012).

Broad monetary conditions

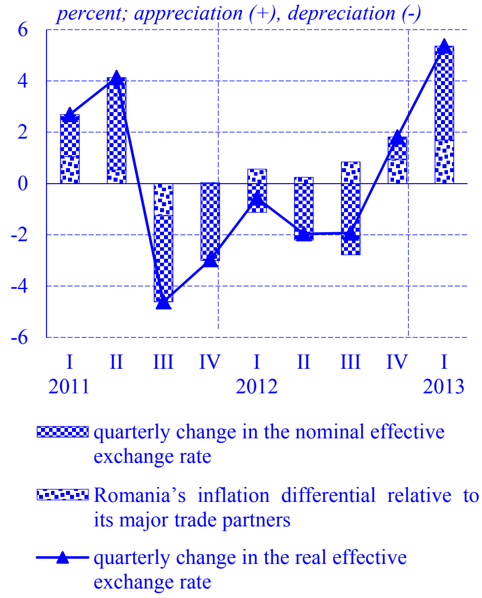
Broad monetary conditions capture the impact exerted on the future developments in aggregate demand by the dynamics of real interest rates in lei applied by credit institutions to their non-bank clients and by the real effective exchange rate of the leu[27]. The exchange rate exerts its influence via the net export channel, as well as via the wealth and balance sheet effect[28].

In 2013 Q1, nominal interest rates in lei[29] applied by credit institutions to their non-bank clients posted different developments: deposit rates saw a relative stagnation, whereas lending rates inched down. Given the low dynamics of the nominal interest rates, the decrease in inflation expectations[30] in the first quarter of the year mirrored the slight increase in both real deposit and lending rates. Overall, the deviations of real interest rates from the medium-term trends are further indicative of a stimulative impact on future economic activity[31], yet slightly lower than that seen in 2012 Q4.

The domestic currency continued to appreciate in both real and nominal terms in the first quarter of 2013 as compared with the previous quarter's average, these dynamics being reflected in the deviation of the real effective exchange rate[32] from the medium-term trend. The real appreciation of the leu versus the preceding quarter is attributed to the nominal appreciation of the domestic currency, as well as to the positive inflation differential versus Romania's trading partners. The nominal effective exchange rate developments are the result of the appreciation of the leu versus the US dollar and the euro. Against this background, the deviation of the real exchange rate versus the medium-term forecasted trend indicates, *ceteris paribus*, a slightly restrictive impact versus the preceding quarter on future aggregate demand via the net export channel.

In 2013 Q1, investor sentiment towards Romania's sovereign risk[33] continued to improve as compared with the previous quarter's level, reflecting both fundamentals and a regional trend. The impact

Quarterly Change in the Effective Exchange Rate



Source: Eurostat, U.S. Bureau of Labor Statistics, NBR, NBR calculations

[27] This definition of real broad monetary conditions is used in the model for analysis and medium-term forecasting.

[28] The wealth and balance sheet effect of the exchange rate is manifest, in the case of indebted economic agents, by changing the allocation of resources available, on the one hand, for consumption and investment, and for granting and repayment of foreign currency-denominated loans, on the other hand.

[29] Nominal interest rates on loans and deposits in lei are calculated as interest rate averages weighted by the volume of new loans/deposits.

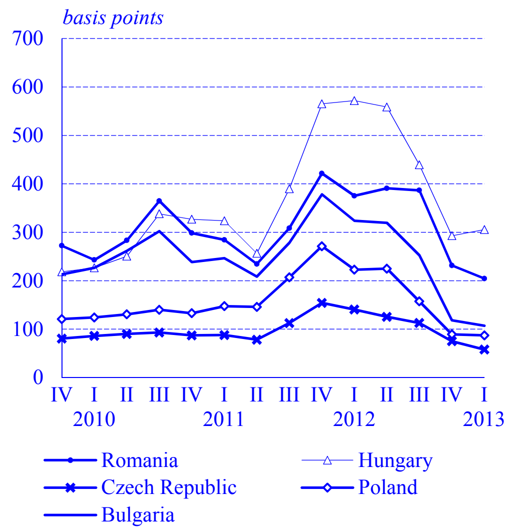
[30] The information on this indicator has been taken over from the NBR's monthly survey among bank analysts.

[31] The real lending rate deviation from the medium-term trend further exerts a relatively neutral impact on the economic activity in the following quarters.

[32] The exchange rate used in this assessment is based on the RON/EUR and RON/USD exchange rates weighted by the shares of the two currencies in Romania's foreign trade.

[33] The risk level associated with investments in the national economy is correlated with developments in CDS (Credit Default Swap) spreads.

5-year CDS Spreads for Romania and Other Countries in the Region



Source: NBR calculations based on Bloomberg data

of the expected exchange rate developments[34], corroborated with the favourable effect of the real foreign interest rate staying below the medium-term trend is to a small extent countered by the risk premium being slightly above the medium-term trend. Therefore, in 2013 Q1 as a whole versus the previous quarter, the wealth and balance sheet effect suggests a lower stimulative impact on future economic activity.

According to the NBR assessment, real broad monetary conditions in 2013 Q1 indicate a slightly stimulative effect on future economic activity. Looking at the breakdown of the real broad monetary conditions, the stimulative impact from the wealth and balance sheet effect, as well as that from the real deposit rates are partially countered by the restrictive impact from the real exchange rate via the net export channel, whereas real lending rates have a relatively neutral effect.

Over the forecast interval, real broad monetary conditions are expected to have a more conducive impact on the economic activity compared with the February 2013 Inflation Report, as a result of changes in the determinants' impact. Thus, the real exchange rate is projected to exert a less restrictive impact on net exports throughout the reference interval, while the impact of the deviation from the medium-term trend of the real interest rate on the foreign currency loans denominated in lei is anticipated to be more stimulative over most of the forecast interval[35]. This development is the result of forecasting more favourable values for the wealth and balance sheet effect of the exchange rate, boosted by the improvement in investor sentiment towards Romania's economy in the context of anticipating further low levels of the budget deficit and the current account deficit over the projection interval, as well as of Romania's sovereign debt being included in key emerging-market bond indices[36].

Similarly to the previous projection round, the path of the monetary policy rate is calibrated so as to ensure that the inflation rate returns and consolidates inside the variation band around the central target, via the effective anchoring of economic agents' inflation expectations, thus contributing to creating the necessary prerequisites for sustainable economic growth in the medium and long run. In line with the projected trajectory of the monetary policy rate, the cumulative impact of the deviations from the trends of real interest rates on leu-denominated loans and deposits is expected to further have a stimulative effect on aggregate demand throughout the forecast interval, albeit slightly lower than in the previous projection round.

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[34] Proxied by the expected change in the real effective exchange rate deviation.

[35] Overall, the two mentioned components define the wealth and balance sheet effect within the model for analysis and medium-term forecasting and represent the cumulative impact of the deviation from trend of the real interest rate on foreign currency loans and the expected change in the real effective exchange rate deviation.

[36] GBI-EM by JP Morgan and the index computed by Barclays Capital.

1.4. Risks associated with the projection

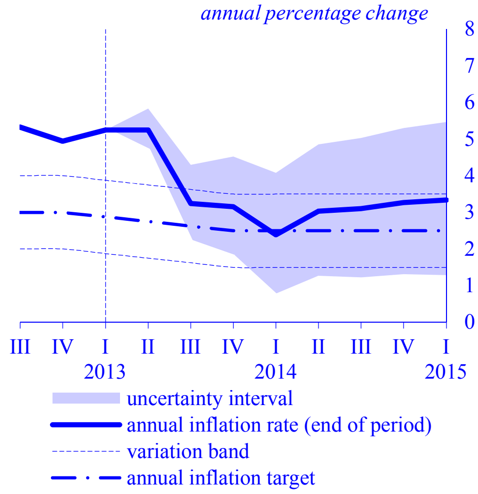
The balance of risks to the annual CPI inflation rate is further tilted to the upside compared to its path in the baseline scenario, the asymmetry being however lower in the current forecasting round than in the previous one.

This configuration of the balance of risks is shaped by both external and domestic factors. The external factors are associated with the uncertainties surrounding the economic and financial developments in the euro area. Domestically, in the context of the continuation of the sustainable fiscal consolidation in line with the commitments assumed under the agreements signed with the EU, the IMF and the World Bank, relevant factors refer primarily to the likelihood of failing to firmly fulfil the set of structural reforms agreed on with the international institutions.

Over the reference interval, relevant risks, whose balance is relatively in equilibrium, stem from the external environment, being associated with possibly higher volatility of capital flows channelled towards emerging economies – with potentially unfavourable effects on the financing of domestic economy. These risks are generated by the fragility of the slow recovery of Romania's major EU trade partners, potentially fuelled by the recent difficulties faced by the banking systems of some of the euro area countries, given the persistence of the sovereign debt sustainability issues in some of these economies. Against this background, frequent shifts in investor sentiment may trigger volatile capital flows between the domestic economy and the external environment, potentially enhancing the regional financial fragmentation, with the influences on Romania's economy being difficult to *a priori* assess. Regardless of their initial direction, inasmuch as they are large and easily reversible, the capital flows not backed by macroeconomic fundamentals can have a negative impact on financial and price stability, as well as on the sustainable economic recovery. Nevertheless, insofar as the recent favourable developments across the Romanian economy carry on, thereby shaping a lasting improvement in macroeconomic fundamentals, the risk of unsustainable capital flows will be lower than previously. Thus, it should be pointed out that the Cypriot crisis had limited effects on the domestic economy, despite the substantial contagion potential that might have been presumed.

Domestically, the main upside risks to the projected inflation rate are related to the persistent structural rigidities across the domestic economy which are likely to constrain the flexible adjustment of domestic economic factors, viewed as pivotal in ensuring the resilience of the Romanian economy in the face of adverse shocks arising from either external or internal sources. Consequently, any delay in effectively and timely achieving a consistent structural reform mix, such as that included in the agreement concluded by the Romanian authorities with the international institutions (the EU, the IMF and the World Bank), could generate in the near run,

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Note: The uncertainty interval was calculated based on the forecast errors in the NBR projections during 2005-2012. The forecast errors are positively correlated to the time horizon they refer to.

Source: NIS, NBR calculations and projections and especially in the medium run, spillover risks and even amplify the unfavourable shocks on inflation and economic growth.

Given the baseline scenario assumptions, the balance of risks to the developments in administered and volatile food prices over the reference period seems to be relatively in equilibrium. Despite the relative decline in the uncertainty surrounding the future evolution of administered prices, following the release by relevant authorities of calendars on the deregulation of natural gas and electricity prices, the impact that each liberalisation stage will have on consumer prices is still difficult to accurately assess[37]. The uncertainties surrounding the evolution of the domestic food price dynamics refer to the weather conditions that are likely to have a bearing on the agricultural product supply and to lead to CPI inflation rate deviations from its path in the baseline scenario. Such uncertainties are all the more significant as food items continue to hold a relatively large share in the consumer basket.

The balance of risks posed by global commodity prices is viewed as being in equilibrium in the short run; however, over the medium and long run it is not ruled out that the volatility in the dynamics of the prices of such product categories may steepen, possibly amplified by substantial fluctuations in the EUR/USD exchange rate. To this assessment add potential future intensifications in the structural trends on the international markets[38] which make this risk factor to be further relevant to the future evolution of inflation in Romania.

2. Policy assessment

In line with the central bank's forecasts, at the outset of 2013, the annual inflation rate saw a new increase, followed by two successive smaller decreases, reaching 5.25 percent in March, i.e. still above the level recorded in December 2012 and hence above the upper bound of the flat target band. The relative step-up in inflation was due almost entirely to the adjustment of some administered prices, as well as to the excise duty hikes in January – and mainly to the higher excise duty levied on tobacco products. The inflationary impact of these factors was only partly offset by that generated – against the background of *inter alia* an improved leu exchange rate evolution and of some favourable base effects – by the slower annual dynamics of volatile prices and by the deceleration of the adjusted CORE2 inflation, given the persistence of the negative output gap, as well as the maintenance of a prudent monetary policy stance.

[37] For instance, it is still uncertain whether the electricity and natural gas price adjustments for industrial consumers have a material impact on prices for household end-users. Moreover, the relevant authorities have not yet made available any impact studies accurately quantifying the impact of the scheduled electricity market liberalisation stages on electricity prices.

[38] For instance, the increase in food consumption in emerging economies and the reduction in agricultural plots in Asian countries.

In the context of the considerable revision of some of the main assumptions, the updated quarterly forecast of medium-term macroeconomic developments reveals a significant improvement in the short-term inflation outlook compared to the previous projection. Thus, for 2013 Q2, the annual inflation rate is anticipated to post levels comparable with that seen in March and therefore stand significantly lower than previously forecasted. Furthermore, the 12-month CPI inflation rate is expected to return inside the flat target band two quarters earlier than previously projected, i.e. in Q3, while at end-2013 it is seen falling to 3.2 percent, i.e. lower than previously forecasted. The main determinant of such an improvement is the relatively more favourable effect of supply-side factors, stemming from the downward revision of the anticipated annual dynamics of volatile prices and administered prices – only partly counterbalanced by the upward revision of the expected dynamics of tobacco product prices.

Over the second segment of the forecast interval, the annual inflation rate is expected to post similar or only marginally higher-than-previously projected levels (3.3 percent at end-2014), thus remaining in the upper half of the flat target band. From the perspective of monetary policy conduct, it is relevant that, alongside the relative improvement in the expected behaviour of volatile prices and tobacco product prices, the anticipated downward correction of annual core inflation, against the background of the fading out of the adverse effects generated on processed food prices by supply-side shocks, as well as its subsequent remaining in a range below the central target, is a major determinant for the projected annual headline inflation rate to return and then consolidate within the target band. Over most of the forecast interval, the annual adjusted CORE2 inflation rate is forecasted to be almost unchanged from the previous projection, as the impact of the downward adjustment of inflation expectations, anticipated to proceed at a marginally slower pace, as well as that of the slightly lower-than-previously forecasted intensity of the negative output gap-induced disinflationary pressures, as a result of the lower projected negative output gap (following the upward revision of the historical data, and particularly of the GDP growth forecasts) are offset by the impact generated by the deceleration in the anticipated annual dynamics of the leu exchange rate.

The tailoring of the monetary policy response to the context anticipated by the current medium-term inflation forecast is further constrained by the persistence of uncertainties, as well as of a relative asymmetry of the related balance of risks. A major source of uncertainty and of both-way risks comes further from the external environment and especially from the developments in the economies and banking systems of the euro area and the public policies aimed at the sustainable resolution of the ongoing issues, as well as from their potential impact on the international financial market liquidity and confidence.

In view of the high sensitiveness of the international investor sentiment towards these developments, one cannot rule out the risk of a possible intensification, in the future, of the leu depreciation pressures and of the ensuing deterioration of the inflation developments under the impact of a decline in net capital flows targeting the Romanian economy that might be triggered by the potential worsening of the European context, very likely associated with an increase in global risk aversion. The resulting adverse impact on the leu exchange rate and hence on inflation, as well as on the costs related to the fiscal deficit and public debt financing, could be magnified by the recent pick-up in the volume of leu-denominated government securities held by non-residents, alongside the potential reallocation of this capital towards portfolio investments viewed as less risky, including towards sovereign debt instruments issued by other countries. Assuming a protracted deterioration of the European context and of the international market sentiment, the inflationary impact of the leu exchange rate is however expected to be moderated in the short run and even offset in the medium term by the relative step-up in the negative output gap-induced disinflationary pressures, against the background of a protracted recession/slow-in-coming recovery of the euro area economy, but also of the occurrence of the wealth and balance sheet effect of the exchange rate.

Nevertheless, it is equally possible to witness a step-up in the appreciation pressures on the leu against the major currencies – generating disinflationary effects – assuming the persistence of/ improvement in the international financial market sentiment[39] and the possible protraction, in this context, of the spur given to capital inflows into the local market by the Romanian sovereign bonds being included into the Barclays and JP Morgan emerging-market local-currency government bond indices, as well as by the persistent attractiveness of investments in the domestic currency. The latter would stem also from the continuation of the fiscal consolidation process, the acceleration of structural reforms, as well as from the enhanced efforts aimed at raising EU funds, in line with the commitments assumed under the agreements with the EU, the IMF and the World Bank. In its turn, the implementation of the commitments thus assumed supports the time consistency of the macroeconomic policy mix, which allows the prudent tailoring of the monetary policy stance to the prospects for the inflation rate to return inside the target band in Q3, while effectively anchoring inflation expectations and improving the transmission of the monetary policy signals – largely contingent on the restoration of both consumers' and investors' confidence in the future economic developments.

[39] Most likely as a result of the dissipation of fears concerning some European economies and of the progress in reducing imbalances, implementing structural and institutional reforms in adjusting the balance sheets of the banks/non-financial sector in the euro area countries, as well as due to the monetary policy measures implemented by the European Central Bank.

As regards the potential risks to the inflation outlook posed by the external environment via developments in the international agri-food commodity and energy prices, including the oil price, their balance seems to remain relatively in equilibrium, at least in the short run, as such prices may post both-way deviations from the forecasted trajectory. From this standpoint a key role is played, on the one hand, by the dynamics of global economic recovery and the size of the demand for such goods, decisively shaped by the evolution of the Chinese economy, and, on the other hand, by the developments in global output and stocks, including those of agricultural products, that are highly dependent on weather conditions. The balanced balance-of-risks assessment is also due to the relatively high probability of improvement compared to last year in the domestic agricultural performance that is likely to mitigate the possible adverse effects induced by external prices on the prices of some agricultural products.

The moderation, against this background, also of the risks posed by domestic developments to inflation and inflation expectations is enhanced by the rebalancing in the current context of the balance of risks associated with administered price adjustments for which main pieces of information are provided by the calendars on the deregulation of electricity and natural gas prices, approved by the authorities in line with the commitments assumed under the agreements signed with the EU, the IMF and the World Bank.

With a view to effectively anchoring inflation expectations and strengthening the prospects for the annual inflation rate to return inside the variation band around the medium-term target, as the adverse effects of supply-side shocks are seen fading, the NBR Board has decided in its meeting on 2 May 2013 to keep the monetary policy rate unchanged at 5.25 percent per annum. Moreover, the NBR Board has decided to ensure adequate liquidity management in the banking system and to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. At the same time, in order to moderate interest rate volatility on the interbank money market and consolidate the transmission of the policy rate signal, the NBR Board has decided to narrow the corridor defined by interest rates on the standing facilities to ±3 percentage points. Therefore, the interest rate on the lending facility was lowered to an annual 8.25 percent from 9.25 percent, while the deposit facility rate was raised to 2.25 percent per annum versus 1.25 percent previously.