NATIONAL BANK OF ROMANIA

INFLATION REPORT
February 2015

Year XI, No. 39

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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.

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

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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.

The Inflation Report was approved by the NBR Board in its meeting of 4 February 2015 and the cut-off date for the data underlying the macroeconomic projection was 30 January 2015.

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

Abbreviations

CCR	Central Credit Register
CPI	consumer price index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
EIA	US Energy Information Administration
ESI	Economic Sentiment Indicator
EU	European Union
Eurostat	Statistical Office of the European Union
GDP	gross domestic product
GVA	gross value added
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
ROBOR	Romanian Interbank Offer Rate
VFE	vegetables, fruit, eggs
1W	1 week
3M	3 months
6M	6 months
12M	12 months
3Y	3 years
5Y	5 years
10Y	10 years

Contents

SUMMARY

Developments in inflation and its determinants

In 2014 Q4, the annual CPI inflation rate fell again under the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target. The December reading, i.e. 0.83 percent, was 0.7 percentage points below both that seen at end-Q3 and that forecasted for year-end in the November 2014 Inflation Report, staying however above the historical low recorded in June 2014 (0.66 percent). The average annual HICP inflation rate[1] came in at 1.4 percent in December 2014, remaining on a quasi-stable path as of mid-year.

The adjusted CORE2 inflation[2] was fairly steady during Q4, reaching the previously-projected level in December. The low level of core inflation (1 percent starting with September) continued to be supported by fundamental factors, especially by the joint influence of the persistent, yet slightly narrowing, negative output gap and the significant improvement in economic agents' inflation expectations.

Given the core inflation readings, the slowdown in the overall CPI inflation rate versus Q3 and its running below the November forecast at end-2014 were exclusively driven by developments in the CPI components affected mainly by supply-side factors. Specifically, the prevailing impact came from the unanticipated shocks on volatile prices: fuel prices, on account of the marked decline in the international oil prices – mitigated by the depreciation of the domestic currency against the US dollar – and VFE prices. The latter fell against the background of a new bumper crop across the region and amid domestic supply being supplemented by higher imports from the European states hit by the Russian import ban as of August 2014. A lower influence on the annual CPI inflation rate resulted from the further deceleration of administered price dynamics.

Unit labour costs in industry entered an upward path in July-November on account of the ongoing slowdown in the dynamics of labour productivity across this sector altogether. In the economy as a whole, after the hike in the gross minimum wage in July, the growth rate of gross nominal wage earnings followed a slight uptrend until November. This tendency is expected to carry on at the onset of 2015, fostered by the new advance in the minimum wage in January and by other increases announced for both public and private sectors. In the short run, the persistence of the negative output gap mitigates the risk of significant wage cost-related inflationary pressures. However, over the medium term, with GDP nearing its potential level and given additional rises in the economy-wide minimum wage, maintaining an adequate match between wage increases and labour productivity gains is of the essence for consolidating price stability.

Monetary policy since the release of the previous Inflation Report

In its meeting of 4 November 2014, the NBR Board decided to cut the monetary policy rate to 2.75 percent per annum, from 3.00 percent. The decision was substantiated by the macroeconomic prospects stemming from the updated NBR forecast, as well as by the related risks. The forecast placed the annual inflation rate at levels markedly below those previously projected, since some

1 Calculated as the average price change in the last 12 months compared to that in the previous 12 months.

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.

fundamental factors (negative output gap, inflation expectations and the inflation reported by the main trading partners) were seen having a stronger disinflationary impact, complemented by a favourable influence from agri-food prices. The risks associated with the forecast were primarily posed by the external environment, as a potential source of excess volatility of capital flows, against the background of adjustments in the monetary policy stance by major central banks worldwide, the ongoing cross-border deleveraging of banks, and geopolitical tensions. Furthermore, considering the goal to further harmonise the reserve requirements mechanism with the relevant standards and practices of the European Central Bank and the major central banks in the EU Member States, the minimum reserve requirements ratio on foreign currency-denominated liabilities of credit institutions was cut to 14 percent from 16 percent. At the same time, with a view to reducing the volatility of interbank market rates and consolidating the transmission of the monetary policy rate signal, the symmetrical corridor defined by the interest rates on the NBR's standing facilities around the policy rate was narrowed to ±2.50 percentage points from ±2.75 percentage points.

Subsequent to the decision taken in November, the annual inflation rate entered a trajectory below that previously forecasted, with prospects of remaining in the short term below the lower bound of the variation band of the flat target. The deviations from the November forecast were mainly triggered by the unexpectedly faster decrease in volatile prices, especially on account of the decline in the global oil price. At the same time, higher uncertainty appeared to surround external developments, in the context of renewed regional geopolitical tensions and further adjustments in the monetary policy stance by major central banks worldwide.

In this context, the NBR Board decided in its meeting of 7 January 2015 to cut the monetary policy rate to 2.5 percent per annum, from 2.75 percent. Moreover, seeking to further consolidate the transmission of the monetary policy rate signal, the NBR Board decided to narrow the symmetrical corridor defined by interest rates on the NBR's standing facilities around the policy rate to ±2.25 percentage points from ±2.5 percentage points.

Inflation outlook

The current projection sees the annual CPI inflation rate running below the lower bound of the ±1 percentage point variation band of the 2.5 percent target until the end of 2015 Q3, before returning inside the band in 2015 Q4 and remaining there until the projection horizon.

According to the baseline scenario, real GDP growth is estimated to have slowed down somewhat in 2014 compared to a year earlier, owing largely to a lacklustre performance in Q2. The recovery manifest in 2014 H2 is largely ascribed to improved consumption dynamics and a reversal of the downturn in gross fixed capital formation, whereas exports are assessed to have further grown at a positive rate, also as a result of a plentiful harvest. Domestic demand is seen consolidating over the forecast interval and, thus, resuming its role of key driver of economic growth. Consumption is projected to increase at a slightly swifter pace than investment, with the latter expected to underpin GDP advance starting with 2015, after two years of negative contributions to growth. The rebound in domestic demand is anticipated to be bolstered by: the rise in households' real disposable income, due to nominal increases and to the projected inflation rate staying at relatively low levels; the consolidation of productive capital inflows (EU structural and cohesion funds and foreign direct investment flows); as well as further easing of lending conditions, on the back of the pass-through of previous policy rate cuts and gradually stronger economic activity in the periods ahead.

The expansion of domestic demand will drive a wedge between the growth rate of imports and that of exports in the first part of the reference period, while the gradual recovery of the European economy is expected to boost Romania's exports towards the projection horizon. Net exports are therefore seen to have a slightly negative contribution to economic growth in 2015 and a relatively neutral one afterwards. As a result, the baseline scenario entails the lack of any significant corrective pressure on the leu exchange rate arising from the external position until the projection horizon.

The negative output gap has been revised for the entire forecast interval to sizeably lower values than in the November 2014 projection round, implying weaker disinflationary pressures. The reassessment took account of higher-than-expected real GDP growth in 2014 Q3, the NIS revisions of seasonally-adjusted real GDP historical series in the context of shifting to the European System of Accounts (ESA) 2010, and the real broad monetary conditions being projected a tad more stimulative over most of the forecasting interval. The deviation of GDP from its potential level is foreseen remaining at negative, albeit gradually declining, values during the reference period.

The baseline scenario of the current projection places the annual CPI inflation rate at 2.1 percent at end-2015, 0.1 percentage point lower than in the November 2014 Inflation Report, and at 2.4 percent at end-2016.

The CPI inflation rate is seen running below the previously-projected values almost throughout the reference period, except for 2016 Q1. At the same time, the adjusted CORE2 inflation rate forecast has been revised upwards in the first half of the period and downwards thereafter. The diverging revisions are attributed to the favourable impact expected in 2015 from supply-side shocks whose effects would later fade out, on the one hand, and to the opposite developments in some fundamental drivers of core inflation, import prices in particular, over the two-year projection interval, on the other hand. A significant influence on the forecast revision had the unexpected developments that occurred after the November projection was published.

The annual adjusted CORE2 inflation rate is forecasted to range between 1.1 and 1.5 percent throughout the reference period, with a peak in 2015 Q2. This inflation measure is seen reaching 1.3 percent and 1.4 percent at end-2015 and end-2016, respectively. Compared with the previous projection, the significantly downward revision of the negative output gap entails weaker pressure to drive down core inflation throughout the projection interval. The downward revision, also during the entire projection interval, of economic agents' inflation expectations, partly as a result of the recent disinflationary performance, acts in the opposite direction. Imported inflation also played a role in the annual adjusted CORE2 inflation rate being revised upwards in 2015 and downwards in 2016. As against the previous forecast, this influence is on the upside in 2015 considering the recent softening of the leu versus the US dollar and the euro. However, for next year, these effects are expected to fade away, whereas the dynamics of external prices relevant to Romania's imports are projected to post lower levels than envisaged in November.

The projections for exogenous CPI components in terms of the monetary policy scope show their cumulative contributions to the headline index dynamics having far lower magnitudes than in the previous forecast for 2015 and marginally higher in 2016. The most substantial reassessment was the downward revision of the contribution of fuel prices in 2015, reflecting the base effect of the sharp fall in oil price on international markets in 2014. Another base effect, stemming from the plentiful harvest and the domestic supply being supplemented by imported fruit and vegetables from European countries hit by the Russian import ban imposed in 2014, stood behind the significantly downward revision of VFE prices contribution to headline inflation in 2015 Q1 - Q3. The revised projections for tobacco product prices and administered prices are due to changes in the current legislation regarding the determination of the leu-denominated level of excise duties, as concerns the former, and the calendar and magnitude of future natural gas price adjustments, in the latter case.

Given the projected dynamics of its components, the annual CPI inflation rate will remain below the lower bound (1.5 percent) of the variation band of the target by 2015 Q3, will return inside the variation band in the next quarter and will stabilise at levels slightly lower than the 2.5 percent mid-point of the target until the forecast horizon. It is envisaged that annual inflation will bottom out at 0.1 percent in 2015 Q1, mainly on the back of base effects stemming from the movements in volatile prices. The average annual inflation rate is projected to run below the lower bound of the variation band of the target until the end of 2015, then to return inside the band and stick to levels below the mid-point of the target until the end of 2016.

Going forward, the stance of monetary policy is shaped with a view to ensuring price stability over the medium term, amid firm anchoring of inflation expectations, so as to support economic growth, including via the restoration of confidence and the sustainable recovery of lending.

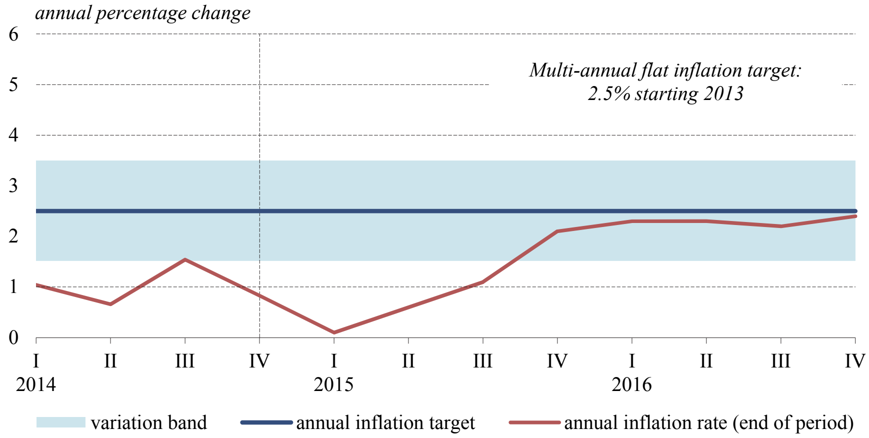
The assessment of the risks to the current inflation rate projection reveals a balance tilted to the upside, especially due to the uncertainties surrounding the external environment. Relative to the November 2014 Inflation Report, uncertainties at the current juncture appear to be higher, following recent events mainly in Europe and across the region that might have adverse consequences for Romania's economy.

Growing uncertainties are fuelled by the recent escalation of the conflict between Russia and Ukraine and the situation in Greece. Further relevant are the risks of a possibly widening divergence between the monetary policy stances pursued by the world's major central banks, the US Federal Reserve and the ECB in particular, as well as of the ongoing cross-border deleveraging in the banking system, that could bring about capital outflows from the region. The risks associated with the latter appear however to be on the wane, considering both the relatively favourable outcome of the comprehensive assessment exercise of significant credit institutions completed by the ECB at the end of the last year and the easing of liquidity strains they have been facing, amid the implementation of the expanded asset purchase programme recently adopted by the ECB. Against this backdrop, the major risks to the inflation projection refer to possible wide fluctuations in foreign investors' risk aversion, entailing successive reallocations of exposures to emerging economies and hence heightened volatility of capital flows channelled to these economies, Romania included. These would induce instability of both foreign financing sources for the national economy development and the leu exchange rate, with a detrimental impact on price stability and the consolidation of economic growth assumed in the baseline scenario of the projection.

Given the investors' medium- and long-term bias towards economies with relatively low external and domestic macroeconomic imbalances, Romania's progress in this direction over the recent years carries the potential to mitigate to some extent the risk associated with unfavourable effects of global or regional portfolio shifts. At the same time though, the persistence of structural rigidities across the Romanian economy dampens its capacity to react in order to mitigate the consequences of adverse external shocks and is viewed as a risk factor by international investors. For this reason, the firm and consistent implementation of the structural reforms agreed upon with the EU, the IMF and the World Bank is a prerequisite for bringing sustainable capital flows into the Romanian economy.

The risks that the aggregate consumer price index components affected mainly by supply-side shocks deviate from their trajectories assumed in the baseline scenario appear to be relatively balanced during the reference period, despite the persistence of specific uncertainties. Thus, the uncertainty surrounding administered prices is associated, over the medium term, with the magnitude of the impact that the natural gas and electricity market deregulation stages will exert on end-user prices. As for international commodity prices, heightened risks are associated with the future path of the EUR/USD exchange rate, which depends on several factors linked to both the global economic environment and a potential escalation of geopolitical tensions. Domestic food price dynamics are still strictly dependent on weather, and implicitly on the good performance of agricultural output. Another incidental factor specific to the current reference period is the possible persistence of domestic supply being supplemented by imports from countries hit by Russia's recent ban.

Inflation Forecast



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

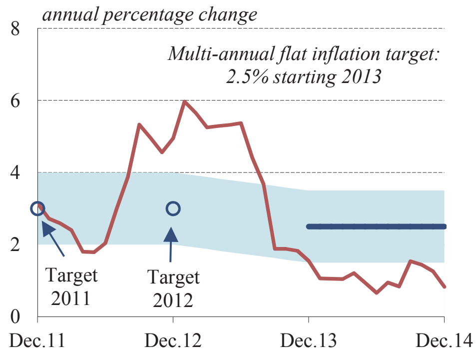
Source: NIS, NBR projection

Monetary policy decision

Given the downward shift of the forecasted path of the annual inflation rate and its running below the mid-point of the target until the end of the forecast horizon, driven by the slowdown in the anticipated volatile price dynamics, the persistence of the negative output gap, the adjustment of inflation expectations to lower levels, as well as by the ongoing subdued inflation in the euro area, the NBR Board decided in its meeting of 4 February 2015 to lower the monetary policy rate by 0.25 percentage points to 2.25 percent per annum. Moreover, with a view to mitigating interbank money market rate volatility and consolidating the transmission of the policy rate signal, the NBR Board decided to narrow the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate to ±2.00 percentage points from ±2.25 percentage points. Thus, the interest rate on the NBR's lending facility (Lombard) was lowered to an annual 4.25 percent from 4.75 percent, while the deposit facility rate remained at 0.25 percent per annum. The NBR Board also decided to pursue adequate liquidity management in the banking system and to keep unchanged the current levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

I. INFLATION DEVELOPMENTS

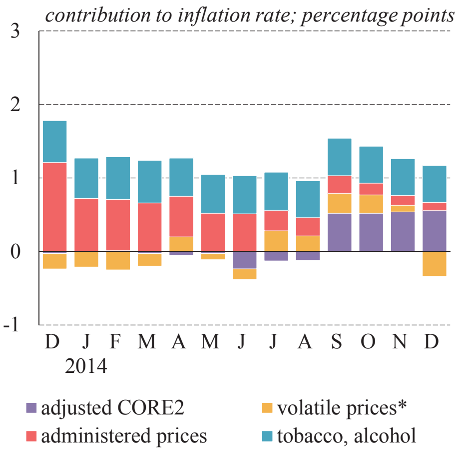
Inflation Developments



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

Source: NIS, NBR calculations

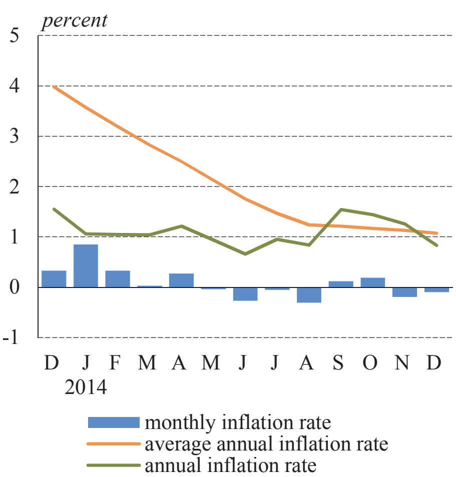
Annual Inflation Rate



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

Source: NIS, NBR calculations

Inflation Rate



Source: NIS

At end-2014, the annual CPI inflation rate dropped 0.71 percentage points from end-Q3 to 0.83 percent, thus standing below the lower bound of the ±1 percentage point variation band of the 2.5 percent target. Exogenous variables were fully accountable for this development, amid the substantial decline of international oil prices, as well as the fall in agri-food commodity prices under the joint impact of an above-average harvest at regional level and the banned access to a major market for European countries (Russia). Concurrently, the persistent negative output gap and the improvement of inflation expectations, together with the slight appreciation of the domestic currency versus the euro, underpinned the adjusted CORE2 inflation remaining at a low level (1 percent).

The sharp fall in the annual inflation rate in 2014 Q4 was triggered mainly by volatile prices, with fuel prices making the largest contribution. The annual dynamics in the latter sub-group entered negative territory October through December 2014 (-5.5 percentage points to -1.8 percent), as Brent crude oil price decreased by 35 percent from end Q3[1], with the downward impact on domestic prices being partly offset by the appreciation of the US dollar (5.9 percent versus the domestic currency compared with September 2014). The disinflation seen in 2014 Q4 was also the result of the steeper annual decrease in VFE prices (-2.7 percentage points to -3.3 percent in December 2014), against the backdrop of a new plentiful harvest at regional level and the domestic supply being supplemented by imports from European countries hit by the Russian import ban as from August 2014[2].

As regards administered prices, their annual dynamics dropped in Q4 by another 0.7 percentage points, reaching 0.4 percent in December. The downward trend seen in the annual growth rate of administered prices was mainly driven by the downward base effect stemming from the decision to discontinue the natural gas price liberalisation October 2014 through June 2015. This was accompanied by similar base effects with a bearing on the dynamics of other categories of administrative prices (communal services, heating), that were kept unchanged or even decreased over the period under review.

Tobacco and alcohol product prices saw marginal monthly changes in 2014 Q4, causing their annual dynamics to remain at 6.4 percent.

[1] The Brent oil price went down from approximately 99 USD/barrel in September 2014 to 64 USD/barrel in December 2014, the lowest level in five and a half years, amid the robust dynamics of oil output and the sluggish consumer demand (Source: Monthly Reports of EIA and OPEC). For further details, see the box titled "Oil prices – their impact on inflation and economic activity", p. 22.

[2] Available data indicate a 26.1 percent annual increase in the volume of fruit and vegetables imported August through October 2014; the intra-EU market contributed by 20 percentage points to this development, while the non-EU market accounted for 6.1 percentage points (4.7 percentage points in relation to the Republic of Moldova). (Source: ComExt).

The 2014 cumulated growth is essentially accounted for by the hike in excise duties that stood behind approximately 80 percent of the overall price increase of tobacco products and respectively 50 percent in the case of alcoholic beverages.

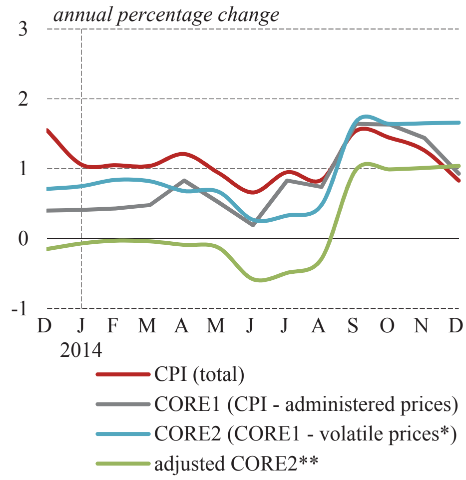
The annual growth rate of the adjusted CORE2 index remained low at 1.0 percent as from September 2014, amid the persistent negative output gap and the ongoing improvement of inflation expectations. Looking at the breakdown by categories of goods and services, the developments were slightly heterogeneous. Specifically, the group of non-food items saw a slight pick-up in their annual price dynamics (+0.2 percentage points to 1.8 percent), possibly on the back of a faster growth pace of trade in such goods (especially on-line). Processed food prices remained relatively unchanged from the previous year (0.2 percent in annual terms at end Q3 and Q4), given the low costs of agri-food commodities and transport. The annual growth rate of market service prices slowed down slightly (by 0.1 percentage points to 2 percent), mainly on account of the year-on-year appreciation of the domestic currency versus the euro.

Inflation expectations of consumers and of trade and services companies further improved in September-December 2014, while firms in industry and construction maintained a stable price outlook. At the same time, financial analysts expect a lower annual inflation rate for end-2015 compared with the results of the previous surveys, further close to the central bank's annual target. Given the primarily backward-looking nature of inflation expectations in Romania, the recent steep fall in oil prices is most likely to have influenced their downward movement.

The average annual inflation rate measured by the Harmonised Index of Consumer Prices (HICP) – a relevant indicator for the assessment of Romania's convergence process – remained relatively unchanged from the preceding quarter, standing at 1.4 percent in December 2014. Despite these relatively steady developments, the differential versus the EU-wide average inflation widened to 0.8 percentage points (versus 0.6 percentage points at end-Q3), the sharp decline in energy prices in the latter part of 2014 prompting an increasing number of European states to post negative HICP inflation rates.

The actual annual inflation rate at end-2014 stood 0.7 percentage points below the level projected in the November 2014 Inflation Report. The main explanation for this deviation lies with the decline in international oil prices (-0.4 percentage points), with quotations dropping significantly below the considered hypothesis in the previous forecast, based on futures prices. Moreover, the forecasting error was due to a significant extent to the sharper-than-expected decline of vegetable and fruit prices (-0.3 percentage points), probably on account of domestic supply being increased by imports from European states affected by the recent lack of access on the Russian market.

Headline Inflation and CORE Inflation

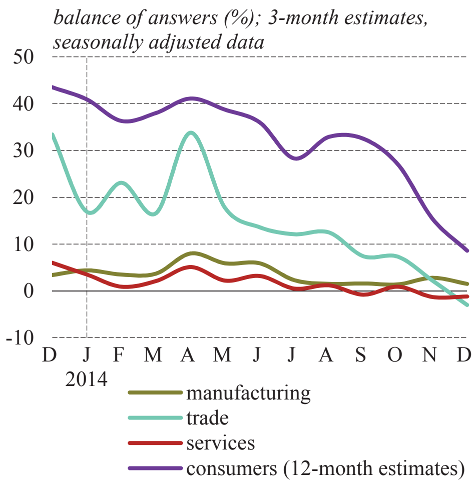


*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

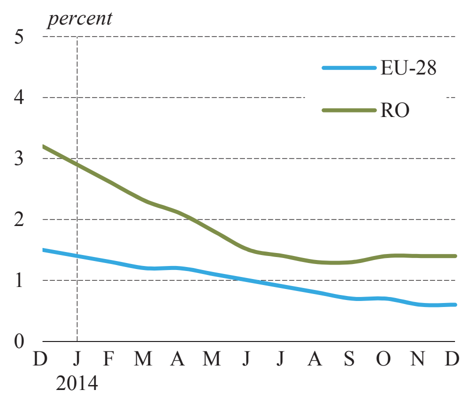
Source: NIS, NBR calculations

Inflation Expectations of Economic Agents



Source: EC-DG ECFIN

Average Annual HICP Inflation Rate*



*) 12-month average rate of change

Source: Eurostat

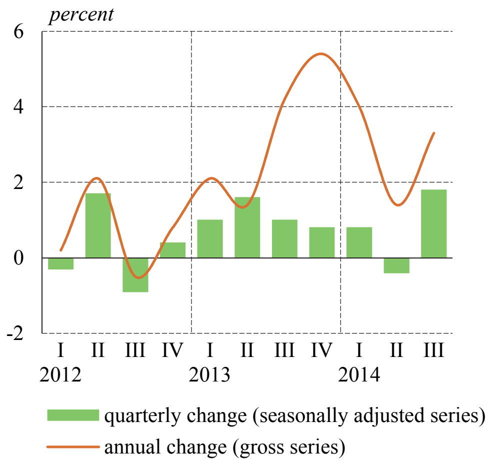
II. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2014 Q3, the annual growth rate of real GDP picked up considerably (from 1.4 percent to 3.3 percent), the national accounts data indicating the recovery of industry, services and agriculture (with quarterly GVA dynamics ranging between 1.5 percent and 2 percent), as well as the marked deceleration in the decline in construction (to -0.5 percent)[1]*.*

On the demand side, the strong pace of increase of real GDP in annual terms was ascribable to domestic absorption, whose dynamics stood at 3.3 percent after the relatively modest reading, i.e. merely 0.4 percent, recorded in 2014 Q2. The analysis by demand components points to final consumption being the driver of domestic demand growth for the fourth quarter in a row. However, the novelty in the period under review was the fading out of the erosion effect exerted by capital investment, with the significantly slower contraction in gross fixed capital formation contributing to this development. In 2014 Q3, net external demand made virtually no contribution to real GDP dynamics, as exports of goods and services and imports thereof rose at similar tempos.

Real Gross Domestic Product

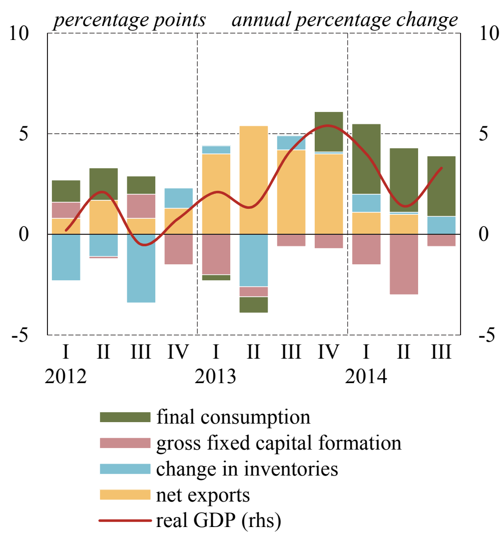


Source: NIS

1.1. Demand

The real growth rate of final consumption accelerated slightly from the previous quarter, i.e. to 4.3 percent, owing to both private and government consumption (up by 2.8 percent and around 22 percent respectively). The swifter advance in the former case was attributable to the rebound in the components whose path is in line with the performance of agriculture (self-consumption, purchases on the agri-food market and household goods industry) given that better weather conditions led to making up for the delay in wheat harvesting and to higher productions of sunflower seeds and potatoes than those recorded in the same year-earlier period. Retail purchases of goods and services further posted positive real dynamics (about 5 percent), albeit slower

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

[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.

than in the prior quarter both in the case of durables (motorcars[2] in particular) and non-durables, especially fuels (in line with car market developments) and pharmaceutical and cosmetic products. Moreover, the turnover volume of market services to households saw a trend reversal as compared with 2014 Q2 (-2.2 percent), as the somewhat rainy summer season affected receipts of the tourist industry, as well as of accommodation and food service activities. Looking at the financing sources, the slacker rise in purchases of durables was associated with a less fast advance in new consumer loans (with their annual growth rate going down 8.8 percentage points, albeit remaining very alert, i.e. over 40 percent).

In 2014 Q3, the general government budget ended on a surplus worth lei 3.9 billion, i.e. 0.6 percent of GDP[3], as compared with the lei 1.5 billion deficit reported in the same year-earlier period, marking thus a substantial shift from the usual budget execution pattern (the general government deficit in 2014 Q2 was close to that in the same year-ago period). Behind this development stood primarily the swifter pace of increase of budget revenues (9.5 percent[4] versus 1.2 percent in the previous quarter), on the back of the fading-out of an adverse base effect[5], as well as of the return to positive territory of the dynamics of non-tax revenues (20.3 percent against -11.4 percent) and EU funds, along with the faster rise in receipts from social security contributions (7.6 percent as compared with 5.7 percent). In the same direction worked the decline in public expenditure in annual terms (-1.3 percent versus 1.3 percent in 2014 Q2), whose main determinant was the annual drop in government spending on goods and services (-14.3 percent against 6.1 percent), also due to a base effect[6] becoming manifest. Similar, albeit of a lower magnitude, contributions had the steeper fall in other transfers and the ongoing, yet relatively slower, decrease in expenditure for projects financed from non-redeemable external loans (-8.4 percent against -12.8 percent) and in capital expenditure (-5.9 percent as compared with -17.7 percent).

2 The aforementioned assertion is corroborated, on the one hand, by the lower share of new motor vehicle purchases by individuals in total receipts from such sales, which shrank from a peak of 41 percent in May (following the implementation of the car fleet renewal programme) to 30-31 percent in August-September (according to the Automotive Manufacturers and Importers Association). On the other hand, a base effect becoming manifest cannot be overlooked either – in 2013, the full extent of the impact exerted by the launch of the said programme in June was felt in Q3.

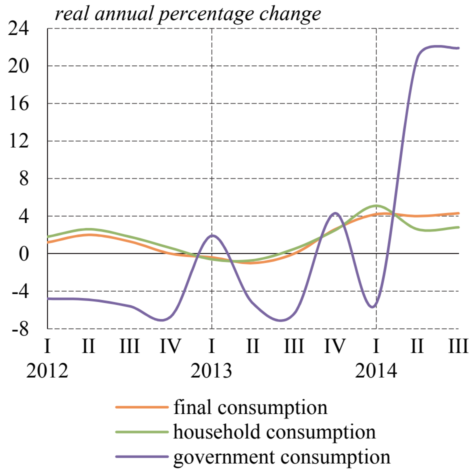
3 The analysis relied on the operational data relating to the September 2014 budget execution, as published by the MPF. The GDP level released by the MPF in the November 2014 budget execution statements was used for 2014.

4 Unless otherwise indicated, percentage changes refer to the annual growth rates in real terms.

5 Associated with the June 2013 substantial receipts from licence fees whereby rights to use radio frequencies are granted.

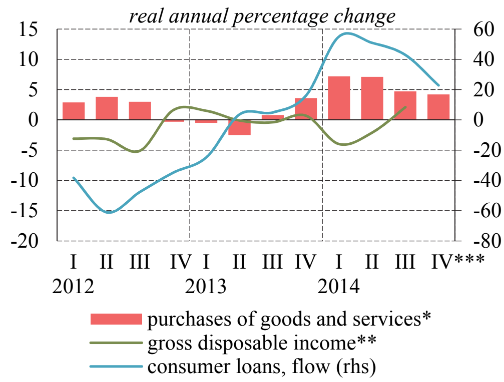
6 In 2013 Q3, the settlement of arrears of local government and the public health care system impacted the performance of outlays on goods and services.

Actual Final Consumption



Source: NIS

Household Consumption and Main Financing Sources



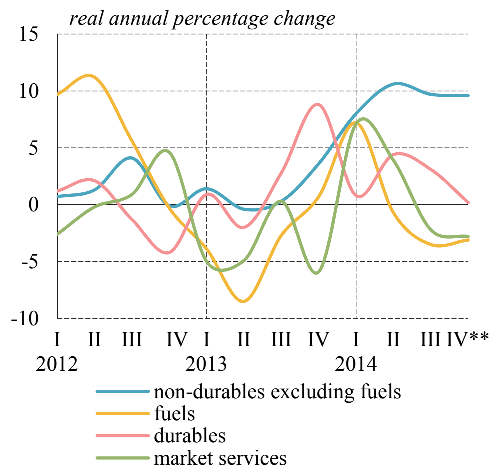
*) based on data concerning the turnover volume in trade and market services to households

**) based on national accounts data (according to ESA 2010 methodology starting 2013 Q1)

***) Oct.-Nov.

Source: NIS, NBR calculations

Purchases of Goods and Services*

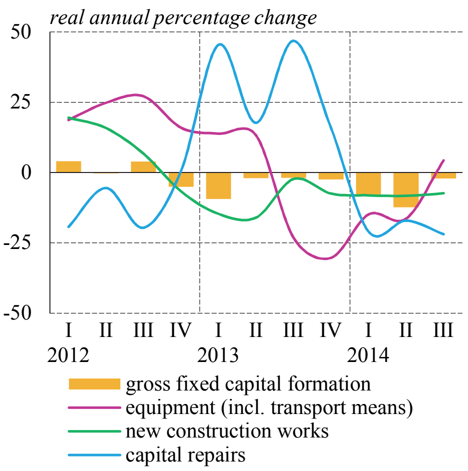


*) based on data on the turnover volume of retail trade and market services to households

**) Oct.-Nov.

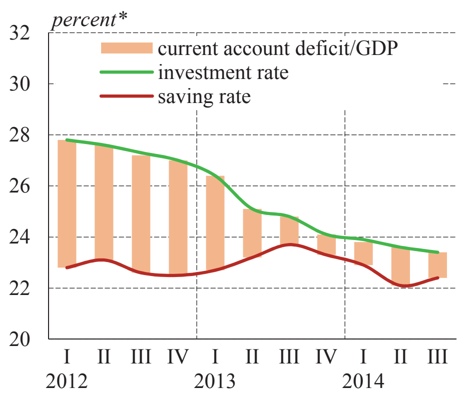
Source: NIS, NBR calculations

Investment



Source: NIS, NBR calculations

Investment Rate and Saving Rate

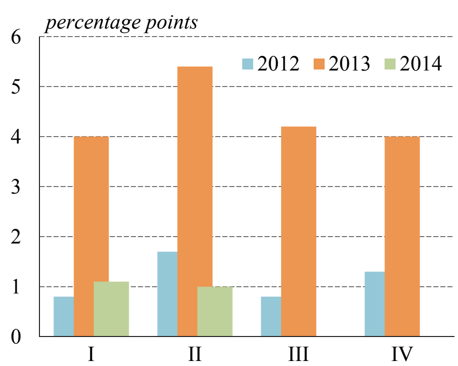


*) four-quarter average

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

Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

The decline in gross fixed capital formation starting 2012 Q4 slowed down markedly in the quarter under review (to -2.1 percent from -12.3 percent in 2014 Q2), amid the steeper downtrend in financing costs (particularly in the case of leu-denominated loans to both companies and households), as well as the law on the tax exemption on reinvested profit being enforced as of 1 July 2014. A decisive impact had the reversal in the drop in equipment purchases (transport means bought by companies and public institutions included), i.e. their volume saw a slight increase of 4.3 percent. The components holding relatively low shares in total capital investment, namely lease purchases and "other investment"[7], also had a favourable influence (the EUR value of contracts increased by almost 9 percent in the former case, while in the latter case the real growth stood at approximately 25 percent). As for construction investment, its trend remained virtually unchanged in 2014 Q3. Specifically, the cumulated volume of new construction works and capital repair works further decreased by around 9 percent, given that public investment contraction was offset only to a small extent by the step-up in residential and non-residential construction works.

After being a driver of real GDP growth for eleven quarters, net external demand made practically no contribution thereto July through September 2014, against the backdrop of the positive differential between the dynamics of exports of goods and services and imports thereof narrowing to merely 0.1 percentage points. Looking at net external demand components, in 2014 Q3 both exports and imports of goods saw sizeable trend reversals, their volumes shrinking by 5.2 percent and 0.9 percent respectively[8]. Their worse performance in real terms was mirrored by declines in value as well, yet this outcome was in contrast to the developments revealed by trade balance data, namely a rise in imports and particularly exports, which saw faster-paced growth. An explanation for the divergent trends shown by the series of national accounts data and trade balance data respectively could lie in the fact that the revision of non-financial accounts data to include changes entailed by the implementation of the sixth edition of the Balance of Payments and International Investment Position Manual (BPM6) has yet to be completed.

[7] Expenses targeting mainly geological works, investment in agriculture, research and design studies relative to investment objectives, as well as expenditure for services related to ownership transfer.

[8] In fact, the modest increases (below 2 percent) in real terms in "goods and services" were ascribable to the rebound in exports and imports of services.

1.2. Supply

The faster annual growth rate of real GDP in 2014 Q3 was fuelled by all economic sectors, industry and services in particular, whereas the recovery in agriculture and the slower pace of decline of GVA in construction had a relatively low impact.

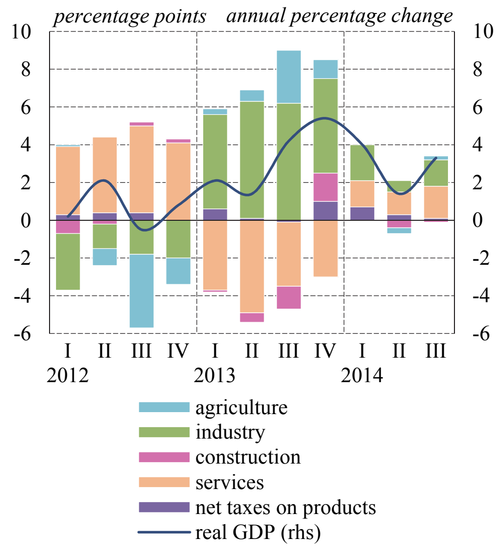
In the quarter under review, GVA in industry reported the swiftest dynamics, i.e. 4.7 percent, almost three times faster than in 2014 Q2.

Nevertheless, services made the largest contribution to economic growth, i.e. 1.7 percentage points. The IT&C sub-sector accounted for half of the said contribution, its growth rate accelerating for the fifth quarter in a row, to 20.8 percent, due to consumers' stronger preference for extensive packages including replay features and other related services apart from voice, text and data services. Benign developments were also recorded by "wholesale and retail trade, accommodation and food service activities and transportation services", the GVA of which saw a trend reversal (+4 percent in 2014 Q3), the impact of the rebound in real terms in wholesale trade except for motor vehicles and transport (in line with the favourable performance of industry and agriculture) being only partly offset by the slower-paced increase in the turnover volume of household purchases of goods and services cumulated with wholesale trade in motor vehicles.

Agriculture made a positive contribution to real GDP dynamics, albeit clearly lower than that of industry and services, i.e. 0.2 percentage points, given that the improved rainfall levels versus the May-June period had a favourable bearing on crops. As a result, GVA in agriculture rose by 1.9 percent against -8.4 percent in 2014 Q2.

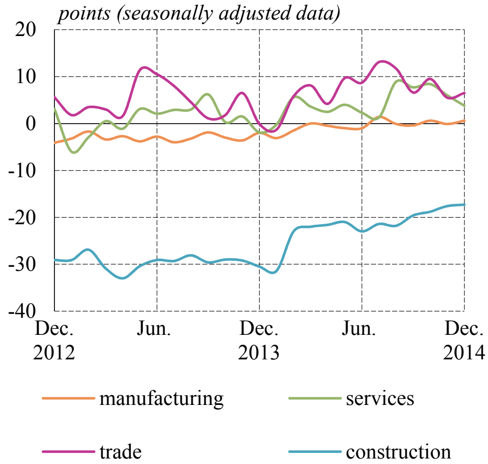
The annual rate of decline of GVA in construction decelerated considerably, from -6.7 percent to -1.6 percent, leading thus to a lower negative contribution to real GDP growth (-0.1 percentage points).

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

Corporate Sector: Confidence Indicators for the Next 3 Months



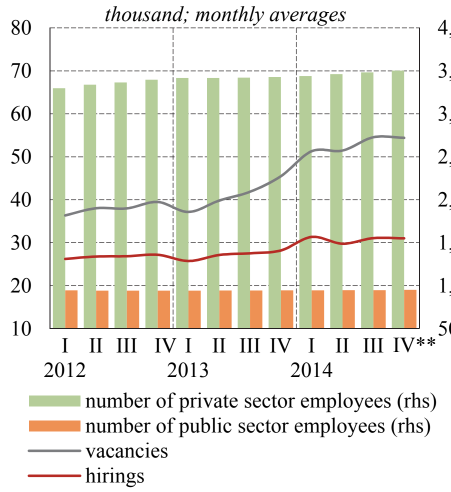
Source: EC-DG ECFIN

2. Labour market

Labour market conditions[9] continued to improve September through November 2014, the positive labour absorption rate being attributable to the private sector this time as well. Employment prospects for early 2015 are further heterogeneous. According to NBR estimates, the uptrend in the annual growth rate of average net wage earnings will persist at the beginning of 2015, chiefly as a result of a new stage of increase in the minimum gross wage economy-wide. In industry, the substantially slacker pace of growth of labour productivity was the key determinant of the annual dynamics of unit labour costs remaining in positive territory.

[9] The analysis is based on seasonally adjusted data.

Labour Demand Measures*

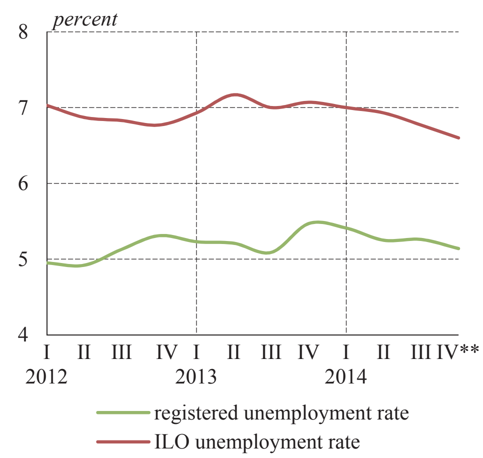


*) seasonally adjusted data

**) Oct.-Nov.

Source: NEA, NIS, NBR calculations

Unemployment Rate*

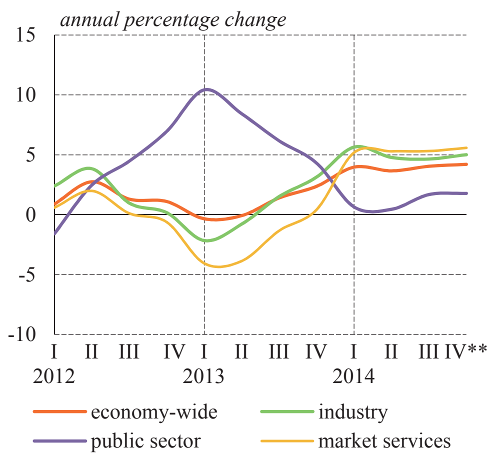


*) seasonally adjusted data

**) Oct.-Nov.

Source: NIS, NBR calculations

Net Real Wage*



*) deflated by CPI

**) Oct.-Nov.

Source: NIS, NBR calculations

Similarly to the picture seen in June-August 2014, September through November 2014 vacancies followed an uptrend, which did not translate however into a significant step-up in hirings (the ratio of vacancies to hirings was further approximately 1.8:1 versus 1.4:1 two years before). Thus, the number of payrolls reported by employers further rose at a sluggish tempo (1.7 percent in annual terms economy-wide, amid minor changes in the budgetary sector). Possible explanations lie in companies' shift to more flexible working arrangements, against the backdrop of persistent uncertainties surrounding the sustainable recovery of domestic demand and the economic activity of their main trade partners, as well as in an emerging shortfall of skilled staff in currently developing business areas. In the period under review, the upward path of payrolls continued to be bolstered by the hirings in the services sector and industry, particularly the IT&C sub-sector[10], scientific and technical services and the automotive industry, with construction also witnessing a slight rise. In early 2015, labour market prospects[11] are relatively heterogeneous. Thus, job creation is further seen in industry and trade, whereas managers in services and construction remain cautious, even though they have turned slightly more optimistic. Overall, the gradual economic rebound is also mirrored by the drop in excess labour supply, as indicated primarily by the ILO unemployment rate, which reached a five-year low in November, i.e. 6.5 percent.

Following the July 2014 stage of increase in the minimum gross wage economy-wide, the annual growth rate of average gross wage earnings was further higher than 5 percent September through November 2014, i.e. 5.7 percent, with the 0.5 percentage point pick-up from June-August 2014 owing probably also to one-off factors (a different bonus distribution calendar than in the previous year). This development was driven equally by the budgetary sector and the main sub-sectors of the private sector. The uptrend in the annual dynamics of average gross wage is expected to persist in early 2015, given: (i) the lei 75 increase in the minimum gross wage (to lei 975) as of January 2015[12], higher than the rise enforced in 2014; (ii) the announced wage increases for some staff categories in the budgetary sector and (iii) most private companies' intentions to award pay rises largely as a result of labour productivity gains and their improved financial results[13].

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10 New hirings are expected in the said sub-sector in 2015, partly in the context of government-backed finance for some companies.

11 According to the DG ECFIN/NIS survey and the Manpower Employment Outlook Survey.

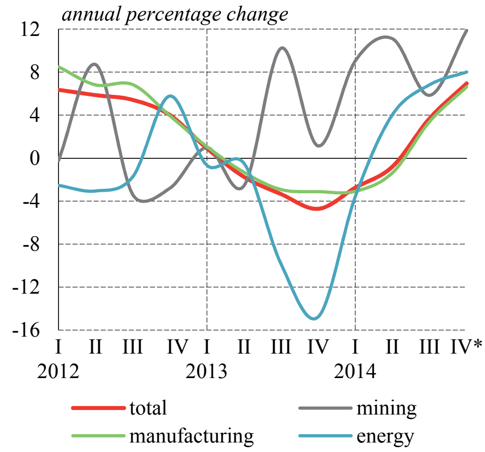
12 According to NBR estimates, the new stage of increase in the minimum gross wage economy-wide will benefit approximately 20 percent of the total number of employees.

13 According to KPMG's "Pulse of Economy 2014" Survey Report available at http://www.kpmgpulsesurvey.com/

After staying negative for five quarters, the annual dynamics of unit labour costs in industry ran in positive territory as of July 2014, i.e. 6.9 percent in October-November. This deterioration was ascribable mainly to the substantially slower-paced labour productivity in manufacturing and the energy sector. The breakdown by manufacturing sub-sectors points to markedly faster annual growth rates of unit labour costs in the manufacture of machinery and equipment and the automotive industry, as well as the food industry, the manufacture of textiles and furniture. Conversely, crude oil processing, metallurgy and manufacture of electronic products further reported negative annual ULC dynamics.

Looking at consumer demand, in the first two months of 2014 Q4 household income[14] kept rising at a moderate real pace in annual terms, being chiefly supported by the advance in wage earnings, given the minor rate of change of social transfers and the decline in workers' remittances from abroad against the same year-earlier period.

Unit Labour Cost in Industry



*) Oct.-Nov.

Source: NIS, NBR calculations

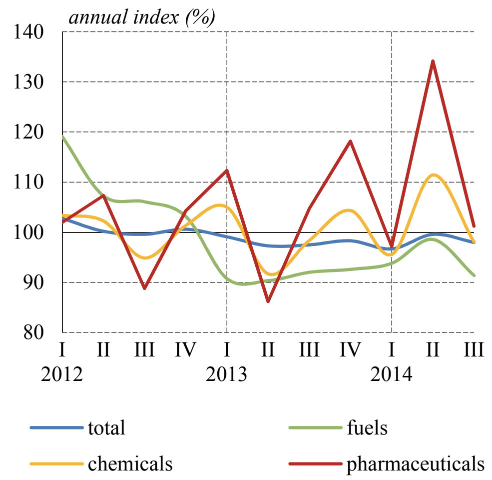
3. Import prices and producer prices

In 2014 Q3, import prices and agricultural producer prices further witnessed decreases in annual terms, while the growth rate of industrial producer prices for the domestic market came down to almost 0 percent, amid the drop in most commodity prices, the decline in electricity costs, and also the favourable movements in the exchange rate of the domestic currency versus the euro. The main driving factor for the period ahead will be the sharp fall in world oil prices, with a swift pass-through into import prices and producer prices in the energy sector and a lag of nearly a quarter for the other categories of domestic producer prices.

The disinflationary impact of external prices became more pronounced in 2014 Q3, with the annual unit value index (UVI) of imports declining by 1.6 percentage points to 98 percent. This favourable impact on imported inflation was enhanced by the slight appreciation of the leu versus the euro, but offset by the depreciation of the former against the US dollar.

Among the goods holding a relevant share in the CPI basket, non-food items in particular exerted significant downward pressure on imported inflation, as follows: (i) the annual UVI of fuels decreased by 7.2 percentage points as a result of the sharp decline in world oil prices (see the box titled "Oil prices – their impact on inflation and economic activity"); (ii) the annual price index of pharmaceuticals dropped markedly (-32.9 percentage points to 101.2 percent), its high volatility stemming from the significant

Determinants of the downtrend in the unit value index of imports in 2014 Q3



Source: NIS, NBR calculations

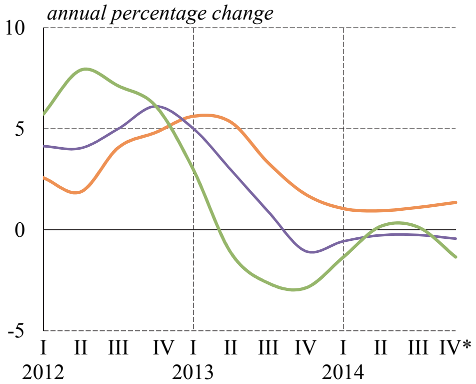
[14] Approximated by the sum of net wage-related income, social transfers (state social security, unemployment benefit and health insurance) and workers' remittances from abroad.

price differences among the main categories of goods (generic versus innovative medicines); (iii) the UVI values posted by textile products fell deeper below 100 percent, possibly on the back of the decrease in cotton prices on international markets. Looking at food items, annual indices generally remained stuck at values below 100 percent, directly associated with the above-average agricultural year in most areas of Europe and in the US, and with the additional supply generated by the recent ban on imports imposed by Russia on EU countries. As an exception, the group of vegetal products posted an increase in the annual import unit value index amid adverse weather conditions in Central and South America that placed prices of citrus fruits and coffee on an upward trend.

Intermediate goods added to the fall in imported inflation in Q3, given that the sharp decline in oil prices led to the drop in the annual unit value index of imported chemical products by 13.3 percentage points to 98.1 percent. Moreover, the prices of base metals further followed a downward path, amid the negative outlook on the global economic growth. By contrast, the annual unit value indices of imported capital goods stayed in positive territory and even followed a slight uptrend. In the case of road transport means, a possible driver of this step-up was the increased preference for new cars to the detriment of used ones.

Consumer Prices and Industrial Producer Prices

annual percentage change



*) Oct.-Nov.

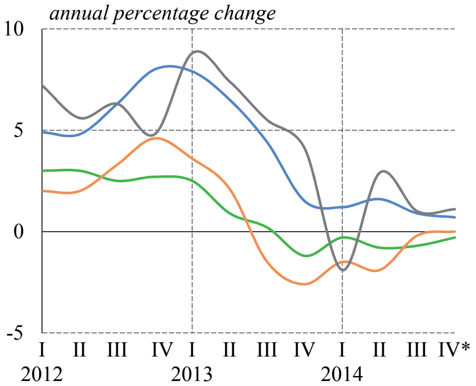
Source: NIS

The annual dynamics of industrial producer prices for the domestic market slowed down to 0.5 percent, owing to the drop in most commodity prices, oil price in particular, and also to the decline in electricity costs. The breakdown by main industrial group shows significant decelerations in the energy sector (-1.9 percentage points to 1 percent) and in the consumer goods sub-sectors (on average -0.7 percentage points to 0.9 percent).

Looking at energy prices, the lower annual inflation rate was prompted by the hydrocarbon processing sub-sector, where producer prices decreased by 5.1 percent in annual terms as a direct result of oil price movements. Prices for the production and supply of electricity and heating posted a similar trend following the cut in electricity prices by approximately 4 percent in July for non-residential consumers who did not exercise their eligibility right.

Industrial Producer Prices for Domestic Market by Industrial Products Group

annual percentage change



*) Oct.-Nov.

Source: NIS

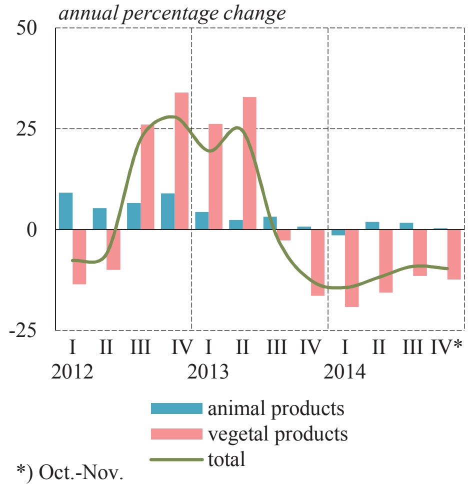
Producer prices for consumer goods followed a downward path on the back of non-durables, in particular wearing apparel, pharmaceuticals and cosmetics. At the same time, producer prices in the food industry continued to drop, albeit at a slightly slower pace, amid the fading away of the base effect stemming from the weak 2012 harvest that stood behind the upward trajectory of agri-food commodity prices in 2012 H2-2013 H1.

Producer prices for intermediate goods displayed a significant slowdown in their pace of decline in annual terms – from -1.9 percent in 2014 Q2 to -0.2 percent in the period under review; this was notably driven by metallurgy (+4.2 percentage points), with the closure of certain production capacities at global level in 2014 H1 leading to the rise in aluminium prices on the external market. The chemical industry and the construction materials industry saw similar but less pronounced developments, amid the ongoing upward trend in domestic demand, visible since early 2014. The annual dynamics of prices for capital goods remained relatively unchanged (around 1.1 percent in Q2 and Q3), on the back of mixed influences: the slight appreciation of the domestic currency and the pick-up in producer prices in metallurgy, respectively.

Given the new plentiful harvest, the crop sector further underpinned the fall in agricultural producer prices (-9.1 percent) in Q3 as well. Against the background of the favourable developments in fodder prices, animal product prices slowed down their rate of increase to 1.7 percent.

For the period ahead, plummeting oil prices stand as the most important determinant of domestic producer prices and of import prices. Moreover, most commodity prices (cereals, cotton, metals) stayed on a downward path, amid the persistent negative outlook on global economic growth. These developments are likely to be partly offset by the weaker leu in US dollar terms, as well as by the higher utility costs[15].

Agricultural Producer Prices



*) Oct.-Nov.

Source: NIS

[15] In 2014 Q4, the average trading price for electricity on the OPCOM market stood 35.4 percent above the Q3 average.

Oil prices – their impact on inflation and economic activity

1. Oil prices and their determinants

After having fluctuated around USD 110 per barrel on average over the last four years, Brent oil prices dropped significantly starting with the latter half of 2014. At end-January 2015, Brent oil traded on international markets slightly below USD 50 per barrel.

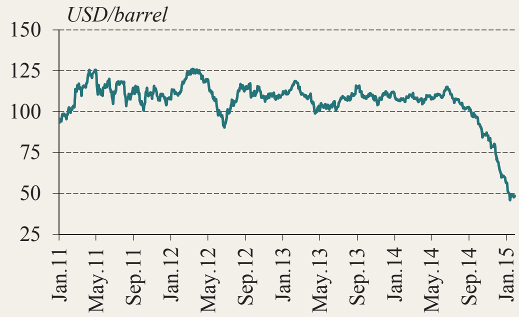
Which was the driver of the oil price fall in 2014?

The recent decline in oil prices is mainly ascribable to a supply shock. In 2014, the cumulated oil production of OPEC and the US rose by 1.2 million barrels per day on average, owing solely to the higher-than-expected increase in the latter's oil production (up 16.4 percent from 2013) as a result of fracking. The rise in the crude oil supply occurred amid modest dynamics of world liquid fuel consumption, on the back of the lower-than-expected global economic activity – against the backdrop of escalating geopolitical tensions and the weakening growth momentum in Europe, the IMF forecast for global growth in 2014 was revised downwards by 0.4 percentage points to 3.3 percent.

The last four-and-a-half decades saw only five such episodes of plummeting crude oil prices caused by geopolitical tensions, financial and economic crises or by OPEC's decision to lift production quotas. A similar price fall to the recent adjustment occurred in 1986, when oil prices dropped by over 60 percent within a half-year following OPEC's decision to increase its market share to the detriment of non-OPEC countries.

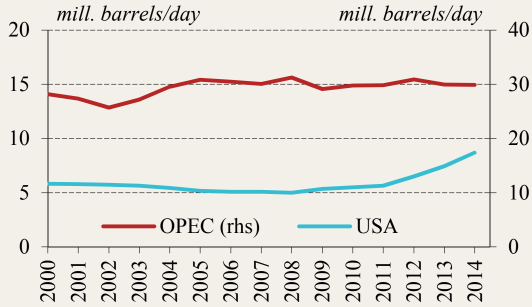
The heightened uncertainty surrounding developments in demand for and particularly supply of oil worldwide fuelled oil price volatility, which hit, in January 2015, record highs since the outbreak of the financial crisis. Given this context, the path of future oil prices is highly unpredictable.

Brent oil price developments



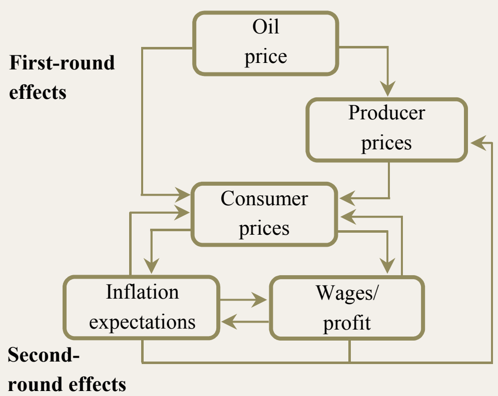
Source: Bloomberg

Crude oil production



Source: EIA

Transmission channels of oil price movements to consumer prices



Source: ECB

2. The impact on inflation

International oil price fluctuations pass through into domestic inflation via various channels and their final impact can be broken down into direct and indirect first-round effects and second-round effects.

First-round effects are characterised by a temporary upturn or downturn in the general price level, therefore they do not exert persistent inflationary or deflationary pressure. However, mention should be made that these effects, albeit transitory, translate into the annual inflation rate over four quarters. Two types of first-round effects can be distinguished: direct first-round effects, which have an impact on fuel prices, a CPI component, and indirect first-round effects, which pass through to consumer prices via production costs, including economic operators' transportation costs.

Unlike first-round effects, second-round effects may exert a persistent impact on inflation. The short-lived change in consumer prices due to first-round effects can be incorporated in inflation expectations and thus influence economic agents' future price and wage setting behaviour. In this case, the initially transitory shock may have long-term effects.

As for indirect and second-round effects, they can only be estimated. It is hardly possible to gauge them precisely, given that econometric models use a simplified representation of the economy and the strength at which shocks propagate may vary over time. According to ECB estimates[1] for the euro area, a 10 percent change in the oil price has an approximately 0.6 percentage point impact on the annual HICP inflation (excluding food and energy) over three years. Dybczak, Voňka and van der Windt (2008)[2] showed that, as far as the Czech economy is concerned, an oil price increase by 5 percent per annum over four years would cause the annual inflation rate to accelerate by 0.4 percentage points each year.

How does an oil price fall pass through into domestic inflation?

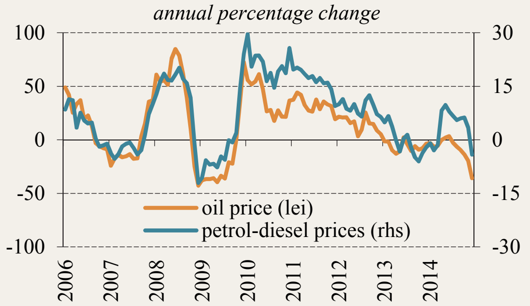
Direct effects

In 2014, fuels held 8.3 percent of the CPI basket in Romania, with petrol and diesel together accounting for around a half of the said share.

NBR estimates show that the transmission of a decline in oil prices to fuel prices is relatively fast, i.e. a 10 percent drop in Brent oil prices results in an approximately 3.3 percent decrease in petrol and diesel prices within a quarter after the oil price shock. The pass-through is marginally asymmetric, in that the response of fuel prices is slightly stronger to oil price increases than to oil price declines.

Oil and fuel price developments

annual percentage change



Source: Bloomberg, NIS, NBR calculations

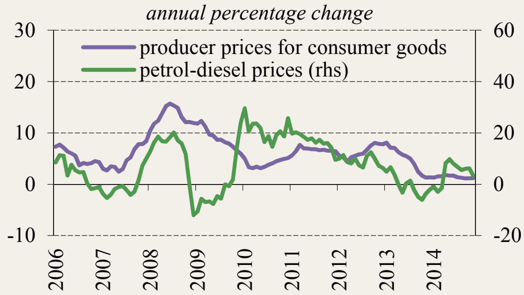
Indirect effects

Around 17 percent of the change in fuel prices passes through into producer prices for consumer goods over a one-year horizon. Changes in the latter prices feed through into core inflation by around 70 percent over the same horizon.

The assessment of a 10 percent oil price fall scenario indicates an approximately -0.2 percentage point impact (direct and indirect effects) on the annual CPI inflation rate over a one-year horizon[3].

Fuel and producer price developments

annual percentage change



Source: Eurostat, NIS, NBR calculations

[1] "Oil prices – their determinants and impact on euro area inflation and the macroeconomy", *Monthly Bulletin*, ECB, August 2010.

[2] "The effect of oil price shocks on the Czech economy", *Working Paper Series* No. 5/2008, Czech National Bank.

[3] The said assessment used several multivariate and univariate models that produced similar results.

Second-round effects

As first-round effects fade away from the annual inflation rate after four quarters since becoming manifest, the inflation path following the initial shock will be influenced by the size and persistence of second-round effects. Thus, a downward revision of inflation expectations as a result of a 10 percent decline in the oil price is expected to exert a relatively low impact on CPI inflation, adding to first-round effects about -0.05 percentage points over a one-year horizon. This assessment strictly depends on the specific context of the economy under investigation at the time the shock hits, and particularly on the stance of the monetary policy, which aims to steadily anchor, over the medium term, inflation expectations at the set inflation targets. For instance, if the oil price fall results in lower inflation expectations and core inflation implicitly, a potential monetary policy easing could foster economic activity and thus partly offset the initial slowdown in the inflation rate owing to the aforementioned first and second-round effects.

3. The impact on economic activity

Given the low dependence of the Romanian economy on crude oil imports, the impact of a 10 percent oil price decline on domestic economic growth over a one-year horizon is estimated to be only marginally positive, with potentially benign influences coming from companies' lower production costs (e.g. energy costs) and more favourable prospects for external demand. Under a 10 percent oil price change scenario, the ECB[1] estimated that the overall impact on the euro area GDP would be of approximately 0.24 percentage points after three years since the shock hit.

III. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

October 2014 through January 2015, the central bank extended the rate-cutting trend – lowering the monetary policy rate in two consecutive steps of 0.25 percentage points each, to 2.5 percent – and further narrowed the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate (to ± 2.25 percentage points from ± 2.75 percentage points previously). Given the renewed widening of the structural liquidity surplus, the NBR kept unchanged the minimum reserve requirements ratio on credit institutions' leu-denominated liabilities and maintained the adequate liquidity management in the banking system, while cutting the minimum reserve requirements ratio on foreign currency-denominated liabilities of credit institutions by 2 percentage points to 14 percent[1]*. The measures were aimed at further tailoring the monetary policy stance so as to anchor medium-term inflation expectations in line with the flat inflation target, while also ensuring the sustainable revival of lending and enhancing the functioning of the monetary policy transmission mechanism.*

The decision to lower the monetary policy rate by another 0.25 percentage points to 2.75 percent, taken by the NBR Board in its meeting of 4 November 2014, was warranted by the annual inflation rate becoming quasi-entrenched below the lower bound of the variation band of the flat target in the recent period and especially by its expected path remaining below the mid-point of the flat inflation target, and hence significantly lower than previously projected[2], throughout the policy-relevant horizon. Specifically, during the first two months of 2014 Q3, the 12-month inflation rate stood at 0.95 percent and 0.84 percent respectively, before edging up to 1.54 percent in September, amid the fading away of the statistical effect associated with the cut in the VAT rate on some bakery products[3]. At the same time, according to the new forecast, the projected annual inflation rate was seen staying below the lower bound of the variation band of the target or in close proximity until mid-2015 (its lasting return inside the band thus taking place four quarters later than previously anticipated) and below the mid-point of the target[4] until towards the end of

1 Starting with the 24 November – 23 December 2014 maintenance period.

2 The medium-term forecast included in the August 2014 Inflation Report.

3 Measure implemented in September 2013.

4 The newly-projected values of the annual CPI inflation rate were 1.5 percent at end-2014 and 2.2 percent at end-2015, 0.7 percentage points and 0.8 percentage points, respectively, lower than forecasted previously.

the projection horizon. The significant change in the inflation outlook compared to the previous quarterly exercise came from all CPI components, with administered prices and notably adjusted CORE2 inflation further making the largest contributions. The downward shift in the trajectory of the forecasted annual core inflation rate reflected the direct/indirect effects of the decline in the anticipated values of inflation rate in the euro area and other EU countries and, particularly, the stronger disinflationary impact assumed to be exerted by the fundamental factors of adjusted CORE2 inflation, against the background of a steeper downward correction of inflation expectations and amid the increase in the forecasted values of the aggregate demand deficit, which were seen, however, reverting to a narrowing trend in early 2015. The major premises and assumptions underlying such a pattern of the negative output gap were, on the one hand, the slower-than-expected economic growth in the first part of 2014 and, on the other hand, the gradual return to a slightly countercyclical stance of the fiscal policy and the maintenance of stimulative real monetary conditions, associated with a relative improvement in the monetary transmission mechanism.

The NBR Board lowered the monetary policy rate by another 0.25 percentage points, to 2.5 percent, in its January 2015 meeting. The extension of the rate-cutting cycle was warranted primarily by the annual inflation rate re-embarking on a downward trajectory in October 2014 and by the outlook for faster disinflation in the short run[5], implying a significant drop in the 12-month inflation rate below the forecasted level, under the impact of the unexpectedly sharp decline in global oil prices, overlapping the influence of subdued euro area inflation, the ongoing downward adjustment in inflation expectations, and the persistence of the negative output gap. However, the magnitude of the negative output gap in the latter half of 2014 appeared to have been lower than the forecasted readings, given the considerable pick-up in economic growth in Q3 (from 1.4 percent to 3.2 percent in annual terms) as well as the relative consolidation of the dynamics of some relevant indicators of consumer and investment demand in the early months of 2014 Q4. Nevertheless, the annual rate of change of credit to the private sector remained in negative territory throughout the period[6], while narrow money saw its annual pace of increase decelerate.

However, the annual rate of decline of credit to the private sector tended to slow down during October and November 2014 (-4.3 percent versus -5.0 percent in 2014 Q3), mainly reflecting the renewed step-up in the annual growth of the domestic currency

[5] The 12-month inflation rate declined to 1.44 percent in October and 1.26 percent in November.

[6] Unless otherwise specified, indicators are calculated as average annual changes expressed in real terms.

component (6.6 percent in October and 7.7 percent in November against 5.9 percent in September), as well as the slower contraction in foreign currency credit (based on readings expressed in euro)[7]. The period under review saw a relative improvement, albeit modest and uneven, in the demand for loans and a highly likely easing of lending standards[8], which prompted a slower annual decline in both household and corporate loans. Behind the developments in household credit stood the faster growth rate of the leu-denominated component (13.2 percent October through November 2014 versus 11.0 percent in Q3), amid the rebound in the dynamics of consumer loans[9] and the further alert pace of increase of housing loans. As regards lending to non-financial corporations, the foreign currency component made the largest contribution, whereas the rate of change of leu-denominated corporate credit shrank to 2.8 percent from 4.5 percent in Q3.

The annual dynamics of broad money (M3) witnessed a decline October through November, to stand at 4.0 percent against 4.6 percent in Q3, posting uneven monthly developments. Specifically, the opposite movements – a decline in October, followed by an increase in November – reflected primarily the characteristics of the general government budget execution pattern (surplus/deficit sequence), as well as the effects of the reduction and renewed rise respectively in disbursements related to EU funds. Under their influence, the growth rate of narrow money also decelerated to 9.4 percent from 10.0 percent in Q3, solely ascribable to the performance of household and corporate overnight deposits. The pace of increase of time deposits with a maturity of up to two years slowed as well (to 0.3 percent, i.e. 0.5 percentage points below the Q3 reading), on account of the ongoing decline in the annual rate of change of leu- and foreign currency-denominated corporate deposits and the more negative dynamics of household deposits in domestic currency (-2.9 percent October through November versus -2.1 percent in the previous three months), given households' further shift towards other financial assets (government securities and time deposits with a maturity of over two years).

In addition to lowering the monetary policy rate, the central bank continued to narrow the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate (to ± 2.25 percentage points from ± 2.75 percentage points previously) in order to reduce interbank money market rate volatility and consolidate the transmission of the policy rate signal. In particular,

7 Both developments also reflected the relative reduction during the reported period in the volume of operations to remove non-performing loans from credit institutions' balance sheets.

8 According to the November 2014 Bank Lending Survey conducted by the NBR.

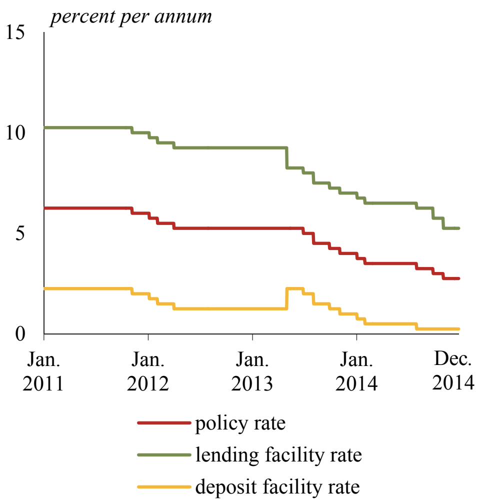
9 Their annual dynamics thus returned into positive territory for the first time in six years.

the interest rate on the NBR's lending facility was successively lowered from 5.75 percent to 5.25 percent and then to 4.75 percent, while the deposit facility rate was kept unchanged at 0.25 percent. At the same time, during 2014 Q4, the NBR continued to pursue adequate liquidity management in the banking system, by further tailoring its actions to the specifics of liquidity conditions. Hence, in October, against the background of a wider liquidity shortfall in the banking system (associated with the increase in the balance of the Treasury's leu-denominated account), the central bank continued to conduct 1W repos via fixed-rate tenders with full allotment[10]. In the following months, the NBR mopped up – via the deposit facility – the excess liquidity generated and fuelled by Treasury operations, as well as by the reduction in banks' demand for reserves as a result of the cut in the minimum reserve requirements ratio on their leu-denominated liabilities[11]. During the period under review, the NBR Board left unchanged the minimum reserve requirements ratio on credit institutions' leu-denominated liabilities, but lowered the minimum reserve requirements ratio on their foreign currency-denominated liabilities to 14 percent from 16 percent in its meeting of November 2014. The measure, meant to continue the harmonisation of the reserve requirements mechanism with ECB standards in the field, became effective starting with the 24 November – 23 December 2014 maintenance period.

2. Financial markets and monetary developments

Average interest rates on the main segments of the financial market fell to historical lows in 2014 Q4, while the EUR/RON exchange rate trended upwards towards the end of the reported period, owing to heightened global risk aversion. The annual dynamics of credit to the private sector remained in negative territory September through November 2014, while the annual rate of change of broad money continued to decline.

NBR Rates



2.1. Interest rates

The average interbank money market rate resumed its decline during Q4, under the impact of the marked change in liquidity conditions, and reached new historical lows[12] of 0.44 percent in November and 0.43 percent in December, close to the lower bound of the corridor defined by interest rates on the central bank's standing facilities around the policy rate. The quarterly average interbank deposit rate

[10] Two such operations were carried out in October, whereby lei 4.5 billion and lei 1 billion respectively were injected into the market.

[11] The decision to cut the minimum reserve requirements ratio on leu-denominated liabilities of credit institutions to 10 percent from 12 percent was taken by the NBR Board in its meeting of September 2014 and the measure came into force starting with the 24 October – 23 November 2014 maintenance period.

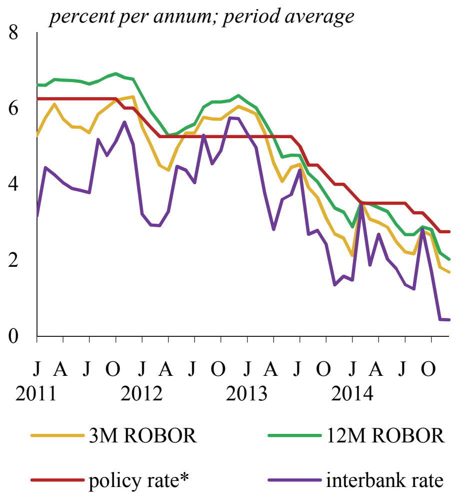
[12] Data series since 1993.

shed 0.79 percentage points against the previous three months, to stand at 1.07 percent. Against this background, but also as a result of narrowing the corridor defined by interest rates on the central bank's standing facilities around the policy rate, the volatility of overnight rates abated somewhat.

Overnight rates on the interbank money market remained in the vicinity of the monetary policy rate at the onset of the quarter under review, amid a slightly wider liquidity shortfall in the banking system, which prompted the NBR to further conduct liquidity-providing 1W repos. However, once Treasury injections resumed, very short-term rates embarked on a downward course and neared the deposit facility rate towards end-October. Overnight rates consolidated at those levels afterwards, given that the rise in liquidity injections associated with transactions in the MPF's foreign currency-denominated account and then the reduction in banks' demand for reserves[13] led to a renewed wide liquidity surplus in the banking system.

The change in liquidity conditions and credit institutions' revised expectations on the outlook of these conditions also affected longer-term (3M to 12M) ROBOR rates, which resumed a downward path in the latter half of October, more visible in the case of 3M rates. The decline extended into the following months as well, albeit at a slower pace, under the impact of the NBR's decision to lower the monetary policy rate and credit institutions' revised expectations on its future path. The average readings of longer-term rates posted historical lows in December, with the 3M ROBOR shedding 1.07 percentage points (to 1.69 percent) and 6M and 12M ROBOR rates averaging out at 2.00 percent and 2.02 percent respectively, down approximately 0.9 percentage points each against September.

Policy Rate and ROBOR Rates



*) end of period

Developments on the government securities market reflected primarily the influences exerted by: (i) the easing of liquidity conditions on the interbank money market; (ii) the downward adjustment of inflation expectations; (iii) the large volume of securities maturing (in October[14]), as well as by (iv) the temporary renewed heightening of external financial market volatility in December, implying adjustments in global financial investors' exposure to emerging economies.

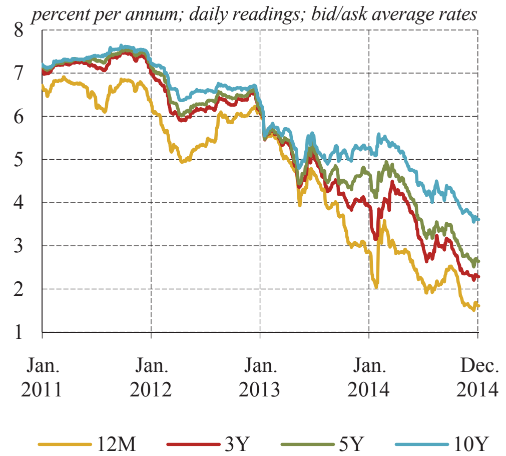
Under the circumstances, investor appetite for government securities on the primary market was relatively strong during the quarter under review, particularly in October, when the ratio of the bid volume to the announced volume in the securities auctions

[13] As a result of the cut in the minimum reserve requirements ratio on leu-denominated liabilities of credit institutions (to 10 percent from 12 percent previously) becoming effective on 24 October.

[14] Lei 7.1 billion, the peak for 2014.

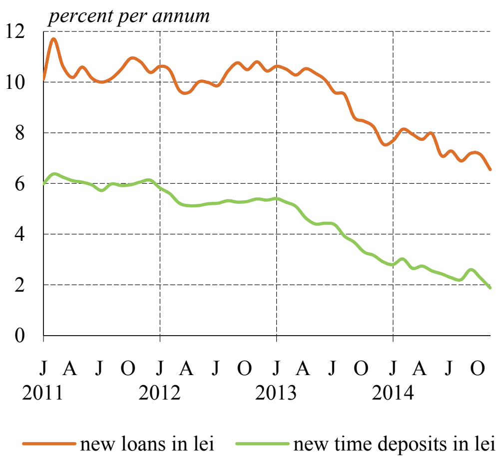
reached the highest level in 2014. Against this backdrop, the quarterly volume of issues marginally exceeded the indicative one[15], while the average maturity of securities issued was slightly longer than in the previous quarter. Maximum accepted bid rates at primary market auctions re-embarked on a downward course and hit historical lows towards end-December: 1.48 percent on securities with a maturity of six months (down 1.12 percentage points versus September), 1.65 percent for one-year securities (down 0.64 percentage points against September), 2.83 percent on securities with a residual maturity of five years (0.73 percentage points lower than in September) and 3.72 percent for 10-year bonds (down 0.67 percentage points from September).

Reference Rates on the Secondary Market for Government Securities



Benchmark rates[16] on the secondary market for government securities also followed a largely downward path, brought to a halt by a brief episode of slight increase in mid-December, ascribable to the temporary renewed heightening of global risk aversion. The decline was more visible for short-term securities (-1 percentage point for the six-month maturity versus -0.7 percentage points for 10-year bonds), which shaped a steeper slope of the yield curve against end-Q3.

Bank Rates



In turn, credit institutions' average interest rates on new time deposits and new loans for non-bank clients stuck to their downward trend September through November 2014, shedding 0.32 percentage points to 1.88 percent and 0.33 percentage points to 6.55 percent respectively, thus reaching new post-1990 lows for both companies and households at the end of the period under review. The decline was somewhat more pronounced in relation to non-financial corporations, with the average remuneration of new time deposits shedding 0.34 percentage points (to 1.35 percent) and the average lending rate on new business edging down 0.42 percentage points (to 5.58 percent in November). As for households, the average interest rate on new time deposits inched down 0.04 percentage points (to 2.93 percent), while that on new loans diminished 0.14 percentage points (to 7.81 percent in November). The performance of the latter mainly reflected the impact of the larger share held by the flow of housing loans in total new business to households, to the detriment of consumer credit, business development loans and loans for other purposes (with above-average interest rates).

15 Moreover, in October, the MPF launched 10-year EUR-denominated bonds on the external market, in amount of EUR 1.5 billion, at an average yield of 2.97 percent.

16 Bid/ask average.

2.2. Exchange rate and capital flows

The EUR/RON exchange rate followed a smoothly upward path in the first two months of 2014 Q4, with only short-lived fluctuations, mainly triggered by swings in international financial market sentiment. The exchange rate uptrend steepened in December, amid heightened global risk aversion.

The EUR/RON pair moved within a relatively narrow variation band during the first part of October, before witnessing several episodic increases, interrupted by periods of relative stabilisation/marginal decline[17]. The exchange rate fluctuations reflected primarily the mixed influences of external developments during the reported period, namely: (i) the sporadic rekindling of financial investor concerns over the slowdown of euro area economic growth and the increase in the related downside risks, a context which sparked a temporary pick-up in global risk aversion and volatility on world's financial markets[18]; (ii) the successive episodes of improving global financial market sentiment, brought about by the generally successful completion of the stress test exercise carried out across the European banking system, by consolidated expectations of further monetary policy easing in the euro area, and by upbeat US economic growth data; and (iii) hence the US dollar sticking to its fast appreciation trend versus the euro. To these added the influences exerted by investors' further favourable perception on the Romanian economy[19], amid the statistical data released during that period[20] confirming or even exceeding analysts' expectations regarding domestic economic developments.

The upward path of the EUR/RON exchange rate steepened in December, with its monthly change edging up to 0.7 percent, given that international financial markets – regional ones included – came under the impact of renewed global risk aversion, owing inter alia to (i) heightened uncertainty surrounding the knock-on effects of the abrupt decline in oil prices on the world economy; (ii) invalidated expectations of a decision on additional non-standard instruments in the ECB Governing Council meeting of December 2014; (iii) markedly higher risks to the Russian economy and the ensuing sharper depreciation of the rouble, (iv) mounting concerns over the situation in Greece. A temporary influence also had the higher

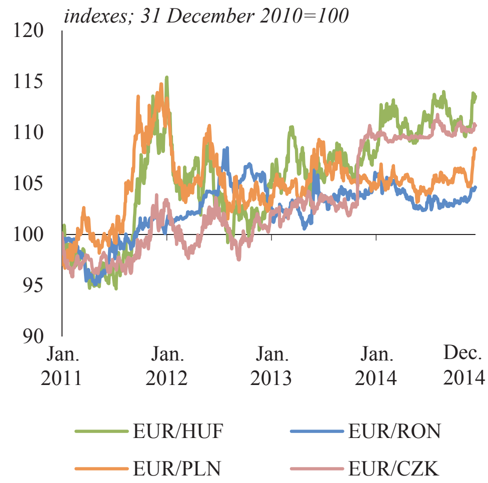
Key Financial Account Items (BPM6 methodology)

EUR million

	11 mos. 2013			11 mos. 2014		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	**2,961**	**-33**	**2,994**	**553**	**-3,413**	**3,965**
Direct investment	**545**	**2,423**	**-1,878**	**339**	**2,471**	**-2,131**
Portfolio investment	**320**	**5,426**	**-5,106**	**79**	**2,884**	**-2,805**
Financial derivatives	**-393**	**-351**	**-41**	**-514**	**-444**	**-70**
Other investment	**631**	**-7,531**	**8,162**	**2,450**	**-8,324**	**10,773**
- currency and deposits	364	-2,906	3,270	2,056	-2,786	4,842
- loans	-159	-4,302	4,143	190	-5,509	5,700
- other	425	-324	750	203	-28	231
NBR's reserve assets, net	**1,858**	**0**	**1,858**	**-1,802**	**0**	**-1,802**

*) "+" increase/"-"decrease

Exchange Rate Developments on Emerging Markets in the Region



Source: ECB, NBR

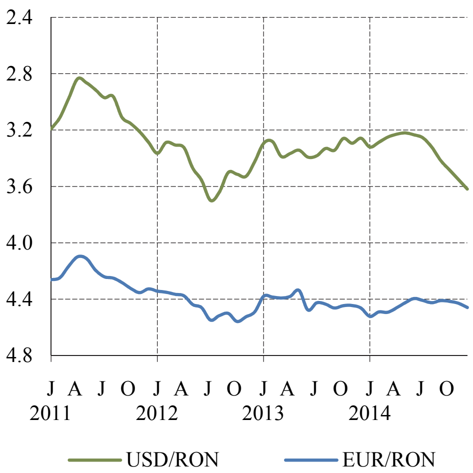
[17] October through November, the domestic currency depreciated against the euro by 0.4 percent; in the same period, the Polish zloty and the Czech koruna weakened versus the single currency by 0.5 percent and 0.3 percent respectively, whereas the Hungarian forint appreciated by 2 percent.

[18] In October, the VIX index reached its highest value since 2012.

[19] Under the circumstances, Romania launched a new bond issue on external markets on 21 October 2014.

[20] The annual growth of real GDP (flash estimate) in 2014 Q3 and that of industrial output in September exceeded analysts' expectations, while the current account posted a monthly surplus in October for the second consecutive month.

Nominal Exchange Rate



uncertainty over the Fed decision (in the meeting of 17 December) on the prospective adjustment of the monetary policy stance, amid the somewhat brighter picture painted by the US economy.

The fluctuations in global risk appetite entailed the halving of the negative balance of non-residents' transactions on the interbank forex market in October as against the previous month and afterwards its widening, especially in December. In turn, residents' excess demand for foreign currency witnessed an increase in November, largely attributable to seasonal developments in imports.

October through December, the domestic currency depreciated against the euro[21] by 1.1 percent in nominal terms and 1.2 percent in real terms. In relation to the US dollar, the leu weakened by 5.3 percent in nominal terms and 5.4 percent in real terms, given the former's considerable strengthening against the single currency. Looking at the average annual exchange rate dynamics in 2014 Q4, the domestic currency saw its nominal appreciation versus the euro diminish slightly and posted the first nominal depreciation against the US dollar in the past seven quarters.

2.3. Money and credit

Money

Annual Growth Rates of M3 and Its Components

real percentage change

	2013	2014				
	IV	I	II	III	Oct.	Nov.
	quarterly average growth					
M3	5.3	7.8	5.2	4.6	3.2	4.8
M1	9.5	15.0	10.7	10.0	7.8	10.9
Currency in circulation	6.3	13.4	9.3	9.9	9.0	11.8
Overnight deposits	11.2	15.9	11.5	10.2	7.2	10.4
Time deposits (maturity of up to two years)	2.4	3.1	1.5	0.8	0.0	0.5

Source: NIS, NBR

September through November 2014, broad money (M3) dynamics[22] continued to decelerate, to 3.8 percent from 5.0 percent June through August 2014, amid the further atypical budget execution pattern (in September and October), higher repayments of companies' external debt, as well as money-holders' portfolio shifts towards other types of financial instruments.

Looking at the main components of M3, the growth rate of narrow money (M1) continued to decline, while the pace of increase of time deposits with a maturity of up to two years re-embarked on a downward trend, due to the fall in the dynamics of overnight deposits and of leu-denominated household time deposits of up to two years, as well as to the slower rise in similar corporate deposits in both lei and foreign currency[23]. The M3 breakdown by currency continued to improve, as leu-denominated deposits saw their share consolidate at 70.2 percent, i.e. the highest average since 2012 Q3.

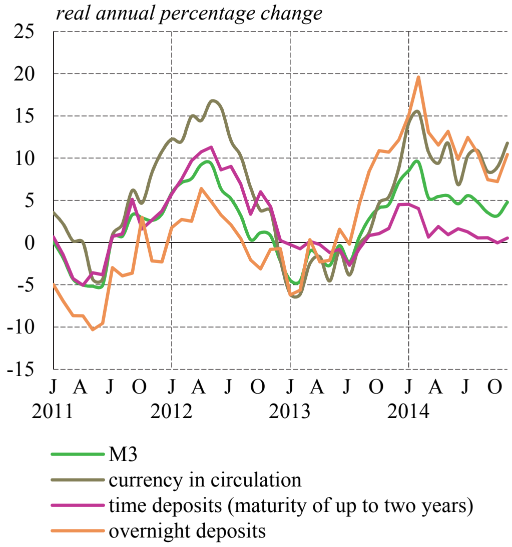
21 In the same period, the Polish zloty and the Czech koruna weakened versus the single currency by 0.6 percent and 0.1 percent respectively, whereas the Hungarian forint appreciated by 0.8 percent.

22 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2014.

23 In turn, the rate of change of marketable instruments entered negative territory, mainly on account of the drop witnessed by repo operations, whose share in M3 thus remained subdued.

The breakdown of deposits in M3 by institutional sector points to a decline in the dynamics of household deposits during the period under review, owing largely to shifts of some of these deposits towards other types of financial assets (cash, foreign currency-denominated deposits with a maturity of over two years); an opposite, albeit weaker impact had the larger payments from European funds[24] and the compensations collected by holders of pre-1990 car savings deposit accounts[25]. The growth rate of M3 deposits from non-financial corporations diminished as well, mainly on the back of the rise (also one-off in nature) in payments to the government budget[26] and the larger volume of external debt repayments[27], to which added companies' keener interest in alternative financial assets (government securities, leu-denominated deposits with a maturity of over two years); their joint impact more than offset that exerted by the increase in disbursements from the government budget[28]/European funds. By contrast, the dynamics of M3 deposits held by non-monetary financial institutions edged up slightly, given the rise in a bank's stakes in the capital of an institution belonging to the financial auxiliaries sub-sector; however, the share of non-monetary financial institutions' deposits in M3 remained quasi-stable at 5.9 percent.

Main Broad Money Components



Source: NIS, NBR

From the perspective of major M3 counterparts, the slower growth rate of broad money reflected the decline in the dynamics of banks' net foreign assets and of credit institutions' leu-denominated government security holdings, only partly offset by the slacker advance in central government deposits and by the drop in the dynamics of long-term financial liabilities (capital accounts excluded).

24 According to press releases from the Ministry of European Funds and the Agency for Payments and Interventions in Agriculture, the period under review saw an increase in payments from structural funds (in September and particularly in November, when the Treasury extended a loan for payments to recipients of European funds) and in agriculture payments (especially in October, when disbursements were announced in relation to the second tranche of the 2013 life annuity, down-payments under the single area payment scheme, state subsidies for diesel fuel); however, the breakdown of these amounts by group of recipients is not possible.

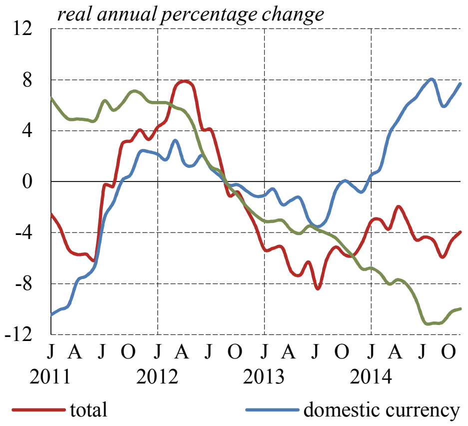
25 In line with Government Decision No. 392 of 2014.

26 Payment of the second tranche of the tax on special constructions. At the same time, according to budget execution data, the real average annual growth rate of monthly profit tax remained very alert when looking at the past two and a half years.

27 According to balance-of-payments provisional data, non-financial corporations' average volume of net repayments on external debt peaked at a 2014 high September through November.

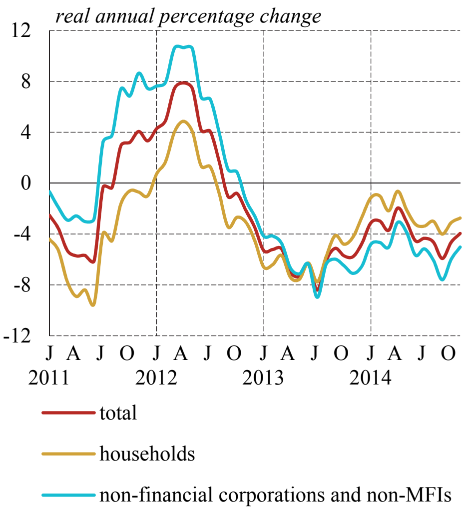
28 According to budget execution data, goods and services-related monthly expenditures and capital expenditures saw their real average annual dynamics pick up.

Credit to Private Sector by Currency



Source: NIS, NBR

Credit to Private Sector by Institutional Sector



Source: NIS, NBR

Credit

September through November 2014, the dynamics of credit to the private sector[29] remained in negative territory (-4.8 percent from -4.5 percent June through August 2014), reflecting the mixed impact of (i) the relative reduction in the volume of operations to remove non-performing loans from credit institutions' balance sheets[30]; (ii) the lower dynamics of the flow of new loans[31], and (iii) the statistical effect of the higher annual inflation rate[32]. The breakdown by currency shows that the uptrend in the dynamics of the leu-denominated component over the past year has come to a halt, due exclusively to the temporary drop witnessed in September, while the pace of decline of foreign currency credit (expressed in euro) has stabilised after almost three years of going deeper into negative territory. The average share of forex-denominated credit in total credit to the private sector continued to narrow during this period and stood at 56.4 percent, the lowest level since 2008 Q4.

The breakdown by institutional sector points to a marginal decline in the rate of change of household credit, as the impact exerted by the reduction in the dynamics of the foreign currency component (irrespective of purpose) was almost fully offset by that of the growth rate of leu-denominated consumer credit entering positive territory (for the first time since 2009 Q2), also due to the lower net volume of asset sales. In turn, the pace of increase of leu-denominated housing loans stuck to a very high level by historical standards, in spite of a slight deceleration due to a base effect associated with the year-earlier launch of the "First Home" government programme exclusively in domestic currency. The dynamics of loans to non-financial corporations fell as well. This was attributable to the leu-denominated component and more specifically to overdraft and revolving loans. An opposite, weaker impact came from the slower rate of decline of foreign currency credit (expressed in euro), ascribable inter alia to the reduction in the volume of sales of forex-denominated NPLs.

29 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2014.

30 Sales, cancellations and acquisitions of loans, according to monetary statistics data. Adjusted for the impact of these transactions, the dynamics of credit to the private sector continued to improve.

31 Based on CCR data referring to loans in excess of lei 20,000 granted in the respective month.

32 The rate of change of credit to the private sector went up in nominal terms.

IV. INFLATION OUTLOOK

The baseline scenario of the current projection places the annual CPI inflation rate at 2.1 percent at end-2015, 0.1 percentage point lower than in the November 2014 Inflation Report, and at 2.4 percent at end-2016.

The CPI inflation rate is seen running below the previously-projected values almost throughout the reference period, except for 2016 Q1. At the same time, the adjusted CORE2 inflation rate forecast has been revised upwards in the first half of the period and downwards thereafter. The diverging revisions are attributed to the favourable impact expected in 2015 from supply-side shocks whose effects would later fade out, on the one hand, and to the opposite developments in some fundamental drivers of core inflation, import prices in particular, over the two-year projection interval, on the other hand. A significant influence on the forecast revision had the unexpected developments that occurred after the November projection was published.

The annual adjusted CORE2 inflation rate is forecasted to range between 1.1 and 1.5 percent throughout the reference period, with a peak in 2015 Q2. This inflation measure is seen reaching 1.3 percent and 1.4 percent at end-2015 and end-2016, respectively. Compared with the previous projection, the significantly downward revision of the negative output gap entails weaker pressure to drive down core inflation throughout the projection interval. The downward revision, also during the entire projection interval, of economic agents' inflation expectations, partly as a result of the recent disinflationary performance, acts in the opposite direction. Imported inflation also played a role in the annual adjusted CORE2 inflation rate being revised upwards in 2015 and downwards in 2016. As against the previous forecast, this influence is on the upside in 2015 considering the recent softening of the leu versus the US dollar and the euro. However, for next year, these effects are expected to fade away, whereas the dynamics of external prices relevant to Romania's imports are projected to post lower levels than envisaged in November.

The projections for exogenous CPI components in terms of the monetary policy scope show their cumulative contributions to the headline index dynamics having far lower magnitudes than in the previous forecast for 2015 and marginally higher in 2016. The most substantial reassessment was the downward revision of the contribution of fuel prices in 2015, reflecting the base effect of the sharp fall in oil price on international markets in 2014. Another base effect, stemming from the plentiful harvest and the domestic supply being supplemented by imported fruit and *vegetables from European countries hit by the Russian import ban imposed in 2014, stood behind the significantly downward revision of VFE prices contribution to headline inflation in 2015 Q1-Q3. The revised projections for tobacco product prices and administered prices are due to changes in the current legislation regarding the determination of the leu-denominated level of excise duties, as concerns the former, and the calendar and magnitude of future natural gas price adjustments, in the latter case.*

Given the projected dynamics of its components, the annual CPI inflation rate will remain below the lower bound (1.5 percent) of the variation band of the target by 2015 Q3, will return inside the variation band in the next quarter and will stabilise at levels slightly lower than the 2.5 percent mid-point of the target until the forecast horizon. It is envisaged that annual inflation will bottom out at 0.1 percent in 2015 Q1, mainly on the back of base effects stemming from the movements in volatile prices. The average annual inflation rate is projected to run below the lower bound of the variation band of the target until the end of 2015, then to return inside the band and stick to levels below the mid-point of the target until the end of 2016.

Going forward, the stance of monetary policy is shaped with a view to ensuring price stability over the medium term, amid firm anchoring of inflation expectations, so as to support economic growth, including via the restoration of confidence and the sustainable recovery of lending.

The assessment of the risks to the current inflation rate projection reveals a balance tilted to the upside, especially due to the uncertainties surrounding the external environment. Relative to the November 2014 Inflation Report, uncertainties at the current juncture appear to be higher, following recent events mainly in Europe and across the region that might have adverse consequences for Romania's economy.

Growing uncertainties are fuelled by the recent escalation of the conflict between Russia and Ukraine and the situation in Greece. Further relevant are the risks of a possibly widening divergence between the monetary policy stances pursued by the world's major central banks, the US Federal Reserve and the ECB in particular, as well as of the ongoing cross-border deleveraging in the banking system, that could bring about capital outflows from the region. The risks associated with the latter appear however to be on the wane, considering both the relatively favourable outcome of the comprehensive assessment exercise of significant credit institutions completed by the ECB at the end of last year and the easing of liquidity strains they have been facing, amid the implementation of the expanded asset purchase programme recently adopted by *the ECB. Against this backdrop, the major risks to the inflation projection refer to possible wide fluctuations in foreign investors' risk aversion, entailing successive reallocations of exposures to emerging economies and hence heightened volatility of capital flows channelled to these economies, Romania included. These would induce instability of both foreign financing sources for the national economy development and the leu exchange rate, with a detrimental impact on price stability and the consolidation of economic growth assumed in the baseline scenario of the projection.*

Given the investors' medium- and long-term bias towards economies with relatively low external and domestic macroeconomic imbalances, Romania's progress in this direction over the recent years carries the potential to mitigate to some extent the risk associated with unfavourable effects of global or regional portfolio shifts. At the same time though, the persistence of structural rigidities across the Romanian economy dampens its capacity to react in order to mitigate the consequences of adverse external shocks and is viewed as a risk factor by international investors. For this reason, the firm and consistent implementation of the structural reforms agreed upon with the EU, the IMF and the World Bank is a prerequisite for bringing sustainable capital flows into the Romanian economy.

The risks that the aggregate consumer price index components affected mainly by supply-side shocks deviate from their trajectories assumed in the baseline scenario appear to be relatively balanced during the reference period, despite the persistence of specific uncertainties. Thus, the uncertainty surrounding administered prices is associated, over the medium term, with the magnitude of the impact that the natural gas and electricity market deregulation stages will exert on end-user prices. As for international commodity prices, heightened risks are associated with the future path of the EUR/USD exchange rate, which depends on several factors linked to both the global economic environment and a potential escalation of geopolitical tensions. Domestic food price dynamics are still strictly dependent on weather, and implicitly on the good performance of agricultural output. Another incidental factor specific to the current reference period is the possible persistence of domestic supply being supplemented by imports from countries hit by Russia's recent ban.

1. Baseline scenario

1.1. External assumptions

Expectations on the Developments in External Variables

annual averages

	2015	2016
Effective EU economic growth (%)	1.28	1.83
Annual inflation rate in the euro area (%)	0.50	1.33
Annual CPI inflation rate in the US (%)	1.32	2.20
3M EURIBOR rate (% p.a.)	0.08	0.19
USD/EUR exchange rate	1.18	1.16
Brent oil price (USD/barrel)	53.0	61.9

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

The scenario for external demand evolution foresees that the slow-paced dynamics in real terms of the effective EU GDP[1] persist into 2015, as the impact of unfavourable factors that dampened economic growth last year – notably subdued global trade, stalling economic reforms in some countries[2], as well as the lingering geopolitical tensions – is seen making itself felt over the next quarters as well. Further on, the ECB's very accommodative monetary policy stance, enhanced by the new package of policy measures aimed at easing financial conditions announced on 22 January 2015[3], sets the stage for a recovery of economic activity that is likely to benefit also from the favourable impact on exports of the expected gradual upturn in global activity[4], as well as of the persistent effects of the softer euro versus the US dollar. Against the November 2014 Inflation Report, projections were revised downwards, with the external negative output gap[5] expected to have a relatively tighter impact on economic activity in Romania for most of the forecast interval.

Annual HICP inflation is expected to stay low over the short term, including amid the recent decline in the oil price, before rising gradually until the forecast horizon as a result of the gradually narrowing negative output gap, the increasing inflationary pressures stemming from the weaker euro, and the expected favourable impact of the ECB's newly-introduced monetary policy measures. Annual inflation rate in the USA is foreseen running higher than in the euro area.

The anticipated historical low levels of the nominal 3M EURIBOR reflect the ECB's persistently accommodative policy stance.

1 EU-28 excluding Romania. For further details, 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.

2 According to ECB assessments (see December 2014 Eurosystem staff macroeconomic projections for the euro area on the ECB's website).

3 In its meeting on 22 January 2015, the ECB decided to launch a new programme of non-standard measures on monetary easing meant to prevent a stalemate of the euro area economy and ensure the sustainable inflation convergence with the target. These measures consist in an expanded asset purchase programme from March 2015 to September 2016 at least, with combined monthly purchases of public and private sector-issued bonds amounting to a maximum volume of EUR 60 billion.

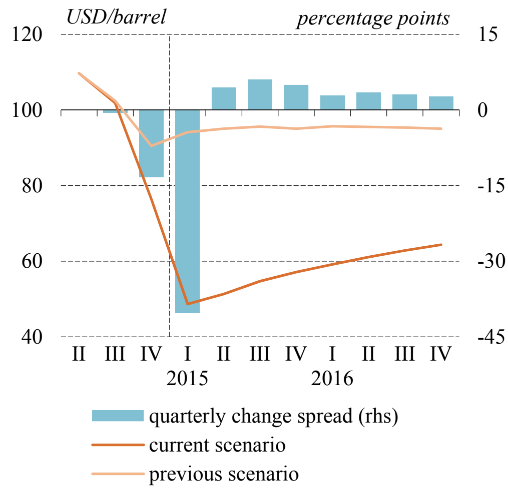
4 See footnote 2. However, the hypothesis is surrounded by elevated uncertainties, amid worsening projections for most economies, except the US (e.g. in January 2015, the IMF revised the global economic growth outlook for 2015 from 3.8 percent, the figure envisaged in October 2014, down to 3.5 percent).

5 A relevant measure to approximate the external demand impact on Romania's exports within the NBR model.

The path of the EUR/USD exchange rate is foreseen to follow a slight depreciation trend of the euro over the entire projection interval, given the weaker growth outlook in the eurozone than in the USA and expectations of diverging monetary policy stances in the two economic blocs.

The scenario for the international Brent oil price hinges on oil futures and foresees a new significant decline in 2015 Q1, after that seen in the previous quarter, amid excess supply – also considering OPEC's decision late last year not to cut production – and subdued demand. For the remainder of the forecast interval, the international Brent oil price is expected to rise somewhat, remaining however below the path in the November 2014 Inflation Report.

Brent Oil Price Scenario



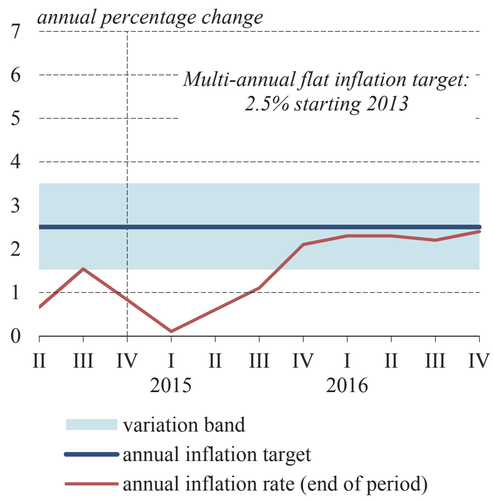
Source: Energy Information Administration, NBR assumptions based on Bloomberg data

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 2.1 percent at end-2015 and at 2.4 percent at end-2016, i.e. inside the lower half of the variation band of the central target. In 2015 Q1, the annual inflation rate is projected to remain on the sharp downtrend seen in 2014 Q4[6], reaching 0.1 percent in March 2015, also as a result of a sizeable base effect. The contributors to this evolution are the expected negative impact of developments in volatile prices[7] and the disinflationary effects triggered by tobacco prices, which are slightly alleviated by the projected increases in administered prices and the prices included in the adjusted CORE2 index. Starting in 2015 Q2, annual CPI inflation is envisaged to resume a moderately upward path, before re-entering the variation band of the target in 2015 Q4 and remaining below the 2.5 percent mid-point until the forecast horizon. In turn, the average annual inflation rate is projected to run beneath the lower bound of the variation band of the target until the end of 2015, then to return inside the band and stick to levels below the mid-point of the target until the end of 2016.

Compared to the November 2014 Inflation Report, headline inflation is expected to be 0.1 percentage points lower at end-2015. This revision is solely attributed to more favourable influences coming from fuel prices, the other CPI components having a more unfavourable contribution to the annual inflation rate. In the course of 2016, more favourable influences come from the adjusted CORE2 inflation and, marginally, from administered prices, whereas fuel and VFE prices have slightly more unfavourable contributions.

Inflation Forecast



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

Source: NIS, NBR projection

[6] The annual CPI inflation rate fell to 0.83 percent at end-December 2014, down 0.71 percentage points against end-September 2014. For further details, see Chapter 1. Inflation developments.

[7] Determined by the expected negative annual dynamics of fuel prices and volatile food (VFE) prices, under the persistent impact of the tumbling oil price in 2014 Q4, as well as of transitory shocks hitting vegetable and fruit prices in 2014 H2, amid the good performance of the agricultural sector and the substantial rise in imports of such goods included in the CPI basket.

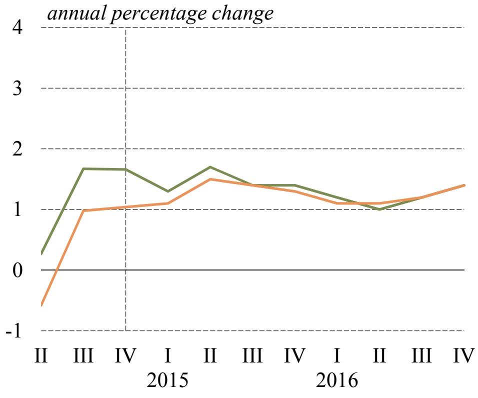
The Annual Inflation Rate in the Baseline Scenario

annual percentage change

	2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Forecast*	0.1	0.6	1.1	2.1	2.3	2.3	2.2	2.4

* end of period

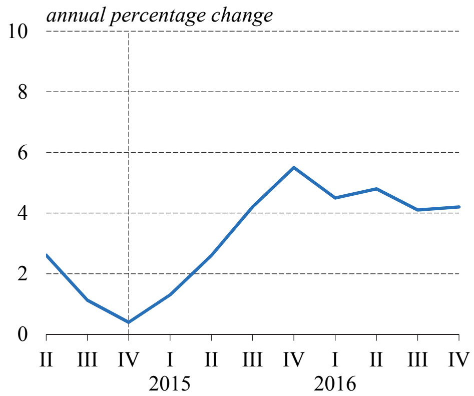
Annual CORE2 Inflation and Annual Adjusted CORE2 Inflation



*) end of period

Source: NIS, NBR projections

Administered Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

The annual adjusted CORE2 inflation rate is expected to follow a slight uptrend[8] in 2015 H1 and to reach 1.5 percent at the end of 2015 Q2, given the stronger inflationary pressures, at this horizon, coming from imported consumer goods prices, especially on the back of the recent developments in the leu exchange rate, along with the gradual reduction in the negative output gap, which will be fostered by the envisaged consolidation of domestic demand. The annual core inflation rate will subsequently remain on a relatively stable path to come in at 1.3 percent and 1.4 percent at end-2015 and end-2016 respectively. The gradual abatement of the disinflationary influence coming from the aggregate demand deficit will be countered by the weakening of inflationary pressures from import prices[9], whereas the contribution of economic agents' inflation expectations[10] is projected to remain fairly stable.

Compared to the November 2014 Inflation Report, the forecasted annual adjusted CORE2 inflation rate was revised upwards by 0.4 percentage points at the end of 2015, amid the GDP deviation reaching less negative levels and stronger inflationary pressures from import prices, while the economic agents' inflation expectations are seen having a more favourable contribution[11]. The 2016 levels were revised downwards, under the influence of inflation expectations running at lower levels, more slowly rising import prices foreseen at this horizon[12] and the persistence of the negative output gap, albeit on the wane.

The dynamics of tobacco product prices are largely shaped by the current legislation on setting the excise duties levied on these goods, given that the other elements of setting their selling prices[13] are envisaged to have only marginal contributions. Consistent with the changes to the current Tax Code[14], excise duties on cigarettes are foreseen to be raised as from 1 April 2015 by roughly 3.1 percent compared to the lei-equivalent prevailing by then and, starting with 2016, this level is to be indexed every year on 1 April with the average annual inflation calculated in September of the year prior

8 Starting from 1 percent at end-2014.

9 Particularly given the fading-out of the shock triggered by the recent significant depreciation of the euro against the US dollar, with a detrimental impact on the USD/RON exchange rate.

10 Envisaged to run at levels lower than the mid-point of the inflation target.

11 Following favourable incidental effects that became manifest after the publication of the previous Inflation Report, mirrored by the significant fall in the international oil price and fruit and vegetable prices.

12 Chiefly as a result of the downward revision of the projection on movements in "effective" external prices (a composite indicator quantifying the impact of euro area and US price dynamics on domestic inflation, according to the shares held by these regions in Romania's foreign trade).

13 Such as costs, e.g. wage costs in specialised companies.

14 According to Government Emergency Ordinance No. 80/2014 amending and supplementing Law No. 571/2003 on the Tax Code, starting 2015 excise duties shall no longer be expressed in EUR/1,000 cigarettes, but in RON/1,000 cigarettes.

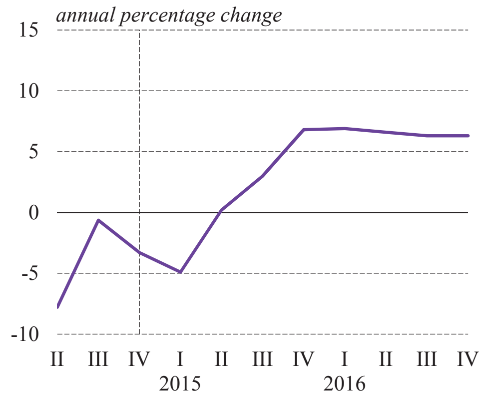
to implementation. The expected contribution of tobacco product prices to the annual CPI inflation is 0.1 percentage points at the end of 2015, being revised upwards by 0.2 percentage points compared to the previous Inflation Report[15], and almost nil at the end of 2016.

The scenario for administered price developments includes information from the relevant Romanian authorities and the latest changes to the legislation in this field. The group's annual dynamics are projected to amount to 5.5 percent at the end of this year and 4.2 percent at the end of next year. At end-2015, the contribution of administered prices to the annual CPI inflation is expected to be relatively unchanged compared with the previous round in view of the mutual offsetting of the revised contributions from the sub-items of this index[16].

Volatile food prices (VFE) are anticipated to go down in 2015 Q1 (-4.9 percent) amid the bumper harvest of 2014 and the temporary shocks associated with international trade in goods under "fruit and vegetables"[17], their path being thereafter marked by the seasonal effects specific to normal agricultural years[18]. The contribution of volatile food items to the annual CPI inflation rate is 0.4 percentage points for both the end of 2015, similarly to the previously-projected level, and the end of 2016.

Fuel prices are projected to fall in the course of 2015, with the group's annual dynamics set to reach -4.1 percent in December (revised downwards by 7.3 percentage points against the previous round) after bottoming out at -12 percent at the end of 2015 Q2. This evolution is primarily ascribed to the annual dynamics of the international oil price, which are forecasted to stick to negative values, albeit fluctuating from quarter to quarter, by the end of 2015. Starting 2016 Q1, the positive annual dynamics of the oil price, the quasi-stable path in the USD/RON exchange rate and the

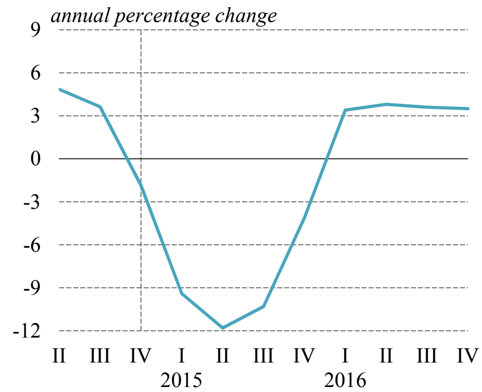
VFE Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

Fuel Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

15 Following the methodological changes on the determination of the lei-expressed excise duties on tobacco products.

16 On the one hand, the assumptions on heating and electricity price dynamics for 2015 were revised downwards given the much lower-than-previously-expected inflation in the former case in 2014 Q4 and the projection of slightly lower electricity price inflation in 2015 Q1 in the context of revised assumptions on the reservation component of the energy bill, in step with the liberalisation stage. On the other hand, the annual natural gas price dynamics were revised upwards for 2015 H2, amid the reassessment of the impact of the decision to extend the deadline for supplying natural gas at regulated prices (to 1 July 2021 from 31 December 2018), as approved by Parliament via Law No. 127/2014. The revision occurred also in the context of the developments seen late last year that are expected to continue in early 2015, which indicate lower-than-previously-projected increases following the decision to discontinue natural gas price liberalisation October 2014 through June 2015, this process being expected to resume after mid-2015.

17 Given Russia's ban on imported food from the EU and the increase in exports of fruit and vegetables from certain European countries hit by such restrictions (e. g. Italy, Germany, Poland) to the Romanian market.

18 The standard assumption in the absence of any other relevant information takes into account normal agricultural years in 2015 and 2016.

inflation expectations embarking on a slightly upward curve are foreseen to send fuel prices back onto a rising trend, causing the group's annual inflation to reach 3.5 percent at the end of next year. Starting 2016, consistent with the changes to the current Tax Code, fuel excise duties are to be indexed every year in January with the average annual inflation in September of the previous year.

Components' Contribution to Annual Inflation Rate*

percentage points

	2015	2016
Administered prices	1.0	0.8
Fuels	-0.3	0.3
VFE prices	0.4	0.4
Adjusted CORE2	0.8	0.8
Tobacco products and alcohol	0.2	0.1

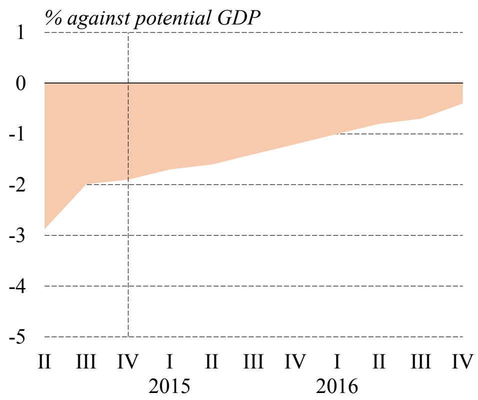
*) end of period; figures are rounded to one decimal place.

The cumulative contribution of components exogenous to the monetary policy influence, namely administered prices, prices of volatile food items (VFE), fuel prices and tobacco product and alcohol prices, to the annual CPI inflation rate is seen reaching 1.3 percentage points at end-2015 (0.4 percentage points lower than in the previous Inflation Report) and 1.6 percentage points at end-2016.

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

Output gap

Output Gap



Source: NIS, NBR projection

According to the NIS[20], seasonally adjusted real GDP saw a 1.8 percent rise in quarterly terms in 2014 Q3, its annual dynamics standing at 3.3 percent[21]. As compared with the November 2014 Inflation Report, in the context of ESA 2010 adoption, the time series on GDP and its components were revised for the entire historical period, with the quarterly GDP growth rates going up in 2014 H1. The evolution of some relevant monthly macroeconomic indicators[22] points to positive GDP dynamics for 2014 Q4 as well.

The potential GDP growth in 2014 is assessed to have been fuelled, via total factor productivity, by both the performance of the agricultural sector in 2013 (through the considerable carry-over effects) and the performance envisaged for the year under review. The contribution of labour remained slightly positive in 2014, while the dynamics of capital stock decelerated slightly, amid the marked declines in gross fixed capital formation manifest by mid-year. For 2015-2016, the baseline scenario assumes positive contributions of all production factors to potential GDP growth, given the anticipated favourable labour market developments[23]

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

[20] NIS Press Release No. 15 of 14 January 2015.

[21] Based on non-seasonally adjusted data.

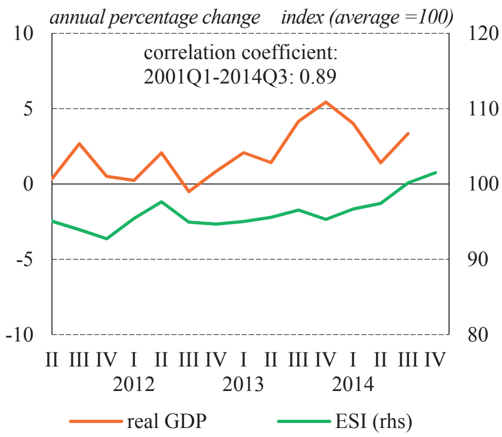
[22] For instance, in 2014 Q4, the capacity utilisation rate in industry saw a 0.3 percentage point rise versus the previous quarter and retail trade turnover (excluding motor vehicles and motorcycles) and industrial production increased by 2.1 percent and 0.9 percent respectively during October-November 2014 compared with the averages for Q3.

[23] Under the assumption of working hours remaining unchanged over the projection interval, the favourable joint effect of the slight contraction in unemployment rate and the increase in the economic activity rate is partly offset by the reduction in the working age population (EC autumn forecast).

and the improved dynamics of gross fixed capital formation, with a positive impact on the capital stock. Total factor productivity is expected to benefit from further staff training programmes and streamlining of production capacities, supported by the anticipated absorption of EU structural and cohesion funds at a rate similar to that reported in 2014[24] and the positive signals on the adjustment of corporate balance sheets, which creates the conditions for the allocation of funds to increase productivity. However, this scenario is still fraught with uncertainties surrounding external developments and the volatility of capital flows to the economies in the region, carrying the potential to deviate the dynamics of production factors from the path implied by the above-mentioned scenario.

As compared with the previous forecasting round, the output gap in 2014 Q3 is assessed as being considerably less negative (entailing, *ceteris paribus*, weaker disinflationary pressures), given the higher-than-expected real GDP dynamics in 2014 Q3, the NIS revisions of the historical data series of the seasonally adjusted real GDP, and the reassessment of the impact of output gap determinants. The aggregate demand deficit in 2014 Q4 is assessed at a level slightly lower than that in the previous quarter. With the external demand further exerting a restrictive influence of a similar size, this reassessment of the negative output gap in 2014 Q4 is attributable to its declining persistence and the slightly stimulative nature of real monetary conditions in Q3. Looking at the latter, the real interest rates in the banking system exerted a favourable influence, while the wealth and balance sheet effect of the exchange rate and the deviation of real effective exchange rate of the leu from the medium-term trend (with an impact on net exports) are seen to have had slightly restrictive influences. The impact of the fiscal impulse[25] is assessed to have been slightly stimulative in 2014 Q4.

Economic Sentiment Indicator* and Economic Growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

The slight narrowing of the negative output gap in 2014 Q4 is supported by a number of monthly indicators correlated with the cyclical position of the economy. Favourable signals come from the economic sentiment indicator (above the average, up 1.4 points from Q3) and the industrial production (up 0.9 percent in October-November compared with the 2014 Q3 average), while the ILO unemployment rate is assessed to be slightly above the medium-term trend in this quarter as well.

The GDP deviation from its potential is foreseen to narrow gradually throughout the projection interval, remaining however negative at this horizon. This is foreseen to be the result of the persistence of the stimulative impact of the real broad monetary conditions, to which

[24] The 2014-2015 period will see the overlapping of EU funds of 2007-2013 and 2014-2020 financial years respectively, due to the activation of the exit rule (T+2) applicable to the funds allotted during 2013 financial year.

[25] It quantifies the impact of the discretionary component of fiscal policy in the NBR model.

add the favourable effects of the anticipated gradual recovery in external demand, while the fiscal impulse is expected to have a pro-cyclical effect in 2015 and a slightly counter-cyclical one in 2016[26]. As compared with the previous forecasting round, the negative output gap is projected at lower levels over the entire interval (implying weaker disinflationary pressures), especially on account of the persistent nature of the reassessment made at the starting point of the projection. In the current forecasting round, the negative output gap is projected to narrow at a faster pace in the first quarters of the projection interval, mainly due to the more stimulative real monetary conditions, also in the context of the monetary policy easing cycle in the recent periods. On the other hand, external demand is expected to have a relatively more restrictive impact for the most part of the forecast interval, its dynamics being however conditional upon the effectiveness of the recently announced ECB measures meant to spur economic activity.

According to the baseline scenario of the projection, the annual economic growth rate in 2014 is estimated to have slightly slowed down compared with the previous year, mainly on account of the unfavourable developments in 2014 Q2. Over the projection interval, the GDP dynamics are supported by the rebound in domestic demand, which, by fuelling imports, entails a slightly negative contribution of net exports, despite the anticipated persistence of the positive growth rate of exports. The anticipated revival of domestic demand is due mainly to the actual individual final consumption of households, bolstered by the expected rise in their real disposable income and the further easing of lending conditions. Starting with 2015, in the context of a performance similar to that in 2014 with regard to productive capital inflows (via EU structural and cohesion funds and foreign direct investment flows), gross fixed capital formation is also seen to make a positive contribution to domestic demand. The baseline scenario of the projection envisages a slightly negative contribution of net exports to economic growth in 2015 and a relatively neutral contribution subsequently.

Aggregate demand components

In 2014 Q4, the quarterly dynamics of the actual individual final consumption of households are expected to remain at a level close to that recorded in the preceding quarter[27]. This is supported by the 1.2 percent real increase in net wages in October-November 2014 versus the Q3 average and the 2.1 percent growth in retail trade (except for motor vehicles and motorcycles), whereas the consumer confidence indicator saw a 6.4 point improvement in the

[26] The impact of the discretionary component of fiscal policy on the economic activity is expected to be slightly neutral in both 2015 and 2016, given the fiscal deficit adjustment to sustainable levels in the previous periods.

[27] In 2014 Q3, the actual individual final consumption of households grew by 1.3 percent quarter on quarter.

fourth quarter as a whole compared with Q3. In this context, in 2014 Q4, the negative deviation of this GDP component from its medium-term trend is assessed to narrow slightly compared with the preceding quarter.

Actual collective consumption of general government is expected to pick up significantly in 2014 Q4, being however in line with the 2014 budget deficit standing within the limit established with international financial institutions[28].

After the 2013 decline, the annual average growth rate of actual individual consumption of households is foreseen to recover and stay in positive territory starting with 2014. Throughout the forecast interval, in the context of the already recorded progress in household balance sheet consolidation, which is anticipated to go on in the future, the sustained growth of actual individual consumption of households will be spurred by the more stimulative interest rates applied by financial institutions, the forecasted moderate increase in employment in the private sector and the faster rise in the real disposable income of households[29]. Lending conditions[30] are expected to ease further, also as a result of the pass-through of the successive policy rate cuts[31]. The rise in the real disposable income of households is foreseen to occur on the back of the nominal increase in this category of income and the projected CPI inflation rate staying at relatively low levels. To these add the premises for an anticipated absorption of EU funds similar to that recorded in 2014, given the overlapping of the multi-annual financial frameworks in 2015, favourable effects on consumption being expected to stem particularly from the programmes addressing labour productivity, with a positive impact also on employment and the wage dynamics in the private sector. The dynamics of the actual collective consumption of general government are foreseen to be positive throughout the forecast interval.

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[28] According to the latest data released by the MPF, the general government balance as a share in GDP stood at -1.85 percent at end-2014 (cash-based methodology). In 2014, the cash deficit target was 2.2 percent of GDP (Ministry of Public Finance “Report on the macroeconomic situation for 2014 and the projections for the years 2015-2017”).

[29] Given the improvement in the main labour market indicators and the adoption by the Government of Romania of a set of measures (in line with the Fiscal Strategy for 2015-2017), of which the most worthy to mention are the minimum wage increase in two steps by lei 75 each as of 1 January 2015 and 1 July 2015 respectively, the indexation of all pensions by 5 percent and the rise in the wages of teachers by 5 percent as of 1 March 2015 and by another 5 percent as of 1 September 2015.

[30] The sustainable resumption of lending is conditional upon the continued progress in reducing the indebtedness level of borrowers and the non-performing loans of financial institutions.

[31] The speed at and the extent to which monetary policy decisions are passed on to financial institutions’ interest rates applicable to their non-bank clients largely depend also on the lending terms and standards set by commercial banks and the net effect on the dynamics of bank interest rates may differ, in terms of magnitude, from the signals sent by the changes in the NBR’s key interest rate.

In 2014 Q4, the quarterly growth rate of gross fixed capital formation is foreseen to pick up, being supported by developments in construction (2.8 percent increase in October-November 2014 versus the Q3 average and the 3 point improvement in the related confidence indicator in 2014 Q4) and in the equipment sub-sector (the 2.8 percent rise in the turnover of capital goods for the domestic market during October-November 2014 compared with Q3 average). Against the background of the anticipated developments in gross fixed capital formation, its deviation from the medium-term trend is assessed to remain in negative territory in 2014 Q4, yet slightly narrower than in the preceding quarter.

The annual average growth rate of gross fixed capital formation is estimated to have been negative in 2014, being hampered by the unfavourable developments recorded in 2013[32] and in the first part of 2014. In 2015 and 2016, this component is expected to gradually recover, given the further absorption of EU structural and cohesion funds, acting as a catalyst on the investment sector, as well as the announced increase in the share of public spending for investment[33]. The anticipated pick-up in private and public investment spending, amid the continued easing of lending conditions and the gradual recovery of international economic activity, will have a favourable impact on investment in the export-oriented sectors. These factors are projected to support the capital endowment economy-wide and hence the labour productivity growth.

The quarterly dynamics of exports of goods and services are estimated to re-enter positive territory in 2014 Q4, due to the 2014 agricultural output similar to that recorded in 2013 and the persistence of favourable structural changes that contributed to the positive performance of exports, particularly in 2013[34,35]. In the context of the recent regional and geopolitical tensions and the anticipated economic activity developments of Romania's main trade partners, the forecasted quarterly growth rate of exports is moderate compared with the previously-recorded levels. This assessment relies on the EU economic sentiment indicator standing 0.5 points lower in 2014 Q4 than in Q3 and on the modest rise in the euro area industrial production (0.3 percent during October-November 2014 as against the Q3 average). The quarterly dynamics of imports of

[32] Also via a carry-over effect.

[33] According to the Fiscal Strategy for 2015-2017, whose provisions are also found in the state budget for 2015, the share of investment spending in total budget expenditures will move ahead to 18.7 percent in 2015, up 3.2 percentage points from a year earlier.

[34] In 2013, exports of goods and services grew by 16.2 percent in real terms over the year before.

[35] Exports of "machinery, apparatus, equipment and transport means" and "agri-foodstuffs" picked up 12.9 percent and 30.7 percent respectively in 2013 versus 2012. In January-November 2014, exports of these subgroups went up 7.4 percent and 7.8 percent respectively compared with the same year-ago period (balance of payments data expressed in euro).

goods and services are expected to pick up slightly from Q3, amid the forecasted gradual recovery of domestic demand and exports. Under these circumstances, the deviations of exports and imports from the medium-term trends are assessed to be further negative.

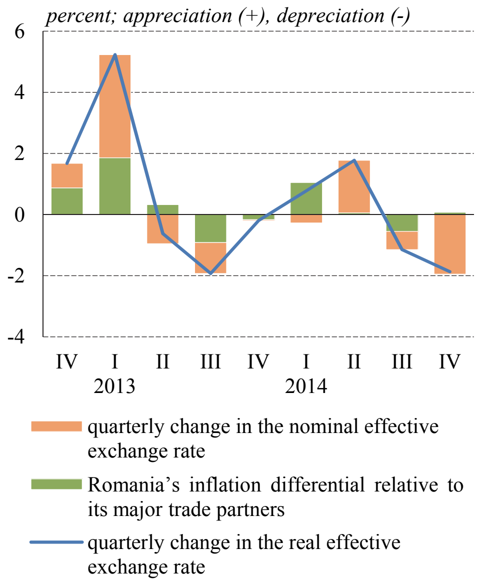
The annual average growth rate of exports of goods and services is projected to stay in positive territory in 2014, supported by the favourable developments seen in 2013 (including via a carry-over effect) and the strong agricultural output. Export dynamics are anticipated to slow down marginally in 2015, being constrained by the slow external demand recovery and the diminishing exports of agri-food items, strictly conditional on the assumption of a normal agricultural year. The annual dynamics of exports are expected to pick up in 2016, in the context of the gradual recovery in the economic activity of external partners[36]. Imports of goods and services are expected to see positive dynamics over the projection interval, amid the increase in domestic demand, supported by the gradual consolidation of final consumption and the recovery of gross fixed capital formation.

Given the projected almost nil contribution of net exports of goods and services and the slightly negative contribution of income balance, the current account deficit-to-GDP ratio at end-2014 is anticipated to stand at a level similar to that recorded a year earlier. In the medium run, the current account deficit-to-GDP ratio is foreseen to post relatively low and sustainable levels. Against the background of recording appropriate levels of international reserves, the projected relative stability of the current account deficit contributes to diminishing Romania's vulnerabilities to a potentially increased capital volatility affecting emerging economies and, hence, no significant corrective pressures are expected on the exchange rate of domestic currency in the baseline scenario.

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. The exchange rate exerts its influence via the net export channel, as well as via the wealth and balance sheet effect of economic agents[37].

Quarterly Change in the Effective Exchange Rate



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

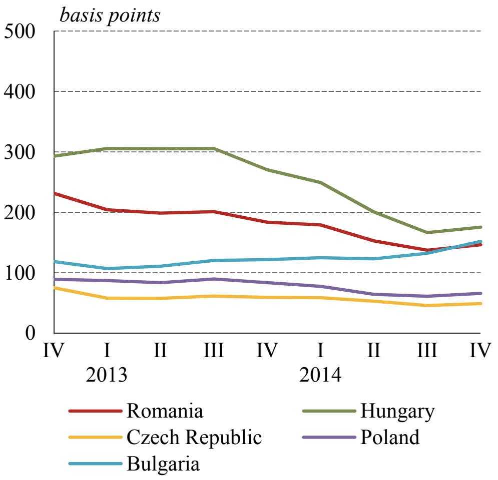
[36] Assumed to also benefit from the favourable impact of the ECB's recent measures to boost the euro area economy.

[37] The wealth and balance sheet effect of the exchange rate is manifest, in the case of 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. For further details, see the monetary policy glossary available on the NBR website.

In 2014 Q4, nominal interest rates[38] applied by credit institutions to their non-bank clients stayed on a downward path, also as a result of the time-propagated impulse sent by the monetary policy rate cuts. The drop in nominal interest rates is, however, lower than the decrease in inflation expectations, which caused the increase in real interest rates on both loans and deposits. The cumulative impact on the economic activity in the next quarter of the deviations of real interest rates from their trends is further stimulative, albeit on a decline.

In 2014 Q4 against Q3, the domestic currency depreciated in nominal terms, particularly versus the US dollar, but also versus the euro. Given the only slightly negative contribution of the inflation differential versus Romania's trade partners, the leu softened in real effective terms[39] as well. In this context, the impact on aggregate demand in 2015 Q1 of the real effective exchange rate via the net export channel became stimulative.

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



Source: NBR calculations based on Bloomberg data

In 2014 Q4, the risk associated with investments in the national economy stood marginally higher, as shown by developments in CDS (Credit Default Swaps) quotes. This is in line with the regional dynamics (amid the tensions from Russia), as well as in the context of a global process to reconsider the attractiveness of investments in emerging economies. Nevertheless, the further negative deviation from the trend of the risk premium, together with the real foreign interest rate remaining below the equilibrium level, has stimulative effects on domestic demand. These effects are, however, offset by the impact stemming from the anticipated exchange rate developments[40]. In the context of the aforementioned developments, the wealth and balance sheet effect in 2014 Q4 has a relatively neutral influence on economic activity in the following quarter.

Overall, real broad monetary conditions in 2014 Q4, with an impact on economic activity in the following quarter, are assessed to be stimulative, leading, *ceteris paribus*, to the moderation of disinflationary pressures generated by the negative output gap. Looking at real broad monetary conditions by component, the stimulative impact is exerted by the real effective exchange rate (via the external competitiveness channel) and the deviation of real deposit rates.

Broad monetary conditions are forecasted to have a stimulative effect on economic activity[41] over the projection interval. The

[38] Calculated as volume-weighted averages of new loans and time deposits, respectively.

[39] The relevant exchange rate for the NBR's quarterly projection model implies EUR/RON and USD/RON exchange rates, according to the weights of the two currencies in Romania's foreign trade.

[40] Approximated by the expected change in the real effective exchange rate deviation.

[41] Compared to the previous round, real broad monetary conditions are more stimulative in the current year and slightly less stimulative thereafter.

monetary policy rate path is configured in order to ensure price stability over the medium term, conditional upon the effective anchoring of inflation expectations, so as to support economic growth, including via the restoration of confidence and the sustainable recovery of lending.

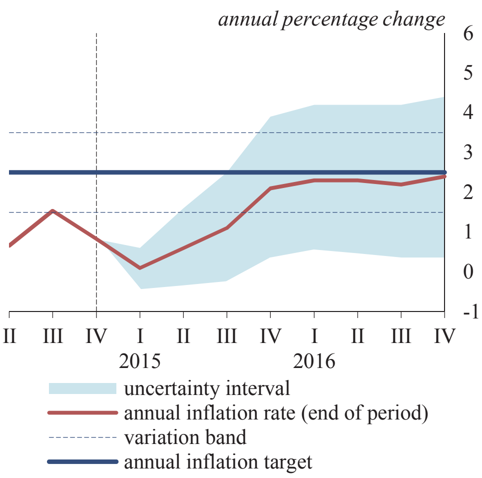
In line with the projected trajectory of the monetary policy rate, the cumulative impact of the deviations from the trends of real interest rates on leu-denominated loans and deposits is expected to be stimulative for aggregate demand. This is enhanced by the impact of the wealth and balance sheet effect of economic agents, which is the result of the projected favourable contributions from the foreign interest rate – reflecting the accommodative monetary policy stance of the ECB –, the exchange rate movements and the risk premium, assuming budget and current account deficits at levels which are not expected to induce volatility to the domestic currency. At the same time, the real effective exchange rate exerts, via the net export channel, a stimulative effect, albeit on a decline towards the projection horizon.

1.4. Risks associated with the projection

In the context of heightened uncertainties surrounding the future configuration of some of the domestic and international macroeconomic environment elements, the balance of risks to the annual inflation rate path in the baseline scenario is assessed to be tilted to the upside, given the data available on the cut-off date of this Report.

For the reference period, the external environment is expected to be the main source of uncertainty against the background of the existing geopolitical instability, with a significant relevance being attached to the economic consequences of the protracted conflict in Ukraine, as well as of the uncertainties concerning the impact the situation in Greece[42] might have on the euro area in general. The persistence of geopolitical tensions between Russia and Ukraine, heightened by the existing issues in some of the economies of the euro area, might increase the risk of significant unfavourable consequences through both the effects on Romania's main EU trading partners and the financial flows. The materialisation of the risks posed by any of these sources might lead to portfolio reallocations by the investors in local financial markets, based on the quality of the fundamentals of the envisaged economies, causing a pick-up in the volatility of capital flows channelled to them, and implicitly to the Romanian economy. Such a context could result in fluctuations in the leu exchange rate that could substantially alter the inflation dynamics from those in the baseline scenario of the projection.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Note: The uncertainty interval was calculated based on the annual CPI inflation forecast errors in the NBR projections during 2005-2014. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

[42] Although the parliamentary elections in Greece were won by the extreme left-wing party, the future decisions concerning the country's economic situation are still not clear and therefore cannot be assessed at the current juncture, not even as alternative scenarios.

Similar influences are also associated with the uncertainties relative to a potentially wider divergence between the monetary policy stances of the major central banks worldwide[43], with subsequent implications on financial market differentiation. Nevertheless, given investors' medium- and long-term orientation towards the economies featuring relatively low external and domestic economic imbalances, as well as towards those involved in consistent reform programmes, the progress Romania made in this direction[44] over the last years and investors' still lower exposures featuring a diversified profile compared to those to other emerging economies carry the potential to partly mitigate the risk associated with the unfavourable effects of a global or regional exposure shift.

The risk of an ongoing cross-border deleveraging of banks and of a further capital withdrawal from the region appears to be lower than that assessed in the previous Inflation Report, considering the successful completion at end-2014 of the comprehensive assessment exercise including the asset quality review and the stress tests carried out by the European Central Bank, as well as the recent measures adopted by this institution regarding the expanded asset purchase programme aimed at providing additional liquidity, mainly through the purchase of sovereign bonds from the Member States in the area[45].

On the domestic front, relevant uncertainties persist concerning the firm and consistent implementation of the set of structural reforms and measures agreed upon with the EU, the IMF and the World Bank; carrying on the consistent structural reform programmes remains of the essence for attracting foreign investment to the domestic economy through the consolidation of investors' favourable perception of risks associated with the Romanian economy.

The risks to inflation stemming from administered prices are relatively balanced in the short run, being conditional upon the possible reassessments of the information provided by the relevant authorities in Romania in the context of a likely reconfiguration of the calendar providing the extension of the deadline for implementing the deregulation of the natural gas market. However, in the medium run, uncertainties remain relative to the measurement,

43 ECB gearing the monetary policy towards a more accommodative stance and Fed abandoning this stance.

44 This progress refers to stronger economic fundamentals, the consolidation of Romanian assets' visibility in benchmark indices relevant to global investments, as well as to improved bank asset indicators, in parallel with the improvement in the liquidity, solvency and provisioning indicators related to the same sector.

45 These measures are anticipated to have beneficial effects on Central and Eastern European economies via both the trade channel and the financial channel, providing an underpinning for consolidation of economic growth and the reduction of the risk of financial asset bubbles emerging in the context of maintaining macroprudential policies.

assumed by the baseline scenario, of the impact that the natural gas and electricity market deregulation stages will exert on end-user prices. The mentioned uncertainties may be enhanced by stronger geopolitical instabilities in Ukraine and/or the Middle East, to the extent to which these tensions would influence the international energy prices.

The evolution of domestic food prices is marked by inherent uncertainties associated with both weather conditions, which can influence the agricultural supply, and, in the context of the present external macroeconomic developments, the possible persistence of domestic supply being supplemented by imports from some countries affected by Russia, a major foreign market for European states, having imposed an import ban.

The risks stemming from international commodity prices are seen to be relatively balanced, considering that the risk of a potential escalation of geopolitical tensions with an impact on stocks, especially in the oil sector, is counterbalanced by a relatively low global demand[46]. However, the persistence of unfavourable developments in the EUR/USD exchange rate similar to the recent ones carries the potential to exert an adverse influence on the leu evolution versus the US dollar and implicitly on the oil price expressed in lei.

2. Policy assessment

In October, the annual inflation rate reversed course, falling during Q4 increasingly below the lower bound of the variation band of the flat target and implicitly below the forecasted values. The inflation deceleration owed solely to supply-side factors, with the major determinants thereof being the steep decline in the international oil price and the annual contraction in volatile food prices. However, the annual adjusted CORE2 inflation rate was further quasi-stable, under the mixed impact exerted, on the one hand, by the relative contraction in the negative output gap and the slight depreciation of the leu versus the major currencies and, on the other hand, by the protracted decrease in the inflation rate in the euro area and the further downward adjustment in inflation expectations. Against this background, the annual inflation rate came in at 0.83 percent in December, its 2014 average standing at 1.1 percent – the lowest level over the past 25 years.

In their turn, the projected annual inflation rate values saw another broad-based downward adjustment, but this time significantly more pronounced over the first segment of the projection horizon. Thus, according to the present forecast, the projected annual

[46] Recent developments indicate the drop in the Brent oil price amid the significant production increase and the sluggish consumer demand.

inflation rate falls to almost zero in 2015 Q1 and subsequently enters an upward trajectory which remains, however, below the lower bound of the variation band of the flat target until Q3, in spite of a more pronounced increase at the beginning of H2; hence, towards the end of 2015, it returns to the lower half of the variation band of the flat target, reaching in December a level only marginally lower than previously projected (2.1 percent compared with 2.2 percent). Nevertheless, over the following four quarters, the path of the projected annual inflation rate is seen stabilising at levels comfortably below the mid-point of the target of 2.5 percent ±1 percentage point and implicitly below the levels pointed out by the previous projection, climbing only marginally to reach 2.4 percent at end-2016 (compared with a previously anticipated 2.6 percent[47] level). Consequently, the average annual inflation rate forecasted for 2015 goes down to 0.8 percent (from 1.5 percent in the previous projection), while for 2016 it is anticipated to stand at 2.3 percent.

The significant change in the short-term inflation outlook is solely driven by the substantial impact expected to be temporarily exerted by the annual dynamics of fuel and volatile food prices falling deeper into negative territory amid a projected protraction over the following quarters of the influences arising from the marked decline in the international oil price, as well as from the relative expansion of the agricultural product supply on account of the domestic and regional bumper crop in 2014. Another factor contributing to the lower path of the forecasted annual inflation rate is the downward revision, almost throughout the projection horizon, of the foreseen magnitude of administered price adjustments; its disinflationary effects are, however, offset in the short run by the transitory pick-up in the forecasted annual adjusted CORE2 inflation rate, entailed by the leu exchange rate behaviour via import prices.

In contrast, at the beginning of 2016, adjusted CORE2 inflation becomes and subsequently remains the main driver behind the slower CPI inflation compared to the previous projection, given that the slightly upward trajectory the annual core inflation enters in Q1 is markedly lower than previously anticipated, not exceeding 1.4 percent at the end of the projection horizon[48]. The new change in the core inflation outlook arises from the downward revision of the inflation forecasts in the euro area and other EU countries – along with the expected developments in the leu exchange rate – as well as from the stronger disinflationary action assumed to be exerted by medium-tem inflation expectations, in the context of the recent protraction of their downward trend. Their influence is only partly

47 The projected annual dynamics for 2016 Q3 in the November 2014 Inflation Report.

48 In the previous projection, the forecasted annual adjusted CORE2 inflation rate stood at 1.7 percent at the end of the projection horizon.

counterbalanced by the impact of the relatively more pronounced narrowing tendency of the forecasted negative output gap readings, having as major premises and assumptions the substantial revision of the historical GDP data series, the significant acceleration of the economic growth in 2014 Q3, and the maintenance of stimulative real monetary conditions, associated with a relative improvement in the monetary transmission mechanism, as well as the persistence of a fragile global and euro area economic recovery and the further quasi-neutral stance of the fiscal policy.

The configuration and determinants of the new inflation outlook provide the central bank with additional room to prudently adjust the monetary policy stance, while maintaining its time consistency and synchronising it with the monetary policy cycles of central banks in the region and the euro area. The use of this additional room – aimed at meeting the medium-term inflation target, in a manner supportive of economic growth, also by restoring confidence and reinvigorating lending – is further conditional upon the characteristics/performance of fiscal policy, structural reforms and EU fund raising, with the steady pursuit and fulfilment of the specific objectives agreed with the EU, the IMF and the World Bank being of the essence for preserving the consistency of the macroeconomic policy mix. Other relevant factors for substantiating the monetary policy decision are further the size and source of uncertainties surrounding the inflation outlook, as well as the nature and probability of risks to the inflation outlook to materialise. From that perspective, the updated inflation forecast is seen to be surrounded by particularly high uncertainty, as well as by multiple and higher both-way risks carrying, however, a relatively low potential to have a lasting impact on medium-term inflation expectations and implicitly on the inflation evolution in the longer run, should they materialise.

The most relevant uncertainties and mixed risks to the future inflation evolution are further posed by the external environment, especially the conflict in Ukraine and its implications, the situation in Greece, as well as the growing divergence between the monetary policy stances pursued by the major central banks worldwide, which, through the potential effects on the global risk appetite and possibly on investors' risk perception of the Romanian economy and financial market, may induce larger upward/downward fluctuations in the exchange rate of the domestic currency and implicitly both-way deviations of the leu exchange rate and of inflation from the anticipated coordinates. However, the mentioned external factors are also expected to produce opposite effects on domestic inflation, either simultaneously or with a time lag, through the changes in the dynamics of the economic activity and the inflation pace in the euro area and the countries in the region – implicitly in the performance of Romania's exports and import prices – as well as in the behaviour of capital flows to the Romanian economy. These developments would affect[49] the dynamics of the narrowing of negative output gap and of the magnitude of its disinflationary pressures.

Nevertheless, in the present context, the major source of uncertainty and both-way risks to the medium-term inflation outlook is the future evolution of the international oil price, including owing to its capacity to generate significant divergent effects, especially on different time horizons. Thus, a potentially persistent decline/low level of the oil price – which seems more likely at the current juncture – would foster on a very short term the deflationary impact from the domestic fuel price, as well as speed up the decrease in the disinflationary pressures from the aggregate demand deficit on a longer time horizon, through the spur to the economic growth from the effects on producer costs and households' real disposable income, as well as on the external demand for Romanian products and services; the latter could be additionally fostered by the potential protraction/strengthening of the depreciation trend of the euro against the US dollar exerting an expansionary impact on the economic activity in the euro area, and implicitly on the economies of Romania's major trading partners.

The domestic environment continues in its turn to generate risks to inflation, in the context of persistent uncertainties relative to the speed of implementing the structural reform measures agreed upon with the EU, the IMF and the World Bank that may favourably or adversely influence foreign investors' perception of the risk associated with the Romanian economy and financial market, and implicitly the behaviour of the leu exchange rate. Other major domestic sources of relatively balanced risks to the inflation outlook are further the size and pace of administered price adjustments, as well as the future developments in food prices, with the temporary deviations from the forecasted coordinates they might post in the forthcoming period being, however, unlikely to affect longer-term inflation expectations.

Given the downward shift of the forecasted path of the annual inflation rate and its running below the mid-point of the target until the end of the forecast horizon, driven by the slowdown in the anticipated volatile price dynamics, the persistence of the negative output gap, the adjustment of inflation expectations to lower levels, as well as by the ongoing subdued inflation in the euro area, the NBR Board decided in its meeting of 4 February 2015 to lower the monetary policy rate by 0.25 percentage points to 2.25 percent per annum. Moreover, with a view to mitigating interbank money market rate volatility and consolidating the transmission of the policy rate

49 Through the foreign trade, financial and confidence channels, as well as through the wealth and balance sheet effect of the exchange rate.

signal, the NBR Board decided to narrow the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate to ±2.00 percentage points from ±2.25 percentage points. Thus, the interest rate on the NBR's lending facility (Lombard) was lowered to an annual 4.25 percent from 4.75 percent, while the deposit facility rate remained at 0.25 percent per annum. The NBR Board also decided to pursue adequate liquidity management in the banking system and to keep unchanged the current levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.