NATIONAL BANK OF ROMANIA

INFLATION REPORT
May 2015

Year XI, No. 40

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N O T E

The Inflation Report was approved by the NBR Board in its meeting of 6 May 2015 and the cut-off date for the data underlying the macroeconomic projection was 30 April 2015.

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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Abbreviations

CPI	consumer price index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
ESI	Economic Sentiment Indicator
EU	European Union
Eurostat	Statistical Office of the European Union
FOMC	Federal Open Market Committee
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
MARD	Ministry of Agriculture and Rural Development
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
ROBOR	Romanian Interbank Offer Rate
UVI	unit value index
VAT	value added tax
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 2015 Q1, the annual CPI inflation rate remained under the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target, reaching an all-time low of 0.4 percent in the first two months of the year. The March reading, i.e. 0.8 percent, is similar to that seen at end-2014. The average annual HICP inflation rate[1] came in at 1.2 percent in March 2015, slightly down from the end of the previous year.

The similarity between the annual growth rates recorded by consumer prices at end-2014 Q4 and at end-2015 Q1 respectively was the result of mutually-offsetting contributions in the period under review from the headline CPI components.

The annual adjusted CORE2 inflation rate[2] went down by 0.2 percentage points from December 2014, to reach 0.8 percent in March. The drivers behind this evolution were the persistence of the negative output gap, the further downward adjustment of inflation expectations, and the deceleration of the annual dynamics of import prices. This deceleration was due especially to the impact of lower international prices of energy and agricultural produce on the prices of imported processed goods, as well as to the appreciation in annual terms of the leu versus the euro in Q1.

Among the CPI components primarily affected by supply-side factors, the faster dynamics of administered prices and the significantly slower fall in annual terms of volatile food prices (VFE) put upward pressure on the CPI inflation rate in Q1. The acceleration in the growth rate of administered prices was driven by the hike posted in January by the electricity price for households, while the evolution of VFE prices has reflected the fading of the impact that complementary imports of vegetables and fruits from European countries hit by Russia's recent ban had on the supply in the domestic market. Conversely, tobacco product prices made a disinflationary contribution in Q1, on account of the base effect arising from the hike in excise duties at the beginning of 2014.

The annual increase in consumer prices at end-Q1 was underestimated by 0.7 percentage points in the February 2015 forecast. This is mainly accounted for by the steeper depreciation of the leu against the US dollar and by the faster resumption in the upward dynamics of the crude oil price compared to the assumptions in the previous baseline scenario.

The year-on-year rise in unit wage costs in industry gained momentum in 2014 Q4 and the first two months of 2015, especially as a result of the worsening labour productivity dynamics, as well as of faster wage increases, mainly owing to the effect entailed by the new hike in the minimum gross wage economy-wide as of January 2015. 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.

[1] Calculated as the average price change in the last 12 months compared to 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.

Monetary policy since the release of the previous Inflation Report

In its meeting of 4 February 2015, the NBR Board decided to cut the monetary policy rate to 2.25 percent per annum, from 2.50 percent, in light of the reconfiguration of the macroeconomic prospects. This outlook confirmed the inflation rate remaining below the lower bound of the flat target in the short run. Furthermore, the updated NBR forecast placed the annual inflation rate at values lower than those previously projected, mainly due to the (then) anticipated steeper decrease in volatile prices in the short term, under the impact of the decline in the international oil price, as well as to the persistence of the negative output gap and of low inflation in the euro area and other European countries, to which added the consolidation of inflation expectations within a lower range. The risks to the forecast were generated by heightened uncertainty surrounding the external developments, mainly owing to the regional geopolitical tensions, the situation in Greece and in the euro area, and to the diverging monetary policy stances of major central banks worldwide. 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 ±2.00 percentage points from ±2.25 percentage points.

Following the Board decision in February, signals emerged pointing to a halt in the considerable decline that the annual inflation rate had seen in the previous period. This trend was brought about by a relatively slower decline in annual terms in fuel prices and volatile food prices. Although the annual inflation rate was expected to enter a slightly upward trend in the period ahead, the persistence of the negative output gap and the effects of euro area deflation on import prices further backed the outlook for the inflation rate to remain below the lower bound of the variation band of the flat target over the short term. Moreover, the risk sources associated with the inflation outlook, as identified in the February analysis, continued to be relevant.

In this context, the NBR Board decided in its meeting of 31 March 2015 to cut the monetary policy rate to 2.00 percent per annum, from 2.25 percent. In addition, with a view to reducing further 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 ±1.75 percentage points from ±2.00 percentage points.

Inflation outlook

The current inflation projection envisages a substantial downward revision of the previous forecast, due largely to incorporating the recent information on broadening the scope of the lower VAT rate to all food items, non-alcoholic beverages and public food services as of June 2015. Thus, the annual CPI inflation rate is expected to run in negative territory until the end of 2016 Q1 (except the end of 2015) and to stand at the lower bound of the ±1 percentage point variation band of the 2.5 percent target at the end of the following two quarters, before returning inside the interval in 2016 Q4.

The inflation rate is foreseen to remain below the midpoint of the target throughout the projection interval, amid the anticipated consolidation, in the same period, of the economic upturn driven by stronger domestic demand. It is expected that the latter will be fuelled by sustained consumption growth and reviving investment. Both domestic demand components will benefit from the further easing of lending conditions, also via the gradual pass-through of the successive policy rate cuts to bank rates. Furthermore, stronger actual individual consumption of households is to be additionally fostered by the expected rise in real disposable income, also as a result of the lower VAT rate becoming applicable to all food items, non-alcoholic beverages and public food services. Gross fixed capital formation is expected to make a positive contribution to economic growth as well, after two years of negative ones, also on the back of the anticipated improvement in productive capital inflows from European structural and cohesion funds and foreign direct investment.

Net exports are seen having a slightly negative contribution to GDP growth over the projection interval, as the domestic demand-induced rise in imports of goods and services is foreseen to outpace that of exports, amid the comparatively slower recovery of external demand. These developments are compatible with the current account deficit-to-GDP ratio staying at relatively low and sustainable levels in the medium run. Against this background, and with international reserves remaining at adequate levels, the baseline scenario of the projection does not envisage any significant corrective pressure on the leu exchange rate.

Compared to the February 2015 round, the projected output gap has been revised markedly for nearly the entire forecast interval. The current projection envisages the negative output gap to narrow gradually, yet at a faster pace, before closing completely towards the forecast horizon. The GDP deviation was revised due to: projecting more stimulative real broad monetary conditions, a slightly favourable revision of the effective external demand gap (backed by the ECB's accommodative monetary policy stance supportive of economic activity across the euro area), and an anticipated stimulative impulse of the discretionary component of fiscal policy.

The baseline scenario of the current projection places the annual CPI inflation rate at 0.2 percent and 1.9 percent at end-2015 and end-2016 respectively, 1.9 percentage points and 0.5 percentage points lower than in the February 2015 Inflation Report.

Both the annual CPI inflation rate and the adjusted CORE2 inflation rate are seen to stand below the previously-projected levels throughout the reference interval, with considerable differences in the first half of the period. Behind the revision stood primarily the incorporation into the new projection of the government's decision of 7 April 2015 to lower the VAT rate on all food items, non-alcoholic beverages and public food services from 24 percent to 9 percent as of June 2015. The measure will have an impact on the prices included in the adjusted CORE2 index, especially via the processed food group, and on prices of VFE. The effects on inflation are temporary: first-round effects on the annual rate will fade out one year later, entailing a contrariwise base effect, while second-round effects are seen to be relatively moderate and to fade gradually towards the projection horizon. Given the large share of processed food items in the adjusted CORE2 index basket (50 percent) and the latter's weight in the CPI basket (approximately 60 percent), the substantial revision of the projected core inflation path dominates the shaping of the headline inflation trajectory.

Under the impact of broadening the scope of the lower VAT rate, the annual adjusted CORE2 inflation rate is projected at negative levels in the first half of the projection interval (-1.7 percent in December 2015). Once the first-round effect of the fiscal measure fades out at the end of 2016 Q2, core inflation is expected to resume positive values and embark on a slightly upward path to reach 1.3 percent at the projection horizon, following the economic agents' inflation expectations reverting to an uptrend and the gradual fading away of the disinflationary pressures of the negative output gap. Compared to the February 2015 Inflation Report, the projected path of the annual adjusted CORE2 inflation rate was revised downwards by 3 percentage points and 0.5 percentage points at the end of 2015 and 2016 respectively. Behind the downward revisions stood mainly the assessment of the recent information on broadening the scope of the lower VAT rate, also reflected by economic agents' significantly dampened inflation expectations, and the projection of less sharp inflationary pressures from import prices. In the opposite direction acted only the projection of a faster reduction in the negative output gap over the reference interval.

All exogenous CPI components in terms of the monetary policy scope will have smaller-than-previously-projected contributions to the headline index starting 2016. In 2015 Q2 and Q3, given the forecast envisaging a less steep year-on-year decrease in fuel prices and faster-rising tobacco product prices, the contribution of exogenous components was revised upwards, while remaining relatively unchanged in Q4.

Given the impact exerted on the adjusted CORE2 index components as well as on VFE prices by broadening the scope of the lower VAT rate, the annual CPI inflation rate is foreseen to move into negative territory from 2015 Q2 until 2016 Q1, except the end of this year, when the projected dynamics of volatile and administered prices induce an inflationary base effect. Once the first-round effect of the fiscal measure fades out in 2016 Q2, the annual inflation rate is projected to increase to 1.5 percent and then re-enter the variation band of the target starting 2016 Q4. Average annual CPI inflation rate is projected to run at levels below the variation band throughout the forecast interval.

The projected monetary policy stance is shaped so as to ensure price stability over the medium term, in line with the flat target of 2.5 percent ±1 percentage point, thus helping pave the way for a recovery of lending and sustainable economic growth.

The balance of risks to the future inflation path is assessed to be relatively in equilibrium over the short term, while, on the medium term, it appears to be tilted to the downside due to uncertainties specific to this horizon. The risks specific to the current round are mostly ascribable to the domestic environment, with external factors maintaining the relevance pointed out in the previous forecast rounds.

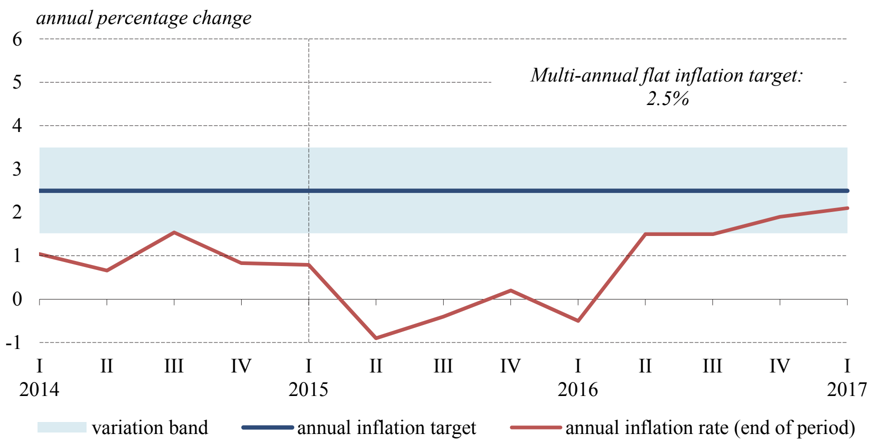
Over the reference interval, the external environment is still an important source of uncertainty, as geopolitical instability lingers. The conflict in Ukraine and the situation in Greece are the cases in point. Moreover, uncertainties arise from the possibly diverging monetary policy stances of the world's major central banks, amid the ECB implementing its expanded asset purchase programme. Should any of these risks materialise, the Romanian economy could be hit by negative indirect effects considering the impact of such developments on the external demand from Romania's main trading partners in the EU. In addition, adverse consequences on investor confidence across financial markets in the region might bring about heightened volatility of capital flows channelled to these economies, Romania included. Such a context could result in fluctuations in the leu exchange rate that could alter the inflation dynamics from those in the baseline scenario. Nevertheless, given the progress that Romania has made over the recent years in terms of strengthening sustainable macroeconomic fundamentals, investors' relatively lower exposure to the country than to other emerging economies implies a lower risk of an unfavourable impact following global or regional portfolio shifts.

On the domestic front, in view of the need to further increase the economy's capacity to mitigate adverse external shocks and to bring non-debt-creating capital flows into the country, the uncertainty surrounding the consistent implementation of an adequate macroeconomic policy mix and the speeding up of structural reforms in accordance with the calendar agreed upon with international institutions (the EU, the IMF and the World Bank) remain a matter of concern. A major source of risks associated with diverting from the current forecast coordinates refers to the implementation of the fiscal measures in the legislative proposal amending the Tax Code submitted to Parliament for debate and approval. On the date of completing the projection, given the uncertainties regarding the final set of fiscal measures and the calendar for their implementation, an assessment of the impact of these measures could not be included in the baseline scenario. An alternative scenario based on the assumption of the new Tax Code being passed as such by the Parliament shows a significant deviation of inflation rate from the path described in this Inflation Report, entailing a delayed return of inflation rate inside the variation band of the target.

Turning to domestic food prices, a risk specific to the current projection round refers to the possible deviation from the ex-ante assessment, included in the baseline scenario, of the magnitude that the impact of broadening the scope of the lower VAT rate is expected to have as of June 2015. The uncertainties relating to the bearing that weather conditions might have on the supply of agri-foodstuffs are further significant as well.

With regard to administered prices, the related uncertainties are associated, over the medium term, with the scale and timing of natural gas and electricity market deregulation stages in the context of possible changes to the information provided by relevant authorities in Romania. The balance of risks posed by international commodity prices appears to be relatively in equilibrium. At the same time, the risk remains that the EUR/USD exchange rate developments may have unpredicted effects on the USD/RON exchange rate and, hence, on the oil price expressed in domestic currency.

Inflation Forecast



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

Source: NIS, NBR projection

Monetary policy decision

Considering the prospects for the annual inflation rate slipping temporarily into negative territory and staying, once the impact of broadening the scope of the lower VAT rate has faded out, below the midpoint of the flat target, amid the gradual narrowing of the negative output gap, and further low inflation expectations and subdued euro area inflation, the Board of the National

Bank of Romania has decided in its meeting of 6 May 2015 to lower the monetary policy rate by 25 basis points to 1.75 percent per annum. At the same time, in order to mitigate interbank money market rate volatility and consolidate the transmission of the policy rate signal, the NBR Board has decided to narrow the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate to ±1.50 percentage points from ±1.75 percentage points; hence, the interest rate on the NBR's lending facility has been lowered to an annual 3.25 percent, from 3.75 percent, while the deposit facility rate has been left at 0.25 percent per annum. Moreover, with a view to fostering the revival of lending and continuing the harmonisation of the reserve requirements mechanism with the European Central Bank standards, the NBR Board has decided to cut the minimum reserve requirements ratio on leu-denominated liabilities of credit institutions to 8 percent, from 10 percent, starting with the 24 May-23 June 2015 maintenance period. The NBR Board has also decided to keep unchanged the minimum reserve requirements ratio on foreign exchange-denominated liabilities and to pursue adequate liquidity management in the banking system.

I. INFLATION DEVELOPMENTS

In 2015 Q1, the annual CPI inflation rate further stood below 1.0 percent, remaining under the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target. Aside from the persistent negative output gap and subdued inflation expectations, other determinants of the modest dynamics of consumer prices were notably the decline in costs of energy and raw materials, as well as the lower imported inflation, also due to the domestic currency appreciation versus the euro. Under the impact of the same factors, the annual adjusted CORE2 inflation rate fell to 0.8 percent in the period under review. Inflationary pressures were visible in exogenous components, special mention deserving the hike in prices for electricity and certain southern fruit.

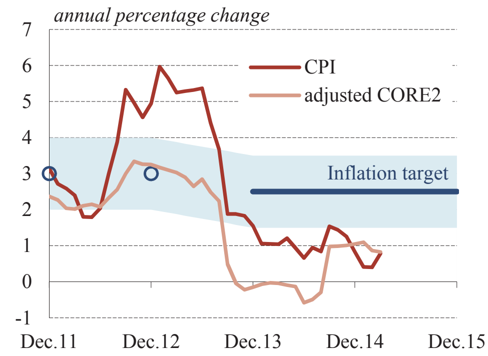
At end-2015 Q1, the annual inflation rate came in at a similar level to that seen in December 2014 (0.8 percent), yet it witnessed uneven developments throughout the quarter, reaching an all-time low of 0.4 percent in the first two months of the year. In January, its trajectory was shaped by the steeper decline in oil prices[1], and therefore in the domestic fuel price (-5.3 percent in annual terms), whereas in February, the CPI rate remained unchanged due to the appreciation of the leu against the euro, which offset the impact stemming from the transitory reversal of the oil price downward trend and from the constant rise in the RON/USD exchange rate (+13.1 percent in March 2015 against December 2014).

The food component of volatile prices recorded a 2.3 percentage point slower annual rate of decrease to 1.0 percent in March. February 2015 saw a trend reversal in the declining prices of fruit and vegetables after having reached lows during 2014 under the joint influence of a domestic agricultural output above the long-term average and the significantly larger imports from the European countries hit by the Russian import ban. Behind this development stood the fading of the impact that complementary imports generated by Russia's trade embargo had on the supply in the domestic market, and also the decrease in the global supply of some southern fruit, concurrently with the strengthening of the US dollar.

Administered prices were a source of inflationary pressures in 2015 Q1, their resumed upward path (+0.9 percentage points to 1.3 percent) being prompted by a wide adjustment in the electricity price for household end-users in January (by approximately 5 percent). This was the result of changes in most electricity bill components, given that January saw an increase both in the share

[1] Brent oil price fell from USD 64/barrel at end-2014 to USD 50/barrel in January 2015, a prevalent level at the outbreak of the financial crisis.

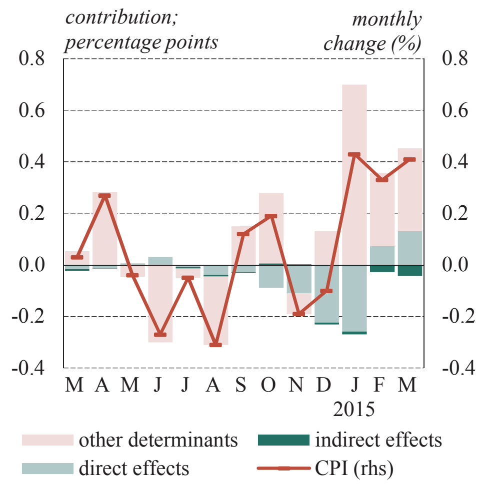
Inflation Developments



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

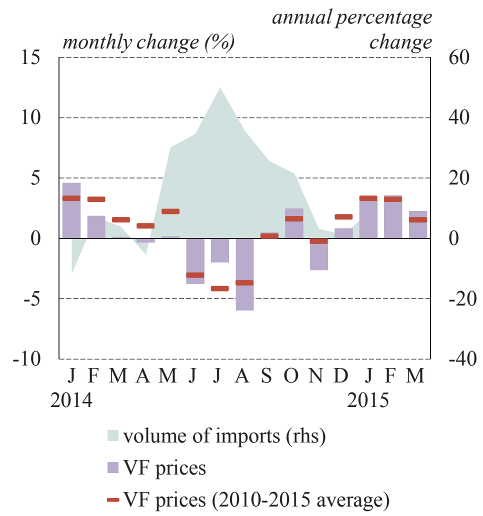
Source: NIS, NBR calculations

Impact of Oil Prices on the Inflation Rate



Source: Bloomberg, Eurostat, NIS, NBR estimates

Vegetable and Fruit (VF) Imports and Consumer Prices

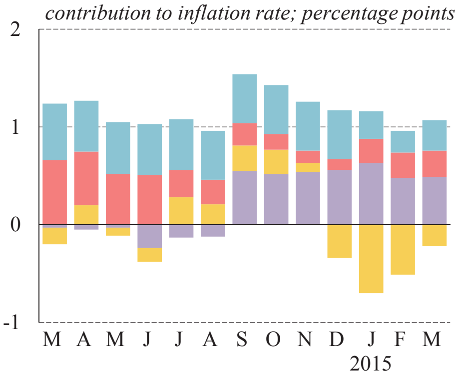


Source: NIS, Eurostat

of the free market component following the implementation of a new stage in the market deregulation calendar, and in the regulated tariff, along with a twofold rise in the cogeneration contribution and a higher mandatory annual quota for acquiring green certificates.

Given the statistical effect associated with the substantially higher leu-expressed excise duties as of early 2014 and with their remaining unchanged in 2015, the annual dynamics of tobacco and alcohol product prices slowed down by 2 percentage points in 2015 Q1, reaching 4 percent in March. This slowdown was moderated by the behaviour of market operators, who incorporated the cigarette excise duty increase into prices ahead of 1 April, when it became effective.

Annual Inflation Rate



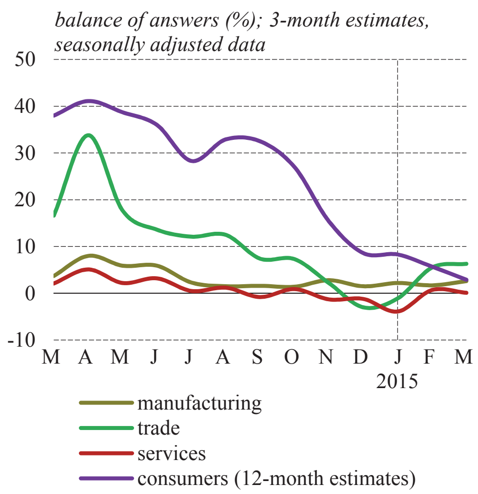
*) products with volatile prices: vegetables, fruit, eggs, fuels

Source: NIS, NBR calculations

In 2015 Q1, the adjusted CORE2 inflation further posted low readings, with the annual dynamics of prices in this category standing at 0.8 percent in March (down from 1 percent September 2014 through January 2015). As regards the drivers of this evolution, the alleviation of disinflationary pressure exerted by the negative output gap amid consolidated signs of economic recovery was counterbalanced by the further downward adjustment of inflation expectations, as well as by the direct and indirect effects of the fall in commodity prices (mainly of energy and agricultural produce), also via imported processed goods.

In particular, the deflationary context in the main trading partner bloc and the strengthening of the leu versus the euro favoured disinflation mainly in the case of non-food items in the first part of 2015 (-0.2 percentage points to 1.6 percent). However, the most significant fall in the annual price dynamics (-0.8 percentage points to 1.2 percent) was seen in market services, whose price sensitivity to exchange rate movements exceeds that of goods, thus enabling a stronger pass-through of the favourable developments displayed by this variable in the period under review. Turning to processed food prices, their annual growth rate was similar to that seen in 2014 Q4 (0.2 percent). The persistence of these subdued levels can be explained by the low costs of raw materials and transport, as well as by the highly competitive environment in this sector.

Inflation Expectations of Economic Agents



Source: EC-DG ECFIN

In the first months of 2015, inflation expectations of consumers remained on the steeply downward path displayed since September 2014, the NIS/DG ECFIN indicator hitting a new historical low in March (2.9 percent, against an average of nearly 50 percent during May 2001[2] – August 2014). A similar trend was seen among financial analysts, who constantly revised their short-term inflation expectations (over 12 months) throughout 2015 Q1. In spite of not following the downward trajectory recorded in the two instances above, the inflation expectations of economic agents

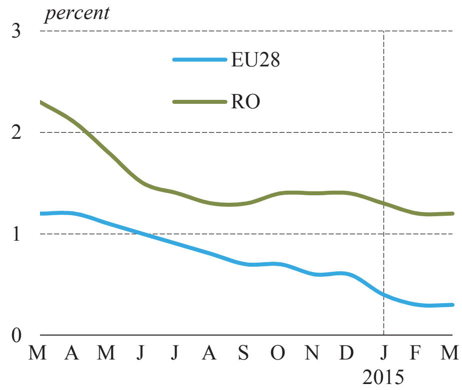
[2] Starting date of the survey.

(in industry, construction, trade and services) revealed benign developments January through March 2015, the balance of answers further hovering around nil.

In early 2015, crude oil price continued to decline, causing another broad-based drop in the average 12-month HICP inflation rate across European countries, coming in at 0.3 percent at EU level in March, down 0.3 percentage points from end-2014. As for Romania, this indicator pointed to a similar tendency, albeit of a slightly lower magnitude (-0.2 percentage points), causing the differential versus the EU average to further widen (to 0.9 percentage points).

The annual inflation rate at end-Q1 stood 0.7 percentage points above the February 2015 Inflation Report forecast. This was mainly accounted for by the steeper-than-expected appreciation path followed by the US dollar and the faster resumption (in terms of both timing and pace) in the upward dynamics of the crude oil price.

Average Annual HICP Inflation Rate*



*) 12-month average rate of change

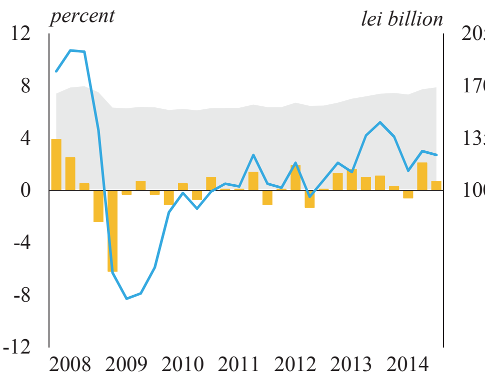
Source: Eurostat

II. ECONOMIC DEVELOPMENTS

1. Demand and supply

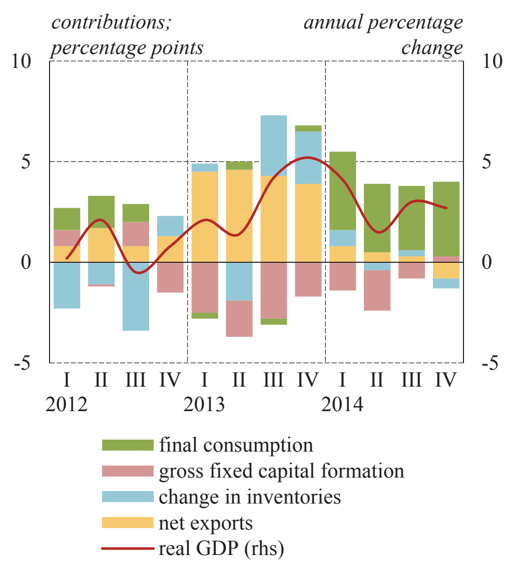
In 2014, Romania's economy expanded by 2.8 percent, thus making up almost entirely for the loss incurred after the outbreak of the global financial crisis. The favourable developments in 2014 Q4 contributed to this outcome, as the annual growth rate of real GDP stood at 2.7 percent. The advance was attributed solely to domestic absorption, being supported by all economic sectors. However, the annual dynamics of real GDP slowed down by 0.3 percentage points compared with the previous quarter, given that the contribution of net external demand turned negative.

Real Gross Domestic Product



Source: NIS, NBR calculations

Demand



Source: NIS, NBR calculations

1.1. Demand

In 2014 Q4, consumer demand posted the fastest annual pace of increase in 2014 (5 percent), both private and government consumption witnessing swifter dynamics. Household purchases of goods stepped up across most commodity groups, with on-line sales reporting the quickest pick-up (over 70 percent), largely boosted by Black Friday.

In 2014 Q4, the general government budget ended on a deficit worth lei 12,912 million, i.e. 1.9 percent of GDP[1], significantly higher than that posted in the same year-earlier period, which amounted to lei 7,651 million[2] and accounted for 1.2 percent of GDP, and approximately equal to the 2014 cumulative deficit[3]. The larger deficit was driven by the substantially faster growth rate of public expenditure (16 percent[4] versus -1.3 percent in 2014 Q3), owing solely to the rise in its primary component[5]. Behind this movement stood chiefly the marked increase in the public wage bill (21.8 percent against 3 percent) – amid the early payment of amounts provided for in the writs of execution issued to budgetary sector staff with regard to salary rights – and the return to positive territory of the dynamics of government spending on goods and services (11 percent as compared with -14.3 percent in the previous quarter), as well as of capital expenditure (21.3 percent

[1] The analysis relied on the operational data related to the December 2014 budget execution, as published by the MPF. The GDP readings released by the NIS were used for 2013 and 2014.

[2] The 2013 budget execution figures have been recalculated by the MPF to ensure comparability with those for 2014.

[3] By comparison, in 2013 Q4 the general government deficit accounted for about a half of the 2013 cumulative deficit.

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

[5] Against the backdrop of a 30.4 percent decline in interest repayments as compared with a 5.1 percent increase in 2014 Q3.

versus -5.9 percent), other transfers and expenditure for projects financed from non-redeemable external loans. In turn, budget revenues saw a slightly slower pace of increase (8.7 percent against 9.5 percent in the preceding three-month period), mainly on the back of the steeper fall in VAT receipts (owing most likely to the step-up in VAT repayments) and the slacker advance in non-tax revenues and receipts from the property tax[6] and social security contributions (also in the context of the cut in the social security contribution rate for employers). In the opposite direction worked the protracted, markedly positive dynamics of EU fund inflows and the swifter rise in revenues from excise duties and the personal income tax.

In 2014 Q4, the downward path of investment came to a halt, the 1.4 percent rise (the first positive rate in the past two years) being primarily driven by the rebound in new construction works. The buildings segment was the major contributor, amid the moderate growth in own funds of companies and households[7] and the further easing of lending conditions, particularly in the case of leu-denominated loans. Infrastructure works followed the opposite trend and continued to decline in late 2014 as well, albeit at a slower tempo than in 2014 Q1-Q3.

The favourable impact of domestic absorption on real GDP dynamics (3.5 percentage points, the most pronounced in 2014) was eroded by external demand, as the negative differential between the annual growth rates of exports of goods and services and imports thereof generated a net contribution of -0.8 percentage points. This outcome was ascribable solely to the worsening of the balance of trade in goods, especially in the case of the following commodity groups:

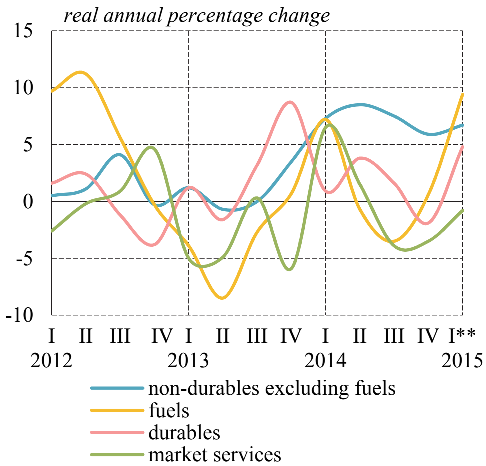
(i) commodities used in metallurgy, against the background of further favourable international commodity prices and probably of domestic companies' interest in boosting their stocks of raw materials, amid the escalation of the Russian-Ukrainian conflict in late 2014. Consequently, the halving of exports of metalliferous ores and imports of such commodities adding to domestic supply led to a 4.2-time wider trade deficit for this category of goods;

(ii) natural gas, with the approximately four-time larger imports than in the same year-ago period (a rate of increase

[6] Their slacker dynamics incorporated a base effect associated with the developments in receipts from the tax on special constructions in the previous quarter.

[7] As suggested by the uptrend in gross operating surplus and household income, respectively, approximated by the sum of net wage-related income, social transfers (state social security, unemployment benefit and health insurance) and workers' remittances from abroad.

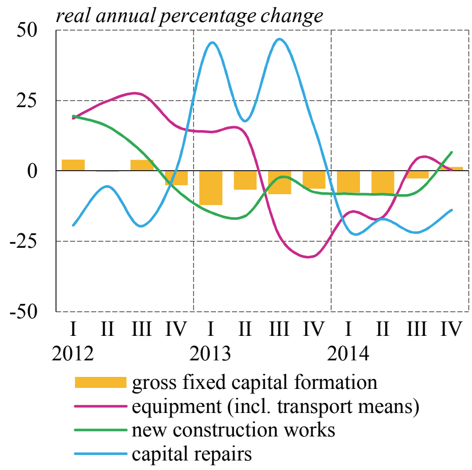
Purchases of Goods and Services*



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

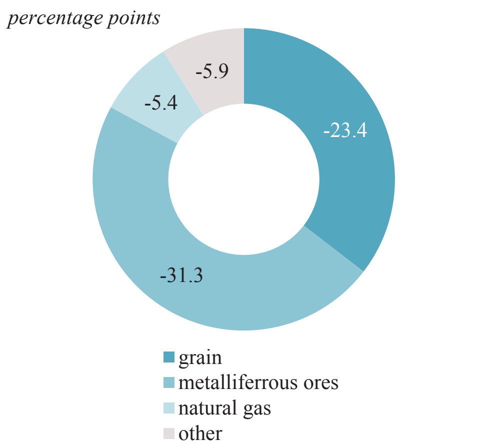
Source: NIS, NBR calculations

Investment



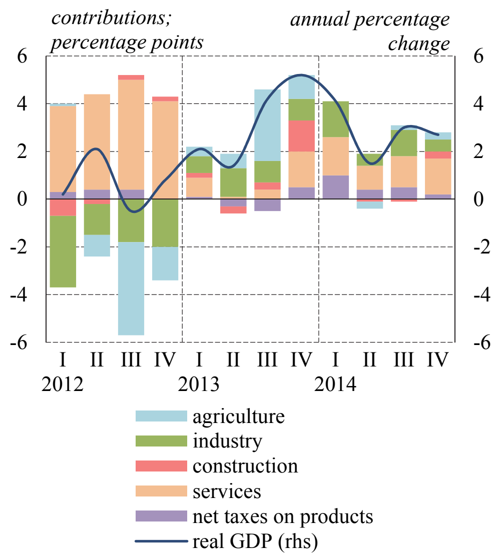
Source: NIS, NBR calculations

Main Contributors to the Volume Decline in Trade Surplus in 2014 Q4



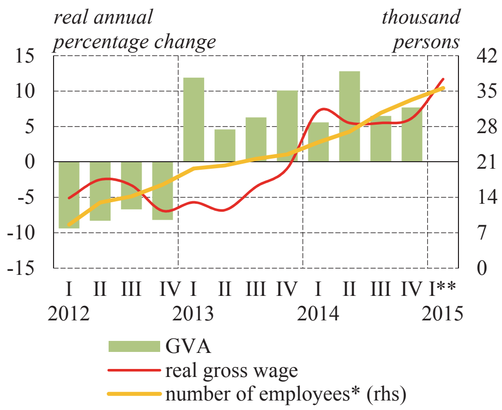
Source: Eurostat, NBR calculations

Supply



Source: NIS, NBR calculations

IT&C Sub-sector



*) seasonally and working-day adjusted series

**) Jan.-Feb.

Source: NIS, NBR calculations

markedly faster than in 2014 Q3) also being most likely linked to the downtrend in international prices (in line with crude oil prices) and the build-up of precautionary stocks;

(iii) grain, whose exports and imports followed opposite paths in 2014 Q4 (down 6 percent in the former case and up 54 percent respectively in the latter). However, given the seasonal nature of grain output, the analysis should cover at least 2014 Q3-Q4. Seen from this perspective, in 2014 the related trade balance posted again a surplus, which was even 3 percent wider than in 2013 H2.

1.2. Supply

The slower annual dynamics of real GDP as compared with Q3 was ascribable chiefly to industry. The main contributors to the reduction to less than half of the GVA growth in this sector (to 2 percent) were the crude oil processing industry, chemicals, and rubber and plastic products, which reported weaker sales on both domestic and foreign markets. Favourable developments were recorded particularly by firms manufacturing electrical equipment, electronic and IT equipment and motor vehicles, as well as by metals companies, the latter of which further capitalised on favourable international prices, which went down in the case of some inputs (iron ores) and up in that of certain manufactured goods (steel).

Services made the largest contribution to economic growth in 2014 Q4 as well, as GVA in this sector rose by 3 percent, the slightly faster dynamics than in Q3 owing largely to trade and the IT&C services. In the latter case, it is worth noting that 2014 was an exceptional year (up 8.2 percent) that witnessed both enhanced consumer preference for more sophisticated services and especially the rise in exports of services following the expansion of multinational corporations in Romania, boosted by increased competitiveness on this segment of the labour market.

Agriculture and construction too posted better performance than in the previous quarter. Thus, the annual dynamics of GVA in agriculture accelerated (to 5.2 percent), with the 2014 output exceeding the long-term average for the second year in a row. With regard to construction, it was only Q4 that witnessed GVA growth in 2014 (2.7 percent), the sector recording a minor advance in the year as a whole, given that the recovery of the building segment was virtually offset by the fall in public financing of infrastructure projects.

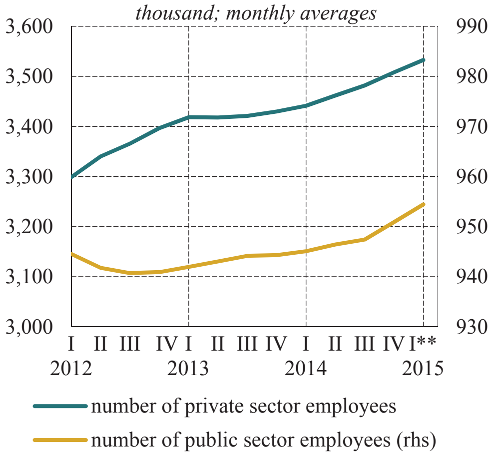
2. Labour market

The improvement in labour market conditions[8] continued into early 2015, the public sector also contributing to the positive labour absorption rate, just as it had done in 2014 Q4. Companies' employment expectations for 2015 H1 have remained generally favourable. The annual dynamics of average gross wage earnings were further on an upward path, chiefly under the impact of a new increase in the minimum gross wage economy-wide in January 2015. As regards industry, however, this rise added to the adverse impact that the slower annual growth rate of labour productivity had on the pace of increase of unit wage costs.

The number of payrolls reported by employers remained on an uptrend January through February 2015, its annual rate of change economy-wide accelerating to 2.4 percent, up 0.5 percentage points from 2014 Q4. Behind this movement stood largely the private sector, amid the moderate advance in hiring in market services and particularly administrative and support service activities. Construction also witnessed a rebound in labour demand, given the signs of recovery in this sector (the decline in the volume of construction works came to a halt in the last quarter of 2014 and their annual growth rate picked up in the first two months of 2015, nearing 15 percent). Similarly to the picture seen in October-December, the number of public sector employees reported a slight rise, on account of hiring in the health care system and public administration. Employment prospects for 2015 H1 remain favourable, pointing to job opportunities in industry, trade and construction, whereas managers in services further show cautious hiring intentions. The reduction in excess labour supply was reflected in both the ILO unemployment rate, which fell to 6.5 percent in January-March 2015 (down 0.1 percentage points from 2014 Q4), and the registered unemployment rate, which was lower than the 2014 average.

The annual dynamics of average gross wage economy-wide stepped up by another 0.9 percentage points January through February 2015, i.e. to 6.8 percent, following largely the direct effect of a new minimum gross wage increase economy-wide to lei 975 (up lei 75) as of January 2015. Nonetheless, the indirect effect of these measures should not be overlooked either, as they also lead to larger wages for above-minimum wage earners, thus putting additional pressure on companies' unit labour costs (see the box entitled "The increase in the minimum gross wage – effects on the labour market"). At a sectoral level, the rise in the annual rate of change of gross wages in the budgetary sector (up 2.5 percentage points) was stronger than in the private sector, given

Number of Employees Economy-wide*

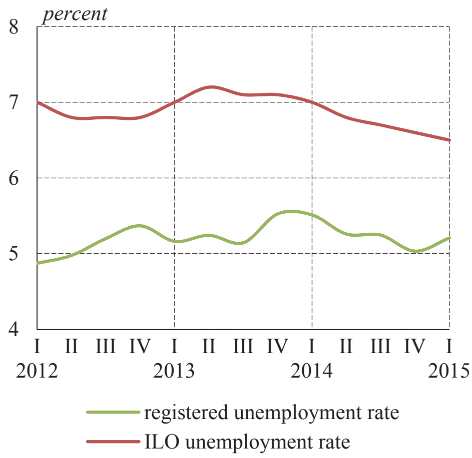


*) seasonally-adjusted data

**) Jan.-Feb.

Source: NEA, NIS, NBR calculations

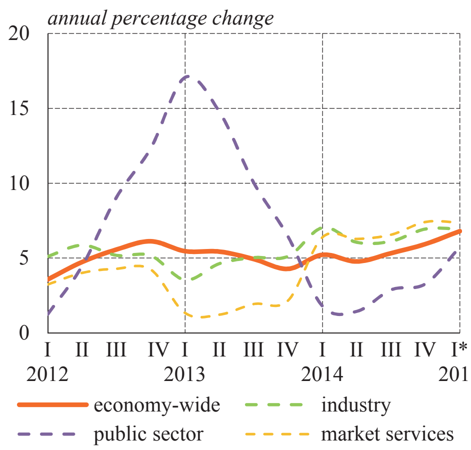
Unemployment Rate*



*) seasonally-adjusted data

Source: NIS, NBR calculations

Gross Wage



*) Jan.-Feb.

Source: NIS, NBR calculations

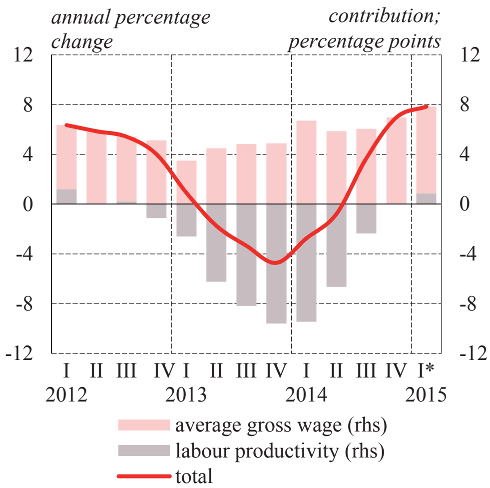
[8] The analysis is based on seasonally-adjusted data.

that all health care system wages exceeding the minimum gross wage economy-wide added lei 100 each in January 2015. The slower advance in the growth rate of private sector gross wages (up 0.5 percentage points) was the result of mixed developments: the increases in manufacturing and construction were partly offset by the deceleration in mining and the energy industry (in the latter sectors the average wages are about two times larger than that in manufacturing, being thus less affected by the change in the minimum gross wage).

In 2014 Q4, the annual pace of increase of unit wage costs[9] in industry further accelerated, to 7.0 percent, with similar rates of change being recorded in early 2015 too. The pick-up was attributable mostly to the slowdown in the annual dynamics of labour productivity, with the swifter-paced rises in wage earnings making also a contribution hereto. The sectoral breakdown shows that unit wage costs in fabricated metal products, manufacture of machinery and equipment, of electrical equipment and of textiles witnessed the highest positive dynamics. Nevertheless, crude oil processing and metallurgy also seem to come under pressure, as they have seen a gradual narrowing of the positive differential between growth of labour productivity and that of wages.

Looking at consumer demand, household real income further increased in annual terms in 2014 H2 and the first two months of 2015, on the back of both the advance in social security income and the low inflation rate.

Unit Wage Costs in Industry



*) Jan.-Feb.
Source: NIS, NBR calculations

[9] Calculated as a ratio of gross wage to labour productivity.

The increase in the minimum gross wage – effects on the labour market

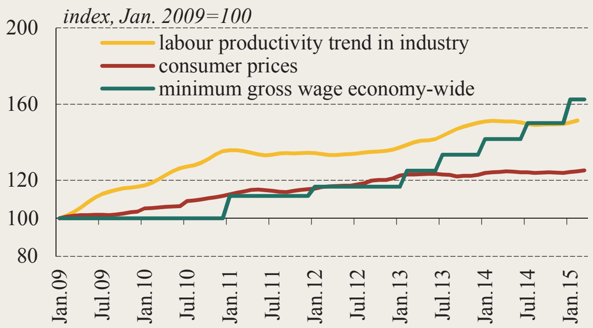
1. Economic context

January 2009 through December 2013, the minimum gross wage economy-wide was raised by a cumulative 33 percent, closely tracking the path of consumer prices while also benefiting from the steady improvement in the labour productivity trend in industry (+50 percent). Nevertheless, starting 2014, the developments in the minimum wage departed from price dynamics, i.e. the minimum wage posted a 22 percent growth, much faster than the 2 percent increase in prices, amid insufficient productivity support.

Looking at the EU Member States, in the past six years Romania has witnessed the strongest hike in the minimum wage, which, however, is still the second lowest across the EU. The ranking is similar in terms of labour productivity, with only one country recording a lower level.

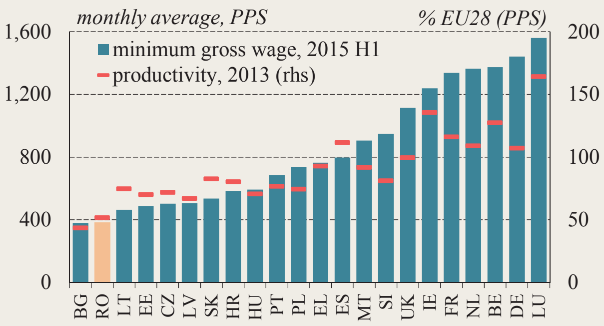
Minimum Gross Wage

Romania



Source:NIS, Eurostat

European Union



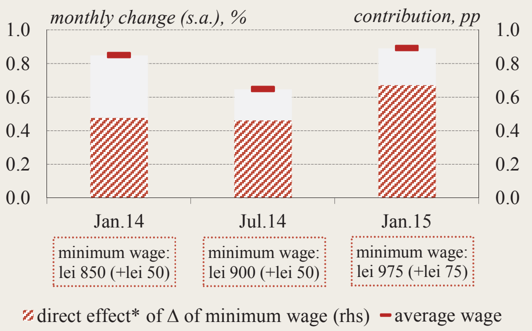
Source: Eurostat

2. Effects of the increase in the minimum gross wage

Wage earnings

The NBR conducted in 2014 a survey on firms' behaviour on the labour market, where the sample is representative of around two thirds of private sector employees[1], i.e. of companies with at least 20 employees which were set up before 2010. On the extreme assumption that wages of the other third exceed the minimum level, survey evidence shows that a raise in the minimum gross wage directly affects at least 22 percent of private sector employees. In particular, the last three increases directly contributed to the month-on-month growth of the average gross wage in the private sector by around 0.5 percentage points. If indirect effects are also taken into consideration, the overall impact is likely to have been larger – part of respondent firms stated that they also granted increases to above-minimum wage earners; in this case, an additional of at least 9 percent of employees are affected.

Impact of the Increase in the Minimum Gross Wage on Average Wage



*) Minimum impact, estimated based on a statistical survey conducted by the NBR. The survey covered approximately 64% of private sector employees, the remaining 36% being assumed to earn wages that exceed the minimum gross wage.

Source: NIS, NBR, NBR estimates

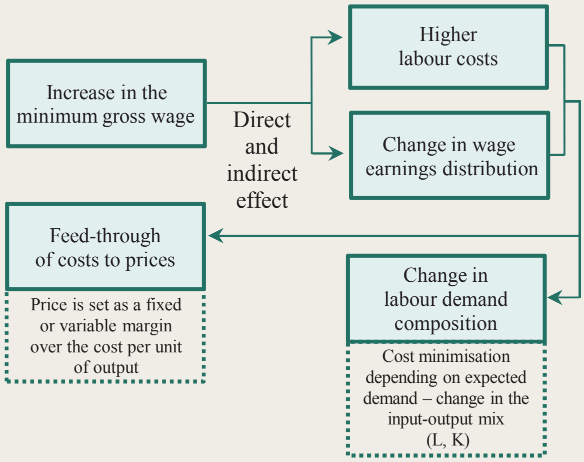
[1] The number of private sector employees is approximated as the difference between the number of employees economy-wide and that of employees in public administration, healthcare, education, and arts, entertainment and recreation.

Labour costs account for a third of total costs of firms, more than 70 percent of which faced an increase in such expenses during 2010-2013 (the period covered by the survey), with the last three hikes in the minimum wage fuelling the upward trend.

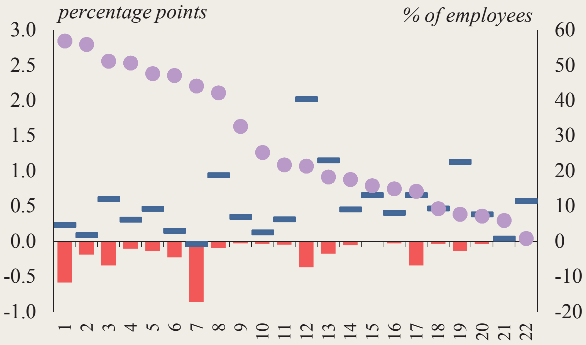
Moreover, the wage earnings distribution squeezed around the minimum threshold, and the higher ratio of minimum wage to average wage (which is assessed to stand close to 50 percent at end-2016 following the implementation of all the minimum wage increases previously announced) points to the risk of a barrier to entry on the labour market for low-skilled and unskilled workers (the young), in whose case the mismatches between labour demand and supply are already the largest.

At the microeconomic level, the raise in the minimum wage has had an uneven impact, more pronounced in the case of small and medium-sized enterprises. Profit margins have been under stronger pressure in light industry, food industry, manufacture of wood products, manufacture of non-metallic mineral products, transport and storage, accommodation and food services, and construction, as in these sub-sectors more than 40 percent of employees are paid the minimum wage. Nevertheless, the influence of the minimum wage increases in 2014 and 2015 (the one forthcoming in July 2015 included) is offset by the 5 percentage point reduction in the social security contribution rate for employers as of October 2014. Mention should be made, however, that, although the net effect of the two measures on the net profit margin is slightly positive for the population of firms of which the sample is representative, there are industries where this effect is virtually nil (food industry, trade) or even marginally negative (light industry). Additionally, the minimum wage increases scheduled for 2016 are expected to exhaust the buffer created by the October cut in the social security contribution rate in several sub-sectors.

Feed-through to the Economy of the Increase in the Minimum Gross Wage on the Supply-side



Effect of the Change in the Minimum Gross Wage and the Social Security Contribution Rate on Firms' Profitability in 2014-2015



Δ of net profit margin generated by the increase in the minimum wage*
cumulative effect (minimum wage and SSC)
minimum gross wage employees (rhs)

1. accommodation and food services
2. food industry
3. other manufacturing
4. other non-metallic mineral products
5. construction
6. wood
7. light industry
8. transportation and storage
9. beverages
10. trade
11. automotive industry
12. administrative services
13. professional activities
14. printing and recording
15. IT and telecommunications
16. chemical industry
17. real estate
18. electrical equipment and electronic products
19. publishing
20. metallurgy
21. crude oil processing
22. tobacco

*) The impact of the increases in the minimum wage and of the cut in the social security contribution rate for employers was calculated, ceteris paribus, based on an average net profit margin (net profit/turnover) in 2013.

Source: MPF, NBR, NBR estimates

Pass-through to prices and the impact on labour demand

Theoretically, an increase in wages that is not covered by productivity gains may generate inflationary pressures[2] economy-wide and at the same time may contain firms' ability to create new jobs. This theory is empirically

2 According to the survey on the price-setting mechanism carried out by the NBR in 2013, most companies in Romania set the prices of their goods or services as a fixed and/or variable margin over the cost per unit of output. Moreover, higher labour costs are the second most important factor when firms decide to increase their prices (see NBR Occasional Papers No. 10/2015).

confirmed by the results of the survey on the labour market: 58 percent of companies stated that they would pass through a raise in the minimum wage into prices and about 47 percent said that they would cut down on hiring.

With a view to identifying the relevant factors conducive to one or both responses, two probit models, which also quantify the individual contribution of factors to the increase/decrease in the probability of the two events at firm level, were estimated:

$$Prob(\uparrow P / \uparrow MW) = f(w_{MW}, w_{LC}, c, size, agr, \downarrow Q_{2010-13}, \downarrow P_{2010-13}, \uparrow Csup_{2010-13}, \uparrow Cfin_{2010-13})$$

$$Prob(\downarrow NewHires / \uparrow MW) = f(w_{MW}, w_{LC}, w_{TEN5}, size, tax, uncert, \downarrow empl_{2010-13}, \downarrow benef_{2010-13}, \uparrow Csup_{2010-13})$$

The influencing factors can be grouped as follows: (i) firm-specific factors – the share of employees directly and indirectly affected by the hike in the minimum wage (w_{MW}), the share of labour costs in total costs (w_{LC}), perceived competition (c), the share of workers with over 5 years of tenure (w_{TEN5}) and the size of the firm (*size*); (ii) labour market institutional features – the existence of a collective pay agreement (*agr*) and the perception on how high the payroll taxes are (tax), as well as (iii) factors associated with the economic context during 2010-2013 – the fall in demand ($\downarrow Q_{2010-13}$), price cuts ($\downarrow P_{2010-13}$), business environment uncertainty ($uncert$), the increase in costs of supply ($\uparrow Csup_{2010-13}$) and in financing costs ($\uparrow Cfin_{2010-13}$), the adjustment in the number of employees via dismissals or temporary layoffs ($\downarrow empl_{2010-13}$) and in non-pay benefits ($\downarrow benef_{2010-13}$) [3].

Firm-specific factors. As expected, both the probability of a price increase and that of a containment of hiring are directly correlated with the impact exerted on the firm by a minimum wage hike. Specifically, chances that a firm raises prices and/or lowers labour demand grow by around 23 percent when the share of minimum wage earners goes up and by 7 percent in the case of an increase in the share of labour costs. Moreover, if the share of workers with over 5 years of tenure grows larger, the probability of a halt in future hiring rises by 7 percent.

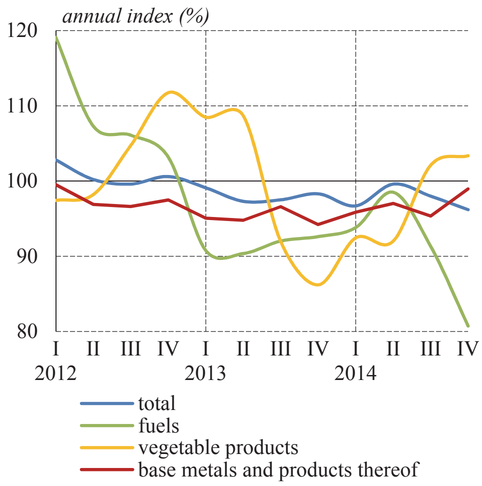
Looking at firms' size, the survey showed that large companies (with more than 200 employees) were less likely to cut down on hiring (-6 percentage points) and especially pass through the minimum wage increases into prices (-12 percentage points). When the company perceives strong competition, chances to increase prices drop by about 4 percentage points.

Labour market institutional features. The survey points to the high relevance of collective pay agreements in firms' decision to raise prices (+8 percentage points) and of the perception on high payroll taxes in containing future hiring (+10 percentage points).

Economic context during 2010-2013. The probability of a feed-through to prices is around 5 percentage points higher where the firm faced either a fall in demand or an increase in costs (be they costs of supply or financing costs) in the past; the probability of a lower ability to create jobs goes up if the business environment is marked by uncertainty (+9 percentage points) and the firm resorted to an adjustment in the number of employees via dismissals or temporary layoffs (more than 5 percentage points).

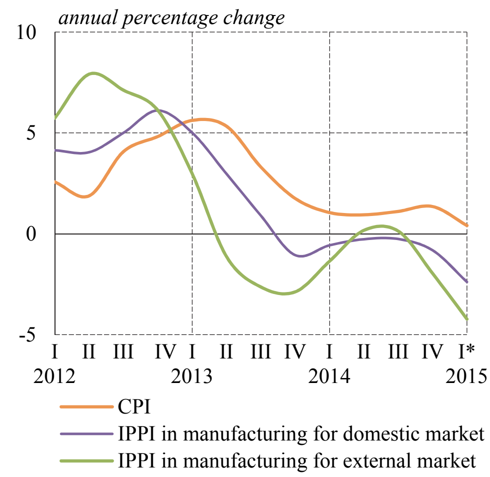
[3] The marginal effect of factors (calculated as an average effect per sample, ceteris paribus) should be interpreted depending on the type of the explanatory variable: a change in continuous variables (w_{MW}, w_{LC} and w_{TEN5}) determines an increase by x percent in the probability of a feed-through to prices/reduction in hiring, to which the transition of discrete variables (the remaining variables) from 0 (the factor does not occur) to 1 (when it occurs) adds y percentage points.

Unit Value Index of Imports in 2014 Q4



Source: NIS, NBR calculations

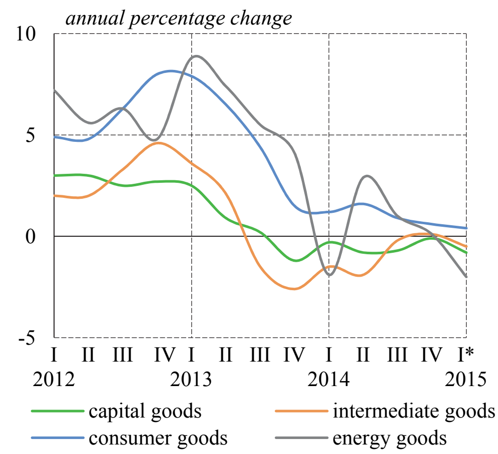
Consumer Prices and Industrial Producer Prices



*) Jan.-Feb.

Source: NIS

Industrial Producer Prices for Domestic Market by Industrial Products Group



*) Jan.-Feb.

Source: NIS

3. Import prices and producer prices

In 2014 Q4, the trend in domestic and external prices was under the influence of the steep drop in prices of oil and other commodities, in the context of higher supply and lower-than-expected global growth. Against this background, the annual unit value index (UVI) of imports fell at a faster pace, the annual growth rate of industrial producer prices came down to almost 0 percent and agricultural producer prices further declined year-on-year. The said trends are expected to persist in the coming period, amid the downward revision of global growth forecasts, the still optimistic expectations of the new season harvest and the pass-through effects of lower energy prices.

In 2014 Q4, import prices continued to follow a downward path, the annual unit value index of imports shrinking to 96.2 percent (down 1.8 percentage points from the previous quarter's average), as the impact of plummeting oil prices was still largely felt, despite the significant depreciation of the domestic currency versus the US dollar, i.e. by 8.6 percent in annual terms.

The marked decrease in crude oil prices in the latter half of 2014 – under the joint impact of the larger supply provided by some major producers (the USA, Libya and Iraq) and the weak global demand – generated similar trends in other commodity prices as well. Thus, the lower demand for drilling rigs on the back of plunging oil prices, together with the slowdown in economic activity in the world's largest consumer, i.e. China, and the low energy prices, contributed to the ongoing drop in prices of most metals at end-2014. Unlike the latter, external agricultural producer prices slightly recovered, further hovering however around five-year lows.

The annual unit value indices of imports of goods holding a relevant share in the CPI basket reflected the said developments as follows: the UVI of minerals decreased substantially (to 79.9 percent, down 10.8 percentage points from 2014 Q3), whereas the UVI of vegetable products and fats was slightly higher than the prior quarter's average. External prices also led to below par UVI values for base metals and industrial machinery and equipment, while vehicles and transport equipment continued to make a positive contribution to imported inflation, given that the annual dynamics of new imported car registrations were further swifter than those of used car registrations.

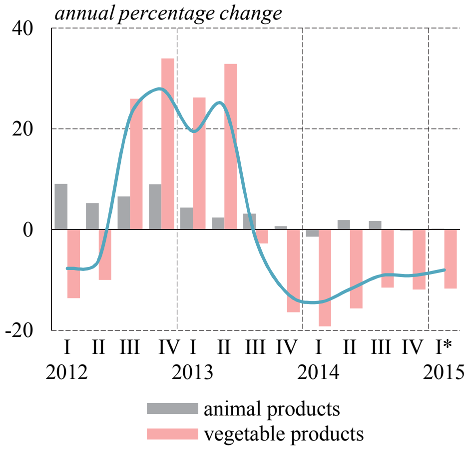
The path of industrial producer prices for the domestic market reflected, to some extent, the aforementioned movements, their annual growth rate coming down to almost 0 percent in 2014 Q4, i.e. 0.2 percent against 0.5 percent in Q3. Energy prices were the main contributor, with producer prices for consumer goods making however a marginal contribution too, on the back of low commodity prices.

The marked deceleration in the dynamics of energy prices (to 0.1 percent) was ascribable chiefly to the hydrocarbon processing sub-sector, where production prices shrank by 14.7 percent in 2014 Q4, whereas those for the production and supply of electricity and heating posted a two-time swifter annual pace of increase (to 2.5 percent), as a result of the fading-out of the statistical effect linked to the 2013 decreases. Consumer prices rose at a slower tempo than in 2014 Q3, i.e. merely 0.6 percent, on account of some low commodity prices (cotton and wool) and certain favourable base effects becoming manifest (in the manufacture of beverages, for instance). Producer prices of intermediate goods and capital goods briefly returned to levels close to those seen a year before (after four consecutive quarters of sticking to lower values year on year), largely on the back of early signs of recovering demand for construction works and road transport means.

Against the backdrop of plentiful supply due to two successive years of bumper crops both domestically and internationally, the prices of major agri-food commodities stayed on a steadily downward path October through December 2014 as well, posting an annual rate of change of -9.1 percent. The trend was manifest in both crop and livestock sub-sectors, with the former prevailing however in terms of weight and magnitude.

In the early months of 2015, global market prices continued to decline for most commodities, amid elevated stocks and the downward revision of projections on world economy's growth. Under the circumstances, the annual unit value index of imports and the industrial producer price index for the domestic market are expected to remain on a downtrend or even embark upon a steeper downward path, as commodity price changes feed through along the production chain also via imported manufactured goods. In fact, the annual growth rate of industrial producer prices for the domestic market fell into negative territory in the first two months of 2015, reaching -0.8 percent. Considering the full deregulation of the natural gas market for non-households as of 1 January 2015 and the sharper downturn in international natural gas prices, the related producer price dynamics are likely to incorporate these developments as well later on. The downtrend might be dampened by the doubling of the contribution to high efficiency cogeneration starting with 1 January 2015, the stronger US dollar against the leu and possibly an uptick in crude oil prices (most projections hint at such a trajectory, yet the heightened price volatility adds to the uncertainty surrounding the assessments).

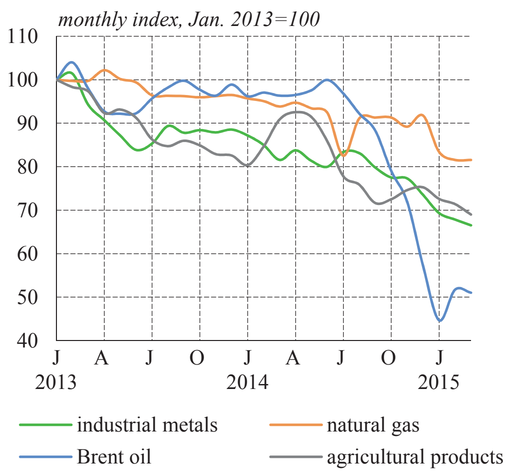
Agricultural Producer Prices



*) Jan.-Feb.

Source: NIS

Main Commodity Price Developments



Source: Bloomberg, IMF

III. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

During 2015 Q1, the central bank extended both the policy rate cutting cycle, lowering the monetary policy rate in two consecutive steps of 0.25 percentage points each in February and March to 2.0 percent, and the narrowing trend of the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate (to ± 1.75 percentage points from ± 2.25 percentage points previously). At the same time, the monetary authority maintained the adequate liquidity management in the banking system and kept unchanged the minimum reserve requirements ratios on both leu- and foreign currency-denominated liabilities of credit institutions. The decisions were aimed at ensuring price stability over the medium term, in line with the 2.5 percent ± 1 percentage point flat target, amid the improvement in the functioning of the monetary policy transmission mechanism and in a manner supportive of economic growth.

The decision taken by the NBR Board in February was warranted by the annual inflation rate re-embarking on a descending trajectory in October – thus falling in 2014 Q4 increasingly below the lower bound of the variation band of the flat target and implicitly below the previously-forecasted values[1] – and by its projected path[2] seeing a renewed broad-based downward adjustment. Specifically, forecasted inflation was expected to run comfortably below the lower bound of the variation band of the flat target until 2015 Q3, before edging higher, but still shy of the mid-point of the target. The significant change in the short-term inflation outlook was solely driven by the substantial disinflationary impact expected to be temporarily exerted by supply-side factors, i.e. the marked decline in the international oil price and the relative expansion of the agricultural product supply on account of the domestic and regional bumper crop in 2014. Over the longer term, the main driver behind the slower CPI inflation compared to the previous projection was the annual adjusted CORE2 inflation dynamics standing markedly lower than previously anticipated. This change in the core inflation outlook was due to the downward revision of

[1] The annual inflation rate came in at 0.83 percent in December, its 2014 average thus standing at a 25-year low of 1.1 percent.

[2] The baseline scenario of the February 2015 projection placed the annual CPI inflation rate at 2.1 percent at end-2015 and at 2.4 percent at end-2016, lower than in the November 2014 quarterly exercise (2.2 percent for December 2015 and 2.6 percent for September 2016). Consequently, the average annual inflation rate forecasted for 2015 was seen going down to 0.8 percent (from 1.5 percent in the previous projection), while for 2016 it was anticipated to stand at 2.3 percent.

the inflation forecasts in the euro area and other EU countries, as well as to 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 was only partly 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, as well as the persistence of a somewhat fragile global and euro area economic recovery and the further quasi-neutral stance of the fiscal policy.

The NBR Board lowered the monetary policy rate by another 0.25 percentage points, to 2.0 percent, in its March 2015 meeting. Behind the decision stood the consolidated prospects for the annual inflation rate to stay below the lower bound of the variation band of the flat target in the short run, the outlook for a renewed slight uptrend in early Q2 notwithstanding, given the further decline CPI inflation had witnessed in the first months of 2015 to a new historical low[3] of 0.4 percent in February. The current and expected performance of inflation reflected primarily the impact exerted by the protracted negative dynamics of volatile prices and of euro area inflation, as well as by the persistence of the negative output gap. The disinflationary pressures stemming from the latter factor were seen sticking to a slight downtrend, given that the dynamics in the early months of 2015 of almost all relevant indicators of consumer and investment demand – including those regarding developments in liquidity across the economy (mainly in M1, which is linked to economic activity) – hinted at the consolidation of economic growth in the period ahead. Nevertheless, the annual rate of change of credit to the private sector[4] was virtually unchanged and hence remained in negative territory throughout the period.

The quasi-standstill in the dynamics of private sector credit (-4.2 percent January through February 2015 versus -4.3 percent in 2014 Q4) largely reflected the mutually-offsetting effects exerted by the pick-up in the annual growth of the volume of new business, on one hand, and by the ongoing removal of non-performing loans from banks' balance sheets[5], on the other. Against this background, the annual growth rate of leu-denominated credit decelerated slightly in the first two months of 2015 Q1, to stand at 6.5 percent from 7.1 percent in 2014 Q4. In the case

[3] In the past 25 years.

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

[5] To which added the statistical impact of the slower annual inflation rate and of the temporarily sharper year-on-year depreciation of the leu against the Swiss franc and the US dollar.

of the foreign currency component (expressed in euro), the joint impact of the aforementioned factors was more than offset by the statistical effect of the stronger CHF in relation to the EUR, which translated into a slower rate of decline (-9.5 percent against -10.3 percent October through December 2014). Developments across the main customer categories were only partly correlated with the results of the Bank Lending Survey[6] conducted by the NBR, which highlighted expectations of a broad-based increase in the demand for loans January through March 2015 and a mixed outlook for credit standards, i.e. easing for corporate credit and potential tightening for housing loans. Specifically, the annual dynamics of loans to non-financial corporations went deeper into negative territory, coming in at -7.6 percent versus -6.5 percent in the closing quarter of 2014, on account of the steeper decline in the rates of change of both short-term leu-denominated credit and medium-term foreign currency loans. By contrast, the rate of change of household loans further posted less negative readings (-1.0 percent from -2.6 percent in 2014 Q4), prompted by the ongoing robust dynamics of housing loans and by the slower contraction in annual terms in the other types of credit.

Looking at M1, the swifter dynamics to 16.8 percent January through February 2015 from 11.9 percent in 2014 Q4 mainly reflected the significant inflows into household and corporate overnight deposits, as well as the relatively fast-paced growth of currency in circulation. The latter was primarily associated with the considerable rise in budget expenditures in December 2014, as well as with the temporary advance in disbursements related to EU funds and in the annual dynamics of the retail trade turnover volume. The performance of M1 was the sole driver behind the increase in liquidity across the economy (with the annual growth rate of M3 picking up to 6.7 percent from 5.1 percent October through December 2014), given that the annual rate of change of time deposits with a maturity of up to two years declined to -0.5 percent against 0.4 percent in 2014 Q4, owing exclusively to the contraction in corporate time deposits, reflecting inter alia companies' possible shift towards other financial assets.

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 ± 1.75 percentage points from ± 2.25 percentage points previously) in order to reduce interbank money market rate volatility and consolidate the transmission of the policy rate signal. In particular, the interest rate on the NBR's lending facility was lowered in two steps from 4.75 percent to 3.75 percent, while the deposit facility rate was kept unchanged at 0.25 percent. At

[6] February 2015.

the same time, the NBR continued to pursue adequate liquidity management in the banking system, which – given the change in banks' net liquidity position during the period under review, namely a considerably faster widening of the liquidity surplus in January, followed by a quick reduction in its magnitude and then by the re-emergence of a temporary liquidity shortfall towards end-March – entailed mopping up excess reserves via the deposit facility and holding a liquidity-providing operation on 30 March respectively. The latter was conducted in the form of a 1W repo via a fixed-rate tender with full allotment[7].

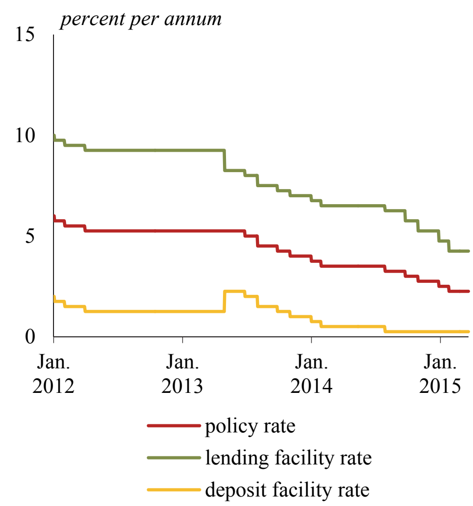
2. Financial markets and monetary developments

The average quarterly interbank money market rate hit a new historical low in 2015 Q1, while the EUR/RON exchange rate posted lower monthly readings on average in the latter part of the reported period, amid the relative improvement in global risk aversion. The annual dynamics of credit to the private sector remained in negative territory December 2014 through February 2015, while the liquidity across the economy expanded at a faster pace.

2.1. Interest rates

Interbank money market rates remained close to the lower bound of the corridor defined by interest rates on the central bank's standing facilities around the policy rate during the first two months of 2015 Q1 (with their monthly average reaching a new historical low[8] of 0.42 percent in January), before temporarily reverting to relatively higher readings at end-March. The quarterly average interbank deposit rate shed another 0.38 percentage points against the previous three months, to stand at 0.69 percent, while the volatility of overnight rates abated slightly, also as a result of the NBR further narrowing the corridor defined by the interest rates on the central bank's standing facilities around the policy rate.

NBR Rates



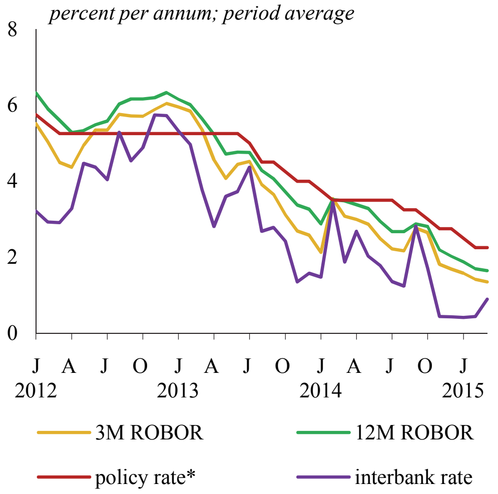
Overnight rates on the interbank money market remained in the vicinity of the NBR's deposit facility rate for most of the period under review, given that the net liquidity surplus in the banking system widened considerably in January – amid the ample liquidity injections carried out by the Treasury – and stuck afterwards to high readings, despite the reversal of the impact exerted by the main autonomous liquidity factors. The extension of the autonomous liquidity absorptions, mainly associated with transactions in the

7 Whereby approximately lei 1 billion was injected into the market.

8 Data series since 1993.

MPF's leu- and foreign currency-denominated accounts[9], into the closing part of 2015 Q1 led towards end-March to the emergence of a temporary liquidity shortfall and to the increase in overnight rates to values close to the monetary policy rate. Credit institutions' demand for reserves was accommodated by the NBR, which conducted – for the first time since October 2014 – a 1W repo via a fixed-rate tender with full allotment.

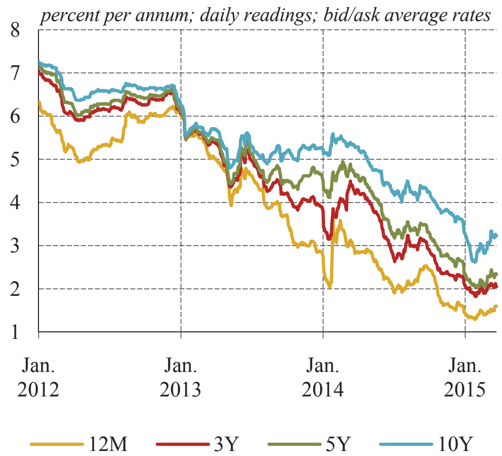
Policy Rate and ROBOR Rates



*) end of period

Also reflecting the easing of liquidity conditions in January and especially the impact of the successive policy rate cuts, longer-term rates on the interbank money market saw their downtrend extend until the latter half of March. Subsequently, 3M to 12M ROBOR rates recorded a short-lived rise, before stabilising towards the end of the reported quarter at levels approximately 0.55 percentage points to 0.80 percentage points lower than the monetary policy rate. Against this background, the average readings of longer-term rates posted historical lows in March, with the 3M ROBOR shedding 0.34 percentage points against December 2014 (to 1.35 percent) and 6M and 12M ROBOR rates averaging out at 1.59 percent and 1.65 percent respectively, down around 0.4 percentage points each.

Reference Rates on the Secondary Market for Government Securities



Developments on the government securities market reflected primarily the mixed influences exerted by (i) credit institutions' outlook for the monetary policy rate and liquidity conditions on the interbank money market; (ii) JP Morgan's announcement of 22 January on increasing the weight and maturity of Romanian securities included in the local currency bond market indices; (iii) the fluctuating global risk aversion, which witnessed a rise at the end of the first ten-day period in February and improved thereafter. Under the circumstances, investor appetite for government securities diminished in February – a context in which the overall volume of securities issued stood marginally below the indicative one –, before recovering slightly towards the end of the quarter under review. Maximum accepted bid rates remained on a downward course in January, before posting a trend reversal, initially for a couple of maturities (i.e. 10 years and 1 year) and then for almost the entire maturity spectrum, the exception being 3-month certificates[10]. As compared to the December readings, maximum accepted bid rates inched up 0.04 percentage points (to 1.69 percent) for one-year securities and went down 0.24 percentage points (to 2.59 percent) and 0.61 percentage points (to 3.11 percent) on securities with a residual maturity of around five and ten years respectively.

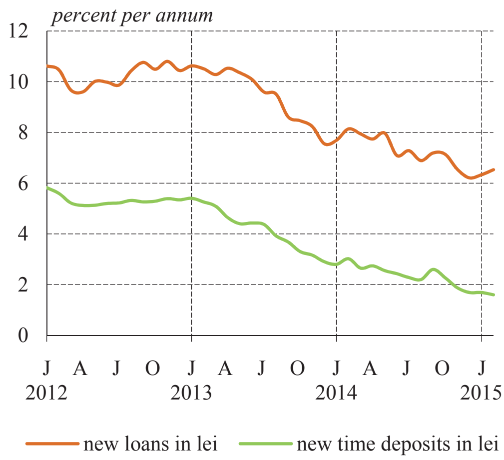
[9] At the end of 2015 Q1, the general government budget posted a surplus of lei 4,899 million lei, or 0.7 percent of GDP, on the back of revenues from the domestic economy exceeding the quarterly target by 6.5 percent, while the EU funds stood at 31.1 percent of the programmed amounts and total budget expenditures accounted for 80.9 percent of the Q1 programme (according to data in the Budget Execution Report for 2015 Q1, available in Romanian on the MPF website, at http://www.mfinante.ro/execbug.html?pagina=buletin).

[10] The MPF issued again 3-month securities in February, for the first time in five years.

Benchmark rates[11] on the secondary market for government securities moved in step with primary market rates, declining further in January and then embarking on a slight uptrend, which came to a temporary halt at end-February. However, at the end of the quarter under review, these rates stood below the end-2014 readings by values ranging between 0.01 percentage points for one-year securities and 0.4 percentage points for 10-year bonds, with the slope of the yield curve thus slightly flattening against December 2014.

December 2014 through February 2015, the average remuneration of new time deposits diminished further, edging down 0.28 percentage points to 1.60 percent. Downward adjustments were seen for both households (-0.53 percentage points to 2.41 percent) and non-financial corporations (-0.32 percentage points to 1.03 percent), thus marking new post-1990 lows. By contrast, the average lending rate on new business remained virtually unchanged, inching down 0.02 percentage points to 6.53 percent, given that the influence of the cut in the interest rate on corporate loans (-0.39 percentage points to a new post-1990 low of 5.19 percent) was offset by the effects of the higher interest rate on household loans, which added 0.19 percentage points to 8.0 percent in February. Nevertheless, the latter was solely due to structural changes (the lower share of new housing loans in total new business to households, amid the ongoing assignment of collateral ceilings under the "First Home" programme), with average interest rates on new consumer and housing loans shrinking over the reported period as a whole.

Bank Rates



2.2. Exchange rate and capital flows

The EUR/RON exchange rate saw a downward correction at the onset of 2015 Q1 after the previous months' increases, while the fluctuations recorded thereafter tended to alleviate, amid the improvement in international financial market sentiment following the decisions taken/measures implemented by the ECB and the messages and signals coming from the Fed on the prospects for the normalisation of the US monetary policy.

The relatively steep upward path that the EUR/RON had embarked on in 2014 Q4 extended into the first part of January 2015 as well, given that global risk aversion was further fuelled by fears surrounding the outcome of the Greek election and the euro area growth prospects, to which added concerns over the financial standing of some banks in the region as a result of the sudden appreciation of the Swiss franc[12]. However, the exchange rates of the currencies in the region, the leu included, witnessed an abrupt

Key Financial Account Items (BPM6 methodology)

EUR million

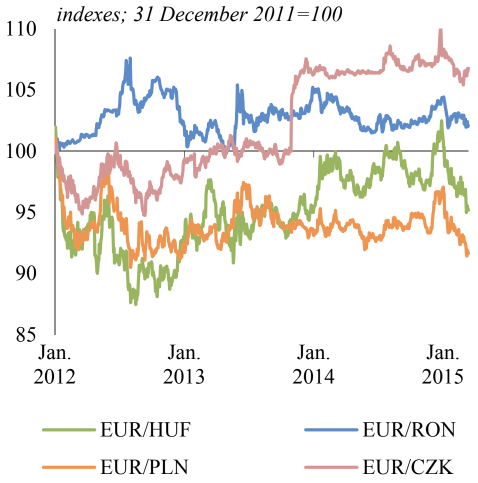
	2 mos.2014			2 mos. 2015		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	**-349**	**-1,303**	**954**	**-1,518**	**-2,418**	**900**
Direct investment	**-66**	**527**	**-592**	**151**	**553**	**-402**
Portfolio investment	**-9**	**976**	**-986**	**-248**	**-321**	**72**
Financial derivatives	**-59**	**-62**	**2**	**-224**	**-75**	**-148**
Other investment	**670**	**-2,745**	**3,415**	**1,154**	**-2,576**	**3,730**
– currency and deposits	568	-1,527	2,094	684	-66	750
– loans	-41	-987	947	351	-2,318	2,670
– other	143	-231	374	119	-192	310
NBR's reserve assets, net	**-883**	**0**	**-883**	**-2,351**	**0**	**-2,351**

*) "+" increase/"-"decrease

11 Bid/ask average.

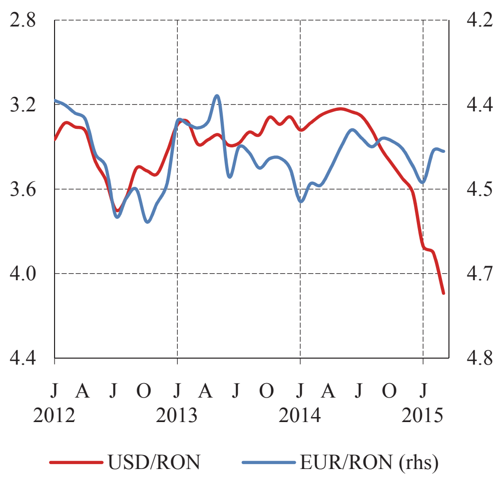
12 Following the Swiss National Bank's unexpected decision to scrap the EUR/CHF floor.

Exchange Rate Developments on Emerging Markets in the Region



Source: ECB, NBR

Nominal Exchange Rate



downward correction towards end-January, amid the improvement in global financial market sentiment thanks to the approval and announcement by the ECB of the expanded asset purchase programme, whose features exceeded expectations. Developments in the EUR/RON also reflected the impact of JP Morgan's announcement on increasing the weight and maturity of Romanian securities included in the local currency bond market indices. The reported period also saw a markedly steeper strengthening trend of the US dollar in relation to the major currencies, meaning that the leu weakened month on month by a hefty 6.5 percent in nominal terms against the US currency compared with a 0.6 percent depreciation versus the euro.

The EUR/RON temporarily re-embarked on a slight uptrend in early February, unlike the exchange rates of other currencies in the region, reflecting the relatively stronger unfavourable influence exerted during that period on the local financial market by the slow-in-coming resolution of the situation in Greece and by resurfacing geopolitical tensions. However, towards the end of the month, the currency pair moved back into line with the slightly downward trend prevailing throughout the region , amid (i) the improved financial market sentiment prompted by the Eurogroup agreement on a four-month extension of the Greek financial assistance programme, and (ii) the further positive trend in domestic economic fundamentals[13]. The EUR/RON exchange rate tended to stabilise in the first part of March, before witnessing another downward adjustment[14], thanks to the decrease in global risk aversion fostered by (i) the launch by the ECB of the expanded asset purchase programme on 9 March, and especially by (ii) the change in expectations on the timing and particularly the pace of US monetary policy normalisation following the FOMC meeting of 17-18 March.

On the interbank forex market, these influences led to a significant pick-up in the turnover in March, especially on account of non-residents' transactions. This was accompanied by the temporary rise in residents' excess demand for foreign currency in January and March, also due to one-off operations, so that the negative balance of transactions on the interbank forex market posted a relative widening.

[13] Statistical data on 2014 Q4 GDP dynamics – flash estimate, industrial production index and retail trade turnover were in line with/slightly exceeded financial analysts' expectations.

[14] Also seemingly prompted by several statistical indicators released during that period exceeding expectations, in particular those regarding the general government budget execution in the first two months of 2015 and the current account performance in January (i.e. a record surplus).

January through March 2015, the domestic currency strengthened against the euro[15] by 0.6 percent in nominal terms and 1.8 percent in real terms. In relation to the US dollar, the leu weakened by 11.6 percent in nominal terms and 10.6 percent in real terms, given the former's considerable strengthening against the single currency. Looking at the average annual exchange rate dynamics in 2015 Q1, the domestic currency saw its nominal appreciation versus the euro increase, while depreciating more visibly against the US dollar in nominal terms.

2.3. Money and credit

Money

December 2014 through February 2015, broad money (M3) dynamics[16] re-embarked on an upward trajectory (6.9 percent from 3.8 percent during September-November 2014), reflecting the increase in EU fund-related payments (in the first two months of the period under review[17]) and especially in budget expenditures (at end-2014). An opposite effect had money-holders' partial portfolio shifts towards other types of financial instruments and, possibly, the higher repayments on the non-banking private sector's domestic and external[18] debt.

Behind the pick-up in M3 dynamics stood the growth rate of narrow money (M1), which peaked at a two-year high, fuelled by both its major components[19]. By contrast, the rate of change of time deposits with a maturity of up to two years re-entered negative territory after 18 months of positive readings, exclusively on account of the performance of corporate deposits, particularly those denominated in foreign currency. Against this background, the leu-denominated component saw its majority share in broad money consolidate at 71.0 percent, the highest average since 2012 Q3.

Annual Growth Rates of M3 and Its Components

real percentage change

	2014				2015	
	I	II	III	IV	Jan.	Feb.
	quarterly average growth					
M3	7.8	5.2	4.6	5.1	7.3	6.0
M1	15.0	10.7	10.0	11.9	18.3	15.2
Currency in circulation	13.4	9.3	9.9	11.5	15.9	14.4
Overnight deposits	15.9	11.5	10.2	12.1	19.6	15.7
Time deposits (maturity of up to two years)	3.1	1.5	0.8	0.4	-0.5	-0.6

Source: NIS, NBR

15 In the same period, the Polish zloty and the Hungarian forint appreciated in nominal terms by 2.2 percent and 2.4 percent respectively in relation to the single currency.

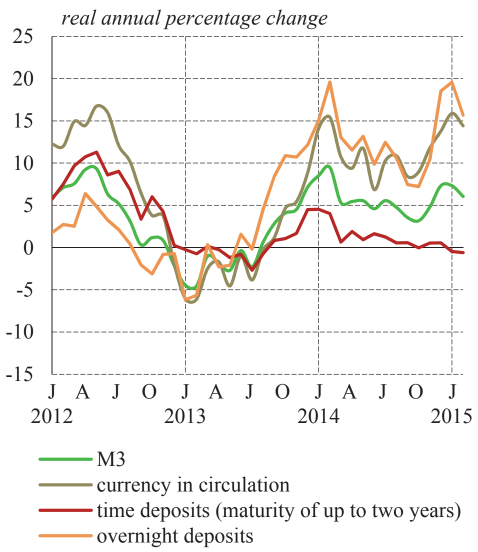
16 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2014-February 2015.

17 According to press releases from the Agency for Payments and Interventions in Agriculture, December 2014 saw disbursements related to crop and livestock subsidies, compensation for damage caused by severe weather conditions in the beekeeping and crop sectors during 2014, as well as to financial aids for purchasing a selection of animals of specialised breeds, while in January 2015 payments were made in the crop sector, along with area payments (the latter were made via a loan extended by the MPF to the MARD, pursuant to Government Decision 10/2015). At the same time, the MPF granted loans to Management Authorities for payments to eligible recipients of European funds (Government Decisions 13/2015 and 106/2015).

18 According to balance-of-payments provisional data, the average monthly volume of repayments on external debt in the non-banking sector December 2014 through February 2015 exceeded that recorded during September-November 2014.

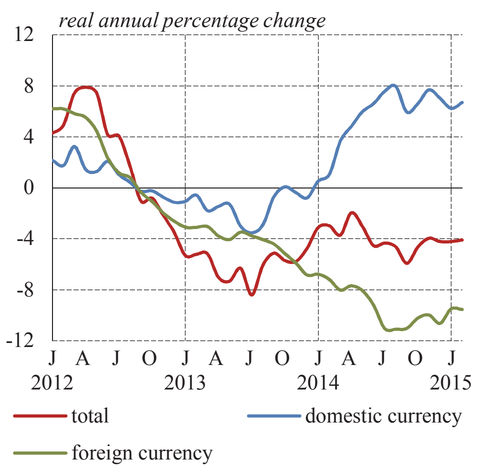
19 The rate of change of currency in circulation peaked at a nine-quarter high, while that of overnight deposits posted the highest reading since 2008 Q3.

Main Broad Money Components



Source: NIS, NBR

Credit to Private Sector by Currency



Source: NIS, NBR

The M3 breakdown by institutional sector points to a pick-up in the dynamics of deposits from non-financial sectors and a decline in the rate of change of deposits held by non-monetary financial institutions. In the case of households, the advance was associated with the rise in wage earnings[20], also on account of the ahead-of-schedule payment of rights awarded in court[21], as well as with the larger payments related to European funds. Behind the faster dynamics of deposits from non-financial corporations stood the additional payments to the beneficiaries of European funds, as well as the increase in certain types of budget expenditures, i.e. VAT-related repayments[22] and goods and services-related expenses[23]. The reduction in the rate of change of M3 deposits held by non-monetary financial institutions was most likely due to the relative step-up in portfolio shifts towards other types of financial assets (government bonds in domestic currency, leu-denominated deposits with a maturity of over two years).

From the perspective of major M3 counterparts, the faster pace of increase of broad money reflected the pick-up in the rate of change of credit institutions' government security holdings, the contraction in the dynamics of central government deposits, as well as the slower rate of decline of long-term financial liabilities[24]; an opposite, albeit lower influence had the slacker advance in banks' net foreign assets.

Credit to the private sector

December 2014 through February 2015, the dynamics[25] of credit to the private sector posted slightly less negative readings (-4.2 percent from -4.8 percent September through November 2014), reflecting primarily the slower contraction of the foreign currency component (expressed in euro), associated with the statistical effect of the weaker EUR versus both the CHF and the USD[26,27]; the rate of

20 The real average annual growth rates of net wage earnings economy-wide and of staff-related budget expenditures peaked at six-year highs.

21 Pursuant to Government Decision No. 935/2014 on supplementing the budget of the Ministry of National Education for the payment of amounts established by court rulings declared enforceable by 31 December 2013 and to the Explanatory Memorandum of the Government Emergency Ordinance amending the 2014 government budget and introducing some budgetary measures.

22 According to data on the National Agency for Fiscal Administration website, the volume of VAT repayments during this period peaked at a three-year high.

23 According to budget execution data, in December 2014 goods and services-related expenditures posted the highest annual dynamics in the past 11 months.

24 Capital accounts included.

25 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2014-February 2015.

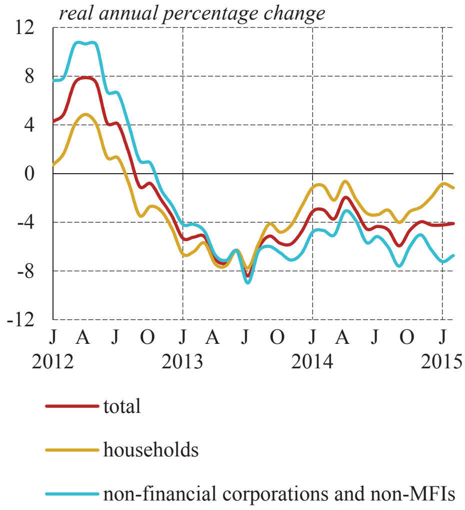
26 Looking beyond the statistical influence of the stronger Swiss franc and US dollar, the dynamics of foreign currency credit (expressed in euro) went deeper into negative territory.

27 The drop in the annual inflation rate also had a statistical effect.

change of leu-denominated credit continued to decline slightly, yet remained very alert when looking at the past six years. The average share of the forex-denominated component in total credit to the private sector continued to narrow and stood at 56.3 percent, the lowest level since 2008 Q4.

The breakdown by institutional sector points to mixed developments, as the rate of decline of household credit slowed and the dynamics of loans to non-financial corporations went deeper into negative territory. Developments in the rate of change of bank lending to households reflected primarily the rise in the volume of new business and the decline in the flow of non-performing loans removed from credit institutions' balance sheets[28]; to these added the statistical effect of the appreciation of both the Swiss franc and the US dollar. The currency breakdown of household credit shows a further advance in the dynamics of the leu-denominated component, which posted the highest reading since 2008 Q4, amid the pace of increase of housing loans[29] remaining very alert and the rate of decline of consumer credit and other loans[30] decelerating. Looking at loans to non-financial corporations, the fall in dynamics was associated with the decline in the flow of new business and with the increase in the volume of sales of loans from credit institutions' balance sheets and it reflected the performance of the leu-denominated component, and more specifically of short-term credit and/or overdraft loans, whereas the rate of change of foreign currency credit (expressed in euro) remained relatively unchanged.

Credit to Private Sector by Institutional Sector



Source: NIS, NBR

[28] Calculated based on monetary statistics data.

[29] The dynamics of leu-denominated housing loans were further affected by the fading out of the base effect associated with the 2013 launch of the "First Home" government programme exclusively in domestic currency.

[30] Consumer credit, other loans and business development loans have been analysed as a single indicator, with a view to eliminating the effect of statistical methodological changes introduced as of January 2015.

IV. INFLATION OUTLOOK

The annual CPI inflation rate is forecasted at 0.2 percent and 1.9 percent at end-2015 and end-2016 respectively. Under the impact of broadening the scope of the lower VAT rate, the annual adjusted CORE2 inflation rate is projected at negative levels in the first half of the projection interval. Once the first-round effect of the fiscal measure has faded out at the end of 2016 Q2, core inflation is expected to embark on a slightly upward path – remaining however at relatively low levels until the projection horizon – following the economic agents' inflation expectations reverting to an uptrend and the diminishing disinflationary impact of the negative output gap. The annual CPI inflation rate is foreseen to run in positive territory at end-2015 and then re-enter the variation band of the target by end-2016, reflecting mainly the cumulative contribution of exogenous CPI components in terms of the monetary policy scope. The balance of risks to the future inflation path is assessed to be relatively in equilibrium over the short term, while, on the medium term, the balance appears to be tilted to the downside, particularly due to uncertainties surrounding the domestic environment.

1. Baseline scenario

1.1. External assumptions

The scenario for developments in the effective EU GDP[1] foresees a recovery at growth rates marginally higher than those projected in the February 2015 Inflation Report. Thus, the external output gap[2], albeit still negative, is expected to have a less restrictive impact on domestic economic activity than anticipated in the previous projection round.

Expectations on the Developments in External Variables

annual averages

	2015	2016
Effective EU economic growth (%)	1.43	1.96
Annual inflation rate in the euro area (%)	0.04	1.15
Annual CPI inflation rate in the US (%)	0.18	2.13
3M EURIBOR rate (% p.a.)	0.02	0.03
USD/EUR exchange rate	1.08	1.05
Brent oil price (USD/barrel)	57.9	64.6

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

Further supportive of economic activity recovery in the euro area are the favourable effect of relatively weak global oil prices, the recent developments in economic agents' confidence amid the progress relative to structural reforms and fiscal consolidation, as well as the beneficial impact of the ECB's new monetary policy measures[3]. Their potential influence on the EUR exchange

1 EU-28 excluding Romania. For details on how this indicator was constructed, see the November 2012 Inflation Report, p. 35.

2 Approximated by the effective EU GDP gap deemed as a relevant measure to assess the impact of external demand on Romania's exports within the NBR model.

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 scheduled to last from 9 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.

rate, the cost of credit and asset prices is seen mitigating the still unfavourable effects on economic activity induced by the persistence of: geopolitical tensions, relatively low productive capacity utilisation in several countries (exerting negative effects on investment spending), high unemployment rates reflecting also structural distortions on the labour market, as well as of the household deleveraging trend (whereas corporate deleveraging has waned as of late)[4].

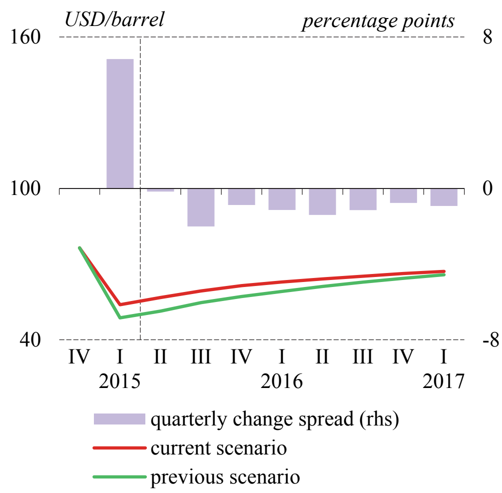
Annual HICP inflation in the euro area is expected to stay quite subdued over the short term, before rising gradually until the forecast horizon, but remaining at lower levels than those deemed by the ECB as being compatible with price stability. In light of the ECB taking on a more accommodative monetary policy stance, the rising trend in annual HICP inflation rate is also fostered by: relatively brighter economic growth prospects leading to a gradually narrowing negative output gap, the recent softening of the euro versus the US dollar, and the expected reversal of the downturn in oil prices seen at the beginning of the year. In 2015, annual inflation rate in the US is foreseen to post very low levels, close to those in the euro area, an outlook also mirrored by expectations of the Fed possibly deferring the decision to hike its monetary policy rate. The anticipated US inflation path in 2016 is consistent with the long-term targets of the Fed.

The nominal 3M EURIBOR rate is anticipated to remain subdued, at lower levels than those expected in the previous projection round, amid the ECB's persistently accommodative monetary policy stance aimed at fulfilling its price stability mandate.

The euro is anticipated to follow a slight depreciation trend versus the US dollar in the short run, before posting a quasi-stabilisation until the forecast horizon.

The scenario on the international Brent oil price is based on futures prices and foresees a return of the quarterly dynamics into positive territory in 2015 Q2. For the remainder of the forecast interval, the positive quarterly dynamics are set to linger, amid expectations of growing global demand for oil once economic growth strengthens, along with the slightly shrinking oil supply attributed to scant investment and the partial loss of productive capacity in some oil-exporting countries.

Brent Oil Price Scenario



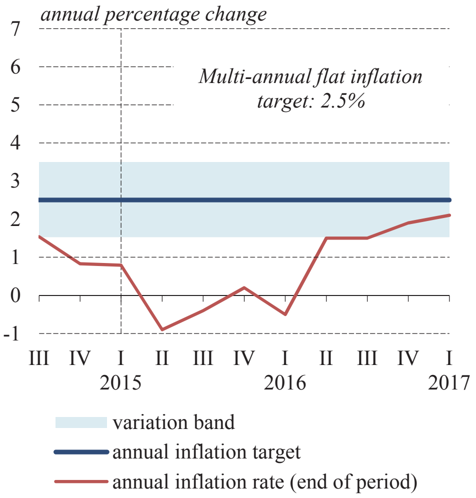
Source: Energy Information Administration, NBR assumptions based on Bloomberg data

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 0.2 percent at end-2015 and 1.9 percent at end-2016, i.e. below the lower bound and inside the lower half respectively of the ±1 percentage point variation band of the

[4] Source: Economic Bulletin No. 2/2015, ECB.

Inflation Forecast



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

Source: NIS, NBR projection

The Annual Inflation Rate in the Baseline Scenario

annual percentage change

	2015			2016				2017
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Forecast*	-0.9	-0.4	0.2	-0.5	1.5	1.5	1.9	2.1

*) end of period

2.5 percent flat target. Given the impact of broadening the scope of the lower VAT rate[5], the annual CPI inflation rate is foreseen to run in negative territory from 2015 Q2 until 2016 Q1, except the end of this year. Once the first-round effect[6] of the fiscal measure fades out in 2016 Q2, the annual inflation rate is projected to rise to 1.5 percent and then re-enter the variation band of the target starting 2016 Q4. Average annual CPI inflation rate is projected to run at levels below the variation band throughout the forecast interval.

Compared to the February 2015 Inflation Report, the projected path of the annual CPI inflation rate was revised downwards by 1.9 percentage points and 0.5 percentage points at the end of 2015 and 2016 respectively. For this year, the revision takes into account the significantly smaller contributions from the adjusted CORE2 inflation, administered and VFE prices, whilst fuel prices are seen having a larger contribution. For next year, dampening effects on CPI inflation are expected from the adjusted CORE2 inflation, administered and fuel prices, whereas the other consumer basket components are foreseen to have an impact similar to that described in the previous Inflation Report.

In the current projection round, the decision to broaden the scope of the lower VAT rate appears set to weigh significantly on the adjusted CORE2 index, especially via processed food items[7], and on VFE prices. The experience of previous VAT rate changes in Romania[8], together with those identified in other countries[9] revealed, on the one hand, that most of the first-round impact fed through into consumer prices in the month when the measure took effect and, on the other hand, that the accounting impact[10] may not

5 On 7 April 2015, the Government passed an Emergency Ordinance amending and supplementing Law No. 571/2003 regarding the Tax Code; it sets forth that the scope of the reduced VAT rate of 9 percent shall include all food items, non-alcoholic beverages and public food services, except alcoholic beverages, as of June 2015. The measure will have an impact on the prices of around 32 percent of the goods and services included in the CPI basket.

6 The first-round effect is the direct impact of the change in the VAT rate on consumer prices and, hence, on CPI inflation rate. While the effect on the price level is permanent, that on inflation is temporary, as the said measure impacts the monthly rate only in the month when the new VAT rate affects prices and the annual rate over a 12-month period.

7 Processed food items account for 50 percent of the adjusted CORE2 index basket.

8 The last two changes occurred on 1 July 2010, when the standard VAT rate was raised from 19 percent to 24 percent (for details, see the August and November 2010 Inflation Reports), and 1 September 2013, when the VAT rate was lowered to 9 percent, from 24 percent, for certain bakery products (for details, see the November 2013 Inflation Report).

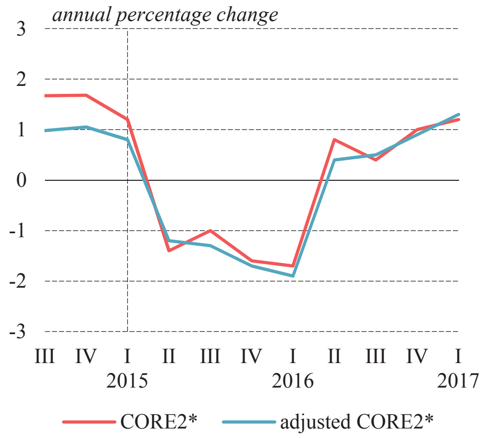
9 For example, Hungary in January 2006, the UK in December 2008 and Latvia in July 2012 lowered the VAT rate, while Hungary in September 2006 and July 2009, the Czech Republic in January 2008, the Netherlands in October 2012, and the UK in January 2010 and January 2011 increased the VAT rate.

10 The decision to broaden the scope of the reduced VAT rate, effective 1 June 2015, entails a maximal accounting impact of -3.8 percent on consumer prices.

pass through entirely to final selling prices, as part of the shock might be incorporated into producers' and retailers' profit margins. The aforesaid factual evidence coupled with the anticipated narrowing of the negative output gap that may encourage producers to restore their profit margins[11] were taken into account when determining the assumption regarding the pass-through of the maximal accounting impact of the VAT rate decrease on consumer prices. While first-round effects fade away after four quarters since becoming manifest, the outlook for medium-term annual inflation rate is influenced by the persistence of second-round effects[12].

The annual adjusted CORE2 inflation rate is projected to post negative values over the first half of the projection interval, under the impact of first- and second-round effects of the fiscal measure to broaden the scope of the lower VAT rate, which will be slightly moderated by the gradually abating disinflationary influence of the negative output gap underpinned by the envisaged domestic demand consolidation. At the end of 2016 Q2, when the first-round effect of broadening the scope of the reduced VAT rate falls out from the calculation of the annual adjusted CORE2 inflation, this indicator will rise sharply, before re-entering a slightly upward path over the remainder of the projection interval. This evolution is expected to be driven by economic agents' inflation expectations re-embarking on an uptrend after the first-round effect of the fiscal measure fades out and by the decline in the disinflationary impact of GDP deviation[13]. These influences are foreseen to be mitigated by decreasing inflationary pressures coming from import prices[14].

Annual CORE2 Inflation and Annual Adjusted CORE2 Inflation



*) end of period

Source: NIS, NBR projection

Compared to the February 2015 Inflation Report, the projected annual adjusted CORE2 inflation rate was revised downwards by 3 percentage points and 0.5 percentage points at the end of 2015 and 2016 respectively. The direction and magnitude of this revision stem mainly from the substantial impact of the recent information on broadening the scope of the reduced VAT rate, which also affects economic agents' inflation expectations, forecasted at markedly lower levels in the current projection round, and from

11 Particularly after Russia imposed a ban on food imports, domestic food producers faced tougher competition, which could have reduced commercial margins.

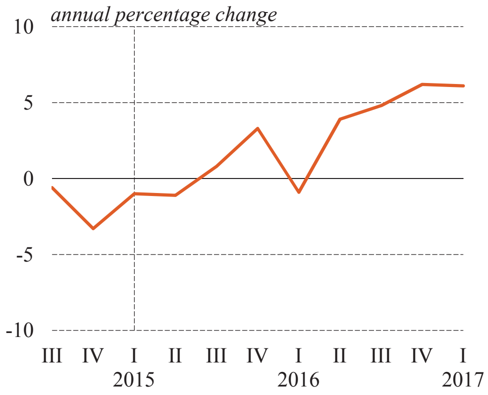
12 Second-round effects quantify the indirect impact of the VAT rate change on inflation via various economic mechanisms and are more persistent than first-round effects. For a detailed theoretical description of these effects, see sources such as the monetary policy glossary available on the NBR website or the August 2010 Inflation Report.

13 The impact of GDP deviation on the annual adjusted CORE2 inflation rate is calculated as a 4-quarter moving average. In quarterly terms, the disinflationary impact of GDP deviation is seen fading out in the latter half of 2016, before the emergence of a slight demand surplus towards the projection horizon.

14 Particularly amid 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 and, hence, on the annual imported inflation rate.

less pronounced inflationary pressures of import prices[15]. An opposite impact comes only from the GDP deviation, which is seen reaching relatively less restrictive levels, during the second half of the projection interval in particular.

VFE Prices Annual Inflation*

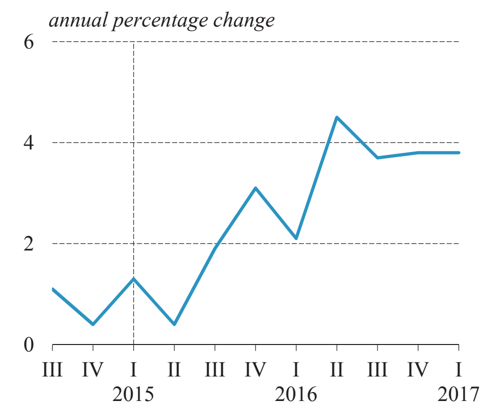


*) end of period

Source: NIS, NBR projection

Volatile food prices are projected to decline in 2015 Q2, amid the implementation of the reduced VAT rate for such items, their annual dynamics being still under the influence of the 2014 plentiful harvest and of the transitory shocks associated with foreign trade in "fruit and vegetables". Starting with 2015 Q3, their dynamics will be marked by some unfavourable base effects, assuming normal harvests in 2015 and 2016, as well as by seasonal effects specific to these products. For this CPI basket group too, the annual inflation rate is expected to climb markedly at the end of 2016 Q2, once the first-round effect of broadening the scope of the lower VAT rate has faded away. The contribution of volatile food items to the annual CPI inflation rate stands at 0.2 percentage points at the end of 2015, i.e. 0.2 percentage points lower than the previously-projected level, and 0.4 percentage points at the end of 2016, similarly to the figure anticipated in the prior forecast.

Administered Prices Annual Inflation*



*) end of period

Source: NIS, NBR projection

The annual dynamics of alcoholic beverage and tobacco product prices are largely shaped by the current legislation on setting the excise duties levied on these goods[16], given that the other underlying elements of their selling prices, depending on the manufacturer, are expected to have only marginal contributions. Similarly to the February 2015 Inflation Report, the contribution of this component to the annual CPI inflation rate is projected at 0.2 percentage points at the end of 2015 and 0.1 percentage points at the end of 2016.

The scenario for administered price changes includes information from the relevant Romanian authorities and the latest developments in various administered price groups. The annual dynamics of administered prices are forecasted at 3.1 percent and 3.8 percent for end-2015 and end-2016 respectively. These values are below the previously-projected levels, especially this year, amid the

[15] 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 regional economic blocs in Romania's foreign trade).

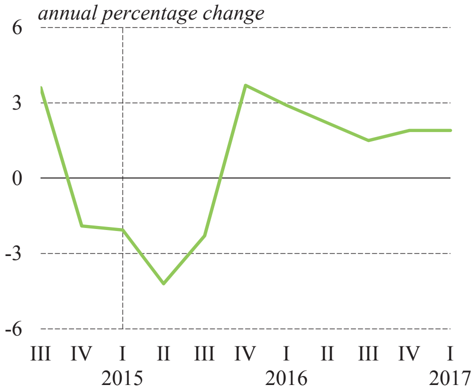
[16] In accordance with the current Tax Code, starting with 2016, excise duties on cigarettes are foreseen to be indexed yearly on 1 April to the average annual inflation rate calculated in September of the year prior to implementation.

reassessment of the "natural gas" price dynamics for April[17] and the revised path of pharmaceutical prices[18].

The annual rate of change of fuel prices is projected to post negative readings in 2015 Q2 and Q3, before re-entering positive territory in the final quarter of this year (3.7 percent in December, following an upward revision of 7.8 percentage points compared to the previous projection), amid expectations of further negative annual dynamics of the international oil price, yet of a lower magnitude than previously envisaged. Starting with 2016 Q1, the annual positive dynamics foreseen for the crude oil price and the re-entering of inflation expectations on an upward path, which has an impact on this group of the CPI basket as well, help consolidate the growth rate of fuel prices at positive levels. Therefore, the group's annual inflation is foreseen to come in at 1.9 percent at the end of 2016.

The cumulative contribution of components exogenous to the monetary policy influence, namely administered prices, volatile food (VFE) prices, fuel prices and tobacco product and alcohol prices, to the annual CPI inflation rate amounts to 1.2 percentage points and 1.3 percentage points at end-2015 and end-2016 respectively.

Fuel Prices Annual Inflation*



*) end of period

Source: NIS, NBR projection

Components' Contribution to Annual Inflation Rate*

percentage points

	2015	2016
Administered prices	0.6	0.7
Fuels	0.3	0.2
VFE prices	0.2	0.4
Adjusted CORE2	-1.0	0.6
Tobacco products and alcohol	0.2	0.1

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

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

Output gap

In 2014 Q4, the seasonally adjusted real GDP saw a 0.7 percent rise in quarterly terms[20], its annual dynamics standing at 2.7 percent[21]. The evolution of some relevant macroeconomic indicators (i.e. economic sentiment indicator, retail trade turnover, excluding

[17] Regulated prices of natural gas delivered to household end-users are estimated to have decreased by 3.9 percent in April 2015. For further details, see the press release issued by the Regulatory Authority for Energy in Romania on 27 March 2015 concerning the prices for the regulated supply of natural gas to consumers, available at: http://www.anre.ro/ro/presa/comunicate/comunicat-27-03-2015-preturi-furnizare-reglementata-gaze-naturale-clienti-casnici.

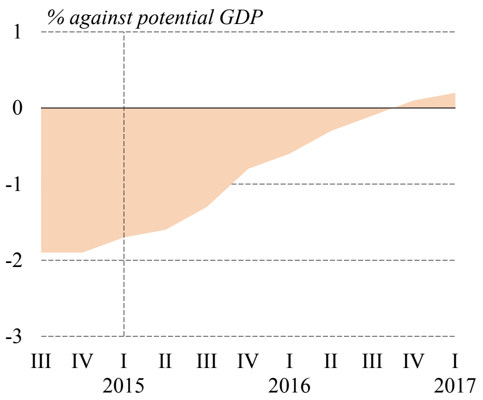
[18] Based on the request by the Ministry of Health addressing all Marketing Authorisation Holders or their representatives to update all the prices of human pharmaceuticals, pursuant to Order No. 75/2009 issued by the Minister of Health. For further details, see the press release of the Ministry of Health dated 23 February 2015, available at: http://www.ms.ro/index.php?pag=62&id=14623&pg=1.

[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] According to NIS Press Release No. 81 of 7 April 2015. Compared with the February 2015 Inflation Report, the historical GDP data series and the related components were generally subject to moderate revisions.

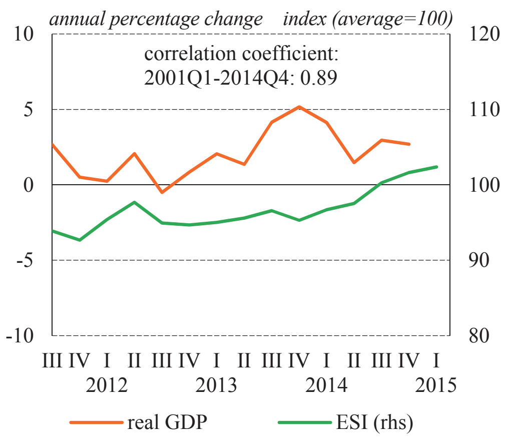
[21] Based on non-seasonally adjusted data.

Output Gap



Source: NIS, NBR projection

Economic Sentiment Indicator* and Economic Growth



*) seasonally-adjusted data

Source: NIS, EC-DG ECFIN

motor vehicles and motorcycles, and industrial production index) points to positive quarterly GDP dynamics for 2015 Q1[22] as well.

The potential GDP growth in 2015 and 2016 is fuelled by the stabilization of the positive dynamics of production factors, namely capital stock (amid expectations of a gradual recovery of gross fixed capital formation) and labour (given the favourable trends in the activity rate and employment). Concurrently, total factor productivity is projected to stick to an upward trend[23], under the joint impact of: (i) the efforts to build on the previous progress in the absorption of EU structural and cohesion funds[24] (also by taking measures to address institutional rigidities), thereby boosting programmes for staff training and the streamlining of production capacities, as well as (ii) the signals on the moderation of corporate balance sheet adjustments, which creates the conditions for the allocation of funds to increase the efficiency of resource utilisation. However, this scenario is still fraught with considerable uncertainty surrounding the external environment 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 developments.

The negative output gap in 2014 Q4 is assessed at a level close to that in the previous forecasting round, under the joint impact of real GDP staying in line with the forecasted level in 2014 Q4, the NIS moderate revisions of the historical data series of the seasonally adjusted real GDP, and of the marginal reassessment of the impact of output gap determinants. The negative output gap in 2015 Q1 is expected to narrow versus the previous quarter. With external demand and the fiscal impulse[25] further exerting a restrictive influence, behind the narrowing of the negative output gap is seen to stand the stimulative nature of real broad monetary conditions in 2014 Q4. Looking at the latter, the real bank interest rates and the deviation of the real effective exchange rate of the leu from the medium-term trend (with an impact on net exports) exerted

[22] In 2015 Q1, the economic sentiment indicator went up 0.8 points from the previous quarter (mainly on account of the 5.6 point advance in consumer confidence), while retail trade turnover (excluding motor vehicles and motorcycles) and industrial production increased by 1.5 percent and 1.1 percent respectively during January-February 2015 compared with the averages for 2014 Q4.

[23] Throughout 2015, the dynamics of the total factor productivity trend are also fuelled by carry-over effects from the previous-year performance of the agricultural sector. This adjustment is intended to capture the assumption according to which good or poor agricultural years do not influence the output gap, i.e. they do not put additional demand-side inflationary or disinflationary pressures.

[24] The 2014-2015 period will see the overlapping of EU funds of 2007-2013 and 2014-2020 financial years respectively, which adds to the prospects of further measures to enhance the administrative capacity-building of the structures involved in the management of European funds.

[25] The fiscal impulse quantifies the impact of the discretionary component of fiscal policy in the NBR's quarterly projection model.

favourable influences, while the wealth and balance sheet effect of the exchange rate is seen to have had a slightly restrictive impact. The narrowing of the negative output gap in 2015 Q1 is also hinted at by a number of indicators correlated with the cyclical position of the economy, such as industrial production, real net wage and the ILO unemployment rate[26].

The negative GDP deviation from its potential is foreseen to narrow gradually throughout the projection interval, witnessing marginally positive values close to the projection horizon. This is anticipated to be the result of the persistence of the stimulative impact of real broad monetary conditions, to which add the projected gradual recovery in effective external demand and the effect of the fiscal impulse, expected to become countercyclical. As compared with the previous forecasting round, the aggregate demand deficit is seen at lower levels starting with 2015 Q3, implying considerably weaker disinflationary pressures, on account of the more stimulative impact of real monetary conditions throughout the projection interval, the slightly favourable revision of the effective external demand gap (backed by the ECB's accommodative monetary policy stance supportive of economic activity across the euro area), as well as of the discretionary component of fiscal policy, foreseen to be countercyclical over the forecast interval.

The baseline scenario envisages GDP growth consolidating during the reference period, on account of the expected positive performance of domestic demand, as a result of the further uptrend in the actual individual final consumption of households and the anticipated rebound in gross fixed capital formation. The projected rise in the actual individual consumption of households is supported by the expected growth in their real disposable income (also in the context of the lower VAT rate becoming applicable to all food items, non-alcoholic beverages and public food services as of June 2015) and by the further easing of lending conditions. Gross fixed capital formation is also seen to make a positive contribution to domestic demand, on the back of the anticipated improvement in productive capital inflows from European structural and cohesion funds and foreign direct investment. Net exports are seen having a slightly negative contribution to GDP growth over the projection interval, as the domestic demand-induced rise in imports of goods and services is foreseen to outpace that of exports, amid the comparatively slower recovery of external demand.

[26] January through February 2015, compared with the average for 2014 Q4, industrial production and net real wage rose by 1.1 percent and 1.4 percent respectively, whereas the ILO unemployment rate dropped by 0.1 percentage points in 2015 Q1 from the previous quarter (seasonally-adjusted data).

Aggregate demand components

In 2015 Q1, the positive quarterly dynamics of the actual individual final consumption of households are expected to strengthen[27]. This is supported by the increase, in January-February 2015 versus the 2014 Q4 average, in real net wages and in retail trade (except for motor vehicles and motorcycles), in parallel with the significant improvement in the consumer confidence indicator in the first quarter as a whole. In this context, in 2015 Q1, the negative deviation of this GDP component from its medium-term trend is assessed to narrow sharply compared with the preceding quarter.

In January-March 2015, the actual collective consumption of general government is expected to stand at a level similar to that recorded in 2014 Q4, being in line with the measures taken to keep the budget deficit within the limit established with international financial institutions[28].

The growth rate of actual individual consumption of households is anticipated to remain robust throughout the forecast interval, in the context of the projected faster rise in the real disposable income of households and the moderation in private sector deleveraging, amid the easing of lending conditions and the favourable developments in interest rates applied by credit institutions, as a result of the gradual pass-through of the recent policy rate cuts. The rise in the real disposable income of households is foreseen to occur on the back of the increase in labour productivity and the scheduled fiscal easing measures[29]. Moreover, favourable influences are seen to be exerted by the anticipated improvement in the absorption of EU funds, favourable effects on consumption being expected to stem particularly from the programmes intended to increase labour productivity, with a positive impact also on employment and subsequently 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.

In 2015 Q1, the quarterly growth rate of gross fixed capital formation is foreseen to recover, being supported by several indicators, such as the volume of construction works, the confidence

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27 In 2014 Q3 and Q4, the actual individual final consumption of households grew by 0.8 percent and 2.5 percent respectively in quarter-on-quarter comparison.

28 According to the latest data released by the MPF, the general government balance as a share in GDP stood at 0.69 percent in March 2015 (cash-based methodology). In 2015, the cash deficit projection is 1.8 percent of GDP (Ministry of Public Finance “Report on the macroeconomic situation for 2015 and the projections for the years 2016-2018”).

29 Given the Government of Romania’s decision on broadening the scope of the lower VAT rate (9 percent) to all food items, non-alcoholic beverages and public food services as of June 2015 and the scheduling of a set of measures (in line with the Fiscal Strategy for 2015-2017), such as 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.

in construction, the turnover of capital goods for the domestic market, and the industrial output of capital goods[30]. As a result, the deviation of gross fixed capital formation from the medium-term trend is assessed to have remained in negative territory in 2015 Q1, yet narrower than in the preceding quarter.

After the declines recorded in 2013-2014, gross fixed capital formation is expected to gradually recover in 2015 and 2016, supported by 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[31]. Private and public investment spending is forecasted to pick up also amid the continued easing of lending conditions and the anticipated recovery of the economic activity of Romania's main trade partners, with a favourable impact on investment in the export-oriented sectors. These factors are projected to have a positive impact on the capital endowment economy-wide and hence on labour productivity growth. However, the pronounced declines seen in the past two years[32] point to high uncertainty surrounding the investment recovery throughout the forecast interval.

The quarterly dynamics of exports of goods and services are estimated to re-enter positive territory in 2015 Q1. This assessment relies on the restoration of confidence in the economy at EU level, the rise in the euro area industrial output[33] and the anticipated moderate economic growth in both the euro area and the EU. The quarterly dynamics of imports of goods and services in 2015 Q1 are expected to be similar to those recorded at end-2014, amid the forecasted increase in domestic demand and exports and the import content of the latter. Under these circumstances, the deviations

[30] The volume of construction works, the turnover volume of capital goods for the domestic market and the industrial output of capital goods rose by 2.2 percent, 9.9 percent and 2.9 percent respectively in January-February 2015 as against the previous quarter's average, whereas confidence in construction grew by 2.9 points in 2015 Q1 versus 2014 Q4.

[31] According to the Fiscal Strategy for 2015-2017, the share of investment spending in total budget expenditures is set to move ahead to about 18.5 percent in 2015-2017, due also to the co-financing of European projects, as compared with roughly 15 percent in 2013-2014.

[32] The average annual dynamics of gross fixed capital formation stood at -7.9 percent and -3.5 percent in 2013 and 2014 respectively. Among possible factors that hampered the investment recovery during that period were the infrastructure perceived as being low quality (see, for instance, the IMF opinions included in Country Report No. 15/80 – March 2015), the overlapping of some fiscal and budgetary measures (the introduction of the corporate tax on special constructions, the lowering of subsidies for renewable energy projects) and the uncertainties surrounding some external developments (the conflict between Russia and Ukraine), with a negative bearing on foreign direct investment.

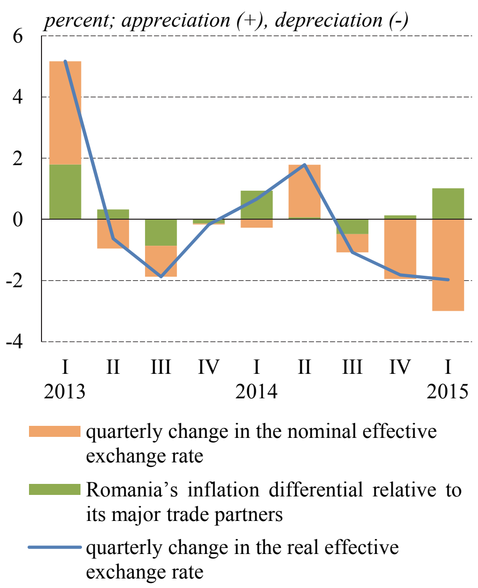
[33] In 2015 Q1, the economic sentiment indicator in the EU picked up 1.2 points as compared with 2014 Q4. In addition, the euro area industrial output increased by 0.7 percent in January-February 2015 versus the previous quarter's average.

from the medium-term trends are assessed to be further negative for exports and stay in positive territory in the case of imports.

The annual growth rate of exports is projected to stay positive over the forecast interval. However, export dynamics are anticipated to slow down as against 2013 and 2014[34], under the constraints of the still slow external demand recovery and the persistent geopolitical uncertainties, to which adds the assumption of normal agricultural years, with an impact on exports of agri-foodstuffs. Imports of goods and services are expected to see a substantial increase over the projection interval, being fostered by the rise in domestic demand, supported by the consolidation of final consumption and the rebound of gross fixed capital formation.

In 2014, the balance-of-payments current account deficit held a 0.4 percent share of nominal GDP, down from 2013, amid the surplus in trade in goods and services, which offset the slightly larger income deficit. 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. Hence, no significant corrective pressures are expected on the exchange rate of the domestic currency in the baseline scenario.

Quarterly Change in the Effective Exchange Rate



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

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 effect on wealth and balance sheets of economic agents[35].

In 2015 Q1, the average interest rates applied by credit institutions to the new time deposits and new loans of their non-bank clients decreased in nominal terms, also as a result of the time-propagated impulse sent by the monetary policy rate cuts. The drop in nominal interest rates is estimated to have been reflected into real rates almost entirely, given the relatively unchanged inflation expectations as

[34] In 2013 and 2014, exports of goods and services saw real annual increases of 16.2 percent and 8.1 percent respectively. The main subgroups that contributed to export growth are "machinery, apparatus, equipment and transport means" and "agri-foodstuffs". In the medium run, the persistent rise in exports of machinery and transport equipment is conditional upon factors such as the expansion of production capacity, the improvement in infrastructure, and external demand developments.

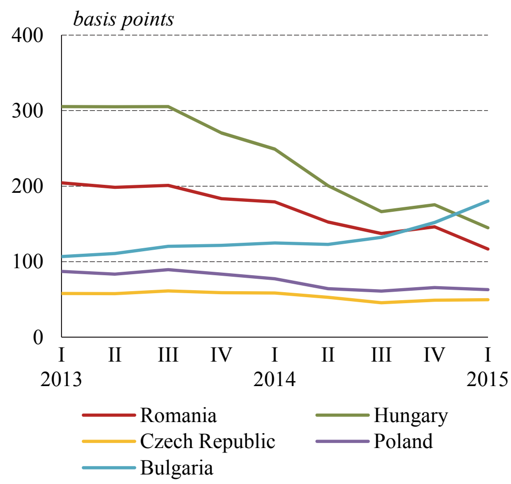
[35] For further details, see the monetary policy glossary available on the NBR website.

compared to the previous quarter. The cumulative impact on the economic activity in 2015 Q2 of the deviations of real interest rates from their trends is estimated to be slightly more stimulative.

In 2015 Q1 against 2014 Q4, the domestic currency depreciated in nominal effective terms, reflecting particularly the dynamics versus the US dollar. Given the negative contribution, albeit of a lower magnitude, of the inflation differential versus Romania's trade partners, the leu softened in real effective terms[36] as well. In this context, the impact of the real effective exchange rate on aggregate demand in 2015 Q2 via the net export channel is anticipated to be more stimulative.

In 2015 Q1, the downward path of CDS (Credit Default Swaps) quotes points to a lower sovereign risk. This is in line with regional developments[37], except for Bulgaria. The further negative deviation of the risk premium from the trend, together with the real foreign interest rate remaining below the equilibrium level, has stimulative effects on domestic demand. In terms of the wealth and balance sheet effect, these contributions are offset by the impact stemming from the anticipated real effective exchange rate developments. Thus, the wealth and balance sheet effect in 2015 Q1 has a relatively neutral influence on economic activity in the following quarter.

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



Source: NBR calculations based on Bloomberg data

Overall, real broad monetary conditions in 2015 Q1, with an impact on economic activity in the following quarter, are assessed to be stimulative, leading, ceteris paribus, to the mitigation of disinflationary pressures generated by the aggregate demand deficit. Looking at the structure of the real broad monetary conditions, the stimulative impact is exerted by all sub-components, except the wealth and balance sheet effect, which has a relatively neutral impact.

Real broad monetary conditions are forecasted to have a stimulative effect on economic activity[38] over the projection interval. The monetary policy rate path is configured in order to ensure price stability over the medium term, in line with the 2.5 percent ±1 percentage point flat target, thus helping pave the way for a recovery of lending and sustainable economic growth.

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

36 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.

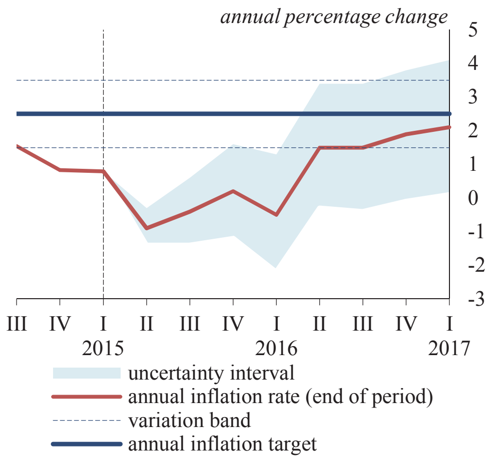
37 In the context of the positive sentiment induced by the quantitative easing measures adopted by the ECB at end-January 2015, as well as the alleviation of tensions that rocked the financial market in Russia at end-2014.

38 Compared to the previous round, real broad monetary conditions are more stimulative throughout the projection interval.

stimulative for aggregate demand. This adds to the impact exerted via the wealth and balance sheet effect, which is mainly the result of the projected favourable contributions from the foreign interest rate, reflecting the easing of the ECB's monetary policy stance. At the same time, the real effective exchange rate exerts, via the net export channel, a stimulative effect, albeit diminishing until the projection horizon.

1.4. Risks associated with 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

The balance of risks to the inflation path is assessed to be broadly in equilibrium in the short run, while medium-term uncertainties appear to tilt the balance to the downside at this horizon. The risks specific to the current round stem mostly from the domestic environment, with external factors remaining as relevant as in the previous forecasting rounds.

Over the reference interval, the external environment is still an important source of uncertainty amid the persistence of geopolitical instability (the conflict in Ukraine and the situation in Greece being the cases in point), as well as against the background of possibly diverging monetary policy stances of the world's major central banks in the context of the ECB implementing its expanded asset purchase programme[39]. Should the risks posed by any of these sources materialise, the Romanian economy could be hit by negative indirect effects considering the impact that such developments might have on the external demand from the EU, Romania's main trading partner. In addition, adverse consequences on investor confidence across financial markets in the region might bring about heightened volatility of capital flows channelled to these economies, Romania included. Such a context could result in fluctuations in the leu exchange rate that would alter the inflation path from that in the baseline scenario. Nevertheless, given the progress that Romania has made over the recent years in terms of strengthening sustainable macroeconomic fundamentals[40], investors' relatively lower exposure to the country than to other emerging economies implies a lower risk of an unfavourable impact following global or regional portfolio shifts.

On the domestic front, in view of the need to further increase the economy's capacity to mitigate adverse external shocks and

[39] The ECB gearing the monetary policy towards a persistently accommodative stance and anticipation of the Fed possibly abandoning this stance.

[40] For example, the Romanian authorities' commitment to implementing the set of structural reforms and measures agreed with the international institutions (the EU, the IMF and the World Bank), the consolidation of the visibility of Romanian assets in benchmark indices relevant to global investments, as well as the improvement in bank asset quality indicators following the clean-up measures aimed at removing non-performing loans from balance sheets, along with adequate bank prudential indicators (solvency, liquidity and provisioning).

to bring non-debt-generating capital flows into the country, the uncertainties on the consistent implementation of an adequate macroeconomic policy mix and the speeding up of structural reforms in accordance with the calendar agreed upon with the international institutions (the EU, the IMF and the World Bank) remain a matter of concern. A major source of risks associated with diverting from the current forecast coordinates refers to the implementation of the fiscal measures in the legislative proposal amending the Tax Code[41] submitted to the Parliament for debate and approval. On the date of completing the projection, given the uncertainties regarding the final set of fiscal measures and the calendar for their implementation, an assessment of the impact of these measures could not be included in the baseline scenario. An alternative scenario based on the assumption of the new Tax Code being passed as such by the Parliament shows a significant deviation of inflation rate from the path described in this Inflation Report, entailing a delayed return of the inflation rate inside the variation band of the target.

With regard to administered prices, the related uncertainties are associated, over the medium term, with the scale and timing of natural gas and electricity market deregulation stages in the context of possible changes to the information provided by the relevant authorities in Romania.

The evolution of domestic food prices is marked by inherent weather-related uncertainties, carrying the potential to influence the agricultural produce supply, as well as by the uncertainties surrounding the ex post assessment of the magnitude of the impact exerted by the fiscal measure on broadening the scope of the lower VAT rate as of June 2015.

The balance of risks stemming from international commodity prices is seen to be broadly in equilibrium, given that the risk associated with higher political instability, which could limit the expansion of the oil production or distribution capacity in the future, is counterbalanced by the risk of relatively low global demand. At the same time, the risk that the EUR/USD exchange rate developments may have unforeseen effects on the USD/RON exchange rate and, hence, on the oil price expressed in lei remains relevant.

[41] The main measures set forth by the Government Emergency Ordinance amending and supplementing Law No. 571/2003 on the Tax Code adopted on 7 April 2015 refer to: the cut in the standard VAT rate by 4 percentage points as of 1 January 2016 and by another 2 percentage points starting 1 January 2018; the reduction of excise duties on the main energy products in the CPI basket as of 1 January 2016; the reduction of excise duties on alcohol and alcoholic beverages as of 1 January 2016; changes to personal and corporate income tax and to the taxation of micro-enterprises; as well as the lowering of social security contribution rates as of 1 January 2018 or 1 January 2019.

2. Policy assessment

In line with the NBR's forecasts, in the first part of 2015 Q1, the annual inflation rate continued to fall deeper below the lower bound of the variation band of the flat target, in February reaching a new historical low in 25 years, i.e. 0.4 percent, before rising again in March to touch 0.79 percent. The configuration of the annual inflation rate path was mainly the result of the significant fluctuations posted over the quarter by the negative annual growth rates of fuel prices and volatile food prices, which eased towards the end of the interval, after taking a dip in January. Their influence was partly offset by the impact of the opposite, albeit less pronounced changes in the annual adjusted CORE2 inflation rate, chiefly reflecting the effects generated by the persistence of the negative output gap, the annual inflation rate remaining in/getting deeper into the negative territory in the euro area/the EU, as well as by the further downward adjustment in inflation expectations.

The updated projection of medium-term macroeconomic developments reveals, however, a significant change in the inflation outlook from that highlighted by the previous quarterly forecast[42], particularly on the first segment of the projection horizon, ascribable mainly to broadening the scope of the lower VAT rate to all food items, non-alcoholic beverages and public food services[43] as of 1 June 2015. Under the influence of the direct effect that this fiscal measure is expected to temporarily exert, the forecasted annual inflation rate falls steeply at end-Q2 to enter negative territory and stays therein for 12 months, except for December 2015, when it temporary climbs to 0.2 percent. Furthermore, the slightly upward path the inflation rate is seen embarking on subsequently – after the fading out of the impact generated by the pass-through of the VAT rate cut – stays at values considerably lower than previously forecasted and post a lasting return to the lower half of the variation band of the flat target no sooner than 2016 Q4 to reach 1.9 percent in December, amid the anticipation of lagged effects of the decline in food prices. In line with these developments, the average annual inflation rate is expected to fall to 0 percent and 0.8 percent respectively for 2015 and 2016 (from 0.8 percent and 2.3 percent in the previous projection).

42 February 2015 Inflation Report.

43 Following the implementation of this measure, the VAT rate goes down from 24 percent to 9 percent for those goods and services whose prices account for 81 percent of the prices of the "food items, non-alcoholic beverages and public food services" category in the CPI basket.

The envisaged VAT rate cut is likely to affect particularly[44] core inflation[45] via multiple channels, which causes the anticipated trajectory of the annual adjusted CORE2 inflation rate to be more strongly impacted by this measure, posting a far more substantial downward shift in the updated forecast; consequently, its falling into negative territory is deeper and more protracted than that recorded by the similar path of headline inflation, while its subsequent reversal to the previously-forecasted values is slightly more pronounced. Apart from the significant direct effect temporarily exerted by the VAT rate cut, the forecasted pattern of the adjusted CORE2 inflation also reflects the influence of the likely readjustment of near-term inflation expectations at lower values, as well as the impact of the reduction in the anticipated dynamics of import prices caused by the further downward revision of forecasted inflation in the euro area/EU, alongside the expected evolution of the leu exchange rate. All these prevent the opposite impact on the future core inflation behaviour exerted by the faster narrowing and then the closing of the anticipated negative output gap towards end-2016 from becoming more apparent. Underlying the expected developments of the output gap are the following assumptions: further stimulative real monetary conditions, associated with a relative improvement in the monetary policy transmission mechanism, the increase in household real disposable income, including as a result of the VAT rate cut for food items, the fiscal policy reverting to a slightly counter-cyclical stance, as well as the consolidation of economic recovery in the euro area/EU.

In this context, the adjustment of the monetary policy conduct with a view to ensuring price stability over the medium term, in a manner supportive of economic recovery while synchronising it with the monetary policy cycles of central banks in the region/euro area, is further conditional upon the characteristics of the fiscal policy, structural reforms and of EU fund raising. Pursuing and fulfilling the specific objectives agreed on with the EU, the IMF and the World Bank, and implicitly preserving the macroeconomic policy mix coherence and enhancing the growth potential of the economy, are of the essence for a sustainable and lasting economic growth. From this standpoint, the uncertainties and risks related to the future fiscal policy stance and to the medium-term inflation outlook

[44] The direct impact of this measure is even more strongly felt by the VFE component, its contribution to the change in the headline inflation outlook being, however, considerably lower, given its significantly smaller share in the CPI basket.

[45] Also as a result of the large share (about 42 percent) held in the adjusted CORE2 index by the prices of goods and services to be affected by the VAT rate cut.

arising from the recently finalised draft of the new Tax Code[46] become particularly relevant, as they add to the high uncertainty already surrounding the updated macroeconomic forecast, given that the size and duration of the direct and indirect effects expected to be generated by the VAT rate cut, as of 1 June, on the inflation evolution – possibly via short-term inflation expectations, too – are difficult to foresee and consequently uncertain. The likelihood that medium-term inflation expectations may be affected by this measure is, however, very low – even if its implementation follows/overlaps with previous supply-side shocks[47] – given mainly the temporary nature of the slip of annual inflation rate into negative territory, the moderate pass-through expected at the CPI level, the recent step-up in wage growth and the prospects for its consolidation, also amid the gradual hike in the gross minimum wage economy-wide, as well as the ongoing change in the economy's cyclical position.

The external environment continues to generate uncertainty and two-way risks to the inflation outlook that carry, in the assumption of their materialisation, a relatively subdued potential to affect medium-term inflation expectations in a lasting manner, and implicitly the inflation developments in the longer run. In the current context, the main sources of such risks and uncertainties are further the situation in Greece, the conflict in Ukraine, and the expected growing divergence between the monetary policy stances of the world's major central banks, which, by influencing the global risk appetite and investors' perception of the risk associated with the Romanian economy and financial market, might entail larger upward/downward fluctuations in the exchange rate of the domestic currency and hence 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 evolution of Romania's exports and import prices – as well as changes in the behaviour of capital flows to the Romanian economy. These developments would affect[48]

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[46] The initial draft of the new Tax Code contains multiple fiscal easing measures, the most significant including: (i) the cut in the standard VAT rate by 4 percentage points as of 1 January 2016 and by another 2 percentage points starting 1 January 2018; (ii) the diminution of excise duties on the main energy products as of 1 January 2016; (iii) the reduction of excise duties on alcohol and alcoholic beverages, as well as the removal of the excise on coffee as of 1 January 2016; (iv) the elimination of the tax on special constructions as of 1 January 2016; (v) the cut in the personal and corporate income tax as of 1 January 2019; (vi) the lowering of the social security contribution rates for both employees and employers as of 1 January 2018.

[47] The steep decline in the international oil price and the relative pick-up in the supply of agricultural produce on account of the good output obtained domestically and across the region in 2014.

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

the dynamics of the narrowing of the negative output gap and the magnitude of its disinflationary pressures.

Another source of uncertainty and two-way risks to the inflation outlook is further the future evolution of the international oil price, which can have significant divergent effects on the national economy, especially on different time horizons. Thus, a potentially weaker-than-projected oil price evolution, possibly along with a lower-than-expected appreciation of the US dollar[49], would enhance the deflationary/disinflationary influence of the domestic fuel price and other imports in the short run, but also speed up the fading of disinflationary pressures exerted by the negative output gap over a longer time horizon, by spurring both domestic demand – through producer costs and household real disposable income – and external demand for Romanian products; a higher-than-expected rise in the latter might also stem from a more vigorous recovery of the European economies amid the monetary policy measures implemented by the ECB and the accumulated depreciation of the euro against the US dollar.

The domestic environment continues to generate mixed risks to the future inflation dynamics, against the background of persistent uncertainties surrounding the implementation of the structural reforms agreed on with the EU, the IMF and the World Bank, which may affect foreign investors' perception of the risk associated with the Romanian economy and financial market, and implicitly the leu exchange rate behaviour; adding to these are the uncertainties on the size and pace of administered price adjustments, as well as the future evolution of volatile food prices, yet the temporary deviations from the forecasted coordinates that the inflation dynamics might witness in this case are unlikely to affect inflation expectations in the longer run.

Considering the prospects for the annual inflation rate slipping temporarily into negative territory and staying, once the impact of broadening the scope of the lower VAT rate has faded out, below the midpoint of the flat target, amid the gradual narrowing of the negative output gap, and further low inflation expectations and subdued euro area inflation, the Board of the National Bank of Romania has decided in its meeting of 6 May 2015 to lower the monetary policy rate by 25 basis points to 1.75 percent per annum. At the same time, in order to mitigate interbank money market rate volatility and consolidate the transmission of the policy rate signal, the NBR Board has decided to narrow the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate to ±1.50 percentage points from ±1.75 percentage points; hence, the interest rate on the NBR's lending facility has been lowered to an annual 3.25 percent, from 3.75 percent, while the deposit facility

49 In relation to the European currency.

rate has been left at 0.25 percent per annum. Moreover, with a view to fostering the revival of lending and continuing the harmonisation of the reserve requirements mechanism with the European Central Bank standards, the NBR Board has decided to cut the minimum reserve requirements ratio on leu-denominated liabilities of credit institutions to 8 percent, from 10 percent, starting with the 24 May-23 June 2015 maintenance period. The NBR Board has also decided to keep unchanged the minimum reserve requirements ratio on credit institutions' foreign exchange-denominated liabilities and to pursue adequate liquidity management in the banking system.