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N O T E

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Some of the data are still provisional and will be updated as appropriate in the subsequent issues.

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Foreword

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

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

Inflation Report was completed on 7 November 2005 and approved by the NBR Board in its meeting of 9 November 2005.

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

ABBREVIATIONS

AMIGO	Household Labour Force Survey
ANRE	Romanian Electricity and Heating Regulatory Authority
ANRGN	National Authority for Regulation in Natural Gas Sector
CPI	Consumer Price Index
ECB	European Central Bank
EIA	Energy Information Administration (within the U.S. Department of Energy)
EU	European Union
EUROSTAT	Statistical Office of the European Communities
GCF	Gross Capital Formation
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IFS	International Financial Statistics
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
OPEC	Organisation of Petroleum Exporting Countries
ULC	unit labour cost
1W	one week
12M	12 months

Contents

I. SUMMARY

In 2005 Q3, disinflation resumed, mainly as a result of slower increase in administered prices and stronger nominal appreciation of the domestic currency against the euro. The average annual inflation rate dropped one percentage point over the previous quarter to 8.9 percent, falling back into the target band (see Chart on next page). Consumer price growth deceleration was, however, still impeded by the movements in prices of oil and of some vegetal products, as well as by pressures arising from the persistence of rapid growth in aggregate demand.

Excess demand shrank slightly in 2005 Q2, given that GDP growth slowed to 4.1 percent, compared with 5.9 percent in Q1, due mostly to the larger negative contribution of net exports. On the other hand, domestic absorption dynamics stayed high (10.2 percent), as both household consumption of goods and services and investment posted significantly faster annual growth rates than in the previous quarter. Their expansion was mainly driven by the stepped-up growth of disposable income and private-sector indebtedness, with the latter being fostered by favorable access conditions to alternative sources of bank and non-bank financing.

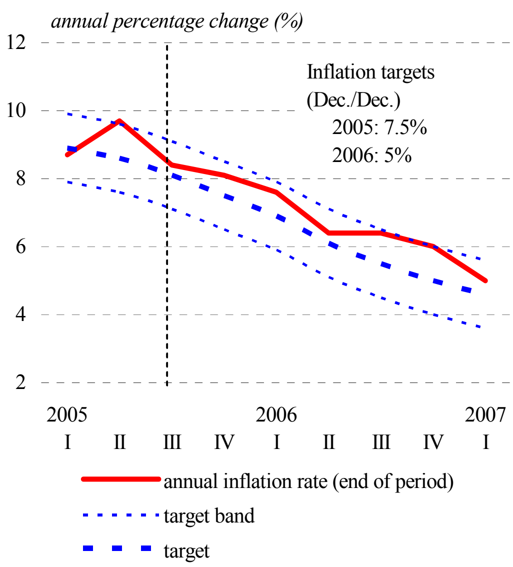
The third quarter of 2005 was a special period for the National Bank of Romania as regards the monetary policy strategy and tactics. In August, the NBR shifted formally to inflation targeting, the adoption of which had been prepared during the past 16 months. Also in view of this change, the response of monetary policy played an important role given the challenging macroeconomic conditions, as the National Bank of Romania had to deal with the still overly rapid growth rate of domestic demand, on the one hand, and the impact of the strong resurgence in speculative capital inflows on the domestic financial market, as well as with the risk of an increase in such inflows, on the other. The central bank undertook strenuous efforts to reconcile the need of minimizing this threat in the short term with the goal of ensuring sustainable disinflation in the medium and long run. For this purpose, the National Bank of Romania adopted and implemented an adequate mix of monetary policy, prudential, as well as some administrative measures, the last two categories being meant to preserve financial stability and enhance the effectiveness of monetary policy instruments with a view to maintaining a stable aggregate price level. Moreover, the monetary authority was particularly interested in strengthening its credibility by ensuring that the inflation target is met; consequently, it deemed necessary to revise the year-end inflation target to 7.5 percent as a result of considerably stronger-than-expected pressure on the aggregate price level coming from some supply-side factors.

The major constraints on monetary policy were best reflected by the double shift in the conduct of interest rate policy in only three months. Interest rate policy, mainly geared towards preventing the economy from overheating, was tightened in early August by raising the average effective interest rate on sterilization operations to 8.5 percent and by eliminating the departure between the policy rate and the average effective sterilization rate. However, shortly thereafter, under the impact of the severe constraint exerted by higher capital inflows, the National Bank of Romania Board decided to gradually ease interest rate tightness. The relative easing of interest rate policy was achieved by the NBR's loosening control over liquidity by initiating partial sterilization of the liquidity surplus via deposit-taking operations rather than through cuts in its key interest rates, given the signaling effect of the policy interest rate. Behind this initiative stood the following: (i) the assumption that turning the liquidity surplus into a catalyst for demand growth is a difficult process and (ii) the fact that the monetary authority stands ready to revert to higher sterilization and resort to the policy rate lever in case of a prospective upsurge in RON-denominated credit. In order to put a brake on credit growth, foreign exchange credit in particular, the central bank tightened reserve requirements for foreign exchange liabilities of credit institutions, adopted tougher requirements on bank credit to households and took measures to restrain banks' supply of foreign exchange-denominated loans. In this context, the broadly-defined monetary conditions, including the developments in interest rates, exchange rate of the domestic currency and liquidity across the economy, have remained on course to achieve continuation of disinflation in line with the programmed trend.

According to the baseline scenario of the forecast on macroeconomic developments, the annual inflation rate is expected to range between 8.1 percent and 8.3 percent; the fact that this forecast is higher than the 7.5-8 percent band forecasted in the Inflation Report issued in August 2005 is attributed to the upward revision of oil and food prices, as well as of the exchange rate of the domestic currency. Disinflation will continue in 2006, largely as a result of gradual reduction in excess demand – assuming increasingly austere fiscal and income policies, as well as monetary policy tightening – and of further favorable effects of developments in the exchange rate of the domestic currency on import prices. Should the necessary adjustment of fiscal and income policy stance not be performed, monetary policy would have to react more decisively, facing however the constraint arising from the risk of a rebound in speculative capital inflows. Even assuming the implementation of an adequate macroeconomic policy mix, the achievement of administered price adjustments as projected and the temporary slowdown (in the first few months of next year) in the decline of inflation expectations are likely to take end-2006 inflation rate close to the upper bound of the target band.

The NBR Board made an in-depth assessment of the current and future economic developments, as well as of the ensuing risks from the perspective of attaining the inflation target and sustaining disinflation in the medium-term, and inferred that the conflicting nature of the challenges the central bank must deal with will likely persist during the current period. Nevertheless, the Board found that the relevance of the risk of increased speculative capital inflows is offset by the stronger threat, in the short term at least, of exacerbating demand-side inflationary pressures. Consequently, the NBR Board decided to keep the policy rate at 7.5 percent and significantly increase the volume of liquidity-absorbing operations. Furthermore, the National Bank of Romania Board decided to remain vigilant and closely monitor any developments that might affect the future path of disinflation, standing ready to take prompt remedial measures.

Inflation Forecast



Note: ±1 percentage point around the (dis)inflation path

II. INFLATION DEVELOPMENTS

As expected, disinflation resumed in 2005 Q3. The average annual growth rate of consumer prices dropped one percentage point from the previous quarter to 8.9 percent, falling back into the National Bank of Romania's target band. Behind this development stood the alleviation of some supply-side shocks that were manifest in 2005 Q2, whereas robust demand depressed disinflation, the same as in the prior quarter.

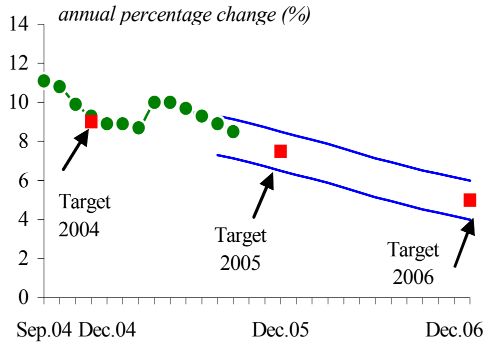
The resumption of disinflation was buttressed chiefly by the following:

(i) less strong direct and second-round effects of the change in administered prices, which fell to 12.5 percent[1], from 14.3 percent in 2005 Q2, following the smaller adjustment of electricity price and cheaper medicines and telephony prices. As regards the former item, the explanation lies with the lower production costs due to the increase in the weight of hydroelectric power to the detriment of costlier thermoelectric power; as for the latter items, nominal strengthening of the *leu* played the key role – in addition, it should be pointed out that the Ministry of Health[2] decided to contain the gross margin, distribution margin and the margin related to additional import services, and to remove the depreciation margin included in the former calculation of medicines prices;

(ii) faster nominal strengthening of the *leu* against the euro, which overlapped in 2005 Q2 the favourable developments in external prices for non-durables and completely offset the quicker rise in both durables and non-durables prices during 2005 Q3; aside from the direct impact induced via import prices, this factor also spurred competition between Romanian-made products and competitive imports;

(iii) cut in prices for milling and bakery products, as the grain reserves of 2004 were sufficient to stem inflationary pressures that could have been generated by the decline and weak quality of 2005 crops.

Inflation Developments



Note: ±1 percentage point around the (dis)inflation path

Source: NIS, NBR calculations

Administered Prices versus Market Prices

annual percentage change (%)

	2004		2005		
	III	**IV**	**I**	**II**	**III**
Inflation Rate	**11.9**	**10.0**	**8.8**	**9.9**	**8.9**
Administered prices	**17.9**	**11.2**	**10.8**	**14.3**	**12.5**
1. Non-food items:	**17.2**	**12.1**	**12.0**	**16.5**	**14.7**
electricity	30.7	17.7	12.5	12.5	9.6
heating	0.0	10.4	12.0	12.0	12.0
natural gas	36.1	22.2	21.6	45.2	45.3
medicines	-6.6	–6.9	1.4	1.0	–1.3
2. Services, of which:	**18.2**	**9.8**	**8.9**	**11.0**	**9.1**
water, sewerage, refuse collection	23.2	23.4	22.4	27.8	27.4
telephony	15.4	–0.1	3.1	4.3	–1.0
passenger railway transport	17.5	19.2	14.6	12.0	9.9
(passenger) city transport	16.4	17.0	16.3	21.0	25.9
Market prices (CORE1)	**10.1**	**9.5**	**8.2**	**8.5**	**7.8**

Source: NIS, NBR calculations

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[1] Unless otherwise indicated, the growth rates in this section are annual percentage changes.
[2] Order No. 924 of 31 August 2005.

CPI by Category of Products

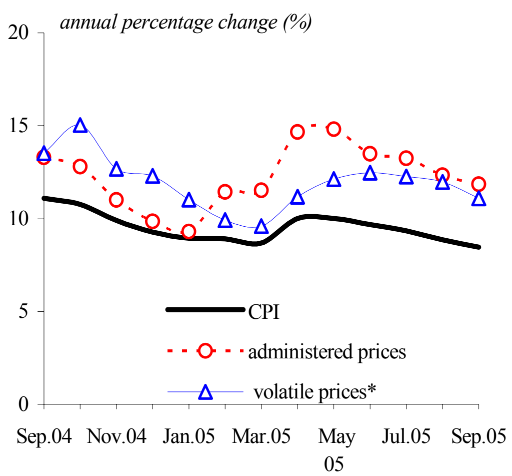
annual percentage change (%)

	2004		2005		
	III	IV	I	II	III
Food, beverages, tobacco	11.4	9.8	8.1	8.0	6.8
Wearing apparel and footwear	7.2	6.0	5.5	4.9	4.2
Household appliances, furniture	7.0	6.7	6.5	6.0	5.0
Fuels	15.6	20.1	15.8	18.3	16.9
Utility expenses*	23.2	18.4	16.5	23.0	21.8
Healthcare	1.7	0.9	4.9	4.5	3.0
Transport	15.2	15.8	15.3	19.0	21.2
Post and telecoms	14.2	1.0	-0.7	-0.4	-2.3
Leisure and culture	10.9	8.7	8.5	7.5	7.5
Other goods and services	6.3	6.6	6.9	6.3	5.2

*rent, water, sewerage, refuse collection, electricity, heating, gas

Source: NIS, NBR calculations

Inflation Rate



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

Source: NIS, NBR calculations

The same as in 2005 Q2, the pressures engendered by the developments in industrial producer prices for the domestic market abated, with the growth rate of manufacturing prices being only 0.9 percentage points above the change in consumer prices for July-August 2005. Among the determinants were further (i) the faster nominal strengthening of the *leu* against the euro, (ii) larger exposure of the productive sector to external competition and retail sector competition, and (iii) favourable cost developments relative to some non-energy raw materials. The same as in the previous quarter, ULC growth accelerated in the first two months of 2005 Q3 by another 2.4 percentage points to reach 13.7 percent, against the backdrop of faster increase in gross wage and further declining productivity gains. Among the manufacturing sub-sectors having a direct impact on consumer prices, significant pressures were generated only by light industry[3], while food and tobacco-processing industries saw ULC growth rates below the previous quarter's level (and lower than the average recorded across manufacturing). The two sub-sectors of the energy sector – i.e. electricity production and distribution, and water collection, treatment and distribution – posted higher ULC growth rates (up by some 10 percentage points to 40 percent); these developments can be ascribed to the absence of any measures whatsoever to cut payrolls or cap wage increases following the considerable retrenchment of activity.

Volatile prices still had a negative bearing on disinflation. They went up at a rate (12.7 percent) slightly faster than in the previous 3-month period, with the sharper pick-up in vegetables prices prompted by weak output as a result of adverse weather conditions offsetting both the slowdown in the increase of fuel and fruit prices and the cheaper eggs. Special mention deserves the fact that, despite the 1.4 percentage point slowdown in 2005 Q3, the growth rate of fuel prices was 8 percentage points above average, putting further pressure on consumer prices.

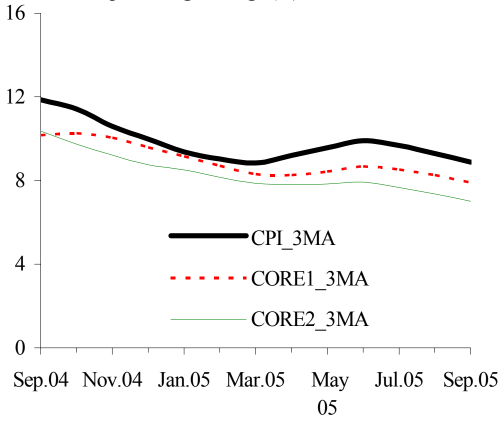
Over the period, the occurrence of several one-off factors – above all, the dampening impact of widespread floods – stymied the reoccurrence of upswings in households' goods and services purchases; this could be put down on supply-side constraints rather than the slower rise in consumer demand. Against the background of larger incomes and readily-available bank and non-bank financing, consumer demand remained robust, creating favourable conditions for the tensions induced by staff and material costs to feed through into prices (the growth rate of administered prices, albeit slower, was much higher than inflation rate, whereas ULC in industry further worsened). At aggregate level, the output gap[4] was further

[3] In textiles and wearing apparel industries, ULC growth rate stepped up 2 to 3 percentage points; in leather and leather products industry, the growth rate remained above 30 percent, the sizeable deceleration notwithstanding.
[4] Based on quarterly changes.

positive, hinting at persistent excess demand; nevertheless, CORE2[5] inflation, after having stagnated in 2005 Q2, shrank 0.9 percentage points[6], which leads to the conclusion that this development was mainly underpinned by the sharper nominal strengthening of the *leu* against the euro and the heightening of domestic and international competition both in the trade and the productive sectors.

Trend* in Inflation Rate

annual percentage change (%)



*) compiled on a 3-month moving-average basis
CORE1 (which strips out administered prices)
CORE2 (which strips out administered and volatile prices)

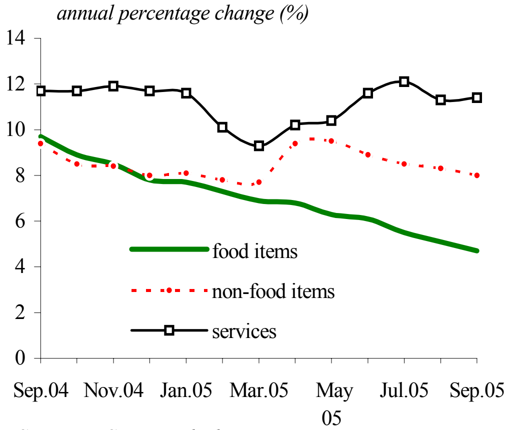
Source: NIS, NBR calculations

CORE2 disinflation can solely be attributed to the developments in food and non-food prices, whereas the growth rate of market prices for services quickened by almost one percentage point, most notably as a result of lacking constraints from external competition and, consequently, larger second-round effects of higher administered prices and costlier fuel. Even though the prices of the two groups of goods posted comparable disinflation rates – the growth rate of food prices was far below average, whilst that of non-food prices was above average because of the hike in excise duties levied on tobacco and cigarettes in April.

In 2005 Q3, annual inflation rate surpassed by 0.3 percentage points the short-term inflation forecast prepared in June. The deviation owed much to the larger-than-expected increase in fuel prices, given that (i) one of the main assumptions underlying the baseline scenario for this exogenous variable envisaged lower pressures from harmonisation with the European market since the levels attained at end-June were already comparable with those in half of EU25[7] Member States and (ii) domestic producers and distributors proved exceedingly sensitive to the soaring oil price on world markets. In addition, the impact of multiple floods on vegetables supply was underestimated, pay rises exceeded expectations, and the use of monthly rates of increase in prices entailed some aggregation-related drawbacks (calculations should rely on fixed-base indices of CPI components, which are not yet disseminated by the NIS).

CORE2 by Group of Commodities

annual percentage change (%)



Source: NIS, NBR calculations

Opposite influences were exerted by the discrepancies between actual and forecast levels of RON/EUR and RON/USD exchange rates, i.e. larger-than-expected nominal appreciation year on year. This was the key reason behind the smaller-than-forecasted change in administered prices (by 1.5 percentage points, owing to medicines and telephony prices); furthermore, the July advance in natural gas prices (7.5 percent) was below the 10.2 percent average announced by the National Regulatory Authority in Natural Gas Sector and medicines prices dropped also as a result of the Ministry of Health's decision in late August 2005.

[5] By stripping out administered and volatile prices (the latter refer to fruit, vegetables, eggs and fuels).
[6] Compared with the previous quarter.
[7] The new Member States (except Hungary), Greece, Ireland, Luxembourg, Spain.

III. ECONOMIC DEVELOPMENTS

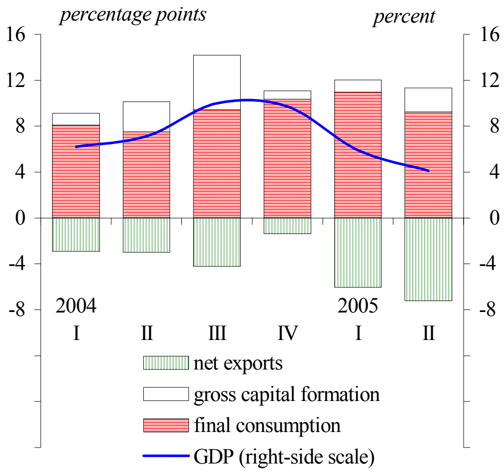
1. Demand and supply

In 2005 Q2, real GDP rose by 4.1 percent[8], its annual growth rate further slowing against the previous quarter (by 1.8 percentage points). Output gap remained positive, even though it narrowed from the previous quarter.

On the supply side, the grim performance of agriculture was still the main reason behind the slowdown in economic growth in 2005 Q2. The one-off impact of this sector left aside, the GDP rate of increase dropped by merely 0.7 percentage points. Behind this stood the sharper slowdown in industrial output, whereas the annual growth rate of gross value added accelerated (only marginally) in services and construction sectors.

1.1. Demand

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

Consumption remained the fastest growing component of domestic demand. The rebound in investment however caused the gap between the growth rates of gross fixed capital formation and final consumption to narrow to 1.5 percentage points from 6.9 percentage points in 2005 Q1. On the other hand, the contribution of exports to the economic expansion continued to narrow (their annual growth rate touched 3.3 percent in 2005 Q2, the lowest in the last 13 quarters); against the backdrop of still fast-paced imports (16.1 percent), the negative contribution of net external demand to GDP growth added 1.2 percentage points to 7.2 percentage points, standing at a 7-year high (quarterly figures).

1.1.1. Consumer demand

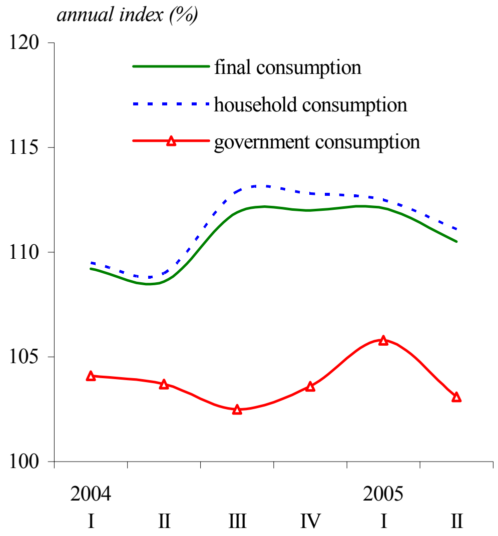
The growth rate of final consumption remained fast at 10.5 percent, albeit sliding 1.5 percentage points below the average for the past three quarters, hinting at the persistent potential inflationary pressures. Household purchases of goods and services gathered pace against the preceding quarter, the slowdown in consumer demand being largely caused by the decline in self-consumption (due to poor harvest) and the base effect manifest at the level of government consumption in view of the organisation of local elections in the same year-ago period.

[8] Unless otherwise indicated, the growth rates in this section are annual percentage changes.

Household consumer demand

Behind the robust 11.1 percent rise in household actual final consumption stood chiefly the goods and services purchases, the annual growth rate of which added 4.9 percentage points on the previous quarter to 20.8 percent. The strong increase in consumer demand was mainly underpinned by further high growth rates of household incomes[9] and readily-available financing through both banks[10] and non-banks (car leasing sales, consumer loans granted by specialised companies via partnerships concluded with household appliances retail networks). Moreover, higher households' consumption propensity was spurred by the lower attractiveness of the major saving instruments, i.e. bank deposits and government securities, their annual growth rate decelerating to 4.9 percent, from 10.3 percent in the prior quarter – a possible cause for this performance could have been the shift to investments in movable and immovable assets.

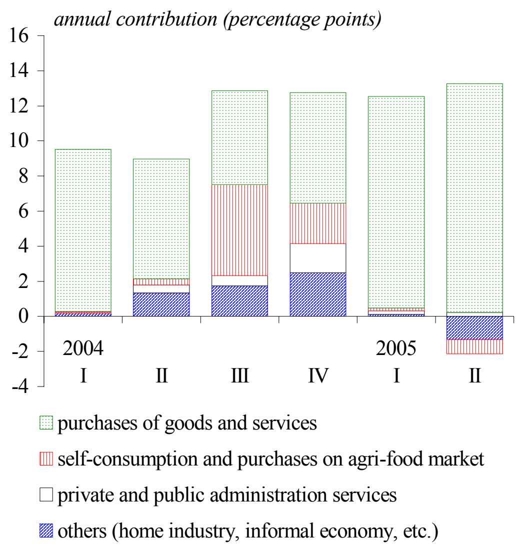
Actual Final Consumption



Source: NIS

Structural analysis of consumer demand underscores the higher propensity for purchases of durables (sales thereof grew at an annual rate of nearly 28 percent, more than 12 percentage points higher than in the previous quarter), propelled by "IT&C" and "motorcars" (car sales were also fostered by the implementation of the nationwide programme to renew the fleet of vehicles, which included the granting of the scrap premium). Sales of non-durables continued to expand at a rapid pace (almost 22 percent versus 2004 Q2), although their growth slackened somewhat compared with 2005 Q1, due primarily to sales of foodstuffs and pharmaceuticals.

Household Final Consumption Growth



Source: NIS, NBR calculations

Nevertheless, the acceleration of household purchases of goods failed to bring about an expansion in domestic production. Actually, slower growth was recorded by durables (including transport means[11], although their growth rate remained strong at about 39 percent), while non-durables saw negative growth year on year. Therefore, it may be asserted that in order to meet the strong consumer demand imports were more heavily resorted to, being fostered by further nominal strengthening of the RON and the positive performance of external prices for some goods included in this category (annual growth of prices for non-durables exported by EU25 Member States slowed slightly from 2005 Q1).

[9] In 2005 Q2, real growth rate of whole-economy net average wage stayed at the previous quarter's level, i.e. 13 percent, while that of inflows of residents' remittances and private current transfers accelerated to 16.9 percent (against 5.8 percent in 2005 Q1).

[10] Over the period, the balance on consumer loans rose gradually (by 61.5 percent in real terms, compared with an annual growth of 39.3 percent in the previous quarter).

[11] This category also includes auto vehicles that are considered as corporate and public investment and belong to gross fixed capital formation, according to National Accounts methodology.

Government consumer demand

Over the reported period, the slowdown in total final consumption was also attributed to the deceleration of growth in general government actual final consumption (3.1 percent against 5.8 percent in 2005 Q1) probably as a result of the base effect, namely the local elections organised in 2004 Q2.

Budgetary developments

In 2005 Q2, the consolidated general government budget showed a surplus of 0.2 percent of GDP as compared with a deficit of 0.5 percent of GDP in the same year-ago period, which was indicative of a drop in the growth rate of general government actual final consumption and of a possible decline in public spending for investment. In year-on-year comparison, the consolidated budget primary balance improved significantly, the 0.1 percent of GDP deficit turning into a 0.7 percent of GDP surplus. These developments were largely attributed to the narrower share of budget expenditures in GDP (from 7.7 percent to 7.2 percent of GDP year on year), as well as to the increase in budget revenues (from 7.1 percent to 7.4 percent of GDP year on year).

The rise in budget revenues was mainly due to: VAT receipts (up 0.3 percentage points of GDP on the back of higher turnover of retail trade of goods and services) and (ii) receipts from social security contributions (up 0.2 percentage points of GDP owing to wage hikes and larger number of payrolls). The step-up in such revenues offset entirely the contraction in receipts from income tax and profit tax (down 0.2 percentage points and 0.02 percentage points of GDP respectively), caused by the introduction of the 16 percent flat tax rate.

Conversely, the weights in GDP of most categories of consolidated general government budget expenditures shrank compared with 2004 Q2, except for staff costs, whose share in GDP widened by 0.1 percentage points following the rise in the wages of public sector employees at the end of 2004 and at the beginning of 2005. Capital expenditures posted the steepest decline (0.3 percentage points of GDP), ahead of subsidies and material expenditures which went down 0.2 percentage points and 0.1 percentage points of GDP respectively; capital expenditures and subsidies posted lower year-on-year levels even in absolute terms.

A second budget revision was made in July, when the fiscal deficit target for 2005 was raised from 0.74 percent to 1 percent of GDP, as a result of the increase by nearly RON 1,017 million (almost 0.4 percent of GDP) in the budget reserve fund of the government earmarked for covering part of the flood damages.

The pick-up in budget expenditures was envisaged to be partly offset by the rise in budget revenues (RON 300 million) owing to collections from profit tax and value added tax.

1.1.2. Investment demand

In 2005 Q2, the growth rate of gross fixed capital formation accelerated to 9 percent, up 3.8 percentage points over the previous quarter, boosted by new construction works (6.7 percent) amid the rebound in residential works as well as by farm investment (6.6 percent).

As for investment in equipment (transport means included), the slowdown in own resources given the sluggishness of industrial production (whose growth rate decelerated from 7.8 percent in 2004 Q4 to barely 0.7 percent in 2005 Q1) contained investment growth economy-wide. The impact of this development was only partially offset by the readily-available bank loans (lower interest rates coupled with the stronger domestic currency) and further development of leasing[12]. Hence, equipment purchase, albeit the fastest expanding component of investment spending (8.5 percent), was still below the average growth rate recorded in the period prior to the investment boom of 2004 Q2 and Q3[13], whilst capital repair dropped roughly 3 percent year over year.

As for capital investment, imports had generally a more substantial contribution to meeting excess demand both for purchases destined to retooling (given the drop in domestic output of most products) and transport means purchases. As far as the latter is concerned, two segments of domestic supply, i.e. "commercial vehicles" and "transport means other than land vehicles", reacted positively to the step-up in investment demand, although their growth rates were lower than the rate of increase of imports. Furthermore, output of motorcars for the domestic market further rose at a robust pace (nearly 68 percent, according to data released by the Automotive Manufacturers and Importers Association).

1.1.3. Net external demand

The negative contribution of net external demand to GDP growth seen in the last two years continued to increase, from -6 percentage points in 2005 Q1 to -7.2 percentage points in 2005

Investment

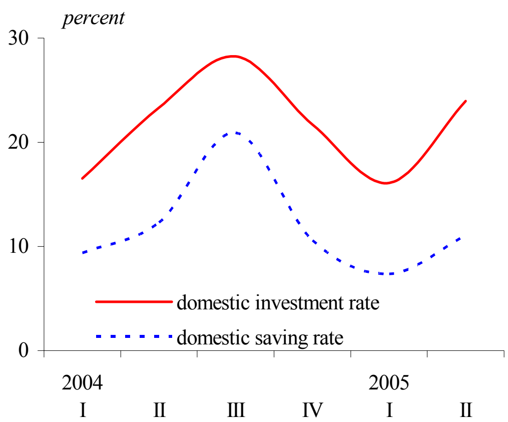
annual percentage change (%)

	Year	I	II	III	IV
Total	2004	7.2	12.0	18.1	1.7
	2005	5.8	7.6		
- new construction works	2004	7.6	9.6	13.3	6.9
	2005	2.2	6.7		
- equipment	2004	14.9	26.4	38.4	5.5
	2005	9.6	8.5		
- others*	2004	–30.7	–40.2	–38.8	–37.6
	2005	–4.9	6.6		

* vineyards, orchards, afforestations, livestock purchases

Source: NIS

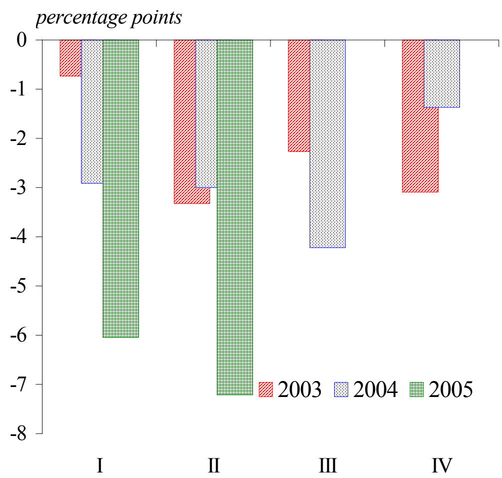
Investment Rate and Saving Rate



Note: domestic investment rate is the ratio between gross capital formation and GDP; domestic saving rate is the difference between GDP and final consumption as a share of GDP

Source: NIS, NBR calculations

External Demand Contribution to GDP Growth



Source: NIS

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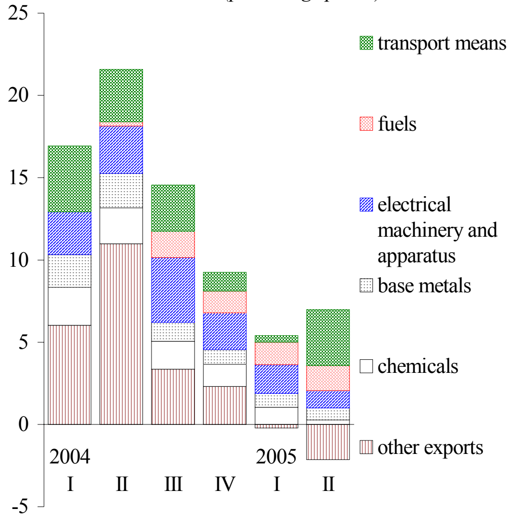
[12] According to data released by the Association of Leasing Companies of Romania, leasing agreements signed in 2005 H1 neared EUR 1 billion, accounting for more than 60 percent of the 2004 figure. However, industrial and farm equipment purchases constituted only 6 percent of the total, as auto vehicles purchases held an overwhelming share of nearly 90 percent of total, of which motorcars made up three fourths.

[13] Quarterly growth rates averaged 12 percent during January 2003 – March 2004.

Dynamics of Export Physical Volume

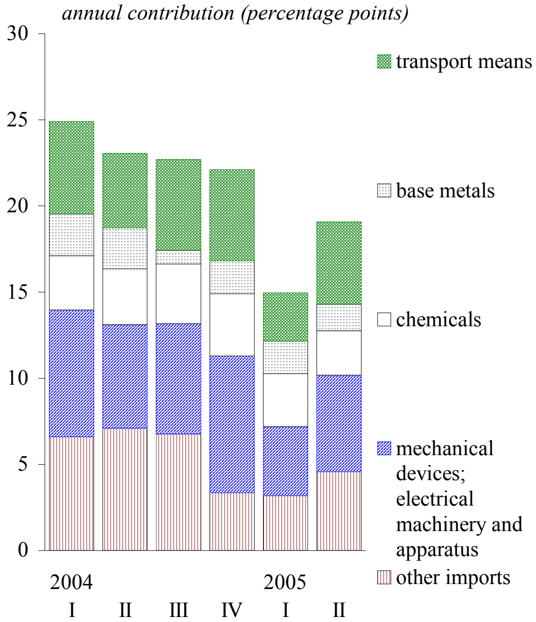
annual contribution (percentage points)



Source: NIS, NBR calculations

Dynamics of Import Physical Volume

annual contribution (percentage points)



Source: NIS, NBR calculations

Q2. However, the development was not attributable to the faster pace of increase of imports but rather to the slowdown in the annual growth rate of exports to barely 3.3 percent, due mainly to the base effect[14]; on the contrary, quarter-on-quarter developments hint at an upturn in exports, given that the volume of exports of goods and services (+4.5 percent) exceeded by far that recorded in the first quarter (0.6 percent)[15].

In year-on-year comparison, the performance of exports worsened on the background of (i) lower competitiveness of domestic producers and stiffer foreign competition (light industry is a case in point), which led to a fall in the physical volume of Romanian exports to the EU, from 102.8 percent in 2005 Q1 to 96 percent in 2005 Q2, in spite of the rise in EU demand for imports and (ii) fading effects of the previously favourable international conditions (metallurgy and chemicals).

The pick-up in the physical volume of exports[16] compared to the same year-ago period was generated by only five industries: road transport means, oil processing, electrical machinery and apparatus, metallurgy and chemicals[17] (the contributions made by the last two were significantly lower than the quarterly readings of the last two years, falling below one percentage point).

As for imports of goods and services, their annual volume index remained high in 2005 Q2, albeit slightly on the wane versus the previous quarter, from 118.4 percent to 116.1 percent, as a result of the base effect and the slowdown seen in the considered period[18]. Changes in the physical volume of transport means and materials (primarily motorcars), mechanical devices, chemicals, electrical machinery and apparatus, and base metals accounted for more than 75 percent of the annual change in the physical volume of imports of goods.

1.2. Supply

The same as in the first 3-month period of 2005, in Q2, agriculture was the main culprit for the slowdown in economic growth, as losses caused by adverse weather conditions led to a 10.4 percent drop in the sector's gross value added.

[14] In 2004 Q2, exports of goods and services rose at an annual pace of 24.6 percent, i.e. one of the fastest rates in the past 7 years.

[15] Seasonally-adjusted quarterly changes (NBR calculations).

[16] $\Delta_{pv}=(I_v / I_{uv}) \times 100 - 100$, where Δ_{pv} = physical volume change, I_v = value index, I_{uv} = unit value index; calculations based on trade balance data.

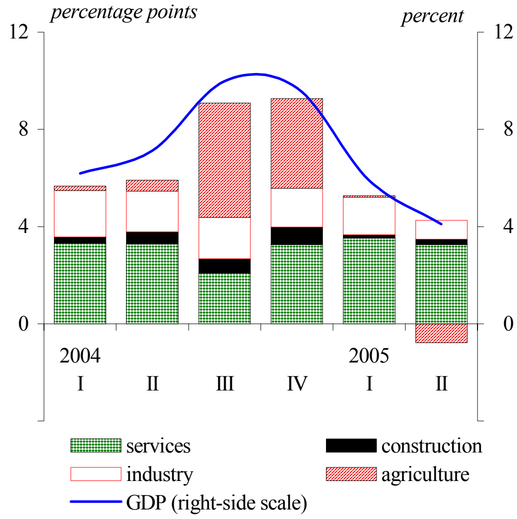
[17] Including rubber and plastic products industries.

[18] -1.5 percentage points compared with Q1 to 6.8 percent (seasonally-adjusted quarterly change; NBR calculations).

In industry, the growth rate slowed down markedly to 2.6 percent, i.e. almost half the rate of increase in the first quarter. The slackening may be the result of (i) flagging external demand for some products holding a significant share in Romanian exports (for the aforementioned reasons); (ii) stiffer competition from imports, fuelled by the further nominal strengthening of the domestic currency against the major currencies; (iii) build-up of stocks of finished goods in manufacturing.

In construction and services, gross value added stepped up 4 percent and 7.1 percent respectively, these annual growth rates being only 0.2-0.3 percentage points higher than in 2005 Q1. In construction, the performance was underpinned by the upturn in residential buildings following the resumption of some projects that had been put on hold due to contract renegotiation initiated by the big construction companies hit by the considerable appreciation of the domestic currency against the euro. As for services, according to the data available, the improved performance in retail trade, services to population, telecommunications, and banking and insurance services, contrasted with the weaker performance in wholesale trade, freight forwarding and services to companies (associated with the developments in industry, agriculture and construction).

Contribution of Main Supply Components to GDP Growth



Source: NIS, NBR calculations

2. Labour market

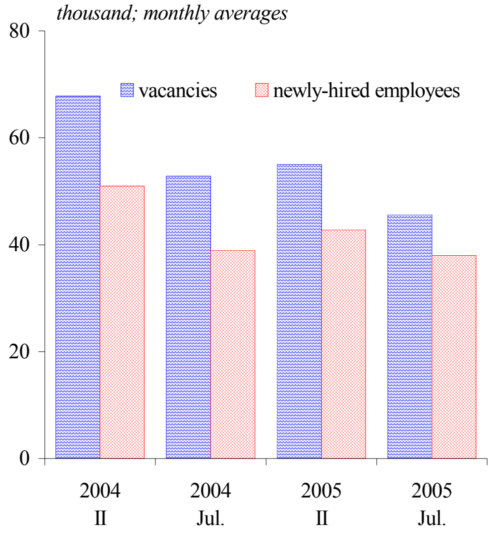
Pressures on the labour market continued to be significant in 2005 Q2, although available data for Q3 show they loosened slightly. Changes in labour market conditions have not been reflected so far by the developments in wages which were not supportive of disinflation. On the supply side, rigidity of wages in industry contributed to worsening of ULC amid the drop in labour productivity; on the demand side, the persistently high net real wage fostered the inflationary potential of household consumption.

2.1. Labour force

Unemployment rate hit a 13-year low in 2005 Q2 (5.6 percent), down 1.4 percentage points compared with the same year-earlier period, given that in the last four quarters the number of hirings from among the unemployed was 2.3 times higher than the number of lay-offs, while more than 580 thousand persons were no longer registered with the National Employment Agency (NEA) as they did not renew their applications for a job. Compared with 2004 Q2, redundancies fell by about 22 percent, job cuts being reported only in industry while in construction and services sectors the number of employees continued to increase. However, the same as in 2005 Q1, the increase in the number of employees economy-wide was probably due not only to new openings but also to the formalisation of some labour contracts following the loosening of fiscal policy. The assumption is backed by a downward trend of hirings through NEA, which recruits people especially from among the registered unemployed[19].

Number of Vacancies and Number of Filled Vacancies

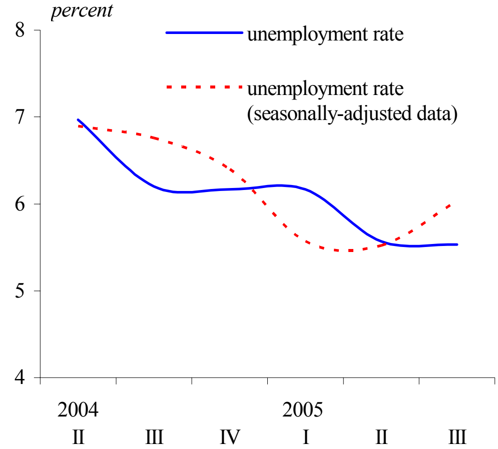
thousand; monthly averages



Source: NEA

The indications of the weaker demand for additional labour force detectable in the first few months of 2005 were corroborated by the most recent data. Unlike previous years, when in Q2 the number of vacancies identified by the NEA attained its peak, in 2005 Q2 it dropped by 2.8 percent compared with Q1. In year-on-year comparison, the number of vacancies fell significantly (18.8 percent), which might be attributed to: (i) the employers' concern for enhancing efficiency following the recent increase in the number of employees (especially in construction and services, where labour productivity appeared to improve[20]) and (ii) the companies' unfavourable expectations of the economic outlook (in industry). Moreover, the unemployed erased from the NEA records because they did not renew their applications for a job declined by 35 percent compared with the same year-earlier period[21]; this might be ascribed to the increased difficulties encountered by jobseekers in finding a job by themselves amid strong regional differences regarding the labour demand/supply ratio (unemployment rate at county level fluctuated within a range of 8 percentage points) and to recruitment difficulties as inappropriately skilled labour could not meet the employers' requirements (in 2005 Q2, the number of the newly-employed was 22 percent lower than the number of vacancies notified by the NEA).

Unemployment Rate



Source: NEA, NBR calculations

Available data for 2005 Q3 show the unemployment rate remaining low at 5.5 percent; nevertheless, leaving out seasonal influences, the unemployment rate crept up compared with the previous quarter, an atypical pattern for the last few years[22]. This development, associated with a further decline in the number of vacancies, suggests a possible easing of labour market pressures.

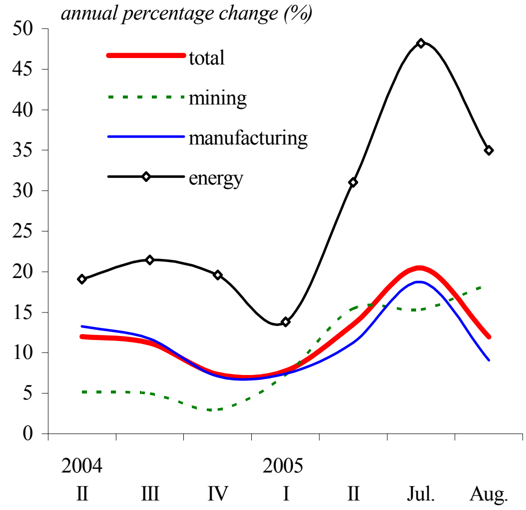
[19] The remainder is accounted for by students, pensioners or employees seeking for a job.
[20] According to calculations based on data concerning employment (AMIGO survey) and GVA for 2005 Q1, labour productivity in the aforementioned sectors reverted to annual positive rates, after falling in 2004 Q2-Q4.
[21] The unemployment outflows in the past three years were probably associated with the expanding informal economy and external migration.
[22] This trend reversal made the analysis of available data released by AMIGO survey (2005 Q1) less relevant and that is why it was abandoned.

2.2. Incomes

In 2005 Q2 compared with Q1, the annual growth rate of gross average wage economy-wide accelerated slightly in nominal terms following: (i) wage indexation that should have been granted starting from the beginning of the year in the hydrocarbon sector; (ii) bonuses and incentives in the energy sector; (iii) bonuses from net profit and other bonuses paid in private services. In manufacturing, against the backdrop of slower growth rate of economic activity by 5.1 percentage points, the annual growth rate of gross wage (14.9 percent) decelerated 1.5 percentage points, which was not enough to offset the unfavourable development of labour productivity. Nominal ULC rose significantly in consumer goods industries (food industry, tobacco processing, light industry, equipment, TV and radio sets and communications) as well as in intermediate and capital goods industries (metallurgy, chemicals, machinery and equipment).

Unit Labour Costs in Industry

annual percentage change (%)



Source: NIS, NBR calculations

Thus, significant inflationary pressures were induced by nominal unit labour costs given that their annual growth rates stood at 20.7 percent in hydrocarbon sector and 31.1 percent in energy sector and ranged from 18 percent to 41.2 percent in most manufacturing sub-sectors with direct impact on consumer prices. Data available for 2005 Q3 show that inflationary pressures[23] stepped up amid further decline in productivity gains. Under the circumstances, the spread between the annual dynamics of labour productivity and that of real gross wage (deflated by IPPI for the domestic market) narrowed from +6 percentage points in 2005 Q1 to +0.4 percentage points in Q2, to reach -4.2 percentage points July through August. However, it is likely that the productivity decline in industry was less significant as long as the comparison between statistical data and business surveys suggests that the year-on-year drop in the number of employees reported by employers was dampened by the (i) formalisation of some labour contracts following the introduction of the flat tax rate and (ii) the fact that some of the redundancies called for by the developments in economic activity indicators affected the employees who had not concluded formal labour contracts.

Labour Productivity and Real Gross Wage in Industry

annual percentage change (%)

	2004			2005			
	II	III	IV	I	II	Jul.	Aug.
Labour productivity	10.0	10.5	13.7	7.1	2.7	-3.4	5.5
Real gross average wage*	4.1	2.3	3.8	1.0	2.3	4.5	6.1
Real gross average wage**	0.1	-1.5	2.1	5.0	13.8	14.0	18.2

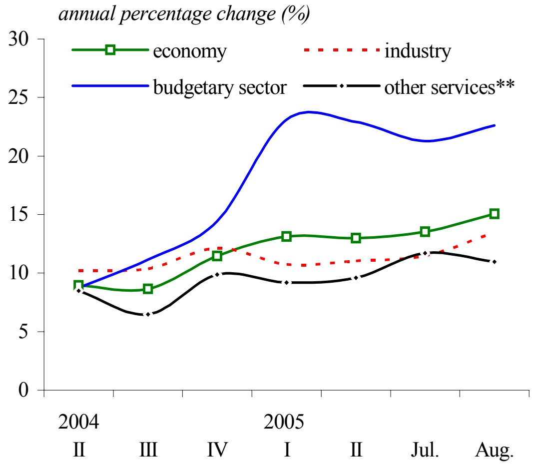
*) deflated by industrial producer price index for domestic market

**) deflated by industrial producer price index for external market

Source: NIS, NBR calculations

[23] Annual growth rate of 13.5 percent in industry in 2005 Q2 (5.6 percentage points higher than in Q1) and 16 percent in July-August 2005.

Net Real Wage*



*) deflated by CPI
**) data comparability has been, to some extent, affected by NIS changes to the structure of the number of employees and wages by sub-sector (August 2005)

Source: NIS, NBR calculations

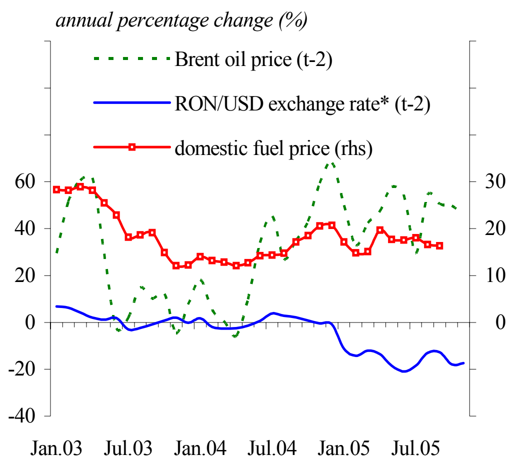
On the demand side, high growth rates of net real average wage recorded in Q2 and Q3 (13 percent and 14.3 percent respectively in July-August[24]) spurred consumption of goods and services and, implicitly, its inflationary potential. An additional impact had: (i) inflows from remittances and private transfers[25], whose annual dynamics in real terms accelerated from 5.8 percent in Q1 to 16.9 percent in Q2 and 55.4 percent in July-August, and (ii) incomes from pensions, whose annual growth remained high (11.3 percent in real terms during April-June 2005), albeit it followed a downward trend compared with previous quarters.

3. Import prices and producer prices

In 2005 Q2, the inflationary pressures exerted by material costs eased due to favourable developments in the exchange rate and prices for some raw materials. Despite the deceleration of their growth rate, the external prices for imported energy resources and animal products further recorded significant changes. The annual growth rates of import and producer prices are likely to stay on a downward drift in Q3 as well, while a trend reversal is expected in the case of import prices for energy products.

3.1. Import prices

Oil and Fuel Prices



*) (-) RON appreciation, (+) RON depreciation

Source: NIS, EIA

The pressures brought about by external prices for imported goods receded in April-June 2005, as the annual growth rate of the unit value of imports slowed to 4.1 percent from 5.9 percent in 2005 Q1. Most commodity groups, save "footwear", provided an underpinning to the deceleration in unit value of imports. Albeit lower than in Q1, the annual price increases of "mineral products"[26] and "livestock and animal products" stayed above average (34.2 percent and 17.9 percent respectively), which had a significant impact on domestic price developments.

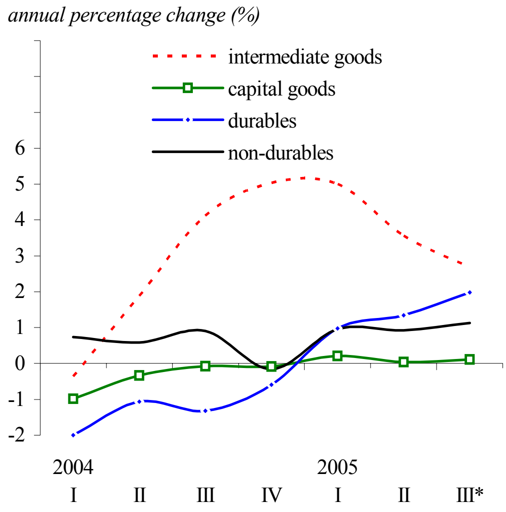
Prices for industrial goods saw generally marginal changes, as illustrated by the 0.5 percent drop in the unit value of imports of goods originating in the European Union (Romania's main trading partner and supplier of industrial goods in particular) and by the modest growth rate of producer prices for EU25 exports (0.7 percent, down from 1.3 percent in 2005 Q1, mainly as a result of developments in the intermediate goods sub-sector; the only group that did not bolster disinflation was that

[24] Annual changes.
[25] Converted into RON at RON/EUR average exchange rate for the period in order not to be overestimated following the appreciation of the RON.
[26] Ores, coal, crude oil, petroleum products, natural gas.

of "durables", as the annual growth rate of their prices added 0.4 percentage points to 1.3 percent).

Prices of energy products are expected to show a trend reversal in 2005 Q3 given that Brent oil prices resumed the sharply upward path and hit an all-time high of USD 67.3 per barrel in August; the external price of natural gas further headed upwards to reach 60.9 percent in 2005 Q3 as compared with the same year-ago period. As regards industrial goods, data available for July-August 2005 show that the trend of prices for intermediate goods persisted in Q2 and that prices for consumer goods (durables and non-durables) increased at a faster pace.

EU-25 IPPI for Exports



Source: Eurostat *) July - August

Nominal appreciation of the domestic currency continued in 2005 Q2 and Q3 as compared with the same year-ago period. However, quarter-on-quarter exchange rate developments differed somewhat from those recorded in the first 3-month period of 2005; thus, the appreciation trend of the domestic currency against the euro slowed down, while the strengthening of the domestic currency against the US dollar came to a halt, causing the favourable impact of exchange rate developments on imported inflation to lower.

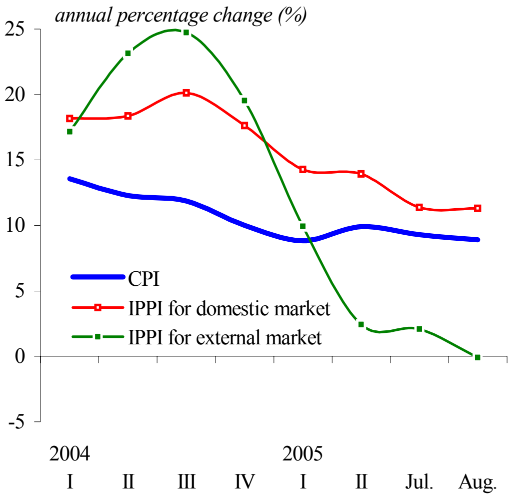
3.2. Producer prices

3.2.1. Industrial producer prices

Industrial producer prices for the domestic market stuck to the downward trend in 2005 Q2, their annual rate of increase decelerating by 0.4 percentage points versus the previous quarter to 13.9 percent. The slowdown was entirely due to the developments in manufacturing (the annual growth rate of producer prices fell 1.4 percentage points to 12.3 percent); the lower pressures exerted by some raw materials costs (grains, cotton, metals) and the strengthening of the domestic currency versus the major currencies further had a favourable impact on producer price developments in manufacturing. Under the circumstances, the gap between the annual growth rate of manufacturing prices for the domestic market and that of consumer prices narrowed from 4.9 percentage points in Q1 to 2.4 percentage points in the period under review.

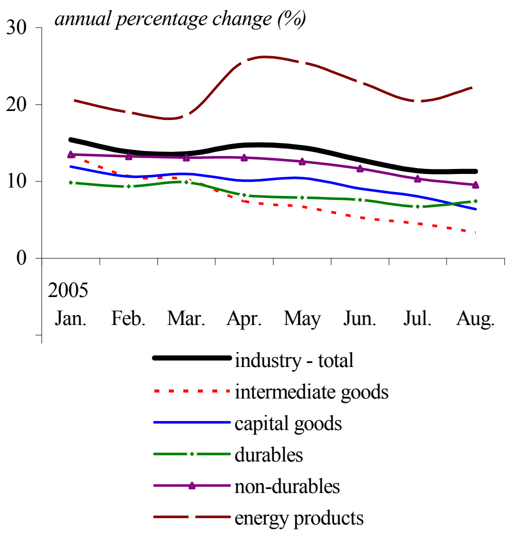
The annual growth rate of producer prices for intermediate goods slowed down markedly (4.9 percentage points to 6.5 percent), as a result of developments in metallurgy. In this case, the steep decline may be associated with a similar trend seen on world market, due to the weakening of pressures formerly exerted by strong demand from China, as well as with the sharp drop in domestic demand (sales on the domestic market fell by 13 percent year on year, nearly twice as much as in Q1).

Consumer Prices and Industrial Producer Prices



Source: NIS

Industrial Producer Prices* by Main Group



* for domestic market

Source: NIS

Producer prices for durables and non-durables posted decelerating growth rates as well. The slowdown in the growth rate of prices for non-durables, which hold the largest share in the CPI basket, was relatively low (0.8 percentage points to 12.4 percent), the positive performance in food industry[27] (due mainly to the slackening of the annual growth of domestic prices for agricultural produce[28]) and textiles being partially offset by the faster increases in producer prices for wearing apparel and leatherwear (owing particularly to the persistent pressure exerted by ULC[29]). Disinflation was fostered to a larger extent by prices for durables, whose annual growth rate stood at 7.9 percent, 1.8 percentage points lower than in the previous quarter; moreover, prices for durables increased at a slower pace than prices for non-durables.

By contrast, the annual growth rate of energy prices accelerated to 24.6 percent, 5.2 percentage points above the average for the previous quarter. Behind this development stood particularly the price hikes in the oil processing (11 percentage points to 39.5 percent) and hydrocarbon extraction (14.3 percentage points to 43.9 percent), which could be attributed to the escalating oil price on the international market in the previous quarter and to the implementation in April of another stage of harmonisation of domestically-produced natural gas prices with import prices.

The disinflation seen in the case of industrial producer prices in the first two quarters of 2005 is likely to continue in Q3 as well. Unlike the previous 3-month period, disinflation may be significantly bolstered by the developments in energy prices (July saw a 3.6 percentage point deceleration in producer prices compared with the average for Q2), due possibly to: (i) liberalisation of power market for consumers (except for residential users) and (ii) widening of the share of cheaper electricity produced by hydroelectric power plants.

3.2.2. Agricultural producer prices

The same as in 2005 Q1, agricultural producer prices saw a negative annual growth rate in Q2 (-11 percent) due to the base effect in the vegetal products sector. Given the sizeable positive change in vegetables prices, quarter-on-quarter developments in prices for vegetal products (up 5.9 percent) were less favourable; yet prices for grains decreased further, as the excess

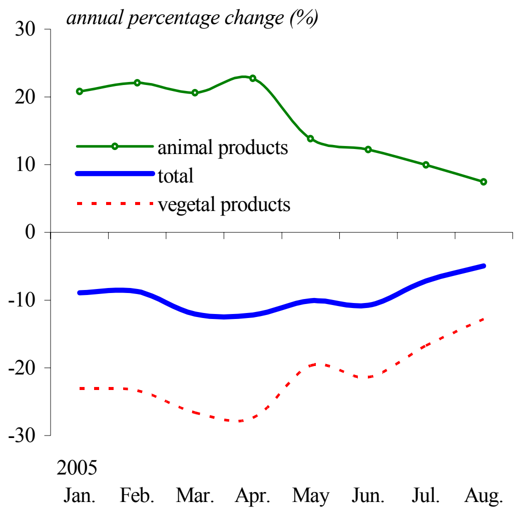
[27] The annual growth rate of which slowed from 9.9 percent in Q1 to 7.4 percent in the period under consideration.
[28] See Sub-section *3.2.2. Agricultural producer prices*.
[29] In the past four quarters, the two sub-sectors posted real increases in ULC ranging from 11 percent to 26 percent, which are accountable for the persistently high growth rates of producer prices (14.3 percent and 12 percent respectively in 2005 Q2).

supply generated by last year's bumper crop stifled the effects of grim expectations of this year's harvest.

The trends seen in the previous quarter continued to be manifest in the animal products sector, with the annual growth rate of producer prices slowing by another 5 percentage points to 16.2 percent; behind this decrease stood the developments in all groups of animal products, particularly in the case of pork; the annual growth rate of pork prices fell by more than 30 percentage points compared with the average for 2005 Q1, largely as a result of price cuts in the period under review (due to the step-up in domestic demand, possibly fostered by the keener interest of private stockbreeders in this sub-sector[30] and by the competition from imports).

The easing of the pressures exerted by prices of agricultural products is likely to continue in Q3, although the adverse weather conditions will have a negative impact on the contribution of the vegetal products sector, which is generally favourable at this time of year.

Agricultural Producer Prices



Source: NIS

[30] The joint effect of subsidies granted by the Ministry of Agriculture, Forests and Rural Development, sufficient fodder supplies and higher prices.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

The third quarter of 2005 was a special period for the central bank as regards the monetary policy strategy and tactics. In August, the NBR shifted formally to inflation targeting, the adoption of which had been prepared during the past 16 months. By adopting inflation targeting, the central bank assumed more clearly the task of consistently pursuing the fulfilment of its fundamental objective, its accountability for achieving the inflation target being more clearly expressed.

In the period under review, monetary policy had to deal with the tighter constraint from short-term capital inflows, which rose to an unprecedented level, and with the risk of an increase in such inflows. The central bank undertook strenuous efforts to reconcile the need of minimizing this threat in the short run with the goal of ensuring sustainable disinflation in the medium and long run. For this purpose, the NBR adopted and implemented an adequate mix of monetary policy, prudential, as well as some administrative measures, the last two categories being meant to preserve financial stability and enhance the effectiveness of monetary policy instruments with a view to achieving and maintaining price stability. Under the impact of these measures, the broadly-defined monetary conditions, including the developments in interest rates, exchange rate of the domestic currency and liquidity across the economy, have remained on course to achieve medium-term disinflation.

The third quarter of 2005 witnessed extremely challenging macroeconomic conditions from the perspective of monetary policy conduct; the central bank had to deal with the still overly rapid growth rate of domestic demand, on the one hand, and the impact of the strong resurgence in speculative capital inflows on the domestic financial market, on the other; another matter of concern was the risk of worsening of inflation expectations against the backdrop of persistently unfavourable impact of some of the supply-side factors (the increase in fuel price) on consumer price index, which made the central bank revise the year-end inflation target to 7.5 percent.

The still fast growth of domestic demand in Q2 – despite the decline in self-consumption – and, especially, the developments in some relevant indicators in Q3 pinpointed the persistence of pressures exerted by the rapid increase of domestic absorption on the main macroeconomic equilibria. According to statistical data, the main driver of this growth was further household consumption; thus, July through August, sales of most market goods and services posted annual average rises relatively higher than in 2005 Q2. During the period, the high growth of private consumption was steadily fostered by fast upward trend of household disposable incomes as a result of: (i) the sharp increase in net real wages (their average annual growth rate went up 14.3 percent during July-August, compared with 13 percent in Q2); (ii) the increase in remittances from Romanian workers abroad to a record high (due also to seasonal factors); and (iii) the rise in the number of employees economy-wide.

The effect of higher incomes on household consumption was enhanced by that of changes in household behaviour in the last few years; thus, heavy resort to bank and non-bank loans by individuals as well as further decline of the annual real growth rate of household savings with banks may suggest that individuals chose to increase current consumption to the detriment of future consumption, which contrasted with the behaviour prevailing in the past years. During July-August, the average annual growth rate (in real terms) of balance of household loans rose to 62.2 percent (compared with 53.1 percent in Q2 and 43.4 percent in Q1). This development was mostly driven by consumer loans[31], the real average annual growth rate of which (77.9 percent) outpaced by far that recorded in the previous quarter (61.2 percent). Although the growth pace of foreign currency-denominated consumer loans slowed, they continued to be the fastest-growing component of consumer loans (annual increase of 303.6 percent compared with 403.1 percent in the previous quarter) given that lending terms were seen as being more affordable. The rise was also underpinned by promotional banking products provided by a large number of credit institutions interested in expanding their market share, the relatively attractive supply of some of the banking products being supported by resources of the parent banks.

Behind the strong domestic demand during the period under review stood also the higher growth rate of private sector investment[32], bolstered by large inflows of funds. Thus, July through August, long-term credit rose at a real average annual rate almost similar to that recorded in the previous quarter, with the annual rate of increase of *leu*-denominated loans being two

[31] Information on consumer and mortgage loans is provided by "Financial Behaviour of Households and Companies by County" prepared by the NBR (CREDITCOOP is not referred to).
[32] In 2005 Q2, the annual growth rate of gross fixed capital formation was 9 percent (5.2 percent in the previous quarter).

times higher than in 2005 Q2. The average monthly volume of medium- and long-term foreign credits[33] to non-bank sector increased by EUR 203 million (EUR 187.3 million in the previous quarter). Pressures exerted by excess domestic demand, to which external financing contributed significantly, further fed mostly through into the trade deficit, whose widening slowed down only slightly July through August, compared with the previous quarter.

Inflows of potentially volatile capital were much higher in 2005 Q3. The inflows of speculative capital increased starting July, due mainly to (i) the still high interest rate differential between domestic and world markets, (ii) the expectations of further nominal appreciation of the *leu* against the euro, due also to the expected flexibilisation of the exchange rate regime following the shift to inflation targeting and (iii) the possible decrease of sovereign risk premium. Large inflows of volatile capital brought about the surge of transactions[34] performed by bank clients on the interbank forex market to monthly record highs and, especially, the expansion of the balance of non-residents' *leu*-denominated time deposits (a more than threefold increase in August). The adverse direct effects of volatile capital inflows were mainly the strong increase of pressures on the exchange rate and rapid nominal appreciation of the *leu* as well as the expansion of surplus liquidity in the banking system and costlier sterilisation operations performed by the central bank, as part of the volatile capital was mopped up.

These macroeconomic conditions, which featured fast expansion of domestic demand financed from foreign borrowings, either directly by or via banks, on the one hand, and the increase of risks to macroeconomic equilibria and financial stability associated with the rise in volatile capital inflows, on the other, rendered the dilemma concerning the interest rate policy more difficult.

To the macroeconomic challenges added also the slightly slower disinflation (compared with the short-term forecast of the NBR) attributed mainly to higher-than-expected increase of prices for fuels and vegetables. In order to strike a balance between the need to strengthen its credibility by ensuring that the inflation target is met, on the one hand, and the need to increase the role of anchoring public expectations through the announced inflation target, on the other – both playing a more significant role in the context of the new monetary policy strategy – the central bank revised the year-end inflation target.

[33] Gross capital inflows.
[34] In 2005 Q3, the volume of non-residents' transactions in total transactions rose more than 16 times from Q2.

Even under these circumstances, the persistence of pressures from high growth rates of prices for services as well as the likelihood of larger second-round effects of administered price adjustments due for the coming months on core inflation continued to pose a risk to keeping disinflation in line with the targeted trend.

In the context of major challenges stemming from economic conditions, the central bank decided to combine in a flexible and consistent manner the monetary policy, exchange rate, prudential and even administrative measures. During the first part of the period under review, in an attempt to prevent the economy from overheating, the central bank relied, to a larger extent, on the interest rate policy. Thus, after deciding to put a halt to key rates[35] cuts in July, in August the NBR tightened further interest rate policy by raising the average effective interest rate on sterilization operations to 8.5 percent – one of the benchmarks used by credit institutions in setting lending and deposit rates. Moreover, in order to enhance the transparency of the central bank and consistency of monetary policy decisions as well as with a view to boosting the signalling role of interest rate – given the adoption of inflation targeting in August – the central bank decided to eliminate the departure between the policy rate and its effective sterilization rate.

Nevertheless, over the period, the interest rate policy was affected by the restrictions deriving from the significant rebound in speculative capital inflows and by its scant efficiency which was ascribed to the large share of foreign exchange-denominated loans in non-government credit (59.4 percent in August); the two reasons underlay the central bank’s decision to refrain from making increased resort to the interest rate policy. In order to tighten further the monetary policy and ensure better functioning of (RON-denominated) credit channel and interest-rate channel, on the one hand, and to mitigate the risks that fast-paced foreign exchange-denominated loans posed to financial stability, on the other, in July the National Bank of Romania adopted a package of measures meant to: (i) gradually apply[36] the 30 percent reserve ratio on all foreign-exchange liabilities, irrespective of their maturity and the date they had been raised, (ii) reduce[37] to 16 percent from 18 percent the

[35] The policy rate was kept at 12.5 percent while average effective interest rate on sterilization operations was left unchanged at 8 percent, the departure between them being temporarily extended.

[36] The measure was implemented in two stages: for the 24 July-23 August 2005 maintenance period, a 15 percent ratio on foreign-exchange liabilities with maturities longer than two years which had been raised by 23 February 2005 was applied, while the 30 percent ratio was applied to the above-mentioned liabilities starting with the 24 August-23 September 2005 maintenance period.

[37] Starting with the 24 August-23 September 2005 maintenance period.

reserve ratio on RON-denominated liabilities with maturities of up to two years and (iii) amend the norms on containing household credit risk by tightening bank lending requirements[38].

At the same time, the central bank resumed its intervention in the foreign exchange market in an effort to deter volatile capital inflows by stifling expectations of steady strengthening of the domestic currency and by increasing the unpredictability of exchange rate movements. The record-high purchases in August notwithstanding, the domestic currency continued to strengthen (by 1.7 percent in nominal terms against the euro, after posting an appreciation of 1.4 percent in July).

Against the backdrop of still rising volatile capital flows, in spite of the implemented mix of measures, the National Bank of Romania decided to radically change its manner of approaching the macroeconomic context, by adopting the extreme solution of easing *de facto* the interest rate policy. The daily average interest rates on banks' deposits with the central bank were lowered gradually in anticipation of the restrictive effects of (i) changes to required reserves for foreign exchange deposits and (ii) the maintenance of policy rate at 8.5 percent. This decision was implemented via the liquidity policy, with the NBR starting in the latter half of August to gradually reduce the volume of surplus liquidity absorbed through one-month deposit operations; under the circumstances, credit institutions resorted more frequently to the deposit facility, causing the average interest rates on both one-month deposits and the deposit facility to take a dive.

However, this measure was not efficient enough, as the interbank foreign exchange market still experienced noticeable rises in arbitraging operations; as a result, the National Bank of Romania viewed the sharp cut in its key rates as a necessary step. Therefore, the central bank decided to lower the policy rate to 7.5 percent, the interest rate on the lending facility to 14 percent and the interest rate on the deposit facility to one percent, the same level applied by the ECB. Moreover, the National Bank of Romania continued to mop up only part of the liquidity surplus, whereas the banks' heavier resort to the deposit facility led to a sharp decline in the average interest rate on bank deposits[39] with the NBR (5.2 percent in September). The market reacted swiftly to these decisions; capital inflows ceased to grow while the domestic currency appreciation came to a halt, posting a trend reversal towards end-September.

[38] Which came into force on 28 August 2005.
[39] Daily average balance of one-month deposits and of the deposit facility.

In an attempt to mitigate the effects the looser interest rate policy had on liquidity in the economy and to improve non-government credit structure in order to support financial stability, the National Bank of Romania Board decided in September to take some administrative measures with a view to containing the expansion of foreign exchange-denominated loans. The measures consisted in limiting credit institutions' exposure to at most 300 percent of a credit institution's own funds[40] when granting foreign exchange-denominated loans to unhedged borrowers, natural and legal persons (entailing credit risk for the credit institutions acting as lenders).

2. Financial markets and monetary developments

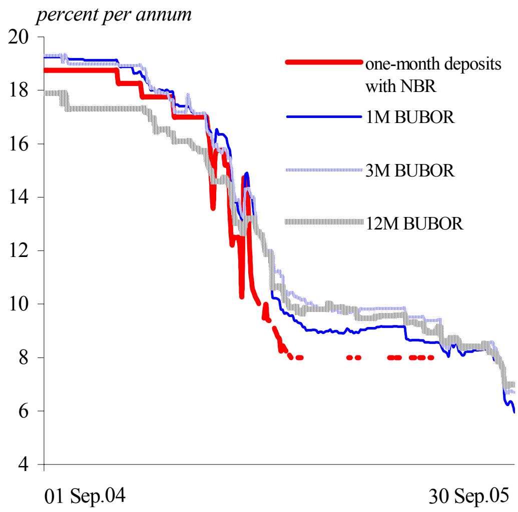
The unexpectedly strong increase in volatile capital inflows and the manner in which the NBR attempted to consolidate monetary stability and preserve banking system soundness had a heavy impact on monetary conditions in 2005 Q3. The RON saw stronger nominal appreciation against the EUR, while short-term interest rates went down, their trend sharpening at the end of the considered period. Money demand was further robust, while the growth rate of non-government credit accelerated particularly on the back of the fast increase in household loans.

2.1. Interest rates

Given the specific liquidity conditions and the frequent and sizeable changes to the central bank's interest rates, the interbank deposit rates followed a downtrend July through September, with occasionally rapid and sharp downward adjustments.

Thus, after remaining relatively stable in July, in the latter half of August, interbank deposit rates witnessed a plunge as a result of the NBR's decision to stop siphoning off entirely the liquidity surplus[41] via one-month deposit-taking operations. The significant cut in the volume of deposits taken by the monetary authority coupled with the rise in excess reserves in the banking system, following the NBR's purchases of foreign exchange in the considered period, on the one hand, and with the slight drop

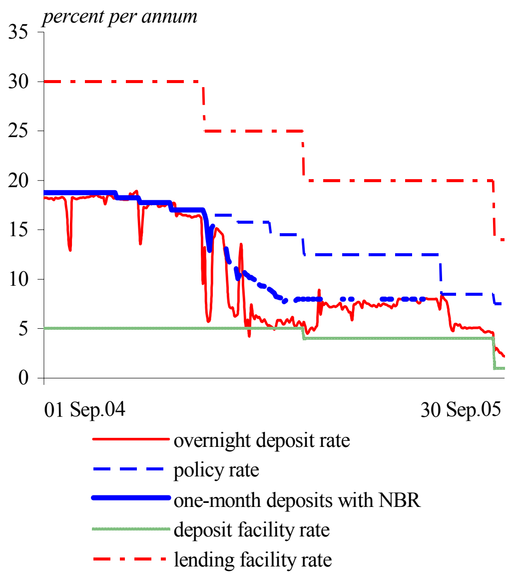
Interest Rate on Deposit-taking Operations and BUBOR Rates



[40] The measure is effective as from 26 September 2005.
[41] To this end, the central bank (i) adopted a system based on fixed rate auctions, whereby the ratio of mopped-up liquidity to the total volume of bids submitted by banks was gradually reduced and (ii) cut down significantly the frequency of auctions.

in demand for liquidity[42], on the other, led to an unprecedented increase in banks' resort to the deposit facility. Against this background, daily interbank deposit rates plummeted, moving gradually away from the policy rate and nearing the floor of the corridor defined by the standing facility rates. The decline in interest rates sharpened in September amid the step-up in liquidity surplus and the fall in the deposit facility rate; in September, the average interbank rate dipped by 4 percentage points from June to 3.4 percent.

Interbank Money Market Rates

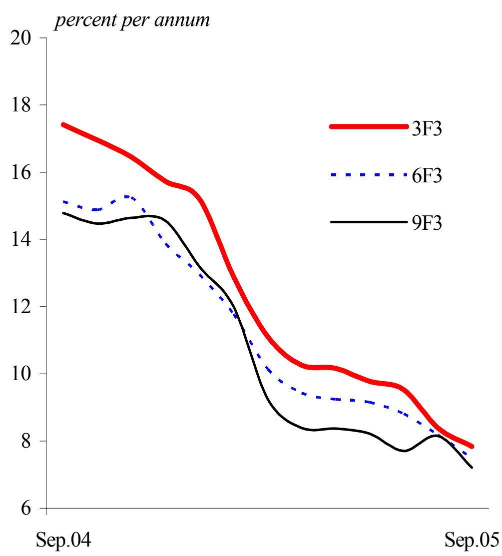


Following the increase in both the liquidity surplus and interbank market uncertainty, interbank deposit rates on overnight transactions fell occasionally even below the deposit facility rate, fluctuating in a wider range (between 1.1 percent and 7.6 percent). Under the impact of the same factors, the volatility of overnight rates rose gradually, hitting a record high in September.

The pick-up in liquidity surplus caused the interbank market to lose depth, with the average volume of interbank transactions decreasing 18.3 percent quarter on quarter. In month-on-month comparison, the loss of depth was the more so obvious considering that the average flow of deposits in September accounted for only 47.4 percent of the June flow.

1M-12M BUBOR yield curve posted a faster decline[43], showing however a flattening trend. Average overnight and one-week BUBOR rates fell even more sharply, their monthly average standing 3 percentage points lower at end-September, compared to the end of June; as a result, the spread between monthly averages of 12-month BUBOR rate and overnight BUBOR rate widened again, from 1.6 percentage points in June to 3.6 percentage points in September. The spread between overnight BUBOR rate and effective interest rates on overnight transactions rose by 0.2 percentage points.

Implicit Forward Rates



Similar to the previous quarter, forward rates, calculated on the basis of September quotations, indicate that interbank rates will remain unaltered in the following three months (3-month BUBOR rate is expected to reach 7.8 percent in December, staying almost flat compared with Q3). For March and June 2006, 3-month BUBOR rate is anticipated to move down by 0.4 percentage points and 0.6 percentage points respectively, compared to the level for December 2005. According to the NBR's monthly survey, the 12-month BUBOR rate is expected to drop half of a percentage point in October and one

[42] Due to the reduction from 18 percent to 16 percent of the reserve ratio on RON-denominated deposits.
[43] The decline was far steeper than that anticipated by implicit forward rates calculated based on June quotations.

percentage point by October 2006 (compared with the level recorded at end-September 2005).

Unlike interbank rates, interest rates on the primary market for government securities fell steeply only in September, down 1.7 percentage points on 3-month T-bills and 1.1 percentage points on 3-year bonds. By contrast, interest rates on newly-issued government securities flattened out somewhat in July and August after edging up in the previous quarter.

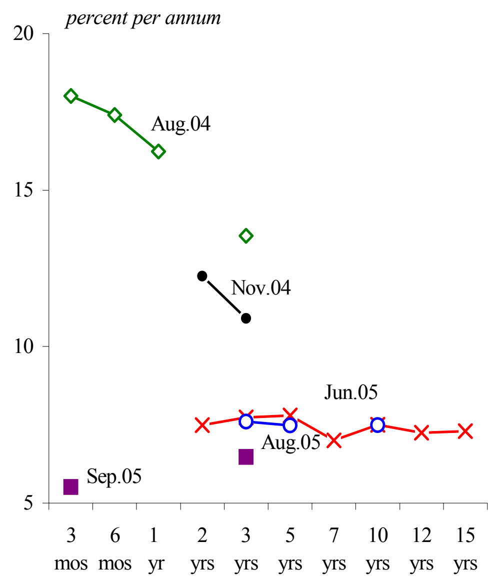
In September, the fall in interest rates on government securities was fostered by strong demand of market participants[44] for government paper, on the one hand, and by the low volume of government securities on offer, on the background of further surplus in the Treasury's account, on the other. As a matter of fact, this surplus allowed the Ministry of Public Finance to make net redemptions of roughly RON 63 million, i.e. the entire amount projected to be redeemed.

In the quarter under review, the Ministry of Public Finance issued particularly government securities with maturities of 3, 5 and 10 years and only to a small extent 3-month Treasury certificates; the interest rates on the newly-issued securities ranged between 5.4 percent and 8 percent.

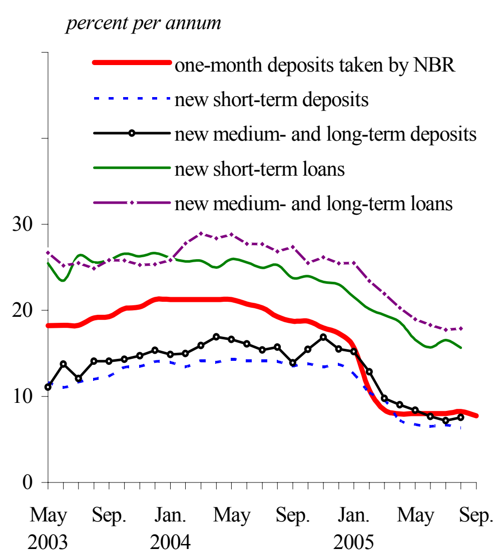
Unlike other categories of interest rates, the interest rates applied by banks to non-bank non-government clients decreased at a slower pace June through August 2005. The development was illustrative of the fact that the NBR interest rate cuts over the first half of the year no longer acted as an incentive. The drop in the average interest rate on deposits with the central bank in September is seen to gradually feed through to the interest rates applied by credit institutions, which are expected to move down faster in the coming months.

In 2005 Q3, the average interest rate on new time deposits went down 0.4 percentage points, while that on new loans declined by one percentage point. In the latter case, the steeper decrease was due to the 1.3 percentage point drop in the interest rate on loans granted to legal entities, possibly as a result of stiffer competition. By contrast, the smaller adjustment of interest rates on time deposits may be attributed to the relative sensitiveness of some credit institutions (holding a large share of household savings[45]) to the NBR officials' statements on the maintenance of interest rates at attractive levels for depositors.

Yield Curve (Treasury certificates)



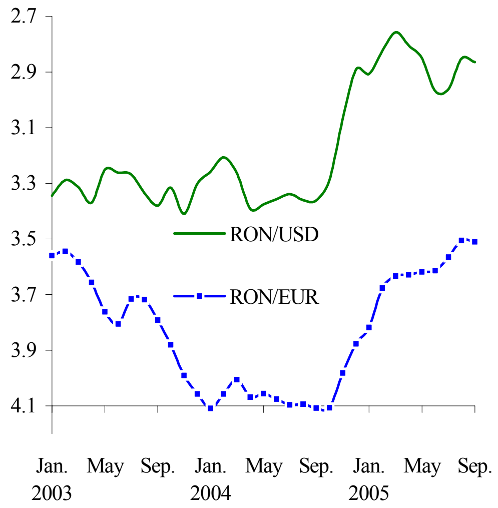
Bank Rates



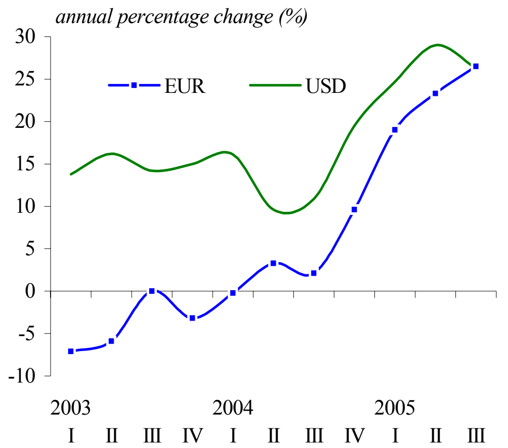
[44] The required level for bids was exceeded significantly.
[45] The average interest rate on household time deposits fell by only 0.2 percentage points in August compared to May.

2.2. Exchange rate and capital flows

Nominal Exchange Rate



Developments of RON Exchange Rate*)



*) appreciation (+), depreciation (-) in real terms deflated by CPI

Source: NIS, NBR

Approaching the adoption of direct inflation targeting was one of the catalysts for the occurrence of the effects of April liberalisation of non-residents' access to *leu*-denominated time deposits. Starting July, capital inflows increased sharply, leading to record high turnover on the interbank foreign exchange market, which exceeded by far the previous quarter's readings, and to an unprecedented increase in pressures on the exchange rate of the domestic currency.

On this background, in July and August, the nominal appreciation of the domestic currency against the euro accelerated significantly. Towards the end of Q3, interbank forex market conditions changed markedly, causing the fall of RON/EUR rate to come to an end and leading subsequently to a trend reversal thereof; nevertheless, the domestic currency appreciated by 3 percent in nominal terms versus June (-4.7 percent in real terms). In the quarter under review, the RON strengthened by 3.6 percent in nominal terms against the USD (5.3 percent in real terms), regaining part of the ground lost in the previous 3-month period. Calculated as annual average change for the third quarter, the domestic currency strengthened further against the EUR (16.2 percent in nominal terms and 26.5 percent in real terms), slowing however its appreciation against the USD (16 percent in nominal terms and 26.3 percent in real terms).

The mounting pressures on the exchange rate of the RON stemmed from the very high levels of oversupply on the foreign exchange market[46] in the first two months of the third quarter, fuelled by short-term capital inflows[47] which reflected non-residents' keener interest in acquiring RON-denominated assets (see Section 1. *Monetary Policy*). Seasonal factors, such as the pick-up in the volume of remittances from abroad[48], the rise in receipts from tourism, as well as the lower demand for foreign currency to make payments on external private debt also contributed to the step-up in the foreign currency surplus on the forex market. Moreover, forex market supply was fed by part of the financial flows which were specifically aimed at bridging

[46] In July, the surplus on the interbank foreign-exchange and the exchange offices market came in at EUR 373 million compared to an average of EUR 75 million in 2005 Q2; in August, the surplus amounted to EUR 1,162 million.
[47] In July and August, non-residents' net sales on the interbank foreign exchange market stood at EUR 136 million and EUR 159 million respectively, exceeding those in the February-June period (EUR 161 million).
[48] Remittances recorded a monthly average of EUR 341.5 million compared to an average of EUR 196 million in 2005 Q2, while net purchases of foreign currency made by exchange offices July through August hit a record high of EUR 1,012 million.

the higher trade deficit[49] or at meeting the higher level of required reserves in foreign exchange by banks[50]. July through August, capital inflows went up against the background of: (i) the 4.4 time expansion in non-resident banks' deposits compared to the previous quarter; (ii) the sales of foreign securities by resident banks, amounting to EUR 333 million in July and EUR 368 million in August; (iii) the still high volume of foreign loans taken by banks and corporate sector. On the other hand, the EUR 500 million-worth of funds raised by Bucharest Mayoralty at end-June following the bond issue in Luxembourg had no impact on the foreign currency supply in the interbank forex market.

Key Financial Account Items (balances)

EUR million

	2004		2005	
	H1	8 mos	H1	8 mos
Financial account	**1,531**	**1,369**	**1,543**	**1,682**
Direct investment	**1,282**	**1,625**	**1,479**	**1,875**
residents abroad	-8	-39	-3	-39
non-residents in Romania	1,290	1,664	1,482	1,914
Portfolio investments	**-131**	**-144**	**-53**	**679**
residents abroad	-14	-14	-589	112
non-residents in Romania	-117	-130	536	567
Other capital investments	**1,644**	**2,656**	**2,543**	**4,302**
of which:				
medium- and long-term investment	768	1,503	1,812	2,179
short-term investment	439	590	611	842
currency in circulation and short-term deposits	366	477	-343	721

In an attempt to dampen volatile capital inflows and to put a halt to the excessive appreciation of the RON, in July-August period, the central bank purchased a record high volume of foreign currency on the forex market. Starting with the latter half of Q3, the NBR eased the liquidity policy and the interest rate policy in an effort to reduce arbitraging opportunities. Even though it became less predictable[51], in August, the RON/EUR exchange rate continued to decline steeply. However, in September, the downward trend came to a halt and the exchange rate moved up, due to re-emergence of forex deficit on the interbank market, causing the RON to soften 0.1 percent in nominal terms. The drop in foreign exchange supply towards the end of Q3 was mainly due to the declining short-term capital inflows following the decrease in NBR interest rates and interbank rates, as well as to the fact that investments on other markets[52] became more profitable. The seasonal drop in remittances also contributed, to a lesser extent, to the contraction in total foreign exchange sales.

In the coming months, amid further lowering pressures from volatile capital inflows, the scope of influence of the traditional determinants of the exchange rate path is expected to broaden; in this respect, in the short run, the following developments will prevail: (i) possible widening of the trade deficit; (ii) increase in payments on external private debt; and (iii) pick-up in the volume of remittances in December. Some of the effects of the said developments were already manifest in October, when the domestic currency depreciated at a faster pace against the euro.

[49] Trade deficit in the first eight months of 2005 was 39 percent higher than that recorded in the first six months of this year.

[50] According to the NBR Board decision to raise the reserve ratio on all categories of foreign exchange-denominated liabilities.

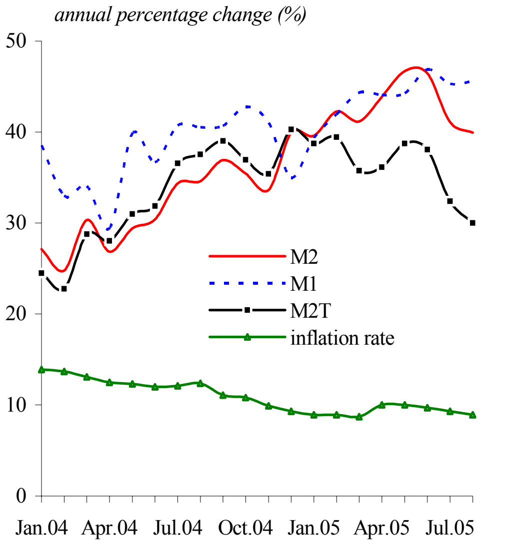
[51] In August, the volatility of the RON/EUR exchange rate reached a 6-month high.

[52] As a result of hikes in FED funds rate, which equalled 3.75 percent in September.

2.3. Money and credit

Money

Broad Money and Inflation Rate



In June-August 2005, money demand remained robust, the growth rate[53] (30.4 percent) of broad money (M2) slowing only slightly compared to previous months' record values. The expansion was largely due to the same factors as in the previous period (foreign capital inflows, including those associated with privatisation proceeds, increase in non-government credit and the change in households' financial asset portfolio structure); the impact of rising public spending during the reported period added to the above-mentioned factors.

However, the structure of M2 witnessed a relative worsening, as a result of the non-bank sector's increased propensity for holding liquid monetary assets. Whilst narrow money (M1) rose at one of its fastest rates in the last decade, quasi-money dynamics slowed; under these circumstances, the share of M1 in broad money peaked at 25.8 percent, a record monthly average for the past 7½ years. Demand deposits remained the fastest-growing component of narrow money, as their rise was driven mainly by the low opportunity costs as well as by certain incidental factors. On the other hand, the increase in currency outside banks followed a relatively stable path, except for June, ahead of the upcoming domestic currency redenomination.

Composition of broad money by currency continued to improve, with the share of forex deposits in M2 touching its lowest monthly average in the last 6½ years, i.e. 32.9 percent.

Broad Money (M2)

percent

	2004		2005			
	III	IV	I	II	Jul.	Aug.
	monthly average					
M1	25.3	24.5	22.7	24.2	25.9	26.7
Currency outside banks	13.7	12.7	11.6	12.5	13.2	13.0
ROL deposits	51.4	52.4	53.4	53.7	54.1	55.2
Foreign currency deposits	34.9	34.9	35.1	33.7	32.7	31.8

The growth of household deposits continued to slow down during the reported period. This was the result of the deceleration in the growth of savings (in both domestic and foreign currencies) that occurred despite the accelerated growth in disposable incomes of households (against the background of the increase in wages and remittances from abroad) and the contraction in government securities portfolio held by individuals. Given the drop in interest rates on time deposits, the sharper decline in *leu*-denominated savings of households was associated with an unprecedented increase in their current accounts.

The growth rate of corporate deposits also slowed, given that the change in *leu*-denominated time deposits[54] stayed on a downward drift, while the change in forex deposits resumed the

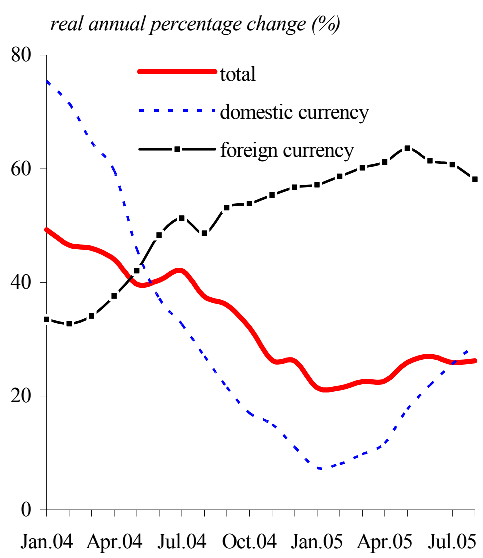
[53] Unless otherwise indicated, percentage changes refer to the annual growth rates expressed in real terms.
[54] Including certificates of deposit and restricted deposits.

downtrend in July[55]. The slower pace of increase in corporate forex deposits was caused by the transfer of privatisation proceeds[56] to the MPF account and by the potential impact (still at an early stage) of liberalisation of residents' access to opening accounts abroad[57]. On the other hand, the following inflows were channelled to the companies' accounts: (i) transfers representing capital increases of newly-privatised companies[58], (ii) changes in non-bank clients' financial asset portfolios (the stock of government securities fell 15.6 percent in real terms during the reported period), and (iii) budget appropriations for the rehabilitation of houses and infrastructure hit by natural calamities.

Non-government credit

The growth rate of non-government credit continued to gain momentum June through August 2005 (26.4 percent, the highest monthly average so far this year), reflecting the faster increase in household loans. The main drivers of this development were the increase in household incomes[59] and the strengthening of the domestic currency, on the one hand, and the keener competition among credit institutions, mirrored by relatively low interest rates and the larger range of banking products, on the other hand, against the background of a pick-up in banks' borrowings and deposits from abroad; another one-off factor that most likely spurred lending during the reviewed period was the fact that borrowers sought to avoid the tighter conditions imposed by the entry into force of the new norms on lending[60].

Non-Government Credit by Currency

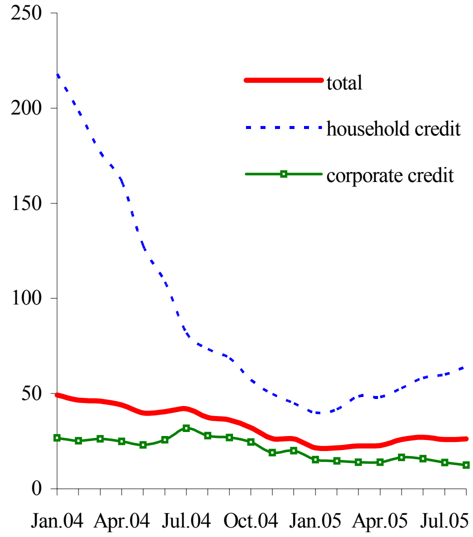


The structure of non-government credit by currency reveals a steady upward trend in *leu*-denominated loans and the commencement of a deceleration in the growth of forex-denominated loans (expressed in EUR). Thus, the share of foreign exchange-denominated loans in total loans witnessed a decline, yet it stayed high (59.7 percent, on average, during the period under review), whereas the spread between the growth rates of forex and *leu*-denominated loans narrowed steadily. It is

[55] After having reached an all-time high in June 2005.
[56] Following the privatisation of Distrigaz Sud and Distrigaz Nord, EUR 208 million were transferred to the MPF account in June and July.
[57] The opening of deposit and current accounts abroad was liberalised as of July 2005.
[58] In June 2005, privatisation proceeds from the sale of Distrigaz Nord amounted to EUR 303 million, out of which EUR 125 million represented the value of shares and EUR 178 million the capital increase (according to a press release of the Ministry of Economy and Commerce dated 28 June 2005).
[59] Real net wages rose by 13.8 percent June through August 2005 as compared to the same period of 2004.
[60] NBR Norms No. 10/2005 on limiting credit risk attached to loans to individuals (effective as of 28 August 2005).

Non-Government Credit by Client

real annual percentage change (%)



quite likely that, towards the end of the period, this trend also reflected the impact of changes to required reserves.

By borrower, loans to households continued to grow faster, their rate outpacing that of corporate loans. Long-term loans in domestic currency to households rose most rapidly due to the relatively low interest rates on real estate and mortgage loans. Nonetheless, demand for consumer loans remained very strong, such loans accounting for 74 percent, on average, of total loans[61]; however, in the case of this category of loans, a gradual rise in the households' preference for forex-denominated loans was manifest.

The growth rate of corporate loans decelerated, a trend which, combined with the steeper decline in interest rates on such loans, may be indicative of a slight slowdown in the expansion of activity in certain sectors and of increased contribution from external resources to financing. *Leu*-denominated short-term corporate loans (most likely taken for financing of working capital needs) witnessed the sharpest upward trend. Long-term loans (in both domestic and foreign currencies) for investment financing further rose at a fast tempo.

[61] According to data in NBR's "Financial Behaviour of Households and Companies by County" based on the information received from credit institutions, except for CREDITCOOP.

V. INFLATION OUTLOOK

The baseline scenario of the projection shows an annual inflation rate between 8.1-8.3 percent at the end of 2005. The upward revision of the August projection (7.5-8 percent) is due to larger than expected increases in oil and food prices, as well as a higher forecasted exchange rate of the RON against the euro for the fourth quarter of 2005. Disinflation is projected to continue through 2006, supported by the gradual reduction of the excess demand and the favourable influence of the RON exchange rate on import prices. It is nevertheless expected that the substantial adjustments projected for administered prices, along with a temporary slowdown in the reduction of inflation expectations in the first part of 2006, will push the year-end inflation close to the upper bound of the target band.

The main risks of deviations from the projected inflation path could be generated by: new significant hikes in world oil and gas prices, increases in administered prices which may differ in terms of magnitude and timing from the forecast assumptions, substantially different exchange rate dynamics as well as less prudent fiscal and wage policies than assumed in the baseline scenario.

1. The baseline scenario of the projection

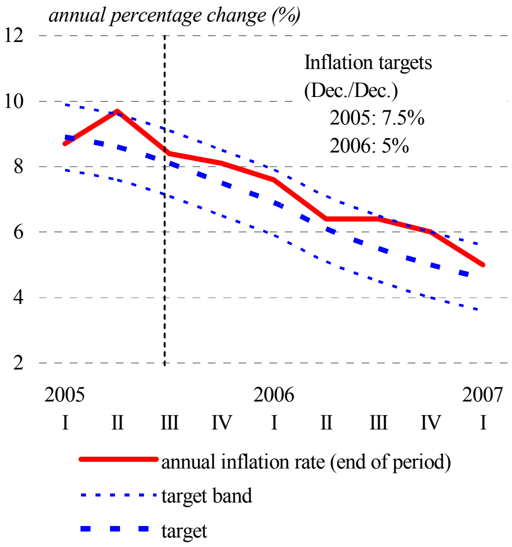
1.1. Introduction

The baseline scenario is built around an interest rate path consistent, over the medium term, with the programmed downward track of inflation. The actual policy rate set by the NBR Board could deviate from the projection as a result of the assessment of risks and uncertainties associated with the baseline scenario, of tactical considerations regarding monetary policy (e.g. the possibility of using alternative instruments to achieve the same objective) or as a response to the impact of unforeseen events.

The projection extends over a six-quarter horizon. However, most of the information regarding exogenous variables such as administered prices, the fiscal programme and external forecasts for the European economy is only available until the end of 2006.

1.2. Inflation projection

Inflation Forecast



Note: ±1 percentage point around the (dis)inflation path

According to the baseline scenario, annual consumer price inflation is projected to remain above the central point of the target for most of the forecast horizon, reaching the upper bound of the ±1 percentage point target band at the end of 2006 (6 percent).

Compared with the previous quarter's forecast, the current projected inflation path is higher over almost the entire projection horizon. For the end of 2005, the NBR forecasts an annual inflation rate of 8.1-8.3 percent, above the 7.5-8.0 percent range forecasted in the Inflation Report issued in August 2005. This is mainly the result of:

(i) higher-than-expected rise of world oil prices in the third quarter;

(ii) higher food prices in the fourth quarter, as a result of increasing damages caused by floods;

(iii) slower appreciation of the RON in the fourth quarter as compared with the previous forecast.

The projected inflation rate for the end of 2006 is also higher (by almost 1 percentage point) than the level forecasted in the previous Inflation Report. Significant inflationary pressures are expected especially from administered prices, which along with the short-lived increase in food prices and the latest surge of fuel prices, will induce a temporary slowdown in the reduction of inflation expectations in the first part of 2006. The resumption of disinflation is nevertheless expected to bring inflation expectations back on a downward trend in the second half of 2006.

Given the magnitude of the exogenous pressures induced by the adjustment of administered prices, disinflation of consumer prices will be caused primarily by decelerating inflation in the CORE2 index. CORE2 inflation is computed by excluding administered prices, as well as other highly volatile price groups (fresh fruit and vegetables, eggs and fuels), from the headline inflation (see Box 1: *Core inflation* – in Inflation Report No. 1 – August 2005).

Import price dynamics will continue to act as the main driver of disinflation for the CORE prices. This process will be augmented by a gradual reduction of excess demand pressures (see Section 1.4.3). Both factors will nonetheless induce weaker disinflationary effects than previously projected. The main causes are related to the slowdown of real appreciation of the

RON and the reduction of the real interest rates compared to the previous forecast, as well as the inclusion in the baseline scenario of wealth and balance-sheet effects generated by exchange rate fluctuations (see Box 1).

Over the projection horizon, we expect that cost-push inflationary pressures will be relatively moderate. The assumed evolution of the oil price is projected to determine a deceleration of fuel price inflation. A temporary, but still important influence is expected in the case of fruit, vegetables and eggs prices as a result of recent floods. Year-on-year inflation for these items is expected to accelerate by mid-2006 (with a maximum impact in the fourth quarter of 2005) and to converge towards the average core inflation thereafter.

1.3. Exogenous inflationary pressures

Administered price inflation exerts a significant influence on headline inflation, both directly, given the 22 percent weight of administered prices in the total inflation index for 2005, and indirectly, through its impact on overall inflation expectations. Over the last few years, the growth rate of administered prices has been significantly higher than that of market prices. It is anticipated that this pattern will be maintained over the forecast horizon, at least until EU accession. Heating prices will be adjusted upward in order to phase out subsidies and arrears, while electricity and natural gas prices will be subject to an adjustment process aimed at covering production costs and keeping pace with import prices, respectively. For the fourth quarter of 2005, the forecast assumes a 20 percent increase in the heating price. In 2006, significant price increases are expected for natural gas, heating and electricity, as well as for water, sewerage, sanitation and city transport.

Fuel prices are forecasted based on several factors, such as: world oil prices, the RON/USD exchange rate (for the RON value of imported oil) and RON/EUR exchange rate (for the excise duty incorporated in the retail price) as well as the timetable for adjustments of excises and other fuel taxes. Taking into account the developments in these factors, a significant disinflation of fuel prices is forecasted, with a short halt in the third quarter of 2006 due to a projected increase in the excise duty on leaded petrol[62]. Such a trajectory depends considerably on the dynamics of world oil price, which is assumed to remain flat over the projection horizon. This assumption is meant to reconcile diverging expert opinions indicating either a reduction in the oil price from the historical

[62] Draft Tax Code on the Ministry of Public Finance website.

highs in the third quarter of 2005[63] or further hikes as a result of ever increasing world demand (see also Section 2).

Recent price dynamics in the euro area is due largely to increases in world oil prices. Compared to the previous quarter, the annual HICP inflation forecast for the end of 2005 has been revised upwards, to 2.2 percent. Assuming that inflation expectations are not affected by the recent price developments, inflation for 2006 is expected to fall below 2 percent. As a consequence, the exogenous impact of foreign prices on import prices will be less significant, their dynamics continuing to be affected primarily by exchange rate developments.

1.4. Aggregate demand pressures

1.4.1. Current aggregate demand pressures

Excess demand in 2005 Q3 remains close to the magnitude recorded in the previous quarter, fuelling inflationary pressures in the short run. Thus, the closing of the positive output gap[64] that had started in the last quarter of 2004 came to a halt in 2005 Q3. Beginning with 2005 Q2, the downward pressures exerted by the adverse supply-side shocks (oil price, floods) on the output gap have been augmented by the restrictive impact of a strong domestic currency on the economic activity in the real sector, which was only partially offset by the expansionary effect of the banks' lending and deposit rates.

Labour market conditions fuel the current excess demand. The household disposable income is influenced by net wages and employment, both remaining above their recent years' trends. Higher disposable income together with more favourable lending terms have resulted in the expansion of non-government credit, especially short- and medium-term household credit, thus fostering aggregate demand. Moreover, decreasing average deposit rates and the real growth of M1 aggregate above the medium-term trend point to the intensification of transactions and suggest a partial switch of disposable income from saving to consumption.

The growth of gross fixed capital formation has reverted to the fast pace of recent years. This development could be attributed to the increase in investment spending, with employment staying above its recent trend and to more favourable lending terms for companies.

[63] According to October Consensus Forecasts.
[64] See Box 2 in the Inflation Report issued in August 2005 (Year I, No. 1, new series) for the definition and further details on the concept of output gap.

Imports remain above the medium-term trend. Given the improvement in disposable income and lending conditions, the real appreciation of the domestic currency against the euro in the last few quarters led to increased consumer preference for imported goods. On the other hand, the real appreciation of the domestic currency has caused export growth to slow down. Export developments are also accounted for by the negative growth of industrial production, especially in export-oriented sectors. This is reflected by the capacity utilization rate which is below its medium-term trend, while labour productivity in industry is declining, unit labour costs are increasing, and external demand for domestic goods is weakening.

1.4.2. Implications of recent exchange rate and interest rate developments

During 2005 Q3, the nominal effective exchange rate[65] continued to decrease at about the same pace as in the previous quarter, yet much slower than in 2005 Q1 and 2004 Q4. This slowdown in the pace of appreciation lends support to the assumption used in the previous projection, according to which the fast drop in Q1 was largely a normal adjustment of the exchange rate to changes in economic conditions relevant for the foreign exchange market. These changes can be ascribed to the cumulative effect of sustainable capital inflows, the adjustment of NBR's policy of foreign exchange market intervention, the liberalization of the capital account and an improved outlook on Romania's joining the European Union. Nevertheless, the considerable magnitude of nominal and real appreciation of the domestic currency over the last three quarters, as well as the significant widening of the current account deficit during the first part of the year, are indicative of pressure from the exchange rate on aggregate demand. This pressure was maintained during 2005 Q3, as the exchange rate continued to induce relatively restrictive effects on excess demand for domestic production, therefore containing inflationary pressures.

The exchange rate has two-way effects on excess demand. The first effect has a direct impact on net exports, while the second one has an indirect impact, through the wealth and balance sheet effects (see Box). The impact of the second channel works in opposite direction to the impact of the net export channel. As a result, while a real appreciation of the RON puts downward pressure on the economic activity (by influencing net exports), through wealth and balance sheet effects it boosts foreign

[65] Computed as an average of the exchange rates of the domestic currency against the euro and the US dollar respectively, according to the weights of the two foreign currencies in Romania's foreign trade.

exchange loans (by lowering borrowing costs in domestic currency), thus fuelling aggregate demand.

With an appreciation rate of the national currency close to the one in the previous quarter, during 2005 Q3, the effect of the *leu* equivalent of foreign currency borrowing costs on excess demand was roughly neutral.

NBR cut its policy rate to 7.5 percent in 2005 Q3. The NBR's interest rate affects the real economy only indirectly, through commercial banks' interest rates. Given the transmission lags between the changes in the policy rate and the interest rates on *leu*-denominated bank loans and deposits, the effects of the monetary policy easing did not feed through significantly into the real economy and into inflation during the third quarter. As a result, banks' real interest rates have the same effect on excess demand as in the previous quarter – expansionary effects in case of real deposit rates while lending rates have remained roughly neutral. Overall, this reflects the still incomplete transmission of the expansionary effect of the NBR's recent rate cut on the economy.

The expansionary effects of the interest rates do not fully offset the contractionary effects of the exchange rate, so the combined effects of interest rates and the exchange rate in Q3 have put downward pressure on excess demand in the short run. However, the combined effects are expected to act in the opposite direction in 2005 Q4, due to ongoing adjustment of banks' interest rates to the moves in NBR rate, as well as to a relatively more stimulative exchange rate.

Box

Wealth and balance sheet effects of exchange rate

In addition to its influence on the external competitiveness of the economy, the exchange rate also impacts households' wealth and companies' net worth. Households' wealth and companies' net worth reflect holdings of resources in the form of goods, money, and other financial assets. However, not all of these holdings of goods/assets represent wealth or own equity of the company, some of them being the counterpart of outstanding loans. Therefore, the wealth of households or the net worth of companies is given by the value of their holdings of goods (assets) net of the value of their liabilities. Exchange rate movements affect the domestic currency value of loans contracted in a foreign currency, thus altering households' wealth and companies' net worth.

The wealth and balance sheet effects of the exchange rate entail changes in the volume of resources that can be allocated to consumption and investment or to repayment of loans.

The wealth effect of the exchange rate consists in the influence of exchange rate movements on consumption and investment given their impact on households' wealth and companies' net worth. The wealth and balance sheet effects are important especially when a large part of the households' or companies' liabilities consists of loans contracted in a foreign currency. Given a foreign currency denominated loan, the exchange rate appreciation results in a reduction of the net present value of the liability expressed in domestic currency (taking into account both principal and interests). Thus, domestic currency denominated wealth increases, improving consumption and investment opportunities.

The balance sheet effect describes the impact of the exchange rate on the output gap caused by the effect of changes in wealth and net worth on the availability of bank loans. It is usually difficult and costly for banks to directly assess the clients' future capacity to repay loans. As a result, households' wealth and companies' net worth, as synthetic indicators, are important factors underlying the decision to grant a loan, as they can be used as collateral. The RON appreciation causes households' wealth and companies' net worth to increase. Moreover, a current lower value in *lei* of foreign currency denominated loans improves the capacity to repay loans. These effects reduce the default risk and improve borrowing eligibility. Therefore, the availability of bank loans increases, which leads to rises in both consumption and investment spending.

The wealth and balance sheet effects of the exchange rate act in opposite direction to the effects through the external competitiveness channel. The overall effect of the exchange rate through these two channels depends on their relative importance.

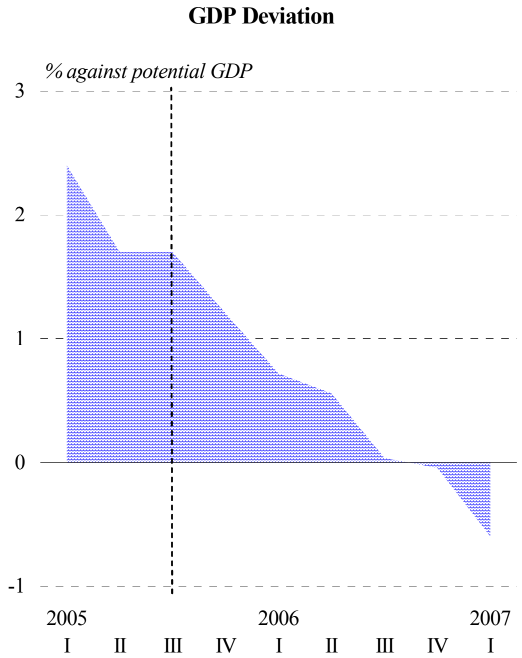
Table 1. Initial state – RON/EUR 4.00	
	RON
Assets	**10,800**
Fixed assets	9,000
Other assets and money	1,800
Liabilities (1,500 x 4 =)	**6,000**
Wealth/Equity (10,800 – 6,000 =)	**4,800**

Table 2. Final state – RON/EUR 3.60	
	RON
Assets	**10,800**
Fixed assets	9,000
Other assets and money	1,800
Liabilities (1,500 x 3.6 =)	**5,400**
Wealth/Equity (10,800 – 5,400 =)	**5,400**

We demonstrate how the appreciation of the domestic currency against the euro leads to a rise in wealth/net worth by way of a simplified example. Consider a household or a company which holds RON-denominated assets (with a total value of RON 10,800 in the example) and it has been granted a foreign exchange loan (EUR 1,500 in the example) – this is probably the most relevant situation for Romania at present. Table 1 presents the initial state, when the exchange rate is RON/EUR 4.00[66]. Appreciation of the domestic currency to RON/EUR 3.60 pushes down the local currency value of the loan from 6,000 (EUR 1,500 x 4.00) to 5,400 (EUR 1,500 x 3.60), increasing wealth/net worth in domestic currency from 4,800 to 5,400 (Table 2). Likewise, depreciation of the domestic currency leads to a decrease in the wealth of households and net worth of companies, with specific effects on their access to financing, as well as on their capacity to service the already existing debt.

[66] The exchange rate level is chosen arbitrarily, for illustrative purposes.

1.4.3. Demand pressures within the projection horizon



Similar to the projections in the Inflation Report issued in August 2005, the baseline scenario for the next six quarters shows the output gap following a downward path. Under such circumstances, the excess demand is expected to be removed by the end of 2006. This will be the effect, in the medium term, of the real appreciation of the domestic currency and of a tight fiscal policy stance, while in the short term it will be caused by the deceleration of non-government credit growth. The current estimate for the output gap over the projection horizon is higher than in the previous forecast. This is attributed both to the inclusion in the baseline scenario of wealth and balance sheet effects of the *leu* appreciation and to lower than previously projected interest rates throughout the forecasting horizon.

The projection indicates that the downward trend of average interest rates on time deposits that started a year ago will be brought to a halt at the beginning of 2006. A moderate increase in average deposit rates in the first part of next year might be due to: (i) diminishing excess liquidity in the money market, (ii) increasing competition among banks for domestic currency resources – given that foreign currency lending has recently become more expensive for banks –, and/or (iii) a reallocation of household savings towards longer maturity term deposits, which usually have higher yields.

For the fourth quarter of 2005, the baseline scenario envisages a relatively sharp reduction of interest rates on loans denominated in domestic currency. This is largely the result of previous policy rate cuts, the downward adjustment of deposit rates, and the signal conveyed by the reduction to 14 percent of NBR's lending facility rate. Over the short term, a slight setback of lending growth[67] is expected, due to the prudential measures taken by the central bank to limit foreign currency credit and to the relative sluggishness inherent to the process of substituting domestic currency credit for foreign currency credit. Over the medium term, however, domestic currency lending is expected to gain momentum against the background of a declining spread between interest rates on *leu*-denominated credits and average interest rates on time deposits. Despite a temporary halt in their downward path in the first part of 2006, average lending rates are expected to be stimulative throughout the projection horizon.

Considering the forecast of a relatively constant average interest rate in the European money market and the rise of interest rates

[67] This restraining effect is expected to exert a mild negative impact on excess demand in the fourth quarter of 2005.

on *leu*-denominated deposits starting from the levels projected for 2005 Q4, the baseline projection envisages further real appreciation of the domestic currency throughout 2006[68]. This appreciation is expected to exert pressures for narrowing the excess demand through a reduction of the relative prices of imported goods and, as a result, of the demand for domestic products. The baseline scenario also includes the wealth and balance sheet effects of the RON appreciation, with opposite, stimulating effects on the output gap – see the Box on *Wealth and balance sheet effects*. Taking into account both channels, the overall excess demand effect could be ambiguous in the case of a large-scale real appreciation perceived to be permanent. Given all this, the current projection assumes a slower pace of real appreciation relative to the previous forecast, with the output gap turning negative in the first quarter of 2007 (as compared to the fourth quarter of 2006 in the former projection).

Unlike the previous projection, the current one benefits from information about the major coordinates of the 2006 fiscal program, which allows the assessment of fiscal policy impact on excess demand. The projected annual deficit of 1 percent of GDP implies for the last quarter of 2005 an expansionary fiscal impulse, attributed almost exclusively to an increase in budgetary expenditures. With wider deficits having lately become typical of the final quarter of each year, the same pattern will be maintained for 2005 Q4, this time also related to government spending needed to alleviate the flood-induced damages. For 2006, the draft budget projects a fiscal deficit of 0.5 percent of GDP. Given the parallel reduction of excess demand throughout 2006, this implies a more restrictive impact of fiscal policy as compared to this year.

In accordance with the projection, economic growth for 2005 will be lower than in 2004. This slowdown was driven, on the supply side, by the adverse effects of floods on output in agriculture and construction sectors and by the slower dynamics in industry; on the demand side, it can be attributed to a relative deceleration of investment and export growth. For 2006, the projection envisages higher economic growth driven by consumption and investment.

Final household consumption is expected to continue to rise at a sustained rate, fostered by relatively low real interest rates on

[68] The planned liberalization of non-residents' access to the local market for government securities starting 1 January 2006 could also put downward pressure on the domestic currency; these effects are nevertheless expected to be insignificant, due to a relative shortage of these instruments given the small need for domestic financing of the budget deficit, as well as to excess liquidity in the money market.

deposits and credits in domestic currency. The stimulating effect of real interest rates feeds into higher demand for consumer goods and services through an increase in consumer loans and a reduction of the savings rate. Real exchange rate appreciation leads to a reduction of the real financial debt, evaluated in domestic currency, of borrowers in foreign currency. This wealth effect also fuels the demand for consumer goods and services. Consumption growth should be mitigated to some extent by the tighter fiscal policy stance over the projection horizon.

For 2006, gross fixed capital formation is expected to be among the most dynamic GDP components. Investment should be spurred by the stimulative lending rates and the real appreciation of the *leu*, which may foster technology-related imports. The surge in investment may also be boosted by the projected increase in government capital expenditures and the funds allocated by the European Union, largely channelled towards rehabilitating the flood-damaged areas and resuming infrastructure projects, respectively. In addition, significant investment programs are expected to be either initiated or continued by the recently privatized companies. The prospects of EU accession will provide Romanian companies with considerable incentives to intensify their investment efforts aimed to improve their capability to cope with the new competition environment within the single market.

The developments in exports are expected to be positive over the projected period. While contained in the short run by the real appreciation of the domestic currency, sustainable export growth should be fostered by long term capital investment and foreign demand growth, especially from the EU, as Romania's main trading partner. Over the forecasting horizon, however, the European Union is expected to experience modest economic growth, with a roughly neutral impact on domestic exports, assuming a constant EU market share for Romania. The prospects for foreign direct investment in export-oriented industries appear to be favourable.

Import growth is expected to accelerate over the forecast horizon. Given the real appreciation of the domestic currency, higher consumption demand fuelled by low real interest rates is more likely to entail a surge in imports rather than in domestic prices. A positive influence on imports is also expected from the increase in investment. However, the recent prudential measures taken by the NBR to limit the expansion of foreign currency lending as well as tighter fiscal policy in 2006 are likely to put a dent on import growth.

2. Uncertainties surrounding the central projection

Given the hypothetical nature of the assumptions employed for the baseline scenario, the projection is subject to uncertainties, which need to be assessed from the standpoint of both their potential sources and the most relevant risks over the forecast horizon.

As stated in the previous Inflation Report, there are a number of permanent sources of uncertainties surrounding the forecast. The scenarios for the exogenous variables represent an important source. The uncertainties refer to supply-side factors such as administered prices, food prices that are highly dependent on weather conditions, international prices of oil and natural gas, as well as to demand-side factors such as some of the coordinates defining fiscal and wage policies or the development of external demand for Romanian exports. Another permanent source of uncertainty is due to the unobservable nature of some of the principal determinants of inflation, such as inflation expectations, the output gap, or the aggregate effects of exchange rate and interest rate fluctuations on excess demand. Last but not least, an additional source of uncertainty derives from the forecasted paths of exchange rate and interest rates, since in an environment characterized by free capital flows and rapid structural changes, financial asset prices are generally more volatile and, as a consequence, more difficult to predict.

For the current projection, the most significant risks that could cause deviations from the baseline trajectory of inflation appear to be related to the fiscal and wage policies for 2006, the future dynamics of administered prices and international prices of oil and natural gas, as well as to the future path of the exchange rate. On balance, the risks of underestimating future inflation seem to prevail. Under a pessimistic scenario with all risks materializing, a significant overshooting of the end-2006 inflation target may be expected.

For next year, the risk of overheating the economy could be generated by a potential mix of looser than projected fiscal policy, excessive wage growth[69], and accelerated non-government credit growth. Given the transmission lags of monetary policy, under such a scenario excess demand could not be entirely removed by the end of 2006, thus hampering the fulfilment of the inflation target.

[69] Excessive in the sense of an average real wage growth well above the accumulated productivity gains.

Fiscal policy risks derive from uncertainties regarding primarily the estimation of budget revenues to be collected in 2006. An important source of uncertainty is the extent to which the business cycle affects budget revenues. The adoption of multi-annual budget programming in view of EU accession emphasizes the importance of medium- and long-term fiscal objectives. In the short term, however, output gap fluctuations can generate deviations from annual fiscal objectives. Thus, in order to achieve continuous disinflation the positive output gap needs to be closed in the course of next year. However, the pace at which excess demand is eliminated may cause deviations of output growth from the path compatible with the projected budget revenues. Given the current relatively low share of public revenues in GDP, such deviations could generate inflationary pressures by means of either (i) a wider-than-forecasted budget deficit that would partially offset the decrease in excess demand in the private sector or (ii) tax adjustments aimed at maintaining the budget deficit on the programmed track, but with a direct impact on prices (e.g. indirect tax hikes).

The future design of wage policy is highly uncertain. Real convergence of the Romanian economy towards the EU economy implies gradual rise of real incomes, particularly of wages. In this vein, maintaining a close correlation of real wage dynamics with productivity gains is critical. Real wage growth in excess of productivity growth on account of overly fast nominal wage adjustments may give rise to inflationary pressures as aggregate demand expansion would outpace supply adjustments. Moreover, price increases tend to gradually offset real wage gains, thereby slowing down real convergence. The risks related to the wage policy stance over the forecasting horizon are clearly illustrated by the recent pattern of wage increases. During October 2004 – October 2005, public sector wages were raised in four stages by a cumulative 50 percent in nominal terms.

Supply-side factors continue to pose risks to the current projection. The next period is marked by high uncertainty surrounding the path of international energy prices. Despite oil and natural gas prices reaching historical highs in 2005, most analysts consider energy prices are more likely to go up than down, due to sustained growth of world demand for petroleum products. A scenario with a rapid increase in the oil price appears plausible, given its high average annual growth rate (in excess of 20 percent) in the period after 11 September 2001. Should such an increase occur, a direct inflationary impact would come from the mounting prices of imported and, to some extent, of domestically produced fuel. Furthermore, additional second-round effects may be generated by the increases in non-energy import prices. A similar line of arguments could be put forward with regard to the consequences on economic growth. A hike in fuel and energy prices amid a slowdown in world economic growth could negatively affect domestic companies, boosting production costs and depressing domestic and foreign demand for their products.

In the absence of an official timetable for administered price adjustments, information regarding their future path is only approximate, being based on the authorities' tentative announcements. Given the significant contribution of administered prices to headline inflation, the higher the likelihood of their deviation from the baseline scenario in terms of magnitude and quarterly distribution, the greater the uncertainty surrounding the inflation projection even in the short run. For 2006, greater risks are associated with the domestic prices of natural gas. In this case, uncertainties are related to (i) future developments in import prices, to which domestic prices must converge, and (ii) the methodology of consumer price determination, based on quarterly cost estimates. There is also significant uncertainty regarding the price of heating, with adjustments depending on the expected price of heating fuel, the level of arrears collection in the system, the pace of removing subsidies, as well as on the consequences of introducing a new billing system.

The forecasted path of the nominal exchange rate (RON/EUR) is surrounded by substantial uncertainty, given the significant impact of short-term capital flows and their associated high volatility. The risks of upward or downward pressures on the exchange rate around the baseline trajectory seem to be balanced. Nevertheless, in the event of major fluctuations, both appreciation and depreciation of the domestic currency might induce adverse effects on the projected inflation rate. For instance, significant depreciation of the RON would seriously hamper disinflation, causing import prices to become an additional source of inflationary pressures. Conversely, an abrupt appreciation of the RON, while facilitating the fulfilment of the target in 2006, would increase the economy's vulnerability through further widening of the current account deficit as well as through a higher degree of euroization/dollarization that would aggravate the currency mismatch in the private sector balance sheets. As a result, the increased likelihood of a subsequent correction through fast RON depreciation generates upward risks for inflation over longer horizons.

3. Policy assessment

The latest inflation forecast illustrates the numerous risks and challenges monetary policy will have to face in the quarters ahead. The analysis of this intricate economic environment is indicative of the fact that maintaining the growth rate of consumer prices on the path consistent with the attainment of the inflation target for end-2006 (the shortest time horizon that is relevant in terms of monetary policy effectiveness) is conditional upon tighter monetary conditions during 2006.

Even if assuming that monetary restrictiveness reaches the forecasted level, the annual inflation rate will remain, for the next five quarters, in the upper bound of a target band of ±1 percentage point around the (dis)inflation path. Although this approach is less ambitious, it is preferable to a more aggressive one, which would allow a more accelerated disinflation but which would also entail substantial economic costs and risks. Therefore, the annual inflation rate will exceed the revised inflation target for December 2005; the main reason for its most likely nearing the upper bound of the accepted target band is the unexpectedly strong impact on price developments during this year of the factors falling beyond the control of the monetary policy authority (larger-than-anticipated increases in administered prices that occurred, during periods of higher aggregate demand, with a certain time lag from the original schedule, unexpectedly strong growth of world oil price, effects of recent floods and unfavourable weather conditions on prices of farm products).

The key argument in favour of tighter monetary conditions that is provided by the baseline scenario is the lingering excess demand at higher-than-expected levels and the persistence, at least in the near term, of pressures induced by excess demand on macroeconomic disequilibria; despite the prompt response of monetary policy, excess demand will not be eliminated sooner than the end of 2006 given the time lags inherent to the transmission of monetary policy signals. In view of ensuring the sustainability of disinflation, the need to tighten monetary conditions in this context is all the more justified as the capacity of trade deficit to take over demand-side pressures and thereby alleviate their inflationary potential, without undermining the sustainability of the external position, has diminished.

Apart from the overly high growth rate of demand, another cause for concern the forecasted environment could generate is the persistence of an inappropriate structure of demand (in terms of the requirements to strengthen the economic growth potential), with household consumption posting the highest rate of increase. The risk that the consumption/saving substitution phenomenon which has been detected recently might gain ground, in the absence of a change in the monetary policy stance, makes this development even more relevant; the potential slowdown in household saving in the longer run could undermine not only the macroeconomic stability but also the rebound in bank intermediation and the investment process. Moreover, the persistence of weak household saving could further erode the external position of the economy, the boost in domestic saving representing the only way to reduce current account deficit in the long run. In this context, monetary policy tightening aimed also at encouraging saving would implicitly diminish households' propensity for consumption, thereby boosting the potential effect of the recently implemented measures intended to contain foreign exchange-denominated loans.

Another strong reason in favour of tighter monetary conditions is the relative expansion in the coming months of the direct impact of supply-side factors on CPI and implicitly of their second-round effects. From this perspective, the greatest risks are generated by the (i) significant administered price increases in 2006; (ii) higher food prices due to floods and unfavourable weather conditions in 2005, and (iii) the unpredictable development of world prices for oil and gas. Another cause for concern is the high sensitivity of inflation expectations to these factors and to the recent effects of the policies destined to maintain inflation rate on the forecasted path, the anchoring and transformation of expectations into a factor that sustains disinflation, requiring the central bank to adopt a firm monetary policy stance.

The change in the monetary policy stance should be made as soon as possible for at least two reasons. The first one is the overly high increase, in the next couple of months, of pressures coming from domestic demand components, i.e. consumption and investment. The larger pressures generated by consumption will be fuelled chiefly by the seasonally-induced wage hikes (wages of public sector employees included) – which are expected to be at least in line with the wage hikes in 2005 – and by the seasonal rise in remittances from abroad; moreover, pressures coming from consumer demand could by boosted by (i) the offsetting effect of the relative fall in self-consumption, given the much poorer performance of agriculture in the summer of 2005 and by (ii) the likely growth of food imports (fruit and vegetables) whose prices are more sensitive to higher demand-side pressures. Investment will be given a boost by the larger budget expenditures specific to the coming period, as well as by the financial efforts destined to rebuild the infrastructure and the dwellings that have been destroyed by the floods in 2005.

The second reason behind the prompt resort to monetary policy tightening is the asymmetric response of banks' interest rates to the movements in NBR interest rates, the former posting a relative rigidity towards the moderate growth of the latter. Therefore, the assumption of delaying the upward revision of NBR interest rates[70] implies – also due to further decline in lending and deposit rates during this period – a higher-than-projected increase in NBR interest rates.

The major risk generated by the quick tightening of monetary policy which is aimed at keeping the annual inflation rate on the projected trajectory is the likely rebound in speculative capital inflows. The concern that this risk may actually materialise is fostered by the fact that the central bank made strenuous efforts in 2005 Q3, thereby assuming large credibility costs. The resurgence in speculative capital could entail either the acceleration in the appreciation of domestic currency or the faster-paced sterilisation of capital inflows and higher costs incurred by the central bank; assuming that inflows will be much larger than previously, both effects are likely to become manifest.

Another risk generated, at least in the short run, by monetary policy tightening is the potential adverse effect of domestic currency overappreciation on trade balance; this might cause trade deficit to reach levels that are incompatible with the sustainability of the balance of payments and implicitly with that of medium-term disinflation. The fast-paced appreciation of the RON against the EUR, which might follow the implementation of the NBR's decision, although likely to decelerate imported inflation, would have several unfavourable consequences:

a) Erosion of external competitiveness of exports in case the increase in productivity of the respective sectors would not offset the effect induced by the lower exchange rate of domestic currency. The contractionary effect of domestic currency appreciation on exports and implicitly on economic growth could however be alleviated by (i) the restructuring that exporters could initiate under pressure from the exchange rate; (ii) trade diversion towards the domestic market by producers whose foreign market shares are contracting; (iii) the possibility that the restrictiveness of the current exchange rate is overestimated, as the difficulties in assessing the equilibrium level of the

[70] According to the inflation forecast.

exchange rate, particularly in emerging economies, are well known.

b) Increase in total domestic demand or at least in demand for imports.

From the perspective of disinflation, such developments might subsequently cause the relatively abrupt adjustment of the exchange rate of domestic currency and its trajectory. This risk is all the more higher as, lately, the effects of RON appreciation on disinflation have been at odds with the more substantial effects of a potential RON depreciation on inflation.

The NBR Board made an in-depth assessment of the current and future economic developments, as well as of the ensuing risks from the perspective of attaining the inflation target and sustaining disinflation in the medium-term, and inferred that the conflicting nature of the challenges the central bank must deal with will likely persist during the current period. Nevertheless, the Board found that the relevance of the risk of increased speculative capital inflows is offset by the stronger threat, in the short term at least, of exacerbating demand-side inflationary pressures. Consequently, the NBR Board decided to keep the policy rate at 7.5 percent and significantly increase the volume of liquidity-absorbing operations. Furthermore, the National Bank of Romania Board decided to remain vigilant and closely monitor any developments that might affect the future path of disinflation, standing ready to take prompt remedial measures.

ESCAPE CLAUSES

Escape clauses define *ex ante* a narrow set of circumstances that are beyond the control of monetary policy and therefore restrict the National Bank of Romania's responsibility for achieving the inflation targets.

These circumstances include:

- major hikes in world prices of raw materials, energy-producing materials and other commodities;
- natural disasters and other extraordinary events having cost and demand impacts on prices, as well as unpredictable changes in agricultural producer prices;
- large fluctuations of the exchange rate of the *leu* that are not connected with domestic economic fundamentals and the domestic monetary policy pursued by the National Bank of Romania;
- major deviations from the administered price adjustment programme announced by the Government, in terms of both magnitude and timing;
- deviation from the programmed fiscal and incomes policies, in terms of both implementation and final results.

Since the proper recourse to escape clauses constitutes a prerequisite for the central bank's credibility, they are to be invoked with utmost caution, and only for well-justified reasons.

Circumscribing the central bank's responsibility for attaining the inflation target contingent upon escape clauses helps to properly set the targets and project the disinflation path, as well as to analyze the actual inflation outcomes relative to the target band.