INFLATION REPORT

August 2023

Summary

Developments in inflation and its determinants

The annual CPI inflation rate remained on a downward path in Q2, falling considerably to 10.25 percent in June (-4.28 percentage points versus March and -6.12 percentage points versus December 2022). In June, the indicator exceeded only marginally (by 0.1 percentage points) the projection in the previous *Inflation Report*. The largest contribution to disinflation in Q2 came from energy prices, the dynamics of which reflected strong base effects, but also a relative stability of the Brent oil price (the spike seen in the first part of April faded away relatively quickly). A favourable, albeit smaller, contribution to disinflation also came from the adjusted CORE2 inflation, which after peaking at 15 percent in February posted a deceleration to 13.5 percent in June, from 14.6 percent in March.

Favourable developments in core inflation came solely from the food segment, amid the correction of the main agri-food commodity prices (wheat, sunflower seeds, maize). By contrast, pressures on companies' wage costs increased significantly, causing the annual price changes in the other two segments of adjusted CORE2 index to remain on an upward trajectory. In the case of services, where highly wage-sensitive items account for approximately 50 percent, the annual pace of price increases climbed to 10.4 percent in June, i.e. 1.3 percentage points higher than in March. Rising pressures of a relatively similar magnitude (+1.4 percentage points in June against March) were also visible for the non-food group, with the trend being mainly driven by import prices. In the period under review, all sub-components of core inflation were supported by excess aggregate demand, although the latter embarked on a downward path starting 2023 Q1 and was revised downwards in the first half of 2023 compared to the previous *Report*. At the same time, the downward trajectory of inflation expectations of economic agents and financial analysts alike continued to mitigate the impact of adverse supply-side shocks on the dynamics of final prices of consumer goods.

The annual dynamics of unit labour costs in the economy as a whole surged in January-March 2023 to reach 12.6 percent (+3.6 percentage points versus the previous quarter), amid the decoupling of the annual growth rate of the compensation per employee (up 2.8 percentage points versus 2022 Q4, to almost 16.7 percent) from that of labour productivity (down 0.9 percentage points, to 3.6 percent). These developments are conducive to a build-up of inflationary pressures. In industry, the annual dynamics of unit wage costs remained on an upward path in the first five months of 2023, gaining momentum in April-May 2023 to reach 25.2 percent

(compared to 22.1 percent in 2023 Q1 and 21.5 percent in 2022 Q4). Although pressures on the other production costs receded amid the easing of commodity markets, industrial activity witnessed a modest evolution, increasingly reflecting the negative influence of the slowdown in global economic growth.

The average annual CPI inflation rate, a measure with inherently higher persistence, resumed a downward path, with the indicator calculated based on the national methodology falling from the 15.3 percent peak seen in March to 14.2 percent in June. The indicator calculated in accordance with the harmonised structure (HICP) saw a similar qualitative evolution, posting a correction to 12.5 percent in June after a 13.2 percent peak also in March. Thus, Romania slightly narrowed its gap with the European average and continued to fare better than the other countries in the region in terms of the average annual change in the HICP.

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

In its meeting of 10 May 2023, the NBR Board decided to keep the monetary policy rate at 7.00 percent per annum. The interest rates on standing facilities were also left unchanged at 6.00 percent per annum (the deposit facility rate) and at 8.00 percent per annum (the lending facility rate). In 2023 Q1 overall, the annual inflation rate declined considerably (from 16.37 percent in December 2022 to 14.53 percent in March 2023), posting the first contraction in nine quarters, in line with expectations. The decrease was mainly driven by the sizeable drop in the dynamics of fuel and electricity prices, under the impact of significant base effects and the change made to the energy price capping and compensation scheme starting 1 January 2023. In turn, the annual adjusted CORE2 inflation rate halted its rise in 2023 Q1, reflecting its lower-than-expected advance in the first two months of the year and the March decline to the December 2022 level, i.e. 14.6 percent, amid disinflationary base effects, falling commodity prices, especially for agri-food items, as well as the downward adjustment of short-term inflation expectations. These fully offset the opposite influences that continued to come in Q1 from the gradual pass-through of increased costs of materials and wages into consumer prices, as well as from the preserved profit margins, in the context of the resilience of consumer demand, but also from the hike in the prices of some imported consumer goods. The latest forecast, based on the available data and the regulations in force, broadly reconfirmed the coordinates of the previous medium-term forecast.

The war in Ukraine and associated sanctions, the turmoil in the US and Swiss banking systems and the absorption of European funds (mainly those related to the Next Generation EU programme – conditional on the achievement of strict targets and milestones in the implementation of the projects) continued to generate significant uncertainties and risks to the outlook for economic activity, hence to medium-term inflation developments. The EU funds absorption is essential for carrying out the necessary structural reforms, energy transition included, but also for counterbalancing, at least in part, the contractionary impact of supply-side shocks. Moreover, heightened uncertainties and risks were also associated with the fiscal policy stance, given on the one hand the public deficit target set for 2023 in order to

continue budget consolidation amid the excessive deficit procedure and the significant increase in financing costs and, on the other hand, the characteristics of the budget execution in the first months of the year, as well as the packages of support measures implemented or extended in 2023, in a challenging economic and social environment domestically and globally, with potential adverse implications for final budget parameters. The Fed's and the ECB's monetary policy decisions, as well as the stance of central banks in the region continued to be relevant.

Subsequently, the annual inflation rate saw a faster decline in the first two months of Q2, falling from 14.53 percent in March to 10.64 percent in May, in line with the forecasts, mainly as a result of the stronger downward trend in energy and fuel price dynamics, under the impact of some base effects, lower crude oil prices and capping schemes for electricity and natural gas prices. At the same time, the annual adjusted CORE2 inflation rate continued to decrease gradually during this period, in line with expectations, and reached 13.6 percent in May from 14.6 percent in March amid stronger disinflationary base effects, falling prices of commodities, primarily agri-food items, as well as the downward adjustment of short-term inflation expectations. The impact of these factors surpassed the opposite influences that continued to come from the gradual pass-through of increased costs of firms, including wage costs, into consumer prices, as well as from the preserved profit margins, in the context of a still robust consumer demand. Economic activity saw a faster-than-expected slowdown in 2023 Q1, which made it likely for excess aggregate demand to narrow somewhat more visibly over this period, compared to expectations. At the same time, in 2023 Q1 the annual growth rate of GDP also shrank faster than forecasted to 2.3 percent from 4.5 percent in 2022 Q4. The decline was primarily driven by the change in inventories, while the pace of increase of household consumption and gross fixed capital formation continued to step up compared to the same year-earlier period and the contractionary impact of net exports posted a relatively modest widening, as the slowdown in the dynamics of the export volume slightly outpaced that in the dynamics of the import volume of goods and services. Trade deficit and current account deficit posted, however, significant decreases in 2023 Q1 versus 2022 Q1 mainly amid the improved terms of trade.

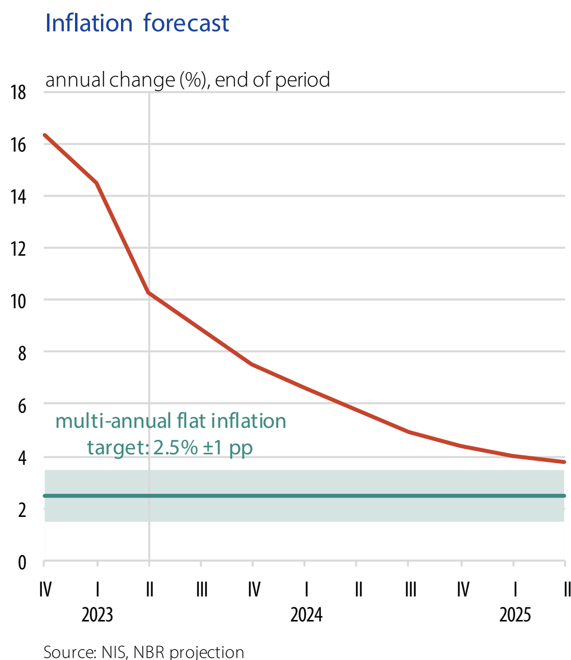
At the time of the NBR Board meeting of 5 July 2023, the latest assessments indicated that the annual inflation rate would continue to fall over the following months, in line with the latest medium-term forecast (May 2023), mainly under the influence of base effects and the downward corrections recorded by some commodity prices in prior quarters. The previously-identified risk and uncertainty factors remained relevant.

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

Inflation outlook

After the release of the May 2023 *Inflation Report*, the global macroeconomic environment continued to benefit from a number of favourable developments: new downward adjustments in some commodity prices, restoration of the efficiency of value chains, less uncertainty facing consumers and companies alike. However, the overall situation has remained fragile and marked by numerous risks. Specifically, external inflationary pressures continued to abate, albeit more slowly than anticipated in the previous *Report*, whereas economic activity in Europe lost significant momentum under the impact of several factors: the lingering effects of adverse supply-side shocks in previous years, the consequences of the war in Ukraine or of the large rate hikes by major central banks over a relatively short time span. Against this backdrop, global growth is expected to slow visibly this year against 2022. Moreover, even though headline inflation saw a significant correction, certain subcomponents have proven to be more persistent than anticipated, entailing many unknowns as to the future path of this variable. In a period marked by evolutions relatively atypical of recent decades, the main sources of global risks and uncertainties are still linked to geopolitical developments, with a potential direct impact on commodity markets, viewed as important supply-side inflationary sources. In addition, the heightening of some risk factors – e.g. those associated with a possible slippage in domestic fiscal policy, whose tackling involved, in similar instances in the past, unfavourable consequences for a wide range of macroeconomic variables – calls for caution in assessing all possible implications.

Inflation forecast



Source: NIS, NBR projection

The baseline scenario assumptions continue to reflect the persistence of the armed conflict in Ukraine and its adverse effects, accompanied by the ongoing medium-term implementation of economic sanctions imposed on Russia. The widespread, orderly decoupling of European countries from energy imports from Russia as early as last year helped ease tensions on wholesale energy markets, thus avoiding disruptions in economic activity. At the same time, however, the protraction of war is likely to prevent a full rebound of economies that are still, at least partly, in a process of recovery after the pandemic-induced losses, with possible mitigating effects on potential GDP growth, especially over the medium term.

In Romania, subsequent to the increased resilience of economic activity at end-2022, the economy almost came to a standstill in 2023 Q1, according to official statistics. The latest developments by sector point to a resumption of growth, but its pace will strengthen especially in the latter part of the year. The assessment reflects, on the one hand, the simultaneous short-term slowdown in the dynamics of trading partners' economies in Europe, influenced by the much weaker-than-expected performance of the German economy, and on the other hand, the adverse effects

of previous supply-side shocks, of those associated with monetary policy normalisation and, to a much lower extent than in the prior *Report*, of the ongoing fiscal consolidation. Given the poor performance at the beginning of the year, also marked by a slowdown in the favourable traction of domestic demand, full-year GDP dynamics were revised to below 3 percent. In correlation with these developments, the positive output gap was also revised downwards between 2023 Q1 and 2023 Q3, but, similarly to the previous round, two of the key findings of the analysis were reconfirmed: the output gap started contracting as early as 2023 Q1 and excess demand fades away almost completely towards the end of the projection interval. Against the background of the stronger-than-expected moderation of the economy in 2023 H1, along with downward revisions of the statistical series of gross fixed capital formation, medium-term dynamics of potential GDP were revised slightly downwards.

Despite these revisions, potential GDP growth is forecasted to continue in the medium term at fairly robust annual rates, strictly conditional on the assumption of absorbing a relatively large volume of EU funds as a share of GDP. With investment as the main beneficiary of these funds, the dynamics of gross fixed capital formation would outpace those of household consumption already starting in 2024. Nevertheless, over the next two years, household consumption (having a much larger share of GDP than investment) will remain the main contributor to economic growth. Looking ahead, while the annual growth rate of consumption is projected to slow, that of gross fixed capital formation is seen following a robust path. Aside from EU funds, another source of investment financing will be foreign direct investment, a component with already noticeable dynamics in the last two years, which persisted into 2023 H1 as well. As for consumption, the persistent decline in households' purchasing power and the detrimental effect of still high uncertainty further prevail, *inter alia* amid the unknowns about the final version of the fiscal consolidation measures to be taken by the authorities.

On the external front, the favourable developments in the current account deficit January through May 2023 suggest that, in the present business cycle, the variable already peaked at 9.3 percent of GDP at the end of last year. The recent correction was driven by the significant downward adjustment in commodity prices, energy prices in particular. Against this background, the adverse price effects that had a decisive impact on the dynamics of this variable over the past two years are currently unwinding. Looking ahead, further corrections to the deficit of trade in goods will be fostered by the renewed momentum of trading partners' economies in Europe and the ongoing restoration of efficiency of global value chains. Over the medium term, the main constraints on larger corrections to the current account deficit stem from the significantly weaker-than-planned progress in fiscal consolidation and the still slower-than-desired pace of implementation of structural reforms economy-wide. Information recently circulated in the media appears to suggest that the EU authorities intend to link much more tightly the progress in fiscal consolidation to that in the volume of EU funds allocated to Romania. Therefore, a slowdown in fiscal correction would be likely to affect both the financing sources of the external imbalance and the implementation of EU-funded investment and structural adjustment programmes, which would additionally complicate the fiscal adjustment process.

According to the baseline scenario, the annual CPI inflation rate is projected to stick to its downward path throughout the projection interval, yet remaining above the variation band of the target (7.5 percent in December 2023, 4.4 percent in December 2024 and 3.8 percent in June 2025, i.e. the projection horizon). Compared to the May 2023 *Inflation Report*, the forecast for end-2023 was revised upwards by 0.4 percentage points. The differences stem chiefly from the faster dynamics of the adjusted CORE2 index and, to a lower extent, from those of the VFE index, with the latter component depending almost entirely on weather conditions, which have recently become highly unpredictable. Conversely, the energy component is expected this year to increase its deflationary contribution (its negative annual rate anticipated for December will be ascribable to the electricity and natural gas components). Therefore, in December 2023 compared to end-2022, energy prices will reduce their contribution to the annual CPI inflation rate by approximately 4.7 percentage points, while CPI inflation is seen declining by about 8.9 percentage points over the same period.

Against the background of a still positive output gap, companies continue to be able to pass on part of the across-the-board increases in production costs from previous periods to final consumer prices. This time too, the persistence of this pass-through exceeded the expectations from previous rounds. Specifically, the annual dynamics of the adjusted CORE2 index will ease only gradually over the projection interval, down to 9.9 percent in December 2023, 5.0 percent in December 2024 and 4.0 percent in June 2025. In recent quarters, an upward surprise has come particularly from the strong pressures from unit labour costs, which posted hefty, double-digit annual growth rates in the private sector. Similar developments, albeit somewhat less brisk, are foreseen to persist in the future mainly because of high wage growth in the private sector (driven by the skilled labour shortage, combined with companies' resilient labour demand, and by a demonstration effect of public sector pay rises), but also as a result of slower productivity dynamics this year. In this context, the annual adjusted CORE2 inflation forecast was revised upwards from the May 2023 *Inflation Report* (+0.6 percentage points in December 2023, +0.2 percentage points in December 2024). For 2024, aside from the stronger wage cost pressures, worth noting is also a mild upward revision of the output gap, which takes into account the available information and the assumptions made when the baseline scenario was completed as regards the slower prospective pace of fiscal consolidation. Conversely, financial analysts' inflation expectations, especially over the longer term, were revised to slightly more favourable values.

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

Since the previous *Inflation Report*, risks to the baseline scenario appear to have risen in number and, at the same time, to have diversified. The assessed balance of risks suggests possible upward deviations of inflation from its path in the baseline scenario. While the developments attributed to the economic effects of the war in Ukraine, but also to the more general, geopolitical ones, were reconfirmed as a major

source of uncertainty, the risks associated with the future fiscal stance amplified noticeably. Hence, the authorities are highly likely to take corrective measures with a direct impact on the annual inflation rate.

Recently, possible fiscal correction measures have circulated in the media. Of these, the measures to raise indirect taxes (VAT, excise duties) would entail additional inflationary pressures as early as the first month of their implementation, causing CPI inflation to deviate from its path in the baseline scenario. In theory, these increases produce effects over a limited period of 12 months until they drop out of the calculation of the annual inflation rate. However, insofar as the potential increases in indirect taxes will take place at different points in time (e.g., 1 September 2023 for certain VAT rates, 1 January 2024, 1 July 2024, etc. for certain excise duty hikes), their effects will overlap, sending inflation rates higher over longer periods. Moreover, indirect tax hikes, implemented repeatedly at rather short intervals, could trigger second-round inflationary effects amid the upward adjustment of economic agents' inflation expectations. Furthermore, depending on the composition, dosage and implementation timing of the fiscal measures, their cumulative impact on domestic economic activity might be unfavourable. Even so, the disinflationary effect arising from a downward correction of aggregate demand is likely to be more than offset by the direct inflationary one, as a result of these measures entering into force.

Given that Romania is still under the excessive deficit procedure, an insufficient correction of the budget balance relative to the committed targets could lead the EU authorities to impose a tighter correlation between the progress in fiscal consolidation and the volume of EU funds allocated to Romania. Thus, any delays, over the short and medium term, in implementing the fiscal correction would imply both the persistence of twin deficits over longer periods and a lower level than that assumed in the baseline scenario of financing sources for the current account deficit (EU funds). In such an event, a number of unfavourable direct influences would affect the coordinates of the domestic macroeconomic environment (larger risk premium, softer currency, higher inflation, weaker economic growth).

According to the baseline scenario, corporate profit margins will narrow over the next eight quarters. Their decline will take place in tandem with the expected robust dynamics of wage costs. In fact, as the inflationary impact of high energy and other commodity prices fades away gradually, wage costs are set to become one of the main drivers of corporate costs. Pay rises even higher than those assumed in the baseline scenario are not ruled out, considering the persistent labour market features: negative natural population change, negative net migration, high proportion of inactive persons, significant shortage of adequately skilled workers in some sectors. Assuming that excess demand in the economy would stay high for longer, labour cost growth could be absorbed partly through declines in firms' profit margins and partly via further increases in final consumer prices. These potential bouts of inflation would directly affect households' purchasing power and, in this case, the causal chain of higher prices – lower real wages – wage claims could bring about a self-sustained inflationary spiral.

The multifaceted effects, especially the economic ones, of the war in Ukraine remain a sizeable source of risks and uncertainty to the macroeconomic projection. In conjunction with the other confirmed or, as the case may be, newly-emerged hotbeds on the map of geopolitical risks, particularly those concerning China-US relations, there are risks of delays or even reversals in the recent progress in restructuring and streamlining value chains, potentially fuelling new bouts of inflation. Moreover, the postponement of some investment projects amid elevated uncertainty or bottlenecks in export and import flows could propagate adverse effects also on economic activity, which might implicitly entail the materialisation of stagflation risk. This poses challenges in terms of the optimal calibration of the macroeconomic policy mix, which is of the essence for an absolutely necessary and orderly adjustment of domestic and external imbalances.

Monetary policy decision

Given the outlook for the annual inflation rate to decline further over the next two years, on a somewhat higher-than-previously-anticipated path only in the medium segment of the projection horizon, and in view of the related risks and uncertainties, the NBR Board decided in its meeting of 7 August 2023 to keep the monetary policy rate at 7.00 percent. Moreover, it decided to leave unchanged the lending (Lombard) facility rate at 8.00 percent and the deposit facility rate at 6.00 percent. Furthermore, the NBR Board decided to keep the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.