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N O T E

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and National Bank of Romania supplied data.

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

The drafting, English version and technical coordination
of the Inflation Report were carried out by the Economics Department.

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Foreword

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

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

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

Inflation Report was completed on 1 November 2010 and approved by the NBR Board in its meeting of 2 November 2010.

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

ABBREVIATIONS

AER	annual effective rate
AMIGO	Household Labour Force Survey
BSE	Bucharest Stock Exchange
CCR	Central Credit Register
CD	certificate of deposit
COICOP	Classification of Individual Consumption According to Purpose
CPI	Consumer Price Index
ECB	European Central Bank
EIA	Energy Information Administration (within the U.S. Department of Energy)
Eurostat	Statistical Office of the European Communities
FED	Federal Reserve System
FOMC	Federal Open Market Committee
GFCF	Gross Fixed Capital Formation
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IFI	international financial institution
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MFI	monetary financial institution
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NCP	National Commission for Prognosis
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
OPEC	Organisation of Petroleum Exporting Countries
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
ULC	unit labour cost
UVI	unit value index
1W	one week
12M	12 months

Contents

I. SUMMARY

Developments in inflation and its determinants

In September 2010, the 12-month CPI inflation rate rose to 7.77 percent, 3.39 percentage points above the June reading. Thus, in 2010 Q3, inflation stood significantly above the upper limit of the variation band around the central target (3.5 percent) set for this year. The main driver of this evolution was the 5 percentage point increase in the standard value added tax rate starting 1 July 2010. Additional adverse effects stemmed from administered price dynamics and from the unfavourable influences on agri-food prices of adverse shocks on specific domestic and international markets.

The VAT rate hike fed through into the consumer price index components gradually and to different extents, with the strongest effects by the end of 2010 Q3 being manifest in the case of tobacco prices, administered prices and telephone rates. As for other groups of products, such as those whose prices are included in the adjusted CORE2 index[1], the magnitude and persistence of the negative output gap economy-wide, as well as seasonal factors, along with the gradual pass-through, cushioned to some extent the impact of the shock[2]. Given the data available by the completion date of this report, the cumulated direct impact of the VAT rate increase on the entire consumption basket is assessed so far to be lower than that assumed in the NBR's August forecast (about 61 percent compared with 75 percent).

Adverse supply-side shocks, apart from that related to the VAT rate hike, came from administered prices and food prices as a result of some of the risk scenarios considered in the previous Inflation Report partly materialising. In the latter case, the unfavourable developments were attributed to the hefty rises in external prices, along with the contraction in the domestic supply of some groups of products in the wake of June-July floods, given significant base effects.

Apart from the above-mentioned factors, behind the pick-up in inflation stood also the temporary worsening of inflation expectations under the impact of adverse shocks and the uncertainties surrounding the prospects for a consistent implementation of fiscal consolidation and income policy measures.

In the July-August period, the annual growth rate of gross nominal wage in the industrial sector remained at a level similar to that seen in Q2. The marked slowdown in the annual pace of increase of labour productivity in the industrial sector caused a lower year-on-year decline in unit labour costs July through August than in the previous 3-month period. However, these developments have not fuelled cost-push inflationary pressures. At the same time, unit labour cost dynamics remain favourable to external competitiveness of Romanian products given that the real effective exchange rate in this quarter stood close to the level consistent with fundamentals, according to NBR assessments.

In 2010 Q2, real GDP decline slowed for the fourth successive quarter, its annual pace decelerating significantly to -0.5 percent from -2.6 percent in the previous quarter. The lower annual GDP contraction was due to a modest quarterly rise (+0.3 percent), as well as to a base

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

[2] The increase in this component was merely 2.4 percentage points.

effect. The year-on-year decline in final consumption and gross fixed capital formation decelerated considerably, particularly in the former case. Annual growth of exports further picked up in Q2, lagging however behind that of imports. Consequently, the contribution of net exports to annual GDP dynamics turned negative after six quarters of positive readings. Against this background, the slower year-on-year contraction in economic activity was attributed to the positive contribution of domestic absorption, solely on account of the favourable influence from the change in inventories.

Overall, developments in aggregate demand components hint at still uncertain short-term prospects for economic recovery. The delay in clear signals emerging in regard to an easing of financial constraints on households and corporations and a revival in the propensity for consumption and investment – reflected also by the annual real dynamics of loans to the private sector remaining in negative territory – contributes to the persistence of the negative output gap.

Monetary policy since the release of the previous Inflation Report

On 4 August 2010, the Board of the National Bank of Romania decided to leave unchanged the monetary policy rate at 6.25 percent per annum. In the macroeconomic context marked by uncertainties related to the implementation of structural reforms and fiscal consolidation measures, as well as to the external environment evolution, monetary policy set as a priority for the period ahead the countering of possible second-round effects of the standard VAT rate increase starting 1 July 2010. As a result, this decision was aimed at ensuring adequate real broad monetary conditions for a firm anchoring of inflation expectations and maintaining the annual headline inflation rate, recalculated by excluding the first-round effect of the VAT increase, on a path in line with medium-term inflation targets.

The first months of implementing the VAT rate hike saw a lower direct impact of this measure on the CPI than the central bank had initially projected. Even against this background, the magnitude of the exogenous inflationary shock caused the annual CPI inflation to reach markedly higher levels starting July, despite the depth and persistence of the negative output gap in this period. The difficulty in anticipating the gradual pass-through of first-round effects and the risk of some significant second-round effects becoming manifest continued to be the sources of concern for the central bank.

Over the same period, amid the persistence of the aggregate demand shortfall, economic activity witnessed divergent sectoral developments in the near run. Hence, a clear trend for short-term economic growth was still difficult to detect.

The uncertainties surrounding the persistence of effects from the VAT rate hike and from fiscal consolidation measures appeared to be augmented by the emergence of main risks related to future developments in administered prices and volatile food prices.

Against this backdrop, in its meeting of 29 September 2010, the NBR Board restated the need to maintain a prudent monetary policy stance in an attempt to firmly anchor inflation expectations. Therefore, the NBR Board decided to keep unchanged the policy rate at 6.25 percent per annum and to continue ensuring an adequate management of liquidity in the banking system, as well as to maintain the existing levels of minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities.

Inflation outlook

The updated projection envisages the inflation rate remaining at levels above the upper limit of the variation band around the central target until 2011 Q3. The decline in inflation rate and its relative stabilisation in early 2012 at figures close to the central target will be supported by GDP staying below its potential level over the entire forecast horizon. After reaching its estimated trough in 2010 Q4, the negative output gap is seen narrowing as the economy gradually recovers, with a return to positive annual growth being foreseen in 2011. The upturn in economic activity will imply a moderate widening of the balance-of-payments current account deficit that is not expected to generate significant inflationary pressures from the leu exchange rate. Given the high uncertainties associated, particularly over the short term, with domestic and global macroeconomic developments, the balance of risks surrounding the inflation forecast appears to be further tilted to the upside.

Following the assessment of short- and medium-term inflation outlook and considering the objective of ensuring price stability in the long run, the NBR Board decided to maintain the 2012 inflation target at 3 percent ±1 percentage point and to adopt a flat multi-annual inflation target of 2.5 percent ±1 percentage point as from 2013.

The adopted targets reflect the prospects for the consolidation of disinflation after the fading of the temporary effects of VAT rate increase, as well as the requirement of sustainably curbing the annual inflation rate in the medium term to a level compatible with the inflation criterion in the Maastricht Treaty and subsequently with the ECB's quantitative definition of price stability. At the same time, these targets indicate the NBR's concern for setting credible and feasible objectives whose achievement should not hamper the relative price changes triggered by structural adjustments in the Romanian economy. The assumed targets will be discussed with the government.

For end-2010, the baseline scenario of the current projection places the annual CPI inflation rate at 8.2 percent, 0.4 percentage points higher than the level published in the August 2010 Inflation Report. The first-round effect of the VAT rate hike on the annual CPI inflation is seen fading by the end of 2011 Q3, with the inflation rate being expected to re-enter the variation band around the 3 percent central target in 2011 Q4. The projection envisages the end-2011 inflation rate to stand at 3.4 percent, 0.3 percentage points above the previously projected figure.

The upward revision of the CPI inflation forecast throughout the reference period is due to some updated scenarios on the impact of several supply-side factors being less favourable, as well as to their estimated impact, although perceived as short-lived, on inflation expectations. Such adverse effects on CORE2 inflation are mitigated to a certain extent by the persistent negative output gap which was subject to a downward revision in the current forecasting round. This should act especially via the more negative output gap containing the potential pass-through of second-round effects of the VAT rate increase.

For this year, the projected additional inflationary impact is generated by the adverse shocks on domestic and external agri-food markets feeding through especially into the dynamics of fruit and vegetables prices, given the presence of base effects. A favourable influence of a lower magnitude stems from the downward revision in the short run of scenarios on fuel price increases. For 2011, amid the revised scenario for the oil price trajectory, the inflationary impact of fuel prices is projected to become more unfavourable. Higher contributions to inflation than in the previous projection are expected from volatile food prices as well as from CORE2 inflation.

While the projection for headline inflation was revised upwards, owing mainly to some exogenous supply-side shocks, the projected CORE2 inflation for end-2010 is marginally below that in the prior forecasting round, as it incorporates lower first-round effects of the VAT rate increase for Q3 than those previously anticipated. Although CORE2 inflation has remained on a downward trend starting 2011 Q1, its fall is relatively slower in the updated baseline scenario largely as a result of inflation expectations being revised upwards.

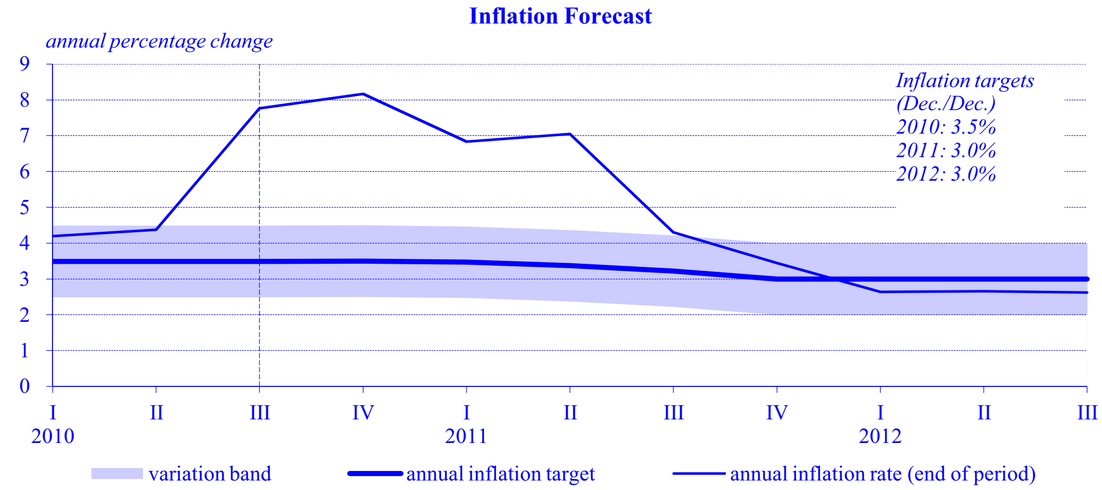
For the entire projection horizon, the central bank has set as a priority the consolidation of prospects for resuming disinflation. The monetary policy rate will follow a trajectory leading to the adequate calibration of real monetary conditions to this end, also fostering the gradual revival of lending to the real economy. This will allow the annual CPI inflation rate to converge towards the medium-term targets and the economy to resume a sustainable growth path. The fulfilment of these goals is strictly conditional upon the firm and consistent implementation, within the macroeconomic policy mix, of fiscal consolidation measures, as well as of structural reforms, along with the increase in European funds absorption, in line with the commitments set under the multilateral external financing arrangement concluded with the European Union, the International Monetary Fund and other international financial institutions.

Similarly to the previous projection, the uncertainty associated with the current forecasting round is high, while the overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to be tilted to the upside. Again, the relevance of risks associated with the domestic environment prevails over the reference period. The risks generated by the external environment persist, although their sources have altered to some extent.

The tense political and social climate in Romania is a major risk to the effective implementation of fiscal consolidation and income policy measures, as well as of structural reforms. The failure to meet the objectives set under the external financing arrangement concluded with the European Union, the International Monetary Fund and other international financial institutions might lead to further deterioration of confidence of foreign investors and of the domestic business environment in the local authorities' capacity to manage macroeconomic developments in a sustainable manner. As a result, tighter financing constraints for both public and private sectors might dampen not only the short-term outlook for economic recovery, but also the longer-term growth potential of the economy. In the near term, there is considerable uncertainty over the effects that the materialisation of such risks might have on the direction of the deviation of inflation rate from its projected trajectory in the baseline scenario. Over the longer term though, the delay in eliminating structural rigidities economy-wide might postpone the fulfilment of the price stability and euro adoption objectives.

A significant risk arises from potentially larger-than-projected increases in administered prices. The particular relevance of this risk for the reference period derives from the possible solutions that may be resorted to in case of tighter fiscal constraints. For instance, the removal of subsidies from local governments for goods and services to households (e.g. heating) might push prices of those items sharply higher.

One of the risks related to the external environment arises from the uncertainties surrounding the future developments in commodity prices or agri-food prices. The heightening of tensions on international markets for such goods might materialise in domestic price increases larger than those projected. Another risk is associated with the recent significant appreciation of the euro against the US dollar. A possibly faster-than-expected trend reversal would lead, via the depreciation of the leu versus the US dollar, to steeper increases in fuel and other commodity prices than those considered in the projection.



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

Source: NIS, NBR calculations

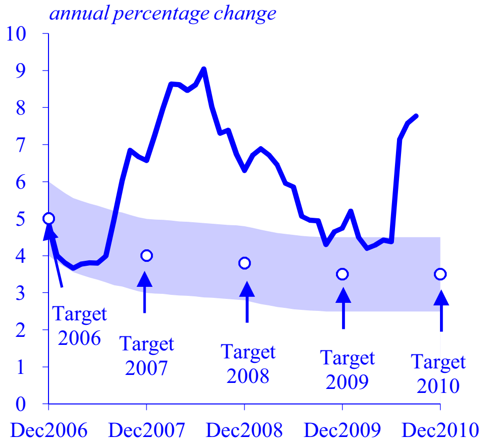
Monetary policy decision

In view of the need to ensure a firm anchoring of inflation expectations in a bid to consolidate prospects to resume disinflation given the persistence of significant uncertainties surrounding domestic developments and the recovery of the global economy, the Board of the National Bank of Romania has decided in its meeting of 2 November 2010 to keep unchanged the monetary policy rate at 6.25 percent per annum. Moreover, the Board has decided to pursue an adequate management of liquidity in the banking system and to maintain the existing levels of minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities. In this context, the Board has reiterated that the resumption of disinflation and restarting sustainable economic growth hinge decisively on a firm implementation of fiscal consolidation measures, structural reforms along with the increase in European funds absorption, in line with the commitments set under the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions.

II. INFLATION DEVELOPMENTS

Inflation Developments

annual percentage change



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

Source: NIS, NBR calculations

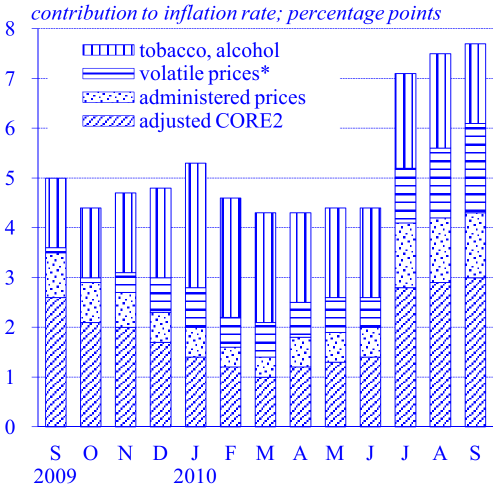
In 2010 Q3, the 12-month CPI inflation rate accelerated by 3.39 percentage points to 7.77 percent exceeding markedly the upper bound of the variation band of ±1 percentage point around the 3.5 percent annual target. The main driver of this evolution was the rise in the standard VAT rate starting with July, whose pass-through into prices was however contained by the persistent demand shortfall. In addition, the pressures on the agri-food markets intensified amid the strong increase in external prices and the fall in domestic supply on some segments. Under such influences, the adjusted CORE2 measure[3] went up by approximately 2.4 percentage points.

The hike in the standard VAT rate from 19 percent to 24 percent affected goods and services holding roughly 91 percent of the consumer basket, the remainder being accounted for by products that are either subject to a 9 percent VAT rate (books, newspapers, magazines, medicines, hotel accommodation) or exempt from VAT payment (medical care, cultural and education services, financial services, renting services).

Consumer prices reflected the VAT rate hike to different extents, the average pass-through rate being estimated at 61 percent until September. Thus, the transmission of the fiscal shock was low for prices of non-food items included in core inflation, moderate for prices of food items and full for administered prices[4] and telephone rates. The prices of tobacco products were a one-off case, their above-par elasticity being explained by the manner of calculating the excise duty levied on them[5].

Annual Inflation Rate

contribution to inflation rate; percentage points



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

Source: NIS, NBR calculations

In spite of the rise in the VAT rate having a below-average impact on volatile prices, the annual dynamics of such prices sped up by 8.3 percentage points to 12.6 percent in September. The recurrent floods in Romania and other European countries June through July caused the regional supply of fruit and vegetables to decrease significantly with a bearing on both domestic producer prices and external prices. Thus, after having posted negative readings until June 2010, the annual growth rate of volatile food prices included in CPI reached 11.8 percent at the end of Q3. Moreover, the annual pace of increase of fuel prices accelerated by 1.5 percentage points to 13.2 percent (staying, however, close to the average for 2010 Q1-Q2); one of the main drivers of this development was further the movement in the international oil prices. Their lower readings

3 The annual changes in special aggregate measures (except for CORE1 and CORE2) are calculated by the NBR.

4 Except for medicine prices, which are subject to a low VAT rate, and heating prices, the adjustment of which is to be reflected by statistical data in Q4 once heating starts being supplied.

5 Depending on the maximum retail price which includes VAT as well.

in June-August than in the previous months[6] contributed, alongside the trend reversal in the RON/USD exchange rate[7] and the drop in the consumer demand in July, to cushioning, to a certain extent, the impact of the VAT rate hike on fuel prices. The relative upturn in sales in August is likely to have fostered the persistence of this first-round effect in September, when the successive fuel price increases were only partly accounted for by the magnitude of the international oil price hike.

Other adverse influences apart from that associated with the change in the fiscal regime were also visible in the annual dynamics of administered prices that gathered momentum from 3.6 percent in June 2010 to 7.9 percent in September. Behind this evolution stood: (i) the rise in medicine prices in July; (ii) adjustments in the prices of local public services, including as a result of the decline in the transfers to local budgets; (iii) the pick-up in the prices of subway and railway passenger transport in September, and particularly (iv) the fading of the favourable base effect associated with the fall in the natural gas price in July 2009 (in June, the annual dynamics stood at -5.1 percent and in September it would have come in at zero percent should the VAT rate have not been raised).

Tobacco product prices went up over the reported period by about 10 percent, which led to an annual dynamics of almost 40 percent in September (similar to that seen in June 2010). As already mentioned, the manner of calculating the excise duty enhanced the VAT hike-induced inflationary effect; other factors putting additional pressure were the increase in the collateral for fiscal warehouses (following the application of Emergency Ordinance No. 54 of 23 June 2010 for combating tax evasion) and the hike in unit production costs (by more frequent recalibrations of manufacturing lines and the reduction of the equipment utilisation – called for by the drop in the volume of sales). Consequently, in 2010 Q3, the analysis of core inflation must further take into account the relevant adjusted CORE2 measure, which eliminates the change in the prices of excisable products.

The persistent negative output gap and the uncertainties surrounding the impact of austerity measures on consumer demand caused most retailers to absorb a significant part of the price increase triggered by the change in the VAT rate. Thus, the annual rate of adjusted CORE2 inflation saw a lower pass-through rate than that estimated for headline inflation (by approximately 7 percentage points), accelerating by only 2.4 percentage points during the quarter, out of which roughly 0.15 percentage points

Administered Prices versus Market Prices

annual percentage change; end of period

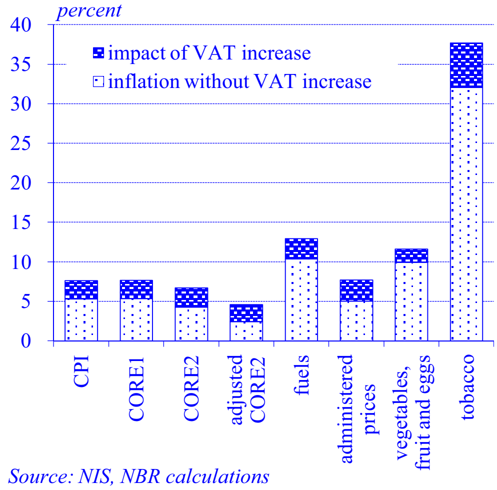
	2009		2010		
	III	IV	I	II	III
Inflation rate	**4.94**	**4.74**	**4.20**	**4.38**	**7.77**
Administered prices*	**4.7**	**3.4**	**2.2**	**3.6**	**7.9**
1. Non-food items*:	**0.9**	**0.6**	**0.4**	**2.4**	**6.8**
electricity	0.2	0.2	4.2	4.2	8.6
heating	11.8	4.2	2.8	3.2	3.2
natural gas	–8.4	–8.4	–8.4	–5.1	4.2
medicines	5.7	8.2	2.5	6.4	8.0
2. Services*, *of which:*	**13.5**	**9.9**	**6.0**	**6.1**	**11.2**
water, sewerage, waste disposal	16.3	15.0	11.3	10.0	15.7
fixed telephony	16.6	7.9	x	x	x
passenger railway transport	0.0	0.0	0.0	0.0	8.6
(passenger) city transport	7.6	7.4	5.3	4.7	6.7
Market prices (CORE1)	**5.0**	**5.0**	**4.6**	**4.5**	**7.8**
CORE2**	**5.9**	**4.9**	**4.4**	**4.5**	**6.8**
CORE2 less tobacco, alcohol	4.2	2.8	1.6	2.3	4.7
tobacco, alcohol	24.2	29.3	36.7	29.7	31.0

*) NBR calculations

**) CORE1 - volatile prices

Source: NIS, NBR calculations

VAT Increase Contribution to the Annual Inflation Rate

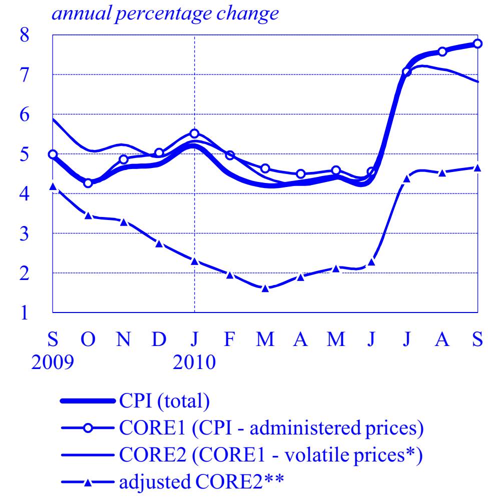


Source: NIS, NBR calculations

[6] Brent crude oil price went down to an average reading of USD 76/barrel compared to almost USD 82/barrel in April-May 2010.

[7] The domestic currency appreciated by 6.3 percent in September against June 2010.

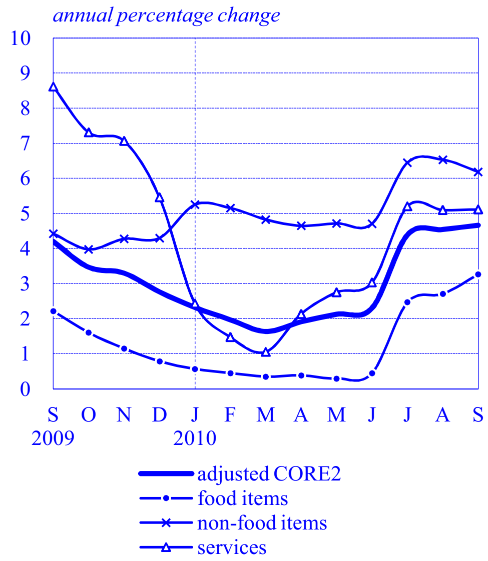
Headline Inflation and CORE Inflation



*) products with volatile prices: vegetables, fruit, eggs, fuels
**) excluding tobacco and alcohol

Source: NIS, NBR calculations

Adjusted CORE2 Components



Source: NIS, NBR calculations

were accounted for by the strains under which agri-food markets came.

In spite of the increase in the domestic output of grains and sunflower seeds compared to the previous year, the annual growth rates of producer prices entered upward trends[8] as a result of international market developments. Following the ban on grain exports by Russia and Ukraine which were hit by severe drought worldwide agri-food commodity markets saw a surge in prices and worsening expectations. Under the circumstances, large domestic producers became reluctant in delivering commodities on the domestic market either waiting for higher prices or shifting towards exports, which was conducive to bottlenecks in the output flow and, implicitly, to more expensive milling and bakery products and edible oil (particularly in September).

Stripping out the impact of the change in the fiscal regime, non-food items included in the adjusted CORE2 measure posted a slight disinflation amid the low volume of sales and the lack of pressure from external prices[9], while the annual pace of increase of prices of market services came to a relative standstill. Adverse influences were visible in some goods and services whose prices are sensitive to exchange rate movements (home electronics, motorcars, medical services). Even though the depreciation of the domestic currency against the euro was modest in the current period (0.6 percent in September versus June) and similar to that seen in 2009 Q3, the annual growth rates reported by the afore-mentioned groups accelerated, given that in the previous year the decline in demand put a stronger brake on the corresponding price adjustment; by contrast, in September, the annual dynamics of telephone rates (the most significant sub-group under market services) posted the same level as that seen in June 2010, reflecting the leu change against the euro fully and simultaneously.

The inflation expectations formulated in July by consumers and managers in manufacturing, trade and services[10] reflected the shock induced by the VAT rate hike. Even though they subsided somewhat afterwards, they remained at higher levels than those in 2010 Q2, which might hint at first-round effects persisting in the period ahead.

The comparative analysis of the change in the tradables/non-tradables prices from the standpoint of competitive pressures

[8] Growth rate accelerations by 22 percentage points to 31 percentage points for grains and by 46 percentage points for sunflower seeds in August versus June 2010.

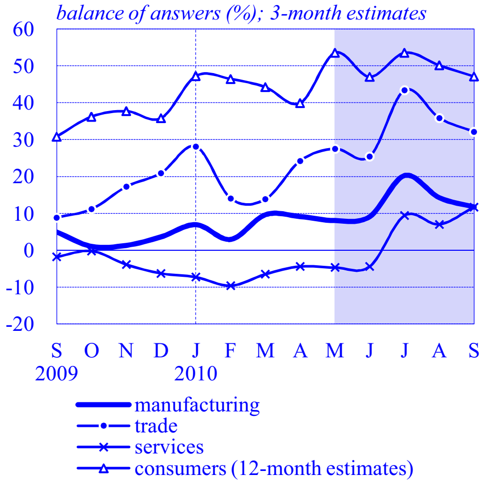
[9] Deflation, in annual terms, in July-August in the case of industrial producer prices for the EU 15 external market related to consumer goods (except food, beverages and tobacco).

[10] According to the NIS/EC-DG ECFIN survey.

is further distorted by administrative[11] and fiscal measures. The annual growth rates of the two groups of products reported comparable accelerations in 2010 Q3 (3.45 percentage points to 7.45 percent for tradables and 3.30 percentage points to 6.64 percent for non-tradables); however, the evolution is ascribable to a large extent to specific factors. Thus: (i) tradables prices came under opposite external influences, with upside pressures generated by conjunctural tensions on international agri-food markets prevailing over downside pressures, associated with non-food items, whereas (ii) non-tradables cover both goods and services that were not affected by the increase in the standard VAT rate and products whose prices reflected this hike fully (some products with administered prices, telephony services). Moreover, the response of market prices related to both groups of products to the increase in the VAT rate was also dependant on the domestic demand elasticity. Under the circumstances, it is difficult to identify the comparative effect of competitive pressures on consumer prices in the two sectors.

Inflation Expectations of Economic Agents

balance of answers (%); 3-month estimates



Note: Starting May 2010, the indicators are calculated acording to NACE Rev.2

Source: EC-DG ECFIN

The average 12-month HICP inflation went up by 0.6 percentage points to 5.2 percent (the highest level in the European Union). Nevertheless, the gap between the average 12-month HICP inflation in Romania and that in the European Union expanded by only 0.2 percentage points, given the advance in inflation in a range from 0.7 percentage points to 1.2 percentage points in seven Member States[12], owing mainly to the rise in energy prices (especially fuels) and to some adverse base effects. In Romania to these influences added the unfavourable impact from the increase in the standard VAT rate and the successive hikes in the prices of tobacco products.

At the end of 2010 Q3, the actual annual inflation rate was 0.23 percentage points below the projection in the August Inflation Report, owing to a lower-than-expected pass-through of the change in the standard VAT rate into consumer prices and as a result of abandoning the reduction/removal of subsidies granted to heating suppliers (the measure was postponed for 2011).

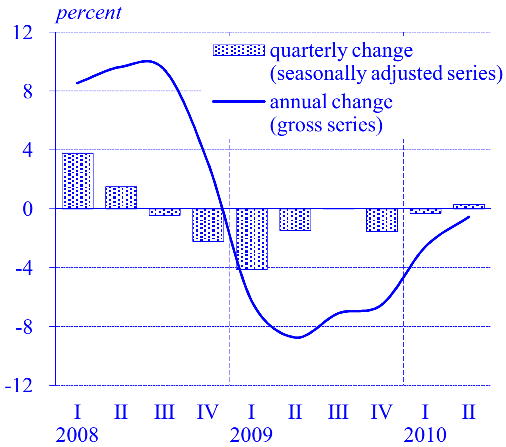
[11] See the paragraph relative to the adjustment in administered prices.

[12] Belgium, Estonia, Greece, Spain, Cyprus, Luxembourg, Portugal.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

Real Gross Domestic Product



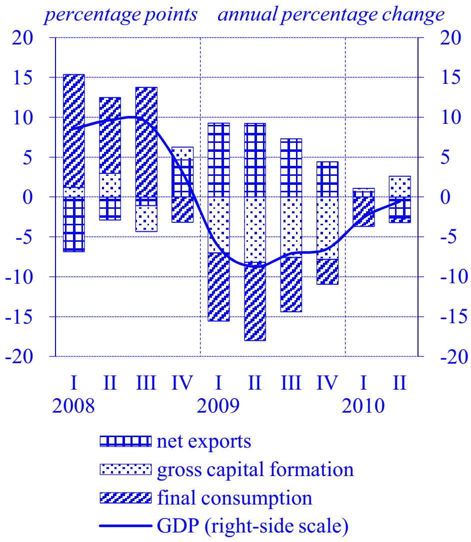
Source: NIS

In 2010 Q2, real GDP reported a slower rate of decline for the fourth quarter in a row to reach -0.5 percent[13]. The outcome is attributable to the slight recovery in the current period (the quarterly dynamics saw a trend reversal from -0.3 percent to +0.3 percent) on the one hand, and to a base effect (a quarterly fall of real GDP by 1.5 percent April through June 2009) on the other.

The same as in the first three months of the current year, the significant gap between the actual annual contraction and the June benchmark projection (-1.6 percent) is entirely ascribable to the difference between the annual rates calculated on the basis of the unadjusted series and those calculated based on the seasonally adjusted series, considered by the forecast.

The slower rate of decrease of the economic activity was due to the upturn in domestic absorption (+1.9 percent year on year compared to -3 percent in 2009 Q1), whereas the net contribution of external demand to GDP dynamics entered negative territory. On the supply side, the slower annual rate of decrease of GDP in 2010 Q2 was supported by all economic sectors, with industry and construction making a stronger contribution thereto.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

The quarter-on-quarter analysis[14] of the economic performance shows that the drivers of the real GDP revival in Q2 (+0.3 percent) were limited – the positive growth rate being mainly accounted for by the cumulative performance of "changes in inventories" and "the statistical discrepancy" (+3.9 percentage points), while the influence of the relative consumer demand recovery (+0.4 percentage points) was of a visibly lower magnitude. Furthermore, the contributions made by gross fixed capital formation and net exports of goods and services saw a significant deterioration given that: (i) investment demand contracted by 4.4 percent, probably owing to the adjustment in the purchases for retooling, as the available statistical data show positive developments in new construction works and capital repairs; (ii) the deceleration by nearly 6 times in the dynamics of exports (to +2 percent) was accompanied by a similar movement in imports, albeit of a lower intensity (+4.9 percent compared to +8.9 percent in Q1), so that the negative contribution of net external demand to GDP dynamics deepened to -2.8 percentage points. On the supply side, favourable

[13] Unless otherwise indicated, the growth rates in this section are annual percentage changes, calculated based on the unadjusted series of national accounts.

[14] Quarter-on-quarter changes in GDP and its components are calculated based on the seasonally adjusted fixed-base series.

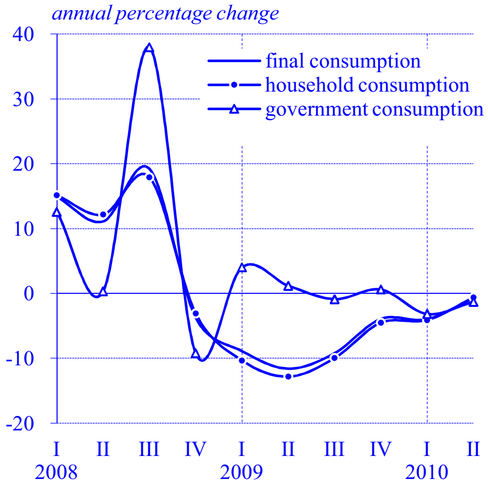
results saw industry (+4.2 percent) and, to a lower extent, agriculture (+0.9 percent, after the 4.3 percent contraction in Q1). The decline in GVA in construction came to a halt, whereas services contracted by 0.8 percent, representing the only economic sector with a negative contribution to the quarterly dynamics of GDP (-0.4 percentage points).

1.1. Demand

Structural analysis of domestic demand shows less abrupt paths for both main components – final consumption diminished by 0.7 percent (versus -4 percent in Q1), while investment posted a 3 times slower annual pace of decrease (to -9.5 percent). Consequently, the cumulative contribution of the demand for consumer goods and capital goods was further negative (albeit on a decrease from the previous quarter), with the build-up in inventories (making a +4.9 percentage point contribution to GDP change) being the most important driver of the domestic absorption dynamics entering positive territory. However, one must not overlook that, in the case of the non-seasonally adjusted data series (expressed in comparable prices), that is used for calculating the volume changes published by the NIS, the "changes in inventories" heading also includes the statistical discrepancy (a residual item whose share in GDP rose to almost 12 percent in 2010 Q2[15]).

Actual Final Consumption

annual percentage change



Source: NIS

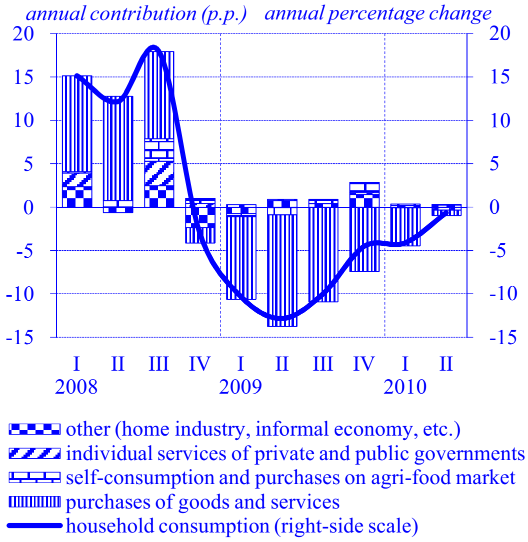
The contribution of net external demand to the GDP dynamics turned negative (-2.6 percentage points), following the faster advance in imports than in exports of goods and services.

1.1.1. Consumer demand

The deceleration in the pace of decline reported by final consumption was due to both private consumption and government consumption, as both components saw slower annual decreases in terms of volume than in 2010 Q1 (by 6.4 times and 2.4 times respectively).

Household Final Consumption by Expenditure

annual contribution (p.p.) *annual percentage change*



Source: NIS, NBR calculations

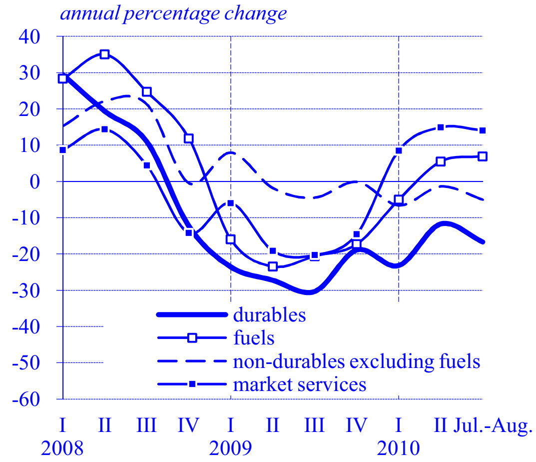
Household consumer demand

The slowdown to -0.6 percent in the annual dynamics of household final consumption in the period under review was bolstered by retail purchases of goods and services, the volume of which was only one percent lower than that in 2009 Q2 (in the first 3 months of 2010, the annual contraction on this segment came in at 6.5 percent). The outcome was entailed, on the one hand, by a base effect, and, on the other, by the short-lived upturn in consumer demand in the current period, partly owing to earlier-than-planned purchases in view of the standard VAT rate hike as of 1 July 2010. As expected, durables were particularly envisaged – the data on

[15] Calculations based on the unadjusted series of national accounts in constant prices (the average for 2000=100).

Purchases of Goods and Services*

annual percentage change

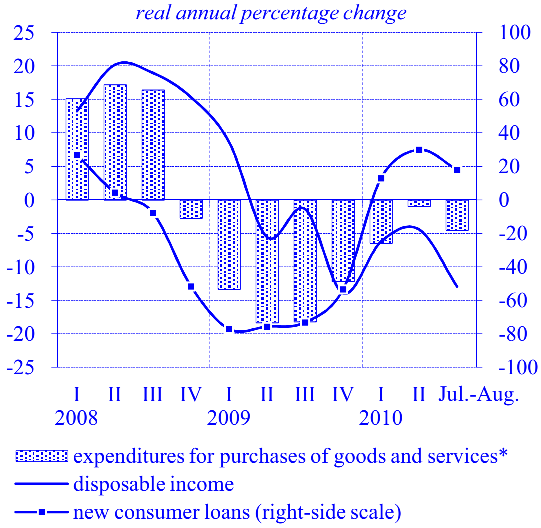


*) based on data on the turnover volume of retail trade and market services to households

Source: NIS, NBR calculations

Household Consumption and Main Financing Sources

real annual percentage change



* for Jul.-Aug. 2010, the turnover volume in trade and market services was used

Source: NIS. MPF. NBR calculations

the volume of retail sales show a trend reversal, of a relatively significant magnitude, in the sales of durables (from around -10 percent January through March to almost +7 percent in the period under review, quarterly changes), compared to the quarterly evolution of sales of non-durables (posting a +3 percent increase April through June after a quasi-stagnation January through March). Consumer demand is unlikely to recover in the period ahead, given that confidence indicators released July through September by the European Commission (EC-DG ECFIN) remained modest on the segment of services providers and trading companies (on a 3-month horizon) and on that of consumers (on a 12-month horizon).

The contribution made by "self-consumption and purchases on the agri-food market" to the change in private consumption was further marginal.

As concerns the influence on consumer prices, the current developments in the volume of retail sales of products holding a large share in the CPI basket suggest a slight accumulation of demand-side pressures in 2010 Q2. This evolution is hinted at by the trend reversal in purchases of non-durables; similar developments are also revealed when excluding fuels, with the volume of sales reporting an almost 2 percent increase in Q2.

The slowdown in the annual pace of decrease recorded by the demand for private consumption may be explained first by the household disposable income[16], whose annual contraction (-4.4 percent) was lower than that seen in Q1 (-6.2 percent). Moreover, the negative influence of the persistent decline in incomes on the consumer demand was mitigated, to a certain extent, by the even lower propensity for saving, suggested by the steepening downward trajectory of new time deposits of households in 2010 Q2, fostered also by the further decreasing interest rates applied by commercial banks.

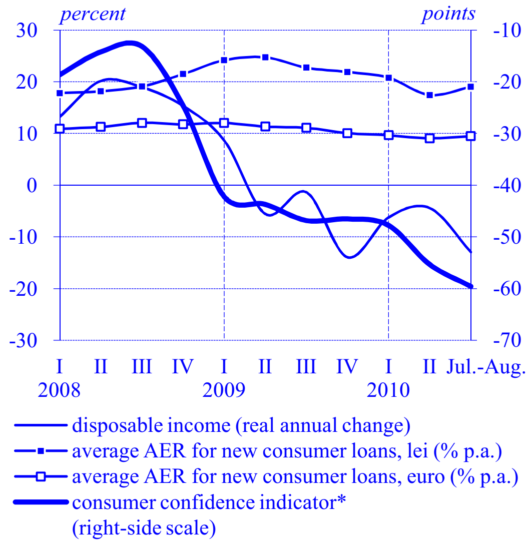
As concerns borrowed resources, it is difficult to estimate their influence (in terms of both size and direction) on private consumption financing, given that the resumption of the upward trend of new consumer loans (both lei- and euro-denominated) in Q2 was attributed to the pick-up in the demand for refinancing previous loans under the impact of some supply-side factors – the measures adopted by commercial banks (the decrease in interest rates on new loans, the elimination or reduction of some fees) and the prospect of a new adjustment in notarial taxes – which were also visible in the case of mortgage-backed loans for personal needs. Furthermore, a number of commercial banks decided to

[16] Household disposable income is approximated by the sum of incomes from wages, social transfers (state social security, unemployment benefit and health insurance) and remittances from abroad, i.e. workers' remittances and current private transfers by nonresidents.

refinance leasing contracts[17]. These new contracts between households and financial institutions made no impact on the new purchases of goods and, consequently, nor were they reflected by the change in consumer spending.

From the viewpoint of the preference for domestic/imported products, Q2 saw a relatively larger contribution of imports to meeting consumer demand. The tendency is more conspicuous for non-durables, the imports of which reported a faster growth rate[18], whereas the domestic supply of such products saw a new contraction in real terms[19]. Imports of durables posted an even faster pace of increase. However, mention should be also made that the annual decline of domestic output of such goods saw a significant deceleration (from -14.7 percent in Q1 to -1.6 percent in the period under review). Sales of domestically-produced motor vehicles witnessed a turnaround; nevertheless, their expansion was about 7 percentage points slower than that of imports.

Main Determinants of Consumer Demand



*) seasonally adjusted data; the latest data refer to 2010 Q3.

Source: EC - DG ECFIN, MPF, NIS, NBR calculations

Government consumption

In 2010 Q2, final government consumption shrank 1.3 percent, in line with developments in the number of employees in the budgetary sector.

Budgetary developments

In 2010 Q2, the consolidated general budget deficit reached lei 9,851 million (1.9 percent of GDP[20], of which the primary deficit equalled 1.5 percent of GDP), having widened against that in the same year-ago period (lei 6,458 million, i.e. 1.3 percent of GDP, of which the primary deficit accounted for 1 percent of GDP). Thus, at the end of 2010 H1, the cumulated consolidated budget deficit ran at lei 18,070 million, marginally below the reference value agreed upon in the arrangements signed with the EU, IMF and other IFIs.

During 2010 Q2, total budget revenues posted a slower pace of decline[21] than in the previous quarter (-3 percent versus -5.7 percent), against the backdrop of the slower decrease in tax

[17] According to the national accounts methodology, car purchases by households are included in the actual final consumption.

[18] The changes in the physical volume of exports and imports of goods were calculated based on balance-of-payments data, deflated by international trade-related unit value indices. The structural analysis was based on the Combined Nomenclature.

[19] Suggested by the negative annual dynamics of the volume of retail sales of domestic industrial companies on the domestic market.

[20] The analysis draws on nominal GDP in the budget execution released by the MPF in July 2010.

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

revenues (-4 percent from -9.1 percent in Q1), whereas non-tax revenue and amounts from the EU saw positive dynamics (13.1 percent[22] and 38 percent respectively). Developments in tax revenues were mainly the result of the opposite effects of the significant improvement in the dynamics of revenues from VAT collection (-0.2 percent against -15.4 percent in Q1), on the one hand, and the further drop in receipts from social security contributions (-8.9 percent), along with the dynamics of receipts from profit tax (-14.5 percent from 4.1 percent in the previous quarter) and from excise duty collection returning to negative territory, on the other hand.

Total budget expenditures recorded again a positive annual growth pace (3.9 percent), in the context of the expansion in current expenditures (+5.6 percent versus -1.9 percent in the prior quarter) being only partially offset by the contraction in capital expenditures (-13 percent against -39.3 percent in 2010 Q1). The breakdown of current expenditures reveals that the pattern seen in the previous three quarters was still manifest; thus, the negative dynamics of staff costs (-4.3 percent versus -12.7 percent in the previous quarter) and goods and services (-6.9 percent from -4.8 percent in Q1) were accompanied by a positive growth rate of transfers (15.1 percent versus 4.4 percent in Q1). In the reported period, the positive growth pace of transfers was fuelled by both social transfers (4.6 percent versus 10.5 percent in Q1) and especially by other transfers (+56 percent against -17.5 percent in Q1), i.e. projects financed from non-redeemable external loans (89.3 percent).

On 18 August 2010, the government performed a budget revision[23] to integrate into the budget the measures aimed at achieving the 6.8 percent of GDP budget deficit target. Compared with the previous budget, the new programme for 2010 envisages a decline in budget revenues by roughly 0.7 percent of GDP (to 32.3 percent of GDP) and a reduction in expenditures by 0.1 percent (to 39.1 percent of GDP). In the context of the downward revision of economic growth forecast, the decrease in planned budget revenues is due mainly to the weaker collection of social security contributions (by 0.7 percent of GDP), excise duties (by 0.4 percent of GDP), as well as of profit tax and personal income tax. The impact of these declines was partially alleviated by the rise in revenues from VAT (0.3 percent of GDP), following the VAT rate increase since July 2010, along with the expected rise in non-tax revenues (by 0.6 percent of GDP). On the expenditures side, the

[22] The dynamics of non-tax revenues may have been affected by the change in the scope of this category of revenues following the change in the regime of some public institutions and authorities (according to Law No. 329 of 5 November 2009 on the reorganisation of public authorities and institutions, rationalisation of government expenditures, support to the business environment and observance of the provisions in the framework agreements with the European Commission and the IMF).

[23] Government Ordinances No. 18 and 19 of 18 August 2010 on the revision of the state budget and state social insurance budget for 2010.

main changes consist in higher social transfers (0.6 percent of GDP) and goods and services expenditures, on the one hand, and the reduction in the planned staff costs (-0.7 percent of GDP) and investment outlays, on the other hand.

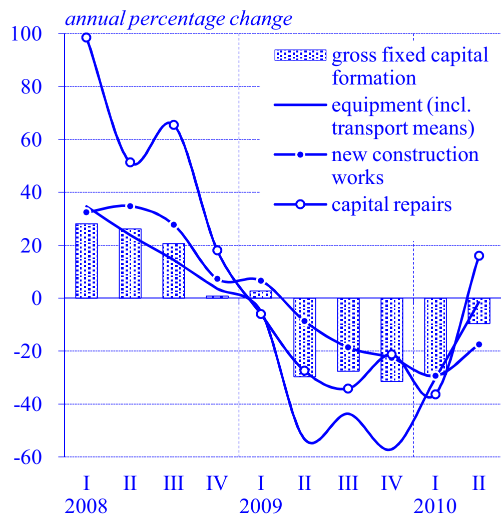
The new budget parameters have also been included in the "Fiscal Strategy for 2011-2013", a multi-annual budget plan devised on the basis of the Law on fiscal responsibility (Law No. 69/2010) adopted by the government on 15 September and subsequently submitted to Parliament. The strategy specifies the fiscal framework for the next three years and sets the budget deficit at 4.4 percent, 3.0 percent and 2.5 percent of GDP respectively, as well as the target values for other key budget indicators, part of which, after being approved by Parliament, will become binding benchmarks in the budget planning for 2011 and 2012[24].

1.1.2. Investment demand

Gross fixed capital formation posted a significantly slower rate of decrease year on year (to -9.5 percent), owing entirely to the base effect associated with the plunge in investment demand in 2009 Q2 (-32.3 percent, quarterly change).

Behind the change in the investment trajectory stood all components, with purchases of equipment (including transport means bought by companies and institutions), new construction works and other investment reporting a slower decline and capital repair works resuming a positive annual growth rate (to reach about +16 percent). Apart from the base effect that supported the relative improvement in the outcomes on all the mentioned segments, the available statistical data point also to some favourable signals conveyed by the current evolution of investment in construction, namely the recovery of quarterly dynamics, April through June, reported by new construction works and particularly capital repair works. Nevertheless, in Q3, these growth rates may revert to the negative territory, given that the volume of expenses related to both types of works contracted July through August by nearly 19 percent and 33 percent respectively versus the average for Q2 (probably owing to heavy rains) and the confidence indicator released by EC-DG ECFIN for this sector remained extremely modest (-41 points, on average).

Investment



Source: NIS, NBR calculations

24 According to Art. 20, para. 1 of Law No. 69/2010, the fiscal framework includes the following indicators: (i) the consolidated general budget balance and (ii) staff costs included therein – both expressed as share in GDP, (iii) the ceilings for redeemable loans which may be taken by administrative-territorial units, as well as for guarantees issued by the government or administrative-territorial units, (iv) total nominal staff costs for the consolidated general budget and its components (excluding the financial assistance from the EU and other donors), (v) nominal balance of the consolidated general government and its components and (vi) primary balance of the consolidated general budget. In compliance with Art. 18 of the cited law, the limits for the first two indicators approved by the Parliament are binding for the next two fiscal years; similar limits set for the other items are binding only for the next fiscal year.

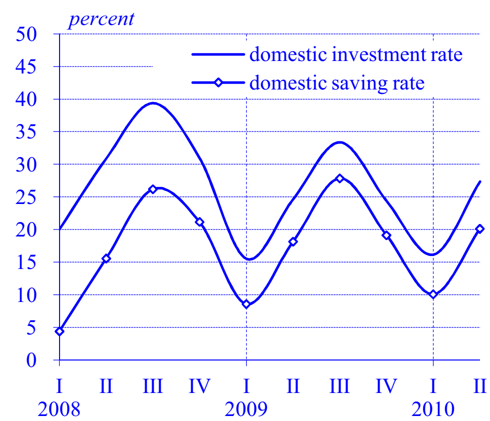
The deceleration in the annual pace of decline of investment may be explained by the developments in most financing channels:

(i) As concerns own sources, the ongoing moderation of the downward path followed by gross value added economy-wide over the past four quarters suggests a similar trend in capital expenditures in the corporate sector. The estimated household disposable income continued to decrease in real terms, albeit at a slightly slower annual pace.

(ii) Bank loans[25] granted to the corporate sector for equipment purchase rose at a slower annual rate than in Q1, whereas the volume of loans for real-estate investment contracted from the same year-ago period. Real-estate loans granted to households saw an upturn; however, the evolution may be explained to a great extent by the expansion of refinancing requests.

As a matter of fact, the resumption of the upward trend in residential investment in the following months is uncertain, in view of further unfavourable expectations on labour market and households' ability to repay their loans, the fiscal adjustment measures in force starting 2010 H2 and also the decision to postpone the purchase of a home in the offing of new price decreases on the real-estate market. A similar outlook is illustrated also by the results of the GfK/DG ECFIN survey among consumers, which indicate households' steep pessimism relative to engaging in investments for home buying/building or repairing over the following 12 months.

Investment Rate and Saving Rate



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

Source: NIS, NBR calculations

(iii) Lease financing continued to contract considerably year on year (-28.4 percent), in spite of the negative dynamics of the EUR-expressed value of the contracts concluded in 2010 Q2 decelerating by about 3 percentage points.

(iv) Nonresidents' direct investment saw also a slower drop, although the annual pace of decline of net flows during the last four quarters continued to be fast (about -51 percent[26]).

(v) Capital investment made from budget sources reported no change in trend from the previous period, its volume posting a new contraction of more than 20 percent in annual terms.

As concerns the markets of origin of capital goods, developments in 2010 Q2 were similar to those in the first three months of 2010 – the market share held by imports followed further an upward trend, as suggested by the stronger pace of increase of the physical volume of imported machinery and equipment (up by more than 40 percent in annual terms[18]); by contrast, domestic supply

[25] NBR calculations based on own data and on those provided by the CCR.

[26] Calculations based on balance-of-payments data.

continued to shrink, albeit at a considerably slower pace than in Q1 (to -2.6 percent).

1.1.3. Net external demand

The faster rise in the demand from the major foreign partners in Q2[27] further had a favourable impact on Romania's international trade. This development is also illustrated by the provisional national accounts data, even though the substantial advance in the annual growth rates compared with the previous period is partly attributable to certain base effects.

(i) For the fourth time in a row, the volume of exports of goods and services recorded a positive quarterly dynamics, the annual rate of increase gaining yet another 2 percentage points against the previous quarter (to 21.4 percent).

(ii) Due to the import content of exports, the volume of imports of goods and services expanded further, the annual rate of increase reaching 24.5 percent.

Almost two thirds of the annual change in the physical volume of exports of goods[18] were accounted for by products with high value added – "machinery and equipment" and "transport means" held about 10 percentage points and 5 percentage points respectively –, which pushed the weight of this type of goods to 44 percent of the total value of exports.

The faster rise in the imports of goods in Q2 was mainly attributable to the purchases of machinery and equipment (almost 11 percentage points) and, to a smaller extent, to "base metals" and "transport means".

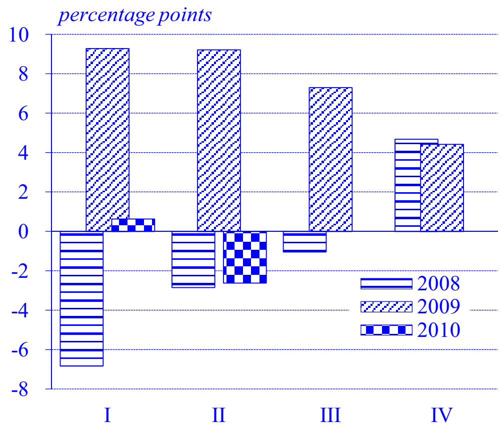
1.2. Supply

In 2010 Q2, the slowdown in the annual decline of GDP was due to the rebound in all economic sectors, with industry and construction in the lead.

The rebound in industry was mirrored by the trend reversal in gross value added (4.2 percent versus -0.2 percent in Q1, quarterly changes). Therefore, the annual growth rate reached 5.9 percent, industry being, for the second consecutive quarter, the only economic sector to make a positive contribution to GDP dynamics (1.6 percentage points).

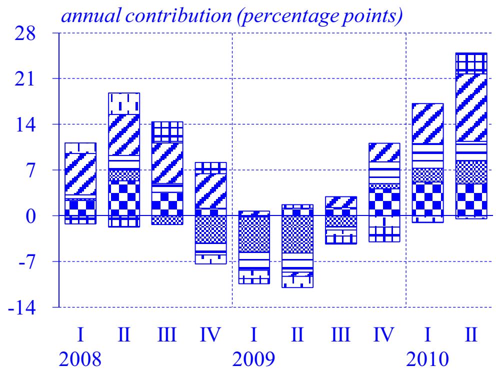
[27] At EU27 level, the annual dynamics of real GDP accelerated markedly (2.2 percent from 0.9 percent in the prior quarter). This development was accompanied by a strong increase in goods and services imports (13 percent against 5.2 percent), due to both a base effect and the faster quarterly dynamics (to 4 percent, seasonally-adjusted data).

Net External Demand Contribution to GDP Growth

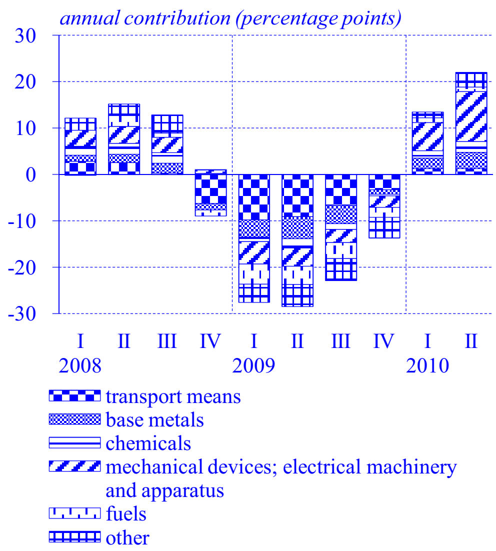


Source: NIS, NBR calculations

Export Physical Volume

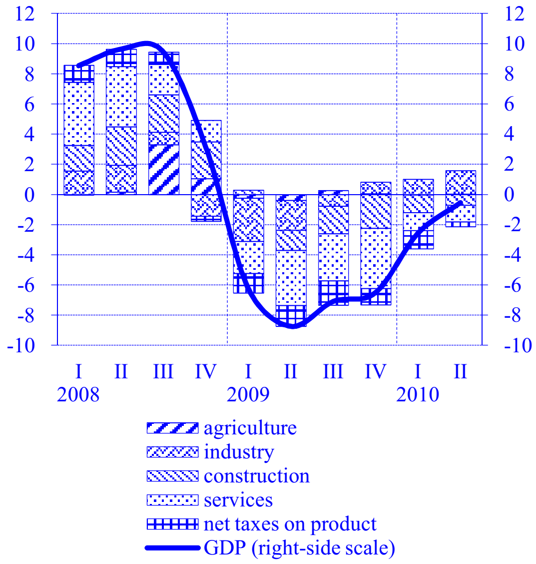


Import Physical Volume



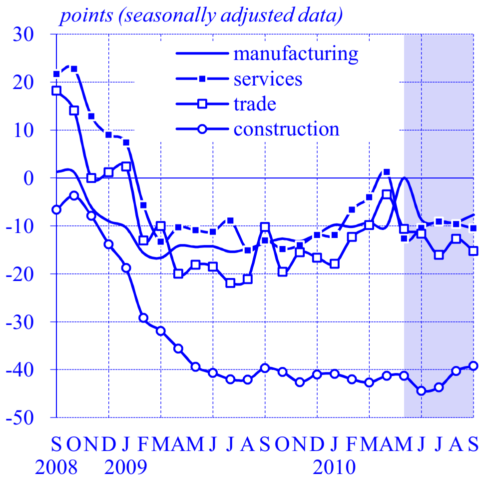
Source: NIS, NBR calculations

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

Corporate Sector: Confidence Indicators for the Next 3 Months



Note: Starting with May 2010, confidence indicators released by DG ECFIN for each economic sector are calculated based on NACE Rev. 2

Source: EC-DG ECFIN

The rebound in industry was, to a large extent, attributed to:

(i) the renewed increase in demand for metallurgical products, as a result not only of a base effect but also of a visible reversal in the trajectory of the quarterly growth rate during the current period. These two determinants contributed to the annual dynamics of output coming close to 50 percent, the rebound in activity being bolstered by both the domestic and the external segments of demand;

(ii) the resumption of production growth in the chemicals and pharmaceuticals sectors, induced by the current evolution and a base effect;

(iii) the further fast increase in output of transport means and, by association, of electrical machinery and apparatus (30 percent and 37 percent respectively, year on year). In the first case, the growth rate showed a twofold deceleration solely as a result of a pronounced base effect (a 36 percent quarterly rise in the same year-earlier period, with higher external demand making a significant contribution amid the unfolding of national car-scrapping schemes in countries such as France and Germany).

Although the construction sector still faced major difficulties, the drop in gross value added decelerated to less than half of the Q1 reading (to -8.3 percent in annual terms), the negative contribution of this sector to GDP annual dynamics, narrowing down to -0.7 percentage points. The annual rate of decline relative to both buildings and engineering works slowed down, but only the buildings segment recorded a quarterly increase. The latter development, more pronounced in the case of capital repair works of residential buildings, may be attributed to a certain extent to the financial straits faced by households during this period, when the consolidation of the current dwelling was a more acceptable option than building a new one.

Gross value added relative to the services sector stuck to the downward path, the annual dynamics in Q2 standing close to that in the previous period (-2.3 percent). Structural analysis shows that the slight sign reversal in the performance of the financial subsector (0.8 percent versus -1.5 percent) was offset by the steeper decline in “trade, hotels and restaurants, transports and telecommunications” stemming chiefly from the smaller recourse to transport services (goods transport and passenger traffic) and telephony services (for households, companies and public institutions).

In agriculture, gross value added rose by 0.7 percent (annual change) mainly on the back of the favourable performance of vegetal production in April through June.

2. Labour market

The uncertainties surrounding the economic environment increased June through August 2010. Behind this stood, initially, the debates on the set of measures aimed at reducing the fiscal deficit and, after the definition of these measures, the impact of the drop in the purchasing power of incomes on the private sector activity. The context had an adverse impact on companies' hiring decisions, creating conditions for a weak labour market and, implicitly, for the persistence of lower real wages. Thus, for 2010 Q3, consumer demand is anticipated to consolidate its dampening influence on inflationary pressures, while a lower contribution, in this respect, is expected from ULC in industry, whose annual adjustment pace slowed down in July and August compared with Q2.

2.1. Labour force[28]

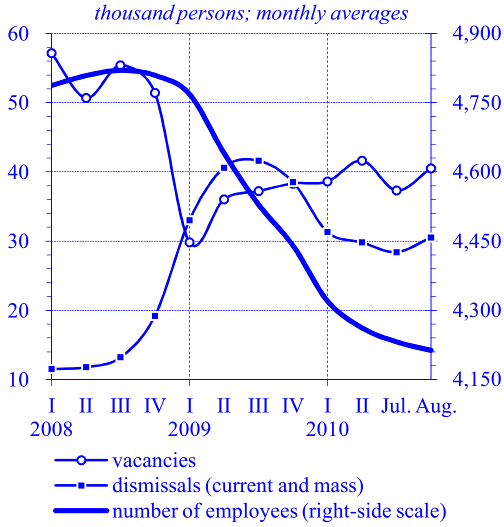
The slight quarterly rise in the number of vacancies and hirings, visible in the prior periods, saw a reversal in July-August 2010. Companies reduced their recruitment activities as they had to revise the profitability of their business plans following the unexpected decision taken by the authorities, at end-June, to raise the VAT rate starting July; this decision, which was taken in addition to the cut in public sector wages as well as in a large number of social allowances and benefits, boosted the uncertainties in the private sector regarding demand and, implicitly, the business prospects. Moreover, the number of lay-offs rose in August compared to the previous three months but the decision regarding the lay-offs may have been taken before the said legislative amendments and, therefore, the impact manifest in Q3 might be limited (in fact, the average for July-August was marginally lower than the Q2 average).

In this context, the staff numbers reported by employers kept shrinking, the pace of decline in July-August 2010 being marginally lower than that reported in Q2 in both the private and public sectors.

As regards the excess labour supply, the unemployment rate in July-August was influenced not only by workforce demand, which showed a relative decline, but also by the higher number of persons who gave up looking for a job via the NEA. This offset the smaller number of hirings from among the unemployed and enabled unemployment rate to stay at 7.8 percent. This development signals the difficulties faced by low-skilled or inexperienced workers[29] in getting a job during a period when employers' recruiting requirements heightened considerably.

Labour Force Demand Measures*

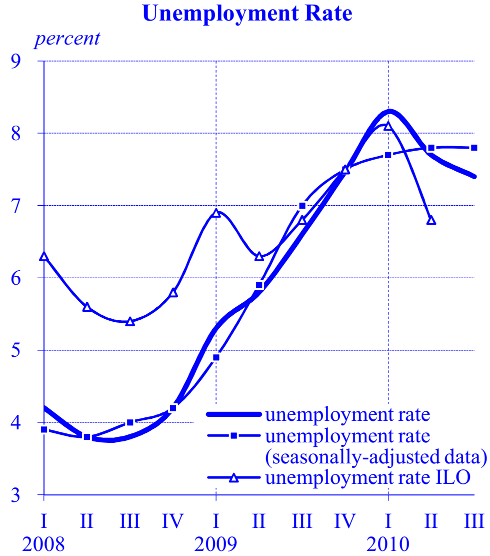
thousand persons; monthly averages



*) seasonally-adjusted data

Source: NEA, NIS, NBR calculations

Unemployment Rate



Source: NIS, NBR calculations

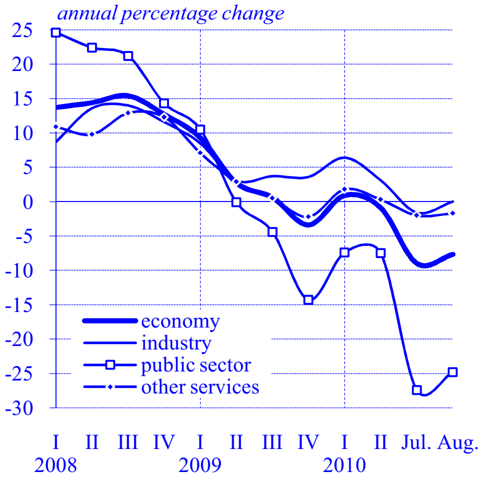
[28] Data in this section are seasonally-adjusted. Unless otherwise indicated, the comparisons are made against the prior quarter's average.

[29] The number of graduates that joined the unemployed ranks rose by 28 percent in July-August 2010 from a year earlier (not-seasonally-adjusted data).

2.2. Incomes

Net Real Wage*

annual percentage change



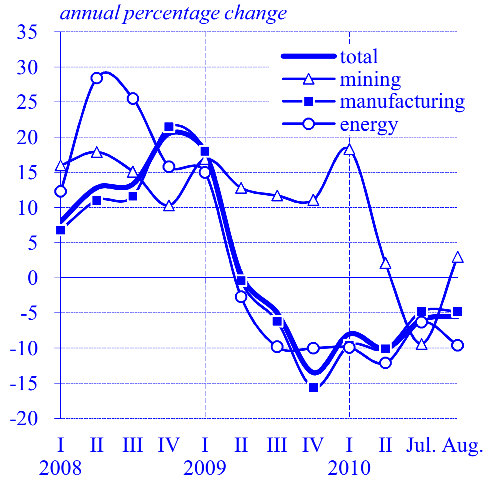
*) deflated by CPI

Source: NIS, NBR calculations

In July-August 2010, the annual dynamics of net nominal average wage economy-wide followed an even steeper downward path, entering negative territory. While in Q2 the slowdown (by around 2.1 percentage points from Q1, to 3.5 percent) was attributable to the change in the pattern of granting Easter bonuses (in March instead of April in 2009) rather than to wage cuts, in Q3, public sector wages were cut by 25 percent[30]. Moreover, the annual growth rate of net wages in the majority private sector decelerated in July-August 2010 (by 0.6 percentage points versus the prior quarter, to 5.2 percent) as a result of fiscal amendments regarding the luncheon vouchers[31]. This development is expected to continue in the subsequent months, given that the package of measures implemented as from 1 July is having an adverse impact on consumer demand and, therefore, on companies' incomes; this environment might also generate a demonstration effect – certain private companies might also contain wages, even if their financial standing does not necessarily require such a measure, just to get in line with the market average level.

Unit Labour Cost in Industry

annual percentage change



Source: NIS, NBR calculations

In industry, the annual growth rate of gross wages stood at 8.3 percent in July-August 2010, a level similar to that reported in Q2, with manufacturing posting even a 0.7 percentage point pick-up. ULC was still lower compared to that in the similar year-ago period, but the gap between the two levels narrowed. Accordingly, the annual decline in ULC equalled only 5.7 percent industry-wide (4.8 percent in manufacturing) compared to 10 percent in Q2, as a result of a marked slowdown in the annual dynamics of labour productivity. These less favourable developments (particularly in intermediate goods-producing subsectors - chemicals, metallurgy) generated neither cost-push pressures nor external competitiveness losses (the gap between the annual dynamics of labour productivity in manufacturing and that of wages expressed in euro remained positive, at about 6 percentage points in the period under review compared to 12 percentage points in 2010 Q2). It is noteworthy that the tendencies described earlier should be regarded with certain caution, taking into account the possibly distorting influences associated with the change in the seasonal pattern of output and, therefore, of labour productivity (for example, in transport means and, possibly, in related

30 According to Law Nr. 118/2010. Based on NIS data, the actual cut equalled 20.7 percent; the difference from 25 percent is justified by: (i) the enforcement of the provision according to which wages cannot be reduced below the gross minimum wage economy-wide and (ii) the payment of wages for prior periods (for further details on this difference, see NIS Press releases Nos. 184 and 207).

31 Government Emergency Ordinance No. 58 of 26.06.2010 stipulates that, starting with July 2010, employees will no longer be exempt from the payment of the personal income tax relative to these vouchers. The prevailing impact of this fiscal measure on the annual dynamics of net wage is illustrated by the fact that the annual dynamics of gross wage rose by 0.3 percentage points in July-August 2010 versus Q2.

subsectors, the sudden drop in demand in 2008 Q4 and 2009 Q1 required, as an alternative to staff cuts, the granting of annual paid leave that generally takes place in August – a practice resumed in 2010).

While the ULC disinflationary potential diminished, an opposite trend was manifest in the case of the real disposable income concurrently with the implementation of the austerity measures starting July; these measures caused the drop in the nominal wages of public sector employees, unemployment benefits and other welfare-related benefits, on the one hand, and in the purchasing power of all categories of incomes, via the impact of a higher VAT rate on the annual inflation rate, on the other hand. Specifically, while in 2010 Q2, the annual decline of the real disposable income slowed down to 4.4 percent (on the back of a slighter contraction of transfers from abroad), in July-August, it reached 13 percent. This development was mainly attributable to a negative annual dynamics of more than 15 percent in the case of wages economy-wide and of around 11 percent in the case of social transfers (compared to -8.9 percent and 2.7 percent respectively in Q2); moreover, incomes from abroad declined at a faster pace (by roughly 4 percentage points) to -12.8 percent year on year.

3. Import prices and producer prices

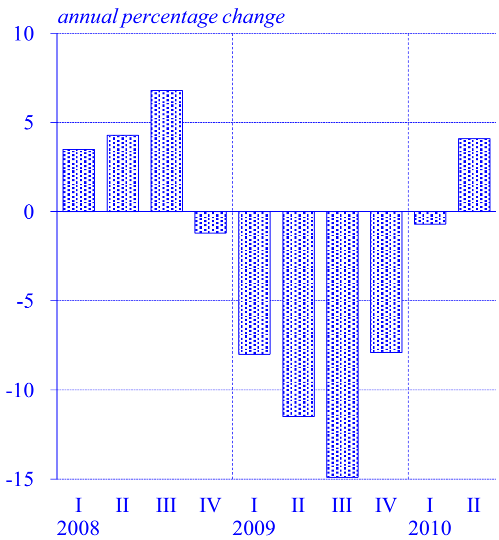
In 2010 Q2, both import prices and industrial producer prices for the domestic market had an adverse impact on consumer prices, which is expected to persist in the period ahead. Despite the negative annual changes further recorded in 2010 Q2, agricultural producer prices are likely to see a trend reversal in the next three-month period, as revealed by their developments in July-August.

3.1. Import prices

April through June 2010, pressures from external prices became manifest, the unit value index of imports increasing from 99.31 percent in 2010 Q1 to 104.07 percent. The contribution of exchange rate movements was modest in the case of the euro, yet unfavourable in the case of the US dollar, the settlement currency of most commodity imports. In addition, the sharpest external price changes in the reviewed quarter were reported by commodity imports: ores (18.1 percent), fuels (33.5 percent), metals (7 percent).

As for consumer goods, pharmaceuticals posted the highest growth rate of external prices (14.6 percent, 11 percentage points above the first quarter's figure), with pressures being visible on all origin markets of such products. Nevertheless, as far as the main supplier, namely the European Union, was concerned, this development

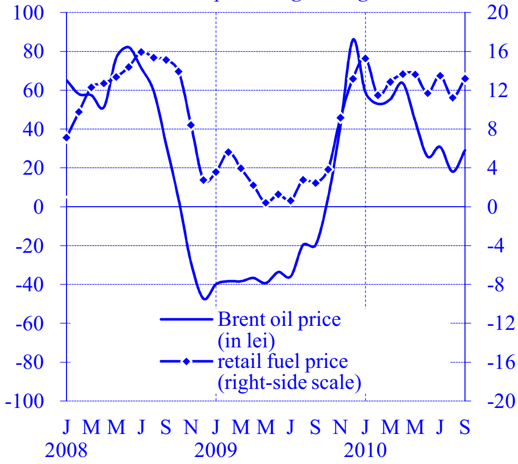
Unit Value of Imports



Source: NIS, NBR calculations

Oil Price and Retail Fuel Price

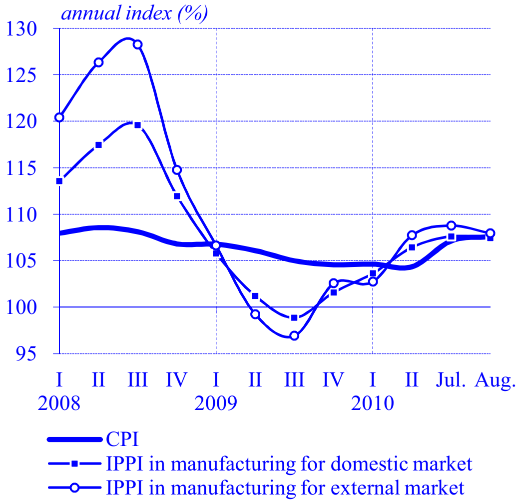
annual percentage change



Source: NIS, EIA, NBR calculations

Consumer Prices and Industrial Producer Prices

annual index (%)



Source: NIS

was not substantiated by the dynamics of producer prices for the external market in the pharmaceuticals industry, which indicates that other categories of costs (such as distribution costs) affected import prices of medicines. With regard to the other imported consumer goods, external prices (except for coffee and vegetal oils) continued to record negative annual changes, comparable in size to those seen in the first quarter of the year.

The same as in Q1, the unit value indices of imports of electrical equipment were significantly above par (105.2 percent), owing possibly to costlier metals. The same factor is likely to have had an impact on transport means, in which case unit value indices moved up from 93.9 percent in Q1 to 102.9 percent.

Given that current developments on the external markets for metals and energy products persisted in 2010 Q3 and that pressures on agricultural commodities grew significantly stronger, unit value indices are expected to stay on the uptrend they have followed since 2009 Q4.

3.2. Producer prices

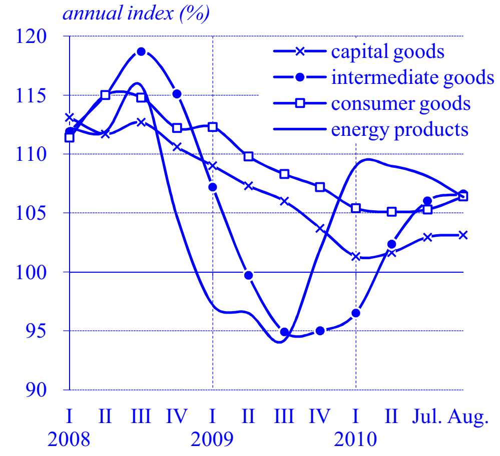
3.2.1. Industrial producer prices

In 2010 Q2, the annual growth rates of producer prices for the domestic market stayed on the uptrend they followed starting late 2009 (up 1.5 percentage points from the previous quarter's average to 5.3 percent), the major contribution coming from intermediate goods. The faster annual dynamics of prices for intermediate goods (up by about 6 percentage points) was due to the base effect associated with the pronounced downward trend in the first part of 2009, as well as to current developments marked by the hike in external prices for commodities. In terms of structure, metal processing exerted the strongest impact, as the annual growth rates of producer prices accelerated from 7.4 percent in 2010 Q1 to 10.4 percent in April-June. This development can be ascribable to the effects of costlier commodities and high volatility of orders, as a number of large groups of enterprises decided to switch their production approach from build-to-stock to build-to-order.

As concerns energy products, the other group of goods that influenced the dynamics of industrial producer prices in the past two quarters, the upward curve described by the annual changes in producer prices seemed to flatten out, even though price levels continued to stay significantly above average (9 percent in 2010 Q2) and quarterly growth rates remaining strongly positive (2.5 percent; non-seasonally adjusted series). The annual dynamics of producer prices in hydrocarbon processing – the key subsector for this group of goods – hit a high of 36.6 percent in May 2010 and declined gradually to 19.2 percent in August, amid the slower increase in external oil prices.

The annual growth rates of producer prices for the other groups of goods remained broadly unchanged as compared to the previous quarter, staying below the average industry-wide: 1.6 percent and 5.1 percent respectively for capital and consumer goods. In the latter case however, a structural change was triggered by the trend reversal of the two main segments: higher dynamics of prices for food items and beverages and slower dynamics of prices for the other consumer goods. While low in 2010 Q2, the pressures on producer prices for food items grew stronger in July-August, when the average monthly changes stood at 1.3 percent (as compared with 0.3 percent in the first year-half; seasonally-adjusted series). Behind these developments may have stood: (i) higher supply costs given that external prices for some commodities (grains in particular) followed a strong upward course amid the supply deficit generated by poor crops in some of the major exporting countries (Russia, Ukraine); (ii) fears surrounding the deterioration of this year's agricultural output, in the aftermath of floods affecting some country regions; (iii) the decision of some agricultural producers to cease domestic market sales, anticipating price hikes against the background of external developments.

Industrial Producer Prices for Domestic Market by Industrial Products Group



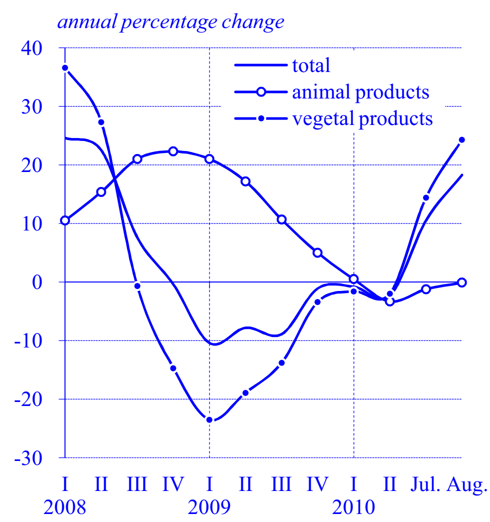
Source: NIS

The annual growth rate of industrial producer prices for the domestic market will stay on an uptrend in the period ahead, as prices for energy products and intermediate goods will further post significant changes year on year, whereas pressures manifest in the case of food prices will increase (according to producers' expectations). In addition, the annual dynamics of producer prices for new orders in manufacturing accelerated to 6.7 percent in August, as compared with the 0.1 percent low reached in 2010 Q1.

3.2.2. Agricultural producer prices

The annual changes in agricultural producer prices stayed in negative territory (2.3 percent) in 2010 Q2 as well, despite their magnitude reduced each month to 0.3 percent in June; this trend was due solely to developments in prices for vegetal products, whereas the growth rates of prices for animal products went deeper into negative territory.

Agricultural Producer Prices



Source: NIS

The same as in the previous quarters, developments in prices for grains (except wheat) further influenced the course and magnitude of movements in producer prices for vegetal products (2 percent as against 2009 Q2). Current developments showed, however, a less favourable performance, the average monthly change in 2010 Q2 standing significantly higher than the previous quarter's figure (2.9 percent versus 0.7 percent), owing possibly to: (i) lower stocks, given that the 2009 crops were poorer than those recorded a year earlier; (ii) suspension of subsidies for various agricultural crops following the expiry of transitory periods Romania negotiated prior to the EU accession; despite the enforcement of these measures since the beginning of the year, their impact on producer prices could have been manifest once the agricultural works were initiated.

Producer prices for animal products dropped 3.3 percent versus 2009 Q2, on the back of movements in prices for all meat categories (except poultry). The major contribution came from current developments, the average monthly rate of decline in prices for animal products being 3 percent in Q2 as compared with 0.7 percent in the first quarter. This can also be due to the effect of removing subsidies for meat production, which may have lead to cuts in the number of livestock in order to contain the financial effort of stockbreeders. Moreover, lifting the embargo on exports of pork products to the EU (since 2010), on condition that raw meat is imported, dampened domestic demand for pork. Hence, in this case, producer prices saw the sharpest decline in 2010 Q2 (6.1 percent year on year). Producer prices on this segment could go down further in 2010 Q3, yet the strong uptrend followed by producer prices for vegetal products (average annual dynamics of 19.3 percent in July-August, particularly on the back of developments in prices for wheat and sunflower seeds) will entail the resumption of positive annual changes at aggregate level.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

During 2010 Q3, the NBR kept unchanged both the monetary policy rate (at 6.25 percent per annum) and the existing levels of minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities. At the same time, the central bank pursued a management of liquidity adequate to the prevailing financial market conditions, which were characterised by lower uncertainties surrounding the financial crisis in the region and a relative normalisation of foreign exchange and money market conditions. These measures were aimed to calibrate real broad monetary conditions with a view to anchoring inflation expectations and countering the second-round effects of the VAT rate increase, as well as supporting the adjustment in interest rates on loans and deposits in domestic currency.

The significant worsening, also compared to previous expectations[32], of the short-term inflation outlook, due to the increase in the VAT rate to 24 percent from 19 percent as from 1 July 2010[33], and the risk of accompanying second-round effects to materialise prompted the NBR Board to keep unchanged the monetary policy rate and the minimum reserve requirement ratios in its meeting of 4 August 2010. Moreover, the NBR Board decided not to revise upwards the end-2010 inflation target, although the inflation rate was foreseen to deviate considerably from this target. The main arguments supportive of this decision were the temporary nature of the deviation and the need to prevent longer-term inflation expectations from losing their anchoring by retaining the central bank's commitment to achieving the announced inflation targets and by reconfirming its focus on the medium-term target. All these decisions were designed to ensure a solid anchoring of inflation expectations and, hence, prevent second-round effects of the VAT rate increase from materialising. In addition, they were meant to pave the way for inflation rate to resume convergence towards the end-2011 central target (3 percent ±1 percentage point) once the direct impact of the VAT rate hike had faded out. Such prospects were grounded on the envisaged persistence of the negative output gap at elevated levels given the anticipations of a slower-than-previously-projected recovery of economic activity, partly because of the expected adverse effects

[32] The medium-term projection in the May 2010 Inflation Report.

[33] The decision – after the Constitutional Court's rejected the proposal of a 15 percent cut in pensions – was taken on 26 June. Thus, the authorities sought to avoid major disruptions in the implementation of the EU-IMF-IFI external financing arrangement.

from the additional fiscal consolidation measures taken by the authorities as from July.

The central bank's response was also motivated by the fact that the risk of second-round effects arising from the VAT rate hike was augmented by the likelihood of new supply-side inflationary shocks. Such shocks were seen coming largely from relatively higher increases in administered prices and some food prices, the latter being chiefly conditional on the size of farming output losses as a result of this year's floods and severe weather conditions. An additional risk to the resumption and subsequent consolidation of disinflation was the possible slippage of fiscal policy from the coordinates agreed with the EU and the IMF which could result in the delay/postponement of fiscal consolidation. This risk arose from the prospects of a slower-than-previously-projected recovery of the economy and uncertainties surrounding the efficacy of additional austerity measures recently implemented by the authorities. At the same time however, the persistence of the negative output gap at elevated levels was expected to dampen both the degree of the higher VAT rate feeding through into the consumer price index and the potential second-round effects of this inflationary shock.

The need to counter the second-round effects of the VAT rate increase was also a reason for the NBR Board to decide, in its meeting of 29 September 2010, to leave unchanged the monetary policy rate at 6.25 percent per annum. Another reason for this decision was the persistence of risks to short-term inflation performance, especially relating to (i) developments in administered and volatile food prices due to seasonal causes and to a base effect and (ii) the lingering uncertainties concerning the efficacy of fiscal consolidation measures given the current social and political climate in Romania.

The risk of significant second-round effects from the VAT rate hike to materialise was still relevant, although July through August the pick-up in annual inflation rate was marginally below the figure in the latest projection exercise, reflecting a lower degree of the VAT rate increase feeding through into the consumer price index amid the persistence of the negative output gap. Furthermore, the annual dynamics of some key indicators on domestic demand staying in/going deeper into negative territory in the first part of Q3 pointed to a renewed decline in GDP and other domestic absorption components over the aforementioned quarter. As for consumer demand, the major indications of such an evolution were the following: (i) the renewed fall of turnover volumes of retail trade and of motor vehicles and motorcycles trade in July, (ii) the abrupt year-on-year reduction in the real net average wage in the same month, reflected also by the substantial cut in budgetary sector staff costs, (iii) the further negative annual dynamics of remittances in July, and (iv) the highly likely extension of – direct and indirect – contractionary effects induced by fiscal consolidation measures. Adding to these indications was the weakening of households' net bank saving[34], as the influence of a sharper slowdown in the change of these clients' investments was stronger than that of the resumed downtrend in the rate of increase of loans to households.

The latter fell deeper into negative territory in July-August (-4.0 percent against an average of -2.8 percent in Q2), owing only partly to the statistical effect exerted by the temporary advance in the annual inflation rate following the VAT rate hike. According to available data[35], households' demand for loans appears to have further been waning in the above-mentioned period amid the worsening in their current and expected financial standing and increased pessimism about their job prospects[36]; an adverse influence also had the rise in lending rates on new business in domestic and foreign currencies generated not only by the developments in ROBOR and EURIBOR rates, but also by the increase in interest spreads associated most likely with the entry into force of Government Emergency Ordinance No. 50/2010 on consumer loan agreements[37]. In turn, credit supply appears to have become relatively more restrictive, as banks announced a possible tightening of their lending standards and terms in Q3, contrary to the relative stabilisation trend seen in 2010 Q2. Against this background, new loans granted to individuals[38] July through August receded, on average, from 2010 Q2 and their average year-on-year dynamics slowed versus the same period. Consequently, the average annual change of consumer credit and other types of loans to households[39] declined to -9.5 percent in the review period (versus -7.7 percent in Q2), largely on the back of the more pronounced decline in the leu-denominated component. By contrast, housing loans saw a relatively faster rate of increase (averaging at 14.9 percent, up 0.3 percentage points from Q2), owing again solely to the foreign currency-denominated

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

[35] The NBR's survey on lending to non-financial corporations and households released in August 2010 and CCR data.

[36] Pursuant to EC – DG ECFIN Survey.

[37] In contrast to the previous months' trend, the average interest rate spread on new leu- and euro-denominated loans to households against 3M ROBOR and 3M EURIBOR respectively widened in the reviewed period.

[38] Given the distorting impact of the implementation of Government Emergency Ordinance No. 50/2010 on some of the data reported by banks in virtue of Norms No. 14/2006 issued by the NBR, information reported to the CCR was employed. This information refers to loans amounting to more than lei 20,000 granted in the reference period, but caution is called for in assessing such information, as it includes refinancing loans.

[39] The two indicators were cumulated in order to remove the altered-methodology effects arising from the entry into force of Norms No. 10/2009 issued by the NBR to implement Regulation (EC) No. 25/2009 of the ECB.

component (24.7 percent compared with 20.5 percent in Q2, EUR-based calculations).

Unlike the relative standstill seen in Q2, the annual dynamics of household savings with banks decelerated markedly in the July-August period (and even turned negative in August) to reach a 9-year low. Behind this stood mainly the decline in these deposits on a monthly basis (even in nominal terms, most notably in July) as a result of the VAT rate increase and wage cuts that depressed household savings with banks. Nevertheless, the share of time deposits (up to and over two years) in total household deposits continued to widen – albeit at a slower pace than in 2010 H1 –, as the individuals' precautionary savings were upheld by uncertainty about their financial standing. Furthermore, in contrast to the previous months, this trend was fostered by the wider interest rate spread on new time deposits in lei and overnight deposits of households. The annual growth rate of time deposits of households however kept declining (12.0 percent, down 6.5 percentage points from the second-quarter average) to the lowest level seen since end-2008; in turn, the annual change in overnight deposits fell deeper into negative territory (-25.5 percent against -21.1 percent in Q2). At the same time, households' propensity for foreign currency-denominated deposits strengthened and the (EUR-based) annual dynamics of such deposits returned to (relatively high) positive readings in the July-August period, unlike the leu-denominated deposits of households which displayed negative annual growth rates.

In this context, the cautious interest rate policy stance was further prompted by the risk of an excessive volatility of the RON exchange rate arising from the potentially wide swings in the risk premium attached to domestic market investments. The premium narrowed sizeably earlier in the quarter (subsequent to the IMF's decision to release a new disbursement under the arrangement signed with the Romanian authorities), but remained at higher levels than those seen prior to the April-June period, which widely mirrored the persistence of fears regarding the implementation of fiscal consolidation measures. The risk perception wor sened again in late August and early September amid the renewed political tensions and the cabinet reshuffle; the ensuing effects were enhanced by the negative signal conveyed by the worsening outlook for budget execution in Hungary. In turn, the global risk appetite remained relatively volatile in the review period, reflecting *inter alia* concerns over the sovereign debt crisis in EU Member States and the short-term outlook for the US economy (see Subsection *2.2. Exchange rate and capital flows*).

The improved investor sentiment in regard to economies in the region during the first part of Q3 and the relative normalisation of money and foreign exchange market conditions allowed the recalibration of the central bank's management of liquidity in the banking system with a view to supporting the adjustment in interest rates on loans and deposits in lei. The central bank's net debtor position vis-à-vis the banking system carried on throughout the quarter, but decreased from the previous period, given the contractionary net effect induced by the autonomous factors of liquidity. From July to September, the reserve surplus was partly mopped up by the NBR's fixed-rate deposit-taking operations with maturity of three and seven days respectively, where banks' bids ranging from lei 4.5 billion to 6 billion were accepted up to the pre-announced volume of lei 1 billion[40]; a major role in draining excess liquidity played the NBR's deposit facility whereby a daily average of lei 1,031 billion was absorbed. Against this background, the average money market rates on short-term maturities dropped gradually, whereas the adjustment of longer-term rates was lower, with such rates remaining slightly above the monetary policy rate.

2. Financial markets and monetary developments

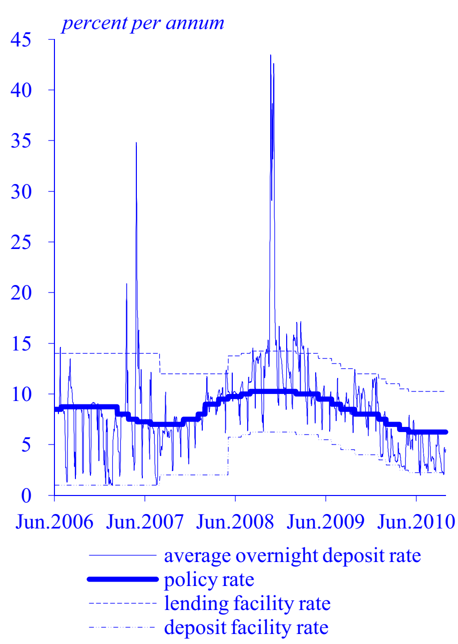
Average interbank market rates declined as compared with 2010 Q2, whereas lending and deposit rates on new business of non-bank clients posted diverging developments in June-August 2010, including under the impact of several one-off factors. Average RON/EUR exchange rate rose further, yet at a much slower pace, reflecting particularly the difficulties in implementing budget austerity measures and the uncertainties about the prospects for fiscal consolidation. Broad money saw a decelerating growth rate, whilst credit to the private sector recorded a slower pace of decline, given the ongoing upward trend followed by the rate of increase of loans in foreign currency.

2.1. Interest rates

In 2010 Q3, interbank market rates stayed on the downward trend they resumed at the end of the preceding quarter, which pushed their average down to 4.2 percent, 1.1 percentage points lower quarter on quarter.

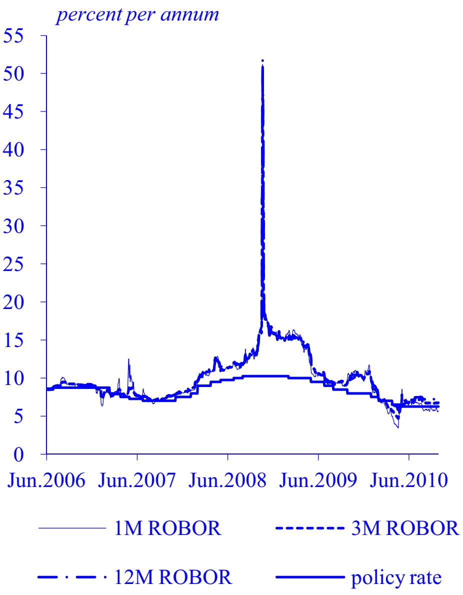
In the period under consideration, overnight rates generally stood at the lower bound of the corridor defined by interest rates on lending and deposit facilities, increasing only temporarily – in the first days of reserve maintenance periods – to levels close to the monetary policy rate. This development was indicative of the relative easing of liquidity conditions, on the back of Treasury's reserve injections, on the one hand, and the mopping-up of liquidity surplus particularly via the deposit facility of the NBR, on the other.

Interbank Money Market Rates

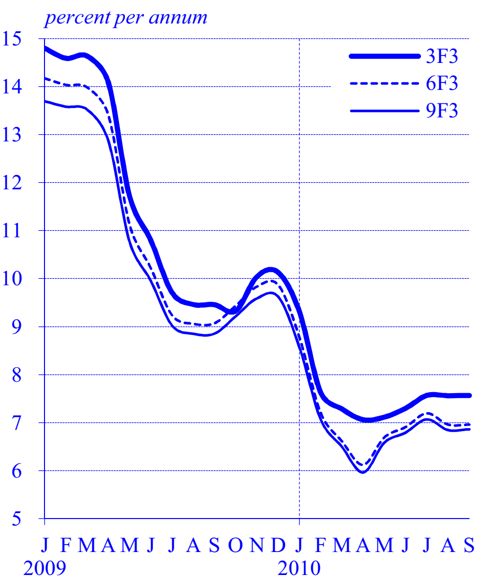


[40] Accounting for more than 80 percent of the average volume of open-market operations aimed at mopping up the reserve surplus.

Policy Rate and ROBOR Rates



Implicit Forward Rates



While initially (1M-12M) ROBOR rates remained at the relatively higher levels reached at end-June, they saw a downward adjustment; towards end-July, this was concurrent with the announcement regarding the successful completion of foreign currency-denominated government securities issued by the MPF on the local market, when the raised funds exceeded significantly the announced volume. Subsequently, 3M-12M rates stabilised at levels slightly higher than the monetary policy rate. As a result, average (1M-12M) ROBOR rates shed 0.2 percentage points in September versus June. Nevertheless, interest rates posted uneven developments across the maturity spectrum: average 1M and 3M rates dropped 0.9 percentage points and 0.1 percentage points respectively, while interest rates on longer maturities increased slightly. Therefore, implicit forward rates (calculated based on September average quotations) followed an upward course as against June: 3M rates rose by about 0.3 percentage points, whereas 6M and 9M rates went up only marginally. Consequently, 3M ROBOR rate is expected to stand at 7.6 percent in December 2010 and then fall to 7.0 percent in 2011 Q1 and 6.9 percent at mid-2011.

By contrast, in 2010 Q3, average yield on the primary market for government securities was 0.5 percentage points higher than in the prior quarter, given that interest rates on government securities issued in this period, for almost the entire maturity spectrum[41], stood at 7 percent, a level reached at mid-June. In an attempt to avoid the rise in public debt costs, the MPF did not agree with increasing such interest rates, by rejecting in whole or in part the bids submitted by participants in leu-denominated government securities auctions; thus, the volume of outstanding leu-denominated securities decreased[42], with budget deficit being financed and public debt refinanced including by using part of funds taken via EUR-denominated government securities issued in July on the domestic market[43], as well as funds from external borrowings.

The average yield on outright operations performed on the secondary market for government securities also saw an upward adjustment to 6.9 percent. However, the quarterly turnover of this market (NBR excluded) continued to decline, reaching lei 16 billion, with the largest part (about 83 percent)[44] being accounted for by outright transactions. Securities with residual maturities of up to and including one year were the most heavily

[41] Except 10-year bonds (7-year residual maturity) with an interest rate of 7.1 percent.

[42] As compared with previous months as well as with the announced volume.

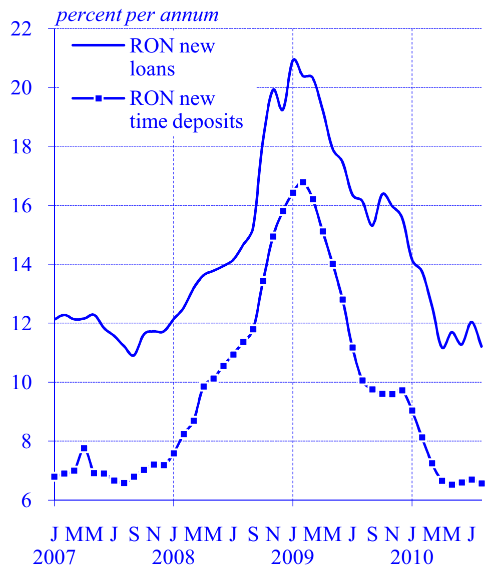
[43] Such securities – in total amount of EUR 1.2 billion – have 1-year maturity and bear a 4.9 percent interest rate.

[44] The volume of transactions in government securities performed via BSE totalled merely lei 70 million. Securities with residual maturities of 1 and 2 years were the most heavily traded (85 percent of total turnover), their average quarterly yields rising to 7.2 percent and 7.3 percent respectively.

traded, their average interest rates rising by 0.3 percentage points as against the previous quarter. Non-residents' holdings of lei-denominated securities witnessed both-way movements, standing lower at end-September than in June.

Average lending and deposit rates on non-bank clients fluctuated slightly in June-August 2010. At the end of this period, average interest rates on households' new time deposits remained almost unchanged (6.56 percent) as compared with May, whereas average lending rates on new business declined marginally by 0.49 percentage points[45] (to 11.21 percent) compared to the same month. Moreover, developments were uneven for the two categories of customers, as interest rates applicable to households were under the impact of several one-off effects. Hence, average interest rates on households' new time deposits added 0.22 percentage points to 7.46 percent, owing particularly to promotional campaigns associated with the introduction of a 16 percent tax rate on gains from such placements[46] as of July 2010. In addition, average interest rates on households' new loans rose by 0.61 percentage points to 12.41 percent, largely due to the increase in margins applied by banks, following the entry into force of Government Emergency Ordinance No. 50/2010 on consumer loan agreements. In contrast, average interest rates on new loans and deposits of non-financial corporations shed 0.74 percentage points and 0.14 percentage points to 10.92 percent and 5.84 percent respectively. In the former case, the fall was mainly triggered by the drop in average interest rate on short-term small-value loans (the equivalent of less than EUR 1 million) with variable interest rate.

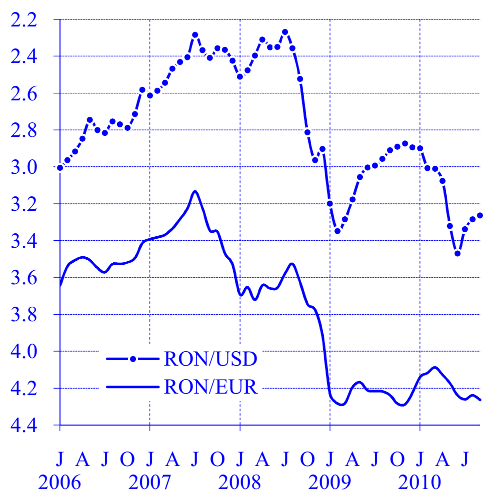
Bank Rates



2.2. Exchange rate and capital flows

The abrupt rise in the RON/EUR exchange rate at the end of the previous quarter was corrected in early July, the exchange rate showing a relative stability by end-August, when it witnessed a new increase episode. Such developments reflected mainly the changes in market sentiment, induced to a lower extent by the fluctuations in global risk appetite and to a higher extent by changes in the magnitude of uncertainties surrounding the implementation and effectiveness of fiscal consolidation measures adopted by the Romanian authorities. Under the circumstances, the RON/EUR exchange rate did not longer follow the sharply downward trend manifest in the case of the Czech koruna and the

Nominal Exchange Rate

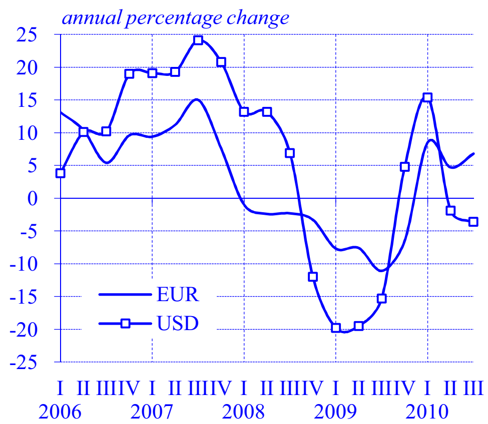


[45] The decline was mostly due to the changes in interest rates on new leu-denominated loans of non-financial corporations, which accounted for more than 80 percent of new loans reported according to NBR Norms No. 11/2009.

[46] Set forth in Government Emergency Ordinance No. 58 of 26 June 2010 on amending and supplementing Law No. 571/2003 on the Tax Code and other financial and fiscal measures.

Polish zloty[47]; by contrast, the volatility of the RON/EUR exchange rate was further lower than those of most exchange rates in the region.

Developments of RON Exchange Rate*



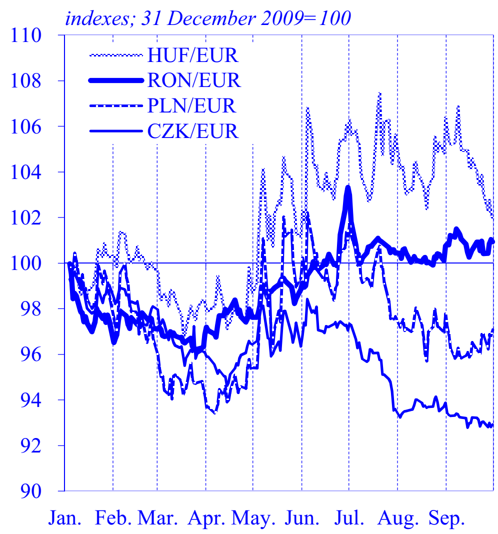
*) appreciation (+), depreciation (-) in real terms; deflated by CPI

Source: NIS, NBR

Hence, in July-September, the domestic currency weakened against the euro by 0.6 percent in nominal terms and appreciated by 2.9 percent in real terms (as compared with a depreciation of 3.6 percent in nominal terms and 3.1 percent in real terms in Q2). However, in relation to the US dollar, the leu appreciated by 5.3 percent in nominal terms and 8.6 percent in real terms (as compared with a depreciation of 12.7 percent and 12.5 percent respectively in Q2), given that the US currency depreciated versus the euro. Looking at the average annual change for 2010 Q3, the domestic currency softened versus the euro in nominal terms for the first time in the past three quarters (0.7 percent) and saw the highest nominal depreciation against the US dollar in the past four quarters (10.4 percent).

The strong upward trend followed by the RON/EUR exchange rate in the last ten-day period of June reversed in early July, amid the alleviation of uncertainties about the implementation of budget austerity measures proposed by the government, due mainly to the optimistic signal sent by the IMF Board decision to release the fifth tranche of the loan to Romania. In this context, on 8 July, the RON/EUR exchange rate reverted to 4.2285, dropping 3.3 percent as compared with end-June. Subsequently, the RON/EUR exchange rate increased slightly, reflecting the relative worsening of market sentiment, stemming particularly from: (i) more numerous signs of weaker-than-expected developments in the US economy, (ii) the suspension, on 17 July, of the financing arrangement between IMF/EU and Hungary and the downgrade in the rating of this country and (iii) the downgrade in Portugal's rating.

Exchange Rate Developments on Emerging Markets in the Region in 2010



Source: NBR, ECB

At end-July, the RON/EUR exchange rate followed a slightly downward path, reflecting, the same as the exchange rates of other currencies in the region, the favourable effects on investors' perception exerted by: (i) lower risk associated with banks and sovereign issuers from the EU, including as a result of the smooth unfolding of the first government securities issue of Greece, following the signing of the arrangement with IMF/EU as well as due to the stress test results in the EU banking sector and (ii) stronger-than-expected developments reported by most euro area economies in Q2. However, the downward movement in the RON/EUR exchange rate was lower (the leu appreciated by 0.5 percent in August, while the Polish zloty, the Czech koruna

[47] In July-September, the Czech koruna and the Polish zloty appreciated significantly versus the euro (by 4.6 percent and 3.8 percent respectively).

and the Hungarian forint strengthened by 2.3 percent, 2.1 percent and 0.8 percent respectively in the same period), given that the improvement in market sentiment was contained by the persistent uncertainties surrounding fiscal consolidation, as well as the worsening prospects for the Romanian economy (the IMF revised to 1.9 percent the GDP decline projected for 2010).

The RON/EUR exchange rate experienced a new increase episode at end-August and early September, amid the heightened political tensions and the cabinet reshuffle. In this context, the rise in the risk premium attached to investment on the domestic market was accelerated by the negative signal sent by the worsening budgetary developments in Hungary. The subsequent dissipation of domestic tensions, followed by the public acknowledgement of the commitment assumed by the Hungarian authorities to bring budget deficit below 3 percent in 2011, pushed the leu and forint exchange rates to resume a downward trend. This development was also underpinned by the relative increase in global risk appetite, fostered among others by the successful unfolding of EUR-denominated bonds issues in Spain, Greece and Poland. Nevertheless, in September as a whole, the leu depreciated by 0.6 percent in nominal terms versus the euro (in the same period, the Hungarian forint weakened by 0.2 percent). By contrast, the Polish zloty and the Czech koruna strengthened by 0.9 percent and 0.6 percent respectively versus the euro.

Key Financial Account Items (balances)

EUR million

	2009 8 mos.	2010 8 mos.
Financial account	**2,372**	**3,480**
Direct investment	**2,963**	**1,807**
- residents abroad	-91	-150
- non-residents in Romania	3,054	1,956
Portfolio investments and financial derivatives	**-107**	**733**
- residents abroad	-322	124
- non-residents in Romania	215	**609**
Other capital investments	**156**	**3,001**
- credits and loans from the IMF	4,925	3,365
- medium- and long-term investments	2,858	-1,246
- short-term investments	-3,652	16
- currency and short-term deposits	-4,919	795
- other	944	71
NBR's reserve assets, net ("–" increase/"+" decrease)	**-640**	**-2,061**

2.3. Money and credit

Money

June through August 2010, the dynamics[48] of broad money (M3) slowed down significantly (-3.3 percentage points to 0.7 percent). Since July, this indicator has stayed in negative territory (for the first time in the last nine-and-a-half years). These developments reflected the relative weakening of the economic activity, partly because of the impact of the austerity measures taken by the government in order to achieve fiscal consolidation, possible M3 portfolio shifts in favour of government securities, as well as the statistical effect of the pick-up in the annual growth rate of inflation owing to the VAT rate hike.

Annual Growth Rates of M3 and Its Components

real percentage change

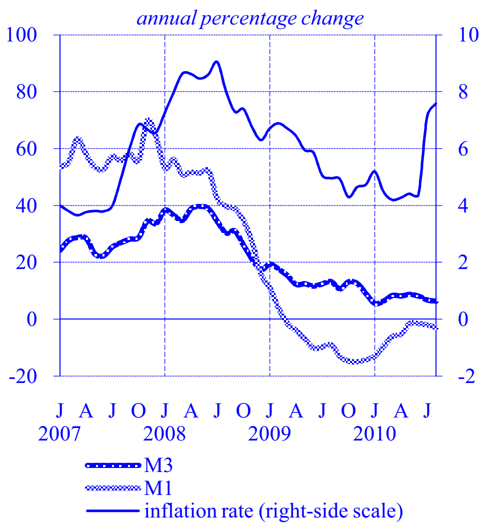
	2009		2010			
	III	IV	I	II	Jul.	Aug.
	quarterly average growth					
M3	6.8	6.7	2.1	3.9	-0.3	-1.1
M1	-14.8	-18.3	-13.5	-6.8	-8.5	-9.7
Currency in circulation	-2.9	-8.9	-5.7	0.6	2.7	2.7
Overnight deposits	-19.0	-21.9	-16.7	-9.9	-13.3	-14.8
Time deposits (maturity of up to two years)	32.8	36.7	15.1	10.8	4.6	4.3

Source: NIS, NBR

Both main components of M3 contributed to this evolution: time deposits with maturity of up to two years saw their growth pace slowing further, while narrow money (M1) continued to post relatively stable negative dynamics. The latter reflected the joint effect of (i) money in circulation resuming an upward trend (after

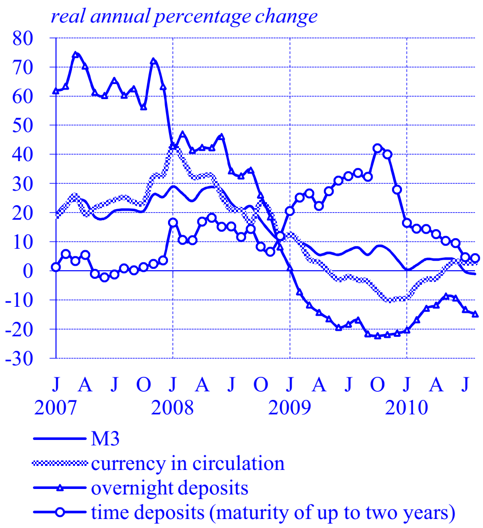
[48] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2010.

Broad Money and Inflation Rate



Source: NIS, NBR

Main Broad Money Components



Source: NIS, NBR

one year of declining in real terms) to the detriment of overnight deposits in domestic currency, (ii) faster growth of overnight deposits in foreign currency (expressed in euro), solely on the back of the change in corporate deposits, which peaked at a two-year high and (iii) the statistical influence of the rise in the annual inflation rate. In turn, developments in time deposits with maturities of up to two years were ascribable chiefly to the slower dynamics of household placements (especially those denominated in domestic currency) which, nevertheless, remained in positive territory. This is indicative of a relative persistence of precautionary demand for money. A similar effect was exerted by the slower annual dynamics of corporate lei and foreign exchange term deposits with maturities of up to two years, which re-entered and fell deeper into negative territory respectively, due also to the shift of part of these funds into term deposits in domestic currency with maturities of over two years and overnight deposits in foreign currency.

The sectoral breakdown reveals that the dynamics of total household deposits in M3 remained on a downtrend and hit the lowest reading in the last nine years. This was due to (i) the decline in incomes and a further high indebtedness of households and, to a lesser extent, (ii) their stronger interest in government securities (possibly as a result of the favourable tax treatment of return on such investments). In turn, the dynamics of total corporate deposits in M3 re-entered negative territory and touched the lowest reading in ten years amid the decline in companies' incomes[49], as well as of a hike in government securities holdings of this sector. The slowdown in the growth pace of M3 deposits of both categories of clients was due chiefly to developments in the domestic-currency component, with the foreign-currency component dynamics remaining at elevated levels, albeit slackening, in the case of households, and relatively steady in the case of companies. Against this backdrop, the share of forex deposits in M3 increased slightly to 32.3 percent on average in the reported period.

From the perspective of M3 counterparts, the slower dynamics of broad money reflected a deceleration in the pace of increase of net foreign assets in the banking system, as well as an acceleration in the growth rate of long-term financial liabilities (including capital accounts). An opposite influence came from credit to the private sector, via the moderation in its negative change, while central government net credit exerted a relatively neutral influence.

[49] According to data regarding the budget execution, the average annual growth rate in real terms of profit tax slowed down significantly in the period under review.

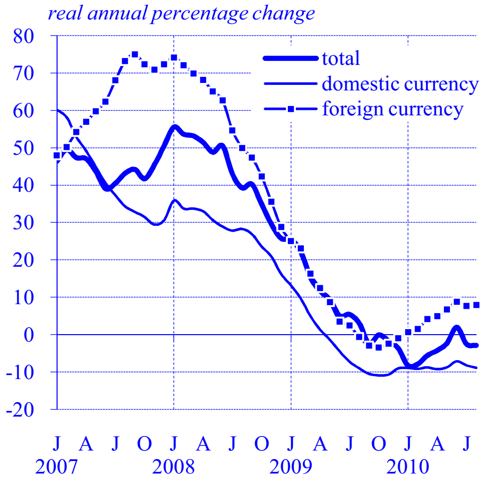
Credit

June through August 2010, the contraction[50] in credit to private sector continued to slow down (-1.1 percent from -4.0 percent in the preceding 3-month period). This evolution was due especially to the foreign exchange component (expressed in euro) – the dynamics of which accelerated to a high since 2009 Q2 –, as well as to the slight slackening of the negative dynamics of the domestic currency component. During the reported period, the change in total privatexsector credit was uneven, as it reverted temporarily to positive territory in June 2010, due partly to the statistical effect of the leu depreciation. Under these circumstances, the share of foreign currency-denominated loans in total private sector credit hit an 8-year high of 62.4 percent, on average, over the period.

The breakdown by institutional sector reveals that corporate borrowings continued to be the most dynamic component, their growth pace reverting to positive territory. These developments were attributable both to the possible lower restrictiveness in loan supply and the rebound, to some extent, of the demand for loans of these entities[51]; the latter occurred against the background of a possibly temporary improvement in industrial activity and the decline in lending rates in non-financial corporations' new business in lei to a two-and-a-half-year low (more visible in case of borrowings equivalent to up to EUR 1 million)[52]. Similarly to the previous quarter, foreign-currency corporate borrowings witnessed the swiftest growth rate, their medium- and short-term components tripling and doubling their dynamics respectively, while the growth pace of the long-term component remained the fastest since end-2008. In turn, domestic currency-denominated corporate loans posted a slower negative change, solely on account of the dynamics of the short-term component reverting to positive readings for the first time in the past year. In the period under review, the total volume of companies' new business[53] expanded, mainly as a result of the change in loans outstanding, hinting at a possible slowdown in banks' debt restructuring operations.

Credit to Private Sector by Currency

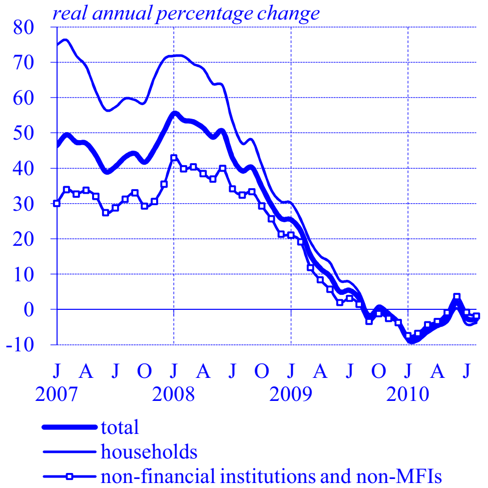
real annual percentage change



Source: NIS, NBR

Credit to Private Sector by Institutional Sector

real annual percentage change



Source: NIS, NBR

50 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2010.

51 According to the NBR's survey on lending to non-financial corporations and households released in August 2010, during 2010 Q2, the credit standards applied to the corporate sector remained broadly unchanged, while the tightening of lending terms grew softer; at the same time, credit institutions expected a lower tighteness of lending standards and terms in Q3. Corporate demand for loans picked up in Q2, after five quarters of decline, but credit institutions expect a reversal of this trend in the next quarter.

52 According to the data reported by banks in compliance with the provisions of NBR Norms No. 11/2009.

53 According to CCR data referring to loans in excess of lei 20,000 approved in the period under review.

By contrast, household demand for loans remained weak, whereas supply continued to be restrictive.[54] Nevertheless, the balance of loans to households halved its negative dynamics, amid a faster growth pace of housing loans and a softer contraction in consumer credit and loans for other purposes[55]. In either case the foreign exchange components (expressed in euro) played the major role, with the growth rate of housing loans even hitting a one-and-a-half-year high, mainly on the back of the "First Home" programme. The volume of new business to households[53] shrank marginally against the prior period, but remained at elevated levels compared to the readings seen since end-2008.

Net credit to central government further saw a relatively steady growth rate, the deceleration in the dynamics of banks' government securities holdings being offset by the slower expansion of central government deposits.

[54] According to the NBR's survey on lending to non-financial corporations and households released in August 2010, household demand for loans remained in negative territory during 2010 Q2 and banks did not expect a recovery in Q3. At the same time, restrictiveness of credit standards to households was little changed in 2010 Q2, as credit institutions expected their tightening in 2010 Q3, especially for consumer loans.

[55] The two categories of loans were analysed in terms of a single indicator, with a view to removing the effect of the changes in the statistical methodology (implemented since June 2010, according to Regulation No. 25/2009 of the ECB concerning the balance sheet of the monetary financial institutions sector).

V. INFLATION OUTLOOK

For end-2010, the baseline scenario of the current projection places the annual CPI inflation rate at 8.2 percent, 0.4 percentage points higher than the level published in the August 2010 Inflation Report. The first-round effect of the VAT rate hike on the annual CPI inflation is seen fading by the end of 2011 Q3, with the inflation rate being expected to re-enter the variation band around the 3 percent central target in 2011 Q4. The projection envisages the end-2011 inflation rate to stand at 3.4 percent, 0.3 percentage points above the previously projected figure.

The upward revision of the CPI inflation forecast throughout the reference period is due to some updated scenarios on the impact of several supply-side factors being less favourable, as well as to their estimated impact, although perceived as short-lived, on inflation expectations. Such adverse effects on CORE2 inflation are mitigated to a certain extent by the persistent negative output gap which was subject to a downward revision in the current forecasting round. This should act especially via the more negative output gap containing the potential manifestation of second-round effects of the VAT rate increase.

For this year, the projected additional inflationary impact is generated by the adverse shocks on domestic and external agri-food markets feeding through especially into the dynamics of fruit and vegetables prices, given the presence of base effects. A favourable influence of a lower magnitude stems from the downward revision in the short run of scenarios on fuel price increases. For 2011, given the revised scenario for the oil price trajectory, the inflationary impact of fuel prices is projected to become more unfavourable. Higher contributions to inflation than in the previous projection are expected from volatile food prices as well as from CORE2 inflation.

While the projection for headline inflation was revised upwards, owing mainly to some exogenous supply-side shocks, the projected CORE2 inflation for end-2010 is marginally below that in the prior forecasting round, as it incorporates weaker first-round effects of the VAT rate increase for Q3 than those previously anticipated. Although CORE2 inflation has remained on a downward trend starting 2011 Q1, its fall is relatively slower in the updated baseline scenario, largely as a result of inflation expectations being revised upwards.

For the entire projection horizon, the central bank has set as a priority the consolidation of prospects for resuming disinflation. The monetary policy rate will follow a trajectory leading to the adequate calibration of real monetary conditions to this end, also *fostering the gradual revival of lending to the real economy. This will allow the annual CPI inflation rate to converge towards the medium-term targets and the economy to resume a sustainable growth path. The fulfilment of these goals is strictly conditional upon the firm and consistent implementation, within the macroeconomic policy mix, of fiscal consolidation measures, as well as of structural reforms, along with the increase in European funds absorption, in line with the commitments set under the multilateral external financing arrangement concluded with the European Union, the International Monetary Fund and other international financial institutions.*

Similarly to the previous projection, the uncertainty associated with the current forecasting round is high, while the overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to be tilted to the upside. Again, the relevance of risks associated with the domestic environment prevails over the reference period. The risks generated by the external environment persist, although their sources have altered to some extent.

The tense political and social climate in Romania is a major risk to the effective implementation of fiscal consolidation and income policy measures, as well as of structural reforms. The failure to meet the objectives set under the external financing arrangement concluded with the European Union, the International Monetary Fund and other international financial institutions might lead to further deterioration of confidence of foreign investors and of the domestic business environment in the local authorities' capacity to manage macroeconomic developments in a sustainable manner. As a result, tighter financing constraints for both public and private sectors might dampen not only the short-term outlook for economic recovery, but also the longer-term growth potential of the economy. In the near term, there is considerable uncertainty over the effects that the materialisation of such risks might have on the direction of the deviation of inflation rate from its projected trajectory in the baseline scenario. Over the longer term though, the delay in eliminating structural rigidities economy-wide might postpone the fulfilment of the price stability and euro adoption objectives.

A significant risk arises from potentially larger-than-projected increases in administered prices. The particular relevance of this risk for the reference period derives from the possible solutions that may be resorted to in case of tighter fiscal constraints. For instance, the removal of local governments' subsidies on goods and services to households (e.g. heating) might push prices of those items sharply higher.

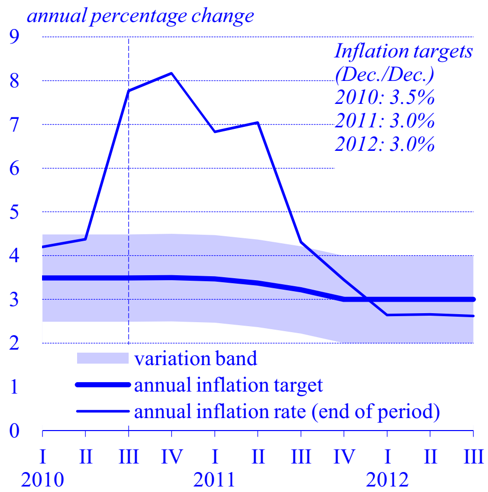
One of the risks related to the external environment arises from the uncertainties surrounding the future developments in commodity prices or agri-food prices. The heightening of tensions on *international markets for such goods might materialise in larger than projected domestic price increases. Another risk is associated with the recent significant appreciation of the euro against the US dollar. A possibly faster-than-expected trend reversal would lead, via the depreciation of the leu versus the US dollar, to steeper increases in fuel and other commodity prices than those considered in the projection.*

1. The baseline scenario of the forecast

1.1. Inflation outlook

According to the baseline scenario of the macroeconomic projection, the annual CPI inflation rate is seen standing at 8.2 percent at the end of 2010 and at 3.4 percent at the end of 2011. Compared to the levels published in the August 2010 Inflation Report, the annual CPI inflation forecast is 0.4 percentage points and 0.3 percentage points higher in 2010 and 2011 respectively. The first-round effect of the VAT rate increase on the annual CPI inflation rate[56] is expected to fade out by the end of 2011 Q3[57], with the inflation rate falling back within the ±1 percentage point variation band around the central target in 2011 Q4, one quarter later than anticipated.

Inflation Forecast



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

Source: NIS, NBR calculations

Table 5.1. The annual inflation rate in the baseline scenario

percent

Period	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3
Target	3.5				3.0			
Forecast	8.2	6.8	7.0	4.3	3.4	2.6	2.7	2.6

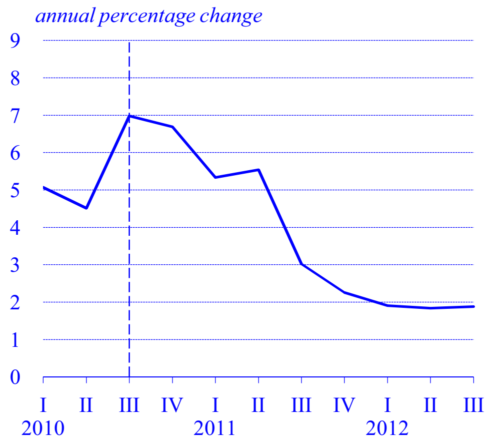
For this year, higher contributions to inflation than those included in the previous Inflation Report are projected from volatile food prices (vegetables, fruit, eggs: VFE), while next year, apart from the more unfavourable influence of these prices, higher contribution will come from CORE2 inflation and fuel price inflation[58].

[56] For details on the impact of the VAT rate increase on quarterly and annual CPI inflation rates, see Subsection *1.1. Inflation outlook* in the August 2010 Inflation Report.

[57] The reassessments of the current forecasting round revealed that first-round effects of the VAT rate hike would affect the quarterly CPI inflation rate in 2010 Q4 as well, primarily due to the lagged incorporation of this increase into the price of heating (no sooner than its being supplied to economic agents in October 2010). Thus, because of a base effect, the direct impact of the VAT rate rise on annual CPI inflation rate will be manifest during 2011 Q3 as well.

[58] By using a measure of inflation that excludes the first-round effect of the VAT rate hike, inflationary pressures relative to the whole CPI basket are anticipated to be stronger than those foreseen in the August 2010 Inflation Report. In this respect, the faster-than-previously-projected dynamics of adjusted CORE2 inflation and VFE inflation are decisive both in 2010 and 2011.

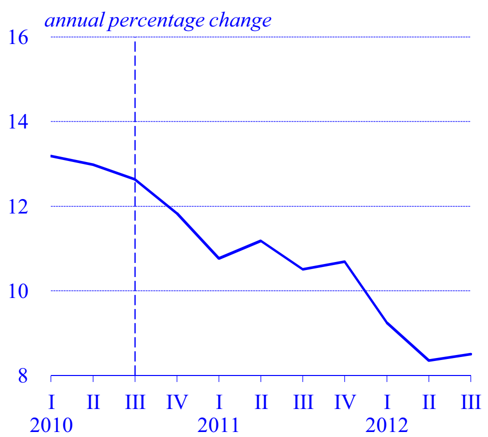
Annual CORE2 Inflation*



*) quarterly average

Source: NIS, NBR calculations

Fuel Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR calculations

In the current projection, the inflation forecast rests on the following:

(i) The annual CORE2 inflation rate is seen declining considerably over the projection horizon, albeit at a slower pace than in the previous round, from 6.7 percent foreseen for 2010 Q4 to 2.3 percent in 2011 Q4, then fluctuating over the remaining part of the forecast horizon[59] close to 2 percent. Starting from a lower than anticipated effective level in 2010 Q3[60], annual core inflation will fall marginally below the previous forecast in 2010 Q4, but will have a larger contribution to CPI inflation during 2011. Such developments in the projected CORE2 inflation rate arise from the opposite action of several determinants, as follows:

- the upward revision in the trajectory of inflation expectations. Similarly to the previous projection, the revision reflects mainly the materialisation or its anticipation of adverse supply-side shocks[61];
- inflationary pressures from import prices marginally higher over the first two quarters of the projection horizon, mainly because of higher expectations for HICP inflation in the euro area. Subsequently, given the dwindling risk aversion of foreign investors and the still high yields on leu-denominated investments compared to those in the euro area, import price inflation is foreseen to run at levels below those in the August 2010 Inflation Report; and
- the negative output gap, expected, *ceteris paribus*, to follow a more favourable trajectory to disinflation than envisaged in the previous Inflation Report[62].

(ii) For the final part of 2010 the projected annual fuel price inflation rate has a more favourable impact on disinflation, due largely to lower inflationary pressures in 2010 Q3 coming from fuel prices and to the downward revision of the oil price assumption in 2010 Q4[63]. Throughout 2011, with the oil price seen rising faster than envisaged in the previous forecast[64],

[59] The last quarter included in the forecast horizon of the current round is 2012 Q3.

[60] By 0.8 percentage points. Part of the reassessment has recently been due to a relatively lower pass-through of the VAT rate hike, via the first-round effect, to CORE2 inflation given the persistence of negative output gap.

[61] For the current round, they are attributed to additional inflationary pressures on food markets (adverse weather conditions domestically and costlier substitutable products internationally) and uncertainties surrounding the upward revision in major administered prices (energy prices in particular).

[62] For further details, see Subsection *1.3.3. Demand pressures within the projection horizon*.

[63] For further details, see Subsection *1.2. Exogenous pressures on inflation*.

[64] The increase in the oil price in 2011 Q4 versus 2010 Q4 is estimated at 9.1 percent as against 7.2 percent in the previous projection.

fuel prices will have a larger contribution to the annual CPI inflation rate.

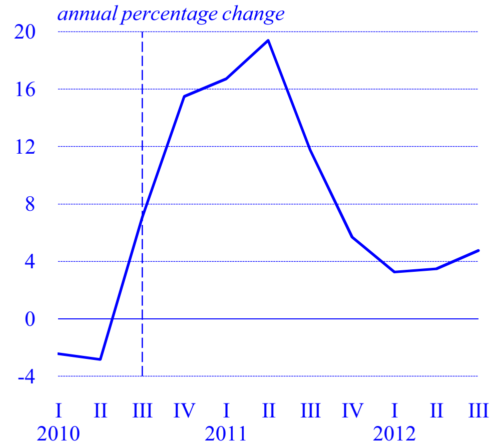
(iii) The joint contribution of administered prices and volatile prices of vegetables, fruit and eggs to the annual CPI inflation rate will be higher than in the previous forecast in both 2010 and 2011, by 0.4 percentage points and 0.1 percentage points respectively.

1.2. Exogenous pressures on inflation

Compared to the previous projection, the cumulative effect of exogenous components[65] is seen making a higher contribution to CPI inflation (by 0.4 percentage points in 2010 and by 0.1 percentage points in 2011). For both 2010 and 2011 additional inflationary pressures stem from volatile food prices, being partly cushioned in the current year by a relatively more favourable evolution of administered prices than in the previous forecasting round.

The scenario for the administered prices growth rates in 2010 was subject to a downward revision compared to the previous projection, on account of the anticipation of an incomplete pass-through into prices of the VAT rate hike. For 2011, in view of the uncertainty associated with the projection of administered prices in the absence of an official adjustment calendar, the expert judgement adopted for the previous two forecasting rounds was kept in place, envisaging an annual 3.8 percent increase[66].

Vegetables, Fruit and Eggs Prices Annual Inflation*



*) quarterly average

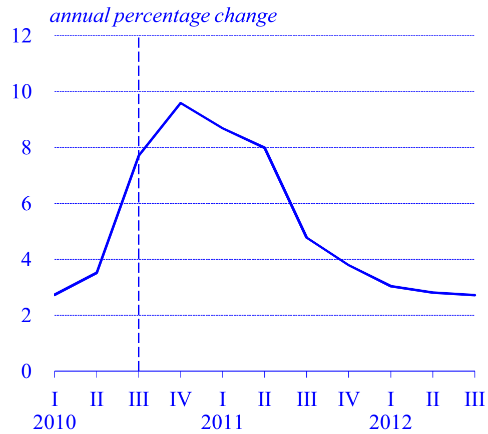
Source: NIS, NBR calculations

Table 5.2. The scenario for the administered and volatile prices*

		Administered prices		Volatile food prices	
		2010	2011	2010	2011
Current projection	Annual change (%)	9.6	3.8	15.5	5.7
	Contribution to annual CPI inflation (pp)	1.6	0.6	1.0	0.4
Previous projection	Annual change (%)	9.9	3.8	8.2	4.8
	Contribution to annual CPI inflation (pp)	1.7	0.6	0.6	0.3

* Calculations for Q4 of current year/Q4 of previous year

Administered Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR calculations

The growth rate of tobacco product prices is projected to make a significant contribution to CPI inflation in 2010 as well (1.5 percentage points) under the impact of the excise duty rise in the first part of the year and of price increases seen in July which

[65] The exogenous components of consumer price inflation include administered prices, volatile VFE prices and tobacco prices.

[66] For details see Subsection *1.2 Exogenous pressures on inflation* in Chapter V in the May 2010 Inflation Report.

incorporated also the new VAT rate[67]. For 2011, in the absence of adjustments provided by the Tax Code in the excise duty on tobacco products, the price increases for this CPI component are seen to be relatively marginal (approximately 1 percent).

The forecast for volatile food prices was subject to an upward revision compared to the previous projection particularly for the current year (7.3 percentage points); therefore, following the favourable evolution in 2009[68], these prices are expected to make a significant contribution to the annual CPI inflation (Table 5.2.) in 2010, considering the low share of this component in the CPI basket[69]. The reassessments were determined mainly by the unfavourable developments of vegetables prices, following the poorer crops recorded in the aftermath of adverse weather conditions and the impact generated by the dynamics of international prices on domestic producers' behaviour.

The scenario on the developments in the euro area economy foresees a moderate recovery, against the background of a relatively modest pace of increase of domestic demand. The economic growth forecast was subject to an upward revision compared to the previous forecasting round, i.e. by 0.5 percentage points for 2010, under the impact of some temporary factors on domestic demand, and by 0.1 percentage points for 2011, with the change reflecting mainly the anticipation of a more favourable evolution of exports, especially to the dynamic emerging economies. For the first part of the projection horizon, the annual HICP inflation rate is expected to report higher than previously projected readings, as a result of the increase in commodity prices; however, the inflation outlook is stable for the period ahead owing to the modest evolution of domestic demand. Compared to the projection in the August 2010 Inflation Report, the trajectory of the 3M EURIBOR interest rate was revised slightly downwards throughout the projection horizon. The current projection has changed the estimated figures for the EUR/USD exchange rate, the euro being expected to become stronger in view of the recent developments in the spot exchange rate, amid the signals on a possible easing of the Fed's policy. The same as in the previous forecasting rounds, the scenario on the developments in the international oil price reflects the anticipation of a gradual recovery of world economy, although the expected readings are lower than previously projected.

[67] The annual growth pace of tobacco product prices in 2010 is mainly accounted for by the developments in these prices in January and July. According to the data released by the NIS, the monthly inflation rates related to such products came in at 13.87 percent and 9.47 percent, respectively, in view of the maximum 4.2 percent impact of the VAT rate increase from 19 percent to 24 percent (excluding the effect on the calculation base of the *ad valorem* duty, which includes VAT).

[68] The annual VFE inflation made a negative contribution to annual CPI inflation at end-2009.

[69] Foodstuffs with volatile prices account for 6.7 percent in the consumer basket.

Table 5.3. Expectations on the developments in external variables

annual averages

	2010	2011
WTI oil price (USD/barrel)	77.4	82.0
EUR/USD exchange rate	1.32	1.30
3M EURIBOR interest rate (% p.a.)	0.78	1.02
Economic growth in the euro area (%)	1.6	1.5
Annual inflation rate in the euro area (%)*	1.8	1.5

* in Q4

Source: Consensus Economics, U.S. Energy Information Administration, Eurosystem staff macroeconomic projections for the euro area

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

The data on the GDP evolution in 2010 Q2[70] indicate a halt in the economic decline in quarter-on-quarter terms, the GDP growth being however modest, i.e. 0.3 percent. In 2010 Q2, GDP declined by 0.5 percent[71] year on year, which hints at a significant deceleration in the annual economic contraction from Q1, when the annual dynamics stood at -2.6 percent.

The delay of sustained economic recovery signals led further to the assessment of lower potential GDP growth rates than those before the economic crisis. The assumption of a significant slowdown in the potential GDP growth is supported by the unfavourable developments in production factors starting from 2008 Q4. Thus, the pace of increase of the capital stock was affected by the considerable fall in investment flows, while the contribution of total factor productivity to potential GDP growth declined markedly. The decline in employment once with the slowdown in the economic activity contributed marginally to potential GDP dynamics.

The economic decline is expected to be resumed in 2010 Q3, as a result of both the inertia of the effects of the economic crisis and the contraction in the short run of aggregate demand following the implementation of the measures designed to contain budget deficit starting from July 2010. The drop in expenditures by cutting budgetary sector wages and the increase in taxes by raising the VAT rate act simultaneously to diminish final consumption. Furthermore, the analysis of a broad set of macroeconomic

[70] The quarterly growth rates of GDP and its components are consistent with the seasonally adjusted data series, whereas the annual growth rates are based on the non-seasonally adjusted data series – both published by the NIS.

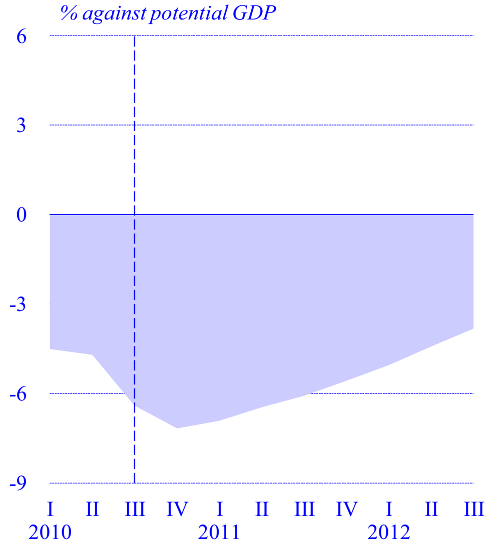
[71] Nevertheless, the corresponding annual dynamics, based on the seasonally adjusted data series, point out a 1.5 percent decline.

indicators[72] shows a wider negative output gap in the economy than in the previous quarter. This implies, *ceteris paribus,* stronger disinflationary pressures from aggregate demand.

The 0.3 percent increase in GDP in Q2 versus the previous quarter was due largely to the cumulative advance in the change in inventories and the statistical discrepancy, while the positive contribution of household actual consumption (up 0.6 percent in quarter-on-quarter terms) was only marginal.

Actual final consumption went up 0.4 percent in 2010 Q2 versus the previous quarter, its components posting divergent developments. Thus, household actual consumption saw a slight 0.6 percent increase quarter on quarter[73], while general government consumption went down by 4 percent.

GDP Deviation



Source: NIS, NBR calculations

In 2010 Q3, household actual consumption is anticipated to decline quarter on quarter against the background of a lower consumer demand induced by the VAT rate hike and the reduction in public sector wages. The direction of consumption dynamics in Q3 is also hinted at by the analysis of the financing sources of household consumption[74], which, in July and August, indicates largely unfavourable developments versus the average for Q2[75]:

– economy-wide wages decreased on the back of the contraction in both net real wage (down 6.3 percent) and number of employees (down 0.8 percent);

– budget transfers (the expenditures of the social security budget, unemployment fund) were 6.3 percent lower in real terms;

– net private transfers and work remittances from abroad shrank in real terms by 3.1 percent and 2.0 percent respectively, yet the two components held a small cumulative share (about 10 percent) in total income;

[72] Among the indicators correlated with the economic cycle the following were considered: the number of employees economy-wide, the industrial production, the unemployment rate, the capacity utilisation rate in industry, the real net wage economy-wide, the real M1 aggregate, the GDP in EA16, the confidence indicator in the economy, the electricity consumption across the economy and the number of new orders in manufacturing.

[73] The slight upturn in household consumption in this period is due, to a certain extent, to some earlier-than-planned purchases in the offing of a higher VAT rate as of 1 July 2010.

[74] According to Chapter III *Subsection 1.1.1.*, the financing resources for consumption subject to the analysis are household disposable income and the new loans to households. The household disposable income is calculated as the sum of wage incomes economy-wide, social transfers, net current private transfers by non-residents and work remittances from abroad.

[75] The growth rates are calculated as the change between the average for July and August and that for Q2. The indicators of the financing sources of consumption are calculated based on the seasonally adjusted data series, except for social transfers, labour incomes and new loans to households. The series expressed in real terms are deflated by the consumer price index.

– new loans to households rose by 13.6 percent[76] in real terms, as credit institutions' August expectations reveal that lending terms and conditions applicable to non-financial corporations will remain unchanged in 2010 Q3, whereas those applicable to households are projected to be tightened somewhat, particularly in the case of consumer loans[77].

In 2010 Q3, new household deposits increased in real terms, yet household deposits (stocks) declined, on the back of the considerable pick-up in inflation rate[78]. In the context of the nominal depreciation of the domestic currency in Q2 and Q3, saving options were different for the two components (leu and foreign currency) in July and August, with foreign currency-denominated deposits[79] being in the spotlight. Amid the decrease in disposable income and saving, in 2010 Q3, the quarterly dynamics of turnover related to market services to households and retail trade (except motor vehicles and motorcycles) as well as to trade in motor vehicles and motorcycles entered negative territory[80].

Unlike household actual final consumption, general government actual final consumption fell by 4 percent in 2010 Q2 as against the preceding quarter, posting an annual change of -1.3 percent. Such figures are indicative of the adjustments made for the purpose of approaching the parameters agreed with international financial institutions, namely to reach a consolidated general budget deficit-to-GDP ratio of 6.8 percent (cash methodology) by year-end. In January-September 2010, the deficit accounted for 4.56 percent of GDP, down from 5.2 percent in the same year-ago period.

In 2010 Q2, gross fixed capital formation declined by 4.4 percent quarter on quarter, countering the slightly positive dynamics recorded in the first quarter of the year. Given the significant drop seen in the previous year[81], this GDP component is assessed to

[76] Loans to households (stocks) went down 1.8 percent in real terms in 2010 Q3 as compared with the previous quarter's average, their annual growth rate moving into negative territory as well (-4.1 percent). The explanation for these apparently diverging developments in loan stocks and flows may lie with the refinancing of some household loans.

[77] According to the National Bank of Romania's quarterly survey on lending to non-financial corporations and households released in August 2010.

[78] In July and August as compared with the prior quarter's average, new household deposits (in both leu and foreign currency) rose 5.9 percent in real terms, whereas the volume of household deposits dropped 2.2 percent in real terms in Q3 (seasonally-adjusted data, NBR).

[79] In July and August, new leu-denominated household deposits increased by 3.8 percent quarter on quarter, while foreign currency-denominated deposits by 8.6 percent (data expressed in real terms). However, July through September, leu-denominated deposits (stocks) fell by 3.1 percent, while foreign currency-denominated deposits by 0.8 percent (data expressed in real terms, NBR seasonally-adjusted data).

[80] The quarterly growth rates of all these indicators were positive in Q2 and negative in July and August as compared with Q2 average.

[81] In 2009, gross fixed capital formation saw a 25.3 percent year-on-year decline as compared with 2008.

stand below the medium-term trend in Q2, an assessment which remains valid for the third quarter as well.

High uncertainties surrounding future economic developments, as well as the low capacity utilisation rate continue to fuel to a large extent the companies' reluctance to technological streamlining, which has a negative impact on the dynamics of potential GDP. The decline in equipment investment was sharp during 2009 Q2 – 2010 Q1[82] and slowed down marginally in 2010 Q2, as reflected by the annual growth rate of 1.6 percent (partially attributable to the base effect). The recent developments in some indicators suggest the increased preference for imports. Hence, after recording a strongly negative dynamics in 2009, imports of capital goods resumed an uptrend in the first two quarters of 2010, posting positive quarterly changes[83]. On the other hand, industrial production of capital goods followed a winding trajectory over the past quarters, as both the quarterly change in July and August as compared with Q2 average and the annual change entered negative territory[84]. By contrast, the other component of investment in the domestic economy, namely new construction works, continued to post negative dynamics in 2010 H1[85].

The analysis of developments in financing resources in Q3 continues to reveal low levels or contraction in investment. Hence, medium and long-term loans to legal entities and long-term loans to households revert to slightly negative levels[86], further reflecting the prudent stance of both companies and households. In addition, net foreign direct investment plunged by 68.6 percent in July and August as compared with the average for Q2, its dynamics in the past twelve months also following a downward course (down 41.3 percent).

In 2010 Q2, the quarterly growth rates of both imports and exports were positive and equal to 4.9 percent and 2.0 percent[87] respectively. A favourable factor spurring exports was the rebound

82 The annual negative changes in investment in equipment exceeded 30 percent in each of the above-mentioned quarters.

83 The growth rate of this indicator stood at 10 percent in 2010 Q1 and at 10.3 percent in 2010 Q2; the annual growth rates in the aforementioned quarters were of 3.4 percent and 21.9 percent respectively (calculated based on balance-of-payments data, expressed in euro, source: EUROSTAT).

84 The quarterly growth rates of this indicator were 6.4 percent in Q2 and -2.9 percent in Q3, while the annual dynamics stood at 10.5 percent and -4.8 percent respectively in the same quarters.

85 Investment in new construction works went down 28.5 percent year on year in 2010 Q1 and 17.5 percent in 2010 Q2.

86 In July and August 2010, the stock of such loans decreased by 0.7 percent in real terms versus the previous quarter's average as compared with the positive dynamics (2.4 percent) recorded in Q2. As against 2009 Q3, this indicator posted a -1.7 percent change, its annual growth rate being also in negative territory in Q2 (-0.3 percent).

87 The reported increases are lower than in the preceding quarter, when the two components rose by 8.9 percent and 12.0 percent respectively. The annual growth rates of both imports and exports stood in Q2 at 24.5 percent and 40.4 percent, respectively.

in external demand, particularly the economic performance of euro area countries[88]. The rise in imports in 2010 Q2 was due to inputs used in export production; hence, imports of intermediate and capital goods picked up quarter on quarter, whereas imports of consumer goods remained relatively flat[89]. In the context of delayed signals of domestic demand upturn, these growth rates could be attributable to favourable developments in export production. For 2010 Q3, the assessments indicate that both imports and exports of goods and services are approaching the medium-term trend.

1.3.2 Implications of recent exchange rate and interest rate developments on economic activity

Over the third quarter of 2010, the domestic currency weakened against the euro, its dynamics remaining on the path seen in the preceding quarter. The leu depreciated against the US dollar as well, albeit to a smaller extent, as a result of the appreciation of the single European currency against the US dollar. The joint effect of the developments in these exchange rates was the quarterly depreciation of the domestic currency (effective exchange rate in nominal terms[90]). In real terms, the effective exchange rate of the leu recorded a quarterly appreciation, given that the differential between inflation rate in Romania and inflation rates in the euro zone and the USA outpaced the depreciation rate of the leu in nominal terms.

Expectations regarding the dynamics of economic activity in the EU improved[91] after the release of positive data on developments in euro area GDP and the outlining of the measures to be taken by Member States to approach public finance vulnerabilities[92].

As for Romania, the recent efforts for fiscal consolidation, in line with the loan agreement concluded with the EU, IMF and other IFIs, have been assessed as supportive of the fulfilment of

[88] In 2010 Q2, euro area GDP increased by 1.0 percent in quarterly terms (seasonally-adjusted data). Euro area imports, an alternative measure of external demand, advanced by 4.4 percent quarter on quarter, as compared with 4.0 percent in 2009 Q1.

[89] In 2010 Q2, the quarterly growth rates of import components are as follows: intermediate goods (10.7 percent), capital goods (10.3 percent), consumer goods (1.0 percent) (based on balance-of-payments data, expressed in euro, source: EUROSTAT).

[90] The effective exchange rate based on which the analysis is conducted implies RON/EUR and RON/USD exchange rates respectively, according to the weights of the two currencies in Romania's foreign trade.

[91] The Economic Sentiment Indicator, ESI, published by the European Commission for the European Union was estimated at 103.4 in September 2010 against 100.3 in June 2010.

[92] Euro area GDP further rose by 1 percent on a quarterly basis, the highest of the last four quarters since euro area economy resumed the upward path. The pick-up was to a large extent due to the 2.2 percent quarterly growth pace in Germany, the euro area's largest economy.

short-and medium-term fiscal goals[93]. Given that the measures implemented since July 2010 aimed at narrowing the budget deficit led to a contraction in domestic demand and data on second-quarter economic activity do not provide clear signs of recovery, investor perception was further characterised by high uncertainty and contributed to the nominal depreciation of the leu in 2010 Q3.

The impact of real effective exchange rate developments on economic activity is analysed via the net export channel and the wealth and balance sheet effects. Given the strengthening of the leu in real terms in 2010 Q3, the stimulative impact of the real effective exchange rate on economic activity via net export channel abated as against the previous quarter. Through the wealth and balance sheet effects, the impulse of the change in real effective exchange rate on future aggregate demand is stimulative as well, due to lower costs in lei attached to foreign currency-denominated loans. In 2010 Q3, the assessments indicate a more stimulative effect of the real effective exchange rate on future aggregate demand than in the prior quarter via either channel. At the same time, the quarter-on-quarter leu deppreciation in nominal terms contributed *ceteris paribus* to the increase in consumer prices via higher import prices.

In 2010 Q3, interest rates applied by credit institutions to their non-bank clients dropped. This adjustment is influenced by the previous cuts in the monetary policy rate.

In 2010 Q3, inflation expectations augmented markedly against the prior quarter, on the back of the 5 percentage point VAT increase starting with 1 July 2010 partly feeding through into consumer prices. Consequently, real deposit and lending rates fell notably versus the previous quarter and their joint effect on future economic activity was assessed to have become slightly stimulative.

The cumulative effect of the leu exchange rate and interest rates applicable to non-bank clients on future aggregate demand is estimated to be stimulative in 2010 Q3.

1.3.3. Demand pressures within the projection horizon

According to the baseline scenario, the negative output gap is expected to widen throughout the projection horizon, compared to the level published in the August 2010 Inflation Report, amid its reassessment to more negative levels at the starting point[94] and the change in the foreseen evolution of fundamentals: the deviation

[93] According to Press Release No. 10/354 of 24 September 2010 by the International Monetary Fund. As stated in the IMF analysis, the main challenge is to ensure “the continuity of the adjustment through continued spending restraint and fiscal structural reforms”.

[94] 2010 Q4.

from the trend of interest rates on both lei- and foreign currency-denominated loans and deposits, the deviation from the trend of the real exchange rate, external demand, fiscal policy stance.

The fiscal impulse is projected to have a pro-cyclical impact almost throughout the projection horizon[95]. Based on the assumption that fiscal policy indicators stay within the limits agreed upon in the EU-IMF-IFIs external financial arrangement until completion and the convergence, after that moment, towards the budget deficit quantitative objective agreed upon with the EU[96], the reassessment of the GDP deviation towards more negative levels entails a narrowing projected structural deficit, a more substantial correction afterwards during the projection horizon and thus a tighter fiscal policy.

The anticipated real broad monetary conditions[97] have, overall, a relatively stronger impact leading to the containment of inflationary pressures, although certain components of this indicator temporarily help boosting aggregate demand. Due to the upward revision of inflation expectations for the projection horizon, compared to the levels in the August 2010 Inflation Report, the cumulative value of deviations of real interest rates on lei-denominated loans and deposits from the trend is expected to exert, over a certain period, a slightly higher stimulative impact on aggregate demand[98], at least in the first part of the projection horizon. The negative deviations from the trend of the real interest rates on foreign currency-denominated loans and deposits are expected to yield the same result, their levels being revised downwards following reassessment at lower values of the scenario regarding the external interest rate and at higher values of that regarding the external inflation rate. On the other hand, the upward revision of the anticipated CPI inflation rate and of the assessment of the EUR/USD exchange rate[99] induces a stronger real effective exchange rate, with a more restrictive impact via the effect on net exports and a more stimulative impact via the wealth and balance

[95] Details on the calculation method of the fiscal impulse and its impact on the GDP deviation from the trend are presented in Box 1 in the November 2008 Inflation Report.

[96] 3 percent of GDP for 2012.

[97] This indicator captures the cumulative impact on aggregate demand of the deviation from the trend of the interest rates on both lei- and foreign currency-denominated loans and deposits, of the real effective exchange rate and of the wealth and balance sheet effects.

[98] This impact might be however offset by the expected tightening, at least for 2010 Q4, of the terms and conditions for household loans and long-term corporate loans (see the National Bank of Romania's survey on lending to non-financial corporations and households released in August 2010).

[99] The inclusion in the baseline scenario of an assumption regarding a weaker USD against the EUR implies, *caeteris paribus*, the projection of a stronger domestic currency against the USD and, therefore, a trajectory of a nominal effective exchange rate also revised upwards. For further details, see Subsection *1.2. Exogenous pressures on inflation*.

sheet effects. The entire set of real monetary conditions in the current baseline scenario is based on the assumption that the trajectory of the NBR policy rate is calibrated so as to offset the potential effects that inflationary pressures resulting from VAT rate hikes and the other supply-side shocks[100] might have on the inflation expectations of economic agents, concurrently helping the gradual resumption of lending to the real economy. As a result, the annual CPI inflation rate is expected to return within the variation band around the central target in 2011 Q4, in parallel with the advance of the economy towards sustainable growth rates.

The current projection foresees the maintenance of slow annual dynamics of final consumption in the first part of the projection horizon. The implementation of the measures aimed at restoring budget balance[101], the anticipated tightening of terms and conditions for household loans, the persistence of labour demand shortfall will exert an adverse impact on the disposable income of households. The sustainable restoration of this component of aggregate demand is foreseen to take place no sooner than in the latter part of the projection horizon, in line with the relative easing of financial constraints.

Amid the persistently low capacity utilisation rate in the economy[102] and of the expected tightening of terms and conditions for long-term corporate loans, the corporations' involvement in new investment projects will resume only gradually. Therefore, gross fixed capital formation is seen having a positive contribution to economic growth starting with the latter half of the projection horizon, concurrently with the narrowing of domestic demand shortage and the rise in external demand.

Real exports are expected to increase due to the closing of external demand shortfall, net exports making a positive contribution to GDP growth in both 2010 and 2011. Insofar as economic activity is projected to recover, imports are foreseen to be boosted by the higher domestic demand for final and intermediate goods destined to consumption, investment and exports. The evolution of real imports is projected to lead to a slight widening of the current account deficit-to-GDP ratio in 2011 compared to 2010, this remaining, however, close to values deemed sustainable, which would not require, for that time horizon, major corrections of the coordinates of the projected macroeconomic environment.

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[100] For details, see Subsection *1.1. Inflation outlook*.

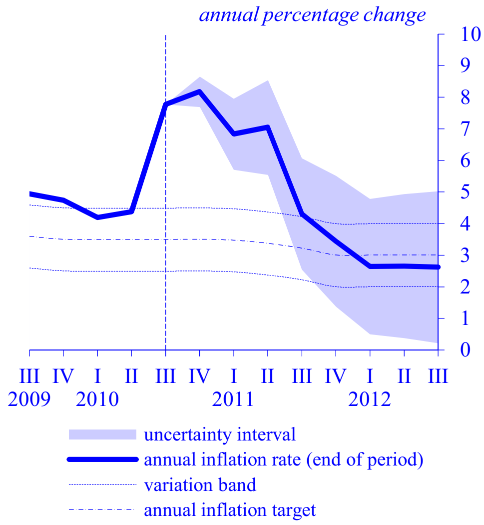
[101] For example, the cut in public sector wages and social transfers, the VAT rate hike and the broadening of the income tax base.

[102] According to the survey conducted by the NBR, in September 2010, the current capacity utilisation rate in industry stood at 76.3 percent of total, 6.1 percentage points lower than the level reported for this indicator in September 2008.

1.4. Risks associated with the projection

The projections on the future developments in the economic activity are always marked by uncertainty. Consequently, there are several cases which, in the event of their materialising, might cause a change in the trajectory of the main macroeconomic variables from that projected in the baseline scenario. A general quantifiable risk measure may be described by the historical distribution of the errors encountered in forecasting inflation rate, illustrated in the adjoining chart; however, higher relevance is assigned to the identification of risk factors specific to each forecasting round, which are selected from among risk factors with an increased manifestation probability during the forecast horizon.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR calculations

The probabilistic distribution of this category of risks to the inflation rate evolution is deemed asymmetrical for the current round, with the likelihood of the annual inflation rate running above the baseline scenario trajectory prevailing.

For a large part of the projection horizon, the general coordinates of the macroeconomic policy mix (monetary, fiscal and income policies, and structural reforms) will be further stipulated in the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions, the firm and consistent fulfilment of which remains a necessary anchor at the current juncture. Nevertheless, the repeated reconfiguration of fiscal policy coordinates in recent months is indicative of a significant likelihood of a risk scenario which might incorporate upward deviations from the anticipated budget deficit. Such a risk might materialise under the impact of a delay, limited efficiency or even failure in implementing the adjustment measures committed to under the financing arrangement or as a result of a stronger-than-expected deterioration of the dynamics of domestic economic activity.

For example, in case of protracted implementation of the measures aimed at restoring budget equilibrium[103], which might dampen incomes and public-sector employment, a plausible scenario would be that of *lower inflationary pressures* in the economy than those in the baseline scenario[104]. Such a development could also be caused by an unfavourable demonstration effect on private sector wages. Opposite pressures, i.e. *higher price increases* economy-wide, could arise from a confidence crunch of the business environment as regards a sustainable budget deficit financing, which might hurt the leu exchange rate. However,

[103] The latest package of such measures implemented starting 1 July 2010 envisages *inter alia* the 25 percent wage cut across public institutions and authorities and the 15 percent reduction in most social transfers.

[104] The assumption does not include the possibility of further increases in indirect taxes that could trigger considerably higher inflationary pressures.

notwithstanding the net influence of the considered scenarios on domestic price dynamics, projected economic growth would most likely be adversely affected, due largely to net wealth loss by companies posting leu-denominated earnings, amid the persistence of their foreign-currency indebtedness at elevated levels and anticipations of unfavourable dynamics of the leu exchange rate according to this scenario. In addition, assuming the enhanced difficulties in Romania's efforts to ensure direct financing on external markets and possibly considerable increases in marginal costs to borrow from the domestic market, the risk of a partial crowding-out of the private sector from the bank credit market to the benefit of the public sector entailing slower growth of economic activity should not be entirely overlooked.

Administered prices are still afflicted by high uncertainties as to the calendar and magnitude of their adjustment. For the current projection round, a relevant risk factor is shaped by the possibility to remove, against the ongoing recessionary background and the diminishing budget revenues, some subsidies from local public governments, namely the state aid[105] for goods and services delivered to households in a centralised system. In case all these risk factors materialise, the reference price of such goods and services at local level could rise markedly against the current levels, fuelling inflationary pressures.

Given the adverse weather conditions in some agricultural areas (floods) of the country and the unfavourable base effect manifest in the second part of 2010, it may be asserted that the risk scenario included in the August 2010 Inflation Report envisaging possible food price hikes has materialised to a considerable extent. Even under such circumstances, for the next eight quarters, food prices should not be taken out from the list of prices posing significant risks to upward deviations from the baseline scenario coordinates, largely associated with uncertainties surrounding commodity prices on external markets. For example, in case of wheat, accounting for about 20 percent of Romania's total value of grain imports[106], external prices went up almost 40 percent during October 2009-September 2010. The persistence of substantial tensions on these markets in the coming periods is conditional upon various risk factors[107] and the projected impact on the path of domestic agri-food prices remains thus uncertain, with a higher likelihood though of an upward deviation from their trajectory in the baseline scenario.

[105] For example, the unitary compensation for the fuel delivered to households for heating via centralised systems.

[106] Calculations for January-July 2010.

[107] Ranging from weather conditions to the behaviour of prominent market players (e.g. Russia and the Ukraine announced in early August 2010 their decision to discontinue wheat exports on international markets) etc.

Although the external environment has remained on a relatively stable trend since the release of the previous Inflation Report, it will still be surrounded by some uncertainty. For the current round, relevant risks refer to the developments on the world's foreign exchange markets. Following the substantial strengthening of the euro versus the US dollar over the past months[108], the future directions in the movements of the EUR/USD exchange rate and the relative importance of these economies within the business cycle to this rate, i.e. corporate expectations on the medium-term developments in macroeconomic policies pursued by the two economies, are questionable. For example, a notable trend reversal in the EUR/USD[109] exchange rate evolution would lead, *ceteris paribus*, to a more significant weakening, compared to the baseline scenario, of the leu versus the US dollar, costlier imports settled largely in USD (oil basically) and, thus, additional hikes in final sale prices of mineral fuels and lubricants on the domestic market. Against this background, given also the relatively limited elasticity of substitution between energy and other factors of production, such a scenario might translate into reassessing the projected GDP figures to lower levels.

2. Policy assessment

In the context of the current quarterly medium-term forecasting round and of drafting the November 2010 Inflation Report, the Board of the National Bank of Romania took the necessary steps to substantiate and set the 2012 inflation target. Following the assessment of the projection scenarios, as well as the associated risks and uncertainties, the decision was taken to keep the inflation target at 3 percent ±1 percentage point in 2012. Furthermore, the NBR Board decided to adopt a flat multi-annual inflation target of 2.5 percent ±1 percentage point as from 2013. Both assumed targets will be discussed with the government.

The chief reason for this particular level of the 2012 inflation target is the imperative of attaining this objective given that, under the impact of multiple shocks on the supply/cost side occurring successively or concurrently since 2007 H2, the annual inflation rate has repeatedly overshot the end-of-year targets over the past years. Thus, the option for the 2012 inflation target mirrors the NBR's concern for setting credible and feasible objectives whose achievement is essential for strengthening central bank credibility and thus enhancing the efficacy of anchoring inflation expectations. In this context, the NBR's prudence in setting the 2012 inflation target is motivated by the heightened risks and uncertainties relative to possible direct inflationary effects that will continue to be generated over the coming years by the factors outside the central bank's sphere of influence, also activated during the implementation of the necessary fiscal consolidation measures.

[108] More than 12 percent July through October.

[109] Equivalent to a stronger US dollar against the euro.

To fulfil the 2012 inflation target, entailing the consolidation of disinflation and the anchoring of inflation expectations at lower inflation levels, is also essential from the standpoint of ensuring the successful shift to the stage of adopting a flat multi-annual inflation target of 2.5 percent ±1 percentage point in 2013. This beneficial, but also ambitious, change to the inflation targeting framework following the recent NBR Board decision implies a longer-term monetary policy commitment to an objective consistent with the medium-term price stability definition in the Romanian economy. It is meant to ensure the reduction in inflation rate to a level compatible with the inflation criterion in the Maastricht Treaty and the ultimate shift to the continuous long-term inflation target, in line with the ECB's quantitative definition of price stability. This process is expected to be supported by the recognised benefits of adopting a flat inflation target, already present in other inflation-targeting EU Member States (the Czech Republic, Poland, Hungary) – primarily manifest through the strong nominal anchor that it provides to inflation targeting strategy –, the major ones being the following: (i) increased predictability and transparency of monetary policy and, implicitly, stabilisation of inflation expectations, (ii) lower persistence of inflation, (iii) increased efficiency of monetary policy – i.e. a relative decline of the growth/inflation trade-off – thanks to the resulting credibility gain, and (iv) the relative reduction in inflation response to oil price and exchange rate shocks (a weaker pass-through of such shocks).

The flat multi-annual inflation target of 2.5 percent ±1 percentage point was regarded as an optimum level of medium-term inflation rate in the Romanian economy starting with 2013 due to: (i) expectations of further increases in tradables prices and particularly in non-tradables prices at a faster pace than that deemed optimal in stabilised economies, largely as a result of the anticipated resumption of economic convergence, including price level convergence, after exiting the contraction phase, (ii) the protracted action of some inflation-generating supply/cost-side factors outside the central bank's sphere of influence (administered price adjustments, indirect tax harmonisation), (iii) the persistence of some asymmetric nominal rigidities and (iv) the occurrence of relative price changes accompanying the sizeable structural adjustments to take place further in the Romanian economy.

The current analysis reveals that the recent inflation performance validates to a great extent the expectations for 2010 Q3. Thus, during the period, the downtrend in the annual inflation rate since mid-2008 was temporarily disrupted by the inflation flare-up stemming from the standard VAT rate increase as from July 2010. During the reviewed quarter, the magnitude of the inflation pick-up was augmented by the slight depreciation of the leu against the euro and especially by the faster annual dynamics of prices of food items (chiefly vegetables and fruit), reflecting the adverse influences of unfavourable weather conditions prevailing in 2010 domestically/internationally as well as those related to some base effects. Therefore, the annual inflation rate returned in July to a path significantly above the upper bound of the variation band around the central target, reaching 7.77 percent in September. The third-quarter rise in the annual inflation rate was however marginally lower than the projected figure (August 2010 Inflation Report), mirroring a relatively lower pass-through so far of the VAT rate hike on the consumer price index amid the persistence of the aggregate demand shortfall and the gradual manifestation of first-round effects.

Nevertheless, the updated trajectory of the projected annual inflation rate is slightly above that presented in the previous quarterly forecast, implying a larger deviation of the expected inflation rate from the end-2010 target. Similarly to the previous projection though, once the direct effect of the VAT rate hike has faded – expected for 2011 Q3 –, the projected annual inflation rate witnesses a strong downward correction. Its implicit return inside the variation band around the medium-term central target is followed by the outlook for reconsolidation of disinflation in the second part of the projection horizon; thus, after dropping to 3.4 percent in December 2011, the projected annual inflation rate will remain, over the following quarters, close to the midpoint of the 2012 inflation target.

The reason behind the relative worsening of the inflation outlook in the first part of the projection horizon is still the recent and future action of some supply-side factors. The most significant inflationary pressures are expected to be induced by volatile prices[110] and the prices of some processed food items. Expectations of higher-than-previously-projected rises in food prices are currently motivated by: (i) the magnitude of food price increases in September, (ii) the relative decline in the domestic supply of agri-food items and the recent rises in prices of some commodities on world markets following this year's severe weather conditions and the ensuing unfavourable inflation expectations, (iii) the likely increase in costs on some segments of agricultural and food output, as well as (iv) the maintenance of some structural dysfunctions and inefficiencies on the local market of agri-food items, implicitly of some distorted price-setting behaviours.

Due to the overly-high share of food items included in the CPI basket relative to other EU Member States with comparable development levels and economic structures as well as to the assumed low price elasticity of demand for food items, the anticipated magnitude of the impact exerted by price increases on headline inflation is significant. This could be even higher than projected assuming a sharper upturn in prices of some commodities on the international market, together with a possibly stronger depreciation of the leu.

[110] Prices of fuel, vegetables, fruit and eggs.

It is however possible that, amid the ongoing decline in household disposable income and the relative worsening of the short-term outlook for consumption demand, some agri-food producers and traders choose to reduce their profit margins in order to contain dwindling sale volumes. The companies manufacturing and selling other types of consumer goods should all the more adopt a similar price setting behaviour given the anticipated decline in demand for such goods. At the same time, the probability ot the risk of a faster increase in some commodity prices on international markets materialising is mitigated, due to the significant inventories of such goods worldwide and the larger-than-expected crops of a key exporting country. Moreover, the inflationary impact of a possible rise in these external prices might be mitigated by Romania's 2010 grain crops, which proved larger than that of a year earlier, despite the unfavourable weather in 2010 and the very good farming output of 2009.

Supply-side inflationary pressures are expected to be additionally fuelled in the short term by the gradual and seasonal pass-through of the standard VAT rate increase on some market segments, the protracted uptrend in fuel prices, and the ongoing administered price adjustment. However, their direct impact on inflation performance is expected to be relatively moderate and short-lived, especially in terms of the VAT rate hike effects. By contrast, a real threat to the consolidation of disinflation in line with the pattern expected for the latter half of the forecast horizon is represented by heftier adjustment of regulated prices (heating) and possibly indirect taxes that could be implemented next year given the need for furthering fiscal adjustment, thereby slowing down disinflation over the longer horizon.

Given the nature of such inflationary shocks, which are entirely beyond the scope of monetary policy, it is the extent to which they may generate significant second-round effects via the risk of worsening inflation expectations over the longer term that is relevant to monetary policy conduct. Even though, in the given context, this risk is substantially mitigated by prospects of persistence of economic contraction and implicitly of the aggregate demand shortfall, it is essential to retain a prudent monetary policy stance. However, for this risk to be prevented from materialising, fiscal consolidation efforts should be stepped up and structural reforms should be implemented at a quicker pace, in line with the commitments under the external financing arrangement with the EU, the IMF and other international financial institutions.

The prospects of a more protracted economic contraction relative to previous forecasts and the relative slowdown in the expected pace of the ensuing economic recovery are highlighted by the updated forecast of medium-term macroeconomic developments. According to these prospects, the projected negative output gap extends its deepening trend until the fourth quarter of 2010 and grows larger than in the previous forecast throughout the projection horizon. As a result, the relative pick-up in disinflationary pressures of aggregate demand is shown by the slight improvement in the outlook for adjusted CORE2 inflation compared to the previous forecast, as its annual rates are expected to remain quasi-steadily below the previously anticipated levels. Nevertheless, the persistence of the statistical effect triggered by the VAT rate increase over the next quarters hampers the clear shaping of the impact of a relative rise in demand-side disinflationary pressures in the first part of the projection horizon.

The pick-up in the annual negative GDP dynamics in 2010 H2, pointing to further deepening of the aggregate demand shortfall, has as major prerequisites and signs: (i) the prospects of a relative slowdown in the recovery of euro zone economy in 2010 H2 amid the still uncertainty-ridden environment, (ii) the re-entry/ deepening into negative territory of the annual dynamics of a number of relevant indicators on consumer and investment demand over the first months of 2010 Q3, (iii) the persistence of feeble lending to the private sector and (iv) expectations of lingering contractionary effects generated by the fiscal consolidation measures implemented since July.

Nevertheless, projections are still fraught with significant uncertainties, especially in terms of (i) the magnitude of economic contraction, (ii) the duration of the decline and the pace of a subsequent recovery, as well as (iii) the timing of a sustainable turning point in the annual GDP dynamics. The contractionary effects of the recently-implemented fiscal consolidation measures[111] are expected however to have a significant short-term impact (during the latter half of 2010 at least) on major domestic absorption components. Adding to this effect, in the following months, the detrimental influence of increases in food prices and administered prices on households' real disposable income, combined with their still relatively high debt service in both domestic and foreign currencies, could depress private consumption demand. Against this background, the size of the short-term decline in consumption and the pace of the subsequent recovery of consumer demand will mainly hinge on the future evolution of labour market conditions, consumer confidence and features of banks' consumer credit supply.

High uncertainties also surround the magnitude of the expected fall and the subsequent return to positive territory of the annual growth rate of investment. The recovery is however foreseen to be slowed down by a possible drop in profits and the larger spare capacity in the sectors hit by the weaker consumer demand and in construction. Other potential factors depressing investment demand are the uncertainties induced by the tense political climate and by the lack of predictability attached to some fiscal

[111] The key measures are the following: the 25 percent cut in budgetary-sector wages, taxation of other salary-related incomes and financial investment incomes, start of layoffs in the public sector.

consolidation measures. An additional adverse effect could arise from the delay in improving bank lending conditions for companies given that the increased reluctance of credit institutions is still fuelled by fears related to the sharper worsening of their loan portfolios, the more negative risk perception on certain economic sectors, as well as the concern for a further reduction in the loan-deposit ratio. The prospects of external financing available to companies are also uncertain, as they depend, *inter alia*, on the external environment perception regarding domestic political, social and economic developments, especially the outcome of fiscal consolidation efforts that are essential to restore confidence in the Romanian economy.

Nevertheless, investment dynamics could be spurred in the near future by a potential increase in public-sector capital expenditures, namely those financed – partly or entirely – via European funds and resources provided by international financial institutions and bodies. Such an outlook however is contingent upon the relative reduction in current budgetary expenditures, as well as on the increased administrative capacity to absorb European funds. However, for investment to bounce back, the business confidence that has recently rebounded slightly, but is still at a very low level, remains of the essence. In the event of a faster and stronger improvement in confidence, the recovery of investment, inventories at least, might start earlier; such an improvement depends nonetheless on the progress and materialisation of fiscal consolidation efforts, which could mitigate the risks to macroeconomic and financial stability in a lasting manner.

The restoration of demand for investment, chiefly in certain industrial sectors, might also be supported by a possibly stronger rebound in external demand, given the rather close correlation between export dynamics and industrial production growth that has been manifest over the last quarters. Recent projections on economic activity in advanced economies, especially euro zone members, reveal however a moderation of the pace of economic recovery in the period ahead, also due to the effects of implementing and expanding the authorities' budget restraints in response to the unprecedented increase in budget deficits and sovereign debts. Adding to these is the risk to the pace of recovery in European economies induced by a potential resurgence in tensions on international financial markets, which may have adverse effects on financing conditions and confidence, as well as by possible contractionary influences arising from a renewed increase in the price of oil and other commodities.

In this context, preserving the credibility of the authorities' economic programme by firmly and consistently complying with the conditionalities in the agreement signed with the EU, the IMF and other IFIs remains essential for a solid anchoring of inflation expectations and hence for resuming and subsequently consolidating disinflation, along with restoring confidence and ensuring a sustainable revival of economic activity. From this perspective, the major risk looming at the current juncture is still the deviation of fiscal policy from the programme coordinates – given the prospects of a relatively slower economic recovery, the so far uncertain efficacy of additional budget adjustment measures, and the recent episodes of heightened social and political tensions – that could translate into the delay or the postponement of fiscal consolidation. In the event of this risk materialising, not only the short-term performance of the leu exchange rate and, in turn, the inflation rate could be adversely affected – given the anticipated worsening of the external financial environment perception regarding the future economic developments –, but also the tempo of recovery of the economy and its growth potential in the medium term could be hampered.

In view of the need to ensure a firm anchoring of inflation expectations in a bid to consolidate prospects to resume disinflation given the persistence of significant uncertainties surrounding domestic developments and the recovery of the global economy, the Board of the National Bank of Romania has decided in its meeting of 2 November 2010 to keep unchanged the monetary policy rate at 6.25 percent per annum. Moreover, the Board has decided to pursue an adequate management of liquidity in the banking system and to maintain the existing levels of minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities. In this context, the Board has reiterated that the resumption of disinflation and restarting sustainable economic growth hinge decisively on a firm implementation of fiscal consolidation measures, structural reforms along with the increase in European funds absorption, in line with the commitments set under the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions.