NATIONAL BANK OF ROMANIA

Inflation Report

November 2019

Year XV, No. 58

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N O T E S

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

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

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Foreword

The primary objective of the National Bank of Romania is to ensure and maintain price stability, with monetary policy being implemented under inflation targeting starting August 2005. In this context, active communication of the monetary authority to the public at large plays a key role, and the major tool that the central bank uses to this end is the *Inflation Report*.

Apart from analysing the most recent economic, monetary and financial developments and explaining the rationale and the manner of implementing monetary policy in the previous period, the *Report* provides the National Bank of Romania's quarterly projection on inflation over an eight-quarter horizon, including the associated uncertainties and risks, and an assessment of the recent and future macroeconomic context from the perspective of the monetary policy decision.

By drafting and publishing the *Inflation Report* on a quarterly basis, in accordance with the frequency of the forecasting cycle, the National Bank of Romania aims to provide all those interested with the opportunity of best comprehending its analytical framework and hence the reasons underlying the monetary policy decisions. Securing a transparent and predictable monetary policy is meant to strengthen monetary policy credibility and thus help achieve an effective anchoring of inflation expectations and lower the costs associated with ensuring and maintaining price stability.

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

The *Inflation Report* was approved by the NBR Board in its meeting of 6 November 2019 and the cut-off date for the data underlying the macroeconomic projection was 31 October 2019.

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

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Summary

Developments in inflation and its determinants

The annual CPI inflation rate returned to the upper bound of the variation band of the flat target of 2.5 percent ± 1 percentage point, ending 2019 Q3 at 3.49 percent (0.35 percentage points below the June level and 0.2 percentage points below the latest forecast). Behind the disinflationary trend stood mainly the declines in vegetable prices amid a good harvest across the EU. Opposite influences stemmed from tobacco product prices and the slightly faster growth of the adjusted CORE2 inflation rate, indicating the persistence of inflationary pressures from fundamentals. The average annual inflation rate continued to fall during Q3 to 3.8 percent for the CPI inflation calculated based on the national methodology and to 3.9 percent for the HICP inflation calculated in accordance with the harmonised structure. At the same time, the average annual indicator further recorded the highest level among the EU Member States for the 14th month in a row, with the differential versus the EU average remaining above 2 percentage points.

In 2019 Q3, the annual adjusted CORE2 inflation rate continued to follow the upward trend seen since the beginning of 2019, coming in at 3.4 percent in September, i.e. 0.1 percentage points above the level posted at the end of the previous quarter. The advance reported by this component owed mainly to food prices, primarily against the background of the persistent effects of the African swine fever virus having a worldwide impact. Moreover, core inflation continued to persistently capture corporate cost pressures amid both the sizeable advance in wage earnings and in recent months the growing pressures from energy costs. Under the circumstances, the annual growth rates of the prices for non-food items and market services moved up gradually to reach peak levels during this economic expansion period.

In 2019 Q2, the annual growth rate of economy-wide unit labour costs slowed down to 3.2 percent (-2.9 percentage points from Q1), solely on account of a deceleration in the annual dynamics of the compensation of employees. On the contrary, in April-August, the annual growth of unit wage costs in industry continued to rise, up to 14.1 percent (+3.8 percentage points versus 2019 Q1), i.e. an outstanding post-crisis level, especially due to productivity losses. The upward movement, having consequences in terms of both inflationary pressures and competitiveness, was primarily triggered by manufacturing (with the notable exceptions of hydrocarbon processing and other transport means), especially as a result of the shrinking production amid the worsening macroeconomic environment in the euro area, the main trading partner.

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

In its meeting of 5 August 2019, the NBR Board decided to keep the monetary policy rate at 2.5 percent per annum and leave unchanged the deposit facility rate and the lending facility rate at 1.5 percent and 3.5 percent per annum respectively. In June 2019, the annual CPI inflation rate went down to 3.8 percent (from 4.1 percent in May), slightly below the forecast, but above the variation band of the target. This owed to the significant drop in the prices of vegetables and fuels. By contrast, the annual adjusted CORE2 inflation rate saw a faster increase from 2.7 percent in March to 3.3 percent in June. Apart from the impact of the new tax levied on telecom companies and of the hike in some international agri-food prices, the advance mirrored rising demand-pull and wage cost-push inflationary pressures, alongside the upward adjustment of short-term inflation expectations. The latest forecast reconfirmed the outlook for the annual inflation rate to remain above the variation band of the target for the remainder of the year, before returning and staying in the upper half of the band until the end of the forecast horizon, on a path relatively similar to that envisaged previously.

The major uncertainties and risks surrounding the inflation outlook stemmed from the future stance of fiscal and income policies, while the evolution of the current account deficit remained a matter of concern. The impact of the new benchmark index for loans to consumers (IRCC) on lending and the monetary policy transmission mechanism was also uncertain. Moreover, emphasis was placed on the proliferation of signs on the worsening of the euro area and global economies and the increasing uncertainties about their outlook, especially amid the trade war and Brexit. Particularly relevant were further the ECB's and the Federal Reserve's decisions on monetary policy easing, as well as the stance of central banks in the region.

Subsequently, the statistical data showed the pick-up in the annual CPI inflation rate in July to 4.1 percent, from 3.8 percent in June, followed by its fall to 3.9 percent in August. The developments placed the annual inflation rate above the variation band of the target, in line, however, with the latest forecast. The evolution owed mainly to the hike in tobacco product prices and, to a lower extent, to the faster increase in fuel prices and core inflation, the impact of which was only partly counterbalanced by that of a slowdown in the annual growth rate of administered prices and volatile food prices. The annual adjusted CORE2 inflation rate continued to rise, at a relatively slower-than-expected pace, going up from 3.3 percent in June to 3.4 percent in August amid the hike in the international prices of some agri-food products, on the one hand, and the cut in the prices of some telephony services, on the other. Demand-pull and wage cost-push inflationary pressures remained further significant. Statistical data on economic growth in 2019 Q2 indicated a mild deceleration in real GDP dynamics to 4.4 percent from 5 percent in the previous quarter (annual changes). On the demand side, the contribution made by household consumption continued to be significant, albeit on a decrease, being marginally exceeded by that of gross fixed capital formation, whose annual dynamics surged (to 18 percent from 3.9 percent in Q1). Net exports had a smaller negative contribution to GDP increase amid a more pronounced slowdown in the annual growth rate of imports than in that of exports of goods and services, also visible in the relative slowing of the annual pace of increase of the negative balance on trade. However, the current account deficit displayed a faster deepening against the same period of the previous year, as a result of the worsening of the primary and secondary income balances.

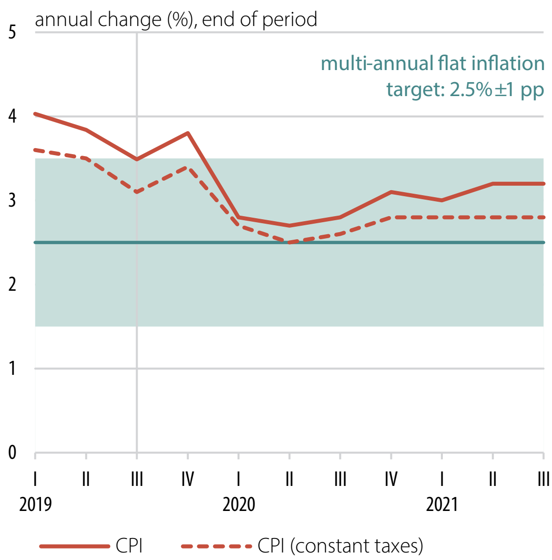
In the NBR Board meeting of 3 October 2019, the latest assessments revealed the prospects for the annual inflation rate to remain above the variation band of the target until the end of this year, on a trajectory slightly below that shown in the latest medium-term forecast published in the August 2019 *Inflation Report*. The uncertainty factors identified previously remained relevant, with those arising from the external environment configuration becoming relatively stronger, given the increasingly obvious weakening of the economic activity in the euro area and worldwide. Particularly relevant were considered the prospective easing of the monetary policy stance by the ECB and the Fed and the conduct of central banks in the region.

Based on the data available at that time and in the context of the identified risks and uncertainties, the NBR Board decided to keep the monetary policy rate at 2.5 percent per annum, while maintaining strict control over money market liquidity. Moreover, the NBR Board underlined that the balanced macroeconomic policy mix and the implementation of structural reforms designed to foster the potential growth are of the essence in preserving macroeconomic stability and strengthening the capacity of the Romanian economy to withstand potential adverse developments.

Inflation outlook

According to the baseline scenario, the annual CPI inflation rate is foreseen to reach 3.8 percent at end-2019, 3.1 percent at end-2020 and 3.2 percent at the projection horizon, i.e. 2021 Q3. Compared to the August 2019 *Inflation Report*, the new scenario envisages lower levels over the entire projection interval, by 0.4 percentage points and 0.3 percentage points at the end of 2019 and 2020 respectively. For this year, the marginally more favourable developments in the exogenous components of the CPI basket add to a slower-than-previously-foreseen advance in core inflation, while the downward revisions for end-2020 and the remainder of the projection interval are solely driven by the adjusted CORE2 inflation. For the end of the current year, the broadest revision in the case of exogenous components is associated with the recent drops in vegetable prices amid bumper crops Europe-wide, whereas the growth rates of administered prices and fuel prices are set to experience smaller revisions in the opposite direction (upwards).

Inflation forecast



Source: NIS, NBR projection

Data published after the release of the August 2019 *Inflation Report* showed slower dynamics of economic activity in Q2, as well as more recently, against the backdrop of a notable worsening trend of exports, given that the global environment played a decisive part in the contraction of Romania's industrial sector. At the same time, household consumption grew at a slower pace in Q2, while the contribution from gross fixed capital formation to economic growth was substantial, yet expected to be only temporary. This short-lived nature is attributed to certain fiscal stimuli in the construction sector, on the one hand, and to an increase in (partly EU-funded) spending on public investment in the run-up to the elections, on the other hand. Under the circumstances, economic activity is envisaged to stick to a decelerating trend in 2019 H2 and 2020, given the gradual fading-away of the authorities' fiscal stimuli and amid the less bright outlook for foreign partners' economic activity. The growth pattern will further reflect the prevailing contribution from household consumption, while net exports of goods and services are foreseen to make new negative contributions, slightly receding over the reviewed interval. Gross fixed capital formation is anticipated to make a significant contribution to this year's economic growth, albeit of a moderate magnitude over the medium term, with the projected values for this horizon (expected to hover around their post-crisis average) mirroring the persistence of structural deficiencies in the economy.

Starting from the most recent levels, the baseline scenario foresees a further widening of the trade deficit, only partly offset by the performance of the services sector, which will continue to fuel the current account deficit worsening. As a result, the current account deficit is expected to overshoot, as early as this year, the 4 percent-of-GDP indicative threshold set by the European Commission as a multi-annual indicator monitoring the external imbalance in EU Member States[1]. Given the faster build-up of external imbalances in the case of Romania than in its regional peers and, hence, the emergence of difficulties in ensuring full current account financing from non-debt-creating flows, this evolution is likely to fuel several vulnerabilities facing the Romanian economy, with an impact also on the gradualness and macroeconomic consequences of future adjustments needed to redress these imbalances.

After having risen in 2019 H1, the output gap is anticipated to relatively flatten out by the end of 2020 H1. Subsequently, it will re-embark on an upward path, reflecting the substantial strengthening of fiscal stimuli owing to the provisions of the pension law (with a more sizeable impact starting September 2020). At the same time, real broad monetary conditions will continue to be accommodative, yet their intensity is seen declining steadily over the next eight quarters, while the influence of external demand is projected at relatively subdued, lower-than-previously-anticipated levels. In fact, the smaller contribution from effective external demand is the main driver of lower output gap values than in the previous *Inflation Report* over the entire forecast interval. Acting in the opposite direction is the slightly more stimulative nature of broad monetary conditions, driven by the contribution from most of its constituents, while the impact of the fiscal stance is projected to be fairly similar to that estimated in the previous round, assuming that the schedule of significant hikes in the pension point remains in place.

According to the baseline scenario, the annual adjusted CORE2 inflation rate is forecasted to reach 3.4 percent at end-2019; thereafter, its path will reflect temporary

1 Calculated as an average for the past three years. For further details, see the European Commission's website, the Section on "Macroeconomic Imbalance Procedure Scoreboard".

disinflationary pressures, owing chiefly to base effects stemming from the swift rise in this indicator earlier this year. Starting from a low of 2.8 percent expected for June 2020, the indicator will edge higher, in line with the inflationary pressures triggered by the rise in excess aggregate demand in the economy and amid gradually stronger upward pressures from the leu-expressed prices of imported goods. In turn, medium-term inflation expectations will remain elevated, anchored in the upper half of the target band. Therefore, the values projected for the annual adjusted CORE2 inflation rate are 3.2 percent in December 2020 and 3.4 percent in September 2021.

Against this background, the monetary policy stance is configured to ensure and preserve price stability over the medium term in a manner conducive to achieving sustainable economic growth and safeguarding a stable macroeconomic framework.

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to its path in the baseline scenario, mainly due to domestic factors. Sizeable risks continue to be associated with the external environment as well, yet such pressures are seen to have a rather disinflationary potential on the aggregate.

A risk that became more relevant in the current round refers to future developments in administered prices, particularly those of electricity and natural gas delivered to household end-users, given that they were affected by the provisions of Government Emergency Ordinance No. 114/2018. Under the circumstances, a resumption of the liberalisation of these price categories would be surrounded by inherent uncertainties over the sequentiality of this process and would, in turn, impact the severity of inflation rate deviations from the trajectory in the baseline scenario.

Based on the most recent information on budget execution, the fiscal and income policy conduct remains a significant source of risks over the projection interval. The future configuration of these policies – under the influence of successive rounds of presidential, local and parliamentary elections scheduled for 2019-2020 – appears to require sizeable offsetting measures to ensure compliance with the reference budget ceilings consistent with the definition of sound public finances. Such measures will help ensure a balanced economic policy mix, also in terms of compressing excess aggregate demand in the economy and, hence, mitigating the risks associated with a further external imbalance worsening.

A particularly concerning risk factor reconfirmed in the current round refers to developments in the labour market amid its still elevated tightness, a feature manifest in the region as well. Under the circumstances, there is a high likelihood of increasing pressures on wages, which could lead to inflation path reconfiguration as against the baseline scenario. With a view to correcting these imbalances, structural reforms targeting this market are called for, but the potentially favourable effects, even assuming a prompt reform implementation, would most likely materialise no earlier than in the medium term.

Turning to the external front, uncertainties are associated with the pace of global economic slowdown, in an international environment saddled with recurrent geopolitical tensions and possible escalations of technology and trade disputes, especially those between the US and China. Any heightening of these tensions could entail, as a direct effect, a spreading of protectionist measures unilaterally imposed by various countries, and, indirectly, a sharper slowdown in China's economic activity, relevant in terms of the country's role within the global value chain. These tensions, all together or separately, can lead to significant disruptions in economic activity, with direct and sizeable consequences on small open economies such as Romania. A more accommodative monetary policy stance of major central banks could help mitigate some of these risks via a more stimulative impact on global aggregate demand. The final configuration of Brexit is still a significant source of uncertainties. Its finality and consequences remain clouded by many unknowns that impede on anticipating the end of this process and, hence, assessing the impact on the macroeconomic framework of Romania's economy.

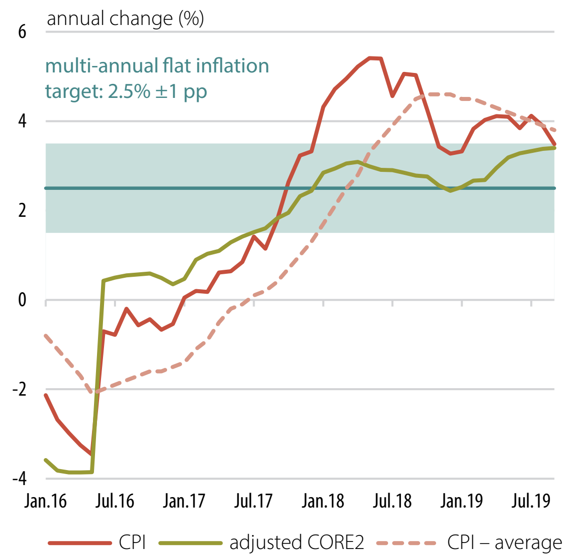
Monetary policy decision

In view of the characteristics of the new medium-term inflation forecast and the multitude of related uncertainties and risks stemming from both domestic and external sources, also in the context of expectations on/the decisions of the ECB and the Federal Reserve on monetary policy easing, as well as of the probable stance of central banks in the region, the NBR Board decided, in its 6 November 2019 meeting, to keep the monetary policy rate at 2.50 percent, while maintaining strict control over money market liquidity. Moreover, the NBR Board decided to leave unchanged the deposit facility rate at 1.50 percent and the lending (Lombard) facility rate at 3.50 percent. In addition, the NBR Board decided to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

1. Inflation developments

The annual CPI inflation rate returned to the upper bound of the variation band of the flat target of 2.5 percent ±1 percentage point, ending 2019 Q3 at 3.49 percent (0.35 percentage points below the level recorded in June). Behind this disinflationary trend stood mainly the declines in vegetable prices, amid a good harvest at EU level, and the cut in the natural gas price for households starting with 1 July. Opposite influences stemmed from tobacco product prices and the slight pick-up in adjusted CORE2 inflation (up to 3.4 percent in September versus 3.3 percent three months prior), indicating the persistence of inflationary pressures from fundamentals (Chart 1.1).

Chart 1.1. Inflation developments



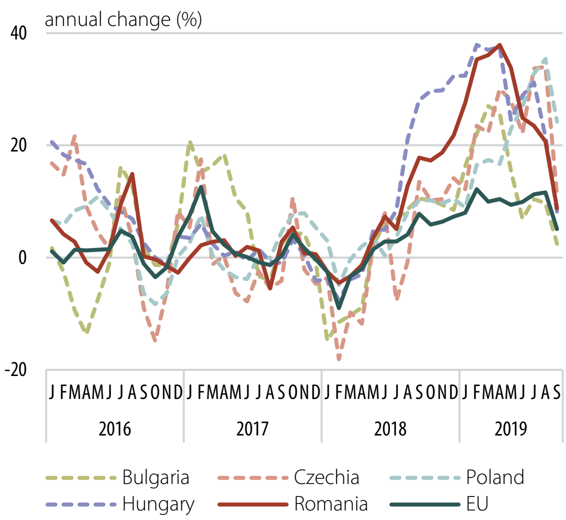
Source: NIS, NBR

In 2019 Q3, the annual CPI inflation rate followed a downward trend, mostly triggered by volatile prices, mainly on account of the drop in vegetable prices throughout the quarter, below the seasonal averages for this period. Behind this stood the good crops recorded both domestically and by the main European trading partners, in contrast to the level of production in the previous year, which had raised the annual inflation rate for the vegetable component to extremely high values, at around 30 percent – a seven-year peak (Chart 1.2).

This picture was completed by the slacker annual growth rate of fuel prices, their marginal drop in the last two months of 2019 Q3 overlapping a favourable statistical effect associated with the sharp price hike in September 2018. The underlying cause for the recent developments was the downward course of the Brent oil price, which in August reached the lowest average price of the year, in an external environment further ridden by uncertainties surrounding trade conditions and economic growth prospects at a global level. Against this background, the hike in the oil price in the second half of September, caused by the attacks on Saudi oil refineries, proved to be short-lived, with no repercussions yet on the price paid by consumers for motor fuels (Chart 1.3).

Moreover, administered prices put a weaker pressure on the annual CPI rate, given the significant decrease in the natural gas price following the Romanian Energy Regulatory Authority's decision of 24 June 2019. This was substantiated by the provision of GEO No. 114/2018 capping to lei 68/MWh the selling price of domestically-produced natural gas to suppliers for residential consumers. In addition, the favourable effect of August 2018 hikes in utilities prices dropping out from the calculation also had an impact.

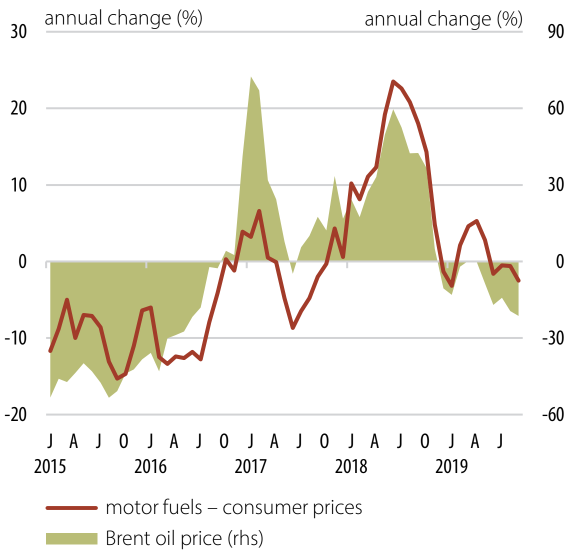
Chart 1.2. Vegetable price in Europe



Note: In accordance with the harmonised price structure.

Source: Eurostat

Chart 1.3. Oil and motor fuel prices



Source: NIS, Bloomberg

Among the exogenous components, the only notable influence towards a faster annual inflation rate came from tobacco product prices, the lei 0.50 increase for a packet of cigarettes, for the third time this year, not being induced by a higher excise duty this time.

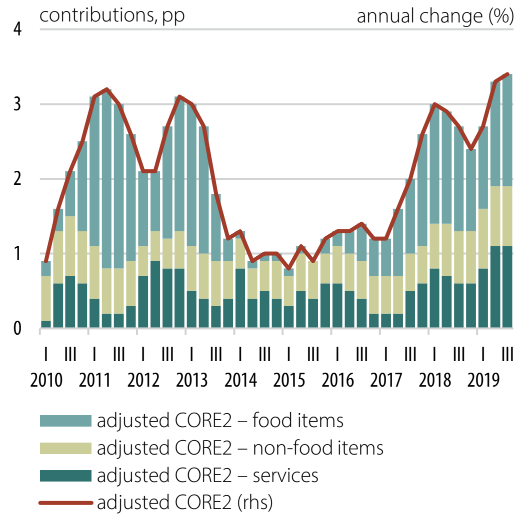
At the same time, the annual adjusted CORE2 inflation rate stayed on the upward trend seen since the beginning of 2019, up 0.1 percentage points from end-2019 Q2 to 3.4 percent in September, thus reaching a 10-year high[2] (Chart 1.4). The step-up was mainly ascribable to food items, mostly due to the persistent effects of the African swine fever virus that affected pigmeat supply at a global level. Locally, new African swine fever outbreaks were identified in the Southern part of the country in the first part of 2019 Q3, thus bringing the total number of pigs slaughtered to approximately 500,000. Specifically, in September, the annual growth rate of consumer prices rose up to 5.8 percent, yet significantly below the hike in the agricultural price of pigmeat. These prices remain a source of pressure on CPI inflation, mainly towards the end of the year, when the specific seasonality of this group suggests faster increases. An additional factor was the break in the cycle of decreases (in annual terms) in the consumer price of sugar after almost two years, associated with the anticipated fall in India's sugarcane production in 2019-2020, along with directing a larger share of the Brazilian crops to ethanol production.

Beyond these supply-side shocks, the path of the annual adjusted CORE2 inflation rate is further marked by a persistent inflationary macroeconomic environment. The latter has been characterised by sizeable excess demand fuelled by double-digit annual growth rates of net wages. In addition, on the demand side, higher labour costs together with recent pressures from energy costs erode producers' margins and call for price increases. Under the circumstances, the annual dynamics of prices for non-food items and market services gradually gained momentum to the highest values of this stage of economic expansion.

Looking at inflation expectations, in 2019 Q3, both consumers and economic agents in all sectors adjusted downwards their expectations on price developments (Chart 1.5). Construction and trade agents reported the largest declines in expectations, yet consumers remained more sceptical regarding the disinflationary trend, posting only

2 After excluding the first-round effects of VAT rate changes.

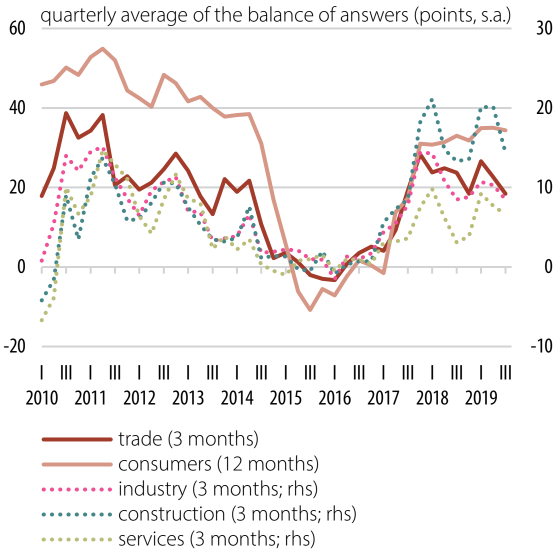
Chart 1.4. Core inflation components*



*) excluding the direct effects of VAT rate changes

Source: NIS, NBR calculations and estimates

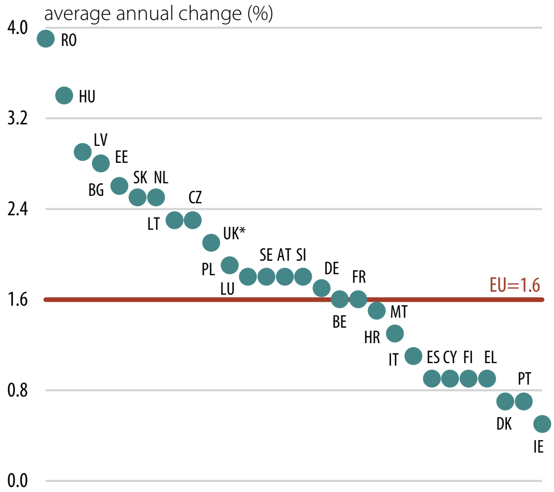
Chart 1.5. Expectations on price developments



Source: EC-DG ECFIN

a marginal decrease in the balance of answers. At the same time, financial analysts' opinions painted a mixed picture. On the one hand, they revised their expectations for the annual inflation rate at end-2019 to slightly lower levels than in the previous period and, on the other hand, the envisaged inflation rates over longer horizons (up to two years) were recalibrated to marginally higher values compared to the prevailing outlook in 2019 Q2. However, in both cases, financial analysts maintained the anticipated values for the inflation rate inside the variation band of the flat target.

Chart 1.6. Average annual HICP in the EU – Sep. 2019



*) August 2019

Source: Eurostat

In 2019 Q3, the annual average CPI inflation rate followed a downward trend, amid the slacker annual CPI dynamics, as well as some favourable base effects. Specifically, based on the national methodology, the average annual inflation rate fell slightly, down to 3.8 percent in September, while the rate calculated in accordance with the harmonised structure declined to 3.9 percent. The latter continues to be the highest level among EU Member States for the fourteenth consecutive month, the differential against the EU average still being significant, i.e. over 2 percentage points (Chart 1.6).

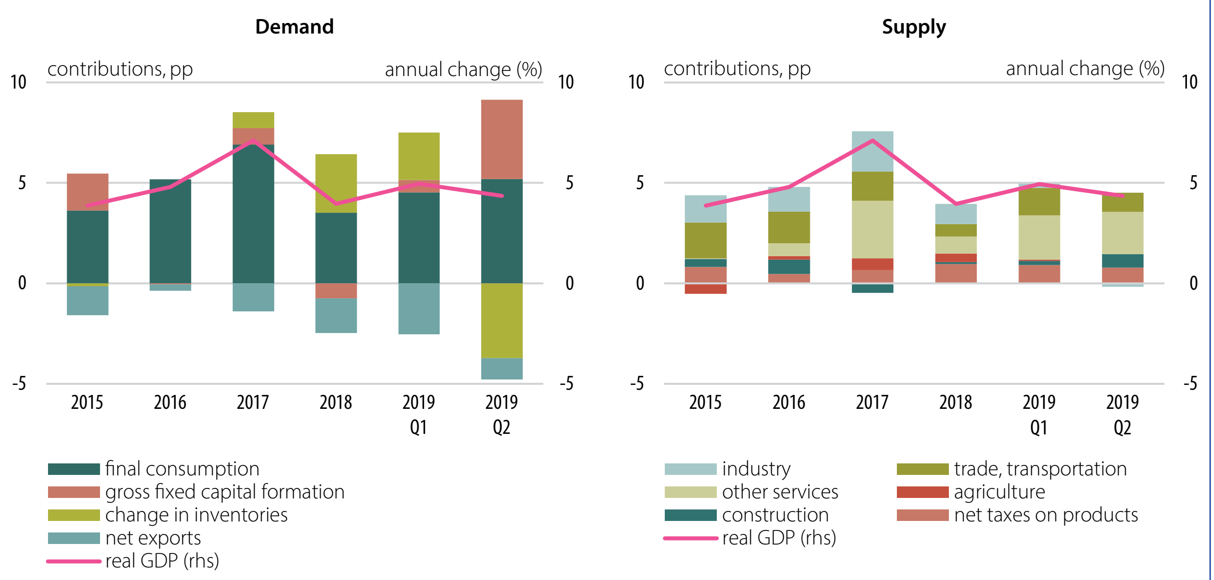
At end-2019 Q3, the annual inflation rate stood below the level anticipated in the August 2019 *Inflation Report* (3.5 percent versus a 3.7 percent forecast). The difference was mainly determined by the substantial drop in the price of vegetables, which was visible almost across the board in the EU Member States. Nevertheless, adjusted CORE2 inflation in September (3.4 percent, annual change) was also lower by 0.2 percentage points than the projected value.

2. Economic developments

1. Demand and supply

The annual dynamics of real GDP remained brisk (4.4 percent) in 2019 Q2 as well, being supported by the persistence of high consumer demand, while also benefiting from a larger contribution of investment. Nevertheless, the economic activity eased slightly, i.e. by 0.6 percentage points, compared to the first three months of the year, as a result of the decelerating pace of exports, affected by the international environment. Imports also reported a slowdown (inter alia via the inputs used to manufacture products targeting external markets), which was, however, insufficient to cancel out the erosion effect of net exports on GDP dynamics. On the supply side, the unfavourable developments in external demand left their mark on industrial activity, which made a negative contribution to the annual economic growth for the first time in the past six years (Chart 2.1).

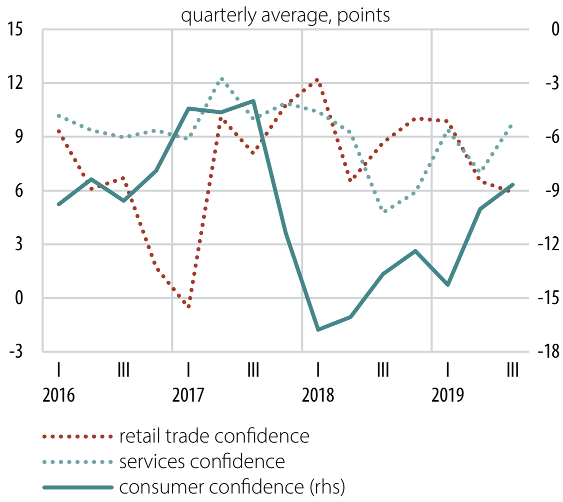
Chart 2.1. Contributions to economic growth



Source: NIS, NBR calculations

In keeping with the recent years' trend, household final consumption expanded at a fast pace, i.e. 6 percent in annual terms, and will probably maintain this trend in the period ahead as well, as the consumer confidence indicator stayed on an upward path in Q3 too. The main contribution will further be made by the robust rise in income from wages and pensions (also as a result of the increase in the pension point starting 1 September 2019). Moreover, consumer credit seems to gain momentum (as indicated by the developments in new loans in July-August), under

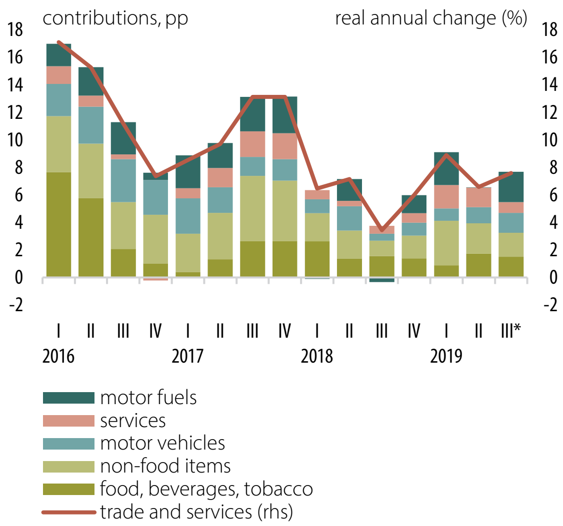
Chart 2.2. Outlook for household consumption*



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

Chart 2.3. Trade



*) Jul.-Aug.

Source: NIS, NBR calculations

the impact of the relative improvement in cost terms over the past months (Chart 2.2).

The high level of consumer demand also mirrors in the retail trade turnover. Although the volume of commercial purchases saw a slower annual increase as compared to Q1, the main contributor was motor fuel trade, a component that moves along a volatile path. The turnover volume of trade in goods and services, except for fuels, continued to rise at a swift pace (approximately 8 percent in Q2 and 7 percent in July-August). A look at the breakdown shows that the expansion of durables purchases comes from both furnishings (due to the buoyancy in the real estate sector) and the automotive segment. In the latter case, households' purchases of new cars strengthened their position, seeing an advance of approximately 30 percent January through September as compared with the same year-ago period. Furthermore, the interest in used cars (approximated by the number of registrations) continued to drop (by 5 percent in the first nine months of 2019 versus the same period in the year before), the car fleet structure also improving in terms of age on account of the reduction in the number of motorcars older than 12 years[3] (Chart 2.3).

In 2019 Q2, the general government budget execution led to a deficit of lei 14.5 billion, i.e. 1.4 percent of GDP, well above that posted in the same year-ago period (lei 10.5 billion or 1.1 percent of GDP). Moreover, the deficit widening as compared with that seen in Q1[4] was more pronounced than that recorded in 2018[5]. It mainly resulted from the increase in total budget spending[6], primarily on the back of the rise in current expenditure – particularly compensation of employees, interest expenses[7], spending on goods and services and other expenses –, but also on account of capital expenditure. To this added the slight reduction in total

3 According to the Automotive Manufacturers and Importers Association.

4 In 2019 Q1, the general government budget execution generated a deficit of lei 5.5 billion (or 0.5 percent of GDP).

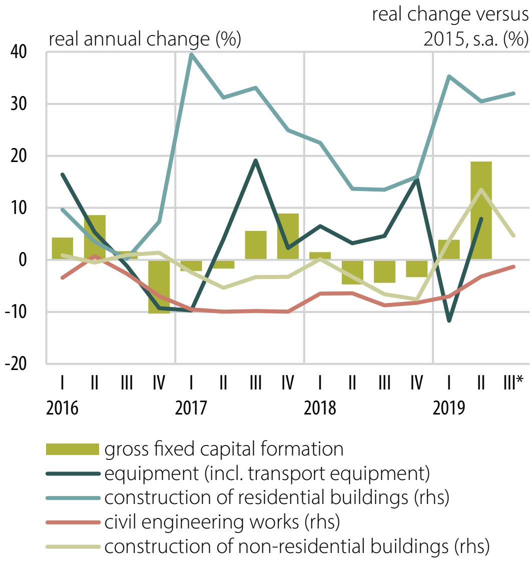
5 In 2018 Q1, the budget deficit amounted to lei 4.5 billion (or 0.5 percent of GDP).

6 Total budget spending posted a slightly faster real annual growth rate, i.e. up to 11.6 percent, from 9.1 percent in the previous quarter.

7 Nevertheless, their real annual growth rate slowed down.

budget revenues[8], due to a base effect[9] and especially to some tax refunds[10,11], whose impact was, however, largely offset by the considerable increase in non-tax revenues – also amid the earlier payment of dividends from state-owned companies –, as well as by the higher revenues from social security contributions.

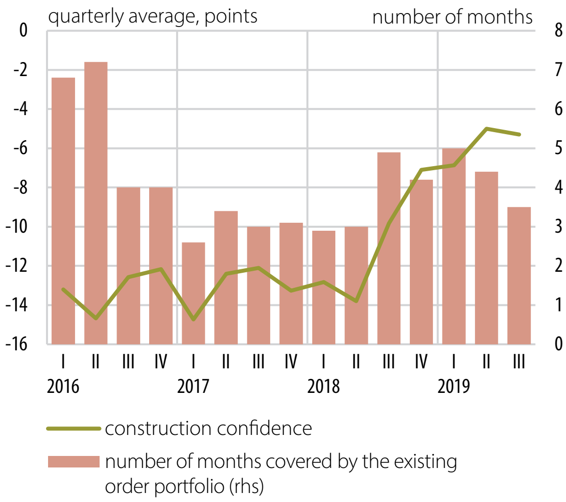
Chart 2.4. Investment



*) Jul.-Aug.

Source: NIS, NBR calculations

Chart 2.5. Outlook for construction*



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

Gross fixed capital formation consolidated its uptrend, the fast quarterly rates recorded since the beginning of 2019 pushing the investment volume higher by 18.9 percent than in 2018 Q2. This was ascribable to the expansion of the construction activity and, to a lesser extent, to the rebound in equipment purchases (Chart 2.4). In construction, companies' expectations remain favourable, their confidence[12] further standing above the 2018 average in July-September, amid the improved labour market regulations in this sector (i.e. fiscal incentives and easier conditions for hiring non-EU workers). Moreover, the stimuli associated with the election cycle and the EU multiannual financial framework are likely to boost public investment over the next months (Chart 2.5). Conversely, equipment purchases will probably moderate, as investment decisions tend to be postponed amid the persistent tensions and uncertainty worldwide. To sum up, the increase in gross fixed capital formation, albeit swift, has a limited impact in terms of enhancing the economic growth potential, given the minor contribution of technological investment.

8 The real annual dynamics of total revenues continued to stand below those of total budget spending, remaining comparable to the previous quarter's level, i.e. 8.3 percent versus 8.5 percent in January-March.

9 Associated with the higher payments of property taxes and fees that are characteristic to the first quarter of the year.

10 Due to the enforcement of Government Emergency Ordinance No. 52/2017 on refunding the amounts representing the special tax for motorcars and motor vehicles, the pollution tax for motor vehicles, the tax on the pollutant emissions of motor vehicles and the environmental stamp duty for motor vehicles.

11 As for tax revenues, mild decreases were also recorded by receipts from VAT and corporate income tax, which also posted a slower advance in real annual terms.

12 According to the EC-DG ECFIN Survey.

Benefiting from favourable weather conditions in Q2 as well, new construction works expanded by nearly 37 percent (annual change), this trajectory being backed by quarterly growth rates of over 10 percent in both buildings and civil engineering works (with the modest performance in the base period also making a contribution).

Residential construction works further witnessed positive developments (36.7 percent in annual terms), amid robust demand, fuelled by the fast rise in household income over the past quarters, as well as by the VAT rate cut to 5 percent when purchasing a second home. In the months ahead, the activity on this segment will probably have the same coordinates, with signs specific to the residential component adding to the positive signals previously identified for the business sector as a whole. Specifically, housing demand remains high, as indicated by the slight increase in consumers' intention to purchase or build a home, noticed in the first three quarters of 2019 as compared with the 2018 average (according to the EC-DG ECFIN Survey). Moreover, the decline in lending in the first half-year, following the prudential measures adopted by the NBR at the beginning of 2019, may come to a halt, as suggested by the actual data for the July-August period, concurrently with the anticipated stabilisation of housing loan market in Q3, in terms of both demand and standards applied by commercial banks[13].

Non-residential buildings also posted a swift increase, i.e. 57.6 percent in Q2 (annual change), while for 2019 H2 the market signals indicate a possible rise in new deliveries on all major segments – industrial, logistic, commercial and office spaces. Moreover, civil engineering works picked up speed to 14.4 percent in annual terms, confirming the recovery trend manifest since the beginning of this year. Thus, total public investment financed via domestic financial resources and non-repayable EU funds grew by 69 percent January through August.

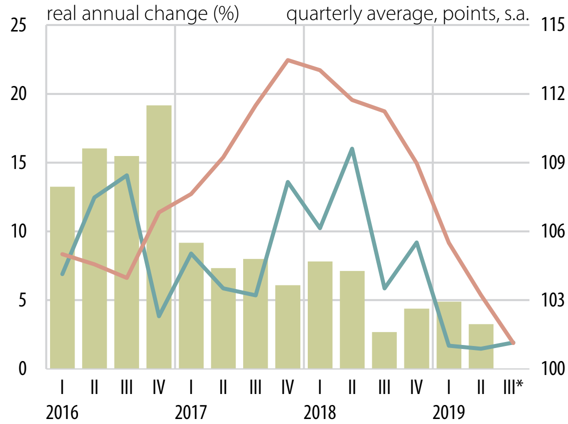
Behind the step-up in gross fixed capital formation stood also the 7.9 percent advance in equipment purchases (including motor vehicles bought by companies and institutions); the investment projects completed or underway in H1 envisaged the expansion or upgrading of production capacities (for instance, in the building materials industry, the automotive industry, the aeronautical industry, crude oil processing, food industry, the manufacture of electrical household appliances, cosmetics, office furniture). However, fixed capital investment will probably moderate in the coming months. This is hinted at by developments in manufacturing, where the relatively low dynamics of orders, particularly those for the external market, are reflected in a decrease in the capacity utilisation rate (to a 9-year low). The slackening appetite for technological investments economy-wide affects the industries producing capital goods, in which case the annual growth rate of the domestic order portfolio dropped to half in April-August as compared to the Q1 average, i.e. down to 6.1 percent. This prospect is also confirmed by the evolution of financing sources. Specifically, during 2019, inflows in the form of equity, including the earnings reinvested in the economy by non-resident direct investment enterprises, declined

13 According to the NBR's August 2019 *Bank Lending Survey*.

slightly as compared with the same year-ago period, whereas the annual advance in the volume of equipment loans decelerated gradually (5.5 percent in July-August, half of the pace of increase seen in 2018 Q3).

In an international environment marked by tensions and uncertainty, the economic activity in the euro area weakened, which strongly affected the evolution of the domestic tradables sector (the industrial output witnessed successive decreases, which made its volume stand 1.6 percent lower January through August than in the same period of 2018). As for demand, the decline was visible in exports of goods, which resumed the series of quarterly contractions started in 2018 Q2 (and discontinued only in January-March 2019). A revival in exports is less likely for the coming period, given that the expectations on economic activity are still subdued at global level and, in particular, at the European level (across the EU-28, the economic sentiment indicator remained in September as well on the downward trend it had entered at the beginning of 2018). In fact, the volume of foreign orders to local industrial companies rose by merely 1.7 percent (annual change) January through August (Chart 2.6).

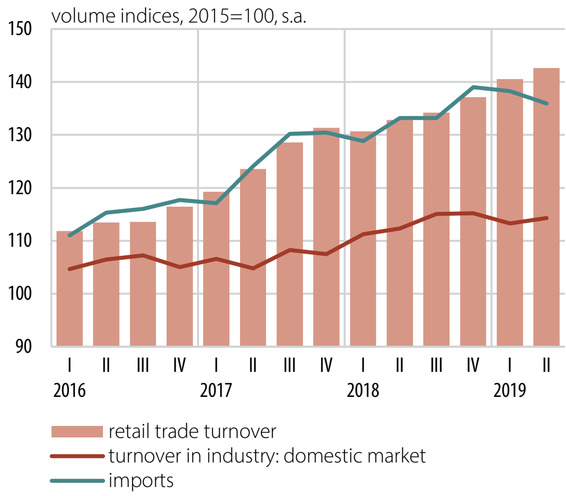
Chart 2.6. Exports



*) Jul.-Aug. for orders

Source: NIS, EC-DG ECFIN, NBR calculations

Chart 2.7. Consumer goods: domestic production vs imports*



*) excluding motor vehicles and fuels

Source: NIS, Eurostat, NBR calculations

Under the circumstances, the annual dynamics of the volume of goods exports slipped into negative territory, solely on account of exports to EU countries (1.7 percent decline, only partly offset by the step-up in trade ties with extra-EU countries)[14]. The change was visible particularly for goods produced in industries integrated in international production chains, with the automotive industry deserving particular mention. Specifically, the volume of exports of motor parts and accessories contracted by more than 10 percent for the fourth quarter in a row. This trajectory, which was, in fact, manifest at different intensity levels in the peer sub-sectors in other Central and Eastern European countries as well, is associated with a weaker demand from the main European car producers, as a result of the changes in the emissions measurement procedure for new motor vehicles, as well as of the escalation of economic warfare between the US and Iran (which also affects the trade relations of European

14 Real annual changes determined based on the Eurostat data broken down by Broad Economic Category (BEC).

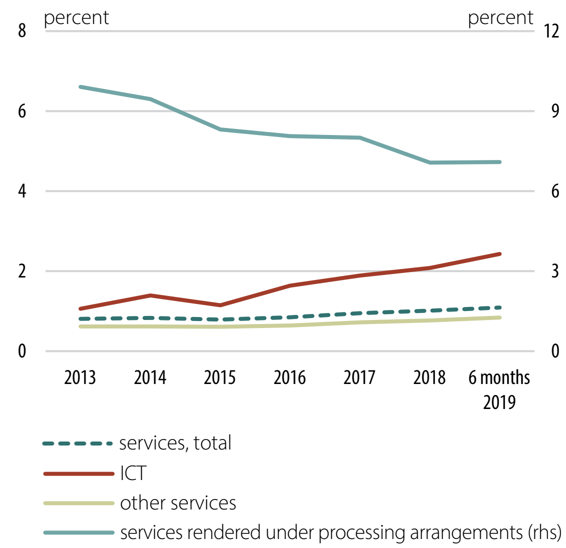
countries with Iran). As compared with 2018 Q2, declining exports were also reported by other industries such as electronic and communication equipment, electrical equipment, air and spacecraft.

At the opposite pole were the exports of motor vehicles (6.6 percent, change in volume), as their expansion, which was boosted by the launch of two models in 2018, is likely to continue due to the broader range of motorcars offered starting in this autumn. Swift growth paces (ranging from 7 percent to 15 percent) were also reported by exports of measuring equipment and control apparatus, electric motors and generators, petroleum products (mainly as a result of the re-commissioning of some of the production facilities subject to technical overhaul in the previous period), as well as agri-food commodities (maize, in particular). Exports to extra-EU markets made the main contribution for the last three categories of products.

The negative impact that the weakening external demand had on the local industry mirrored in the decrease of necessary inputs for production, as well as in the lower appetite for the purchase of new technologies. In this context, the growth pace of the volume of total imports of goods dropped to half versus Q1 (down to 3.2 percent in annual terms), with imports of intermediate goods and capital goods posting the lowest annual rates (below 1 percent), whereas imports of consumer goods continued to outpace the dynamics of local supply (Chart 2.7).

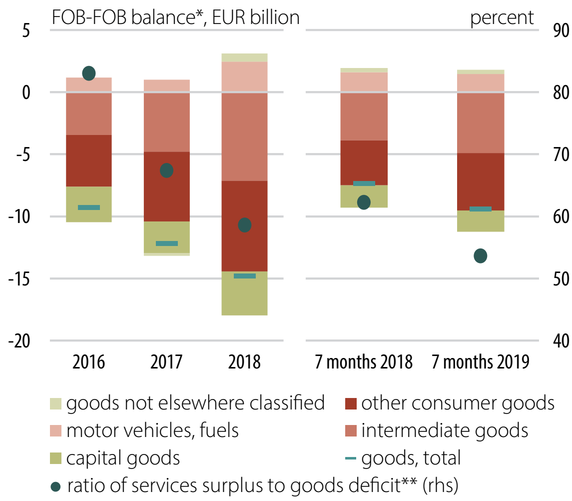
In fact, the widening of the imbalance of trade in goods (to EUR 10.9 billion) caused the increase by 16 percent in the current account deficit January through August 2019 (up to EUR 7 billion). The negative influence of the balance on trade in goods was partly offset by the rising receipts from international services, spurred by the further favourable developments in both freight transport (also as a result of investments made in recent years with a view to expanding the fleets) and ICT, a sub-sector that gradually consolidated its share on the European market (Chart 2.8). Nevertheless, the counterweight of net receipts from services to the balance of trade in goods declined further (from 62.3 percent in January-August 2018 to 53.7 percent in the same period of 2019), the performances of the two aforementioned sub-sectors being eroded by households' stronger preference for international travel and air transport (Chart 2.9).

Chart 2.8. Services share on the EU-28 market



Source: Eurostat, NBR, NBR calculations

Chart 2.9. Balance on trade in goods



*) excluding goods produced under processing arrangements

**) 8 months 2018, 8 months 2019 for the last two periods

Source: Eurostat, NBR, NBR calculations

Labour productivity

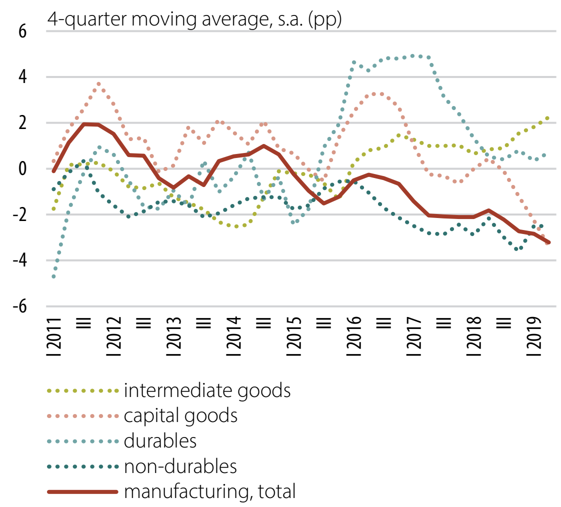
In 2019 Q2, labour productivity economy-wide further reported favourable dynamics (4.5 percent in annual terms), although solely on account of the buoyancy in the construction sector, where the value added saw a strong pick-up, most likely in association with the fiscal stimuli implemented at the beginning of the year. Conversely, the developments in other sectors (agriculture, industry, market services) were less upbeat: slower annual rates of change for the number of employed persons and especially the volume of activity.

Chart 2.10. Labour productivity in manufacturing

*) Jul.-Aug.

Source: NIS

Chart 2.11. Capacity utilisation rate in industry*



*) difference versus the long-term average (2005-2018)

Source: EC-DG ECFIN, NBR calculations

The manufacturing output contracted in annual terms in April-June for the first time after 2009, the dynamics of this segment staying on the downtrend that was subsequent to the peak reached in 2017 Q4. However, the contraction in the number of employees continued to exert a favourable statistical effect on labour productivity, which saw only a marginal decline (Chart 2.10). The same as in the previous quarter, the external demand coordinates were decisive, an additional contribution in the same direction making the domestic orders; these developments mirrored in a drop in the capacity utilisation rate to a post-crisis low (Chart 2.11). The latest data on external demand suggest that the annual decrease in the manufacturing output in Germany for the tenth month in row was due to a continuous reduction in new orders from outside the euro area. This highlights the influence of the trade tensions between the US and China on the evolution of the European industry and further on the domestic industry. The effects associated with the challenging external situation were closely reflected by the developments in the domestic automotive industry, integrated in the European production chains, which saw its output going down in 2019 Q2, as the capacity utilisation rate hit a historical low[15] (for further details, see the Box entitled "The automotive sector – incidental disruptions and structural metamorphosis"). Similar downtrends were also visible for related segments, such as the manufacture of electrical equipment or machinery and equipment.

The prospects remain subdued for the coming period as well, due to international uncertainty, the low confidence of economic agents in this

15 Data available since 2005 Q1.

field (the EC-DG ECFIN indicator remaining in negative territory for both Romania and the euro area) and the difficulties to find adequately skilled employees, given the increased labour market tightness. Despite the positive signals from investments being announced or made in the technological upgrading, the streamlining or the automation of production (in sub-sectors such as the manufacture of motor vehicles, building materials, food industry), a substantial recovery in productivity is, however, conditional on the improvement of global economic growth prospects.

The automotive sector – incidental disruptions and structural metamorphosis

Introduction

The automotive sector, whose beginnings go back more than a century, when the first car models were manufactured on the present-day territory of our country, is now one of the central pillars of the local economy. Aside from the sector's direct footprint – over 187,000 employees[16] and an export orientation reflected in a trade surplus of more than EUR 3.4 billion January through July 2019 (while the current account deficit amounted to EUR 6 billion) –, the motor vehicle industry exerts a significant stimulative effect on other sectors. Thus, Romania's motorcar exports comprise more than one fourth of domestic added value originating in sectors other than the automotive industry (other manufacturing sub-sectors, but mainly services), according to estimates based on input-output tables[17].

The direct footprint of manufacture of transport equipment and its connection to other economic areas are not, after all, surprising, given that motorcars are very likely the most complex products available on a large scale. Nevertheless, they can be a matter of concern, as this year's developments point to a very possible discontinuation of the uptrend that the local automotive sector embarked on as early as 2001.

The automotive sector's weakness of late is not specific to Romania's economy alone, it is a global feature, in an overall environment dominated by the consequences of the US-China trade row and the uncertainty surrounding its possible escalation. The global state-of-affairs also includes geopolitical strains, as well as tensions relating to Brexit (the UK is a significant motorcar manufacturer and, at the same time, a relevant outlet) and to changes in the international trade framework towards a more restrictive configuration. In addition, the goal to minimise pollution has emerged in recent years as a major challenge. In this respect, beyond the focus on cutting polluting emissions of conventional engines, carmakers have recently mapped out bold strategies that envisage a broad-based shift of the production structure towards electric cars, implying fundamental changes in manufacturing processes.

16 The figure refers to the first eight months of 2019, accounting for almost 4 percent of whole-economy payrolls and more than 16 percent of the employees in manufacturing.

17 According to information for 2015 supplied by the OECD-WTO TiVA database.

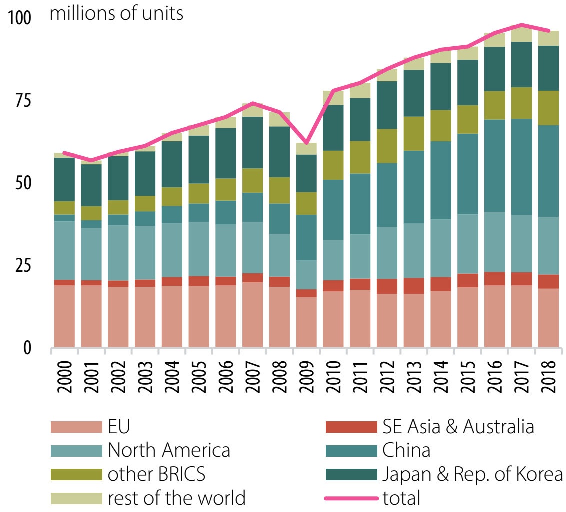
Domestically, the most significant obstacle to motorcar production development is the poor state of transport infrastructure, an improvement in this situation being still remote. At the same time, the constraint of scant, inadequately-skilled labour force has become less acute over the past year and a half, when the sector's number of employees shrank gradually amid both softer external demand and automation efforts. However, this obstacle continues to be relevant, particularly in terms of Romania's capability to attract new major investments. On the one hand, it may be asserted that the importance of these supply-side challenges will subside, in line with the expected moderation of external absorption. On the other hand, they weaken the domestic economy, insofar as carmakers will make adjustments along the extensive margin (by closing down/relocating production facilities), impacting first the factories located in the least favourable areas for production. Yet not all local signals are negative. In particular, assembling unfolds at a sustained pace – Romania hit last year an all-time high in the number of manufactured motorcars and is likely to reach a new peak this year. This is suggested by the first three quarters' figures (up by a cumulative 2.3 percent, according to the Automobile Manufacturers' Association of Romania) and by the launch in production of a new model in early October.

Against this background, this box features a brief assessment of the picture painted by the international automotive sector of late and its relevance for the local manufacturers, as well as possible avenues whereby the domestic industry may strengthen its position.

The international automotive context and the local situation

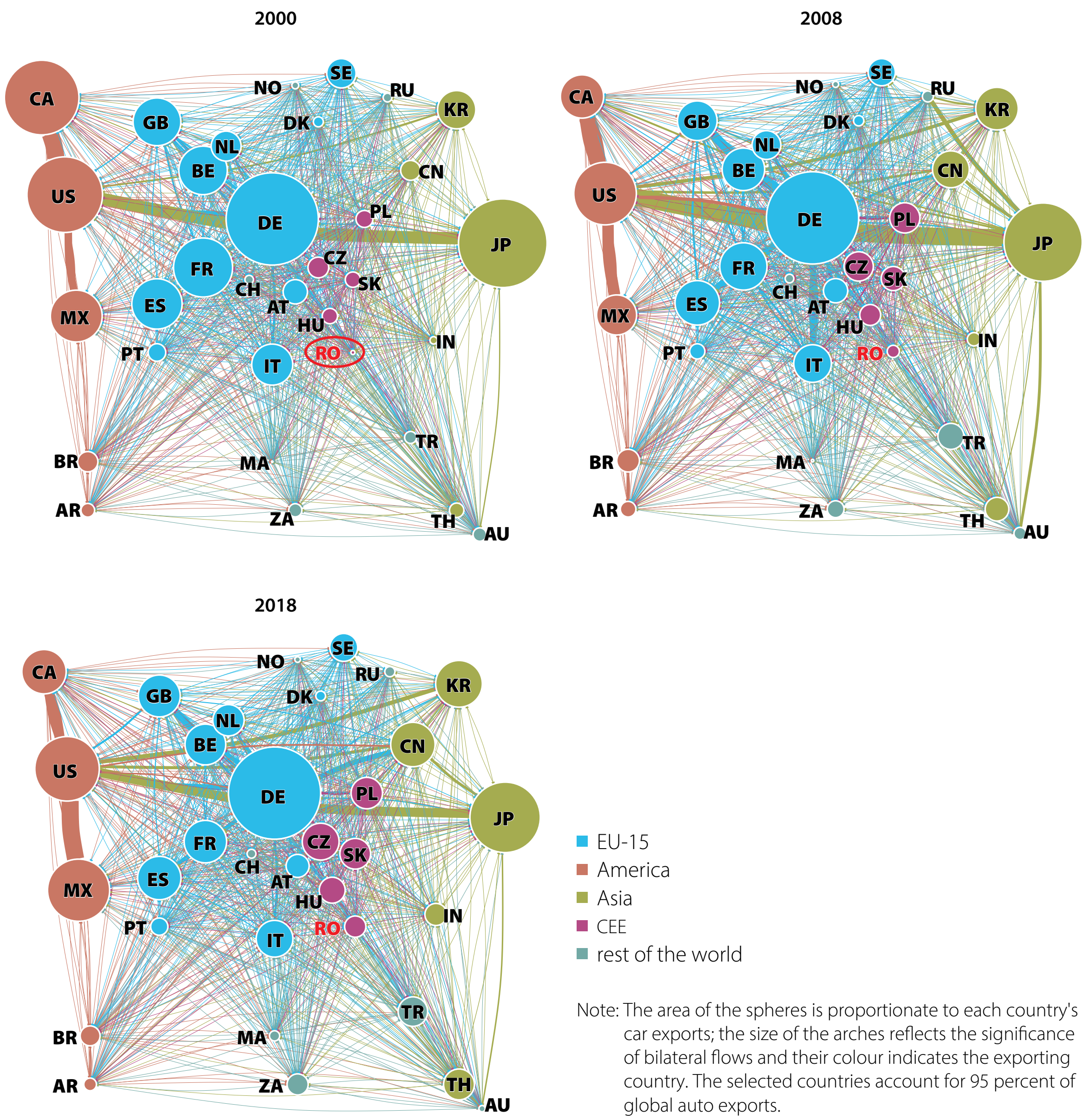
2018 saw the first decline in global motorcar production in the post-crisis period (Chart A). This was relatively small in size and the weakening of demand was not widespread (a decline by 1.1 percent in the number of units traded, according to data provided by the International Organization of Motor Vehicle Manufacturers – OICA), originating mostly in some medium-sized markets that faced specific problems during the year – Iran's economy was subject to new sanctions, Turkey and Argentina experienced episodes of turbulence, while the UK was affected by the fact that the Brexit still held many uncertainties. However, the declining markets in 2018 also included China, which holds a dominant position worldwide (around 30 percent of the global market). It shrank by 2.8 percent amid the uncertainty about the economic dispute with the US, which has depressed investment and caused the deferral of large-value purchases. At the same time, 2018 marked the removal of tax breaks implemented by the Chinese authorities as regards buying

Chart A. Motor vehicle production at global level



Source: International Organization of Motor Vehicle Manufacturers small- and medium-sized vehicles, which at the time of their launch favoured earlier such purchases (in 2016, the annual growth rate of sales surged to double-digit values after two successive decelerations).

Chart B. Trade flows of the global automotive sector



Note: The area of the spheres is proportionate to each country's car exports; the size of the arches reflects the significance of bilateral flows and their colour indicates the exporting country. The selected countries account for 95 percent of global auto exports.

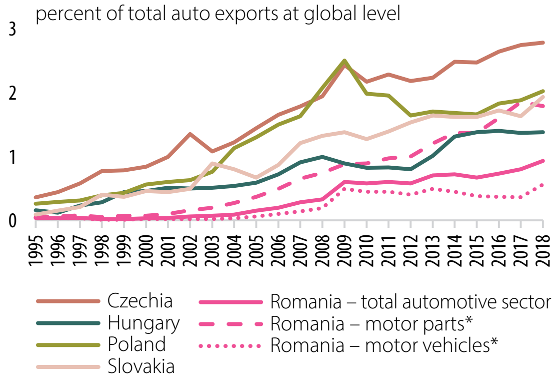
Source: UNCTAD, NBR calculations

By contrast, the US car market, the world's second in terms of size, moved slightly ahead in 2018 (up 0.9 percent), boosted by income dynamics and the Tax Cuts and Jobs Act. These influences prevailed over those associated with slightly less favourable financing conditions and with the higher input costs, driven by a hike in tariffs on steel and aluminium imports (IMF, 2019). However, data on vehicle sales in the US in the first three quarters of the current year point to a decrease in transactions (-0.8 percent), in line with the expected economic slowdown (see the latest IMF forecasts[18]). In fact, almost none of the large economies is anticipated to post a stronger GDP growth in 2019, hinting at a further downward path in global car sales, with a significant contribution expected to be made by the Chinese market, which shrank by 10.3 percent January through September 2019 (according to the China Association of Automobile Manufacturers).

As for the local automotive sector, probably the most relevant international development over the recent period was the contraction of the car industry in Germany, this country accounting for more than one third of Romania's motorcar exports. In 2018, the number of motorcars made in Germany dropped by more than 9 percent (according to OICA data)[19] and the production of the motor vehicle industry as a whole shed 1.7 percent and accelerated its rate of decline to 11.5 percent in January-August 2019. This occurred amid weak external demand, the effect of which prevailed over that of the rise in domestic demand. German car manufacturers were also hit by the implementation of new emission testing standards (*Worldwide Harmonized Light Vehicle Test Procedure* – WLTP), which brought about disruptions in the production flow (IMF, 2019).

The influence of the external environment on Germany's automotive industry should come as no surprise, given its opening and position within the global automotive sector (Chart B). Heavily export-oriented are also the automotive sectors of some emerging economies in the region such as Czechia, Slovakia, Hungary or Poland, but also the Romanian economy, whose share in the international car trade has widened steadily since the early 2000s to just below 1 percent in 2018[20] (Chart C).

Chart C. Market share of auto exports at global level



*) as a share of total global exports for this category

Note: The automotive sector is represented in compliance with the Standard International Trade Classification (SITC) Rev.3 by codes 781, 782, 783, 784 and 786. Parts and accessories of vehicles are represented by division 784.

Source: UNCTAD, NBR calculations

The external market is of prime importance to the domestic automotive industry[21]. In the first nine months of 2019, the Dacia factory manufactured about 260,000 units, while the local market absorbed around 40,000 Dacia cars (some of which had been made abroad). Ford Romania is even more outward oriented, its exports comprising nearly all of the approximately 97,000 units manufactured in the first three quarters of this year. In turn, suppliers of parts and accessories are heavily reliant on external developments, with either direct exposure (exports

18 Included in *World Economic Outlook*, October 2019.

19 Production of commercial vehicles in Germany was similar in both 2017 and 2018, according to ACEA (2019).

20 By comparison, Romania's global market share of trade in goods stood at 0.38 percent in 2018 (Eurostat data).

21 Information on the importance of exports to local motorcar manufacturers is based on the Automotive Manufacturers and Importers Association and the Automobile Manufacturers' Association of Romania.

thereof steadily exceeded motor vehicle exports over the past few years) or indirect exposure, via the connection with the local assembling sector.

Given that the Romanian automotive industry reported in 2018 a historical high in the number of units manufactured, influences from worldwide disruptions were less conspicuous. Conversely, they were more clearly reflected locally in the following year. Specifically, the automotive industry's output dynamics January through August 2019 fell to 1.6 percent (compared to an average annual rate of 12.5 percent over the last ten years), while foreign trade data for the first seven months of the year showed motor vehicle sales rising 5.6 percent, but a more substantial deceleration of growth for trade in parts and accessories (12.1 percent).

Possible remedies for the situation of the local automotive sector

The option to improve the production capacity

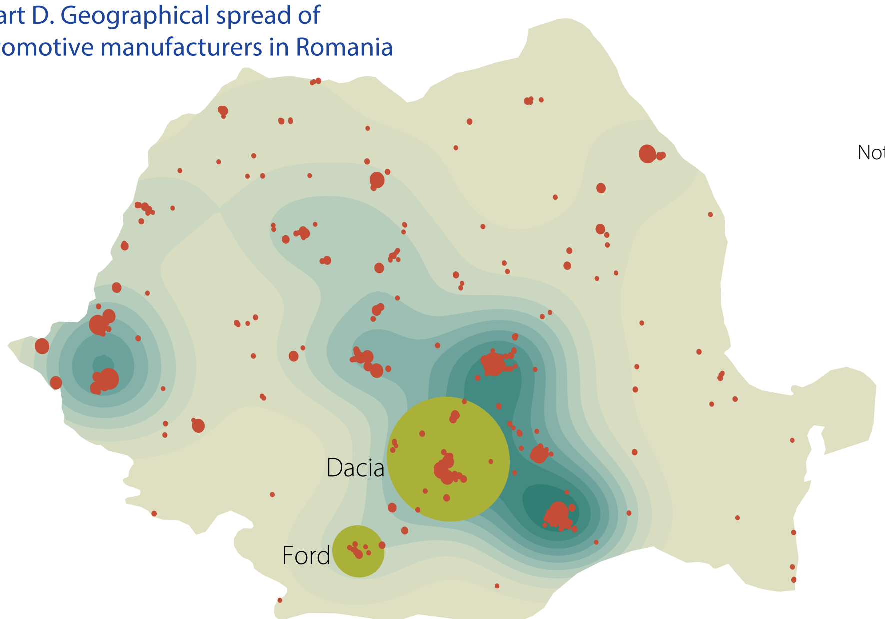
Improvements along the extensive margin in the form of the increase in the existing production capacities or the creation of new capacities would help the local automotive sector overcome the current challenging times[22]. However, the situation of transport infrastructure is a barrier to the possible progress in this area, being a great minus for such an export-oriented sector. At the same time, it fuels the disparities across regions, undermining over time the eligibility of a large part of Romania for investment in this field. At present, the automotive production remains concentrated in the central and western part of the country[23], while automotive firms have a rather sporadic presence in the rest of the territory (Chart D), a situation which will most likely persist in the absence of significant progress in the transport network development. Improving the state of affairs is the task of public authorities, which have generally used inefficiently and insufficiently the solution closest at hand, i.e. the European investment funds. This brings into discussion the possibility that the authorities should try to compensate for the deficiencies in this case (or for other problems) by providing state aids to car producers, especially for major investments. However, such facilities are subject to controversy, not so much with regard to their existence (the international practice has shown that they are nearly always present in one form or another), but to their size, as in recent years there have been cases where the size of aids exceeds, in some opinions, the beneficial effects of the project in question (Pavlínek, 2017).

Another obstacle to increasing the production capacity is the difficulty to recruit skilled staff, the recent experience showing, however, attempts to overcome this hurdle by way of capital-labour substitution (Chart E), which were also made by the leading car producer. Nevertheless, the constraint remains relevant, especially for large-scale projects.

22 This solution has also emerged against the background of recent discussions about a major carmaker that intends to build a plant in the region.

23 The importance of geographical proximity between certain links of the automotive production chain favoured the creation of regional clusters.

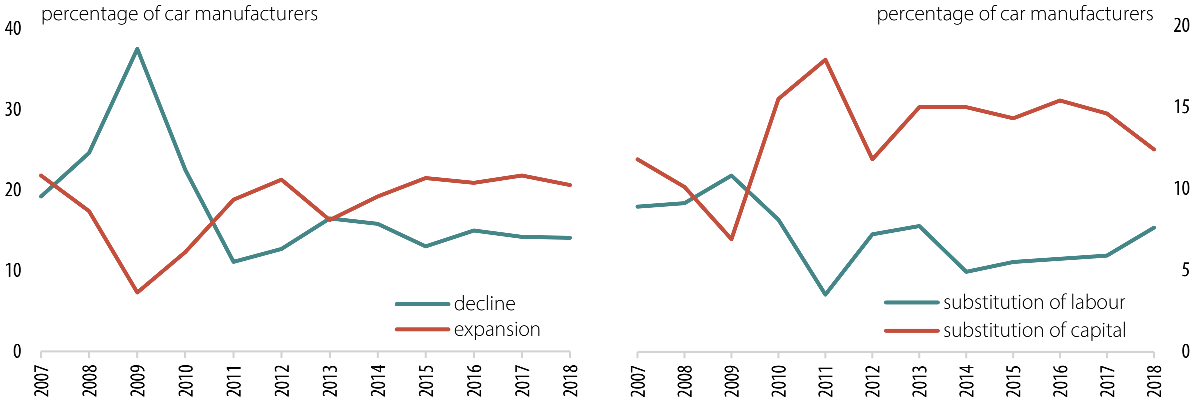
Chart D. Geographical spread of automotive manufacturers in Romania



Note: Each circle depicts an automotive manufacturer, whose turnover is proportionate to the size of its representation. The largest automotive companies (Dacia and Ford) are coloured distinctly. The density of the number of manufacturers increases with the intensity of the ambient colour.

Source: MPF, Google Earth, NBR calculations

Chart E. The decision to invest and recruit in the automotive sector



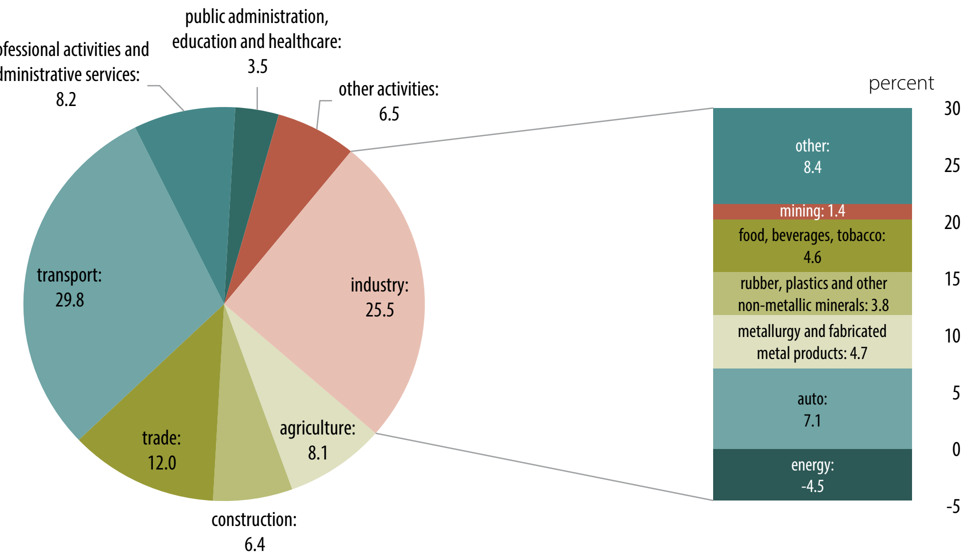
Note: The set "decline" comprises the firms that recorded a downturn in the average number of employees and net negative investment in machinery and equipment between two consecutive years, while the firms labelled under "expansion" hired new personnel and reported positive investment. The other two categories refer to firms that either laid off staff, while investing (signalling a possible substitution of labour with capital), or hired, while recording disinvestments. The companies not listed in the database in both of the two consecutive years have been excluded from the sample. The firms maintaining one of the production factors constant throughout the analysed time frame have been counted out from either of the four categories (their relevance in terms of turnover is low), the sum of the percentages for a given year differing thus from 100 percent.

Source: MPF, NBR calculations

These problems only add to the persistence of the disadvantageous position the local economy holds as compared to the emerging countries in the region in terms of attracting investments from automotive firms. While international carmakers expanded to countries such as Hungary, Czechia or Poland ever since the early 90s, Romania benefited from Renault's presence no sooner than the end of that decade (after the Daewoo experience that ended too early). The negative consequences of the delay in this important investment for the automotive sector and for the economy as a whole also derive from the stimulative effect of the automotive industry on other business sectors, inter alia by attracting new investments. Another aspect refers to the traditional role of driving forces of trade integration, economic opening and convergence that car manufacturers have played over time. To this end, for example, the 1965 Auto Pact between Canada and the United States to consolidate the integration of automobile production in the Great Lakes region is the forerunner of NAFTA. Furthermore, the laws that facilitated the access of multinationals to Spain, promoted in the first part of the 70s, are known as the "Ford laws", being adopted to encourage Ford to set up a production facility in Valencia (Freyssenet and Lung, 2004). Therefore, the automotive sector helped Czechia, Hungary and Poland catch the interest of developed European countries since the early 90s (after the Iberian Peninsula had drawn attention in the preceding years), while this process started in Romania almost a decade later.

Even though adversely hit by the above-mentioned obstacles, the investment activity in the automotive sector appears to be fairly buoyant as compared to the developments in other sectors of the domestic economy, being underpinned by equipment purchases[24] (Chart F). From a broader perspective, the automotive industry accounted for over 10 percent of the total net investment in equipment economy-wide in the period from 2010 to 2018, reaching peaks in 2010 (approximately 27 percent of the total), when most sectors recorded negative net investment, being affected by the economic context, as well as in 2016-2017. Behind the second peak stood the expansion wave of motor parts producers, along with the investments in the automation of the Mioveni plant and with those made in the run-up to the launch of a new model in the Craiova-based enterprise.

Chart F. Breakdown of equipment net investment by economic sector – 2018



Source: MPF, NBR calculations

Despite the negative developments seen by the external environment in 2018, local automotive firms did not change their behaviour as regards the acquisition of production factors. Specifically, the share of firms that wanted to expand (through

24 Net investments (excluding the depreciation and impairment losses) are considered. Source: Ministry of Public Finance.

investment in equipment and hiring) was close to that recorded in 2017; similarly, the share of firms that reduced their activity (as shown by negative net investments and lay-offs) remained relatively unchanged over the past two years (Chart E). This resilience is most likely based on the sustained resumption of car production at the Craiova-based Ford plant, which almost trebled in 2018.

The current year does not benefit from a counterbalancing effect of a similar size. Conversely, according to market signals, 2020 will see the Ford factory getting closer to full capacity (due to the new model which started to be manufactured in the final quarter of 2019), as well as the completion of an investment in enhancing the production capacity of the Mioveni-based plant. The most optimistic scenario places Romania's car production at around 700,000 units in 2020 (compared to less than 500,000 units in 2018), which would probably imply the need for increased production capacity at the supplier level. However, the outlook beyond 2020 is more subdued.

In addition, the diversification of production by attracting another major investor is unlikely, while the automotive production is anticipated to witness further territorial imbalances.

The option of progress in quality

The opinions formulated over the course of time, stating that the success of the local automotive industry on the external market is substantiated by low prices, in a general context marked by a fragile path of income abroad, managed to cast some shadow on the role played by the improved quality parameters of production in establishing and strengthening the relationship between the local automotive industry and the external market. The vector of these improvements was the increased local presence of international automotive firms, the Romanian economy proving to be an important destination of foreign direct investment flows in the automotive sector[25], even though they were lower compared to other emerging economies in the region. Prior to this, in the 90s, local carmakers had marginal access to the external market (for instance, between 1995 and 2001, Romania held a share on the world auto market no higher than 0.04 percent). Earlier before, the process took place in non-market economy conditions, as a result of political decisions and, oftentimes, under barter agreements. Stroe *et al.* (2018) mention that, before 1989, attempts to enter the Western markets were constantly hindered by the obstacle of quality standards. Subsequently, the inability to make the necessary investments in retooling made the management of Dacia adopt an approach that was almost exclusively aimed at preserving price/cost competitiveness as a solution by the time an investor came up. Nevertheless, the limits of this approach became increasingly clearer once household income increased, particularly amid the availability of better equipped Daewoo models manufactured in Craiova starting in 1996.

25 According to the NBR data (2019), in 2018 the FDI stock in the transport equipment industry (also including other transport equipment, which however holds a minor share) exceeded EUR 5.4 billion (6.7 percent of the total FDI stock economy-wide and 21.7 percent of the FDI stock in manufacturing).

Looking at motor parts and accessories, the improvement in their quality has been mainly visible after the adoption of higher production standards, which was either direct (firms with majority foreign capital implementing locally the good practices of the parent company) or indirect (through spillover effects). According to a survey conducted among the Czech car producers, more than half of the firms with majority foreign capital consider that the quality parameters they impose on suppliers with majority domestic capital are higher than those prevailing in the industry when the commercial relationship started (Pavlínek, 2017). In fact, a common practice is to request partner firms to take some preliminary steps (such as the quality certification or the technological audit) before actually initiating the client-supplier relationship. The same survey shows there has been actual progress in terms of both quality and sophistication of products made by suppliers. Even though these results refer to an economy other than that of Romania, they are relevant to the mechanisms enabling the transmission of spillover effects, given the similarities in terms of export orientation and importance of foreign capital between the automotive industries in the two countries.

As for the car manufacturing segment, even though the previous economic crisis was an opportunity for Dacia, its external sales following an upward trend at the time, the positive developments started earlier, in the pre-crisis years, being driven by the higher-than-expected popularity of the Logan model launched in 2004. Specifically, the ACEA data[26] show a leap in Dacia's share on the Western European market, from 0.09 percent in 2005 to 0.24 percent in 2006 and 0.47 percent in 2007. The model was well received in developed countries where households enjoyed strong incomes at the time, taking even the car producer by surprise, as the Logan had been originally designed for emerging markets (Stroe *et al.*, 2018). This points to the important role of quality (including the technical specifications) in supporting local exports of motor vehicles, even though the price competitiveness is most likely at least equally important.

Subsequently, there was further progress on the quality side, inter alia due to the shift in Dacia's production towards a higher market segment thanks to the Duster model. The results of an exercise based on the methodology proposed by Di Comite *et al.* (2014) provide additional information in this respect. The authors of this study propose an equilibrium model in which the utility function of the representative consumer takes into account the quality of goods. Solving the model leads to a relation for the quality parameter, which includes variables that can be approximated based on available indicators and, additionally, a non-observable variable that is, nonetheless, common to the goods traded in the same market. Thus, the quality levels can be compared for two differentiated goods that are present in the same market through a simple difference, as the non-observable variable will be reduced.

26 Referring to car registrations in EU-15 countries, plus Switzerland, Iceland and Norway.

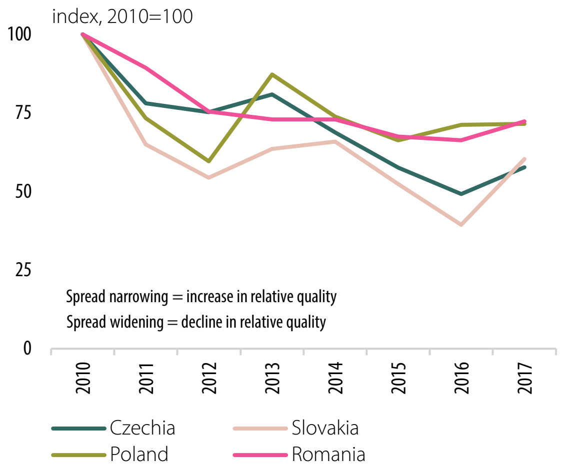
More precisely, according to that methodology, the quality difference between varieties s and t, which are available on the same market i, is given by:

$$\alpha_s - \alpha_t = 2(p^*_{s,i} - p^*_{t,i}) - (c_s - c_t) = (2p^*_{s,i} - c_s) - (2p^*_{t,i} - c_t)$$
$$= p^*_{s,i}\left(2 - \frac{c_s}{p^*_{s,i}}\right) - p^*_{t,i}\left(2 - \frac{c_t}{p^*_{t,i}}\right)$$

In the above relation, α_X is the quality of variety X, $p^*_{X,i}$ is the (equilibrium) price of variety X in the market i and c_X refers to the marginal cost of variety X, where $X \in \{s, t\}$. Thus, the quality differential can be estimated based on the information on the selling prices of the two varieties in (the same) market and the cost structure of producers. Although it is more difficult to be interpreted, as it is expressed only in relative terms versus another competitor, and only in one market, this indicator comprises relevant information about the developments in the quality of a certain product.

This exercise relied on the assumption of a representative car producer in each of the countries subject to analysis (Czechia, Slovakia, Hungary, Poland and Romania) and Germany was selected as the common market in which these producers are present[27]. The unit value of exports (calculated based on the Eurostat data) was used as a proxy for the market price. The ratio of the marginal cost to the selling price was approximated by the share of total costs in turnover, calculated based on information in the OECD database (available until 2017 and covering all the countries subject to analysis, except Romania), as well as on information from the Ministry of Public Finance (for Romania)[28].

Chart G. Quality of auto exports



Note: Quality is shown as a spread against Hungary, which manufactures motor vehicles at the highest quality standards in the region.

Source: NBR calculations

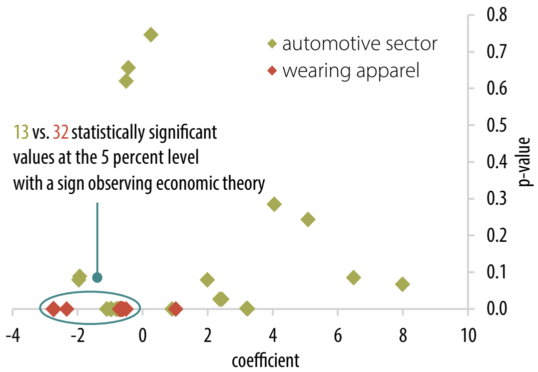
The calculations showed that the models manufactured in Hungary had the highest quality parameters over the entire period from 2010 to 2017, a result that was easy to anticipate, due to the orientation of local enterprises to the high-end segment. The quality differential between Romania and Hungary narrowed during the period under review, suggesting quality improvements in the domestic car production (Chart G). However, Czechia and Slovakia made even more extensive progress in this direction.

Despite the inherent difficulty of measuring quality, there is strong evidence that the Romanian automotive industry as a whole recorded quality improvements over the past two decades and in the most recent period. This favoured the persistent high pace of exports, even though the

27 Where more detailed information is available, the analysis can be broken down to individual producers or even individual car models.

28 Total costs refer to purchases of goods and services, to which add wage costs (for the OECD data). In Romania's case, total costs include the costs of raw materials and consumables, other expenses on materials, utilities expenses, expenses on goods purchased for resale and personnel expenses.

Chart H. Estimates of the price/cost competitiveness effect on exports



Note: Estimates are based on cointegration equations, where the variables showing price/cost competitiveness have been alternatively represented by either ULC or REER (based on IPPI for the respective NACE divisions). 56 models have been applied for each sector, differing in terms of trend specification, external demand proxy (EU or euro area GDP) and indicator on price/cost competitiveness.

Source: NBR estimates

competitive advantage of low wage costs has been gradually eroded. The estimates of export functions, which often indicate a decoupling of price/cost competitiveness from the export path, provide an additional indication in this respect. By comparison, the wearing apparel sector was fully hit in recent years by the shock of weakening price/cost competitiveness and quality gains were not large enough to act as a counterbalance (Chart H)[29].

The ongoing quality improvement is one of the few intensive solutions to support the local automotive sector in extending a trend whose coordinates became clearer once Morocco became a producer of Dacia models. Specifically, the Dacia factory in Tangier, a city on the north coast of Morocco close to the Strait of Gibraltar and Spain, was inaugurated at the beginning of 2012. Benefiting from clear advantages in terms of location and labour costs (the average net wage in Morocco is significantly lower than that in Romania), this production unit was designed to have a capacity similar to that in Romania (around 350,000 vehicles per year). Over time, it has obviously grown into a rival to the Mioveni plant, the manufacture of some models such as Sandero and Logan MCV being gradually relocated from Romania to Morocco. However, it can be argued that the evolution was favourable for the domestic industry as well, helping create production capacity for the higher-end Duster model, which currently accounts for more than three quarters of Dacia's production in the Mioveni-based factory. The continued uptrend in quality would result from strengthening and improving the underlying competitive advantages (technology, human resources specialisation), which would foster the production of more refined models or the improvement of models that are already manufactured here. However, it should be noted that the qualitative leap also depends on the relative position of the model within the product range of the group, being implemented so that the success of a car model does not undermine the sales of another.

Car production – under a new paradigm

Apart from the adverse circumstances of recent years, the automotive sector goes through a period of structural shifts associated with the measures to reduce polluting emissions within a broader context, where more and more decision-makers share the view that reducing carbon emissions and slowing the pace of global warming should rank high on the priority list. Thus, the European Union designed a long-term strategy in line with the provisions of the Paris Agreement, with a view to achieving carbon neutrality – the perfect balance

29 For the real effective exchange rate, this decoupling is also favoured by using imported inputs in production.

between carbon dioxide emissions and absorption in the atmosphere – by 2050. While most of economic sectors reduced their carbon footprint over the past decades, in the case of transport activities it remained relatively stable, and even experienced a slight upward path in the last few years. Given that personal and commercial motor vehicles alone account for about 15 percent of total carbon dioxide emissions across the EU, the transition to more environmentally-friendly technologies in the field of transport equipment will have a significant impact in terms of fulfilling the assumed targets.

Against this background, the solution deemed as the most viable at this moment is electromobility[30], a phenomenon that is seen gaining momentum, according to market expectations. This shift in focus involves a radical change to the manufacturing process. For instance, the technology of electric motor vehicles renders superfluous such subassemblies as the internal combustion engine, transmission and exhaust systems, fuel injectors, etc., and implies, at the same time, the use of fewer components that can be assembled faster. Hence, as the "traditional" technology loses ground, much of the expertise built over time in the auto parts production will become futile, while production networks will become far less complex. The new paradigm will, of course, entail a sustained investment effort addressing the research and development activity, the opening of new production facilities, the installation of battery charging infrastructure, and the modernisation of the electricity grid (Mönnig *et al*., 2019). The prohibitive level of these expenses for many countries – for example, the ACEA paper (2018) reveals high concentration of charging stations EU-wide, about half of them being located in only two countries (the Netherlands and Germany) – dampens somewhat the drive for this structural shift. In fact, for the time being, the increase in the preference of households for e-cars is decisively contingent upon the authorities' support (bearing part of the purchase cost, providing free battery charging, etc.). Nevertheless, amid further technology advancements, electric vehicles, even in the absence of such support, might come to overtake classical vehicles.

Insofar as the shift towards electric motor vehicles becomes mainstream, economies such as Romania's will have to undertake strenuous efforts for preserving competitiveness under the new paradigm, possibly in the form of reskilling of workers in the car industry and spurring research and development activity. This would help production facilities remain in the country and a significant share of added value included in the final product be supplied locally.

Conclusions

The automotive sector in Romania is currently evolving under less favourable auspices, as the 2019 developments point to a very likely halt in the upward trend it has followed for almost two decades. This has occurred in a context marked by the

[30] The term covers a broader range of technical solutions, not only fully electric motor vehicles.

decline in the global auto market, which severely affected the level of production in Germany, the main trading partner.

New investments in production capacity would improve the situation, although a noticeable improvement in this respect is expected no sooner than next year, following the completion of the announced capacity expansion of the Dacia plant and the growth in the number of units produced by the Craiova plant, which was ascribed to the new model recently launched in production. At the same time, attracting a large-scale project that can put a new carmaker comparable in size to Renault and Ford on the map of Romania is little likely, being further hindered by the constraint posed by the poor transport network and the difficulty to recruit skilled staff. In the latter case, problems can be overcome to some extent through shifting to less labour-intensive production processes, through automation and robotisation, as hinted at by recent developments. Conversely, public investment in the infrastructure network is irreplaceable, its absence dramatically limiting the options for new production capacities and thus widening the development gaps among the regions of Romania.

Another possibility to improve the position of the domestic industries manufacturing motor vehicles and motor parts refers to making further progress in product quality. This trend is associated with the local presence of international auto companies, which facilitated the transition from a production process that relied on price/cost competitiveness to a system paying increased attention to quality. Against this background, the car models made in Romania managed to gain importance in foreign markets, which created the possibility for further expansion of the automotive industry. Subsequently, the leap to a higher-end car range helped maintain the upward trend in automotive production and exports, even amid the erosion of the competitive advantage of low labour cost. The persistence of the favourable trend in quality would be strongly boosted by the increased interest in local research and development activities. In this respect, the latest data show that, in 2016, Romania accounted for less than 0.5 percent of the research and development expenses in the automotive industry EU-wide, which is a modest figure, albeit slightly improving over the past years, in light of Romania's importance to the European automotive sector.

In a longer perspective, perhaps the most relevant trend anticipated to have an impact on the evolution of the global automotive sector in the coming decades is linked to the spreading of electromobility solutions, amid the attempts aimed at reducing the carbon footprint. All major carmakers have thus announced massive investments in developing new production processes, but this context also comes with expenses beyond the scope of automotive industry, relating to the general and specific electrical infrastructure. To what extent Romania is prepared to impose itself at regional level as a country attracting new investment flows remains an open question, the answer to which depends on the intensity of efforts towards making the necessary public investment, retraining the labour force, encouraging the research and development activity and ensuring an investor-friendly and predictable legislative and business environment.

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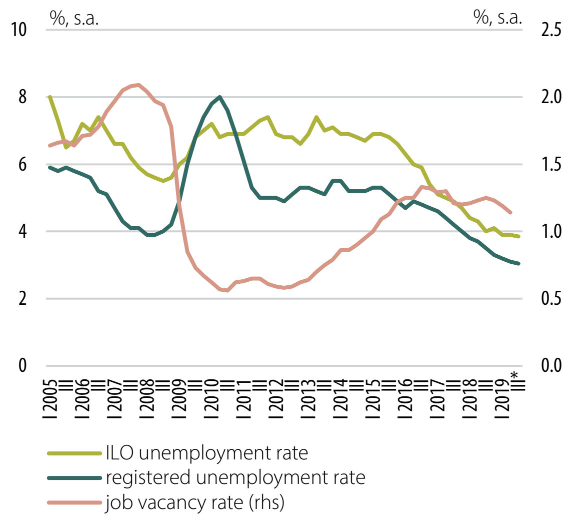
Labour market developments[31]

The capacity of the economy to absorb workforce remained high in 2019 Q2 too, with the job vacancy rate standing marginally below the value recorded in the preceding quarter, largely on account of the lower number of openings in industry. At the same time, the supply of unemployed labour was relatively unchanged (Chart 2.12), with the registered unemployment rate and the ILO unemployment rate dropping to post-2000 lows (3 percent and 3.8 percent respectively).

Chart 2.12. Unemployment and job vacancies



*) Jul.-Aug. for the unemployment rates

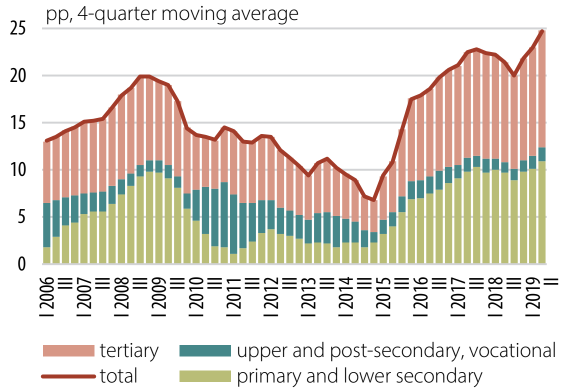
Source: NEA, Eurostat, NBR calculations

Thus, labour market stood further at an elevated level, driven by structural factors, such as the high emigration rate (which is the second cause for the dwindling population; moreover, approximately half of total emigrants are young people, which has adverse demographic consequences in the long term), and the low-skilled workforce available (according to the World Bank's report, *Migration and Brain Drain*, published in October 2019, around 40 percent of those who left the country were tertiary-educated). The difficulties facing

31 The analysis is based on seasonally adjusted data; the main sources are NIS, Eurostat and NEA.

companies in the recruitment process, reflected in the all-time high of the skill mismatch index reached in 2019 Q2, are also echoed by the *PwC European Private Business Survey*, conducted February through April 2019. According to this survey, more than half of the respondents consider that the shortage of skilled workforce leads to financial losses, while nearly 70 percent of them struggle with the lack of technical and administrative/support staff (Chart 2.13). Moreover, on the domestic front, programmes designed to foster mobility continue to deliver modest results, having achieved their set target for 2019 to an extent of only 43 percent at end-August. Hence, given the companies' increased interest in the alternative of resorting to foreign workers (in 2019 H1, the number of work permits for permanent and seconded workers tripled compared to the same year-ago period), the authorities decided to further expand the quota for newly-admitted foreign workers to the Romanian labour market (by another 10,000, to 30,000 persons).

Chart 2.13. Skill mismatch index on the labour market*

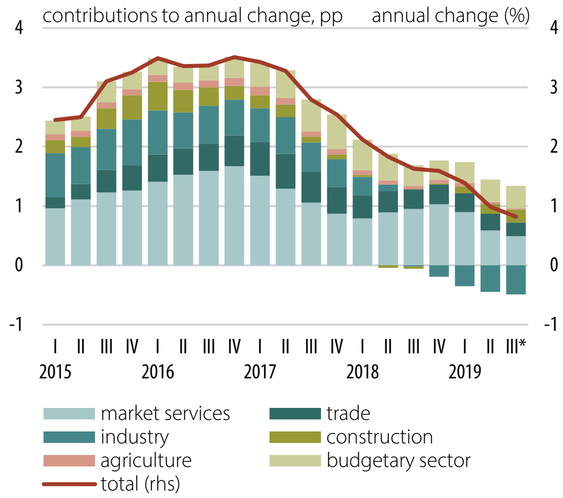


*) calculated as the sum of differences in absolute value across each skill group between labour supply (approximated based on the share of the unemployed with a certain level of education in total unemployed) and labour demand (approximated based on the share of the employed with the same level of education in total employment)

Source: Eurostat, NBR calculations

In this context, the annual dynamics of the number of employees economy-wide continued to lose momentum (down to 0.9 percent in April-August 2019), solely on account of the private sector. Once again, hiring in market services witnessed a slowdown, more pronounced in the ICT sector (owing nevertheless to a base effect[32], considering the latter's significant market share at both European and international levels, along with the lack of noticeable signs of worsening prospects), as well as in the administrative and support services. Industry saw further downsizing in personnel, particularly light industry (given the trend of relocating the activity of some producers to areas with cheaper labour force), automotive industry, possibly in association with the unfolding automation process and the lower production at European level, as well as manufacture of wood and manufacture of machinery and equipment. Conversely, the construction sector recorded a new increase in the number of employees, most likely determined by the tax incentives granted in early 2019 (Chart 2.14).

Chart 2.14. Number of employees economy-wide

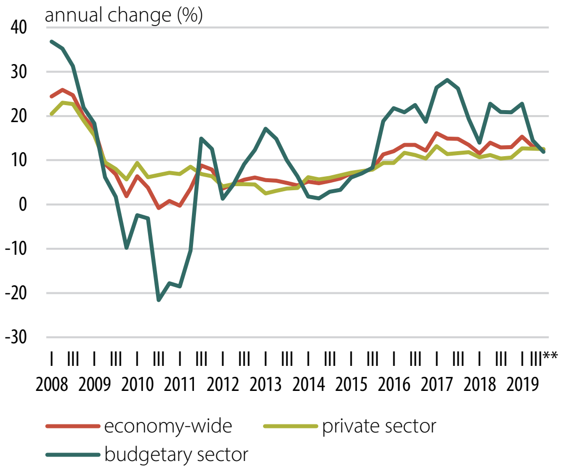


*) Jul.-Aug.

Source: NIS, NBR calculations

32 February 2018 saw two additional categories of employees benefiting from the personal income tax exemption, which enhanced this sector's attractiveness and most likely boosted hiring in 2018.

Chart 2.15. Nominal gross wage earnings*



*) excluding the effect of the transfer of social security contributions for 2018

**) Jul.-Aug.

Source: NIS, NBR calculations

For the coming period, the two surveys usually referred to paint a consistent, less optimistic picture. Specifically, the Manpower survey anticipates a modest rise in payrolls for 2019 Q4, with decelerations in most sub-sectors, accounting for the most pessimistic forecasts in the last four years. Moreover, the EC-DG ECFIN Survey points to stable payrolls in industry, market services and construction for September-November, while expectations on new hiring in trade remain positive, albeit on a wane.

The annual dynamics of average gross wage earnings remained further high between April and August 2019 (12.8 percent), the slowdown from the first quarter (down 2.4 percentage points) owing to developments in the budgetary sector, mainly as a result of the statistical effect associated with the pay rises granted in March 2018 to employees in education and public healthcare. In fact, as in the past three years, both the annual rate of change and the level of the average gross wage in the budgetary sector (16.8 percent and around lei 6,300 on average respectively in the first eight months of 2019) further exceeded the values recorded in the private sector (12.6 percent and approximately lei 4,700 respectively). This may lead, via a demonstration effect, to additional upward wage pressures, apart from those stemming from the already tight labour market (Chart 2.15).

2. Import prices and producer prices on the domestic market

The global economic environment was further marked by uncertainty in 2019 Q3, causing the annual dynamics of commodity prices to remain in negative territory, with inflationary pressures being somewhat sporadic. On the domestic side, the impact of these factors was largely offset by the limited supply on the electricity market, the significant rise in wage costs, and the favourable demand conditions. As a result, producer prices on the domestic market decreased only marginally.

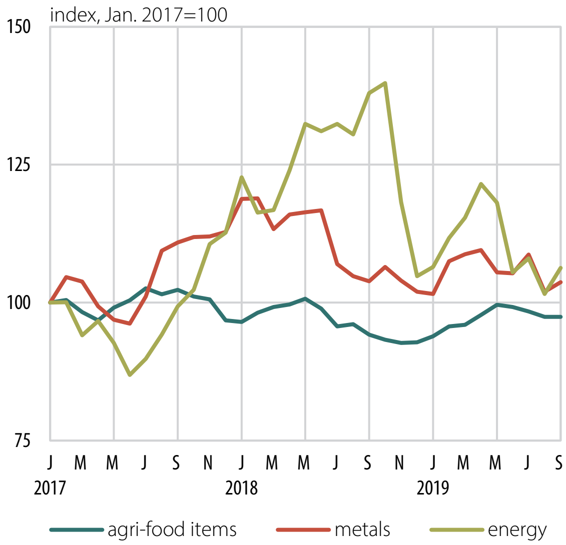
2.1. Import prices

Given the emerging weaknesses in economic activity worldwide and the still subdued prospects, particularly regarding developments in industry, the annual dynamics of energy commodity prices contracted at a faster rate in 2019 Q3 (to -21.2 percent, according to World Bank data). In 2019 Q3 as a whole, crude oil price dropped by 18 percent versus the same year-ago period, the impact of the mid-September Middle East turmoil turning out to be short-lived. Natural gas price followed a similar path, decreasing by nearly a third in annual terms (compared to -23.2 percent in 2019 Q2), due to larger stocks.

The fragility of the global industrial sector preserved the further low international metal prices, the deceleration in their negative annual dynamics (-0.4 percent versus -8.2 percent in 2019 Q2) being attributed to a base effect. Supply-side factors led iron ore price to diverge from the general trend and follow a steep uptrend since the beginning of the year, which, however, came to a halt in the last two months of the quarter under review, amid the re-opening of some mining pits in Brazil.

Moreover, in 2019 Q3, agri-food commodity prices fell from the previous quarter; their annual dynamics re-entered positive territory, yet remained subdued (2.4 percent against -0.9 percent in Q2, according to the Food and Agriculture Organization data). However, inflationary pressures persisted on the pork meat segment, against the background of weaker supply caused by the African swine fever outbreak, which affected particularly producers in Asia, prompting a rise in demand for imports in that area (Chart 2.16).

Chart 2.16. International commodity prices



Source: World Bank, FAO, NBR calculations

Movements in international commodity prices also affected some import prices. Specifically, the annual unit value index of imports (UVI)[33] witnessed decreases for mineral products (down 4.8 percentage points to 104.4 percent) and base metals (down 1.2 percentage points to 98.9 percent).

However, these developments were offset by rises in UVI for some goods holding a relevant share in the CPI basket, specifically meat products (with a 16.6 percentage point increase to 108.9 percent) and pharmaceuticals (with a 24.7 percentage point increase to 116.2 percent). Smaller advances were seen also by vegetal products (up 0.8 percentage points to 102.5 percent), motorcars, as well as wearing apparel and footwear. Overall, in 2019 Q2, UVI stepped up slightly its pace of increase compared to the preceding period, to 101.8 percent.

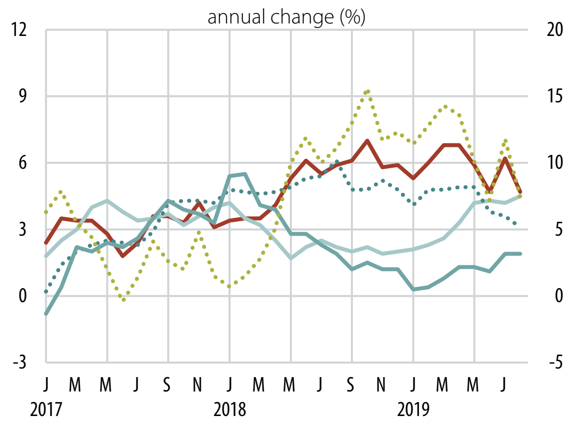
2.2. Producer prices on the domestic market

The external environment continued to influence local developments, causing the annual dynamics of industrial producer prices on the domestic market to slow down slightly in July-August to 5.4 percent (down 0.4 percentage points versus the 2019 Q2 average). Energy prices witnessed a downward correction (down 1.2 percentage

33 Expressed in EUR.

points to 9.6 percent), in line with movements in international energy commodity prices, with annual growth rates in both mining and crude oil processing industries entering negative territory. The weight of this determinant was partly offset by the impact of the lower supply of hydropower amid scant rainfall. Therefore, the annual pace of increase of producer prices in the energy industry stepped up by almost 5 percentage points to roughly 18 percent (Chart 2.17).

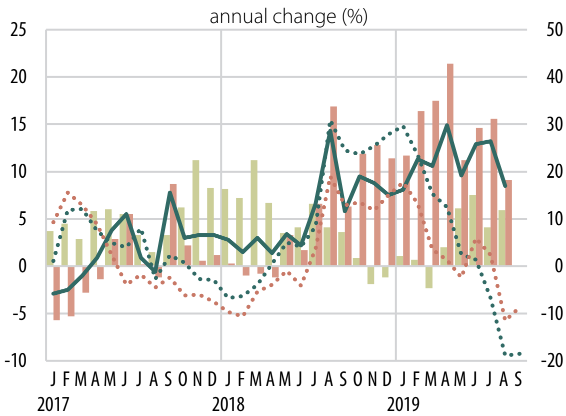
Chart 2.17. Industrial producer prices on the domestic market



Source: NIS, Eurostat

Moreover, prices of intermediate goods recorded losses of momentum in their annual dynamics (down to 3.3 percent), owing also to contained pressures from metal prices. Conversely, the growth rate of consumer goods picked up slightly (4.4 percent) – due to developments in processed food items, given the trajectory of prices for pork meat – and that of capital goods inched up as well (1.9 percent).

Chart 2.18. Agricultural producer prices



Source: NIS, Bloomberg, NBR calculations

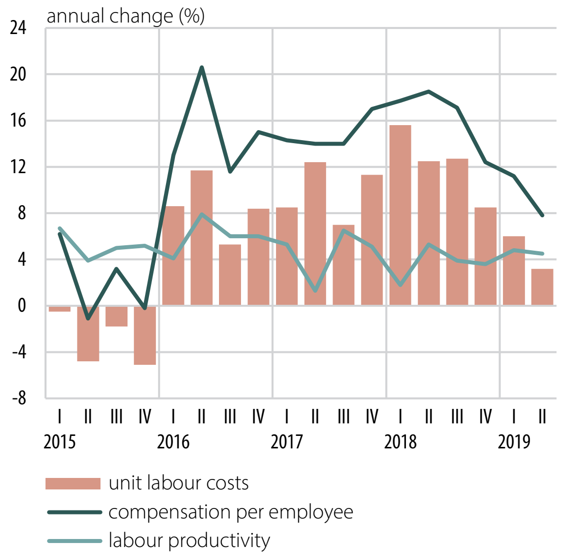
The annual growth rate of agricultural producer prices on the domestic market slowed down July through August 2019 by 1.7 percentage points compared to the 2019 Q2 reading, to 10.8 percent. This was due to vegetal products, whose annual dynamics dropped to 12.3 percent (down 3.3 percentage points), amid a good agricultural output both domestically (slightly narrower versus the bumper crop in the preceding year in the case of wheat), as well as across Europe. The annual rate of change of prices for animal products remained flat, with the slower dynamics for poultry and sheep being offset by steady step-ups on the pork meat segment, in line with external market trends (Chart 2.18).

Unit labour costs

In 2019 Q2, the annual growth rate of unit labour costs economy-wide slowed down to 3.2 percent (down 2.9 percentage points from the previous quarter), solely against the background of slacker annual dynamics of the compensation per employee (Chart 2.19).

By contrast, in the period from April to August, the annual rate of change of unit wage costs in industry moved in the opposite direction, stepping up to 14.1 percent (up 3.8 percentage points versus 2019 Q1), mainly as a result of productivity losses. Behind the advance stood chiefly the manufacturing sector, the growth rate of unit wage costs reaching 14.0 percent (up 4.6 percentage points), especially as a result of the decline in output prompted by the worsening of the macroeconomic environment

Chart 2.19. Unit labour costs



Source: NIS, NBR calculations

in the euro area, the main trading partner. The breakdown shows that this evolution was almost broad-based, with two-digit annual growth rates being reported in sub-sectors such as those related with the construction activity, in light industry, the manufacture of wood, metallurgy and chemicals. Notable exceptions were hydrocarbon processing, due however largely to a base effect associated with the different scheduling of overhauls, and other transport means, where the growth rates of unit wage costs witnessed a correction exceeding 8 percentage points. At the same time, this trend can be seen also in food industry, but the mismatch between wage and labour productivity dynamics remains significant, with the annual rate of increase of unit wage costs reporting two-digit values (around 14 percent), exerting adverse effects in terms of both inflationary pressures and competitiveness.

3. Monetary policy and financial developments

1. Monetary policy

August through October 2019, the NBR kept the monetary policy rate at 2.50 percent and left unchanged the deposit facility rate at 1.50 percent and the lending facility rate at 3.50 percent, while maintaining strict control over money market liquidity. Moreover, the central bank kept the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions at 8.0 percent. The measures aimed to bring the annual inflation rate back into line with the flat target of 2.5 percent ±1 percentage point and keep it there over the medium term, inter alia via the solid anchoring of inflation expectations over the longer time horizon, while safeguarding financial stability.

The August decisions of the NBR Board were taken in a context characterised, on one hand, by the gradual rise – including in the period ahead – in inflationary pressures from fundamentals and, on the other hand, by the increase in uncertainties and risks to the medium-term inflation forecast, generated by the domestic and the external environment. Specifically, the annual inflation rate remained above the variation band of the target in June[34] – also amid the further pick-up in the dynamics of core inflation[35] –, while the new medium-term forecast reconfirmed the prospects for its return into the upper half of the band at the beginning of 2020, but also for its staying there afterwards[36]. Furthermore, the anticipated short-term movements in annual inflation rate around the upper bound of the band were attributable to the action of supply-side factors, which was seen strengthening slightly its inflationary nature in the latter part of 2019, but turning again strongly disinflationary in 2020[37]. By contrast, gradually rising inflationary pressures were expected to stem from the cyclical position of the economy, wage costs and short-term inflation expectations, as well as from the dynamics of import prices in the latter part of the forecast horizon, reflecting inter alia the developments in the leu's exchange rate[38]. Hence, excess aggregate demand was anticipated to increase significantly in 2019 and then more slowly in

34 Despite recording a slight temporary decline, also against the forecast – to 3.8 percent from 4.1 percent in May –, exclusively under the impact of supply-side factors (the significant drop in the prices of vegetables and fuels).

35 The annual adjusted CORE2 inflation rate advanced to 3.3 percent in June from 3.2 percent in May.

36 The annual inflation rate was expected to reach 4.2 percent in December 2019, the same level as anticipated before, and 3.3 percent at the end of the projection horizon, only marginally below the previously-projected value.

37 Mainly on the back of base effects associated with the recent developments in VFE, tobacco and fuel prices, as well as with the tax levied on telecom companies.

38 Thus, the annual adjusted CORE2 inflation rate was expected to exceed the variation band of the target over the next two quarters, reaching 3.9 percent in December 2019, and, after a slight downward correction anticipated for 2020 H1 due to some base effects, to remain marginally above the upper bound of the band, i.e. 3.6 percent at the end of the projection horizon.

2020, to higher-than-previously-projected values, as the economic expansion was expected to decelerate slightly, in annual terms, no sooner than in 2020. Moreover, private consumption was seen as the main driver of economic growth, also amid elevated employment and the level of real bank rates, which was presumed to rise very slowly.

Heightened uncertainties and risks to this outlook were, however, associated with the future stance of fiscal and income policies, as the budget execution features in the first months of the year and the expected impact of enacting the new pension law rendered more likely the adoption of corrective measures to keep the budget deficit within the ceiling set under the Stability and Growth Pact. Rising risks also stemmed from the increasingly clear signs of a worsening of the euro area and global economies, as well as from the uncertainties about their outlook, especially amid the trade war and Brexit. The relevance of external risks was heightened by the probable further worsening of the current account – owing inter alia to price and non-price competitiveness issues in some sectors –, given also the ECB's and the Fed's signals/decisions on monetary policy easing, as well as the higher interest rate differential, with a potential impact on the leu's exchange rate.

According to subsequent statistical data and assessments, the annual inflation rate stood at 3.9 percent in August, in line with forecasts, thus remaining above the June level and above the variation band of the target. The advance versus end-Q2 was due to both the exogenous CPI components[39] and core inflation, whose annual rate continued to rise, at a relatively milder pace than anticipated, moving up from 3.3 percent in June to 3.4 percent in August. The pick-up reflected the opposite influences from the hike in some international agri-food prices, on one hand, and the cut in some telephony services prices, on the other, overlapping the significant demand-pull and wage cost-push inflationary pressures, as well as the elevated short-term inflation expectations.

In fact, according to the new data, economic expansion witnessed only a modest deceleration in Q2[40], given a minor, below-expectations slowdown in its quarterly pace, likely implying a somewhat stronger-than-forecasted advance in excess aggregate demand in this period. Moreover, the contribution made by private consumption to the economic advance remained significant, although it was marginally exceeded by that of gross fixed capital formation, while the negative contribution of net exports diminished – amid a more pronounced deceleration in the growth rate of imports than in that of exports of goods and services –, but the current account deficit posted a faster deepening against the same period of the previous year, as a result of the worsening of the income balance. At the same time, the labour market remained tight, inter alia amid the ILO unemployment rate touching a new historical low in June, at which it subsequently tended to remain. The annual dynamics of average gross nominal wage earnings, but also of real net

39 Given the hike in tobacco product prices and fuel price evolution, whose impact was only partly counterbalanced by the slower dynamics of administered prices and VFE prices.

40 To 4.4 percent from 5.0 percent in Q1.

wage earnings stuck to two-digit readings in the last months, only mildly slower than in Q1, whereas the two-digit annual rate of change of unit wage costs in industry rose rather noticeably.

The main ROBOR rates remained significantly above the monetary policy rate in August and September, although they continued to decline slightly, while the interest rate on interbank transactions saw a lower negative spread vis-à-vis the policy rate during the period as a whole amid the steady mopping up by the NBR of excess liquidity on the money market through deposit-taking operations. The quarterly average of interbank rates decreased, however, visibly against the previous quarter. In turn, the EUR/RON exchange rate was relatively stable for most of Q3, but witnessed a slight upward correction in mid-September, amid investors' weaker appetite for assets on emerging markets, inter alia as a result of their expectations on the magnitude of monetary policy easing by the Fed and the ECB having been invalidated. Due to the considerable interest rate differential, the adjustment of the EUR/RON was, however, markedly lower than the increase posted by the exchange rates of other currencies in the region.

The growth rate of credit to the private sector stepped up again slightly in the first two months of Q3, while its average annual dynamics[41] returned to the Q1 level, representing a 7-year peak. At the same time, the annual rate of change of the domestic currency component climbed again to double-digit readings, strongly supported by new consumer credit, whose volume reached a historical peak; the foreign currency component recorded faster dynamics, on account of loans to non-financial corporations, so that the share of leu-denominated loans in total private sector credit increased only marginally, to 66.7 percent in August. The annual growth rate of broad money decelerated slightly July through August versus the Q2 level, probably due to the moderation of the budget execution easing and to the increase in leu-denominated government security holdings of non-bank entities.

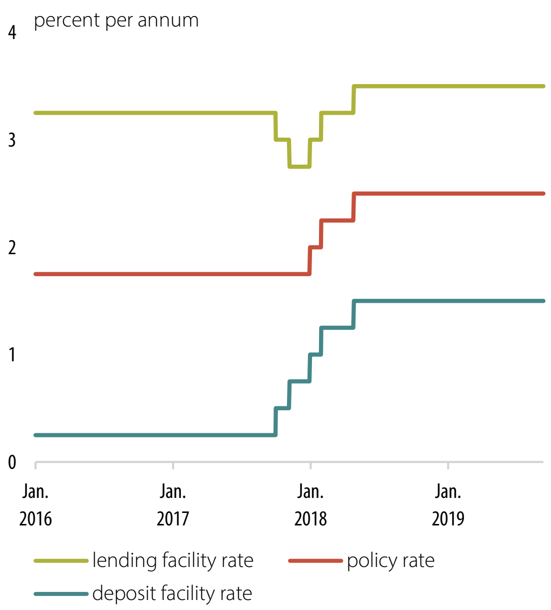
The short-term projection updated in this context reconfirmed the prospects for the annual inflation rate to remain above the variation band of the target until the year-end, on a trajectory slightly below that in the medium-term forecast published in the August 2019 *Inflation Report*, as the action of supply-side factors was anticipated to continue to be slightly disinflationary September through October, before becoming moderately inflationary again in the closing two months of the year. Inflationary pressures from fundamentals were seen as further significant in the near run, only slightly weaker than forecasted in August in the case of those stemming from the cyclical position of the economy, given that economic growth was anticipated to decelerate relatively more visibly in H2, owing primarily to a more modest performance of agriculture, implying a standstill of the positive output gap in this period at the high value recorded in Q2 and slightly below the previously-forecasted levels.

The uncertainties and risks to the latest inflation forecast continued, however, to grow; on the domestic front, they were generated primarily by the future fiscal and

[41] 8 percent from 7.5 percent in Q2.

income policy stance, inter alia amid the 2019-2020 election calendar, given the characteristics of budget execution in the first eight months of the year, as well as the potential impact of the new pension law, which would render necessary, but also unavoidable, a fiscal correction in the future, with a view to bringing the budget deficit back within the ceiling set under the Stability and Growth Pact.

Chart 3.1. NBR rates



Heightened uncertainties and risks, also to the economy's external position, were exerted by the external environment as well – both by means of foreign trade, confidence and foreign direct investment and through the leu's exchange rate –, amid the increased risks to the euro area and global economies posed by the trade war and Brexit, but also the easing of the major central banks' monetary policy stances.

Against this background, tailoring monetary conditions with a view to anchoring medium-term inflation expectations and bringing the annual inflation rate back into line with the inflation target, while safeguarding financial stability, warranted the policy rate status-quo and the maintenance of strict control over money market liquidity. Therefore, in its meeting of 3 October 2019, the NBR Board kept unchanged the monetary policy rate at 2.50 percent, the deposit facility rate at 1.50 percent and the lending facility rate at 3.50 percent, while preserving strict control over money market liquidity (Chart 3.1). In addition, the central bank kept in place the current levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

2. Financial markets and monetary developments

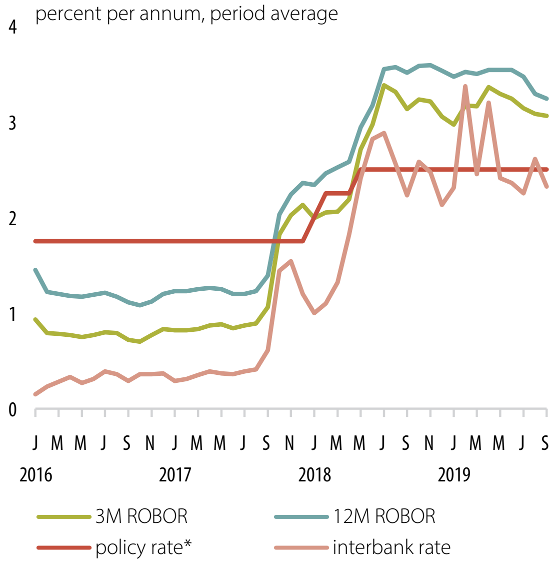
Longer-term interbank money market rates declined slightly in Q3 overall, albeit remaining significantly above the monetary policy rate, while the average interest rate on interbank transactions[42] fell visibly against the Q2 level, affected by the higher values prevailing in April. The EUR/RON exchange rate remained quasi-stable in the first months of Q3, before witnessing a slight upward correction in the latter part of September. The annual growth rate of credit to the private sector regained some momentum in the first two months of Q3, its average thus returning to the Q1 level, representing a 7-year peak, whereas the positive dynamics of liquidity across the economy stuck to the slight downtrend.

[42] The average interest rate on transactions in deposits on the interbank money market (excluding the NBR), weighted by the volume of transactions.

2.1. Interest rates

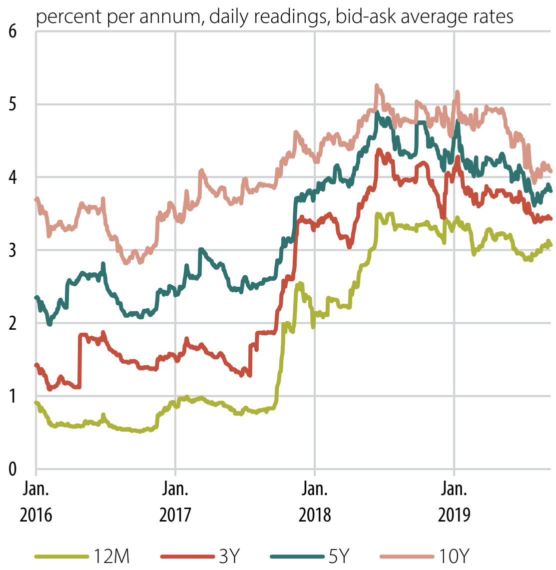
The daily average interbank money market rate saw its fluctuations subside in Q3, its monthly averages remaining in the vicinity of the monetary policy rate, amid the central bank's strict control over liquidity (Chart 3.2). Its quarterly average fell, however, to 2.40 percent, 0.28 percentage points lower than in the previous period, as the Q2 level was affected by this indicator rising and staying in April close to the lending facility rate.

Chart 3.2. Policy rate and ROBOR rates



*) end of period

Chart 3.3. Reference rates on the secondary market for government securities



The net liquidity surplus in the banking system expanded considerably in Q3, as a result of the significant increase in Treasury's injections of reserves at the beginning of the period[43]. The central bank mopped up most of this surplus through 1W deposit-taking operations conducted via fixed-rate tenders with full allotment[44], credit institutions' resort to the deposit facility remaining, however, relevant. Against this backdrop, the daily average interbank money market rate saw both the frequency and the magnitude of its fluctuations around the policy rate – especially the upward ones – abate.

3M-12M ROBOR rates re-embarked on a downward trend in July and continued afterwards to diminish slowly, with their positive spread vis-à-vis the monetary policy rate narrowing slightly, inter alia amid credit institutions' expectations on the consolidation, at least in the short run, of the reserve surplus, but also on the central bank's further strict control over liquidity. Under the circumstances, the quarterly averages of these rates shed around 0.20 percentage points against those in Q2, to 3.09 percent for the 3M rate and to 3.20 percent and 3.33 percent for 6M and 12M rates respectively, hitting five-quarter lows across the entire maturity spectrum.

On the government securities market, the evolutions reflected mainly influences from the external environment, amid expectations on the easing of the monetary policy stance by the ECB and the Fed[45], but also the concerns about the

43 Also in the context of government bonds worth lei 8.9 billion maturing on 24 June.

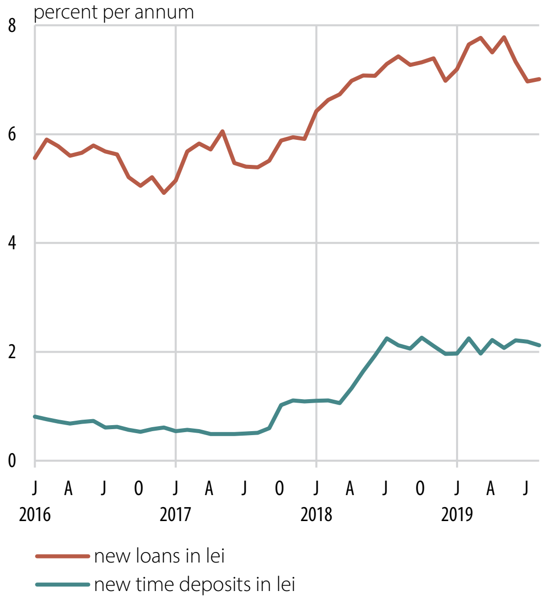
44 The average balance of these operations increased to lei 9.7 billion in July (from an average of lei 2.2 billion May through June), but declined to lei 4.6 billion in the following two months and to lei 5.4 billion in September respectively.

45 Given the heightened risks to the global growth outlook induced by the US-China trade row.

trade row and Brexit, conducive to a weakening of investors' appetite for assets on financial markets in the region during the closing month of the quarter under review. Hence, reference rates on the secondary market stuck to a generally downward path until the end of the second 10-day period of August, with a steeper slope for long-maturity rates, whose levels thus touched lows for the past almost two years (Chart 3.3). Afterwards, they witnessed a partial upward correction, in tandem with similar rates in the region, but possibly also under the influence of domestic political developments, likely to affect the risk perception vis-à-vis the local market. Against this background, the September averages of these rates declined against those in June across the board, standing at 3.79 percent (down 0.28 percentage points) and 4.12 percent (down 0.44 percentage points) for 5-year and 10-year securities respectively and at 2.87 percent (down 0.10 percentage points) and 3.05 percent (down 0.08 percentage points) for the 6- and 12-month maturities respectively. Thus, the positive slope of the yield curve moderated significantly.

On the primary market as well, the average accepted rates remained on a downward path in July[46] (shedding up to 0.2 percentage points for 15-year securities), which steepened in August (up to 0.59 percentage points for the same maturity). This occurred inter alia in a context in which the amounts of bids submitted continued to be more than double the announced volume during this period, while the volume of issues no longer visibly exceeded the announced volume. In September, however, the average accepted rates advanced across the entire maturity spectrum (by up to 0.16 percentage points). The weakening of investor appetite for government securities was also reflected by the decline in the ratio of the amounts of bids submitted to the announced volume to 1.3, even amid the significant drop in the volume of securities issued (to 68 percent of the announced volume)[47]. Nevertheless, the average accepted rates remained lower than those recorded at the end of the previous quarter, at 4.11 percent for 10-year securities (down 0.65 percentage points versus June), 4.06 percent for 7-year securities (down 0.19 percentage points from June) and 3.91 percent in the case of the 5-year maturity (down 0.38 percentage points against June). Moreover, the MPF kept the supply of government securities relatively constant during the quarter under review, at lei 12.3 billion overall (lei 4.2 billion in July[48] and lei 4 billion in August and September respectively), compared to lei 12.1 billion in Q2.

Chart 3.4. Bank rates



[46] The only exception were the 7-year bonds, with the rate adding 0.11 percentage points, to 4.35 percent, in July.

[47] During the reported quarter overall, the ratio of the amounts of bids submitted to the announced volume was slightly lower than in the previous quarter (2.0 versus 2.1), while the ratio of the volume of issues to the announced volume fell to 93 percent from 124 percent in Q2. At the same time, the average maturity of government securities issued remained relatively unchanged (5.7 years against 5.8 years in the prior quarter).

[48] In July, the MPF issued on the external market Eurobonds with maturities of 12 years (EUR 1,400 million, 2.1 percent rate) and 30 years respectively (EUR 600 million, 3.4 percent rate).

The average interest rate on non-bank clients' new loans witnessed a decline in July, for the third consecutive month, and rose only marginally in August (to 7.01 percent), with its average for the two months thus diminishing markedly versus that in Q2 (down 0.55 percentage points). Conversely, the interest rate on new time deposits fell only slightly in both months (to 2.12 percent in August), its average posting a quasi-standstill (Chart 3.4). Looking at the two customer sectors, rates moved further in the same direction only in the case of new loans. Specifically, the average lending rate on new business to households shrank in July for the fourth successive month and edged up marginally in August (to 8.09 percent), its average for the two months declining significantly, by 0.45 percentage points, versus that in Q2. Behind the decline stood the steep decrease during the two months overall in the interest rate on consumer credit, ascribable at least partly – as the IRCC level rose sizeably in Q3 – to the large volumes of short-term secured loans to farmers in this period; by contrast, the average interest rate on new housing loans went up in both months. The average lending rate on new business to non-financial corporations fell both in July and in August (to 5.58 percent, shedding 0.55 percentage points during the two months overall). This was attributable to both major types of loans – below and above EUR 1 million equivalent respectively –, with the former posting a more visible decline, partly explainable in this case as well by the larger volume of secured loans in the agricultural sector. The average remuneration of new time deposits from households witnessed a somewhat sturdier advance in July, after the relative immobility in the previous nine months, but stayed put at 1.90 percent in August, its average adding 0.21 percentage points against Q2. By contrast, the average interest rate on new time deposits from non-financial corporations edged down in both months (to 2.22 percent in August), standing 0.09 percentage points lower on average.

Chart 3.5. Nominal exchange rate

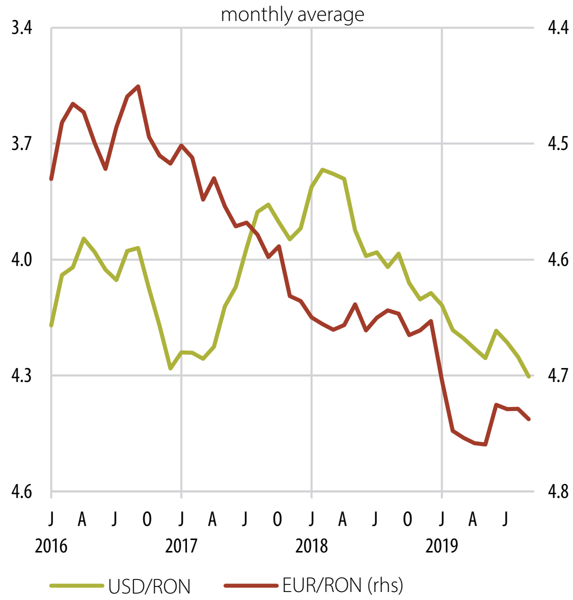


Table 3.1. Key financial account items

EUR million

	8 mos. 2018			8 mos. 2019		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	1,895	5,353	-3,458	4,407	8,640	-4,233
Direct investment	852	4,114	-3,262	360	3,954	-3,594
Portfolio investments	147	1,465	-1,318	1,330	4,648	-3,318
Financial derivatives	x	x	84	x	x	-24
Other investment	3,445	-225	3,670	477	38	440
– currency and deposits	2,446	-610	3,055	-565	-641	76
– loans	-72	-1,381	1,309	-137	-850	713
– other	1,071	1,766	-694	1,179	1,529	-349
NBR's reserve assets, net	-2,633	0	-2,633	2,263	0	2,263

*) "+" increase/"-" decrease

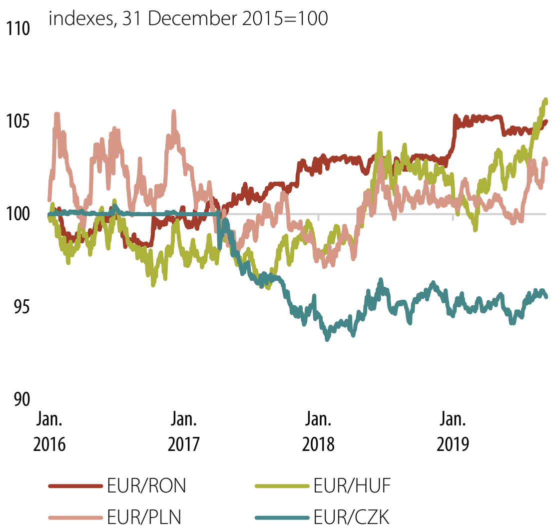
2.2. Exchange rate and capital flows

In the first months of 2019 Q3, the EUR/RON exchange rate remained quasi-stable, before posting, in the second part of September, an upward correction that was, nonetheless, significantly lower than the hikes witnessed by the exchange rates of the main currencies in the region (Chart 3.5).

The EUR/RON stuck in July to the lower readings recorded in the early days of June, but saw slightly larger fluctuations, in an environment of changes in investors' appetite for investing in financial markets across the region, generated by the uncertainties/signals of different intensity coming from the ECB and the Fed about the prospective easing of the monetary policy stance, which also entailed a relatively steep downward path of the EUR/USD exchange rate. However, the EUR/RON also reflected the effects of some seasonal domestic factors, conducive to an increase in the supply of foreign currency on the interbank forex market in this period.

Amid the higher differential of the local interest rate, the EUR/RON subsequently remained relatively stable, even in the context of the rise in global risk aversion and in international financial market volatility in August, primarily due to the re-escalating trade war between the US and China[49] and to the increased risk of a no-deal Brexit (Table 3.1). External influences were more obvious in the case of the exchange rates of the main currencies in the region, which saw the upward path they had embarked on in the second part of July steepen/persist, while also reflecting the impact of some local factors[50] (Chart 3.6). However, the leu saw its depreciation against the US dollar widen, given that the EUR/USD witnessed a renewed significant monthly decline, albeit on a fluctuating path, mirroring the ongoing trade row between the US and China and the relatively divergent nature of US[51] and euro area[52] economic data published in this period.

Chart 3.6. Exchange rate developments on emerging markets in the region



Source: ECB, NBR

The EUR/RON exchange rate saw minor fluctuations also in the period immediately preceding the ECB's and Fed's monetary policy decisions in September, before posting a rise in the second part of the month and stabilising thereafter at those higher readings, amid increased investor fears related to the trade row between the US and China and to Brexit, and hence to the euro area[53] and global economic growth outlook, as well as following

49 On 1 August, the US authorities announced 10 percent tariffs starting with 1 September 2019 on USD 300 billion worth of Chinese imports not already covered by earlier rounds of tariffs), only to decide on 13 August to postpone until 15 December 2019 the entry into effect of this measure for some of these imports (amounting to USD 155 billion). On 23 August, the Chinese authorities announced that they would introduce 5-10 percent tariffs on certain US-origin goods worth USD 75 billion (as of 1 September and 15 December respectively) and re-impose the 25 percent duty on cars and parts originating in the US as of 1 December.

50 Looking at the Polish zloty, its depreciation versus the euro was also fuelled by investors' concerns about the implications for the banking sector/financial market of the impending ruling of the Court of Justice of the European Union on potentially unfair terms in contracts for CHF-denominated mortgage loans.

51 In July, retail sales in the US witnessed a new faster-than-expected increase (by 0.7 percent month-on-month) and the annual core inflation rate went up further (reaching 2.2 percent).

52 Although improving slightly in August, the euro area PMI for manufacturing pointed to a further decline in this sector's activity; however, the similar index for services inched up, remaining in the growth zone. At the same time, euro area economic growth slowed down considerably in 2019 Q2 (0.2 percent in quarterly terms), given that the German economy contracted by 0.1 percent in quarterly terms.

53 Given also the expectations on Germany entering a recession in 2019 Q3, the euro area PMI dropping well below expectations in September and, especially, the decline in the PMI for services, conducive to increased concerns about the weakness of activity passing through to this sector as well.

revised market expectations on the further easing potential of the ECB's and Fed's monetary policy stances[54]. Against this background, the EUR/USD declined at a faster pace, reaching at end-September a post-May 2017 low[55].

The interbank forex market saw further decrease in net demand for foreign currency for the second consecutive quarter, solely due to residents' transactions, whose balance became strongly positive in this period.

During 2019 Q3[56], the leu depreciated against the euro by 0.3 percent in both nominal[57] and real terms; in relation to the US dollar, the domestic currency weakened in the same period by 2.8 percent in both nominal and real terms, given that the US currency continued to strengthen against the euro. Looking at the average annual exchange rate dynamics, the leu saw its nominal depreciation diminish slightly in 2019 Q3, against both the euro and the US dollar.

2.3. Money and credit

Money

Broad money annual dynamics[58] continued to decline slightly in July-August (8.6 percent average in the period as a whole[59] versus 8.9 percent in the previous three months; Table 3.2)[60], amid a relative recovery in the first month of the quarter, followed by a near standstill. During the period, the slowdown in M3 dynamics was associated with the decline in the growth rate of certain government spending categories[61], as well as with the increase in non-bank entities' holdings of leu-denominated government securities.

Table 3.2. Annual growth rates of M3 and its components

nominal percentage change

	2018		2019			
	III	IV	I	II	Jul.	Aug.
	quarterly average growth					
M3	10.7	9.7	9.3	8.9	8.6	8.5
M1	11.8	11.7	11.8	13.5	12.6	12.8
Currency in circulation	9.3	8.0	9.7	10.4	9.5	9.7
Overnight deposits	12.9	13.3	12.7	14.8	14.0	14.1
Time deposits (maturity of up to two years)	9.1	6.8	5.7	2.3	2.5	2.0

The two main broad money components were again characterised by different behaviours in terms of the evolution of annual dynamics. Specifically, narrow money further posted a two-digit pace of increase, given that the slight decline in the rate of change of currency in circulation was mostly offset by the renewed pick-up in

54 In the statement on the monetary policy decision of 12 September, the ECB showed that the deterioration of economic prospects called for action from the fiscal policies of euro area countries that had fiscal space. As for the Fed, the votes in the FOMC meeting of 18-19 September seemed more divided, while the new forecasts on inflation and economic growth, only slightly revised from the previous round, suggested that some members considered the US economy resuming growth in the period ahead as the baseline scenario.

55 USD 1.0889 per euro on 30 September.

56 Versus the previous quarter, based on the September and June averages of the exchange rate.

57 The Czech koruna, Polish zloty and Hungarian forint witnessed sharper depreciations in this period, i.e. 1.0 percent, 2.1 percent and 3.0 percent respectively.

58 Unless otherwise indicated, percentage changes in this section refer to the average of annual growth rates in nominal terms.

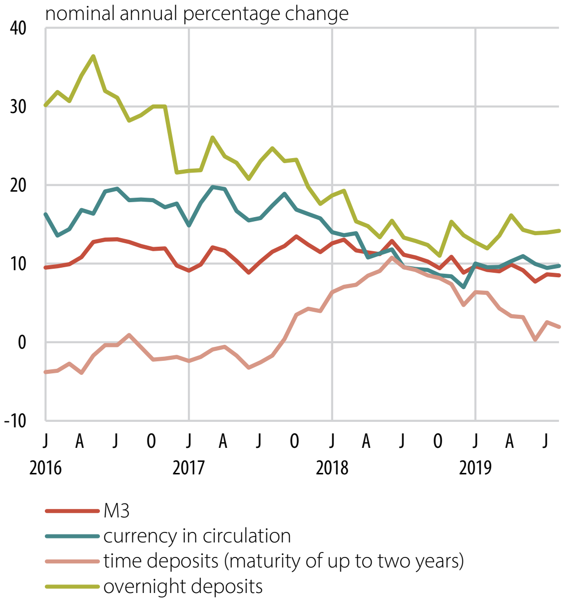
59 A 16-quarter low. A similar level was also recorded in 2015 Q4.

60 In real terms as well, the average annual M3 dynamics remained on a downward trend, reaching 4.4 percent in the first two months of 2019 Q3, from 4.7 percent in April-June.

61 Such as compensation of employees and social security spending (according to the general government budget execution).

the dynamics of corporate overnight deposits (Chart 3.7). By contrast, the growth rate of time deposits with a maturity of up to two years remained on a downward path (to an eight-quarter low), as the influence of the new loss of momentum in the rate of change of household deposits – attributable this time mainly to the further slower growth of the foreign currency component – more than offset the impact of the slight rebound in the dynamics of non-financial corporations' deposits. Therefore, time deposits with a maturity of up to two years were the driving factor behind the pattern of broad money dynamics this time. In this context, the share of M1 in M3 continued to widen, reaching 63.2 percent in August – a new post-November 1994 high.

Chart 3.7. Main broad money components



The M3 breakdown by holder shows a slight deceleration in the growth rate of households' total M3 deposits. This was most likely correlated with the robust dynamics of private consumption – suggested by the evolution of the turnover in retail trade, especially on the motor vehicles and motorcycles segment –, as well as with the somewhat slower annual rate of increase of wage earnings. By contrast, the advance in similar deposits from non-financial corporations saw a renewed step-up, inter alia amid the upward correction witnessed in July, ascribable mainly to the earlier dividend payments made by some state-owned companies to the general government budget in the previous month, but also to a base effect[62].

From the perspective of M3 counterparts, the evolution of its average annual change reflected the dynamics of central government deposits re-entering positive territory and, to a lesser extent, the renewed pick-up in the rate of change of long-term financial liabilities[63]. Smaller-scale expansionary effects stemmed from the re-acceleration of the advance of private sector credit and banks' holdings of government securities, as well as from the further uptrend in the dynamics of net foreign assets of the banking system[64].

Credit to the private sector

The annual growth rate of credit to the private sector picked up slightly again in the first two months of 2019 Q3[65] (to an average of 8 percent – a seven-year high[66] – from 7.5 percent in the previous quarter; Chart 3.8). This hike was driven both by the leu-denominated component – whose rate of change again reached double-digit

62 June 2018 saw the earlier payment of amounts representing part of the expenses on the July pensions, distributed via the Romanian Post National Company.

63 Capital accounts included.

64 Also given that, in July, the MPF issued bonds worth EUR 2 billion on the external market.

65 In real terms as well, the average rate of change of credit to the private sector picked up again (3.8 percent, from 3.3 percent in April-June 2019).

66 A similar level was also recorded in 2019 Q1.

Chart 3.8. Credit to the private sector by currency

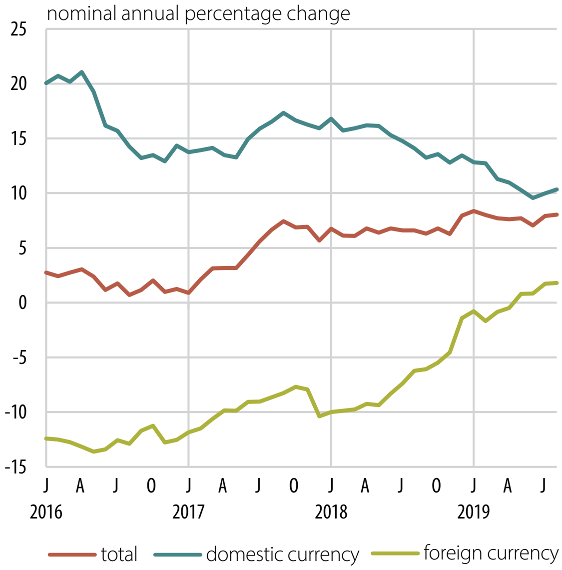
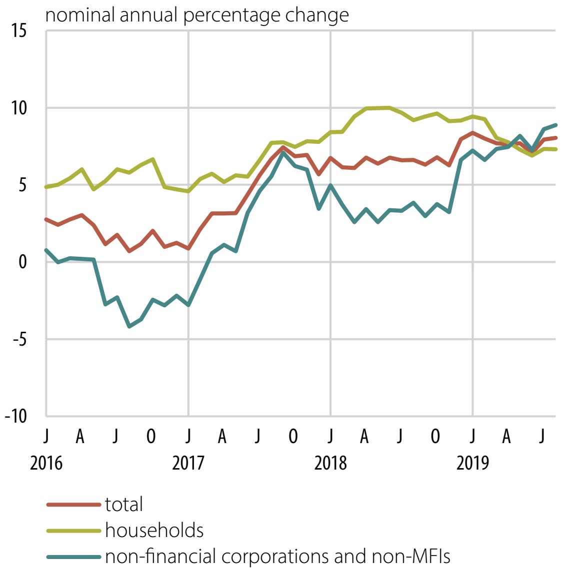


Chart 3.9. Credit to the private sector by institutional sector



levels[67], amid the rise in the volume of new loans to a historical high[68] in July – and by the foreign currency component, whose dynamics[69] further increased on the back of new loans to non-financial corporations. The share of domestic currency loans in total private sector credit further widened, reaching 66.7 percent in August, i.e. a post-June 1996 high.

The breakdown by institutional sector shows that the advance in credit to the private sector was driven by loans to non-financial corporations, whose pace of increase reached an almost seven-year high[70] – marginally exceeding, for the first time in six years, that of household loans – with a major contribution from foreign currency funding, especially long-term. The leu-denominated component also increased at a slightly faster annual rate, under the influence of the considerably higher volume of new business, also on the back of short-term loans to the agricultural sector[71], yet partly counterbalanced by the impact of a slowdown in the growth rate of overdraft loans.

In turn, the growth rate of household loans halted its decline and remained somewhat high (Chart 3.9). Considering the relatively steady negative dynamics of foreign currency loans (expressed in euro), this was driven by the evolution of leu-denominated loans. Their dynamics stuck comfortably to double-digit levels, given that the growth rate of consumer credit and other loans re-accelerated, amid the increase in the volume of new loans to a historical high in July[72]. Loans for house purchase further witnessed a slightly decelerating rate of change, even though new loans saw a renewed step-up versus the same year-ago period, on the back of loans granted without state guarantee[73], this evolution being thus attributable to higher repayments.

67 After having fallen slightly below 10 percent in June.

68 The data on new loans were taken from the Report on interest rates, net of renegotiations.

69 Determined based on EUR-denominated values.

70 Quarterly data.

71 According to CCR data, the volume of new loans to the agricultural sector rose significantly in July, probably also due to the beneficiaries of the payment schemes implemented by the Agency for Payments and Interventions in Agriculture under the 2019 Campaign accessing loans in order to finance current activities.

72 Partly ascribable to the high volume of short-term secured loans to farmers.

73 According to CCR data.

4. Inflation outlook

The current projection shows the annual CPI inflation rate to reach 3.8 percent at end-2019, 3.1 percent at end-2020 and 3.2 percent at the projection horizon, i.e. 2021 Q3. Compared to the previous *Inflation Report,* the projected values were revised downwards by 0.4 percentage points for end-2019 and by 0.3 percentage points for December 2020. The drivers behind the inflation rate standing at levels above the upper bound of the variation band of the target at the end of the current year are the persistence of inflationary pressures associated with aggregate demand and the unfavourable developments in the first part of the year entailed by supply-side shocks. Starting 2020 Q1, inflation rate will return to the upper half of the variation band of the target, remaining therein until the projection horizon. This evolution will be ascribable mainly to the fading out of the inflationary impact associated with the exogenous components of the consumer basket and, to a lower extent, to the adjusted CORE2 index. Annual core inflation rate is anticipated to come in at 3.4 percent at end-2019; subsequently, in the context of some favourable base effects associated with the upward movement in the component seen in the first part of the current year, it will decrease through mid-2020 down to 2.8 percent. For the remainder of the projection interval, the indicator is forecasted to follow an upward trend to reach 3.4 percent at the projection horizon, especially amid the persistence and even step-up in inflationary pressures from the domestic environment, associated mainly with excess demand. In turn, medium-term inflation expectations will remain high, anchored in the upper half of the variation band of the target. Similarly to the previous forecasting round, the balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to the path in the baseline scenario, on account of domestic factors, the external ones generating a net disinflationary impact.

1. Baseline scenario

1.1. External assumptions[74]

External demand, assessed based on the effective EU GDP (EU-28 excluding Romania), is seen decelerating further, its average annual growth rates being expected to stand at 1.5 percent in 2019 and 1.4 percent in 2020 (Table 4.1), i.e. below the levels recorded in the last five years. Compared to the previous *Inflation Report*, the path

[74] Source: NBR assumptions based on data provided by the European Commission, ECB, Consensus Economics and Bloomberg (futures prices).

of this indicator was revised downwards, reflecting mainly the persistent effects of the contraction in manufacturing amid an international environment saddled with major uncertainties (a potentially sharper slowdown in China's economic growth, the ambiguity concerning the completion and consequences of Brexit, increased trade protectionism, running the risk of an additional rise). However, in the medium run, the adverse effects stemming from these sources are foreseen to gradually fade out, allowing for the fundamentals to spur economic activity, yet at slower paces than in the previous years. Thus, external demand is supported by the ECB's persistently accommodative monetary policy, the strong private consumption and business investment. The effective EU GDP gap, an indicator reflecting the cyclical component of economic activity of Romania's main trading partners, is seen posting positive values, with a stimulative impact on the domestic economy, albeit of a lower magnitude than in the previous *Report*.

Table 4.1. Expectations on the developments in external variables

annual averages

	2019	2020
Effective EU economic growth (%)	1.5	1.4
Annual inflation rate in the euro area (%)	1.2	1.3
Annual inflation rate in the euro area, excluding energy (%)	1.2	1.4
Annual CPI inflation rate in the USA (%)	1.8	2.1
3M EURIBOR (% per annum)	-0.4	-0.6
USD/EUR exchange rate	1.12	1.12
Brent Oil price (USD/barrel)	63.2	56.8

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

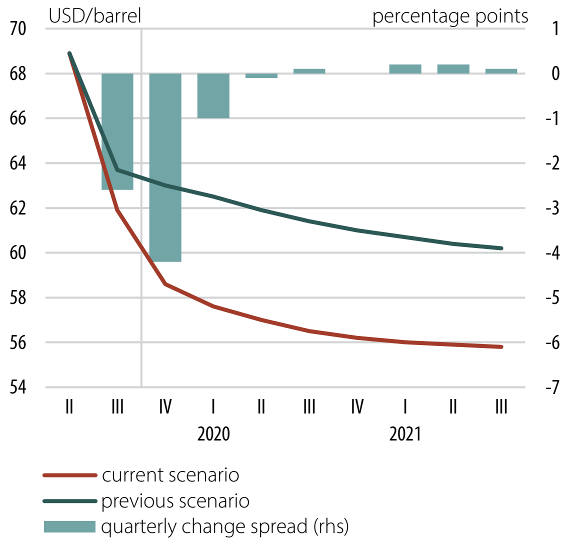
Especially under the influence of slower dynamics of energy prices, the average annual HICP inflation rate in the euro area was revised marginally downwards throughout the forecast interval, being anticipated to follow a slight uptrend, yet remaining below the 2 percent benchmark. The average annual HICP inflation rate excluding energy in the euro area – the relevant measure for shaping the path of prices of imported goods – will follow a moderately upward path over the projection interval, from 1.2 percent in 2019 to 1.4 percent in 2020. The level for the next year was revised marginally downwards compared to the previous *Report*, amid the slowing economic activity in the euro area. The average annual inflation rate in the USA is foreseen to run higher than in the euro area in both years, and exceed the 2 percent level in 2020.

Against the background of the ECB's persistently accommodative monetary policy, which was enhanced by the institution's recent decisions[75], the nominal 3M EURIBOR rate is anticipated to go deeper into negative territory over the projection interval.

The EUR/USD exchange rate forecast shows a slight strengthening of the euro throughout the forecast interval, reaching USD 1.15 per euro at the projection horizon, compared to USD 1.11 per euro in 2019 Q3. The parity of the two currencies is, however, marked by a high level of uncertainty, also depending on the monetary policies in these two economic areas.

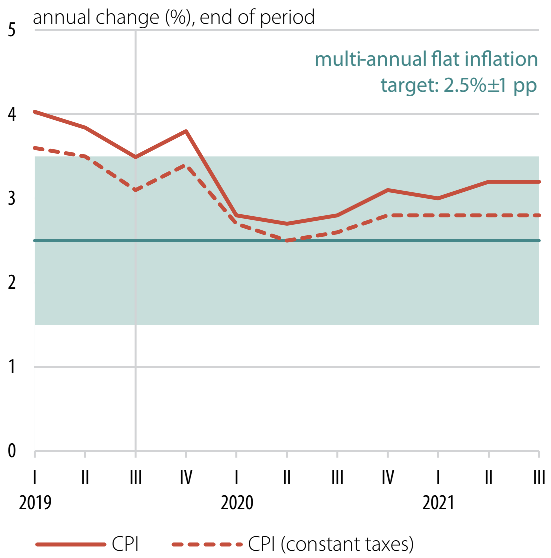
75 In the meeting of 12 September 2019, the ECB's Governing Council decided to cut the interest rate on the deposit facility by 10 basis points (to -0.5 percent), to leave unchanged the interest rates on the main refinancing operations and on the lending facility and restart net purchases under its asset purchase programme (APP) at a monthly pace of EUR 20 billion as from 1 November 2019. The Governing Council expects the programme to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates. Subsequently, in the meeting of 24 October, these policies were reiterated.

Chart 4.1. International Brent oil price scenario



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

Chart 4.2. Inflation forecast



Source: NIS, NBR projection

The scenario for the developments in the Brent oil price, based on futures prices, foresees a further downtrend over the forecast interval to USD 56 per barrel at the projection horizon from USD 62 per barrel in 2019 Q3 (Chart 4.1). Nonetheless, the evolution is marked by high uncertainty, as mirrored also by the revised trajectories of futures prices in the successive projection rounds. The future dynamics of the oil price are conditional on both supply-side factors, carrying mainly an inflationary potential, and demand-side factors, with a net disinflationary impact amid the prospects of a weakening economic activity worldwide.

1.2. Inflation outlook

The annual CPI inflation rate is foreseen to reach 3.8 percent at end-2019, a value outside the variation band of the target. This positioning is driven by persistent inflationary pressures associated with domestic aggregate demand, along with unfavourable supply-side shocks in the first months of the year (the sharp rise in pork meat prices[76], the increase in prices for tobacco products and some telecommunications services, and the hike in vegetable prices, which was only partly offset by the favourable developments in the latter part of 2019[77]). Starting 2020 Q1, inflation rate will return inside the variation band of the target, standing however in the upper half thereof until the forecast horizon (Chart 4.2). The projected values for end-2020 and 2021 Q3 are 3.1 percent and 3.2 percent respectively (Table 4.2).

The annual inflation rate at constant taxes is lower than headline inflation over the entire projection interval, with the contribution of indirect tax changes[78] being estimated at 0.4 percentage points at end-2019, 0.3 percentage points at end-2020 and 0.4 percentage points at the projection horizon. The average annual CPI inflation rate, a more persistent indicator, is anticipated to fall steadily

76 The domestic and global developments in the African swine fever epidemic suggest that this segment will remain a source of upward pressure on CPI inflation.

77 This year's bumper crop across Europe prompted a significant correction in the group's annual growth rate, from 24.6 percent in June to 8.8 percent in September. Yet the latter remained high, significantly above the upper bound of the variation band of the target, owing to the previous price rises amid the poor crop of 2018.

78 Largely the hikes in excise duties on tobacco products and fuels.

Table 4.2. The annual inflation rate in the baseline scenario

annual change(%); end of period

	2019	2020				2021		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	3.8	2.8	2.7	2.8	3.1	3.0	3.2	3.2
CPI projection*	3.4	2.7	2.5	2.6	2.8	2.8	2.8	2.8

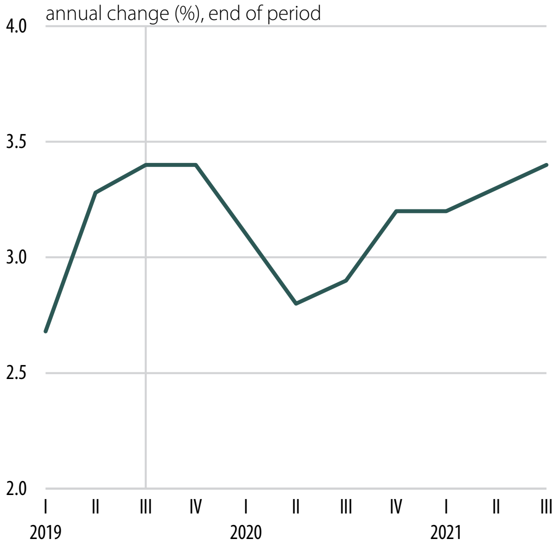
*) calculated at constant taxes

Table 4.3. Annual adjusted CORE2 inflation rate in the baseline scenario

annual change (%); end of period

	2019	2020				2021		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Adjusted CORE2	3.4	3.1	2.8	2.9	3.2	3.2	3.3	3.4

Chart 4.3. Annual adjusted CORE2 inflation



Source: NIS, NBR projection

until end-2020 to 2.8 percent, before reversing its trend to reach 3.1 percent in 2021 Q3.

Compared to the August 2019 *Inflation Report*, the annual CPI inflation rate is projected to follow a lower trajectory, the values for end-2019 and end-2020 being revised downwards by 0.4 percentage points and 0.3 percentage points respectively. For 2019, the downward revisions of projections for core inflation and the dynamics of volatile food prices were only partly offset by those in the opposite direction regarding the dynamics of administered prices and fuel prices. For 2020, the reassessment owes exclusively to the adjusted CORE2 inflation rate.

Following the brisk increase in 2019 H1, against the background of hikes in prices for some telecommunication services and pork meat, the annual adjusted CORE2 inflation rate stabilised in 2019 Q3 at 3.4 percent and is forecasted to remain unchanged until year-end. Amid favourable base effects associated with this component's upward trajectory in the first part of 2019, the indicator is foreseen to decline to 2.8 percent at mid-2020. Subsequently, in the context of persistent pressures from fundamentals, the annual core inflation rate will re-embark on an upward path, being set to reach 3.4 percent in 2021 Q3 (Table 4.3, Chart 4.3).

This will be the result mainly of domestic inflationary pressures associated with excess demand and inflation expectations. The latter are seen remaining above the variation band of the central target until the end of 2019, before returning inside the band, yet standing in its upper half over the medium term. The gradual decline in inflation expectations is expected to be offset in the latter half of the projection interval by pressures from increased aggregate demand (output gap), and by the mild intensification of those from import prices, amid the gradually rising external inflation.

Compared to the August 2019 *Inflation Report*, the annual adjusted CORE2 inflation rate was revised downwards by 0.5 percentage points and 0.4 percentage points for the end of 2019 and 2020, respectively. The revision owes largely to the weaker short-term inflationary pressures on the food segment, having implicitly an impact on the starting values of the projection, as well as on the second-round effects associated with these pressures.

Table 4.4. Components' contribution to annual inflation rate*

percentage points

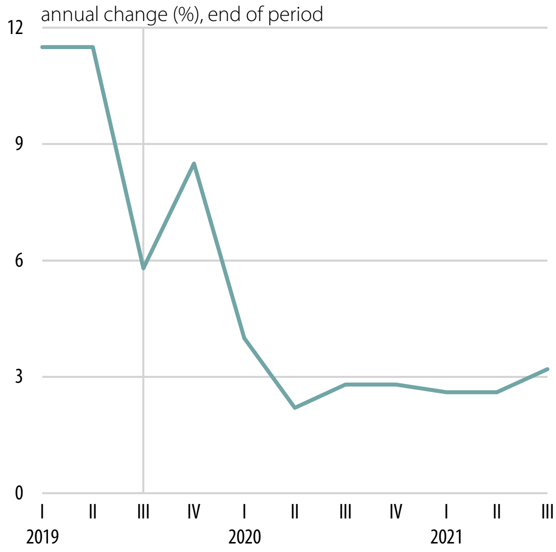
	2019	2020
Administered prices	0.2	0.4
Fuels	0.4	0.2
VFE prices	0.5	0.2
Adjusted CORE2	2.1	2.0
Tobacco and alcoholic beverages	0.5	0.3

*) end of period; values have been rounded off to one decimal place

The cumulative contribution of inflation components beyond the scope of monetary policy, namely administered prices, volatile food prices, fuel prices, tobacco product and alcohol beverage prices, to the annual CPI inflation rate is seen at 1.7 percentage points at end-2019 (a level close to those recorded in the last two years) and 1.1 percentage points at the end of next year, values relatively similar to those projected in the previous round (Table 4.4).

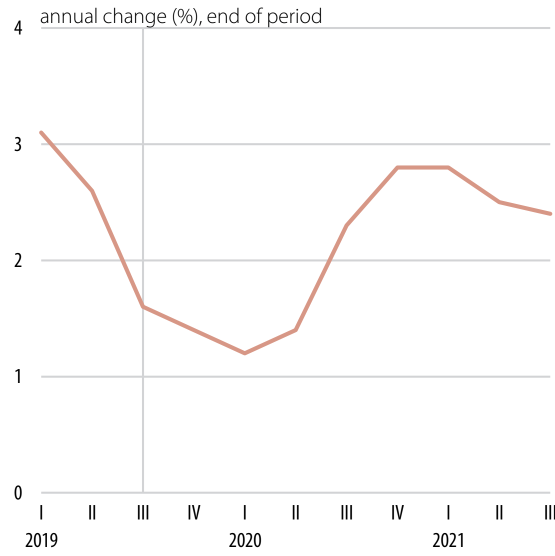
Volatile food (VFE) prices are anticipated to go up by 8.5 percent at the end of 2019, 2.8 percent at the end of 2020, and 3.2 percent at the projection horizon (Chart 4.4). For this year, the forecast of their growth rate is adjusted downwards by 2.9 percentage points, mainly due to the fall in vegetable prices, amid bumper crops recorded both domestically and by the main European trading partners. For 2020 and 2021, their projection is shaped by the assumption of harvests falling close to the average multi-annual agricultural output (the hypothesis of normal agricultural years). In this context, once the effects of the 2019 price revision for this group of products have faded out, the projected value of their annual dynamics for the end of 2020 is revised downwards by merely 0.1 percentage points compared to the previous *Inflation Report*.

Chart 4.4. VFE prices annual inflation



Source: NIS, NBR projection

Chart 4.5. Administered prices annual inflation

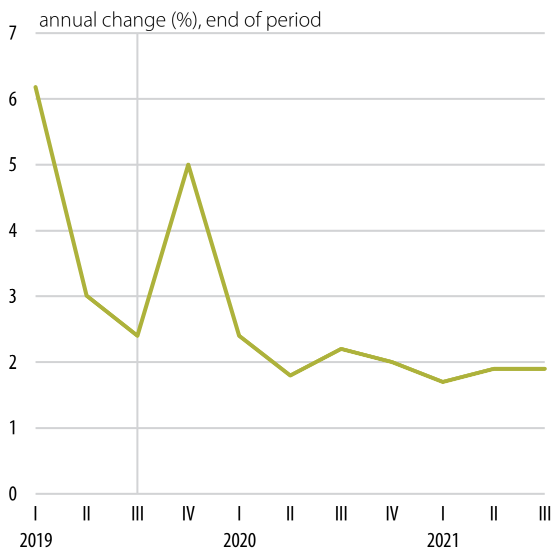


Source: NIS, NBR projection

According to the exogenous scenario for administered prices, their growth rate is foreseen at 1.4 percent, 2.8 percent and 2.4 percent at end-2019, end-2020 and at the forecast horizon respectively (Chart 4.5). Compared to the previous *Inflation Report*, the projection for the end of this year was subject to a 0.4 percentage point upward revision, largely on the back of the recent developments on the water, sewerage and waste disposal segment. For the end of next year, the projected level for administered prices is similar to that envisaged in the previous round, in the absence of new relevant information.

The annual dynamics of fuel prices are forecasted to reach 5 percent at end-2019, 2 percent at end-2020, and 1.9 percent at the projection horizon (Chart 4.6). Compared to the August 2019 *Inflation Report*, the projection was subject to marginal revisions, i.e. up by 0.3 percentage points for December 2019 and down by 0.1 percentage points for December 2020 respectively. The group's inflation path is influenced by the annual dynamics of oil price standing in negative territory over the entire forecast interval (yet saddled with great uncertainties) and by the forecast of a rising euro against the US dollar, impacting the USD/RON exchange rate and, in turn, the leu-denominated fuel prices. To these factors add the weaker inflation expectations starting in the first part of 2020.

Chart 4.6. Fuel prices annual inflation



Source: NIS, NBR projection

The trajectory of the annual inflation rate projected for tobacco products and alcoholic beverages is shaped by the pieces of legislation setting the levels of excise duties on such goods, being influenced by the recent lei 0.50 increase in the price of cigarettes. Their annual price dynamics are envisaged at 6.7 percent, 4.1 percent and 4.8 percent at end-2019, end-2020, and at the projection horizon, respectively. Compared to the prior *Inflation Report*, the level foreseen for the end of this year remains relatively unchanged, while for the end of next year the projection was subject to a marginal downward revision of 0.1 percentage points. The scenario also considered the tobacco companies' past behaviour in terms of final price adjustment following the implementation of changes in fiscal policy.

1.3. Demand pressures in the current period and over the projection interval[79]

Output gap

In 2019 Q2, the quarterly growth of real GDP[80] dropped by 0.2 percentage points (down to 1.0 percent, slightly above the forecast in the prior *Inflation Report*), which prompted a slowdown in the annual rate by 0.6 percentage points (down to 4.4 percent)[81]. Consumption recorded a new positive contribution to quarterly GDP growth, but unlike the previous year when this component was the key driver of

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

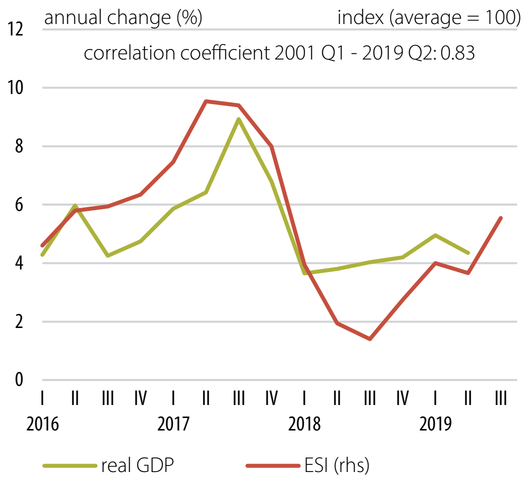
80 For details on recent developments in economic activity, see Chapter 2, Section 1. Demand and supply.

81 According to NIS Press Release No. 256 of 10 October 2019. On 21 October 2019, the NIS carried out revisions of the historical series of quarterly accounts data in order to ensure consistency with the definitive annual data, which were published in a press release on 10 October 2019. The annual dynamics are calculated based on gross data series.

economic activity, GFCF[82] also had a notable positive contribution during Q1 and Q2. In Q2, net exports had a negative contribution, on the rise compared to the prior period, in the context of a quarterly contraction in exports (due to a modest increase in activity in the euro area, also as a result of negative quarterly GDP dynamics in some countries, mainly Germany) and a quasi-standstill in imports, respectively. The contribution of the change in inventories and of the statistical discrepancy (to which an economic substance can hardly be attributed) was negative, following the predominant display of some positive values during the preceding quarters.

For 2019 H2, the forecast anticipates that economic growth will further decelerate, given the prospects of a low agricultural harvest (for cereals and rapeseed) over the envisaged interval. However, positive signals come from the developments in confidence indicators – Chart 4.7, in the turnover volume of retail trade (excluding motor vehicles and motorcycles) and that of market services to households. The monthly data collected from the surveys carried out in Q3 show that consumer confidence is still elevated, supported by the further favourable developments in income. The confidence indicator remains robust in the services sector[83], but decreases in the industrial sector, given that production in this latter sector has been clearly affected during the last few months by the deteriorating external environment. The subdued signals stemming from activity indicators in the euro area, the fading out stimulative impact generated by the real effective exchange rate, and the worsening confidence and production in industry seem to point to modest developments in exports and imports for the last part of this year. The industrial sector contraction and the external environment prospects are assessed to be GFCF deterrents in the latter half of 2019, as compared to the sound increases in H1. The breakdown shows that quarterly GDP growth is assessed to remain ascribable to domestic demand (with positive contributions from both consumption and GFCF, albeit moderate in the case of the latter), while net exports of goods and services are projected to make new negative, slightly lower contributions.

Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

For the current and next year, the baseline scenario of the projection indicates a further deceleration of the annual GDP dynamics, the values nearing those corresponding to potential growth. The outlook for the Romanian economy is further surrounded by uncertainties generated by factors such as the fiscal and income policy stance, the economic slowdown in the euro area and at global level (in the context of

82 In the first two quarters of the current year, GFCF saw quarterly dynamics of 5.0 percent (a value revised upwards from 1.3 percent, according to NIS Press Release No. 170 of 8 July 2019) and 7.3 percent, respectively (well above the forecast in the previous *Inflation Report*), on the back of the rebound in construction.

83 The ESI indicator's breakdown shows that in 2019 Q3 the consumer and services components were on the rise, whereas industry, trade and construction moved in the opposite direction.

increasing trade rows and technology conflicts), and last but not least, the high volatility of historical data series (those corresponding to the change in inventories and GFCF[84] stood out in the assessment of the initial conditions of the current macroeconomic forecast) and the magnitude of their successive revisions. Over the projection interval, the breakdown shows that the GDP path mirrors a rise in final consumption (at an annual pace close to that of 2018, yet significantly slower than in 2017), to which adds, especially for the current year, the stronger advance of GFCF. Albeit slightly on the wane, the contribution of net exports is forecasted to remain negative, amid a systematically slower growth of exports of goods and services (marked by a weakening effective external demand, where Germany holds the largest share) than the dynamics of imports.

Over the projection interval, the annual dynamics of potential GDP are assessed to pick up moderately, against the background of a more robust capital accumulation, of a further slightly positive contribution from labour and, in this context, of a sizeable contribution from total factor productivity (TFP). The potential GDP dynamics are similar to those in the previous *Inflation Report,* encompassing, on the one hand, a stronger build-up in productive capital (as a result of the significant upward revision in the recent GFCF trajectory, simultaneously with further anticipated, though more moderate, increases in the volume of investment) and, on the other hand, the slightly downward revision of the TFP trend contribution. The TFP trend dynamics, expected to be dragging, will continue to be contained by a series of structural deficiencies – modest allocation of resources for the needs of innovation and investment in technology, poor infrastructure, the uncertainty deriving from the high frequency of legislative changes, high skill mismatch[85]. In addition, the assessment captures adverse influences of the uncertainties surrounding the external environment and, implicitly, of the possible volatility of foreign direct investment inflows[86], with an impact on the development projects carried out by firms with foreign capital and/or by those engaged in international trade. Nevertheless, efficiency gains could be obtained also via an assumed better absorption rate of European structural and investment funds[87] within activity streamlining programmes. The same as in the previous forecasting round, labour contribution remains slightly positive, due to the ILO unemployment rate staying significantly below the historical average, affected by the unfavourable multiannual demographic trends – mainly the downward trend in working-age population (15-74 years).

Following the increases of 2019 H1 (up to about 2.7 percent), the output gap (Chart 4.8) is forecasted to relatively level off and even slightly narrow during 2020 Q1 and Q2. Subsequently, the output gap is however anticipated to embark on an

84 In 2019 Q2, mention should be made of the significant negative contribution of the change in inventories to the annual GDP growth, having an opposite sign compared to the previous five quarters, while the GFCF contribution posted a remarkable increase.

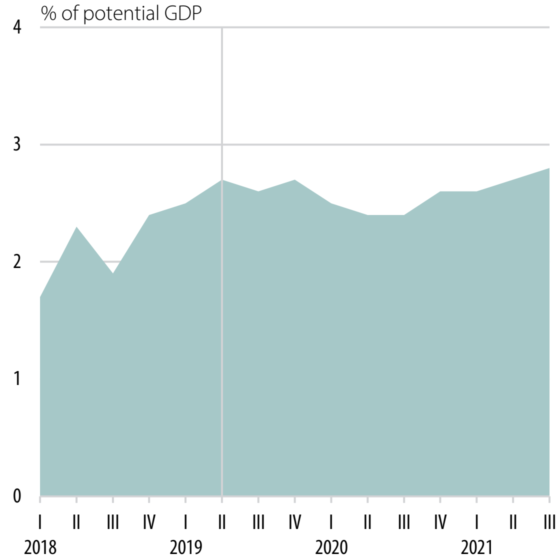
85 Related evidence is brought by the *European Innovation Scoreboard* analysis of the EC, by the *Ease of Doing Business* ranking of the World Bank or the *Global Competitiveness Report* of the World Economic Forum.

86 In the first eight months of 2019, foreign direct investment amounted to EUR 3.6 billion, up by 12 percent against the same year-earlier period. However, their future developments could be affected by the weaker outlook for economic growth in the main countries of origin.

87 According to the Net Financial Balance published by the MPF, in the first three quarters of 2019 structural and cohesion funds inflows totalled EUR 1.6 billion, which was an outstanding figure for this period of the year within the Multiannual Financial Framework 2014-2020.

upward trend, reflecting the much stronger stimuli associated with the discretionary component of fiscal policy, on account of the pension law provisions (with a significant impact as of September 2020[88]). Aside from the aforementioned factor, the projected output gap path mirrors: (i) a lower traction from effective external demand as compared to 2018, and (ii) a further stimulative nature of real broad monetary conditions, yet declining over the entire forecast interval. From the perspective of aggregate demand components, the output gap path is shaped by the gap of actual individual consumption of households and, to a lesser degree, by the GFCF gap. In turn, the gaps of exports and imports of goods and services are assessed at positive values, albeit their net contribution to the output gap remains negative. The assessment of the output gap and of the GDP components' gaps is surrounded by uncertainty, which reflects the high volatility of historical series, as well as the frequency and size of their revisions.

Chart 4.8. Output gap



Source: NBR assessments based on data provided by the NIS

As compared to the previous *Inflation Report*, the output gap is narrower over the entire projection interval, encompassing the lower contribution of effective external demand throughout most of the forecast interval, amid the effects of the anticipated deterioration in the developments of Romania's main trading partners (with a potential impact on economic agents' confidence). An opposite effect comes from the slightly more stimulative nature of broad monetary conditions (brought by the higher contribution of all its components, except for the wealth and balance sheet effect that was assessed to be slightly more restrictive). The impact coming from the fiscal impulse is projected to stay close to that in the previous round, given the unchanged calendar for the significant increases in the pension point.

Aggregate demand components

The actual individual consumption of households is foreseen to record new positive quarterly dynamics in 2019 H2[89], amid an improvement in consumer confidence and due to the favourable developments in their income. Over the projection interval, the dynamics of final consumption mirror those of households' real disposable income, which is forecasted to have strong annual growth rates (yet weaker than in 2017), against the background of wage increases and social transfers, inter alia in the context of the provisions of Law No. 127/2019 on the public pension system[90]. Numerous uncertainties surround the enforcement of these provisions, as well as the overall fiscal and income policy stance, given the multiple election rounds in 2019-2020 and

[88] A 40 percent increase in the pension point.

[89] In addition, the developments in the actual individual consumption of households during the reported period could be affected by the weak agricultural performance, with an unfavourable impact on the variable via its self-consumption component.

[90] Where significant raises in the pension point are mentioned for September 2019, September 2020 and September 2021.

the necessary adoption of compensatory measures aimed at keeping the budget deficit within the authorities' targets. The raise in wages will also be prompted by the high degree of labour market tightness, amid the persistent constraints of structural factors. Last but not least, the anticipated advance in consumption also reflects the stimulative influence of real interest rates.

After the negative value registered the previous year, the GFCF contribution to GDP growth is expected to be significantly positive in 2019 (on account of the outstanding developments in 2019 H1), leading to a relative balancing, though seen as temporary, of the contributions exerted by the domestic demand components. For the current year, the projection mirrors mainly developments in construction (where a certain stabilisation is anticipated, following the exceptional growth rates recorded during the first half of the year, in the context of stimulative fiscal and income policy measures regarding this sector) and in public investment (which had relatively favourable dynamics throughout the year and where an increase in military equipment purchases is scheduled, among others)[91]. Over the remainder of the forecast interval, the GFCF annual dynamics are foreseen to slow down. Apart from the future developments in the aforementioned fields, GFCF will also reflect the stimulative influences coming from EU funds absorption (which benefits from a maturing Multiannual Financial Framework 2014-2020) and from foreign direct investment inflows (which could however be affected by the future worsened economic conditions in the main countries of origin). Adverse influences might be generated by structural factors such as the poor quality of infrastructure or recruitment difficulties due to the shortage of skilled workforce, as well as by the uncertainties surrounding the government economic policies and the potential relocations or restructuring of foreign direct investment. Mention should also be made about the fact that forecast accuracy is further marked by the volatile structure and the substantial revisions of the data released by the NIS.

The quarterly dynamics of exports of goods and services are expected to improve in 2019 H2, but the foreseen values are modest, amid the subdued signals coming from the activity in the euro area and the fading out of the stimulative impact of the real effective exchange rate. Therefore, exports of goods and services are expected to continue their advance over the forecast interval, at annual rates pointing to the persistence of the deceleration trend started in 2017. The anticipated developments in this component take into account: (i) the prospects regarding a slowdown in effective external demand (with Germany holding the largest share); (ii) a decline in price competitiveness due to the reversal of the favourable influence of the real effective exchange rate and to the increase, albeit at slower rates, in unit labour costs, and (iii) a series of dragging structural features of the economy, such as the slow bridging of gaps regarding infrastructure or the sophistication level of production processes, with a direct effect on the structure of value added of the Romanian products targeting external markets. Compared to the previous round, the annual dynamics of the component are considerably weaker, mirroring

[91] As regards public investment, there are major uncertainties stemming from budget constraints related to the other types of government expenditure (social transfers in particular).

persistent effects of the lower-than-expected developments in 2019 Q2 (when a quarterly contraction was registered, amid a modest increase in activity in the euro area), to which adds the unfavourable revision of the outlook for effective external demand (mainly for 2020).

The annual growth of imports of goods and services is forecasted to remain swift throughout the current year and to slow down subsequently, reflecting the path of domestic demand and the stimulative impact (albeit on the wane) of exports. Imports dynamics are foreseen to systematically remain above those of exports, yet the differential is seen to narrow. Therefore, the contribution of nominal net exports of goods and services to the balance-of-payments current account balance is anticipated to stay negative, and to diminish their intensity in 2020.

In 2019 Q2, the current account deficit widened to around 4.9 percent of nominal GDP (cumulated data over four quarters), mirroring the further high values of the deficit on trade in goods and services, the slight improvement of the primary income balance and the diminishing secondary income surplus. The current account deficit is foreseen to continue to rise, being envisaged to exceed, as an average over the last three years, the 4 percent-of-GDP indicative threshold set by the European Commission as a scoreboard indicator for EU Member States[92]. The current account deficit as a share of GDP is anticipated to increase in 2020 as well, driven by a wider negative balance of trade. Regionally, the Romanian economy stands out due to the widening of the balance-of-payments current account deficit, as the balance of trade has worsened in relation to both intra-EU and extra-EU countries[93]. The financing of the current account deficit is anticipated to be only partly covered by stable, non-debt-creating capital flows over the entire projection interval. The key factors influencing the coverage of the deficit by these flows are the magnitude of external imbalances and the possible adverse impact on direct investment associated with the revision of the economic growth outlook for the main countries of origin. A partly counterbalancing effect stems from an expected improvement in the absorption of EU funds. The higher current account deficit carries the potential to act towards deteriorating the macroeconomic equilibria, with a direct influence on the volume and stability of capital flows to the local economy, especially since the position and magnitude of Romania's current account balance are markedly different from those recorded by other emerging economies in the region.

Broad monetary conditions

Broad monetary conditions capture the cumulated impact exerted on future developments in aggregate demand by the real interest rates applied by credit institutions on leu- and foreign currency-denominated loans and deposits of

92 Calculated as an average for the past three years. For further details, see the European Commission website, the Section on "Macroeconomic Imbalance Procedure Scoreboard".

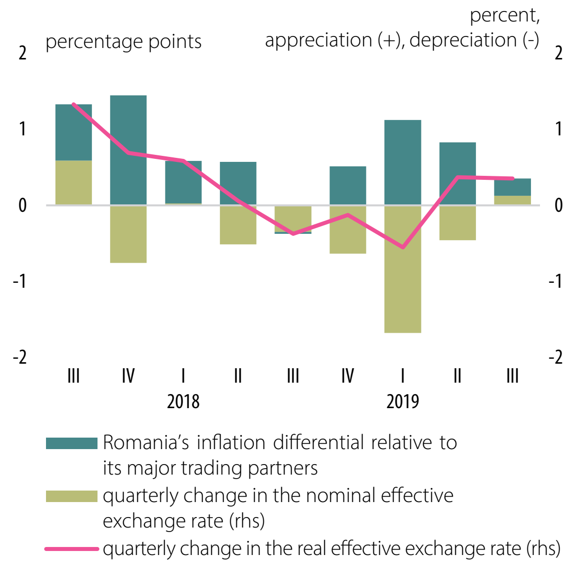
93 In the first eight months of 2019, the negative balance on trade in goods and services increased by approximately EUR 2.1 billion against the same year-ago period. The groups of goods with the largest contribution to this deterioration are the following: chemical products, miscellaneous manufactured articles and mineral fuels.

non-bank clients and by the real effective exchange rate[94] of the leu. The exchange rate exerts its influence via the net export channel, as well as via the effects on wealth and balance sheets of economic agents[95].

The nominal interest rates on new time deposits in lei are estimated to post in 2019 Q3 values similar to those in the previous period and to slightly rise in 2019 Q4. As for the nominal interest rates on new loans, near-term forecasts see them recording a decrease in 2019 Q3, followed by a small increase over the next quarter. Economic agents' saving and investment behaviour is however influenced by real interest rates, calculated based on nominal rates deflated by inflation expectations. Given the significant upswing of the latter in 2019 Q3, real interest rates on both new loans and new time deposits are estimated to decline versus the previous quarter. For 2019 Q4, on the background of marginal changes in inflation expectations, real interest rates are forecasted to slightly rise, reflecting mainly nominal developments. Subsequently, the projection points out a diminishing trend of the stimulative impact of real interest rates on economic activity, in the context of inflation expectations embarking on a downward path.

The domestic currency appreciated in real effective terms in 2019 Q3, on account of the systematically higher domestic inflation rates as compared to those of Romania's trading partners (Chart 4.9), an impact slightly heightened by the exchange rate developments in nominal terms. Over the projection interval, the inflation differential is expected to remain the key determinant, leading to a strengthening of the domestic currency in real terms. Thus, the real effective exchange rate is estimated to reverse from being undervalued to overvalued already in the course of the current year, signalling the erosion of the price competitiveness reserves of Romanian exporters and, implicitly, a gradually increasing restrictive impact on economic activity.

Chart 4.9. Quarterly change in the effective exchange rate



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

In 2019 Q3 and Q4 on the whole, the wealth and balance sheet effect is assessed to have stimulative influences on future economic activity, on account of the real foreign interest rate (3M EURIBOR) standing below its long-term equilibrium level (significant negative gap), given the accommodative ECB monetary policy stance, as well as on account of the developments in real effective exchange rate of the leu. Conversely, the sovereign risk premium, approximated based on the option adjusted spread (OAS), is assessed to have a growing restrictive

[94] The relevant exchange rate for the NBR's macroeconomic model for analysis and medium-term forecasting relies on the EUR/RON and USD/RON exchange rates, with the weighting system mirroring the weights of the two currencies in Romania's foreign trade.

[95] The relevance of this channel has gradually declined in recent periods, given the narrowing of the share of foreign currency-denominated loans in total credit to the private sector, amid the faster rise in leu-denominated flows versus those in foreign currency.

effect, its path being influenced by uncertainties associated with frequent legislative changes and with their effects inter alia on the economy's domestic and external equilibria. Over the projection interval, the wealth and balance sheet effect will exert a slightly and relatively steady stimulative influence on future economic activity, chiefly on account of the impact of the real foreign interest rate, and, to a lesser extent, due to the real effective exchange rate gap.

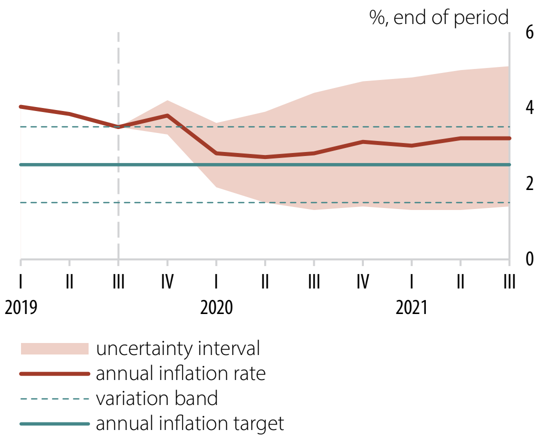
Over all, the baseline scenario of the projection shows a further stimulative nature of real broad monetary conditions, but diminishing throughout the forecast interval. This trajectory is shaped both by the declining stimulative effect of real interest rates and by the developments in the real effective exchange rate, which will exert, starting with the latter half of 2019, an increasing restrictive effect on the price competitiveness of Romanian exporters.

The monetary policy stance is tailored to ensure and maintain price stability over the medium term in a manner conducive to achieving sustainable economic growth and safeguarding a stable macroeconomic framework.

1.4. Risks associated with the projection

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to the path in the baseline scenario (Chart 4.10). From this perspective, the uncertainties arising from the fiscal and income policy stance remain relevant, whereas the risks to the future evolution of administered prices seem to have become more significant. Risk factors also stem from the external environment, but they are assessed to have a net disinflationary impact.

Chart 4.10. Uncertainty interval associated with inflation projection in the baseline scenario



Note: The uncertainty interval was calculated based on the annual CPI inflation forecast errors in the NBR projections during 2005-2018. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

At the current juncture, the future dynamics of administered prices cause heightened uncertainties. Additional inflationary pressures could arise from electricity and natural gas prices, the assessment of their magnitude being, however, marked by the persistence of uncertainties about the timing of the liberalisation of these markets. On the one hand, this could be achieved in a gradual manner, in accordance with the liberalisation calendar proposed in the Senate[96]. On the other hand, the possibility of a sudden liberalisation cannot be ruled out, in the context of a possible repealing of the restrictions imposed on the energy market by GEO No. 114/2018, as subsequently amended by GEO No. 19/2019. Depending on the adopted scenario, the significant additional impact

96 The calendar was brought up for debate in the Senate by the Commission for Energy, Energy Infrastructure and Mineral Resources.

– compared to the baseline scenario coordinates – on the annual inflation rate would be gradual over a longer period of time, in the former case, and more concentrated, putting larger inflationary pressures in the short run, in the latter case.

A risk factor that remains relevant refers to the fiscal and income policy stance, in the context of the busy electoral calendar for 2019-2020, with successive rounds of presidential, local and parliamentary elections. At the same time, however, given the budget execution profile in the first three quarters of 2019, offsetting measures could be called for in the short run in order to avoid overshooting the 3 percent reference value and thus the risk of initiating the specific excessive deficit procedures under the corrective arm of the Stability and Growth Pact[97]. Moreover, in the medium and long term, another source of risks and especially of uncertainty refers to the implementation of the provisions of the new pension law. In the current version, it carries the potential to make significant fiscal corrections necessary for maintaining the fiscal deficit below the 3 percent of GDP threshold – relevant from the viewpoint of public finance sustainability. In this light, uncertainties continue to surround the moment of starting fiscal consolidation, as well as its pace and magnitude, which renders it difficult to assess the impact of these developments on the inflation coordinates in the baseline scenario of the projection.

A durable and sustainable economic growth is conditional on the implementation of a balanced mix of macroeconomic policies, as well as on the acceleration of structural reforms. At the same time, in order to enhance the resilience of the Romanian economy to potential external shocks, given the increasingly fragile international environment, it is necessary to create additional fiscal space to be able to absorb the adverse effects in the event of some of these hypothetical, yet probable shocks, materialising. In this context, the price stability objective would not be jeopardised.

Labour market tightness counts further among the relevant risk factors over the projection interval. In spite of a recent alleviation, this tightness, which is also a regional feature, is anticipated to remain at elevated levels amid structural problems that became entrenched in the course of time (poor labour force mobility, difficulties in staff recruitment faced by companies, the magnitude of emigration, ageing of population). Under the circumstances, pressures on wages could remain high, having implicitly an unfavourable impact on the projected inflation rate; the alleviation of some of these shock sources calls for the implementation of structural reforms targeting labour market, the favourable effects of which could materialise no earlier than in the medium term.

As concerns the prices of volatile food items, inherent uncertainty sources refer to weather conditions, with an impact on the supply of agricultural products locally, as well as regionally or even worldwide. Turning to the prices of tobacco products and alcoholic beverages, any potential deviation from the regulated levels of excise

97 Budgetary discipline is determined based on two criteria: (i) budget deficit should stand below the 3 percent of GDP threshold and (ii) public debt should stand below 60 percent of GDP.

duties applicable to these goods, in the form of possibly higher increases than those set forth in the Tax Code, will lead to upward deviations of the inflation path from the values in the baseline scenario.

Risk factors posed by the external environment are likely to primarily put disinflationary pressures. Uncertainties are associated with the pace of global economic slowdown, in an international environment saddled with recurrent geopolitical tensions and possible escalations of technology and trade disputes, especially those between the US and China. A sharper weakening of China's economic activity could have considerable adverse consequences on global growth on account of the robust ties between China and other trading partners, including Romania, given the high integration of the Asian economy in the global value chain. Moreover, elevated risks stem from a possibly more pronounced slowdown in the economic activity of Germany, with potential contagion effects on the Romanian economy too. There are lingering uncertainties as to the completion and consequences of Brexit. By contrast, opposite influences are associated with the effects of a possible easing of the major central banks' monetary policy stances that could lead to a faster recovery of global aggregate demand.

The developments in the international commodity prices, especially energy prices, continue to be significant sources of uncertainty to the annual inflation rate projection. Similarly to the previous forecasting round, the balance of risks posed by this source is assessed to be in equilibrium. Uncertainties persist as to the future dynamics of oil prices, including amid the high volatility seen recently. These are conditional on both supply-side factors carrying mainly an inflationary potential – oil production cuts agreed on by OPEC and Russia, recurrent escalations of geopolitical tensions, serious damaging of some production facilities – and demand-side factors with a net disinflationary impact – a lower energy consumption worldwide, in line with the slowing trend of global economy.

Abbreviations

CCR	Central Credit Register
CPI	consumer price index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
ESI	Economic Sentiment Indicator
EU	European Union
Eurostat	Statistical Office of the European Union
FAO	Food and Agricultural Organization of the United Nations
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
ILO	International Labour Office
IMF	International Monetary Fund
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NIS	National Institute of Statistics
OPEC	Organisation of the Petroleum Exporting Countries
ROBOR	Romanian Interbank Offer Rate
TFP	total factor productivity
VAT	value added tax
VFE	vegetables, fruit, eggs

Tables

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