NATIONAL BANK OF ROMANIA

Inflation Report

August 2020

Year XVI, No. 61

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NOTES

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.

National Bank of Romania
25, Lipscani St., 030031 Bucharest – Romania
Phone: 40 21/312 43 75; fax: 40 21/314 97 52

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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 5 August 2020 and the cut-off date for the data underlying the macroeconomic projection was 3 August 2020.

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

In 2020 Q2, the annual CPI inflation rate followed the downward trend visible since early this year and neared in June the mid-point of the variation band of the flat target, standing at 2.58 percent compared to 3.05 percent in March. The disinflationary trend owed mainly to the large fall in fuel prices, given the plummeting international oil prices induced by the strong contraction of aggregate demand amid the health crisis and the uncertainties about the trajectory of the global economic recovery. At the same time, however, the simultaneous occurrence of demand- and supply-side shocks, arising from the measures taken to flatten the epidemic curve, put the annual adjusted CORE2 inflation rate on a relatively stable course, coming in at 3.7 percent at quarter-end. Under the impact of these developments, in June, the annual CPI dynamics stood 0.1 percentage points below the latest macroeconomic projection (in the May 2020 *Inflation Report*). Moreover, in the course of Q2, the average annual HICP inflation rate continued to count among the highest across the EU Member States, closing, however, part of the gap with the EU average.

Contrary to forecasts, the annual adjusted CORE2 inflation rate continued to post fast dynamics in 2020 Q2 too, running only 0.1 percentage points below the March level. On the demand side, the slowing wage growth and households' more cautious behaviour, in view of the uncertainties about the future economic situation, caused the output gap to fall deeply into negative territory in Q2. The influence of demand conditions was counterbalanced by the health crisis-specific supply-side developments: the closure of most outlets, the contraction of activity (by reducing the number of employees), alongside additional costs generated by the adoption of protective measures. Looking ahead, it is difficult to anticipate how persistent each of the two categories of shocks will be, while in the short run, at end-Q2, the annual core inflation rate exceeded significantly the previously-projected value (+0.3 percentage points), as a result of underestimating the magnitude of the supply shock to economic agents.

In 2020 Q1, the annual growth rate of unit labour costs economy-wide came in at 6.7 percent, running above the previous quarter's 5.8 percent reading. Given that the COVID-19 pandemic effects are seen to fully become manifest in Q2, unit labour costs are estimated to jump significantly during this period, following a much larger decline in economic activity than the adjustment on the labour market – this behaviour was prevalent during the past recession and will probably be a feature of the present crisis as well, considering the broad government support for retaining employees through furlough schemes. The data available for the industrial sector show the annual growth rate of unit wage costs picking up markedly in April and decreasing mildly in May (45.3 percent and 33 percent respectively, against an average of about 13 percent

in the last four quarters). Leaving aside the impact of firms' recourse to furlough schemes, the change in unit wage costs is similar in terms of magnitude to that seen during the previous recession.

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

The global economy and its outlook have been strongly affected by the major adverse impact and the unprecedented uncertainty generated by the coronavirus pandemic, alongside the containment measures imposed by the authorities. In turn, the National Bank of Romania's response in this context was prompt. Specifically, the NBR Board convened for an emergency meeting on 20 March 2020 and adopted a package of measures aimed at mitigating the economic impact of the pandemic, but also at consolidating liquidity in the banking system so as to ensure the smooth functioning of the money market and of other financial market segments, as well as the smooth financing of the real economy and the public sector.

Thereafter, statistical data confirmed the severe economic impact of the coronavirus pandemic. Thus, the annual CPI inflation rate remained unchanged in March at 3.05 percent and then fell to 2.68 percent in April (from 4.0 percent in December 2019). The annual adjusted CORE2 inflation rate tended however to increase slightly during the first four months of 2020, contrary to forecasts, reaching 3.73 percent in April from 3.66 percent in December 2019. The evolution owed to changes in the consumption structure brought about by social distancing measures, associated also with probable disruptions and cost increases in production and supply chains, overlapping persistent demand-pull and wage cost-push inflationary pressures. According to preliminary data, economic growth slowed down visibly in 2020 Q1 to 2.4 percent from 4.3 percent in the previous quarter, in spite of remaining particularly robust in the first two months of the year. At the same time, the trade deficit posted a markedly faster widening amid a steeper decline in exports than in imports of goods and services. Consequently, the dynamics of the current account deficit regained momentum[1], the improvement in the primary and secondary income balances notwithstanding.

Financial market conditions improved after the adoption of the monetary policy decisions and after the end-March peak in tensions generated by the COVID-19 crisis. Key interbank money market rates witnessed a significant downward adjustment in the closing 10-day period of March and afterwards continued to decline gradually, while yields on leu-denominated government securities went down progressively, amid the increased volume of liquidity injected by the NBR through bilateral repo operations and through purchases of leu-denominated government securities on the secondary market. At the same time, the EUR/RON exchange rate saw lower fluctuations, moving in a narrow range, *inter alia* amid an improvement in global financial market sentiment.

[1] Subsequently, the revisions of balance-of-payments statistics did not confirm the renewed widening of the current account deficit.

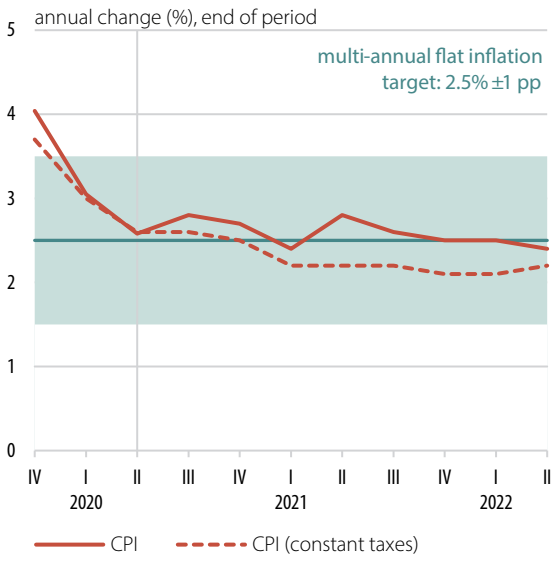
In the meeting of 29 May 2020, based on the available data and assessments, as well as considering the extremely high uncertainty, the NBR Board decided to lower the monetary policy rate to 1.75 percent per annum, from 2.00 percent per annum, as of 2 June 2020. Moreover, the NBR Board decided to cut the deposit facility rate to 1.25 percent per annum from 1.50 percent per annum and the lending (Lombard) facility rate to 2.25 percent per annum from 2.50 percent per annum. Furthermore, 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. Given the liquidity shortfall on the money market, the Board decided that the NBR should further conduct repo transactions and continue to purchase leu-denominated government securities on the secondary market, keeping financial market stability. At the same time, the NBR Board stressed that it would seek to maintain international reserves, forex ones included, at an optimal level.

Furthermore, in view of the elevated uncertainty surrounding economic and financial developments, the NBR Board decision to suspend the previously announced calendar of monetary policy meetings was kept in place, with monetary policy meetings to be held whenever necessary. In addition, the NBR Board underlined that the decisions aimed to ensure and preserve price stability over the medium term in a manner conducive to achieving sustainable economic growth and amid safeguarding financial stability.

Inflation outlook

The current baseline scenario is fraught with multiple interlinked sources of risks and especially of uncertainty, stemming primarily from developments in the public health situation. The contraction – unprecedented in recent history – induced by the spread of the novel coronavirus led to large bottlenecks in global value chains and significant spikes in international financial market volatility. Against this background, economic agents' plans have been severely disrupted and, until the situation returns to normalcy, downside risks to economic activity are expected to prevail. Even in the absence of adverse risks materialising, the recovery of the economies, implicitly that of Romania, is anticipated to be slow. Conversely, the worsening of the epidemic, in a scenario whose probability to materialise has increased, would only fuel the challenges to the authorities' set of measures, given the gradual exhaustion of their room for manoeuvre. Therefore, significant future reconfigurations of the baseline scenario coordinates are likely, insofar as the current sources of uncertainty are progressively clarified.

Inflation forecast



Source: NIS, NBR projection

The baseline scenario of the macroeconomic projection is based on the assumption of keeping the epidemic under control nationwide, which would help avoid the reintroduction of broad-

based administrative social-distancing measures in the future. Nevertheless, the recent resurgence in the number of SARS-CoV-2 infections and implicitly the recent extension of the alert state by another month add to the uncertainty about the gradual normalisation of economic activity. Under the circumstances, for 2020 as a whole, the annual GDP growth rate is expected to post a significant negative value, close to those recorded at the height of the 2008-2009 economic crisis, while income losses at aggregate level are anticipated to be fully recovered within at least a year.

Similarly to the previous *Inflation Report*, the record levels of uncertainty reached in the recent period are expected to weigh mainly on investment dynamics, as the implementation of a number of government programmes aimed to support corporate financing, although having in principle a favourable impact, is unable to clarify the duration and outcome of the crisis, two key variables for companies' investment decisions. The contraction in the disposable income of households and their extremely prudent behaviour, reflected in a higher precautionary saving rate, and the low availability of certain categories of goods and services will probably cause a relatively abrupt discontinuation of the favourable trend of consumption seen in recent years. Conditional on how the medical crisis evolves, the persistence of a wary consumption behaviour of households should not be ruled out, despite the financial support from the government-backed labour retention schemes.

The outlook for a broader contraction in trading partners' economic activity compared to that projected for Romania is seen to translate into a slight deterioration of this year's current account deficit, i.e. above 4 percent of GDP for the third year in a row. This is also anticipated amid a budget deficit widening significantly beyond the EU-defined prudential limits, given the increase in government spending to mitigate the effects of the public health crisis, alongside significant government revenue losses occasioned by the sizeable economic downturn. Hence, the analysis of the determinants of budget deficit dynamics also highlights a rise in public spending, under the action of automatic stabilisers triggered by the countercyclical fiscal policy conduct in the current context.

Given the still presumably temporary nature of the pandemic shock, the assumption of the contraction in economic activity this year being reflected mainly in the dynamics of the cyclical component (output gap) is reconfirmed. However, the prospects of a limited and non-persistent impact on potential GDP will become uncertain should the medical crisis linger on. The negative output gap, expected to open widely as early as 2020 Q2, will be relatively persistent, as it is expected to fully close no sooner than the final part of next year. This assessment is strictly conditional on the implementation of the package of stimulative measures recently adopted by the authorities, with the monetary and fiscal policy conduct having a favourable, stronger impact during the current year.

The build-up of significant disinflationary pressures following the contraction in economic activity is likely to put the annual CPI inflation rate on a downtrend and keep it inside the variation band of the flat target, reaching 2.7 percent at the end of this year and 2.5 percent at the end of the next. Compared to the previous *Inflation Report*, the indicator recorded new downward revisions, albeit of a smaller magnitude,

by 0.1 percentage points for December 2020, whereas for the end of next year it is expected to post a relatively similar value.

Over the short term, unlike the headline index, the annual core inflation rate continued to be under greater inflationary pressures than in the previous *Inflation Report*, which were associated mainly with the influence of supply-side shocks in the specific context of the medical situation. In the medium term though, the projection reconfirms the start of a more significant downward correction of the annual adjusted CORE2 inflation rate, with broadly-based and persistent disinflationary pressures from aggregate demand – including via the foreseen worsening of labour market conditions – anticipated to gradually regain prevalence. Adding to these influences is the somewhat more marked-than-previously-expected weakening of inflationary pressures associated with import price dynamics, especially those foreseen for next year. Therefore, the annual adjusted CORE2 inflation rate was revised slightly upwards for end-2020, namely by 0.2 percentage points to 3.3 percent, and reconfirmed at 2.2 percent for end-2021.

As a conditioning input for the macroeconomic projection, the monetary policy conduct is configured so as to ensure price stability and macroeconomic stability, as well as the smooth functioning of the banking system and financial markets supportive of households and local companies.

The economic impact of the public health crisis on the configuration of the domestic and external environment will continue to shape notable sources of risks and uncertainty in the coming periods. From this perspective, it is still difficult to assess the speed of this process and the degree of symmetry of economic recovery. Specifically, some economies will likely continue to reverse losses consistently, while in others, depending on the economic imbalances already manifest at the beginning of the crisis or accumulated during the pandemic, upturns will alternate with stagnation or even downturns, with a difficult-to-anticipate impact on the future configuration of these economies. In probabilistic terms, the sources of risk from the domestic and external environment appear to be almost on a par at this juncture, and the balance of risks to the annual inflation rate projection is seen tilted, especially in the medium term, to the upside as against the values forecasted in the baseline scenario.

On the domestic front, fiscal and income policies continue to be relevant sources of uncertainty. Specific risks stem from a larger volume of budget expenditures, triggered by a potential extension of the public health crisis either due to an escalation of the unfavourable medical situation at local level, as seen in recent weeks, or associated with a possible worsening of the global pandemic, linked to the onset of the cold season. Moreover, at the time of preparing the baseline scenario, several alternative assumptions were considered as regards the future configuration of social transfers (pensions), yet lacking predictability, in the absence of clearly outlined legal provisions. The medium-term impact of these permanent expenditure increases on the government deficit would be the opposite of that implied by the need to continue the fiscal adjustments related to the excessive deficit procedure against Romania.

Given also the prospective evolution of the current account deficit in the baseline scenario, the absence of a fiscal correction or its late onset would imply a persistence of twin deficits. This carries the potential to weaken the resilience of Romania's economy in the event of other adverse shocks over the medium term and, in the near run, it may affect the financing of these deficits in adequate volumes and at reasonable costs.

A source of risk specific to the present pandemic context is the potential prevalence of adverse supply-side shocks over a longer period, with an impact mostly on the adjusted CORE2 index, especially if the public health crisis lingers on or intensifies. Their slower fading would lead to additional inflationary pressures that would have an immediate impact on the prices of essential goods and services and, over the medium term, as the health crisis is resolved, could be visible in the majority of sectors hit by closure/restraint of activity. At the same time, the net impact on the annual CPI inflation rate from other types of risk factors is marked by considerable uncertainty: the across-the-board spread of African swine fever, weaker harvests of certain crops, grains in particular, downward pressures on the natural gas price in the context of market decentralisation starting with 1 July 2020 or the medium-term outlook for the oil price following the historical lows recorded earlier this year.

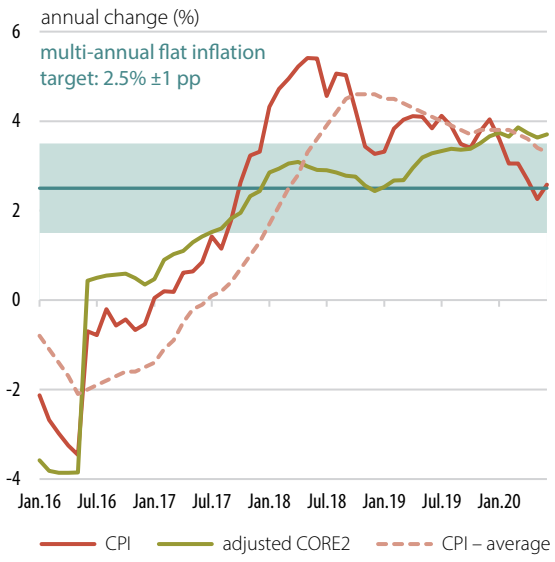
Monetary policy decision

In view of the characteristics of the new macroeconomic forecast and the related extremely high uncertainty, likely to trigger two-way risks to the inflation outlook over the projection horizon, the NBR Board decided in its meeting of 5 August 2020 to cut the monetary policy rate by 0.25 percentage points to 1.50 percent per annum. Moreover, it decided to lower the deposit facility rate and the lending (Lombard) facility rate by 0.25 percentage points each to 1.00 percent and 2.00 percent per annum respectively. Furthermore, 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. Given the liquidity shortfall on the money market, the Board decided to further conduct repo transactions and continue to purchase leu-denominated government securities on the secondary market, while safeguarding financial stability.

1. Inflation developments

In 2020 Q2, the annual CPI inflation rate followed the pronounced downward trend visible since early this year and neared in June the mid-point of the variation band of the flat target (2.58 percent versus 3.05 percent in March). The main disinflationary influence in the reviewed period was exerted by the strong correction in the international crude oil price, amid the large contraction in aggregate demand triggered by the health crisis and the uncertainties about the trajectory of the global economic recovery. However, the simultaneous occurrence of demand- and supply-side shocks (determined by the measures adopted to flatten the epidemic curve) put the annual adjusted CORE2 inflation rate on a relatively stable course, recording 3.7 percent at quarter-end, a value around which it had fluctuated since the beginning of the year (Chart 1.1).

Chart 1.1. Inflation developments

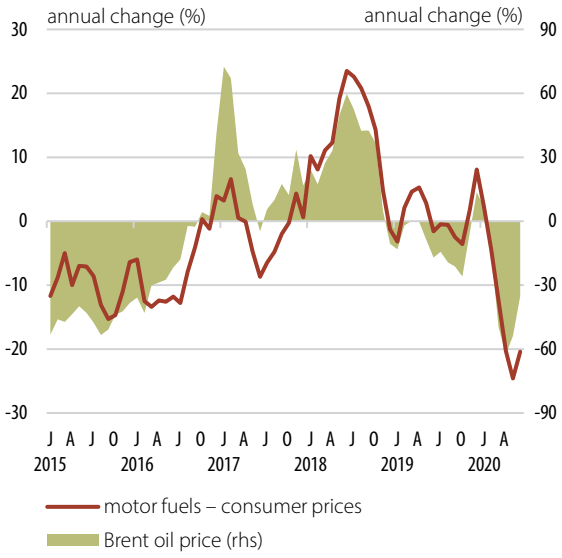


Source: NIS, NBR

One of the first and most obvious repercussions of the global pandemic crisis was the oil price crash, amid restricted mobility and the decline in activity in most economic sectors. Since the crisis broke out, forecasts on global growth have been steadily revised downwards, the information gathered from the publication of new economic indices painting an increasingly clear picture of the real magnitude of the shock. Consequently, the Brent oil price dropped sharply, falling in mid-April even below the USD 20/barrel threshold, down by 63 percent versus the same month of the previous year. It re-embarked on an uptrend in the latter part of the quarter, after a new OPEC+ agreement to limit production was finalised, and amid signals about the gradual recovery of economic activity, as restrictions started to be lifted in more and more countries. Domestically, the maximum decline in fuel prices was -10.1 percent (annual change) recorded in May (versus -3.8 percent in March), before decelerating to -7.8 percent in June (Chart 1.2). In the reported period as a whole, the particularly high volatility of the Brent oil price, along with the price cap during the state of emergency, induced a prudent behaviour among fuel traders regarding the pass-through of changes to final prices, which was more rigid than usual.

Still within the realm of volatile prices, the annual VFE inflation rate picked up at the beginning of 2020 Q2, amid fears surrounding possible disruptions along cross-border supply chains (given the health security measures adopted by all of Romania's important trading partners), as well as the persistence of dry weather

Chart 1.2. Oil and motor fuel prices



Source: NIS, Bloomberg

conditions. At the same time, frictions stemming from the closing of agri-food markets and the perishable nature of these goods prevented a part of local production from becoming available to final consumers, thus being wasted. As weather improved, and national and international movement restrictions eased gradually, the price dynamics in this segment slowed down and returned to normal rates of change for this period, ending the quarter at a value slightly above that seen three months before (5.4 percent versus 4.5 percent in March).

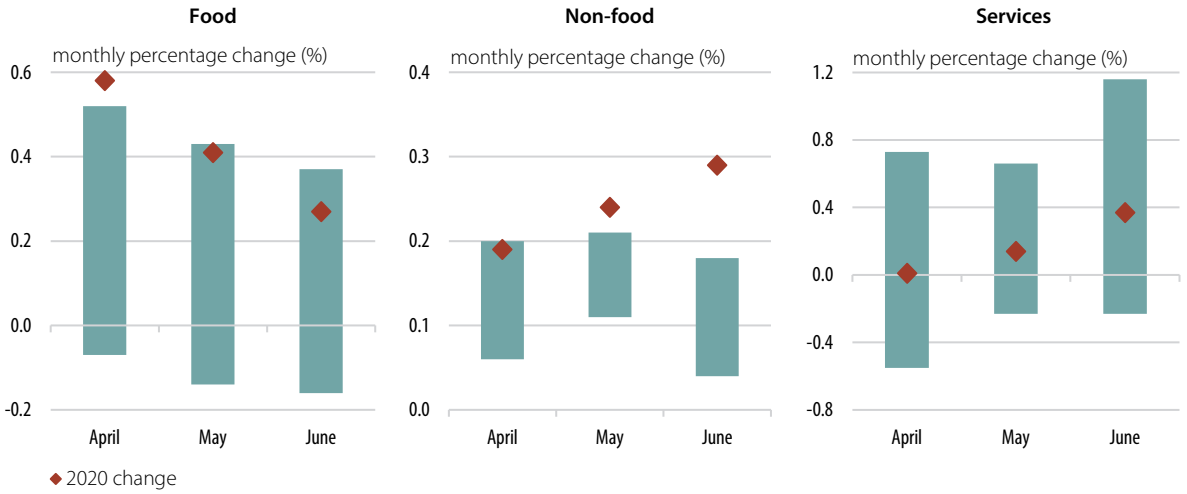
The overlap of negative demand-side shocks with disinflationary effects and supply-side shocks exerting inflationary pressures resulted in the relative stability of adjusted CORE2 dynamics during 2020 Q2. On the demand side, the slowdown in wage dynamics and households' more prudent behaviour, given the uncertainties about future economic developments, along with the temporary mobility restrictions, pushed the output gap deeply into negative territory in 2020 Q2. However, its effect on the trajectory of prices of goods and services is expected to become manifest gradually, as agents revise their expectations on the path of economic activity, and companies operate cost adjustments (e.g. adjusting labour agreements usually takes place with a lag), which in turn will weigh on the evolution of households' disposable income. At the same time, the latest data show a considerable leap in unit wage costs in industry in April-May, despite the state taking over a significant part of the burden by paying furlough benefits. In addition, the influence of demand conditions has been offset by the occurrence of supply-side shocks specific to this health crisis: the closure of most outlets, contraction in activity (by reducing the number of workers or customers), along with additional costs for disinfectants and other protective materials. The duration and intensity of these shocks will continue to depend on the evolution of the health crisis and on the policies adopted in order to flatten the infection curve.

Although they impacted all core inflation components, these influences were mirrored differently in consumer prices, given some of the particularities of each sector (Chart 1.3). On the food segment, the relatively low elasticity of household demand facilitated the partial pass-through of the new costs to final prices ever since the outbreak of the pandemic. The above-mentioned pressures added to pre-existing ones on certain segments, such as pigmeat (due to the effects of the African swine fever), or to anticipated pressures, such as those related to the weak wheat crops expected for this year, the fall harvests being affected by the period of drought during winter[2]. In the latter case, pressures may, however, be limited, considering the high level of commodity stocks and the worldwide optimistic forecasts for most crops, as well as the tendency of domestic prices to get in line with external ones (Chart 1.4). The food

2 The European Commission's most recent forecasts (July 2020) point to a decline in wheat production of around 30 percent compared to the previous year in the case of Romania.

component of core inflation has remained responsible for the further relatively high levels of the aggregate indicator, posting annual dynamics more than twice greater than those recorded by the other two segments (5.5 percent in June).

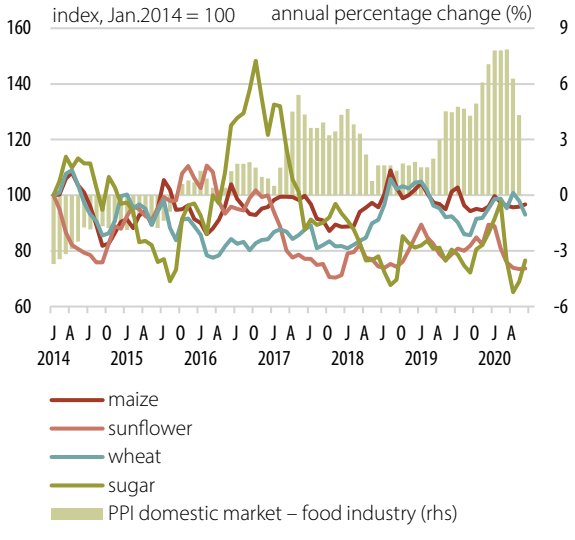
Chart 1.3. Adjusted CORE2 inflation components



Note: The columns mark the range between the minimum and maximum changes in the respective month in 2010-2019. All values exclude the first-round effects of VAT rate changes.

Source: NIS, NBR calculations and estimates

Chart 1.4. Developments in international prices of main agri-food commodities



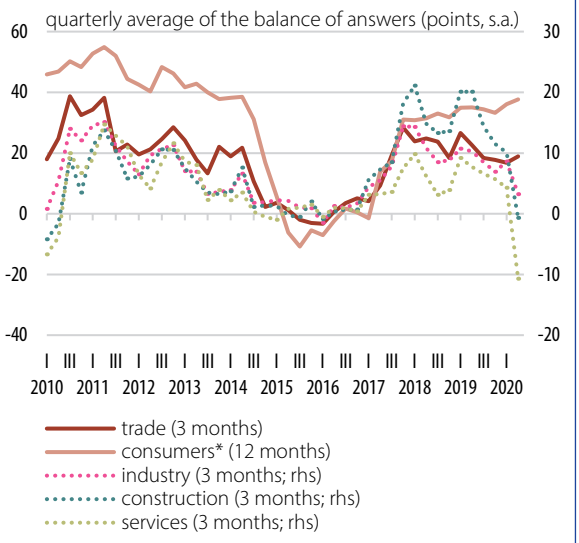
Source: Bloomberg, NIS

As regards non-food items and services, some of the prices could not be collected, at least during the state of emergency (16 March – 14 May), so that the statistical treatment used for replacing missing prices often involved maintaining unchanged the latest price observed (pursuant to Eurostat recommendations)[3]. Afterwards, however, when the situation gradually returned to normalcy and commercial activity resumed, in these cases as well firms tended to pass through the previously mentioned cost pressures to prices. June reported monthly dynamics far higher than those usually seen during this period for services such as hygiene and cosmetics or medical care, or non-food items such as footwear or household appliances and furniture. The reopening process has been gradual, however, marked by uncertainties and asymmetry at the level of various activities (e.g. on 1 July, food service establishments operating inside remained closed, while the maximum number of participants in cultural and social events was still limited). Against this background, the annual core inflation rate on

3 According to Eurostat, when collecting data for April, imputation methods were used for 18 percent of total consumption expenditure underlying the HICP calculation in Romania, this share decreasing in May 2020 to 9 percent, and in June 2020 to 2 percent (significantly below the EU average of 29, 20 and 10 percent respectively).

the non-food segment went up to 2.6 percent at end-2020 Q2, from 2.3 percent in March. With regard to market services, the annual price dynamics fell to 2.5 percent, from 3.4 percent in March, yet a significant role was played by a favourable base effect on the telecommunication services segment.

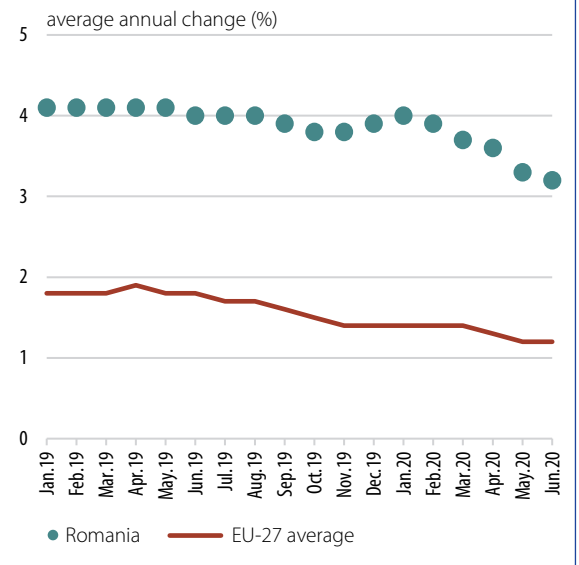
Chart 1.5. Expectations on price developments



*) 2020 Q2 – only April for consumers

Source: EC-DG ECFIN

Chart 1.6. Average annual HICP



Source: Eurostat

In 2020 Q2, economic agents' inflation expectations saw mixed developments, mirroring the complexity of the shocks hitting the economy. Specifically, while companies in construction, services and industry adjusted downwards their expectations on price developments (even down to negative territory for the first two categories), an uptrend can be seen in the case of retailers and consumers (Chart 1.5). At the same time, financial analysts anticipate annual inflation rates one year ahead and two years ahead to be marginally lower than those forecasted at end-2020 Q1, further standing close to the mid-point of the variation band of the flat target.

The average annual inflation rate also followed a downtrend: based on the national methodology, it fell down to 3.3 percent in June 2020, while the rate calculated in accordance with the harmonised structure reached 3.2 percent. Since the decline was lower at EU level, Romania managed to bridge some of the gap (Chart 1.6), falling to second place ever since May 2020 in the ranking of European countries with the highest average HICP inflation rate.

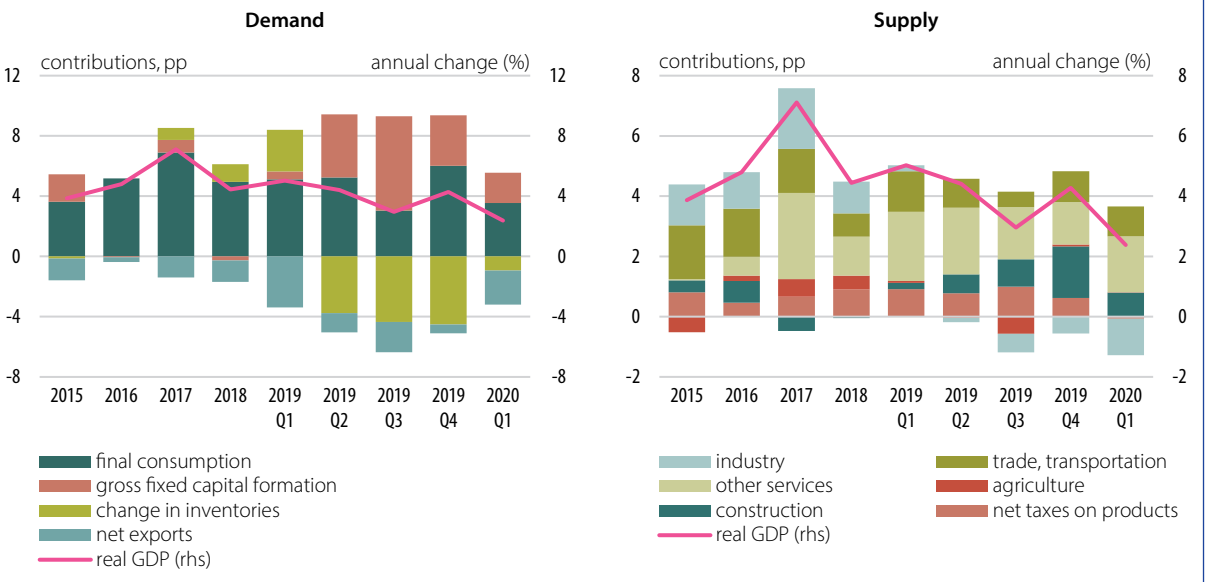
In June 2020, the annual CPI inflation rate stood below the level anticipated in the May 2020 *Inflation Report* by 0.1 percentage points (2.6 percent versus a 2.7 percent forecast). The forecast error was caused by the lower-than-expected performance of vegetable prices in May-June 2020, amid the considerable improvement in weather conditions. At the same time, however, annual adjusted CORE2 inflation at end-2020 Q2 (3.7 percent) was higher by 0.3 percentage points than the projected value, due to the underestimation of the magnitude of the supply-side shock felt by economic agents.

2. Economic developments

1. Demand and supply

The shock wave generated by the measures for flattening the epidemic curve, adopted at international level starting in February-March 2020, also propagated in the Romanian economy via three channels, i.e. supply shock, demand shock and, in close correlation with the latter, adjustment of confidence. The evolution reflects in the slower annual GDP growth in Q1 (down 1.9 percentage points to 2.4 percent) and in the relatively broad-based worsening of economic sectors' performance in April (Chart 2.1). In line with the trend reported by the other European countries, the domestic economy subsequently witnessed a relative recovery amid the gradual easing of restrictions, as shown by monthly business and confidence indicators (Chart 2.2). Nevertheless, the upturn in the business cycle is expected to be a long-lasting but not necessarily continuous process, especially in the context of the protracted health crisis. Moreover, Romania's economic rebound largely depends on the performance of trading partners, the recovery of which will probably be asymmetric, due to the different manners and moments chosen to ease the containment measures, as well as given the different amounts of financial resources mobilised by each economy.

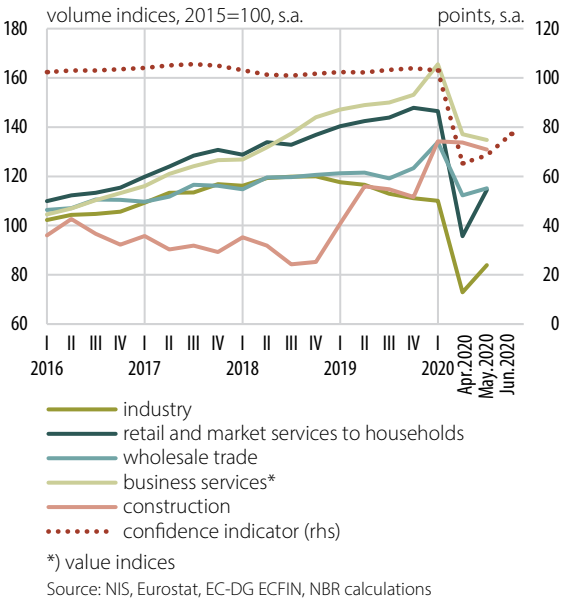
Chart 2.1. Contributions to economic growth



Source: NIS, NBR calculations

On the demand side, the slowdown in the annual growth rate of GDP in Q1 was ascribable to both domestic absorption (decelerations being reported particularly in the case of consumption) and net exports of goods and services, whose negative

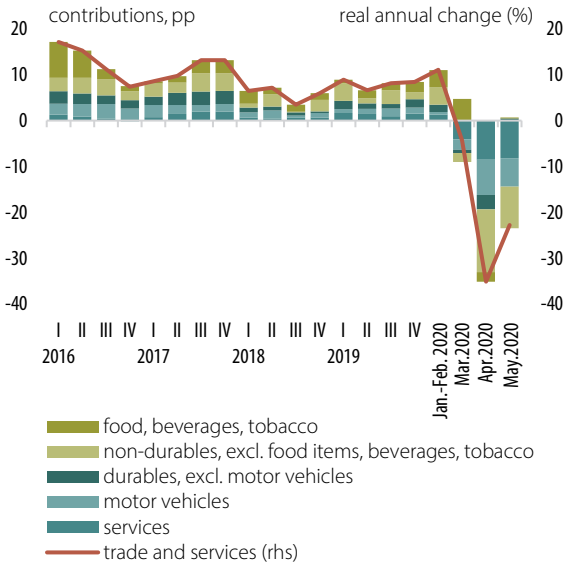
Chart 2.2. Economic sectors



*) value indices

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

Chart 2.3. Trade



Source: NIS, NBR calculations

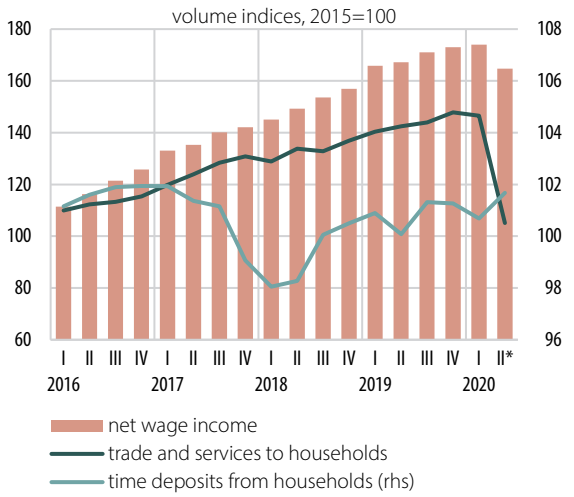
contribution to economic growth widened to -2.3 percentage points. The annual dynamics of consumer demand slowed down markedly to 2.8 percent from 7.5 percent in the previous period, this basically reflecting the effects of the first lockdown measures. Specifically, while the turnover of trade and services rose by approximately 11 percent (annual change) in the January-February period, under the favourable influence of fundamentals (robust growth of households' real disposable income, high employment opportunities, substantial consumer credit flows and high confidence), in March it saw a trend reversal, decreasing by about 4 percent. The first categories of goods that took the brunt of the negative prospects and effects arising from the fast spreading coronavirus were durables (motor vehicles in particular), as well as the accommodation and food service activities, where the businesses were put on hold by the authorities. By contrast, trade in food items saw a temporarily brisker pace of increase of sales volume, i.e. up to 17.7 percent in March, due to the likelihood of disruptions in supply chains and of tightening mobility restrictions (subsequently, sales of food items declined as well – by 4.7 percent in April; Chart 2.3).

The swift change in the economic environment caused a significant deterioration of consumer confidence (in April, the NIS-DG ECFIN indicator lost approximately 17.7 points versus Q1 to -26.1 points). This drop and the mobility restrictions kept in place until mid-May will result in a severe contraction of consumer demand in the second quarter. This outlook is also confirmed by the dynamics of turnover in trade and market services to households. Specifically, turnover plunged in annual terms by about 35 percent in April (a month that was fully affected by the measures taken to contain the virus spread), and slightly less in May, so that it declined by about 29 percent in the first two months of Q2.

Even though the gradual easing of restrictions will weaken the supply-side limitations on trade and services, the activity in this sector will be hindered by the erosion of consumer demand via labour market developments (due to the impact of furlough on wage earnings and to the discontinued upward trend in the number of employees). The latter factors contribute to the worsening of household confidence, which is likely to stimulate consumers' precautionary behaviour, such as the increase in saving to the detriment of consumer spending, particularly for durables and recreational activities

(Chart 2.4). Signals in this respect seem to emerge as early as Q2, the April-May data pointing to an increase in household deposits, whereas the automotive trade saw a contraction of nearly 40 percent and the purchases of furnishings fell by more than 6 percent (concurrently with the 63 percent decline in the real flow of consumer credit). The sharpest decrease, i.e. -80.6 percent (annual change), was reported by market services to households, an improvement in receipts being expected no sooner than after 1 June, along with the resumption of food service activities in open spaces. Nevertheless, the activity in this sector is unlikely to see a substantial recovery until the health crisis is solved, as economic agents will have to keep in place physical distancing measures and the population will be somewhat reluctant to buy such services.

Chart 2.4. Household income, saving and consumption



*) Apr.-May 2020

Source: NIS, NBR, NBR calculations

In 2020 Q1, the general government budget execution led to a deficit of lei 18.1 billion, i.e. 1.7 percent of GDP, well above that posted in the same year-ago period (lei 5.5 billion or 0.5 percent of GDP). Moreover, unlike the usual pattern of budget execution, it was only slightly lower than that recorded in 2019 Q4[4], given that, also as an effect of the fiscal measures adopted to mitigate the impact of the pandemic crisis[5], total revenues reported a relatively strong[6] decline[7] as compared to the previous three-month period, on account of lower receipts from the VAT[8], corporate income tax[9], social security contributions, non-tax revenues[10] and excise duties[11]. Total budget spending decreased as well[12], mainly due to capital expenditure and spending for projects financed from non-repayable external funds[13], an opposite lower contribution having the increase in social security spending, subsidy expenses[14] and interest expenses.

4 In 2019 Q4, the general government budget deficit stood at lei 21.3 billion (or 2.0 percent of GDP).

5 Consisting mainly in granting the possibility to delay the payment of fiscal obligations without penalties during the state of emergency.

6 The annual dynamics of total revenues were also affected by the annual contraction in receipts from property taxes and fees, amid the delay in the first deadline for payment of the tax on land and buildings and the motor vehicle tax.

7 A context in which their real negative annual dynamics stepped up to -6.3 percent, from -1.3 percent in the previous quarter.

8 The fall in net receipts also reflected the impact of the significant rise in VAT returns.

9 Behind the drop in total revenues stood also the decrease in disbursements from the EU, whose impact on budget deficit was partly offset by a similar evolution of spending for projects financed from non-repayable external funds.

10 However, they posted an increase in real annual terms.

11 Due *inter alia* to the lowering of the excise duty on motor fuels at the beginning of 2019; however, excise duty revenues saw a further rise in annual terms.

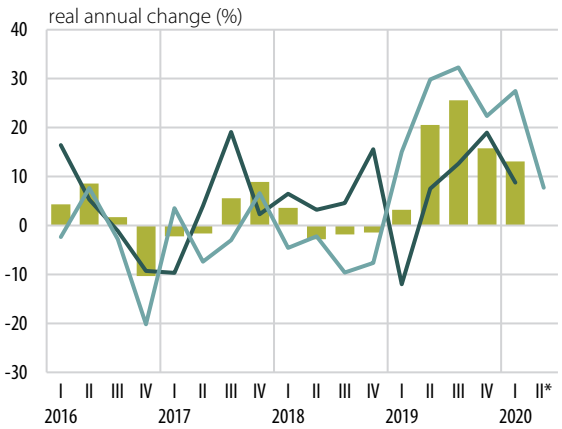
12 Yet, its annual dynamics remained positive, at a level similar to that recorded in the prior quarter (9.1 percent versus 9.3 percent).

13 Spending on goods and services also reported a decline that was nonetheless mitigated by the impact of additional payments for supporting the measures to prevent and combat the pandemic effects; however, it continued to rise in annual terms.

14 Also in the context of the earlier granting of transitional national aids in vegetal and livestock segments.

Gross fixed capital formation continued to rise at a brisk pace (13.1 percent in annual terms), the mild slowdown from 2019 Q4 being primarily ascribed to equipment purchases, the growth rate of which halved to 8.8 percent. Conversely, residential construction and civil engineering works stepped up, also benefiting from favourable weather conditions, so that investment in construction, i.e. new construction works and capital repair works, expanded by 27.5 percent (annual change, Chart 2.5).

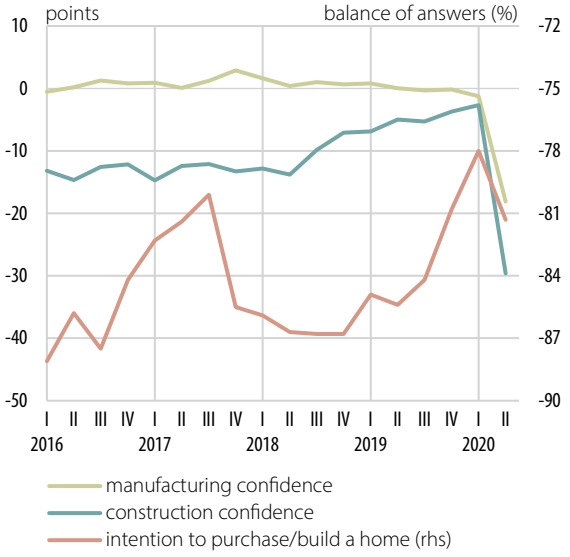
Chart 2.5. Investment



*) Apr.-May

Source: NIS, NBR calculations

Chart 2.6. Signals on investment outlook



Source: EC-DG ECFIN

In the coming period, capital investment will see a contraction, the drop in the financial resources of economic agents (companies, households) and the lingering uncertainties entailing a rise in risk aversion, which will cause delays/halts in both technological and real estate investment plans (Chart 2.6). In the latter case, it is worth noting that the construction sector has been less affected (for the time being) by the restrictions imposed by authorities, as its specifics allow the compliance with physical distancing measures, a negative effect having, however, the restrictions on the movement of goods and labour. Looking at the local corporate sector, negative signs are highlighted by the results of the AmCham Romania survey regarding the quality of the investment climate in Romania, published in July, according to which turnover and investment will see a decline in 2020 (in the opinion of approximately 70 percent and 44 percent respectively of responding companies). As concerns borrowed funds, the second-quarter expectations captured by the NBR's *Bank Lending Survey* show a broad-based contraction in loan demand and a tightening of banks' credit standards for all types of loans, amid the perception of increasing credit risk. The monthly data available up to May on certain financing channels confirm these forecasts – the fall into negative territory of real net wage earnings, slower dynamics of outstanding equipment loans and new housing loans, i.e. down to 4.8 percent and 5.7 percent respectively (real annual changes). Moreover, foreign direct investment flows in January-May 2020 saw a reversal, i.e. net outflows of EUR 341 million versus net inflows of EUR 2 billion in the same year-ago period, on account of lower equity inflows, the losses incurred by direct investment companies and the repayment of some intercompany loans. This is in line with global investment climate coordinates[15],

15 The Economist Intelligence Unit – "Down but not Out? Globalisation and the Threat of COVID-19".

the direct flows being anticipated to decrease by approximately 40 percent in 2020-2021 (according to UNCTAD), as the supply chain disruptions generated by the closure of some large suppliers, the restrictions in the movement of goods and people and the adjustment of demand affect sectors that are important to the international investment circuit. Adding to these are the measures that some developed economies adopted in 2020 H1 to tighten foreign investment regulations.

The bleak investment outlook on the domestic front is compounded by the limited fiscal space that has characterised the Romanian economy ever since before the COVID-19 outbreak. Therefore, it is all the more necessary to reap the benefits of local competitive advantages and the opportunities arising in the pandemic context. Thus, in its capacity as EU Member State, apart from the increased absorption of European funds in the current financial framework[16], a substantial support could come, in the following years, from the use of resources the European Commission intends to mobilise for the kick-start of EU economy – an EUR 1,074 billion budget for the 2021-2027 Multiannual Financial Framework and the launch of a new instrument, i.e. Next Generation EU, worth EUR 750 billion. The access to these funds is however conditional on the implementation of recommendations made to Romania under the European Semester and the identification of viable projects that can contribute to a sustainable economic recovery.

Another counterbalancing factor for the unfavourable situation of domestic capital investment may be, in the longer run, the reconfiguration of global supply chains, given an emerging trend of their repatriation/regionalisation. This new approach took shape as a reaction to the vulnerability represented by the massive concentration of supply in a single area (Asia, particularly China), an option the disadvantages of which were highlighted in the pandemic context. This shift in focus, likely to entail the opening of new production and storage facilities, brings to the forefront the issue of production costs and can lead emerging economies into relatively advantageous positions at European level. Nevertheless, it is a challenge for Romania to reap the benefits of this opportunity, as the investment attractiveness of the domestic environment, shaped by the high quality of digital infrastructure, the size of the local market or the lower labour cost, is diminished by the inadequate quality and size of transport infrastructure, the modest digitalisation of the economy, especially in the general government sector, as well as by the instability of the fiscal and regulatory frameworks.

The stronger erosion effect of net external demand on the annual GDP dynamics was primarily due to the sharp trend reversal of exports of goods and services (from 6.4 percent in 2019 Q4 to -1.3 percent in the period under review), with the swifter growth of imports of goods also making a contribution. While early 2020 saw a gradually improved economic sentiment in the EU (*inter alia* following a relative alleviation of the US-China trade conflict), which also reflected in a mildly higher volume of foreign orders to local industrial companies, the sudden disruptions in the domestic and international supply chains triggered in March by the containment

16 The level of absorption is relatively low as compared with EU countries, yet funds inflows saw a step-up in 2020 H1 versus the same year-ago period in what concerns the financing of cohesion policy and the amounts allocated for agriculture development.

measures dramatically changed foreign trade relations. The export path will most likely remain rather fragile, against the background of a possibly slow recovery in the economic activity worldwide and, particularly, in Europe (Chart 2.7).

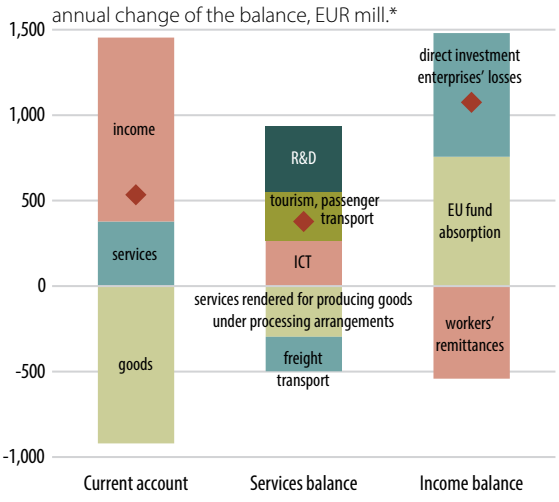
Chart 2.7. Exports

*) April-May 2020 for the latest period

Source: NIS, EC-DG ECFIN, NBR calculations

In 2020 Q1, the volume of exports of goods stood 2.2 percent lower in annual terms, amid the decision to temporarily shut down some local companies holding a large share in exports of finished products (motor vehicles, household appliances), as well as some firms integrated in international production chains, which were affected by adjustments in external demand (resulting from the contraction/ halt in the activity of main European partners) and by commodity supply issues, given the freight transport restrictions. The breakdown shows that the decline in exports was mainly ascribable to categories of goods such as electrical equipment, motor vehicles and motor parts, machinery and equipment, light industry products, petroleum products, furniture. With regard to the automotive industry, the recovery in exports will be closely correlated with the evolution of demand at European level. Specifically, although the two local car manufacturers resumed their activity in May, the same as numerous companies producing motor parts and accessories, the automotive production volume may not reach the pre-pandemic level in the near run. Moreover, the increased global tendency to shift focus to the manufacture of electrical motor vehicles will bring another challenge to the local automotive sector, the course of which is determined by the investment policy of parent companies.

Chart 2.8. Current account (5 months 2020)



*) the positive change points to an increase in surplus or a decrease in deficit

Source: NBR

The annual growth rate of imports of goods stepped up in 2020 Q1 to 4.9 percent, with the faster rise seen in March by the volume of purchases making a significant contribution. The evolution is partly due to the spread of the COVID-19 pandemic across Europe (in view of the swifter dynamics of imports of agri-food commodities, pharmaceutical products, hygienic articles, computer parts), but brisker rates of increase were also reported by other categories of goods (petroleum products, fertilisers, pesticides).

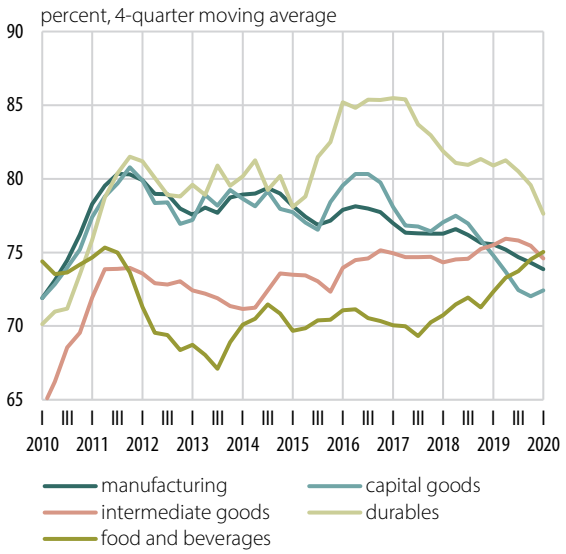
As a result, the trade balance worsened further, a trend that persisted subsequently, the trade deficit in the January-May period widening by 14.2 percent from the same year-ago period. Nevertheless, the current account painted a brighter picture, i.e. 15.6 percent contraction in deficit, due to the rising services surplus and the better performance of the

income accounts. In the former case, the disruptions in international freight transport, along with the decline in receipts from exports of goods produced under processing arrangements, were offset by a double effect generated by containment measures. Specifically, on the one hand, demand for ICT services surged (due also to the large-scale adoption of teleworking solutions) and, on the other hand, international travel and transport activities (for business or personal purposes) contracted. As concerns the primary and secondary income accounts, the turning to surplus of the cumulated balance was due to a better absorption of EU funds for agriculture (European Agricultural Fund for Rural Development, European Agricultural Guarantee Fund), but also to direct investment enterprises' losses (Chart 2.8).

Labour productivity

In 2020 Q1, the annual dynamics of labour productivity economy-wide slowed down considerably to 2 percent as compared with 3.4 percent in the preceding quarter, but remained positive in all main sectors, except for industry. Robust growth rates of labour productivity were seen in construction, which in fact experienced the best post-2008 quarter, as construction works remained buoyant, given the extremely favourable weather conditions at the beginning of the year, as well as in the ICT sector, spurred by companies' fast shift in focus to digitalisation solutions in view of the new economic and social coordinates.

Chart 2.9. Capacity utilisation rate

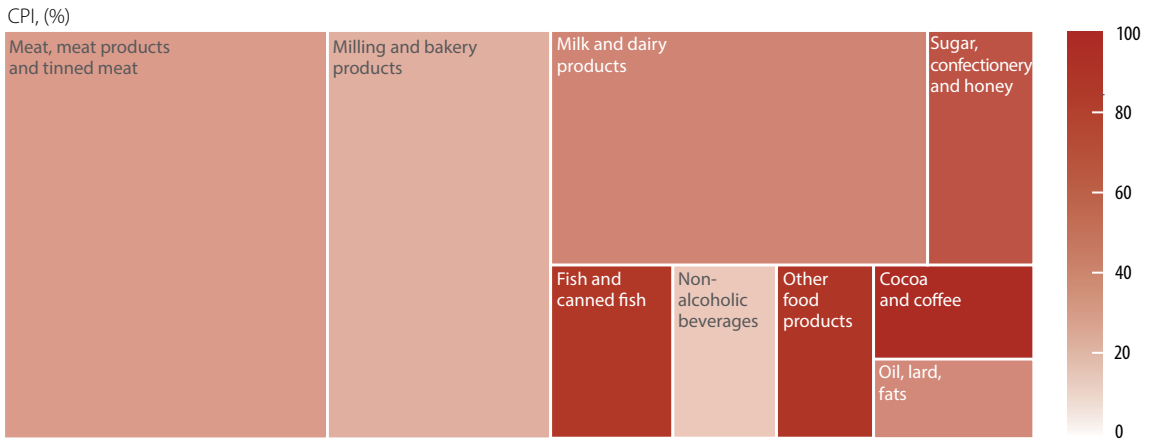


Source: EC-DG ECFIN

Despite the promising year start for the industrial activity, the labour productivity growth returning to positive territory in January-February after six months of declines, all indicators related to industry witnessed sharp drops starting in March. In 2020 Q1 as a whole, new orders from the external market and especially from the domestic market decreased solely as a result of developments recorded in March. Capacity utilisation rate went down only marginally, against the backdrop of mixed developments in the main categories of goods (Chart 2.9). The breakdown shows that the activity in some manufacturing sub-sectors, i.e. food industry, the manufacture of tobacco products, the pharmaceutical industry, the manufacture of computers and electronics or building materials, was less affected by the drop in aggregate consumption and the social distancing measures, their products being in (relatively) high demand in the new epidemiological context. In food industry, the consumption peak reached in March entailed a 10-high in the capacity utilisation rate, while also generating increased interest in new investment in this field. Despite the structural deficiencies still eroding food industry competitiveness (the low technological investments in production capacities, the fragmentation of commodity suppliers, the labour force shortages), the current crisis may be an opportunity for business reorganisation on stronger grounds, based on the principle of integrated local production. At present, the import reliance of the domestic market is quite high, also in the case of products for which there are opportunities for development and investment in all production

chain links (for instance, in the segment of milk and dairy products, approximately 40 percent of domestic consumption, including intermediate consumption, is covered from imports; Chart 2.10), while exports of agri-food items are further dominated by raw materials (accounting for around 70 percent of total agri-food exports in 2019).

Chart 2.10. Food sector's dependency on imports



Note: The area of a rectangle is proportional to the item's share in CPI, while the colour intensity is proportional to the dependency on imports, calculated using the formula (imports*100)/(production+imports-exports), based on the corresponding quantity, and expressed as a 2016-2018 average. The items included are the result of food processing, and refer to goods for both intermediate and final consumption.

Source: Eurostat, NIS, NBR calculations

On the other hand, the pandemic effects were strongly felt in the automotive industry and the related sub-sectors, the engines of the Romanian industry in the latest business cycle and, due to their size, one of the key elements behind the industrial activity resuming an upward path. The car factories in Romania and Europe suspended their activity towards end-March, a decision taken particularly as a result of the plummeting global demand, the motorcar sales in 2020 as a whole being expected to go down by about 25 percent[17]. Due to the increased complexity of a motor vehicle that is made of approximately 30,000 individual parts on average, the shutdown of assembling factories affected numerous producers of motor parts, strongly disrupting the functioning of global production chains[18]. Moreover, as compared to the developments seen during the Great Recession, the domestic road transport equipment industry now finds itself in a weaker position in terms of competitiveness, especially in light of the delay in its integration into the manufacturing of electrical motor vehicles, a trend that is presently gaining popularity worldwide.

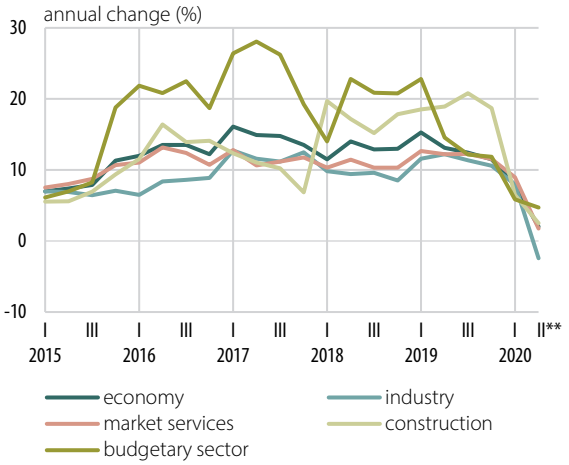
Labour market developments

The measures taken by the authorities to prevent the spread of the COVID-19 pandemic, starting mid-March, have had an impact on the labour market, leading to a significant slowdown in the wage growth rate, to fewer job opportunities and

17 According to the European Automobile Manufacturers' Association (ACEA).

18 On the domestic front, April saw a contraction by 81.6 percent in annual terms in the car manufacturing industry and declines by over 40 percent in rubber and plastic products, electrical equipment, and machinery and equipment.

Chart 2.11. Nominal gross wage earnings*

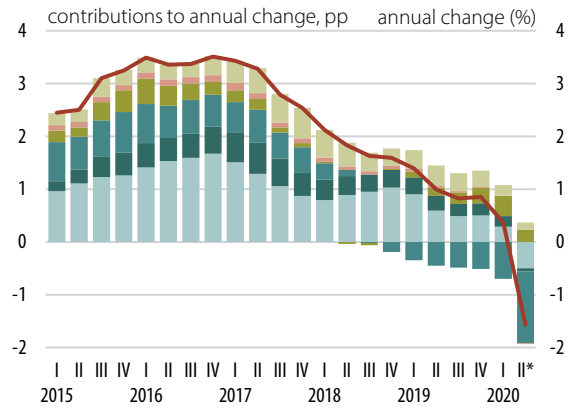


*) excluding the effect of the transfer of social security contributions as of 2018

**) Apr.-May 2020

Source: NIS, NBR calculations

Chart 2.12. Number of employees economy-wide



*) Apr.-May 2020

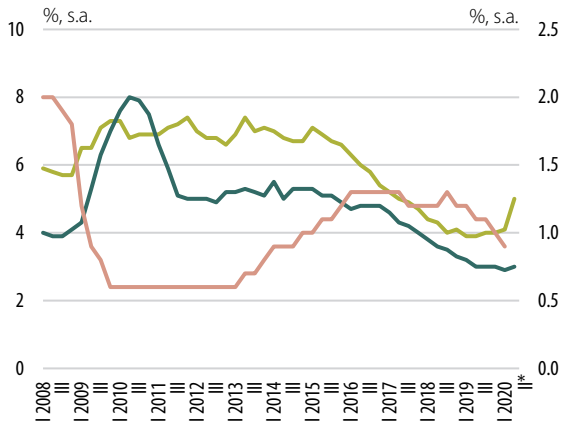
Source: NIS, NBR calculations

lay-offs. However, it should be noted that the government financial support to the most affected companies economy-wide has significantly helped contain the adverse effects. The furlough measure is intended to support the labour market in times of crisis, preventing a steep rise in unemployment and thus contributing to overcoming business cycle fluctuations more smoothly (Box 1).

Following an annual growth rate above 8 percent in January-February 2020, average gross wage earnings witnessed a sharp deceleration, to 6.7 percent in March and 2 percent on average April through May respectively (Chart 2.11). Except for a step-up in the healthcare sector, where the medical staff involved in treating patients infected with the new coronavirus received risk incentives, the slowdown was visible in all economic sectors, largely mirroring firms' recourse to furlough schemes as of mid-March. In the absence of this practice, wage dynamics would have probably remained higher, given that the behaviour of private sector economic agents in the previous recession was to reduce their costs by adjusting the labour factor rather than by cutting wages. The firms that have resorted to furlough to a significant extent operate in the economic sectors most affected by the restrictions introduced under the state of emergency decree, i.e. accommodation and food service activities, transport activities, trade, especially non-food trade (shopping centres), but also industry.

Moreover, authorities' employment support programmes have encouraged the preservation of employment. Specifically, the number of employees decreased in annual terms by merely 1.1 percent March through May 2020 (versus a growth rate of 0.7 percent between October 2019 and February 2020), also marking the end of an eightyear period of steady increases (Chart 2.12). Downsizing in personnel occurred mainly in manufacturing and market services (particularly in accommodation and food service activities, and transport and storage activities). This evolution reflected in a relatively smooth increase in the unemployment rate (compared to the contraction in economic activity), the ILO unemployment rate coming in at 5.2 percent in May (up from around 4.0 percent in December, seasonally adjusted data). Moreover, the registered unemployment rate held steady around the 2.9 percent value seen in the last 12 months (Chart 2.13). The divergent evolution of the two indicators owes also to methodology: the NEA rate is calculated based on the claims submitted by the individuals that register with

Chart 2.13. Unemployment and job vacancies



*) Apr.-May 2020

Source: NEA, Eurostat, NIS

unemployment agencies to receive unemployment benefits (which probably occurs with a certain delay), whereas the ILO unemployment rate is calculated based on a quarterly survey carried out by the NIS.

In 2020 Q1, the job vacancy rate stayed on the gradually descending path it had embarked on in mid-2018. As a result, labour market tightness showed a stronger tendency to abate.

For the period ahead, the labour market outlook is mixed, mirroring the elevated uncertainty surrounding future economic developments. The results of the DG ECFIN survey point to a slight improvement in job opportunities between June and August 2020, as compared to the bleak expectations of economic agents for April-June, revealing a rise in confidence amid the gradual easing of restrictions, but also due to the government support received. Conversely, the Manpower Survey shows hiring intentions reaching a 12-year low in 2020 Q3, 63 percent of employers estimating a return to the pre-COVID-19 employment level no sooner than April 2021.

Box 1. Labour market adjustments. Under which category do short-time work schemes fall?

The COVID-19 sanitary crisis and the measures taken by the authorities to contain its spread led to significant contractions in GDP, likely to entail, sooner or later, the necessary labour market adjustments. Implementing schemes to support the economic agents (both firms and employees) affected by the new economic reality was one of the priorities of the public policies adopted at the peak of the crisis. However, their long-term suitability and sustainability are becoming a concern, especially given that the degree of uncertainty about the path to recovery in activity to pre-pandemic levels remains extremely high, as there is a risk that resources could be allocated inefficiently.

In Romania, authorities opted for measures encouraging job retention, offering financial support to firms in the economy. This approach is in line with the general trend observed at European level, i.e. resorting to short-time work schemes, which is essentially a social security system wherein employers are allowed, for a limited period of time, to adjust their labour force along the intensive margin in case of a recession. This implies a partial or total decrease in the number of hours worked (suspension of employment and furlough) and maintaining the payroll in both cases until the shock has been overcome. The benefits of workers covered by these programmes are generally established as a percentage of wage and are supported by the state. Their objective is to avoid layoffs (adjustment along the extensive margin) as much as possible and to mitigate employees' loss of income, concurrently with adapting the

working hours to unfavourable demand conditions, with the benefit of maintaining the labour force that is already skilled and familiarised with the firm's operations. Therefore, companies can retain human capital, avoiding the costly layoff process during a recession, followed by re-employment and training in the recovery phase.

This box aims to provide a brief overview of the short-time work schemes implemented in Europe amid the pandemic, of the theoretical bases and reasons that determined firms to resort to this strategy of labour force adjustment, as well as of the advantages and disadvantages they imply.

Labour market adjustments

Initially, economic theories assumed economic agents' preference to adapt their production process to short-term demand fluctuations by changing the labour quantity, given that capital is fixed and difficult to adjust. In time, it has been proven that, when a shock occurs, firms are inclined to first resort to the intensive margin, i.e. to lower labour utilisation. The extensive margin, namely labour force adjustment via job destruction, is fallen back on only after a certain period of time, when firms perceive the changes in activity to be permanent, because this strategy may prove to be more costly (expenses incurred by the firing process, followed by the search, employment and training of new employees). One implication of this reality is that companies' strategy to adjust labour along the intensive or extensive margin depends on the flexibility of the labour market, which, in turn, is influenced by the institutional architecture and by the structure of each economy. The third significant strategy available to companies, namely wage adjustment, is more difficult to put into practice, amid the downward rigidity of this income, caused both by institutional factors, such as the minimum wage policy or the coverage of collective agreements, and by economic factors, referring to the negative impact of wage adjustments on labour productivity.

Although labour market flexibility is an oft-discussed topic, it is still a rather vague concept. The definition proposed by Pissarides (1997) brings to the forefront the capacity and speed of the labour market to absorb shocks, which are the most often assessed based on employment developments. For instance, the gradually increasing flexibility of the US labour market (less stringent regulations for the hiring and firing process) led to a change in the behaviour of economic agents over the past decades, the adjustment of labour to shocks via the extensive margin (layoffs) becoming prevalent and fairly fast (Fernald, 2015). From this standpoint, the coordinates are different on the European labour market, where the accent falls on "flexicurity" measures, aiming at combining employers' need for flexibility with the need for job security, which is important for employees. Thus, at least in the short term, European firms choose, to a significant degree, a strategy for decreasing labour costs via the intensive margin (reducing working hours).

How the labour market adjusts to shocks can have implications for the magnitude and duration of the business cycle, as well as for the potential output[19], the latter

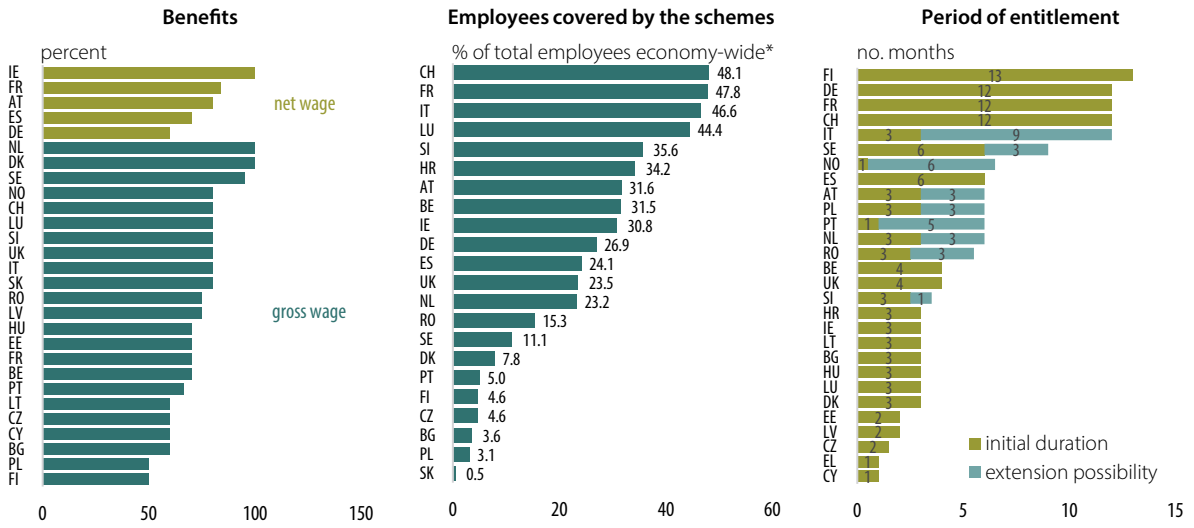
[19] The box mainly discusses the economic behaviour specific to the private sector, yet it should not be overlooked that, from the perspective of the whole economy, the response of the public sector is also important. Usually, it is more rigid in adjusting labour costs in the event of negative shocks at aggregate level (although public income is also affected), a behaviour which may lead to demonstration effects on the private sector and possibly to hampering the process of economic recovery.

influence in fact motivating the use of short-time work schemes, assuming that these would mitigate the hysteresis effects[20]. However, their miscalibration may hinder the efficient allocation of resources in the economy, limiting the transfer of labour from less productive firms to the best performing ones and from sectors where fundamentals would justify a contraction to those that, for similar reasons, should witness an expansion.

Short-time work schemes at European level

Short-time work schemes were already well-established in countries such as Germany, Austria, Belgium or Switzerland, yet the fast spread of the COVID-19 pandemic and the awareness of potential unfavourable effects on economies led to them being implemented at a large scale in the EU. Extremely relevant for this decision was the prospect of financial support offered by the European Commission under the SURE programme (Temporary Support to Mitigate Unemployment Risks in an Emergency). This temporary instrument will have at its disposal approximately EUR 100 billion, will remain operational until 31 December 2022 (with a possible extension as needed), and will offer credit to national short-time work systems under favourable cost conditions.

Chart A. Characteristics of short-time work schemes in Europe during the COVID-19 crisis



*) according to the EU labour force survey (LFS)

Source: ETUI Policy Brief No 7/2020, NBR adaptation

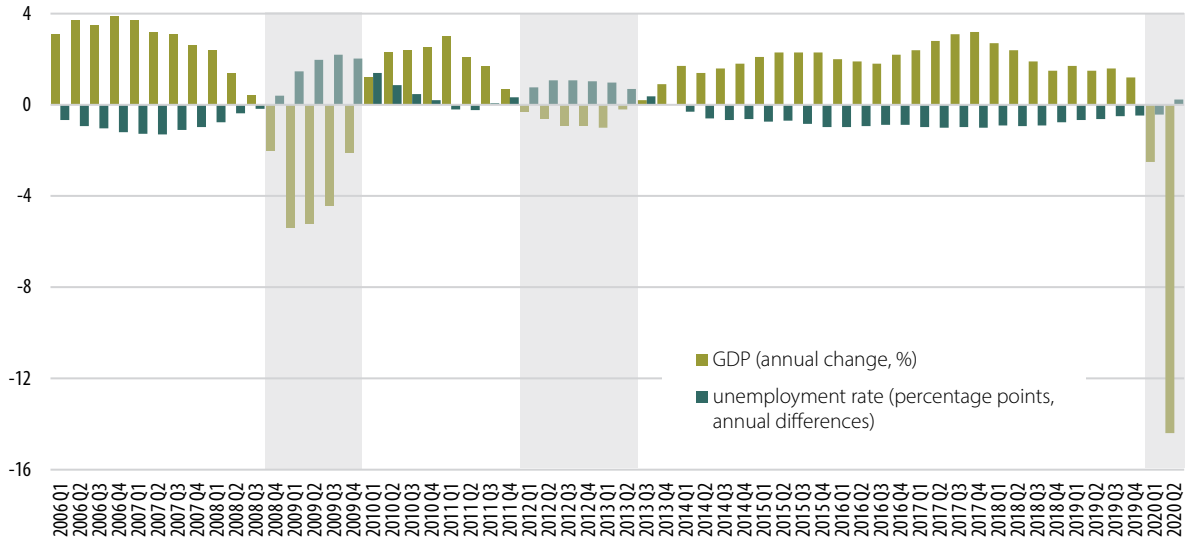
Hence, in Europe[21], the number of employees for whom applications for short-time work were submitted exceeded 50 million, with over 42 million in EU-27 (2020), thus reaching a historical high. Although the schemes' objective is the same in all countries, there are differences in the manner of implementing them, which mainly concern the benefits granted (the minimum and maximum amount,

20 The extension of an individual's job seeking period decreases the chances of success, as a result of skill deterioration of said individual and loss of contact with the labour market, as well as of the changes in firms' requirements.

21 EU-27 (2020), United Kingdom and Switzerland.

the percentage of net or gross wage, which varies depending on country and duration), the period for the application, as well as eligibility (circumstances allowing firms' access to such schemes[22]) (Chart A).

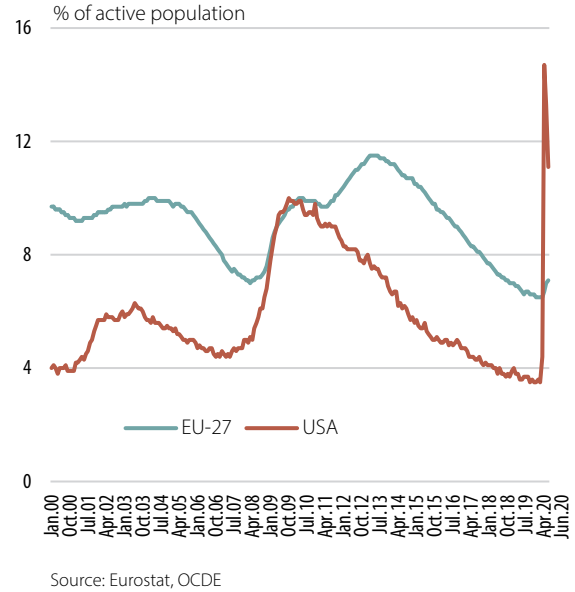
Chart B. Developments in GDP and unemployment rate in EU-27



Source: Eurostat, European Commission, NBR calculations

Implementing such schemes at EU level hindered the rise in unemployment rate in the critical phase of the crisis, unlike at the beginning of the previous recession, when these programmes were not used as intensely, and unlike other countries where such practices are rarer (Charts B and C). In the latter case, worth looking at is the response of the US, which in this period relied largely on the unemployment insurance system, whose coverage and amount of benefits have been recently supplemented, insofar as some of the unemployed received higher income than that when employed, which may affect their motivation to seek a job. Companies' different strategies for labour adjustment basically indicate their adapting to market characteristics where they conduct activities (institutional architecture, legal framework, economic structure), and the effectiveness of each approach depends mostly on the nature of the shock: transitory or persistent. Economic recessions triggered by temporary exogenous shocks usually require a limited reallocation of resources, where job retention policies can be a more appropriate action for both protecting employees and ensuring the quick resumption of firms' activity when the shock

Chart C. Unemployment rate: EU vs. US



Source: Eurostat, OCDE

22 For further details, see ETUI Policy Brief No. 7/2020.

fades out. Conversely, if shocks impose a considerable reallocation of production factors, implementing such strategy may prove unviable in the long term, and it is preferable to resort to the unemployment insurance system, which facilitates resource optimisation.

In Romania, more than 1 million employees (approximately 15 percent of employees economy-wide[23]) had their contracts suspended in the period from 16 March to 1 June 2020, taking advantage of this support scheme, wherein they received 75 percent of gross wage, however without exceeding 75 percent of the average gross wage economy-wide (the benefits are subject to social and health insurance contributions and to taxation). Specifically, wages recorded a downward adjustment, yet the support provided by the state to sustain disposable income, by preserving incomes and payrolls as much as possible, cannot be neglected, the data published by the Ministry of Public Finance showing that in April-May, approximately lei 2.3 billion were granted for paying employee benefits and another lei 400 million for other professionals and persons with individual labour agreements who stopped their activity in the critical period of the crisis (Chart D). Short-time work schemes may play the role of a fiscal stabiliser, mitigating the consumption shock via the financial resources injected by the state into the economy. In theory, such countercyclical policies are recommended during a recession, yet it should be taken into account that the government's intervention is conditioned by the existence of fiscal space, and the procyclical fiscal stance practised in Romania over the past years might bring again to the forefront the implications for public debt sustainability that this budgetary effort may have. At the same time, reducing income uncertainty can be an additional mechanism via which this measure contributes to alleviating the adverse effects of the COVID-19 pandemic on household expenditures and, implicitly, on aggregate demand.

Chart D. Developments in households' income in Romania

*) Apr.-May

**) net values starting with 2013 Q1

Note: Households' income is an NBR estimate of households' own monetary resources, based on the monthly series of average net wage earnings and the number of employees in the economy, social benefits expenditure and remittances of workers from abroad.

Source: NIS, MPF, NBR, NBR calculations

23 According to the EU Labour Force Survey (EU LFS).

Looking ahead, the Romanian authorities extended the support measures beyond 1 June, and will pay 41.5 percent of the wage for three months for employees whose labour agreements are reactivated after being suspended at the beginning of the crisis. Moreover, a monthly stimulus was approved to be granted for one year, accounting for 50 percent of the employee's wage, but not exceeding lei 2,500, for hiring persons over 50 who lost their job during the state of emergency/alert, as well as young people between the ages of 16 and 29 registered as unemployed, and Romanian citizens who returned home after losing their jobs abroad. Subsequently, steps were taken for implementing a flexible work schedule for a limited time, wherein the state would pay much of the wage difference resulting from the fewer working hours, financed via the SURE programme. It should be mentioned that these facilities (both those already in effect and those under discussion) cannot be cumulated for the same employee.

A series of studies in the literature have shown that the short-time work schemes implemented in Germany in the previous recession had favourable effects on employment. This was illustrated by the results of Balleer *et al.* (2013) or Hijzen and Martin (2013), who assess that the schemes saved between 466,000 and 580,000 jobs, i.e. around 1.3 percentage points of the unemployment rate, or an employment rate higher by 2 percent than it would have been had this instrument not been used. By contrast, Cooper *et al.* (2017) show that there have also been negative consequences for the efficient distribution of employees on the German labour market, the output losses being estimated at approximately 1.5 percentage points of GDP. Therefore, in order to mitigate the negative effects, it would be preferable to create a mechanism wherein firms would cover an increasingly significant part of costs, depending on the duration of participation in the programme, as the economy follows the upturn of the business cycle (Hijzen and Martin, 2013; Cahuc and Carcillo, 2011).

While initially the pandemic shock was perceived as temporary, the latest data suggest a prolonged health crisis (beyond the short-time horizon), with a high potential to produce/accelerate structural changes in economic activity globally. Hence, resorting to these support schemes may not completely yield the desired effect, as not only are they costly to maintain for a longer time horizon, but they may also be counter-productive, being likely to affect the efficient allocation of resources in the economy, which implies labour force migration towards firms and industries with more favourable growth prospects. For example, it is possible that the restrictions applied in certain fields – such as tourism, international passenger transport, food service – would persist longer, and consumer demand for these products would not recover any time soon. Concurrently, the sectors/companies with business models compatible with social distancing, such as online trade, courier services, activities than can be carried out at a distance using technology, or the health sector have a high growth potential. Therefore, apart from the measures already implemented for maintaining the labour force in the short term, it is desirable to have active policies capable of favouring a smoother transition to the new economic reality. These may be in the form of professional retraining programmes, training or facilitating the reallocation/optimisation of resources by

developing online platforms meant to reduce labour market frictions and to ease the recruitment process and the matching of candidates with job vacancies.

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2. Import prices and producer prices on the domestic market

The crisis generated by the rapid spread of the COVID-19 pandemic in early 2020 made a significant impact on the international commodity market, with energy and metal prices falling sharply in the first half year, due to their higher sensitivity to developments in economic activity. These trends have led to negative annual dynamics of import prices and producer prices on the domestic market. However, unit wage costs have witnessed inflationary pressures, given the strong contraction in economic activity and the effort to retain employees, the government shouldering a significant part of the burden via furlough payments.

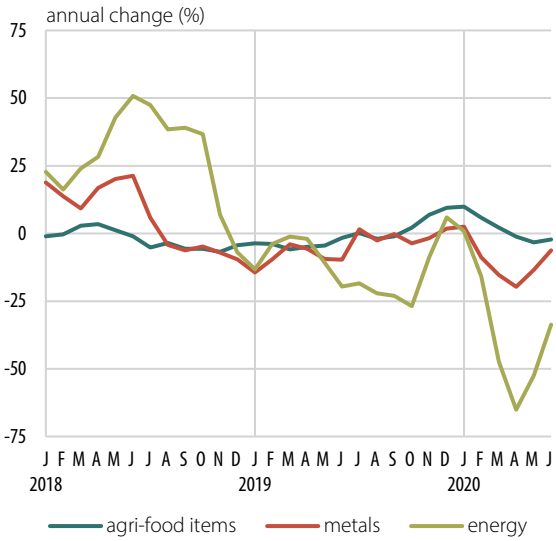
2.1. Import prices

Energy commodity prices decreased markedly in the context of the COVID-19 pandemic, amid weaker demand (the transport sector was among the most affected) and some disagreements within OPEC+ on how to adjust supply, which were subsequently settled. Specifically, the annual dynamics of the energy price index calculated by the World Bank entered negative territory in February, the situation worsening towards mid-2020 Q2 (a contraction in annual terms of 65.1 percent in April). Starting May 2020, the pace of decrease has slowed down somewhat (to -34 percent in June), under the joint action of a recovery in demand, driven by the gradual easing of restrictive measures on mobility, and the adjustment of supply, following the OPEC+ decision to cap output, along with the decline in unconventional mining in the US. Moreover, the annual dynamics of metal prices (including mineral

products) followed a similar path, yet exhibiting lower volatility: the annual rate of decrease intensified from -8.9 percent in February to -19.7 percent in April, slowing down subsequently to -6.2 percent in June, amid the resumption of industrial activity in China.

In turn, agri-food commodity prices posted slight declines across the board, displaying smaller volatility as well – the annual dynamics of the FAO aggregate index stood at 10 percent in early 2020, falling gradually to -2 percent in June (Chart 2.14). Despite some temporary restrictions on exports of agri-food commodities, food supply chains have proved resilient thus far, the demand-to-supply ratio being significantly different from that recorded at the outset of the 2007-2008 global food crisis, according to the latest *FAO Report* (June 2020) – large stocks and favourable forecasts for the next harvest at global level, together with a dwindling demand. However, some logistical bottlenecks have occurred, particularly in the case of highly perishable products (fruit, vegetables, milk).

Chart 2.14. International commodity prices



Source: World Bank, FAO, NBR calculations

In this context, external prices exerted stronger disinflationary pressures on domestic prices in 2020 Q1, the unit value index of imports (UVI)[24] declining to 97.3 percent (versus 98.5 percent in 2019 Q4). To this influence added the slightly slower annual pace of depreciation of the leu against the main currencies. Major contributors to the developments in the aggregate UVI were energy and intermediate goods, such as mineral products, chemicals, plastics and base metals, in line with the movement in international commodity prices, which is expected to have a stronger disinflationary impact during 2020 Q2.

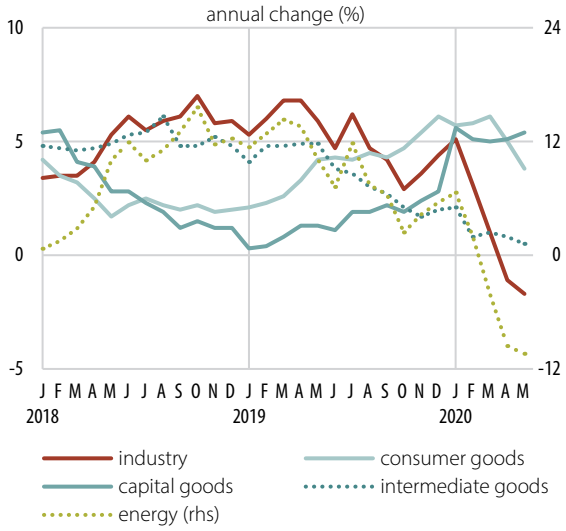
As regards the goods holding a relevant share in the CPI basket, the UVIs of most items saw increases. The main determinants for the agri-food sub-sector were the developments in meat products (given the swine fever related issues) and fruit, their UVIs reaching 137 percent and 122 percent respectively. For the period ahead, these trends may slow down, in light of the latest movements in agri-food prices on international markets. On the non-food segment, rises in UVI or high UVI values were further seen in semi-durables (clothing and footwear).

2.2. Producer prices on the domestic market

In April-May 2020, the annual dynamics of industrial producer prices on the domestic market fell into negative territory to -1.4 percent, (-4.4 percentage points versus 2020 Q1), owing chiefly to the energy sector, in line with developments in the Brent

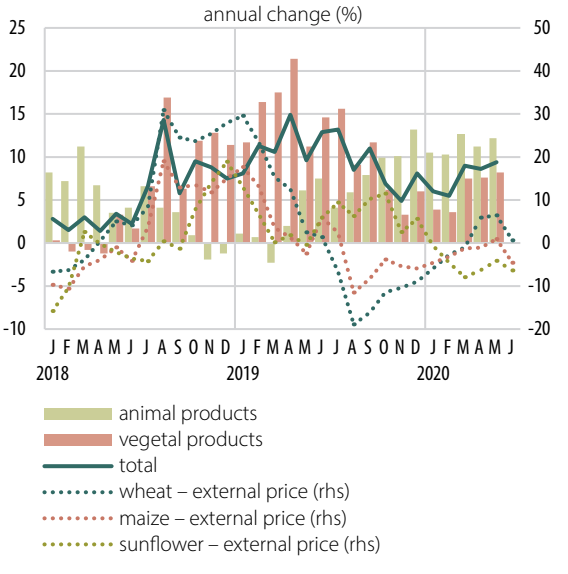
24 Expressed in EUR.

Chart 2.15. Industrial producer prices on the domestic market



Source: NIS, Eurostat

Chart 2.16. Agricultural producer prices



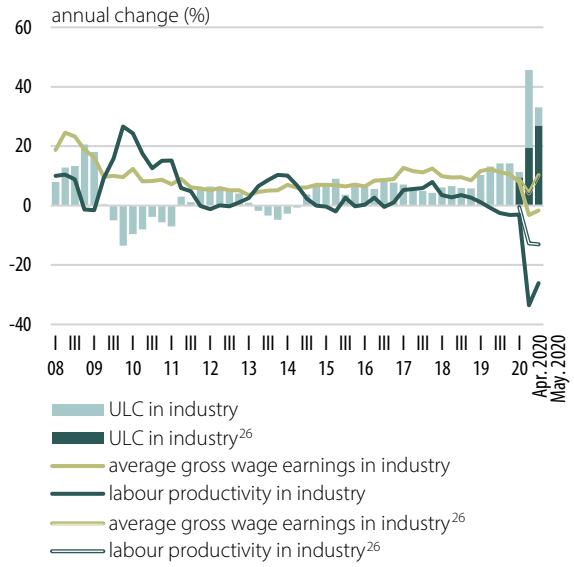
Source: NIS, Bloomberg, NBR calculations

oil price on international markets (Chart 2.15). Producer prices for intermediate and capital goods proved less sensitive to the external influence, domestic estimates showing that in these cases the changes in international commodity prices are passed through to producer prices with a longer lag. In addition, the annual dynamics of producer prices for consumer goods saw the upward path it had followed in the past year come to a halt, dropping to 4.4 percent in the first two months of 2020 Q2 (-1.5 percentage points against Q1). This trend owed entirely to food items, due to the lower pressures from commodity costs (in this case, pork meat, given the weakening global demand amid the measures adopted by the authorities, i.e. reduced mobility of the population, suspension of accommodation and food services activities). By contrast, the annual pace of increase of producer prices for consumer goods excluding food, beverages, tobacco hovered around 3 percent (a value close to the average for the most recent boom phase, i.e. 2015-2019), possibly in the context of the pressure stemming from unit wage costs. The different manner of price adjustment can be accounted for by the various degrees of processing of the goods or the cost structure, as well as by the contract terms set for a certain period. Some literature results obtained based on microeconomic data show that energy producer prices change very frequently, producer prices for intermediate goods and food items display medium flexibility, whereas capital goods and non-food consumer goods seem to have the most rigid prices[25].

In April-May 2020, the annual change of agricultural producer prices accelerated to 9.0 percent versus Q1, (+2.1 percentage points, Chart 2.16). Behind this evolution stood vegetal products, amid estimates of a domestic production below the long-term average for the crops sown in autumn (wheat, in particular). Considering the favourable outlook for global agricultural supply and the tendency of domestic prices to get in line with external developments, these pressures may be limited and short-lived. The annual growth rate of the prices for animal products stabilised at around 11 percent, the tensions

25 Dhyne, E., Konieczny, J., Rumler, F. and Sevestre, P. – "Price Rigidity in the Euro Area – An Assessment", *Economic Paper* No. 380, Economic and Financial Affairs, European Commission, 2009.

Chart 2.17. Unit labour costs



Source: NIS, Ministry of Labour and Social Protection, NBR calculations

built up in the pork meat segment alleviating significantly in the period under review (the annual rate of increase in prices dropped to 17 percent, from 50 percent in Q1).

Unit labour costs

In 2020 Q1, the annual growth rate of unit labour costs economy-wide came in at 6.7 percent, running above the previous quarter's 5.8 percent reading. Given that the COVID-19 pandemic effects have become fully manifest only in Q2, unit labour costs are estimated to jump significantly during this period, as a result of a much larger decline in economic activity than the adjustment on the labour market – this behaviour was prevalent during the past recession and will probably be a feature of the present crisis, considering the broad government support for retaining employees through furlough schemes. The data available for the industrial sector show the annual growth rate of unit wage costs picking up markedly in April and decreasing mildly in May (45.3 percent and 33 percent respectively, against an average of about 13 percent in the last four quarters). Leaving aside the impact of firms' recourse to furlough schemes, the change in unit wage costs is similar to that seen during the previous recession (Chart 2.17).

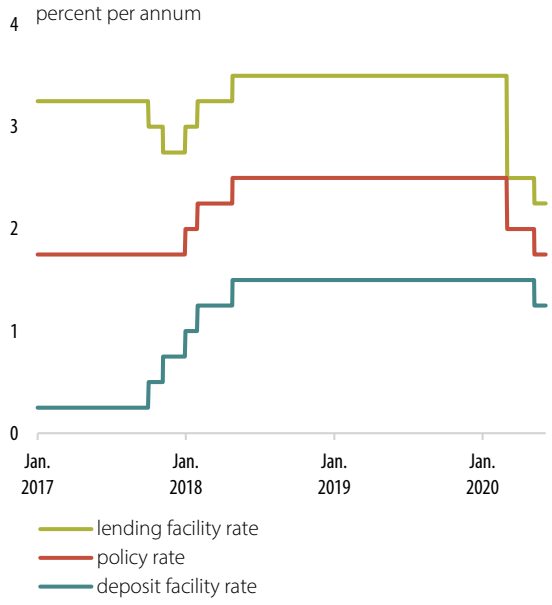
26 Calculated by excluding the number of furloughed employees in industry, which was approximated by adjusting the data on suspended contracts in industry to the ratio of the number of payrolls to total active employment contracts economy-wide (which is higher, some employees having multiple ongoing contracts).

3. Monetary policy and financial developments

1. Monetary policy

Having convened for a meeting on 29 May 2020[27], the NBR Board decided to cut the monetary policy rate by another 0.25 percentage points to 1.75 percent, as well as to lower the deposit facility rate and the lending facility rate to 1.25 percent and 2.25 percent respectively. Furthermore, 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. Moreover, given the liquidity shortfall on the money market, it was decided that the NBR should further conduct repo transactions and continue to purchase leu-denominated government securities on the secondary market, keeping financial market stability. These decisions were meant to support a fast-track economic recovery after the coronavirus-induced contraction, with a view to ensuring price stability over the medium term, in line with the 2.5 percent ±1 percentage point inflation target, while preserving financial stability (Chart 3.1).

Chart 3.1. NBR rates



The decisions were taken in a context in which the main domestic macroeconomic developments had started to reflect the adverse effects of the coronavirus pandemic and of the containment measures taken worldwide and countrywide, while the forecast scenario prepared in the new environment, extremely challenging in terms of unknowns and uncertainties, showed a change in the anticipated inflation pattern versus the previous projection, pointing also to a significant contraction in economic activity this year – on account of the decline in Q2 –, followed by a moderate recovery in 2021.

Thus, according to the latest statistical data, the annual CPI inflation rate remained unchanged in March at 3.05 percent and then fell to 2.68 percent in April, hence marking a steeper decline versus December 2019, attributable especially to the plunge in the oil price. Conversely, the annual adjusted CORE2 inflation rate tended

[27] According to the NBR Board decision of 20 March, given the elevated uncertainty surrounding economic and financial developments in the coronavirus pandemic context, the previously announced calendar of monetary policy meetings was suspended, with monetary policy meetings to be held whenever necessary for an indefinite period.

to increase slightly, contrary to forecasts, reaching 3.7 percent in April 2020 from 3.66 percent in December 2019. The evolution owed to changes in consumption structure brought about by social distancing measures, associated also with probable disruptions and cost increases in production and supply chains, overlapping persistent demand-pull and wage cost-push inflationary pressures.

Moreover, economic growth slowed down considerably in 2020 Q1, in spite of remaining particularly robust in the first two months of the year. At the same time, the trade deficit posted a markedly faster widening – amid a relatively steeper decline in exports than in imports of goods and services –, with an impact on the current account deficit, whose coverage by FDI and capital transfers continued to worsen. Furthermore, the lockdown in numerous economic sectors starting the latter half of March and the visible shrinking of consumer demand, alongside the reduction in external demand, rendered likely a severe contraction of the Romanian economy in Q2, implying an abrupt shift in its cyclical position, from a substantially positive value to a markedly negative one.

In turn, labour market conditions witnessed a sudden deterioration in mid-March, while the number of terminated employment contracts was envisaged to rise in the near term, given *inter alia* the narrowing – as of 1 June – of the scope of government furlough schemes, widely resorted to by employers during the state of emergency. Against this background, a mild slowdown in the growth rate of wages was anticipated, accompanied however by further elevated dynamics of unit wage costs in industry, in the context of notable labour productivity losses.

Influences from the external environment also became increasingly adverse, amid the fast-paced worsening of the evolution and prospects of global, euro area and EU economies – with disinflationary or even deflationary effects in certain countries –, alongside the sizeable contraction of international trade, owing *inter alia* to the major disruptions in global production and distribution chains. In this context, many central banks in advanced and emerging economies, including the ECB and central banks in the region, continued to ease the monetary policy stance by way of unconventional approaches or by additional cuts in key policy rates.

Nevertheless, financial market conditions improved considerably after the adoption of the NBR's monetary policy decisions on 20 March and after the end-March peak in tensions generated by the COVID-19 crisis. Key interbank money market rates witnessed a significant downward adjustment in the closing 10-day period of March and afterwards continued to decline, while yields on leu-denominated government securities went down progressively, amid the increased volume of liquidity injected by the NBR through bilateral repo operations and purchases of leu-denominated government securities on the secondary market, given the liquidity shortfall on the money market. Moreover, the average lending rate on new business almost entirely corrected in March the rise witnessed during the first two months of the year. The slight increase in the IRCC level in Q2, but also the draft legal acts – in various stages of the legislative process – regarding the banking sector compounded, however, the uncertainties about the functioning of the monetary policy transmission mechanism.

During the same period, the EUR/RON exchange rate saw lower fluctuations, under the influence of the relative improvement in global financial market sentiment, as well as amid liquidity conditions on the money market and the interest rate differential. Changes in some of these parameters or an additional worsening of the risk perception vis-à-vis the domestic economy and the local financial market would have, however, been conducive to renewed heightened pressures on the leu's exchange rate, with adverse implications *inter alia* for the confidence in the domestic currency, external vulnerability indicators and, ultimately, for financing costs and the pace of economic recovery following the downturn.

The multiple unknowns concerning the evolution and the implications of the pandemic and of the related measures compounded the forecasting process and rendered it highly difficult, taking to extreme levels the uncertainty associated with the forecast scenario prepared at such a juncture. In light of the scenario, after a moderate decline in April-June, the annual inflation rate was expected to pick up and to fluctuate temporarily around 2.8 percent, before falling to the midpoint of the target in mid-2021 and staying there afterwards[28]. While the return of the annual inflation rate to higher readings in 2020 H2 was entirely attributable to supply-side factors[29], pressures from fundamentals were expected to become strongly disinflationary only in 2021, amid the lag of the disinflationary effects exerted by the negative output gap, anticipated to open markedly in 2020 Q2 and then close progressively.

Thus, in the new scenario, the Romanian economy was foreseen to witness a significant contraction in 2020, followed by a moderate recovery in 2021, as the severe economic decline in 2020 Q2 was anticipated to be corrected partially in the following quarter and somewhat more gradually afterwards, amid the progressive easing of restrictive measures associated with the pandemic crisis. The outlook implied a major turnaround in the output gap pattern. Specifically, after having reached a peak of the current business cycle at end-2019, the output gap was expected to fall markedly into negative territory in 2020 Q2, before closing progressively until 2022.

Under the circumstances, but also as a result of the disinflationary base effects anticipated to be manifest in 2020 Q2 and 2021 Q1[30], the annual adjusted CORE2 inflation rate was expected to stay above 3 percent during 2020, even after a visible decline in Q2, but to fall in 2021 H1 and afterwards fluctuate very slightly around 2.2 percent[31].

The magnitude of economic contraction in 2020 Q2, but also the pace of the subsequent economic recovery were highly uncertain, given: i) the unprecedented nature of such an economic shock domestically and internationally, exerting an

28 Whereas the previous projection, published in the February *Inflation Report*, had seen it at 3 percent in December 2020 and 3.2 percent at end-2021.

29 Their action was envisaged to turn more inflationary than previously forecasted over the short term, as the impact of the decline in oil prices was anticipated to be more than counterbalanced by that of the increase in prices for vegetables/fruit, but also for some essential goods and processed food items, owing *inter alia* to persistent disruptions in domestic and global production and distribution chains.

30 Associated with the introduction of the telecom sector tax and with the hikes in prices for pigmeat and other agri-food commodities respectively.

31 Compared with the previous 3.4 percent projection for the end of the forecast horizon.

unpredictable impact on the activity of various sectors/sub-sectors of the economy, as well as on macroeconomic behaviours, especially consumer behaviour; ii) the particularly elevated uncertainty about mobility restrictions and their lifting – depending on the evolution of the pandemic, which might even see a renewed surge over the short time horizon –, as well as about the effectiveness of national measures/ programmes designed to support firms and households.

A source of heightened uncertainties and risks was also the current and future stance of the fiscal and income policies, given the unusually large widening of the budget deficit in the first months of the year – with potential adverse implications for its financing, as well as for next years' budget execution, especially in view of the election calendar and the provisions of the new pension law –, to which added the requirement for a start of fiscal consolidation in the short run, amid the European Commission's excessive deficit procedure[32].

Increased uncertainties and risks also stemmed from the euro area and world economy contraction, in the context of the coronavirus pandemic crisis, relevant *inter alia* from the perspective of the current account deficit, anticipated to deteriorate further in 2020, as a share in GDP, and improve only marginally in 2021.

This context warranted a prudent cut in the monetary policy rate, to help achieve – alongside the previous package of measures – fast-track economic recovery after the coronavirus-induced contraction, with a view to ensuring price stability over the medium term in line with the 2.5 percent ±1 percentage point inflation target, while preserving financial stability[33].

2. Financial markets and monetary developments

> Longer-term rates on the interbank money market, as well as the interest rate on interbank transactions[34], fell markedly in Q2. By contrast, the IRCC advanced slightly, to 2.44 percent. The EUR/RON exchange rate saw lower fluctuations, moving in a narrow range during the period under review. In the context of the COVID-19 pandemic and of the associated measures, the annual growth rate of credit to the private sector decelerated April through May, whereas the annual dynamics of liquidity across the economy witnessed a strong pick-up.

2.1. Interest rates

The daily average interbank money market rate stayed at the upper bound of the interest rate corridor in the first month of Q2, before falling and remaining largely in

32 Still in force, the temporary suspension of the Stability and Growth Pact notwithstanding.

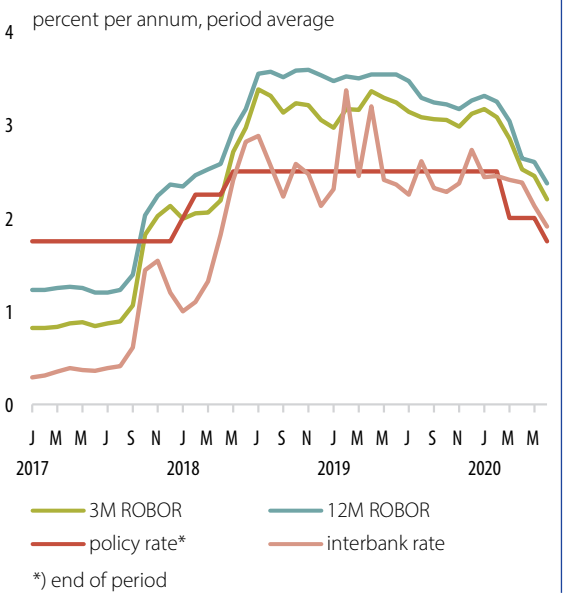
33 In addition, given the elevated uncertainty surrounding economic and financial developments, the NBR Board decision to suspend the previously announced calendar of monetary policy meetings was kept in place, with monetary policy meetings to be held whenever necessary.

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

line with the monetary policy rate. During the reported period as a whole, its average went down markedly versus the previous quarter, by 0.35 percentage points, to a nine-quarter low of 2.09 percent.

Given the significant widening of the net liquidity deficit on the money market at the beginning of the quarter, followed by its gradual narrowing due to the Treasury's reserve injections, the NBR increased the volume of bilateral repo operations[35] and launched in April and then continued the purchase of leu-denominated government securities on the secondary market[36]. To these added banks' resort to the lending facility, which was significant in the first month of the quarter, but much lower afterwards. Against this background, ON rates on the interbank money market stuck to the upper bound of the interest rate corridor in April and in the early days of May, before declining and remaining largely in line with the monetary policy rate[37].

Chart 3.2. Policy rate and ROBOR rates



Longer-term (3M-12M) ROBOR rates continued their downward adjustment during Q2 – after the steep fall following the monetary policy decisions of 20 March –, amid the improvement in current and expected liquidity conditions on the money market, as well as under the impact of the new policy rate cut. Hence, their quarterly averages witnessed significant decreases, of up to 0.66 percentage points, reaching nine-quarter lows, i.e. 2.39 percent for the 3M rate and 2.47 percent and 2.54 percent for 6M and 12M rates respectively (Chart 3.2).

Aside from the impact of the new policy rate cut and of the NBR's outright purchases, the government securities market reflected in Q2 the influences of the gradual improvement in global financial market sentiment, *inter alia* as a result of the further easing of the monetary policy stance by central banks in both developed and emerging economies; in this context, long-term government security yields in advanced economies consolidated at low levels, while those in the region continued to decline. Favourable influences also came from the announcement, at the beginning of June, on the S&P agency maintaining Romania's sovereign rating at investment-grade level.

Under the circumstances, reference rates on the secondary market re-embarked on a downward path once the NBR launched the purchase of government securities at the onset of April, with their decline consolidating and becoming broad-based in May and June. The adjustment was sizeable in the case of securities with a maturity of up to 1 year, but especially for 10-year securities, whose rates reverted

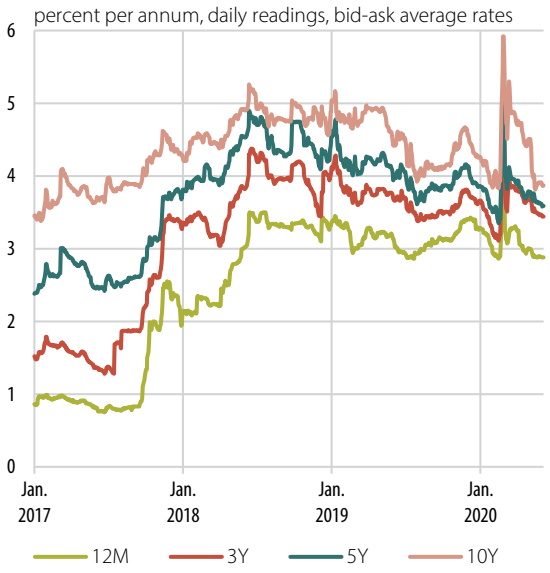
35 The daily average stock of these operations rose in April to lei 13.6 billion, before falling to lei 9 billion in May and lei 5 billion in June.

36 Their volume amounted to lei 4 billion during Q2.

37 Posting, however, somewhat higher readings towards the end of the period.

to readings either similar to or even slightly lower than those recorded immediately before the outbreak of international financial market turmoil[38]. The June averages of secondary market rates fell against those in March by up to 0.4 percentage points for 6-month and 12-month securities (to 2.69 percent and 2.89 percent respectively), by 0.18 percentage points (to 3.48 percent) and 0.33 percentage points (to 3.64 percent) for the 3- and 5-year maturities respectively, and by 0.76 percentage points (to 3.90 percent) for 10-year securities. Against this backdrop, the yield curve saw its positive slope flatten considerably, after having steepened March through April (Chart 3.3).

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



On the primary market[39], the average accepted rates at the auctions continued to go up mildly in April after the leap recorded in March, before witnessing a trend reversal in May, declining until the end of the quarter to values close to or even slightly lower[40] than the levels seen in the period prior to the financial turmoil. The volume of government securities issued rose sizeably from one month to another, reaching for the period as a whole the highest level since 2012 Q1 (lei 22.4 billion), while their net value hit the second peak since 2012 Q1, as most issues were markedly oversubscribed and the MPF accepted increasingly higher volumes compared with the scheduled ones.

Specifically, the ratios of both the amounts of bids submitted and the volume of issues to the announced volume followed a steep upward path during the quarter, coming in at 3.0 and 1.8 respectively in June – similar to the February readings and particularly high from a historical perspective; moreover, their quarterly averages exceeded markedly those recorded January through March (2.6 and 1.7 versus 2.2 and 1.1 respectively).

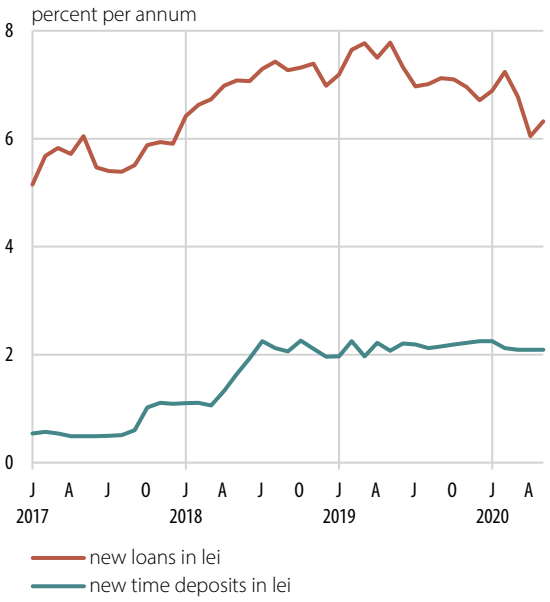
Reflecting the downward path of relevant interbank money market rates, but also the influence of some fluctuations in the credit flow composition amid the pandemic crisis, the average interest rate on non-bank clients' new loans saw a steeper decline in April (down 0.73 percentage points to 6.05 percent), before rising more modestly in May (to 6.32 percent), its average for the period overall shedding a hefty 0.79 percentage points versus that in Q1, to 6.19 percent. Conversely, the average interest rate on new time deposits remained unchanged in both months at 2.09 percent, inching down 0.06 percentage points against Q1 (Chart 3.4).

38 At the same time, rates pertaining to the median segment of the curve saw their advance slow to around 0.2-0.3 percentage points versus the first half of March.

39 In May, the MPF issued on external markets EUR-denominated bonds with maturities of 5 years (EUR 1.3 billion) and 10 years (EUR 2 billion) at average rates of 2.79 percent and 3.62 percent respectively (305 basis points and 375 basis points respectively above the mid-swap rates).

40 In the case of securities with a residual maturity of 11 years.

Chart 3.4. Bank rates



Looking at the two customer sectors, developments in average interest rates were largely heterogeneous. Specifically, the average lending rate on new business to households witnessed a sizeable decline in April (down 1.15 percentage points), partly corrected in May (up 0.44 percentage points to 7.11 percent), its average for the two months diminishing significantly against that in 2020 Q1 (by 1.06 percentage points, to 6.89 percent). The fluctuations reflected primarily the changes in the share of new consumer loans, whose volume shrank in April by about two thirds versus the previous month, under the impact of the pandemic crisis, before witnessing a relative recovery, albeit at a subdued level. New housing loans were impacted to a smaller extent, *inter alia* due to the increase against Q1 in loans granted under the "First Home" programme, but also as a result of the significant rise in the volume of renegotiated loans, as some of the borrowers opted for the loan moratorium. The average interest rate diminished slightly in April and May for both consumer credit (by 0.28 percentage points overall, to 9.37 percent) and housing loans (down 0.27 percentage points to 5.08 percent).

The average lending rate on new business to non-financial corporations went down marginally in April and somewhat more visibly in May (to a two-year low of 5.34 percent), its average for the period overall (5.43 percent) standing 0.32 percentage points below the Q1 reading. The average interest rate on low-value loans declined in both months (by a total of 0.46 percentage points, to 5.42 percent in May), its average for the period shedding 0.50 percentage points against Q1, to 5.48 percent. By contrast, the average interest rate on large-value loans posted an increase of 0.48 percentage points in April, partly corrected in May (down 0.27 percentage points to 5.16 percent); however, its average for the period (5.30 percent) decreased by 0.14 percentage points versus Q1. In the case of firms as well, the pandemic crisis and the related measures affected lending, the volume of new business shrinking more quickly in April and somewhat more slowly in May, probably *inter alia* with a contribution from loans granted under the IMM Invest Romania Programme, but also due to the higher volume of renegotiated loans in the context of the payment moratorium.

The average remuneration of new time deposits from households stuck to the slowly downward trend seen since December 2019, shrinking marginally in April, to 1.75 percent, unchanged in May as well; its average for the two months thus shed 0.10 percentage points against Q1. At the same time, the average interest rate on new time deposits from non-financial corporations witnessed minor fluctuations in both months, its average for the period edging down 0.06 percentage points versus Q1, to 2.21 percent.

Chart 3.5. Nominal exchange rate

Table 3.1. Key financial account items

EUR million

	5 mos. 2019			5 mos. 2020		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	2,263	4,028	-1,764	5,320	5,975	-655
Direct investment	473	2,529	-2,056	-404	-746	341
Portfolio investments	958	1,561	-603	-37	6,502	-6,538
Financial derivatives	6	x	6	0	x	0
Other investment	1,305	-62	1,368	2,883	219	2,664
– currency and deposits	74	-625	699	2	0	2
– loans	-138	-780	642	242	234	8
– other	1,369	1,343	27	2,639	-15	2,654
NBR's reserve assets, net	-479	0	-479	2,878	0	2,878

*) "+" increase/"-" decrease

2.2. Exchange rate and capital flows

The EUR/RON exchange rate saw lower fluctuations in Q2, moving in a narrow range, under the influence of the relative improvement in global financial market sentiment, as well as amid liquidity conditions on the money market and the interest rate differential (Chart 3.5).

Pressures on the EUR/RON exchange rate softened slightly in April – after having strengthened in March –, amid the relative abatement of international financial market volatility[41] (Table 3.1). However, the risk perception vis-à-vis the local economy and financial market witnessed a renewed worsening, amid the further deterioration of the fiscal position and its outlook[42], under the impact of the pandemic crisis and of expectations regarding the implementation of the new pension law. In the context of the NBR's actions related to money market liquidity control and of the interest rate differential, the pace of depreciation of the leu against the euro slowed, however, to 0.2 percent during the month overall, thus remaining markedly below those recorded by the main currencies in the region.

Global financial market sentiment continued to improve in May[43], amid the gradual easing of containment measures launched by the major global economies – enabling the resumption of some economic activities – and the new fiscal and monetary policy measures adopted worldwide, as well as in the context of a comprehensive package of post-pandemic recovery measures taking shape at EU level[44]. Against this background, the exchange rates of the currencies in the region reversed their paths in mid-May or saw their downward trajectories steepen, thus discontinuing or slightly

41 As a result of the fiscal measures and programmes resorted to/announced by governments in many countries and by international and European institutions and bodies, aimed at mitigating the economic impact of the pandemic, as well as the measures taken by major central banks and by those in emerging economies to ease the monetary policy stance.

42 Against this backdrop, Fitch and Moody's revised the outlook for Romania's sovereign rating to "negative" from "stable" on 18 April and 25 April respectively.

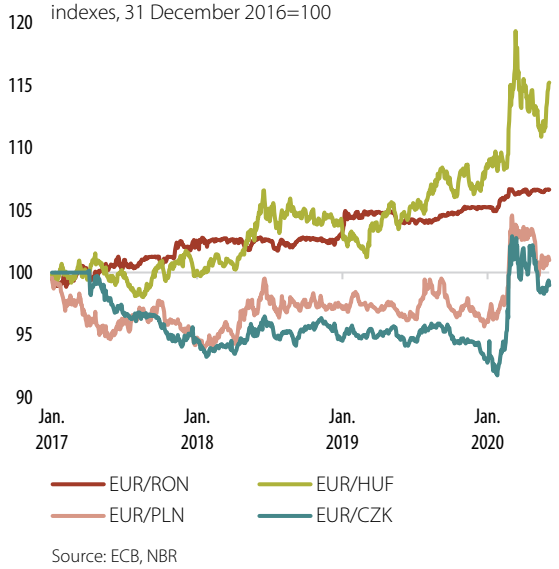
43 Nevertheless, developments were heterogeneous, as several factors fuelled the fluctuations in volatility on the international financial market: the rekindled geopolitical tensions between the US and China; the uncertainties about the future evolution of the pandemic; the worsening of the fiscal position in numerous economies, likely to entail – as the S&P rating agency cautioned – downgrades of the sovereign ratings.

44 Following the proposal put forward by France and Germany on 18 May, the European Commission published on 27 May its proposal for a EU recovery plan worth EUR 750 billion.

correcting the increases seen since the outbreak of financial turmoil in March[45]. The EUR/RON also went down in the first days of the month, but then returned to and consolidated at the initial values, remaining virtually constant as a monthly average.

The EUR/RON exchange rate remained quasi-stable in June, amid the improvement of the return/risk ratio on investments in domestic currency[46] and in the context of a sharp appreciation of the euro against the US dollar[47]; the latter was, however, brought to a halt at the end of the first 10-day period by the temporary rekindling of global financial market volatility, primarily due to increased concerns about the coronavirus pandemic and its economic implications[48]. Thus, the EUR/RON moved again in tandem with developments in the exchange rates of currencies in the region, which stuck to a downward path in the early days of the month, before remaining relatively stable[49].

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



Source: ECB, NBR

The overall interbank forex market deficit quasi-halved in Q2 compared with the substantial level recorded in the first three months of the year, primarily on account of non-residents' transactions, but also due to the shrinking of residents' excess demand.

During 2020 Q2 as a whole[50], the domestic currency weakened against the euro by 0.3 percent in nominal terms[51] and strengthened by 0.2 percent in real terms. In relation to the US dollar, the leu appreciated by 1.6 percent in nominal terms and 2.0 percent in real terms, given the former's depreciation versus the single currency. Looking at the average annual exchange rate dynamics in Q2, the leu saw its nominal depreciation increase versus the euro, but diminish against the US dollar (Chart 3.6).

45 During the month overall, the Polish zloty and the Hungarian forint strengthened versus the euro by 0.4 percent and 1.7 percent respectively. The exchange rate of the Czech koruna remained unchanged as a monthly average, given its increase in the first half of the month, recorded *inter alia* amid the larger-than-expected cut in the monetary policy rate by the central bank on 7 May.

46 Also against the backdrop of the early-June announcement on the S&P agency maintaining Romania's sovereign rating at investment grade level.

47 As a result of the optimism generated by the comprehensive economic recovery plan taking shape at EU level.

48 In the latter part of the month, the strengthening of the euro against the US dollar even witnessed a partial correction, amid the surfacing of political disputes at European level with regard to the economic recovery package.

49 With a very slight uptrend towards the end of the period for the Czech koruna and the Polish zloty, yet much steeper for the Hungarian forint, amid the unexpected policy rate cut by the central bank.

50 Versus the previous quarter, based on the exchange rate averages in June and March respectively.

51 The main currencies in the region also weakened against the euro during this period (the Polish zloty by 0.1 percent, the Czech koruna by 0.4 percent, and the Hungarian forint by 0.6 percent).

2.3. Money and credit

Money

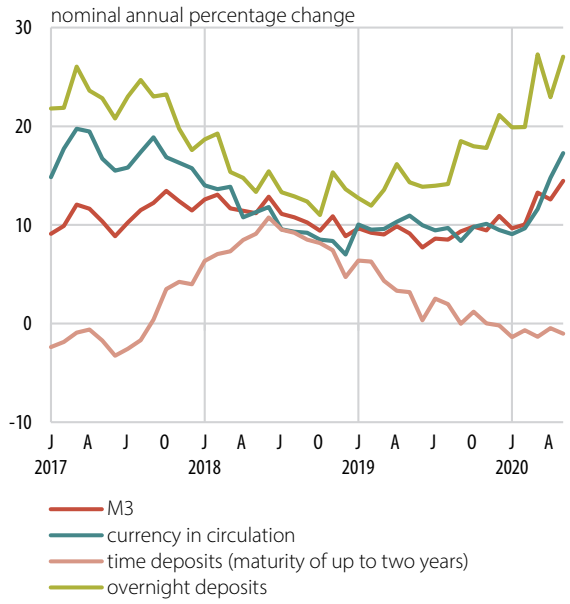
In the context of the COVID-19 pandemic and of the related measures, the annual growth rate[52] of broad money (M3) gained significant momentum April through May 2020 (to an 11-year high of 13.5 percent from 11.0 percent in Q1)[53], due to the large liquidity injections occasioned by the budget execution – *inter alia* amid the slight rise in inflows of European funds[54] –, but also to the keener preference for liquidity for precautionary reasons (Table 3.2).

Table 3.2. Annual growth rates of M3 and its components

nominal percentage change

	2019			2020		
	II	III	IV	I	Apr.	May.
	quarterly average growth					
M3	8.9	8.8	10.1	11.0	12.6	14.5
M1	13.5	13.6	16.3	18.7	20.6	24.2
Currency in circulation	10.4	9.2	9.8	10.1	14.8	17.3
Overnight deposits	14.8	15.5	19.0	22.4	22.9	27.0
Time deposits (maturity of up to two years)	2.3	1.5	0.4	-1.1	-0.5	-1.0

Chart 3.7. Main broad money components



The step-up in M3 growth was primarily due to its more liquid component (M1), whose annual dynamics witnessed a sturdy leap, attributable *inter alia* to the stronger preference for liquidity due to precautionary reasons, as well as to portfolio shifts away from time deposits with a maturity of up to two years. The M1 advance in annual terms was relatively fluctuating over the period, moderating slightly in April – amid the abrupt decline in the dynamics of ON deposits from non-financial corporations, largely offset however by the renewed pick-up in the growth rate of similar household deposits, but especially of currency in circulation –, before gathering considerable pace in May, to a 3½-year high, under the impact of the increase in currency in circulation and in corporate ON deposits (Chart 3.7).

In turn, time deposits with a maturity of up to two years saw a slightly softer annual contraction during this period, exclusively on account of leu-denominated household deposits – whose developments hint at a possible rise in precautionary saving –, while similar deposits from non-financial corporations posted a faster annual rate of decline. Consequently, the share of M1 in M3 continued to widen, reaching a new post-July 1994 high of 66.7 percent in May.

Looking at institutional sectors, the steep advance in M3 dynamics was underpinned by the considerable step-up in the pace of increase of household deposits – to the highest reading

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

53 The average annual M3 dynamics picked up considerably in real terms as well, climbing to two-digit levels (10.8 percent in the first two months of Q2 from 7.5 percent in the previous three months).

54 According to general government budget execution data.

for the past approximately 10 years. This was correlated with the sharp decline in private consumption, but also with the higher rate of change of amounts from EU funds earmarked for households, as well as with the slacker increase in households' government securities portfolio[55], alongside the steeper contraction of this sector's placements in investment funds. The growth rate of similar corporate deposits remained particularly brisk as well, slowing only slightly versus Q1, as its pronounced weakening in April – due to the decline in consumer demand and the increase in profit tax payments to the government budget[56] – was followed by a renewed sizeable pick-up, associated mainly with the fiscal deficit widening.

From the perspective of M3 counterparts, net credit to central government was the key driver behind the faster monetary expansion in the period from April to May overall[57], amid the protracted step-up in the annual dynamics of monetary financial institutions' government security holdings[58]; opposite influences came from the slower growth of private sector credit, under the impact of the pandemic crisis.

Credit to the private sector

In the context of the COVID-19 pandemic and of the related measures, the annual pace of increase of credit to the private sector decelerated to 5.1 percent[59] April through May, from 7.1 percent in the previous quarter[60], amid the contraction in the volume of new loans[61] – cushioned, however, by the go-live of the IMM Invest Romania Programme[62] in May – and the reduction in loans granted through lines of credit[63]. Opposite, yet markedly weaker effects stemmed from the temporary moratorium on payments of loan instalments, based on the pandemic relief measures for borrowers[64], as well as from the decline in the volume of net NPL sales.

The evolution reflected both the steepening downtrend of the annual dynamics of leu-denominated loans, which shrank to a six-year low[65], and the declining rate of change of the foreign currency component (expressed in EUR), which marginally re-entered negative territory. Against this background, the share of domestic currency loans in total private sector credit stuck to a slightly upward path, reaching a 24-year high of 67.3 percent in May (Chart 3.8).

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55 *Inter alia* amid government bonds worth around lei 9 billion maturing in April.

56 According to general government budget execution data.

57 A smaller contribution to the pick-up in the M3 average annual dynamics had the further advance in the growth rate of net foreign assets of the banking system, as the MPF issued Eurobonds worth EUR 3.3 billion in May.

58 Including the NBR, as the central bank launched in April the purchase of leu-denominated government securities on the secondary market, conducting purchases worth lei 3.5 billion during the period under review. Credit institutions' government security holdings continued to grow at a faster annual rate during the two months overall.

59 The lowest reading for the past approximately three years.

60 In real terms as well, the average annual rate of change of credit to the private sector slowed considerably, to 2.6 percent in the period from April to May versus 3.8 percent in the previous three months.

61 Data on new business have been taken from interest rate reports and have been adjusted for the volume of renegotiation operations.

62 Government support scheme approved in the context of the pandemic crisis through GEO No. 42/2020 and supplemented by GEO No. 89/2020, whereby the state guarantees up to 90 percent of the amount of some loans to SMEs and micro-enterprises and fully subsidises the interest and other financing costs until 31 December 2020.

63 Revolving loans, overdraft loans, and credit card loans.

64 GEO No. 37/2020 instituted a loan moratorium for some borrowers – individuals and companies – allowing monthly loan repayments to be postponed for up to nine months, but not beyond 31 December 2020, starting April 2020. In parallel, a large part of credit institutions adopted individual-level solutions to postpone loan repayments starting March for borrowers whose income was temporarily affected by the fallout from the COVID-19 pandemic.

65 Assessment based on quarterly data.

Chart 3.8. Credit to the private sector by currency

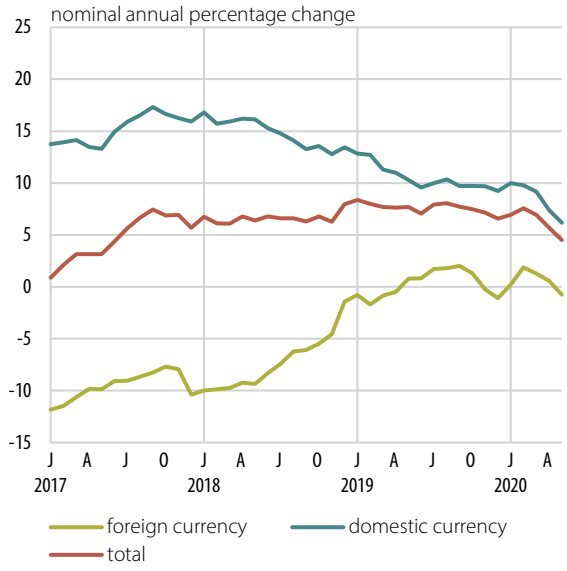
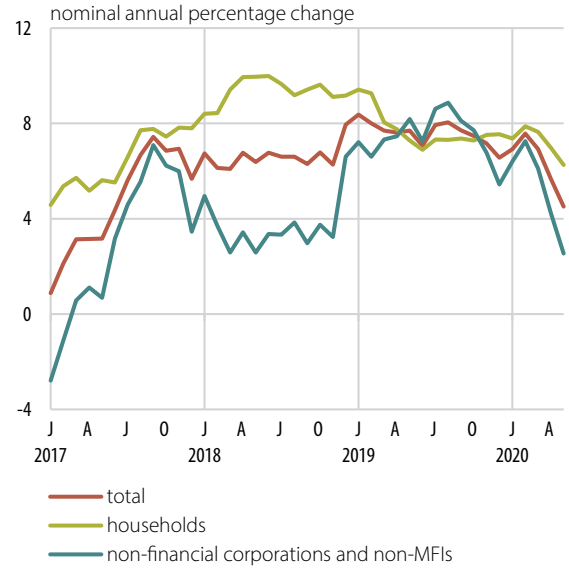


Chart 3.9. Credit to the private sector by institutional sector



In terms of institutional sectors, the slower rise in credit to the private sector was primarily brought about by the marked decline in the annual dynamics of loans to non-financial corporations (to a 12-quarter low), especially as a result of the more visible deceleration in the case of leu-denominated credit (to the lowest reading for the past almost 10 years), but also due to the further slowdown in the growth of the foreign currency component (expressed in EUR). These developments were manifest for short- and medium-term loans (with a maturity of up to five years) and reflected both the sizeable shrinking of the credit flow – countered, however, markedly by the IMM Invest Romania Programme in May – and a renewed contraction in loans granted through lines of credit. At the same time, the long-term component gained significant momentum, hinting at a more inertial behaviour of this type of financing, but also at firms' concern for securing longer-term liquidity in the context of the pandemic crisis (Chart 3.9).

Looking at loans to households, the loss of momentum was much more modest (although their dynamics hit a 12-quarter low). It was ascribable to leu-denominated consumer credit and other loans, which saw notably slower dynamics, amid the significant contraction in new business in annual terms – considerably more moderate, however, in May –, as well as the more sluggish growth rate of overdraft loans and credit card loans, in line with the deterioration of consumer confidence and shrinking consumer demand due to the pandemic crisis. By contrast, the rate of change of leu-denominated housing loans remained brisk and even picked up slightly, prompted by the increased contribution from new business under the "First Home" programme[66], but also by the likely decline in the volume of repayments compared with the same year-earlier period, in the context of debtor relief measures.

66 According to CCR data referring to loans granted with state guarantee associated with the "First Home" programme.

4. Inflation outlook

The baseline scenario of the macroeconomic projection is based on the assumption of keeping the epidemic under control, which would help avoid the reintroduction of widespread administrative social distancing measures. Specifically, the economic activity will continue to return to normalcy as economic agents gradually adapt to the new conditions. Against this background, the annual CPI inflation rate is forecasted to follow a mild downtrend over the projection interval, reaching 2.7 percent at the end of this year and 2.5 percent at the end of the next. The values reflect chiefly the contribution of core inflation, which is projected to recede from the recent elevated levels, largely under the impact of the large aggregate demand deficit in the economy and the fading inflationary pressures from supply-side shocks resulting from the specific context of the medical situation.
The dynamics of some exogenous components of the consumer basket (fuel prices and administered prices) will act in the opposite direction, i.e. towards increasing inflationary pressures, yet their influence is unlikely to change the downward path in headline inflation. The new forecast for the annual CPI inflation rate and the adjusted CORE2 inflation rate reconfirms, with small differences, the values projected in the previous *Inflation Report*.

Both the evolution of the epidemic and its impact on economic activity are fraught with high uncertainty, also reflected in the macroeconomic projection. On the whole, the balance of risks to the annual inflation rate is assessed as being tilted, especially over the medium term, to the upside against the inflation path projected in the baseline scenario.

Baseline scenario

4.1. External assumptions[67]

The baseline scenario for the external environment envisages a sharp contraction, unprecedented in the recent past, of external demand (effective EU GDP) in 2020, with the gradual lifting of social distancing measures being foreseen to entail only a progressive recovery of economic activity (Table 4.1). External demand is, however, expected to see positive dynamics in the course of 2021, given the presumably temporary nature of the pandemic shock; nevertheless, it is assumed that the economies will return to pre-crisis levels of activity relatively slowly, beyond the end

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

Table 4.1. Expectations on the developments in external variables

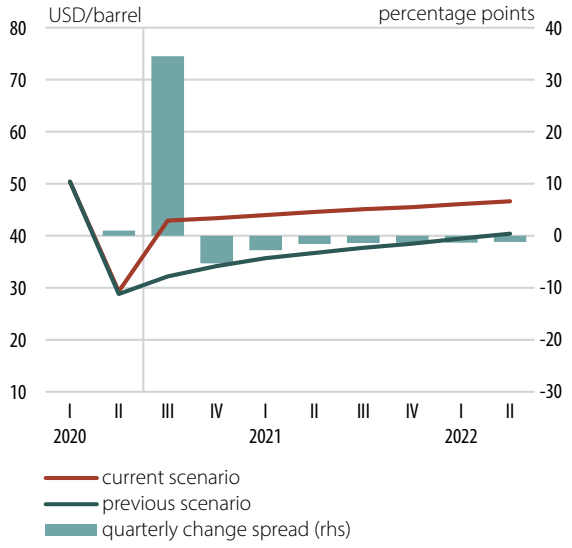
	annual averages	
	2020	2021
Effective EU economic growth (%)	-8.1	5.9
Annual inflation rate in the euro area (%)	0.4	0.8
Annual inflation rate in the euro area, excluding energy (%)	1.3	0.9
Annual CPI inflation rate in the USA (%)	1.0	1.6
3M EURIBOR (% per annum)	-0.4	-0.4
USD/EUR exchange rate	1.11	1.14
Brent oil price (USD/barrel)	41.5	44.8

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

of next year. Compared to the May 2020 *Inflation Report*, both annual growth rates in the projection were adjusted downwards, mirroring the effects of the pandemic crisis and sterner measures taken by the authorities to contain its spread. The effective EU GDP gap, an indicator reflecting the cyclical component of economic activity in Romania's main trading partners, is seen posting negative values until the projection horizon, with a restrictive impact on the domestic economy as well.

The annual HICP inflation rate in the euro area is projected to remain at very low levels (being significantly influenced in the near run by energy prices amid falling oil prices), before rising gradually starting early next year, yet staying well below the 2 percent reference value. The annual HICP inflation rate excluding energy in the euro area (the relevant measure for shaping the path of prices of imported goods) is expected to decline slowly until the end of next year, given the demand deficit and the fading away of shocks related to the medical situation (stronger demand for essential goods and services, disruptions in the production and supply chains, possible price hikes by companies to cover their medical protection expenses). Annual inflation rate in the USA is foreseen to run higher than in the euro area in both years. Nonetheless, this indicator appears set to post lower levels in the medium term than those projected in the prior *Inflation Reports*.

Chart 4.1. Brent oil price scenario



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

Against the background of the ECB's strongly accommodative monetary policy, the nominal 3M EURIBOR rate is anticipated to be stuck in negative territory throughout the projection interval.

According to the forecast, the euro will strengthen slightly against the US dollar over the projection interval, from EUR/USD 1.1 in 2020 Q2 to EUR/USD 1.15 at the forecast horizon. However, the trajectory of the currency pair is marked by significant uncertainty, amplified by developments in the recent period, when the euro appreciated versus the US dollar.

The scenario for the Brent oil price is based on futures prices and foresees a gradual increase up to USD 47 per barrel at the projection horizon (Chart 4.1). The major determinants behind its projected evolution are the recovery of global demand for oil, albeit gradual, and the OPEC+ agreement on curbing output[68]. Future developments in oil prices are beset

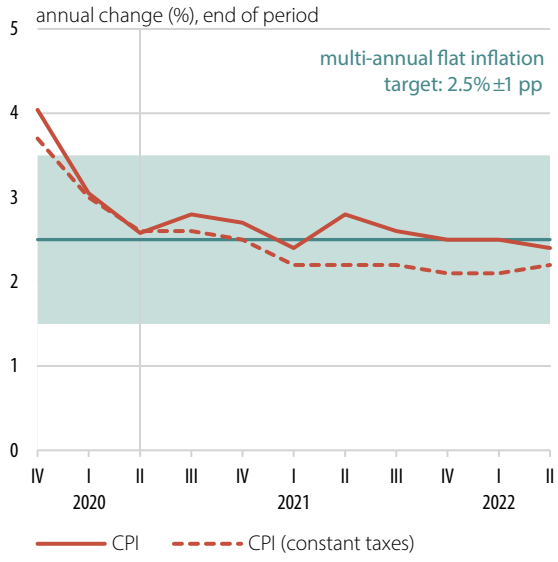
[68] The agreement was initially signed in April, then extended in June. On 15 July, the OPEC+ announced that it would scale back oil production cuts by 2 million barrels per day starting August 2020.

with sizeable uncertainties, conditional on both supply-side factors (the future of agreements to cap output) and demand-side factors (the evolution of the pandemic worldwide).

4.2. Inflation outlook

Following a sharp decline in 2020 H1, associated solely with the dynamics of exogenous components, the annual CPI inflation rate will subsequently stick to a slightly downward path, coming in at values close to the 2.5 percent mid-point of the target throughout the projection interval (Chart 4.2), similarly to the May 2020 projection. The downward trend will reflect the evolution of the adjusted CORE2 index, which is forecasted to drop at a faster pace from the high levels seen in recent periods. This will owe to the gradual fading-out of the unfavourable supply-side shocks generated by the public health crisis, as well as to the disinflationary effect of demand deficit. In the opposite direction will act some exogenous components of the consumer basket, i.e. fuel prices and administered prices, which are foreseen to accelerate their growth rates. Consequently, the annual CPI inflation rate is projected to stand at 2.7 percent and 2.5 percent at end-2020 and end-2021 respectively (Table 4.2). The contribution of indirect tax changes is estimated at 0.2 percentage points at end-2020 and 0.4 percentage points at end-2021[69]. The average annual CPI inflation rate will stay on the downward path it has embarked on in 2020 H1, albeit at slower pace, being anticipated to reach 2.5 percent at the projection horizon, i.e. in 2022 Q2.

Chart 4.2. Inflation forecast



Source: NIS, NBR projection

Table 4.2. The annual inflation rate in the baseline scenario

annual change (%); end of period

	2020		2021				2022	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	2.8	2.7	2.4	2.8	2.6	2.5	2.5	2.4
CPI projection*	2.6	2.5	2.2	2.2	2.2	2.1	2.1	2.2

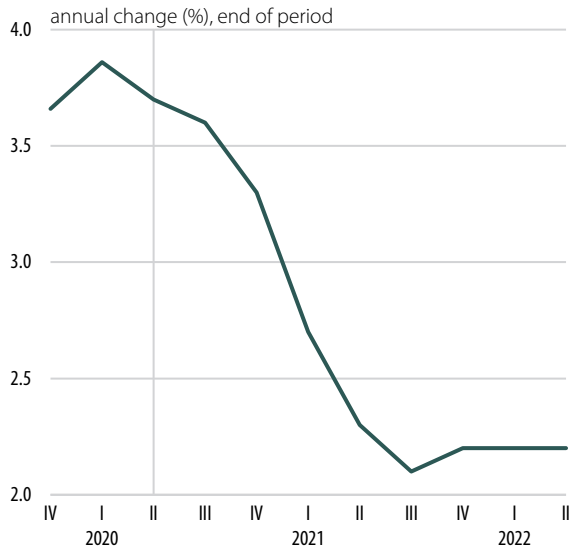
*) calculated at constant taxes

Compared to the previous *Inflation Report*, the annual CPI inflation rate has witnessed only marginal revisions. The forecast for this year-end is 0.1 percentage point lower, given the downward reassessment of the contribution from the exogenous components of the CPI basket, which offsets the slightly higher core inflation values projected at this horizon. For the end of next year, the forecast is similar to the previous one.

The annual adjusted CORE2 inflation rate remained high until end-Q2, reaching 3.7 percent in June and thus exceeding the previous benchmark forecast. Subsequently, it is expected to re-enter the variation band of the central target in the

[69] Their impact is weaker in 2020, due to the atypical cut in the excise duty on fuels at the beginning of this year, which partly offsets the increase in the excise duty on tobacco products.

Chart 4.3. Annual adjusted CORE2 inflation



Source: NIS, NBR projection

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

annual change (%); end of period

	2020		2021				2022	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Adjusted CORE2	3.6	3.3	2.7	2.3	2.1	2.2	2.2	2.2

course of 2020 Q4. The evolution of this component is jointly driven by demand-side and supply-side shocks manifest in the context of the health crisis and the administrative measures imposed by the authorities. Specifically, inflationary pressures are associated with factors such as the rise in unit labour costs following the output contraction (an increase only partly counterbalanced by the government support measures), additional costs generated by the economic agents' measures to prevent infection and the contraction of supply amid the closure of some outlets or the reduction in activity. As the epidemic situation returns to normalcy and economic agents gradually adjust their behaviour to the new conditions, the inflationary pressures associated with the health situation will diminish progressively. Against this background, the disinflationary effect of aggregate demand is expected to become prevalent in the medium term, prompting the annual core inflation rate to decline before stabilising at around 2.2 percent as of mid-2021. The relatively slow dynamics of import prices also contribute to this path of core inflation. Specifically, the HICP inflation excluding energy in the euro area is seen to gradually trend downwards until end-2021 and then slowly recover towards the end of the projection interval (Chart 4.3). Inflation expectations will remain inside the variation band of the target until the forecast horizon, stabilising somewhat after the decrease anticipated during the current year (Table 4.3).

Compared to the previous forecast, the annual core inflation rate is expected to be slightly higher until 2021 Q3, given that inflationary pressures associated with supply-side shocks amid the unfolding health crisis have been underestimated over the short term. Subsequently, the dynamics of this indicator will be marginally lower than those foreseen in the May 2020 *Inflation Report*, mainly on account of the downward revision in the external inflation path and, implicitly, of the weaker pressures from import prices.

Table 4.4. Components' contribution to annual inflation rate*

percentage points

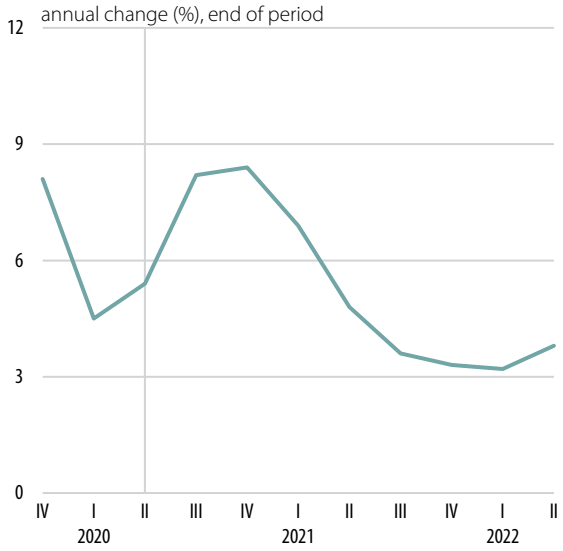
	2020	2021
Administered prices	0.2	0.4
Fuels	-0.6	0.2
VFE prices	0.5	0.2
Adjusted CORE2	2.1	1.3
Tobacco and alcoholic beverages	0.5	0.4

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

The inflation components beyond the scope of monetary policy, namely administered prices, volatile food (VFE) prices, fuel prices and tobacco product and alcoholic beverage prices, are seen to make a cumulative contribution to the annual CPI inflation rate of 0.5 percentage points at end-2020 and 1.1 percentage points at end-2021, both readings being revised downwards by 0.4 percentage points and 0.1 percentage points respectively (Table 4.4).

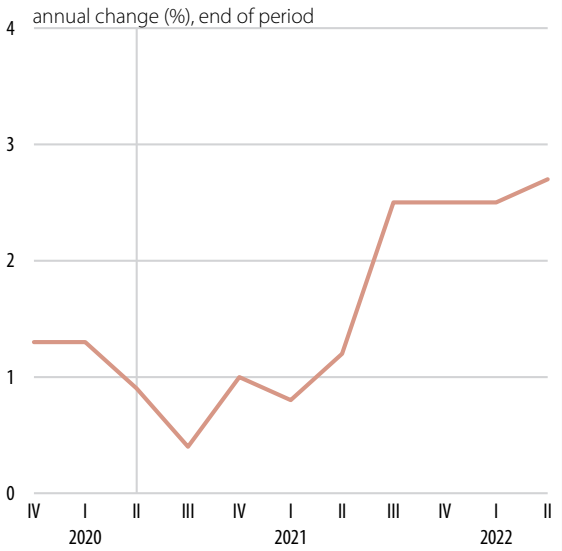
The annual dynamics of VFE prices are anticipated at 8.4 percent at the end of this year and at 3.3 percent at the end of next year (Chart 4.4), assuming harvests nearing a multi-annual average. Compared to the previous forecast, the end-2020 level has been revised downwards by 3.5 percentage points, given an improvement in weather conditions subsequently to the release of the May 2020 *Inflation Report*, which has pushed vegetable prices lower. For the next year, the value is seen as relatively similar to that in the prior projection.

Chart 4.4. VFE prices annual inflation



Source: NIS, NBR projection

Chart 4.5. Administered prices annual inflation



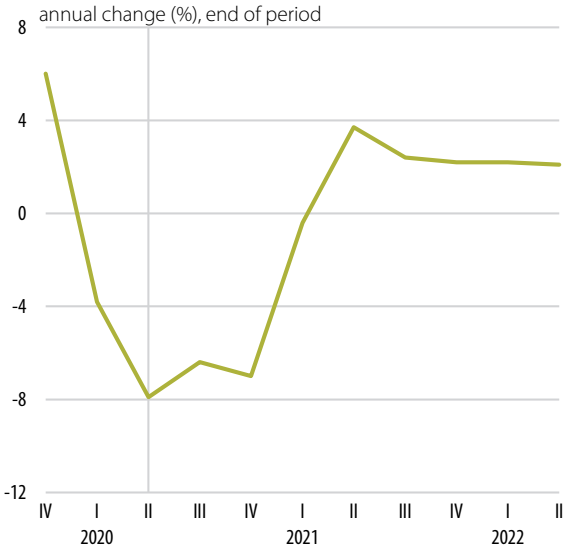
Source: NIS, NBR projection

Looking at the trajectory of administered prices, their growth rate is anticipated at 1 percent and 2.5 percent at the end of 2020 and 2021 respectively (Chart 4.5). Compared to the May 2020 *Inflation Report*, the end-2020 projection was subject to a 1.1 percentage point downward revision, on the back of July's cut in the regulated electricity prices applied by the suppliers of last resort[70], whereas a similar level is envisaged for next year.

The annual dynamics of fuel prices are projected at -7 percent at end-2020, being revised upwards by 0.8 percentage points, and at 2.2 percent at end-2021, following a reassessment of -0.6 percentage points (Chart 4.6). For the current year, the revision owes to the annual dynamics of oil prices being projected to run above those foreseen in the previous round, offsetting the opposite influences coming from the depreciation of the US dollar versus the euro, impacting the USD/RON exchange rate, and, in turn, the leu-denominated fuel prices. For the year ahead, the reassessment

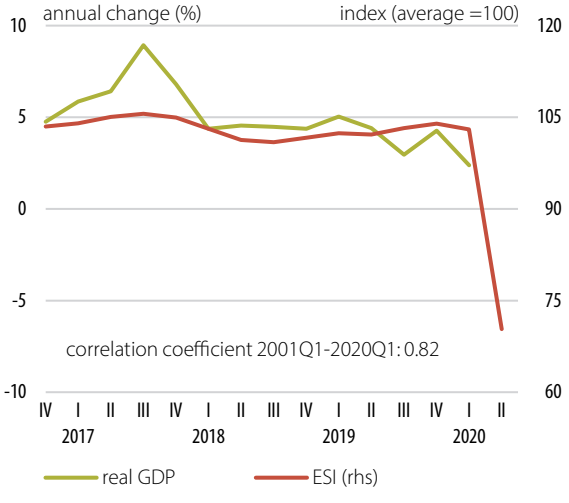
70 Following the meeting of 29 June 2020, the Regulatory Committee of the Romanian Energy Regulatory Authority decided to endorse the prices for the electricity supplied and the amounts of electricity sold under regulated agreements between 1 July and 31 December 2020. For further details, see Press Release of the Romanian Energy Regulatory Authority of 29 June 2020, available at https://www.anre.ro/ro/presa/comunicate/comunicat-29-06-2020-privind-stabilirea-pretului-reglementat-pentru-energia-electrica-livrata-si-a-cantitatilor-de-energie-electrica-vandute-pe-baza-de-contracte-reglementate-in-perioada-1-iulie-31-decembrie-2020.

Chart 4.6. Fuel prices annual inflation



Source: NIS, NBR projection

Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

relies mainly on expectations of slower annual dynamics of the oil price.

The scenario for tobacco product and alcoholic beverage prices assumes annual dynamics of 6.4 percent at end-2020 (revised marginally downwards from the previous *Inflation Report*) and of 4.8 percent at end-2021 (relatively similar to the previous forecast). For the current year, the trajectory of these prices is affected by the two-stage increase in the total excise duty on 1,000 cigarettes, in January and in April respectively. Subsequently, the annual dynamics are shaped in light of the current legislation concerning the excise duties levied on these goods, also considering the past behaviour of economic agents in this industry as regards the final price adjustment following the enforcement of changes in the fiscal legislation.

4.3. Demand pressures in the current period and over the projection interval[71]

Output gap

The spread of the COVID-19 pandemic was reflected in a worsening of economic activity as early as 2020 Q1. Specifically, although real GDP[72] registered a slight quarter-on-quarter increase (0.3 percent), the deceleration against the previous periods was notable, both in quarterly and annual terms (down to 2.4 percent year on year)[73]. Similarly to the previous round, in the baseline scenario assumption of limiting the medical effects of the crisis, most of its economic fallout is estimated to occur during Q2, i.e. a major contraction of economic activity (both in quarterly and annual terms). These developments mirror the hit taken by the sectors vulnerable to social distancing and by those depending on cross-border production and supply chains, as well as the accelerated decline in domestic and global demand, in a context marked by a sharp deterioration in confidence (Chart 4.7[74]), with an impact on economic agents' behaviour.

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

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

73 According to NIS Press Release No. 177 of 7 July 2020. Annual dynamics are calculated based on gross data series. The values thus confirmed the flash estimates published by the NIS in the Press Release No. 134 of 15 May 2020.

74 All confidence indicators have declined as early as March, but mostly in April, when the ESI posted a monthly drop of 34.3 points, a historical record. Subsequently, in May and June, as restrictions gradually eased, the indicators showed a partial recovery of the recorded loss.

The economic contraction forecasted for Q2 is also reflected in the assessed sharp adjustments of GDP components. The actual individual consumption of households is affected by the uncertainty regarding the size and duration of pandemic effects, as well as by the decrease in disposable income, amid both job losses and the deleveraging recorded by this sector (the most severe decline in credit in May was related to the financing sources of consumption). At the same time, gross fixed capital formation is significantly marked by the strong increase in uncertainty and by the drop in the receipts of private economic agents, with the effect of reducing their expenses. A counterbalancing role is expected to be played by public investment – yet limited by the fiscal space narrowed by both the pre-pandemic fiscal conduct and the resources mobilised for combating the pandemic –, and by the absorption of EU structural funds, which, however, is still below the potential. International trade is affected by the significant drop in external and domestic demand, to which add the generalised restrictions on relations among countries, which have disrupted, with persistent consequences, the functioning of cross-border production and distribution networks.

The macroeconomic projection is surrounded by a high degree of uncertainty, given the scarce statistical data available and the limited previous experience regarding economic developments during pandemic crises of such magnitude. This makes it difficult to anticipate the duration and intensity of the crisis, with direct implications for the economic activity outlook. Under these circumstances, the key hypothesis of the forecast in the prior edition of the *Inflation Report* (adopted by most economic analysts) was maintained, namely that the most severe economic effects of the crisis would occur during Q2. Thus, the baseline scenario envisages positive dynamics in 2020 Q3 for both GDP and its components. The near-term forecasts on economic activity have been developed based on the complementary approaches described in the previous *Report* (bottom-up and econometric methods). Moreover, in order to improve projection formulation, a more intensive monitoring of a series of indicators with a higher frequency of publication (daily or monthly) than that of GDP was undertaken. Box 2 describes the signals conveyed by a series of indicators on the economic activity of some sectors, correlated with the stringency of implemented restrictions. The monitored indicators generally showed sizeable deteriorations in April or May, and subsequently they have experienced some improvements.

Box 2. Indicators monitoring economic activity amid the COVID-19 pandemic

Following the outbreak of the pandemic crisis, since the magnitude of its effects and their distribution in time are difficult to anticipate *ex ante*, the data collection and analysis of real time series are essential in monitoring the economy's dynamics in response to the across-the-board restrictions imposed by the authorities and, subsequently, to their gradual easing.

Tracking economic activity via a number of higher-frequency indicators (especially informative are the daily measures, but also standardised monthly indicators, such as the volume of industrial production, make the analysis more comprehensible thanks to their broad scope)[75] has the potential of capturing watersheds in

[75] Other central banks in the region also proceeded to tracking developments in economic activity via relatively high-frequency indicators. See for reference the Magyar Nemzeti Bank, which conducted a similar analysis in its latest *Inflation Report* (June 2020).

economic activity well in advance of the NIS-released GDP figures[76], thereby allowing a real-time snapshot of the economy's response to the authorities' administrative measures. The endeavour helps improve the dataset underlying the near-term forecasts and, implicitly, the accuracy of macroeconomic projections supportive of formulating monetary policy decisions.

Chart A. Signals sent by high-frequency indicators

Note:

(1) The colours (green) and (red) show the major improvement and worsening respectively of the signals sent by indicators on economic conditions and (yellow and orange) the transition situations. The nuances are the result of a conditioned formatting of observations, each observation being assigned a colour of a certain intensity, depending on the position in the distribution of historical values.

(2) Daily indicators "(D)" were aggregated as a weekly average, while for the monthly indicators "(M)" the same value was considered, for simplicity of illustration, throughout the month (an alternative procedure could be to scale the signal strength with the Stringency Index or with the Mobility Index, leading however to the forced correlation of the signals provided by all monthly indicators, covering different economic sectors).

(3) The last day of each represented week is reported on the time axis.

(4) The analysis is based on information available by 28 July 2020.

Source: NBR calculations

The assessment covers a broad range of indicators (Chart A; Table A) on the business environment (industry, trade and tourism) and the labour market, which are representative segments of the real economy. The list continues with financial, risk perception and confidence indicators and, last but not least, the stringency index of restrictions and measures of their impact on mobility respectively. In some instances, in the absence of identifying some of these indicators in the case of Romania, external variables were included as proxy, due to their representativeness for the Romanian economy as well (VIX and Sentix indices respectively).

Given the surge of the COVID-19 pandemic in the latter half of March (which led the authorities to respond by instituting the state of emergency[77] and adopting

76 Data on quarterly GDP dynamics are published with a lag of roughly 45 days since the end the quarter (and those on GDP components with a lag of 65 days).

77 The state of emergency was introduced for 30 days, starting 16 March, and subsequently extended for another 30 days. The state of alert was introduced for 30 days, as from 18 May, and subsequently extended by 30 days on 17 June and 17 July respectively.

a set of military ordinances[78]), the strongest effects of the pandemic crisis on economic activity are assessed to have become manifest in 2020 Q2. The stringency index[79] of restrictions (Chart B) calculated for Romania reflects the severity of the restrictions applied by the authorities, the highest intensity being visible in April.

Table A. Sources of and changes to indicators

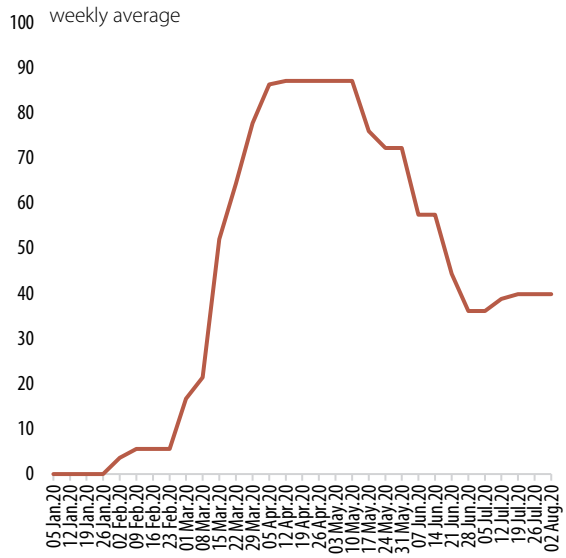
Indicator	Source	Change
(D) Electricity consumption	Transelectrica	%, y-o-y
(M) Industrial production	NIS	%, y-o-y
(M) Retail trade turnover	NIS	%, y-o-y
(D) International flights	EUROCONTROL	%, y-o-y
(M) Nights spent in tourist accommodation establishments	NIS	%, y-o-y
(M) SMARTBILL Barometer	SMARTBILL	%, y-o-y
(M) Company and freelancer registrations	National Trade Register Office	%, y-o-y
(M) Economic Sentiment Indicator (ESI)	European Commission	level
(D) Google trends "unemployment"	Google	%, y-o-y
(D) Active labour contracts	Labour Inspection	%, y-o-y
(D) Suspended labour contracts	Labour Inspection	%, y-o-y
(M) Unemployment rate	NIS	level, seasonally adjusted
(D) BET yield	Reuters	average/week
(D) (10Y) Government bond yields	Investing	average/week
(D) (3M) ROBOR	NBR	average/week
(M) Stock of loans to the private sector	NBR	%, y-o-y
(D) Option Adjusted Spread (OAS)	Bloomberg	average/week
(M) Debit instruments rejected at payment (amounts)	Bloomberg	%, y-o-y
(D) Google trends "crisis"	Google	%, y-o-y
(D) Volatility index (VIX)	Reuters	average/week
(M) Sentix Index	Bloomberg	level
(D) Google trends "restrictions"	Google	%, y-o-y
(D) Stringency Index	Oxford University	average/week
(D) Border crossings	Romanian Border Police	%, y-o-y
(D) Mobility Index	Google	average/week
(D) Road traffic (Bucharest)	tomtom.com	average/week

The reviewed indicators highlight a major contraction in economic activity, amid the sectors vulnerable to social distancing being hard hit (especially transport and accommodation and food service activities and, to a lesser extent, industry and trade) and worsening confidence. The gap seen in the intensification of signals can be explained, especially as regards monthly indicators, by their release with a relative lag against the dramatic change of the economic environment once the

78 In particular, Military Ordinance No. 3/25 March 2020 introduced the obligation to fill in a self-declaration form covering movement outside household/residence, with the grounds listed therein being strictly limited.

79 It measures the authorities' response to the pandemic and is based on 17 indicators providing information on school closing, travel restrictions, income support for citizens, international support or health measures.

Chart B. Stringency Index



Source: NBR calculations based on data released by Oxford University

state of emergency was declared. Since mid-May, when mobility restrictions have gradually started to be lifted, the signals conveyed by the available indicators have been improving progressively.

An in-depth analysis of the developments in these indicators has revealed, in respect of the business environment, gradual declines in electricity consumption since the first days of April amid a temporary disruption in the activity of large economic agents, car manufacturers in particular, or the shift to teleworking. As for trade, a sharp fall in the growth rate of retail trade turnover has already been recorded in March, followed by steep contractions over the next two months, when the industrial production index[80] experienced a similar trend as well. Moreover, the business environment worsened significantly in terms of the number of company registrations and freelancers, as well as the turnover of SMEs, as reflected by the SMARTBILL Barometer[81] readings (down by about 20 percent and 15 percent in April and May respectively). The strong deterioration of the financial standing of some companies is mirrored in the evolution of amounts from rejected debit payment instruments.

The intensification of mobility restrictions at a global level has also led to a setback in airline activity. The number of international flights declined steadily in annual terms, down 17 percent in mid-March and briskly reaching 76 percent in the final week of the month. The steepest downturn occurred around the Easter holidays, when airlines were forced to ground their fleets almost completely, resulting in an approximately 90 percent contraction in activity compared to the same year-ago period.

On the labour market, the number of suspended labour contracts on grounds associated with the state of emergency provided strong signals of the economy's slowdown, given the temporary closing of activity in some automotive, metallurgy and equipment manufacturing companies. The worsening of unemployment rate was contained amid labour retention measures implemented by the authorities, mainly via furlough schemes. As far as the number of active labour contracts is concerned, their decrease took place once the state of emergency was declared. This indicator's evolution clearly marked the point in time when restrictions were lifted in May and the government discontinued furlough payments once the state of emergency ended (except the categories of workers in sectors hit further by the keeping in place of administrative restrictions), as the activity resumed only partially.

80 For industrial production, in order to make the interpretation of signals easier, nuances are obtained based on the values calculated starting January 2018.

81 The indicator (available at: https://smartbill.ro/barometru) measures the evolution of turnover of SMEs in Romania in a sample comprising more than 20,000 companies, generally small-sized enterprises.

Risk perception (e.g. the VIX index) and the economic agents' degree of confidence (the ESI indicator and Sentix index) also worsened when the pandemic broke out, suggesting the global nature of its impact. Online searches for keywords such as unemployment, crisis or restrictions multiplied once the state of emergency was declared. Shortly after detecting the first cases of coronavirus infections in Romania, restrictions depressed mobility (as captured by Google's Mobility Index and border crossings) and tourism was, in turn, affected (the first significant declines in the number of nights spent in tourist accommodation establishments). Investors' risk aversion is also reflected by the movements in financial indicators such as Option Adjusted Spread and the BET stock exchange index. Moreover, at the onset of the pandemic an increase could also be detected in the costs of long-term debt securities (the hike in 10-year government bonds yields over that period reached about 2 percentage points, yet subsequently saw a significant correction). Since mid-May, an across-the-board improvement in available indicators has been manifest.

April through July, the (3M) ROBOR rate incorporated the favourable impact of the recent NBR Board decisions on successive policy rate cuts and the narrowing of the symmetric corridor of interest rates on standing facilities around the policy rate. The stock of credit to the private sector recorded, starting in March, but especially in the months that followed, significantly slower annual rates after private agents, both financial institutions and potential borrowers, adopted a more prudent behaviour (a trend that was only partially offset by the implementation of government programmes aimed at further providing liquidity to privately-owned companies on advantageous terms of cost and guarantees).

In the current environment characterised by elevated uncertainty as to the magnitude of the pandemic fallout on the economy and the pace of economic activity returning to normalcy (closely connected to the set of measures taken by the authorities), it is necessary to continue monitoring this set of indicators and, depending on available data, even add new measures, insofar as they are relevant for capturing economic developments at sectoral level.

Strong uncertainties persist in relation to the pace of economic activity returning to normalcy, which has been affected by the recent resurgence in the number of SARS-CoV-2 infections, thus leading to the extension of the state of alert by another month[82]. However, the return to positive territory of the quarterly GDP dynamics in Q3 is supported by the relaxation of the most severe measures of social distancing that were active until mid-May. This rebound, owing also to the base effect associated to the Q2 contraction, will nevertheless involve only a partial recovery from this unprecedented economic downturn.

The expected economic developments in 2020 H1 are foreseen to bring about a large decline for the entire year. The high degree of uncertainty[83] surrounding the projection is fuelled in particular by the multitude of possibilities regarding

82 Starting with 17 July 2020.

83 Mention should also be made that, similarly to prior forecasting rounds, the accuracy of the macroeconomic projection is marked by the high volatility and magnitude of successive revisions of historical data series.

the evolution of the epidemic situation, which would condition the administrative measures adopted by the authorities. In addition, economic activity is closely linked to factors such as: (i) future configurations of the fiscal and income policy stance, and of monetary policy, respectively, or (ii) the gradual pace of economic recovery in the euro area and worldwide. The breakdown shows that, in 2020, the average annual GDP dynamics are envisaged to reflect the negative contribution coming from consumption and GFCF, to which adds the negative contribution of net exports, amid a more pronounced drop of exports of goods and services than that of imports. In 2021, the gradual recovery of GDP is expected to be shaped by both domestic demand components, with an anticipated stronger increase in household consumption, whereas net exports are foreseen to further make a negative contribution, yet on the decrease.

The path of potential GDP reflects a significant correction of the traction from production factors. Thus, a narrowing of potential GDP is forecasted for the current year. Subsequently, its rebound is moderate, mirroring the general profile of economic activity and, especially, the developments in analytical determinants (labour, capital, productivity). Labour is assessed to make a negative contribution, against the background of the anticipated increase in unemployment rate, alongside a lower average number of worked hours per employee, given the flexible work schemes implemented in the context of the pandemic. The available capital stock is projected to mirror this year's decline in investment. Its contribution to the growth potential of the economy depends mainly on the improvement of the investment climate at corporate sector level (currently assessed as significantly deteriorated, as shown by the AmCham Romania Survey, and in line with global developments). Closely related to the sudden adjustment of investment resources (particularly for technological investment) is the TFP trend contribution. This also reflects certain dysfunctions of the productive capacities as a result of the measures taken for infection prevention (exceptions are recorded by the construction and IT sector, respectively). In the medium and long term, the TFP trend will further be affected by structural deficiencies[84] such as those associated to the quality and size of infrastructure, the regulatory framework, the degree of digitalisation of the economy, the supply of skilled workforce or the absorption of EU investment funds[85].

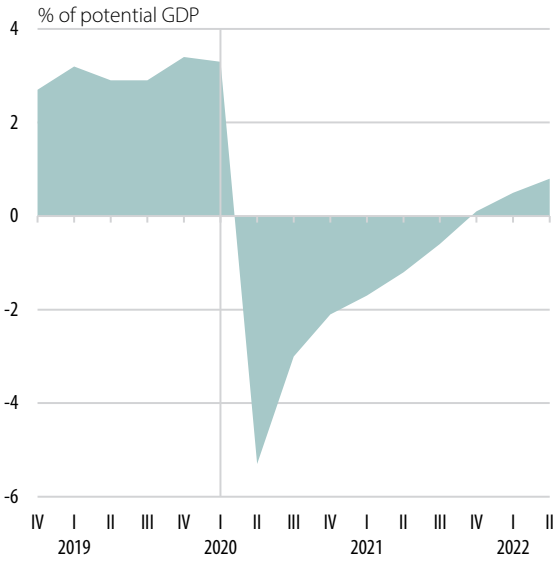
Throughout the current year, given that the pandemic shock is still presumed to be temporary, the contraction in economic activity is expected to be mirrored mainly in a decrease in the cyclical component (output gap) and to a lesser extent in the potential GDP growth rate[86]. Starting from the minimum value of the output gap (Chart 4.8), which is assessed at -5.3 percent in Q2 (down 8.6 percentage points compared to the previous quarter), the economy is expected to function with a demand deficit until the end of 2021. However, the gap is assumed to gradually narrow, becoming slightly

84 Additional evidence is brought by the *Ease of Doing Business* ranking of the World Bank, the *Global Competitiveness Index* Report of the World Economic Forum or the *European Innovation Scoreboard* analysis of the European Commission.

85 Support in attracting European funds could be materialised by accessing the resources mobilised by the European Commission for economic recovery at EU level. For further details, see Chapter 2, Section 1. Supply and demand, and access the website mfe.gov.ro/covid-19/.

86 In a scenario that would involve either the extension of social distancing measures or the future resurgence of the pandemic, the effects on potential GDP dynamics could prove to be more persistent, implying a slower recovery in economic activity.

Chart 4.8. Output gap



Source: NBR assessments based on data provided by the NIS

positive at the projection horizon (2022 Q2)[87]. Compared to the forecast in the previous round, the output gap path was slightly revised upwards, especially in the latter half of the projection interval, benefiting from the reassessments of the fiscal impulse and of the impact exerted by effective external demand gap, as well as from the anticipated positive effects associated with lending to companies (for example, through the IMM Invest Romania programme).

The major adjustment of the output gap during 2020 Q2 reflects the high magnitude of the unfavourable demand shock, amid the worsening in consumer confidence (also in the context of prospects regarding an increase in unemployment rate). At the same time, the massive widening in Q2 of the negative output gap of Romania's trading partners contributes to pushing the domestic output gap into negative territory. The monetary and fiscal policy stance acts in a countercyclical manner, against the background of the extensive measures recently adopted by the authorities. The favourable effects exerted by fiscal and income policy measures[88] are envisaged to be primarily manifest throughout the current year, whereas the stimulative nature of real broad monetary conditions is expected to persist over the entire projection interval.

Aggregate demand components

The annual dynamics of final consumption will post negative values over the short term, due especially to the contribution of households' actual individual consumption, in line with the evolution of disposable income, which is assessed to considerably decrease in the short and medium term. The trajectory of the latter mirrors the labour market outlook, implying, amid lower demand from companies, income and job cuts, which are expected to be manifest throughout the entire year. Furthermore, households are envisaged to reduce or postpone their consumption of goods (durables) and services targeted by social distancing measures, alongside rising their savings, which is typical in times of crisis[89]. In addition, the drop in lending, especially in terms of consumer credit, is likely to affect the future dynamics of consumption. On the other hand, the spending on public goods and services necessary for overcoming the pandemic crisis is anticipated to exert a stimulative effect on final consumption,

87 From the perspective of aggregate demand components, the output gap path is shaped by the negative gaps of actual individual consumption of households and GFCF, respectively. The gaps of the other components are also assessed to be negative, but constantly narrowing, over most of the projection interval.

88 In order to mitigate the adverse effects on the economy, the national authorities adopted a series of fiscal measures, such as the payment of furlough benefits, subsidies granted for the wage costs related to the re-employment of furloughed employees, delayed payments of taxes and duties, paid leaves for parents during school closure.

89 These aspects were also underlined in the European Commission's confidence surveys, which indicate a higher degree of pessimism than during pre-pandemic times with regard to the prospect of making major purchases (both currently and for the next year), especially for the elderly or lower-income earners. At the same time, surveys show a higher likelihood for saving (both at present and for the next year), especially for lower-income earners and young people.

but the influence of actual individual consumption of households will still prevail. Over the medium term, final consumption is expected to make a slow recovery, under the assumption of a progressive improvement in consumer confidence and a gradual fading-out of the negative shocks to disposable income[90], also amid the recovery of labour market conditions, foreseen to take place subsequent to that of GDP dynamics.

Gross fixed capital formation is envisaged to decrease markedly due to a significant increase in uncertainty and to firms' lower volume of activity, correlated with a swift rise in unit labour costs. An additional adverse effect is expected to stem from foreign direct investment, which is forecasted to contract particularly throughout the current year compared to pre-pandemic times, in line with the worsening global investment climate. A counterbalancing part in the medium term could be played by public investment financed via EU funds[91]. Public investment from domestic sources could in turn be affected by the narrow fiscal space constrained by both the pre-pandemic fiscal conduct and the increase in short-term expenditures for supporting the economy. On the other hand, investment schemes targeting the real sector via loans facilitated and guaranteed by the authorities are expected to play a beneficial role in the coming years[92].

The protection measures adopted in a synchronized manner by most economies under the influence of the pandemic crisis disrupted the global supply chains, leading to a severe fall in global trade. Against this background, the flows of imports and exports dropped markedly compared to the pre-crisis period, also impacting external balance.

Exports of goods and services are projected to decline significantly this year, before re-embarking on an upward path as of 2021, albeit at a lower pace. The expected developments in this component take into account: (i) a severe drop in effective external demand throughout the current year, followed by its recovery only in a gradual manner, (ii) a decline in the productivity of exporting companies, coupled with disruptions in supply chains, (iii) a worsening in price competitiveness of local products over the entire forecast interval, and over the longer term, and (iv) the dragging structural features of the economy (e.g. the slow bridging of gaps regarding infrastructure or the sophistication level of production processes) that affect the integration process of key sectors of the economy into global value chains.

The annual dynamics of imports of goods and services are also projected to be negative during this year, reflecting the compression of domestic demand and the dampening effect of exports, given that numerous exporting sectors are extensively using imported intermediate goods. Overall, nominal net exports

90 The medium-term path for the social transfers component of disposable income is surrounded by numerous uncertainties, particularly in connection to the increase in pensions (according to the schedule of Law No. 127/2019).

91 Allocated both via the Multiannual Financial Framework 2021-2027 and the "Next Generation EU", the post-pandemic economic recovery programme.

92 The IMM Invest Romania programme for SME investment financing is already operational, and it may be supplemented with the IMM Leasing scheme, an additional support for companies aimed at stimulating equipment purchase.

of goods and services are anticipated to make a new negative contribution to the balance-of-payments current account balance in 2020, in line with the significant rise in budget deficit.

In 2020 Q1, the current account deficit slightly narrowed to around 4.5 percent of nominal GDP (4-quarter cumulative data), against 4.6 percent of GDP in the previous year, mirroring the worsening balance on goods and services, offset by an improvement in the primary income shortfall and by the slightly larger positive influence coming from the secondary income balance. Despite a foreseen correction in the balance on income, that on trade in goods and services is expected to continue its deterioration in 2020. The current account deficit is thus estimated on the rise throughout the current year, being envisaged to exceed, from a multiannual perspective, the 4 percent-of-GDP indicative threshold set by the European Commission as a scoreboard indicator for EU Member States[93]. For 2021, the current account deficit as a share of GDP is expected to decrease as compared to 2020, amid an anticipated smaller negative contribution of nominal net exports of goods and services. The financing of the current account deficit is foreseen to remain only partly covered by stable, non-debt-creating capital flows over the entire projection interval, the coverage by these sources being assessed to notably decline compared to 2019, against the background of significantly depressed direct investment flows as a result of the current crisis. A positive contribution, particularly in the medium run, is expected from the disbursements of EU funds, given the new programmes introduced and the flexibility provided to Member States by the European Commission.

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 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[95], as well as via the effects on wealth and balance sheets of economic agents[96].

The baseline scenario of the projection shows a slightly decreasing impact of real broad monetary conditions on economic activity, which nevertheless preserve their stimulative nature.

The breakdown of real broad monetary conditions indicates that real interest rates on both new loans and new time deposits in lei are anticipated to exert stimulative effects, mainly on account of their developments in nominal terms, an impact only

93 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". In 2019, the indicator stood at 3.9 percent of GDP.

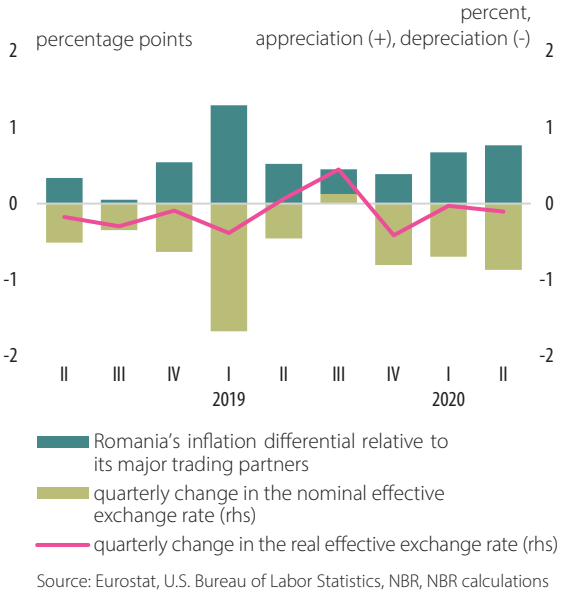
94 The relevant exchange rate for the NBR's macroeconomic model for analysis and medium-term forecasting relies on the EUR/RON and USD/RON exchange rates, with the weighting system mirroring the weights of the two currencies in Romania's foreign trade.

95 The depth of this channel seems to have relatively decreased, due to the strong negative impact of the pandemic crisis on global value chains, also as a result of the administrative measures imposed by most countries, which prompted a drop in multilateral trade flows.

96 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.

partly counterbalanced by the positioning of inflation expectations. The foreseen dynamics in nominal terms encompass the favourable impact of the recent decisions made by the NBR Board to gradually cut the monetary policy rate and to narrow the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate[97].

Chart 4.9. Quarterly change in the effective exchange rate



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

The component related to the effect of the real effective exchange rate (Chart 4.9), via the net export channel, is estimated to further contribute to mitigating the stimulative nature of real broad monetary conditions, due to the anticipated appreciation in real terms of the domestic currency over most of the projection interval.

The wealth and balance sheet effect is estimated to exert a restrictive impact on real broad monetary conditions during the first half of the projection interval, and subsequently a quasi-neutral one. The breakdown shows that the real foreign interest rate (3M EURIBOR) is in a favourable position. On the other hand, there is an unfavourable effect stemming from the anticipated increase in the sovereign risk premium in the first part of the projection interval. These developments take place as investors show a higher risk aversion towards emerging markets, discriminating especially against those with macroeconomic imbalances built up before the current crisis, which risk to become exacerbated in the pandemic context. Subsequently, as of end-2021, the effects of the real foreign interest rate and of the risk premium tend to offset each other. In addition, the changes in the gap of the real effective exchange rate of the leu are assessed to have a quasi-neutral effect via the wealth and balance sheet channel, over the entire forecast interval.

As a conditioning input for the macroeconomic projection, the monetary policy stance is tailored to ensure price and macroeconomic stability, and the proper functioning of the banking system and financial markets to the benefit of households and local companies.

4.4. Risks associated with the projection

The ongoing public health crisis has already struck a hard blow, affecting seriously most economic sectors, while its future evolution is difficult to predict. Its economic impact on both the domestic and external environment continues to reveal considerable sources of risk, the most relevant being probably associated with the future evolution of the pandemic.

97 According to the monetary policy transmission mechanism, this impact is visible with a time lag.

In Romania, the medical arena has witnessed a deterioration in recent months, relatively unlike other EU countries. At the same time, the speed of economic recovery in Romania could be affected both directly and through contagion effects by a broad-based surge in infections with the start of the cold season and the possible flare-up in the pandemic in Europe but also across the world (Box 3). The pick-up in the number of infections could persistently change consumer behaviour by shifting focus to stockpiling essential products – to the detriment of higher value-added goods – and a broad-based propensity to saving. All these would then have a severe impact on the financial standing of some economic agents.

Box 3. Sensitivity scenario on the public health crisis

In the current context, macroeconomic forecasts are surrounded by unprecedented uncertainty, mainly owing to assessments of the duration and intensity of the public health crisis and, implicitly, of its impact on the evolution of the economy. The baseline scenario is based on the assumption of keeping the epidemic under control, which would help avoid the reintroduction of broad-based administrative social distancing measures in the future. From a medical perspective, relevant probabilities are associated with both more favourable developments than those assumed in the baseline scenario, and developments indicating a relative deterioration of this situation and a resurgence in infections, respectively. However, considering the recent notable advance in the number of SARS-CoV-2 infections (relatively broad-based at global level), there seems to be a higher likelihood of materialisation of a scenario in which the pandemic would spike, owing also, in probabilistic terms, to the coming cold season (2020 Q4)[98]. In this context, the present Box looks at the sensitivity of the macroeconomic projection to a more downbeat evolution of the public health crisis compared to the assumptions incorporated in the baseline scenario.

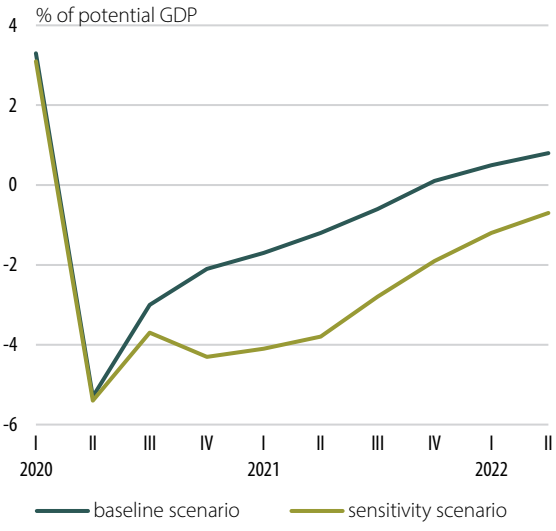
The worsening of the pandemic with the start of the cold season is expected to bring about the reintroduction of relatively broad-based administrative measures on social distancing both domestically and internationally, for a relatively similar length of time as the measures in the first part of the year, with a strong impact particularly on the evolution of the economy in Q4. The contraction in economic activity foreseen for this quarter, albeit notable (with real GDP recording a quarterly decline for both Romania and its main EU trading partners[99]), is forecasted to stand, however, lower than in 2020 Q2, given the authorities' growing experience in managing the crisis, as well as the adjustment of the economic agents' behaviour. Nevertheless, the annual growth rates of Romania's GDP are seen to remain below those in the baseline scenario until the end of 2021, significant influences coming from the adverse evolution of external demand for local products, as well as from households and corporates probably showing overall a reluctant consumer and investment behaviour, respectively.

98 Such a scenario was subject to review by other international institutions and central banks – see, for instance, *June 2020 Eurosystem staff macroeconomic projections for the euro area*, or the *Inflation Report* of May 2020 and June 2020 released by the Czech and Hungarian central banks, respectively.

99 The assumptions on the economic growth of Romania's EU trading partners were based on the scenario in the *OECD Economic Outlook* (June 2020) regarding a spike in the pandemic and imply a slower EU effective GDP growth rate by 2.7 percentage points in 2020 and by 2 percentage points in 2021 versus the baseline scenario.

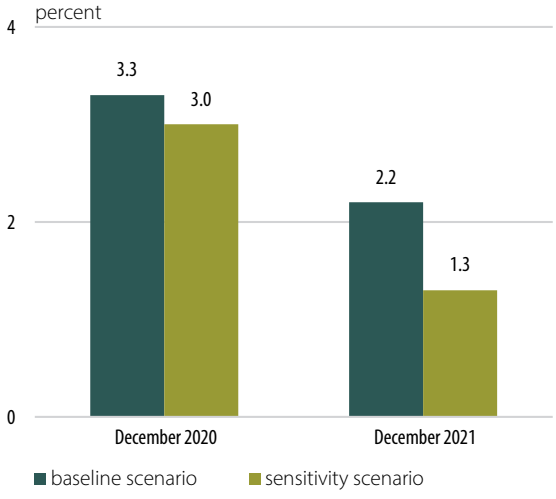
The worsening of economic activity as against the baseline scenario is anticipated to reflect the developments across all GDP components. Thus, a step-up in uncertainty, leading to a larger risk premium, and, implicitly a higher exchange rate of the leu, *inter alia* amid the emerging unfavourable prospects for the twin deficits, is expected to impact the dynamics of investment in the economy (and, consequently the potential GDP trajectory), as well as the pace of increase of private consumption. The latter will reflect labour market developments – conducive to a fall in disposable income and more notable increases in unemployment rates alongside a drop in the number of job vacancies. Net exports are anticipated to post a more pronounced worsening than that in the baseline scenario, with the reintroduction of broad-based restrictions at European level being expected to generate new disruptions in global value chains, therefore weakening yet again the production framework across the world. Under these circumstances, this year income losses on aggregate are anticipated to exceed those recorded at the peak of the 2008-2009 economic crisis, whereas the economic revival expected for 2021 is seen to be much slower compared to the baseline scenario (below the average annual rate of growth since 2010). Moreover, given the large-scale, persistent effects on economic activity of a surge in the pandemic, Romania's production capacity would then be more significantly affected than in the baseline scenario, which would be mirrored in a notably slower growth rate of potential GDP over the medium term.

Chart A. Output gap in the sensitivity scenario compared to the baseline scenario



Source: NBR calculations and assessments

Chart B. Annual core inflation rate in the sensitivity scenario compared to the baseline scenario



Source: NBR calculations and assessments

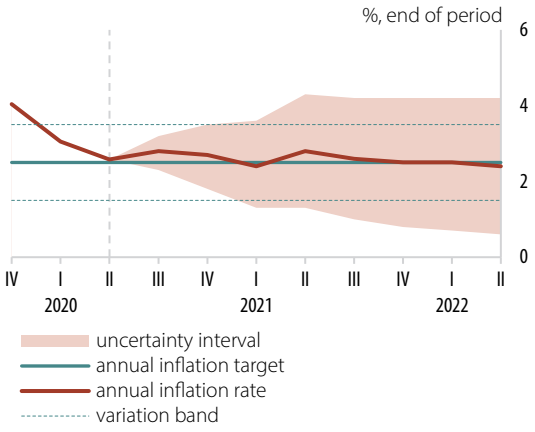
In the short run, inflation rate is assumed to stay at relatively elevated levels, in the context of a series of developments similar to those that marked the outbreak of the epidemic (increased demand for food items, additional costs associated with the health care measures put in place and lower productivity given the measures implemented by economic agents to prevent infection) and show relatively little response to the additional worsening of economic activity. Subsequently, however, the disinflationary impact of aggregate demand (Chart A) is expected to be more

visibly and relatively persistently reflected in core inflation (Chart B). Thus, the annual CPI inflation rate for end-2021 is seen to stand below the projection in the baseline scenario by approximately 0.6 percentage points.

Mention should be made that this simulation was based on a "no policy change" assumption, i.e. no additional economic support measures were considered as having been adopted by the authorities (the Government of Romania, the National Bank of Romania, the European Central Bank) apart from those included in the baseline scenario, in order to isolate the economic effects solely associated with the pandemic. Nevertheless, the contraction of the economic activity would most probably lead to a new rise in the budget deficit, in parallel with an additional deterioration of the current account deficit compared to the baseline scenario. In this illustrative context, the escalation of macroeconomic imbalances could heighten the risk of bottlenecks in the orderly financing of deficits, possibly leading to a step-up in the negative economic effects described in this Box.

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside, especially in the medium run, compared to the path in the baseline scenario (Chart 4.10). At the current juncture, elevated uncertainties stem from the fiscal and income policies, *inter alia* in the context of enacting into law new measures to support the economy or reconfiguring those already in force. At the same time, other sources of risks arise from possible adjustments of labour demand. The risk factors associated with the external environment have rather a disinflationary net 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 2005-2019. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

Similarly to previous forecasting rounds, the fiscal and income policies continue to be a relevant source of uncertainty. The year 2020 will face the pressure from fiscal incentives and extraordinary expenditures to manage the pandemic crisis. In the event of its prolongation, the volume of spending could grow, with an impact on the budget deficit size. At the same time, the future configuration of permanent social transfers is marked by ambiguity; there are several working scenarios, which cannot, however, enable a better predictability of the future amount of budget expenditure as they are not accompanied by adequate legal transpositions[100]. All this could lead to a wide deterioration of the budget balance, calling for a budget consolidation in the near future. The start of this consolidation and the pace and magnitude of the measures to be adopted remain unknown, but they should also be linked to the adjustment calendar imposed by the excessive deficit procedure against Romania. In the absence of a significant correction

[100] According to Law No. 127/2019 on the public pension system, the pension point should go up by 40 percent in September 2020. The public statements by some decision-makers show that this rise may be reconfigured, in view of the limited financial resources (increases of 10 percent and 15 percent were publicly advanced).

of the budget deficit that should start as soon as possible, investor sentiment might deteriorate, which would consequently increase the sovereign risk premium and potentially have an adverse impact on the orderly financing of the twin deficits.

Developments in labour market remain relevant, although its tightness ceased to be a pressing issue, amid the pick-up in the unemployment rate in tandem with the drop in the number of job vacancies. At the current juncture, in spite of the authorities' support (which may be extended by new provisions in the coming months), the difficulties induced by the public health crisis management could lead to a restructuring of companies' production costs, by letting go of production factors whose remuneration followed a steady upward trend over the last years in favour of cheaper and possibly more efficient ones. For instance, companies' technological investments could lead to a fall in wage earnings and other benefits to employees. At the same time, another source of uncertainty refers to potential adjustments in labour demand occurring amid the possible reintroduction of social distancing measures, even if in certain areas only. Under the circumstances, the drop in disposable income and implicitly in aggregate demand would likely heighten disinflationary pressures.

Looking at the factors with a direct impact on the annual inflation rate path, worth mentioning are the uncertainties about the future dynamics of administered prices amid the liberalisation of the electricity market. Although fully liberalised as of 1 July 2020, the natural gas market and the future evolution of gas prices continue to pose risks as stronger disinflationary pressures may arise, in view of the competitive supply of gas.

By contrast, the prevalence of adverse supply-side shocks for a longer period of time is not excluded for the other CPI basket components, especially assuming the extension or worsening of the public health crisis. The slower dissipation of these shocks would result in additional inflationary pressures that would have an immediate impact on essential goods and services, while in the medium run, inasmuch as the health crisis is tackled, they may engulf most sectors affected by the closure or contraction of activity. To these could add inflationary pressures from lower harvests of some crops, for instance for wheat. In addition, a relevant source of risk which grew again in importance relates to the spread of African swine fever, possibly with an adverse impact on the price of pigmeat.

On the external front, in the assumption of a new intensification of the public health crisis towards the end of this year, once with the start of the cold season, the effects on manufacturing and global production capacity become uncertain. Such an evolution could speed up the reconfiguration of global value chains against the backdrop of growing disruptions therein. At the same time, the international trade is marked by elevated uncertainties, should protectionist measures continue to be taken, *inter alia* amid a potential escalation of trade tensions (especially between the US and China, having recently reached the technological sector too). In the context of the turmoil generated by the pandemic crisis, both the decoupling of capital market developments from real economy developments, under the impact of emotional factors prevailing over fundamentals, and the volatility of international financial markets are relevant

risk factors. In the event of some of these developments materialising, the Romanian economy could face contagion effects, especially via the external demand channel.

In view of the rapidly worsening economic picture, as well as the poor prospects, high uncertainties surround the speed and sustainability of the economic recovery. Nevertheless, the financial assistance packages granted by the national and international authorities could underpin a sustained recovery, given that a large number of facilities designed to stimulate the EU economies have recently been configured. The recourse to these resources could bring about relevant changes in the configuration of the external environment, but also the domestic environment, by addressing some of the persistent structural problems faced by the Romanian economy.

The uncertainties about the future dynamics of energy prices, especially Brent oil prices, continue to be relevant, too. Supply-side factors refer to the OPEC+ agreement on capping production. Its stability is surrounded by risks, as the participating countries have already expressed their wish to reconfigure the coordinates of the agreement in light of an anticipated faster revival in demand for this commodity than previously thought. On the demand side, disinflationary pressures could stem from the additional deceleration in global economic activity following a resurgence in the pandemic crisis.

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

Charts