National Bank of Romania

# INFLATION REPORT

# February 2013

**Year IX, No. 31**

**New Series**

***N O T E***

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

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



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## *Foreword*

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

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

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

Inflation Report *was approved by the NBR Board in its meeting of 5 February 2013 and includes data available until 30 January 2013.*

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

# Abbreviations

| | |
|---|---|
| **ANRE** | Romanian Energy Regulatory Authority |
| **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 |
| **GDP** | Gross Domestic Product |
| **HICP** | Harmonised Index of Consumer Prices |
| **ILO** | International Labour Office |
| **IMF** | International Monetary Fund |
| **IPPI** | Industrial Producer Price Index |
| **MPF** | Ministry of Public Finance |
| **NBR** | National Bank of Romania |
| **NEA** | National Employment Agency |
| **NIS** | National Institute of Statistics |
| **OECD** | Organisation for Economic Co-operation and Development |
| **ON** | overnight |
| **OPEC** | Organization of the Petroleum Exporting Countries |
| **ROBID** | Romanian Interbank Bid Rate |
| **ROBOR** | Romanian Interbank Offer Rate |
| **VFE** | vegetables, fruit, eggs |
| **1W** | one week |
| **1M** | one month |
| **3M** | 3 months |
| **6M** | 6 months |
| **12M** | 12 months |

# *Contents*

# SUMMARY

### *Developments in inflation and its determinants*

At end-2012, the annual CPI inflation rate stood at 4.95 percent, down 0.38 percentage points from end-Q3. This places the inflation rate 0.95 percentage points above the upper limit of the target band set for year-end, but marginally below the NBR forecast of 5.1 percent in the November 2012 Inflation Report. The difference from the previous forecast can be accounted for by steeper-than-projected decelerations in the dynamics of volatile food prices and fuel prices, partly offset by slightly faster rises in administered prices and tobacco product prices.

The deceleration in the annual growth rate of consumer prices in 2012 Q4 was due to some factors that mitigated the effects of the adverse supply-side shocks that had triggered the substantial advance in inflation in the previous quarter. In this respect, a particular contribution was made by the significant slowdown in the annual dynamics of volatile food prices (VFE[1]), as a result of the monthly deflation posted by the prices of vegetables in October and November. Moreover, the decrease in the international crude oil prices and the appreciation of the leu against the US dollar in December led the annual growth rate of fuel prices to enter a downward trend in Q4.

The favourable influence of these components on the dynamics of the aggregate index in 2012 Q4 was partly offset by the prices for the other CPI basket components growing faster, in annual terms, than in the previous quarter. In the case of administered prices, this was mainly the result of the value of green certificates[2] being included into the electricity bill for household end-users, while the faster annual increase in tobacco product prices in Q4 was accounted for by other factors than the rise in the excise duties, most likely by the attempt of market operators to cover their financial losses.

During 2012 Q4, the adjusted CORE2 inflation[3] remained at 3.3 percent, 0.3 percentage points above the level seen in September. Behind this stood primarily the hike in the costs of agri-food commodities being gradually incorporated into consumer prices of processed food, following the significantly lower agricultural crops in 2012. Another unfavourable influence stemmed from the upward adjustment of inflation expectations under the impact of both recent price hikes and those expected in the short run. The adverse influences on the annual core inflation rate were mitigated by the persistence of a substantial negative output gap and the favourable effect exerted on import prices and on market prices of services by the appreciation of the leu against the euro in December compared to September.

The annual dynamics of unit labour costs in industry remained in positive territory in October-November 2012. In spite of the deceleration seen in these two months as a whole compared with Q3, the faster growth posted in November versus October does not allow to extrapolate a clear-cut favourable trend to the entire Q4. With a view to strengthening the medium-term prospects for the inflation rate to return inside the target band, it is of the essence to match wage dynamics with those of labour productivity in the periods ahead.

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

In its meeting on 2 November 2012, the NBR Board decided to leave the monetary policy rate unchanged at 5.25 percent per annum. The updated macroeconomic forecast anticipated an annual inflation rate remaining above the variation band around the target in the first part of the projection interval. The short-term inflation prospects had deteriorated as a result of some of the

[1] Vegetables, fruit and eggs.

[2] An instrument for supporting the production of renewable energy, as regulated by Law No. 134/2012.

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

risks pointed out by the NBR in the previous analyses materialising in unfavourable transitory effects exerted by the evolution of domestic and in international food prices, which had magnified the adverse statistical base effects and in the pass-through of the previous depreciation of the domestic currency versus the major currencies. The main risks associated with the new forecast referred to potentially higher volatility of capital flows in the context of a possible deterioration of external developments and to the forthcoming domestic elections. The NBR Board decision was aimed at adequately calibrating the monetary policy stance with a view to preventing second-round effects from the adverse supply-side shocks and at putting in place the conditions for the inflation rate to return in the medium-term inside the variation band around the target.

The statistical data published subsequent to the monetary policy decision adopted in early November revealed the moderate deceleration of CPI inflation in October and November. This evolution showed the maintenance of favourable prospects for the annual inflation rate to return inside the target band by end-2013. However, in the short run, the risks and uncertainties surrounding external developments, capital flows, administered prices and some volatile prices were further relevant. Furthermore, preserving the prospects for the annual inflation rate to near the medium-term target called for further efforts to firmly anchor inflation expectations. In this context, the NBR Board decided in its meeting on 7 January 2013 that keeping in place a prudent monetary policy stance is of the essence for meeting the medium-term financial and price stability objectives, as prerequisites for sustainable economic growth. Hence, the NBR Board decided to keep the monetary policy rate unchanged at 5.25 percent per annum.

### *Inflation outlook*

The forecast envisages the annual CPI inflation rate staying above the ±1 percentage point variation band around the central target (set at 2.5 percent from 2013 onwards) until 2013 Q2, before reaching the upper bound of the band (3.5 percent) at the end of 2013 Q3 and Q4 and, subsequently, re-entering and consolidating inside the target band until the projection horizon.

In 2012 as a whole, real GDP is expected to post a near-stalemate compared to the previous year, after picking up 2.2 percent in 2011. The major causes of this development were the impact of weaker external demand on net exports and on industrial production, as well as the agricultural supply severely affected by inclement weather conditions. The adverse shock coming from the agricultural supply had the strongest impact in 2012 Q3, which led to the intermission of the six-in-a-row quarters of positive annual GDP growth, whereas the high-frequency data on economic growth released during 2012 Q4 point towards the likelihood of negative annual real GDP dynamics over that period as well. In the year as a whole, the favourable contributions from household consumer demand and especially from gross fixed capital formation are foreseen to be largely offset by the cumulative negative contributions from net exports and the change in inventories. In 2013, the GDP is anticipated to expand at a moderate pace, fuelled mostly by domestic demand components. At the same time, the expected slow economic recovery of Romania’s main trading partners will further constrain net export growth, despite the favourable prospects regarding the dynamics of domestic unit labour costs in real terms throughout the projection interval. Under these conditions, in both 2013 and 2014, the balance-of-payments current account deficit to nominal GDP ratio is envisaged to post slightly lower values than in 2012. As a result, no significant corrective pressure on the leu exchange rate is expected during the entire forecast interval. The negative output gap was revised to levels entailing relatively softer disinflationary pressures than in the previous projection round throughout the forecast interval. Their strength is nevertheless anticipated to abate relatively slowly in the medium-term, implying the persistence of a below-potential effective GDP until the projection horizon.

The baseline scenario of the current projection places the annual CPI inflation rate at 3.5 percent at end-2013, the same as in the November 2012 Inflation Report, and at 3.2 percent at end-2014.

While the previous end-2013 inflation forecast is reconfirmed, the contributions from some components of the consumer basket to this forecast have been reassessed. Thus, the anticipated larger contributions from the prices of alcohol and tobacco products, as well as from administered prices are expected to be countered by the more favourable dynamics of the adjusted CORE2 index than in the previous forecast.

The current projection envisages the annual inflation rate peaking at 5.9 percent in 2013 Q2, before slowing down considerably until early 2014 and consolidating close to 3 percent over the remainder of the forecast interval.

The temporary pick-up in consumer price growth in 2013 Q2 will solely be driven by components exogenous to the monetary policy influence, namely administered prices, prices of volatile food items (VFE), fuels, tobacco products and alcohol. In 2013 H2, given the assumption of a normal agricultural year in the baseline scenario, the resumption of disinflation will be supported by the shift from an adverse base effect to a favourable one, which is expected to have a relatively beneficial influence on the price dynamics of VFE as well as of processed food items included in the adjusted CORE2 index.

The projected annual adjusted CORE2 inflation path will run below that in the previous forecast over most of the projection interval, except 2014 Q2 and Q3. The significant downward revision in the first half of the projection interval stems from slower-than-previously-forecasted dynamics of import prices – mainly due to the recent strengthening of the leu –, of processed food prices and of inflation expectations.

The adjusted CORE2 inflation rate is seen following a downward path, sliding from 3.3 percent at end-2012 to a 2 percent low at end-2013, before stabilising around 2.2 percent in 2014. The annual core inflation rate is thus projected to return in 2013 H2 to levels seen before last year's adverse shocks on food prices and the leu exchange rate. The forecasted dynamics are indicative of the fading impact of these shocks and gradually adjusting inflation expectations, also as a result of a prudent monetary policy stance. The persistence of a wide negative output gap is expected to further generate disinflationary pressures, albeit relatively softer than in the previous forecasting rounds given a reassessment of the magnitude of the GDP deviation from its potential over the entire reference interval. This reassessment is largely responsible for the expected return of core inflation rate to slightly above 2 percent during 2014.

The projected monetary policy stance will further seek to calibrate real broad monetary conditions so as to ensure the inflation rate returns and consolidates inside the target band, creating the necessary prerequisites for a gradual recovery of lending to the Romanian private sector, thereby supporting the resumption of sustainable economic growth. For this purpose, special attention will further be paid to the endeavours to anchor inflation expectations to a path converging to the medium-term target.

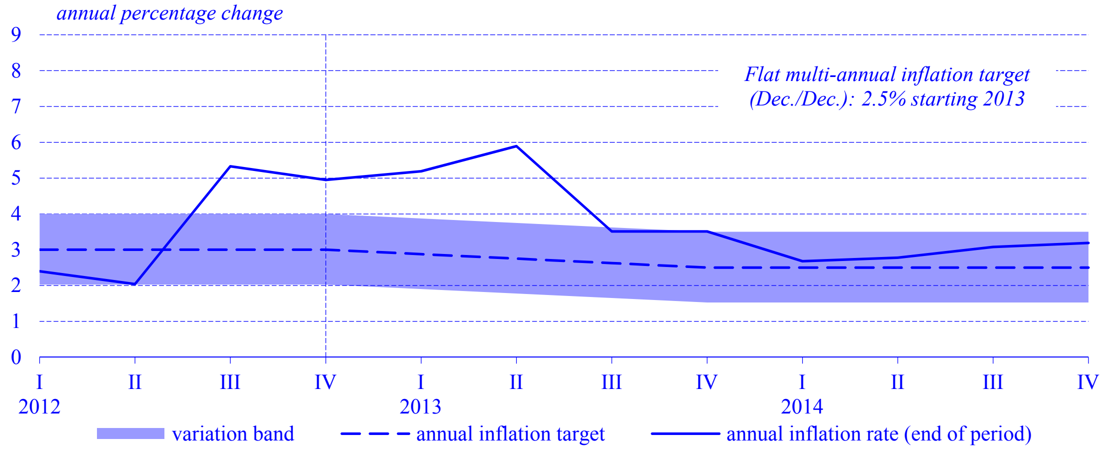
The assessment of the risks to the current inflation rate projection reveals a balance still tilted to the upside, i.e. towards unfavourable deviations from the baseline scenario, but somewhat less skewed than in the previous forecasting round.

Over the reference period, the most relevant external risk derives from possibly higher medium-term volatility of capital flows aimed at financing the domestic economic activity, amid the lingering uncertainties on the time span of the recovery process of the EU economy, and of the euro area in particular. Large amounts of volatile capital flowing either in or out of Romania could pose risks to price and financial stability, as well as to a sustainable rebound in economic growth. On the one hand, should a less favourable scenario on EU-wide economic growth materialise, investor sentiment regarding investments in the region's emerging economies would worsen via contagion effects and the demand for Romania's exports would be additionally constrained. This would ultimately result in weaker capital flows to the Romanian economy and in depreciation pressures on the leu, which could entail adverse effects on domestic consumer price dynamics and financing costs for both private and public sectors, also via the wealth and balance sheet channel for unhedged borrowers. On the other hand, against the backdrop of uncertainty surrounding euro area growth prospects, substantial capital inflows, including the flows seeking temporarily higher returns – and therefore inherently unsustainable –, would increase the leu exchange rate volatility and would prevent an orderly unwinding of macroeconomic imbalances.

Compared to the previous assessment, the balance of risks is less tilted to the upside due primarily to the fading out of domestic political tensions, which were still present when the November 2012 Inflation Report was released. The domestic environment is, however, posing further risks that could cause the inflation rate post upside deviations from the baseline scenario path, owing to the uncertainty surrounding the firm implementation of the macroeconomic policy mix and the structural reforms agreed with the international institutions (the EU, the IMF and the World Bank). Potential slippages from timely and consistently implementing the above-mentioned commitments might trigger a deterioration of investor sentiment towards the Romanian economy, which could heighten the volatility and costs of its financing sources.

Future movements in global commodity prices are a relevant risk factor particularly in the medium term, given that, over this horizon, the persistence or increase of uncertainties regarding the euro area would have a detrimental impact on the dynamics of the EUR/USD exchange rate and, consequently, the RON/USD exchange rate. At the same time, risks associated with unfavourable deviations of the CPI inflation rate from the baseline scenario path continue to stem, in this forecasting round as well, from administered price adjustments in Romania, amid the ongoing uncertainty over the timing and magnitude of electricity and natural gas price increases. Moreover, in view of the large share of food items in the consumer basket, any unfavourable deviation from the baseline scenario assumption, i.e. normal agricultural crops in 2013 and 2014, could weigh heavily on the projected inflation path.

**Inflation Forecast**




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

*Source: NIS, NBR projections*

### *Monetary policy decision*

With a view to effectively anchoring inflation expectations and strengthening the prospects for the annual inflation rate to return inside the target band in the medium term, once the effects of adverse supplyside shocks, temporarily magnified in 2013 H1 by larger administered price adjustments, have faded, the NBR Board has decided in its meeting on 5 February 2013 to keep the monetary policy rate unchanged at 5.25 percent per annum, while ensuring adequate liquidity management in the banking system. Moreover, 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.

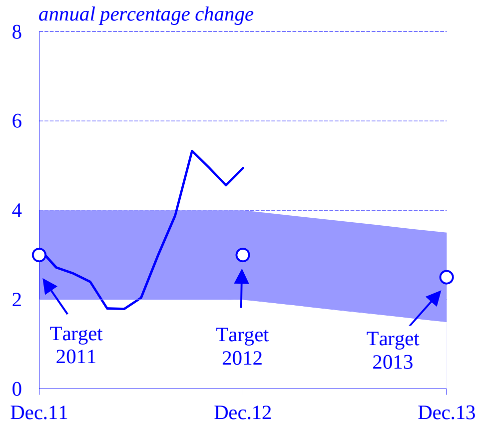
# I. INFLATION DEVELOPMENTS

*At end-2012, the annual inflation rate stood at 4.95 percent, down 0.38 percentage points from the 2012 peak recorded in September, yet it remained outside the variation band of ±1 percentage point around the central target (3 percent). The slowdown in the annual inflation was due to the correction of volatile food prices, the downward trend in world crude oil prices and the domestic currency appreciation versus the euro. Conversely, an adverse impact on inflation had the rise in some administered prices, the gradual incorporation into consumer prices of the hike in the costs of agri-food commodities following the significantly lower agricultural crops and the worsening inflation expectations. Under the influence of the last two factors, which was partly offset by the persistence of a negative output gap, the adjusted CORE2 inflation picked up 0.3 percentage points to 3.26 percent.*

Volatile prices had the largest contribution to the slowdown in the annual inflation rate in 2012 Q4, due mainly to the "vegetables, fruit, eggs" component. Thus, the annual dynamics of VFE prices decelerated considerably (down 9.5 percentage points to 18.2 percent), particularly as a result of the atypical developments reported in this period by vegetables prices (monthly deflation in October and November). The correction was made in the context of the demand response to the September surge in vegetables prices and was accelerated by the perishable nature of these goods, also in view of the shortage of appropriate warehouses. The monthly declines in fuel prices also exerted a disinflationary impact, as reflected by the reversal of the uptrend in their annual dynamics (from 8 percent in September to 5.2 percent at year-end). While in October and November the downward trend in world crude oil prices[1] was the main determinant of these developments, in December the domestic currency appreciation versus the US dollar (3.1 percent against the November 2012 average) had a prevailing influence.

The annual growth rate of administered prices stood at 6.1 percent in December (versus 5.7 percent in September), being mainly driven in the reviewed period by the 7.25 percent hike in the electricity price, following the separate recognition of the value of green certificates[2] – instruments for supporting the production of renewable energy – in the electricity bill for household end-users. Looking further at the energy group, mention should also be made of the pick-up in the annual dynamics of the gas price by another 2.4 percentage points in October versus September, due solely to

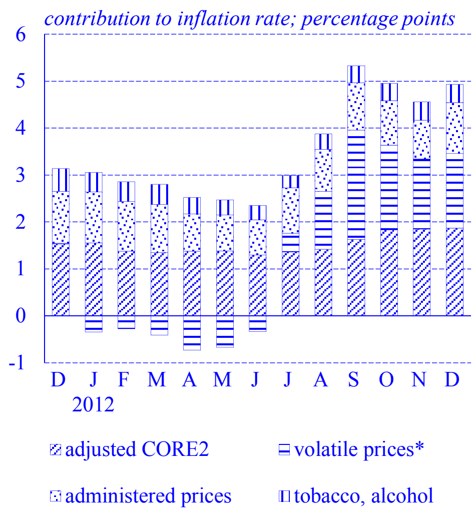
**Inflation Developments**




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

*Source: NIS, NBR calculations*

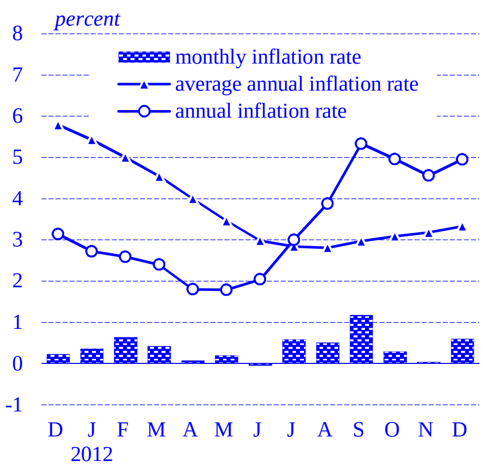
**Annual Inflation Rate**




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

*Source: NIS, NBR calculations*

**Inflation Rate**



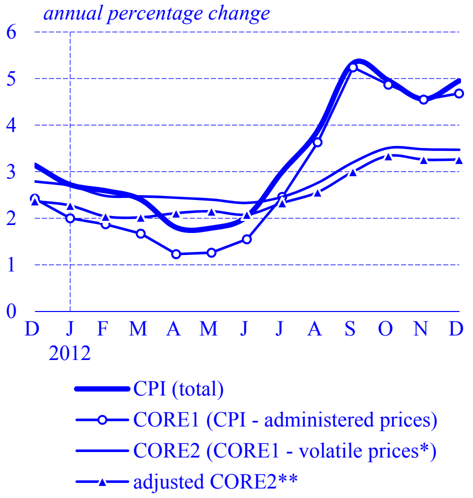

*Source: NIS*

[1] Brent crude oil price decreased to USD 109.3/barrel in December 2012 from USD 113.4/barrel in September 2012, on the back of the worsening outlook for world economic growth, as well as of the large US oil stocks (according to OPEC Monthly Oil Market Reports).

[2] According to Law No. 134/2012.

**Headline Inflation and CORE Inflation**

*annual percentage change*



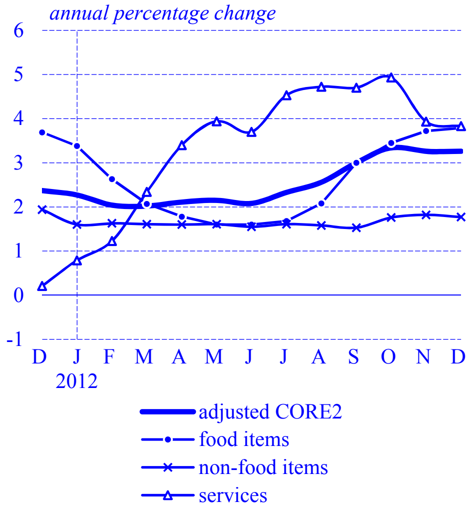

*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

*Source: NIS*

**Adjusted CORE2 Components**

*annual percentage change*




*Source: NIS, NBR calculations*

some statistical effects, once the price adjustment implemented as of mid-September was fully incorporated in the monthly indices.

The annual dynamics of tobacco product prices also accelerated, i.e. to 5.8 percent. However, this time the increase was not due to changes in excise duties, but to the unfavourable effect of some market factors (exchange rate movements, demand contraction at EU level) on the 2012 financial results of a representative operator.

In terms of monetary policy scope, the annual rate of adjusted CORE2 inflation remained at 3.3 percent during 2012 Q4, yet it added 0.3 percentage points versus September. The stagnation of core inflation in the period under review was the result of the divergent developments in the main sub-groups: the pick-up in the annual growth rates of food and non-food prices was offset by the reversal in the uptrend of market services prices.

Most food prices included in the adjusted CORE2 inflation were further hit by the adverse shock coming from the 2012 agricultural supply, yet at a lower extent than in the preceding quarter, owing particularly to consumer demand contraction. The magnitude of price increases was different for the main categories of products, the transmission of the supply-side shock being influenced by the concentration of individual markets (which was significantly higher for oil than for meat or bakery products) as well as by the bargaining power of producers along the supply chain (e.g. limited incorporation of the considerable hike in the cost of fodder into dairy prices). Furthermore, with regard to meat prices, the meat processors' endeavours to shift focus to the external market (also fostered by the lift of the embargo on pork in early 2012) lowered their reliance on the domestic market, enabling them to charge higher prices.

Despite the slight acceleration seen in October-December 2012, the annual growth rate of non-food prices was further nearly two times lower than the adjusted CORE2 inflation, reflecting the persistence of the negative output gap. In the absence of pressures from external prices[3], the explanation for the upward path seen by this core inflation sub-group in the period under review may lie with the worsening unit labour costs in the light industry over the past six quarters.

The prices of market services saw a deceleration in their dynamics, associated largely with the RON/EUR exchange rate movements: appreciation by 0.24 percent in December 2012 compared with September and slower pace of annual depreciation by 1.2 percentage points in the same period.

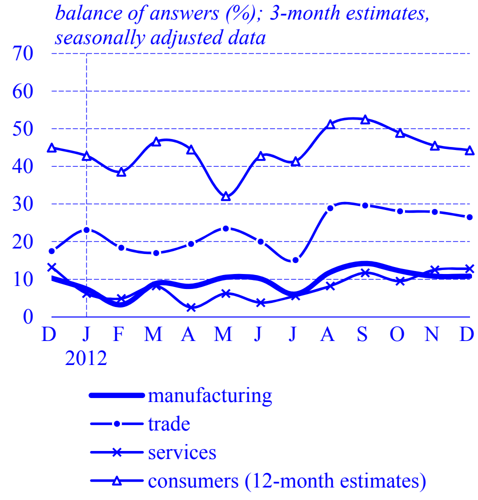
[3] Approximated by EU-15 industrial producer prices for consumer goods for the non-domestic market (except for food items).

Overall, the inflation expectations of economic agents worsened further in the period under consideration on the back of expectations of consumers, managers in retail trade and services, as well as of financial analysts. Given the primarily backward-looking nature of inflation expectations, the hikes in food prices as well as the developments in the exchange rate in September-October 2012 had a major contribution to this adjustment.

As regards the inflation rate criterion laid down in the Maastricht Treaty, the differential widened to 0.6 percentage points, with the average annual HICP inflation rate in Romania rising to 3.4 percent at end-2012 compared with 3.1 percent in September. Moreover, the gap versus the EU average inflation widened to 0.7 percentage points, due also to the curbing of inflation in certain EU Member States against the background of the stalemate in economic activity and the high uncertainty surrounding the recovery perspectives.

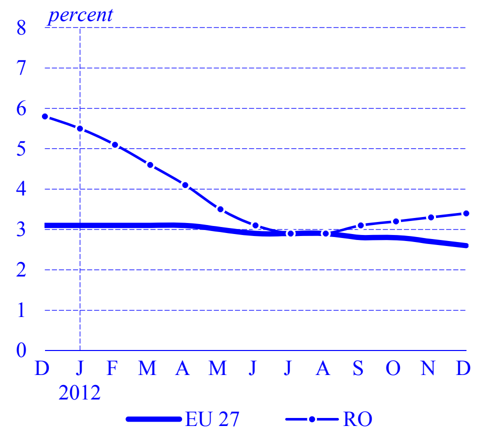
In December 2012, the actual 12-month inflation rate was 0.15 percentage points lower than the projection in the November 2012 Inflation Report. The difference from the previous forecast can be largely accounted for by steeper-than-projected downward adjustments in volatile food prices. In the opposite direction acted the higher-than-forecasted administered price increases.

**Inflation Expectations of Economic Agents**




*Source: EC-DG ECFIN*

**Average Annual HICP Inflation Rate**




*Source: Eurostat*

# II. ECONOMIC DEVELOPMENTS

## 1. Demand and supply

*2012 Q3 marked an intermission of the six-in-a-row quarters of positive annual GDP growth*[1]*. Behind the 0.5 percent economic contraction stood both the fall in activity (down 0.4 percent) from Q2 and a base effect, as in the same year-earlier period real GDP posted one of the fastest paces of increase following the onset of the economic crisis (1.3 percent).*

*The annual decrease in real GDP was attributable, on the one hand, to the 0.9 percent lower private consumption and, on the other, to the larger negative contribution from net external demand, given that the annual decline in exports was swifter than that in Q2 (to -5.2 percent), exceeding the drop in the volume of imports of goods and services, i.e. -2.3 percent. The change in inventories also made a negative contribution (-2.7 percentage points). Apart from the prevailingly residual content of this item, there is also an economic explanation for the slower build-up of stocks, linked to the adverse developments in agriculture in 2012. Thus, in 2012 Q3, the only components of final demand which actually followed an uptrend were government consumption (up 1.7 percent following 10 quarters of negative annual changes) and gross fixed capital formation, whose 11.7 percent advance moderated the decline in real GDP by 3.5 percentage points.*

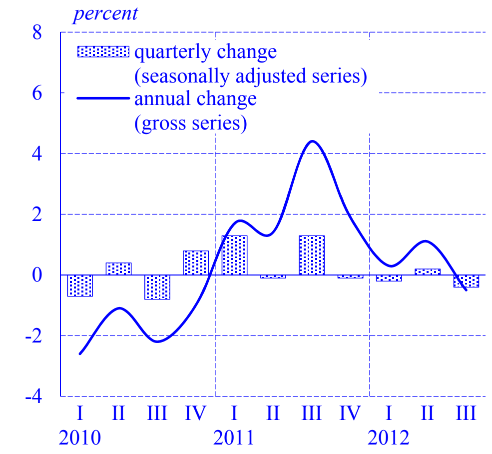
*Turning to quarterly developments in real GDP, the sign reversal of its dynamics was primarily triggered by the deterioration in net external demand (-1.4 percentage point contribution), as a result of a renewed contraction in exports (-2.4 percent) and imports of goods and services posting a near-stalemate (+0.1 percent). Apart from this economically relevant explanation, the two residual items, "change in inventories" and "statistical discrepancy", made a -1 percentage point cumulative negative contribution. By contrast, the major components of domestic demand exerted an overall favourable impact, on the back of both consumer demand and gross fixed capital formation further expanding by 1.2 percent and 2.7 percent, respectively.*

### 1.1. Demand

In 2012 Q3, the annual dynamics of final consumption entered negative territory, to stand at -0.7 percent from +1.3 percent in Q2. This sign reversal owed solely to private consumption (-0.9 percent), deeply hit by the significant drop in vegetal production, directly impacting "self-consumption and purchases on the agri-food market". Retail purchases and market services to households, whose volume remained on a slight uptrend, had an opposite influence.

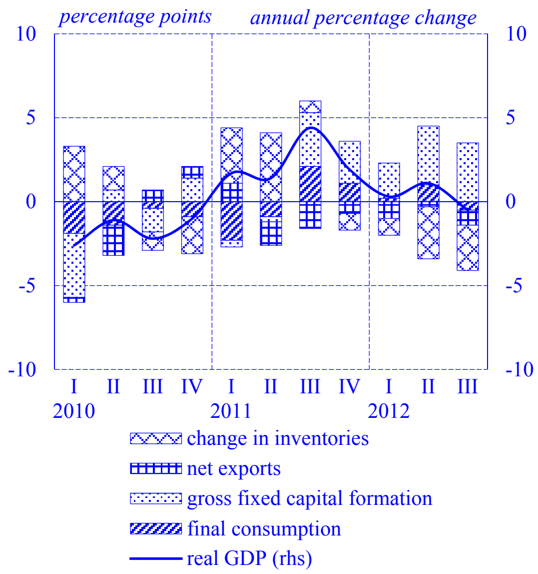
[1] Unless otherwise indicated, the growth rates in this section are annual percentage changes in real terms, calculated based on unadjusted data series. Current developments refer to quarter-on-quarter changes and are calculated based on seasonally-adjusted data series.

**Real Gross Domestic Product**



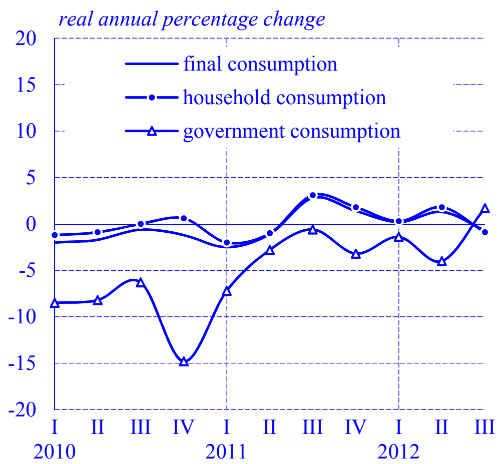

*Source: NIS*

**Contribution of Demand Components to GDP Growth**




*Source: NIS, NBR calculations*

**Actual Final Consumption**



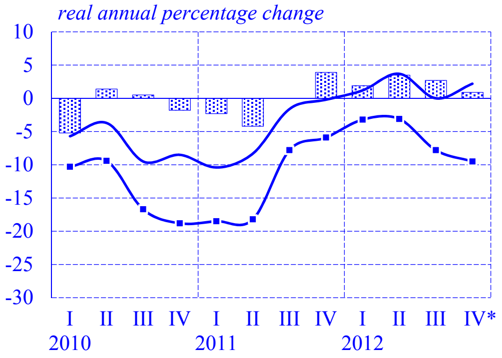

*Source: NIS*

Apparently, this development does not correlate with the path followed by main financing sources – in real terms, household disposable income[2] remained virtually flat, whereas consumer loans declined two times faster, i.e. by 7.8 percent on average. However, a possible explanation for this incongruity lies with households' change of behaviour over the past four quarters, namely their shift to cheaper FMCG, concurrently with the expansion of super- and hypermarkets, discount and specialised stores, and the large-scale promotion of low-end products (e.g. own brands). The further positive dynamics of the turnover volume of trade in non-durables and the rise in sales of household appliances and furniture (up 6.3 percent) support this conclusion. In 2012 Q3, purchases of motor vehicles saw a renewed drop in real terms (by 8.2 percent), with market operators further incriminating the faulty implementation of the car scrapping scheme[3].

After having declined between 2010 Q1 and mid-2012, government final consumption moved up 1.7 percent in real terms in the reviewed period.

In 2012 Q3, the general government deficit stood at lei 382 million[4], i.e. 0.1 percent of GDP[5], well below that seen in the same year-earlier period, which amounted to lei 2,687 million[6] and accounted for 0.5 percent of GDP, as well as below those recorded in the first two quarters of 2012. The improved general government budget execution owed to the markedly faster decline in public expenditure[7] (-4.8 percent versus -0.1 percent in 2012 Q2), mainly underpinned by the slacker dynamics of social payments (-6.4 percent as compared with -4.3 percent in Q2), government spending on goods and services (3.4 percent versus 7.3 percent April through June 2012) and "other transfers" (-34 percent as compared to -3.9 percent in Q2). Their impact was stronger than that exerted by the higher public wage bill (6.2 percent from -0.4 percent in Q2), following the partial reversal of the budgetary sector pay cuts of 2010[8]. Nevertheless, the improvement in the general government budget balance was, to a certain extent, slowed down on account of the annual growth rate of general government revenues entering negative territory after having posted positive

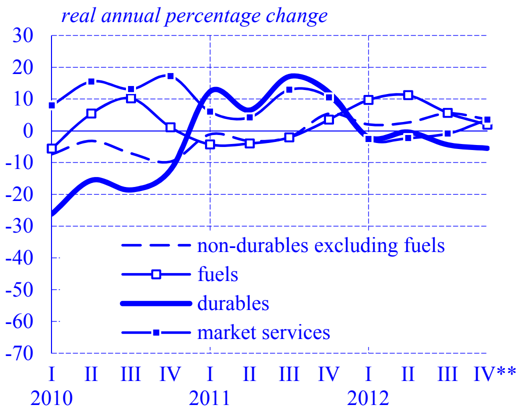
**Household Consumption and Main Financing Sources**




*) Oct.-Nov.

*Source: NIS, MPF, NBR calculations*

**Purchases of Goods and Services***

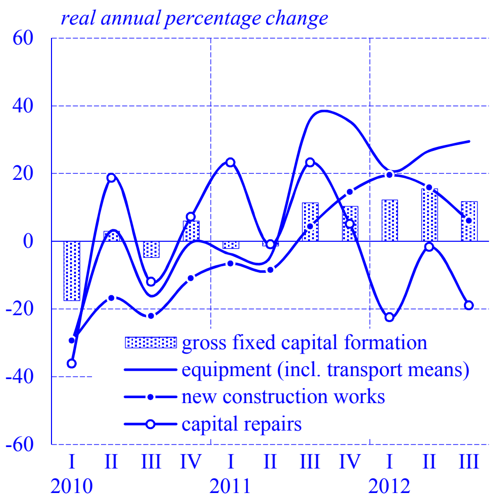



*) based on data on the turnover volume of retail trade and market services to households

**) Oct.-Nov.

*Source: NIS, NBR calculations*

**Investment**




*Source: NIS, NBR calculations*

2 Approximated by the sum of incomes from wages, social transfers (state social security, unemployment benefit and health insurance) and inflows from abroad, i.e. workers' remittances and current private transfers by non-residents.

3 According to the Automotive Manufacturers and Importers Association.

4 Preliminary data published by the MPF in respect of the general government deficit for January-September 2012 showed compliance with the ceiling agreed with the IMF.

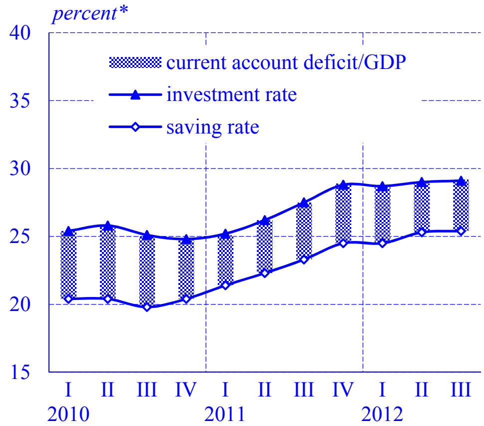
5 The analysis relied on the operational data relating to the September 2012 budget execution, as published by the MPF. The GDP reading released by the NIS was used for 2011.

6 The 2011 budget execution figures have been recalculated by the MPF to ensure comparability with those for 2012.

7 Unless otherwise indicated, percentage changes refer to annual growth rates in real terms.

8 The 8 percent rise in budgetary sector wages became effective as of June 2012. The payments were reflected in budget execution starting with 2012 Q3.

**Investment Rate and Saving Rate**

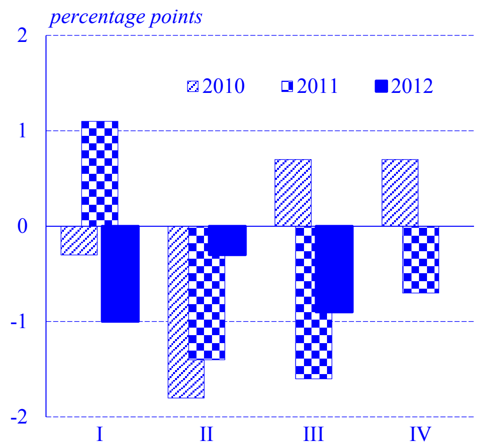



*) last 4 quarters' average

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

*Source: NIS, NBR calculations*

**Net External Demand Contribution to GDP Growth**




*Source: NIS, NBR calculations*

readings for eight quarters, chiefly on the back of the decline in VAT receipts (-3.4 percent from 9.2 percent in Q2) and in the receipts from social security contributions (-6.8 percent from 0.8 percent in the preceding three months).

The 11.7 percent advance in gross fixed capital formation was further supported primarily by technological investments, including transport means purchased by companies and institutions (up 29.5 percent). The growth rate of gross fixed capital formation was 3.8 percentage points slower than in Q2, given the poor performance of capital investment in the construction sector. Thus, the volume of new construction works continued to rise, albeit at an almost three-time slower pace (up 6 percent, mainly on account of infrastructure projects), and capital repair works contracted at a faster tempo (down 19 percent).

Similarly to the previous three-month period, the corporate sector saw the largest capital investment, with borrowed funds further representing an important financing channel – the real stock of loans earmarked for equipment purchases[9] added approximately 6 percent. Furthermore, the significant pickup in the dynamics of net flows of non-residents' direct investment cannot be overlooked. The latter's value expressed in EUR (change in the past four quarters) rose more than four times, with the capital increases performed by a number of corporations making a major contribution to this development.

Fixed capital investment by households was further low, as suggested by the slow-in-coming resumption of the construction of new housing units. Specifically, residential building works contracted and the useful area corresponding to such building permits remained on the downtrend it had embarked upon in 2011 Q4. July through September 2012 as well, residential investment virtually targeted already built houses, with loans representing the main source for financing such purchases – the real stock of housing loans saw a renewed increase, i.e. up 12 percent. However, these transactions have a relatively low bearing on "gross fixed capital formation", as the recorded flow corresponds only to the expenditure for services related to ownership transfer.

The steeper downward path posted by exports of goods and services (-5.2 percent in 2012 Q3) owed both to commercial transactions in all groups of goods[10] (down 5.6 percent) and to services (down 2.9 percent). Behind the lower physical volume of exports stood largely the sluggish euro area economy, as well as the economic slack in non-euro area EU countries[11].

[9] The calculations were based on the data supplied by the Central Credit Register.

[10] The breakdown by destination market/market of origin and by group of goods of the physical volume of exports and imports is based on the series of trade balance data and international trade-related unit value indices released by the Eurostat.

[11] In 2012 Q3, euro area real GDP lost 0.8 percent in annual terms, while real GDP of non-euro area EU countries added merely 0.1 percent, following a 0.4 percent decrease in Q2.

The 16.4 percent drop in the volume of services accounted for more than 90 percent of the sign reversal witnessed by the real dynamics of imports of goods and services, i.e. from +0.2 percent in Q2 to -2.3 percent. Imports of goods shrank by 0.2 percent on account of EU27 purchases (down 1.6 percent) and particularly extra-EU imports (down 11.3 percent). All groups of goods reported volume contractions, with intermediate goods ranking first, in line with the fall in production for external markets, as well as with the lower domestic supply of consumer goods and capital goods aimed at meeting domestic final consumption[12].

## 1.2. Supply

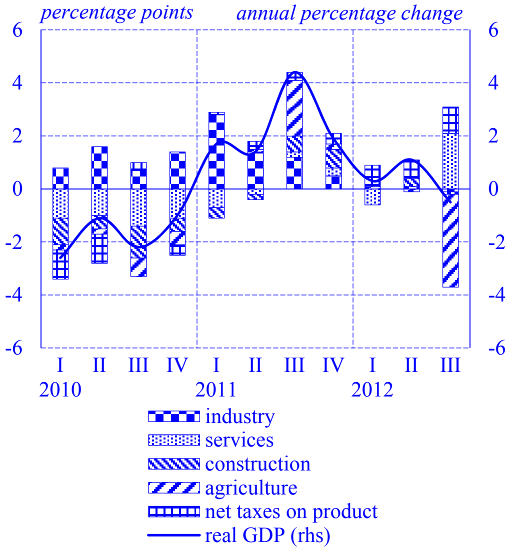
The real GDP uptrend coming to a halt was mainly accounted for by the severe contraction in gross value added in agriculture (by 29.8 percent). This owed, on the one hand, to the protracted drought that hit the 2012 vegetal production, and, on the other, to an adverse base effect, given that 2011 saw bumper crops. Leaving this influence aside, economic growth in 2012 Q3 would have picked up by approximately 2 percentage points, to +3.3 percent. Gross value added in the industrial and construction sectors also made negative, albeit much lower contributions (-0.1 percentage points each), while positive contributions were recorded in services and, once again, in net taxes on products – the latter benefiting from the trade sector's further expansion.

Gross value added in industry shrank by 0.5 percent, chiefly on account of the steeper downward path followed by the production of intermediate goods (-4.4 percent). This owed particularly to metallurgy (this sub-sector has reported heavy losses associated with the worsening situation of the iron and steel industry at European level since early 2012) and to the chemical industry, which was hit by some important corporations halting their activity in 2012 Q3.

Gross value added in construction fell by 1 percent, given that the annual growth rate of engineering works was almost three times slower than in Q2, i.e. 6.6 percent, and thus could not offset the more than 10 percent decline in the "buildings" segment.

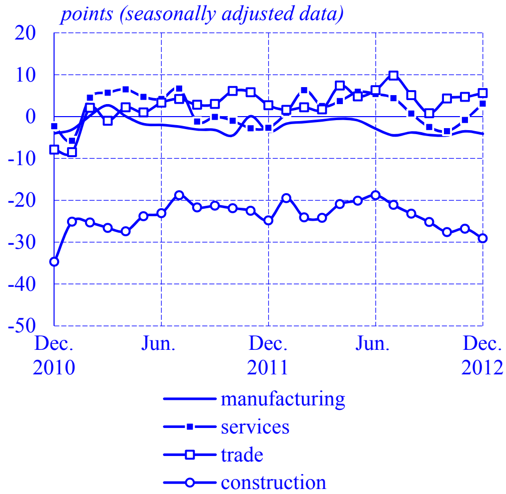
Services were the only economic sector that performed better than in the same year-earlier period (5 percent). Most sub-sectors posted faster paces of growth, except for public services and financial intermediation services, which lost 1 percent and reported a near-stalemate, respectively. The largest contributions to the faster dynamics of services came from: (i) trade, services and transportation, where cumulative gross value added growth stood at 4.1 percent, and (ii) real estate transactions, which increased by 10.5 percent, with market signals pointing at investors' keener interest in projects concerning offices and shopping centres, as well as in purchasing land with a view to developing residential projects.

**Contribution of Supply Components to GDP Growth**




*Source: NIS, NBR calculations*

**Corporate Sector: Confidence Indicators for the Next 3 Months**

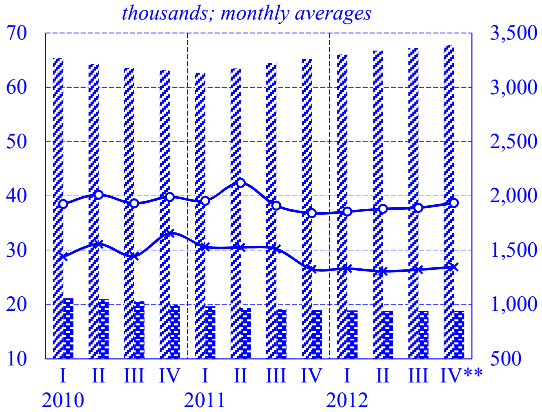



*Source: EC-DG ECFIN*

[12] Domestic supply performance by group of industrial goods is estimated based on the changes in the turnover volume of industrial output for the domestic market.

**Labour Demand Measures***

*thousands; monthly averages*




*) seasonally-adjusted data

**) Oct.-Nov.

*Source: NEA, NIS, NBR calculations*

**Unemployment Rate***

*percent*

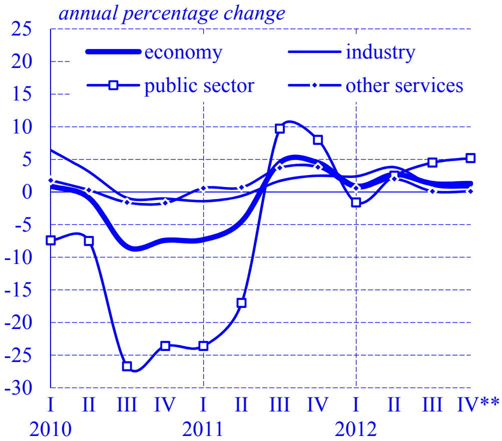

*) seasonally-adjusted data

**) Oct.-Nov.

*Source: NIS, NBR calculations*

**Net Real Wage***

*annual percentage change*




*) deflated by CPI

**) Oct.-Nov.

*Source: NIS, NBR calculations*

## 2. Labour market

*September through November 2012, the labour market saw mixed developments: although the number of employees economy-wide remained on an uptrend, the registered unemployment rate further rose*[13] *and company managers generally expressed cautious opinions with respect to hiring in early 2013. At the same time, the annual increase in wage earnings in the private sector further stood close to 5 percent, while their performance in industry, along with the flagging demand, contributed to the annual pace of growth of unit labour costs staying in positive territory.*

In the period under review, companies' adjustment to the domestic and global economic environment, marked by uncertainty and large discrepancies between sectors, was illustrated by higher flows on various labour market segments. Concurrently, staff numbers in the budgetary sector stabilised, following a more than three-year period of continuous layoffs. In the private sector, job creation carried on at a slow pace, while the number of redundancies went up notwithstanding. Similarly to previous quarters, services were the main sector to report net hires, with industry making a significantly lower contribution. Nevertheless, in certain sub-sectors (wearing apparel, machinery and equipment, transportation and financial intermediation) the number of registered payrolls shrank amid the persistent subdued demand and the uncertainties surrounding the prospects for recovery. Under the circumstances, registered unemployment rate remained on a slightly upward trend, in contrast to the estimated drop in the ILO unemployment rate, which could stem from the formerly unemployed shifting to subsistence agriculture or activities involving tax avoidance schemes. The DG ECFIN/NIS survey points to a modest rise in the number of employees in trade and services, along with downsizing in construction and industry over the following months.

October through November 2012, the annual dynamics of net wage earnings picked up from 5.4 percent in 2012 Q3 to 6.1 percent, although the upward move was not visible across all sectors. Behind this step-up stood mostly education (on the back of teachers' hourly-paid courses amid the introduction of the "zero grade programme" in primary schools) and the energy sector (as a result of a favourable base effect).

In 2012 Q3, the annual growth rate of gross wages in the industrial sector was further higher than the private sector average and represented a source of pressure on unit labour costs. Despite the improvement seen in ULC October through November 2012 – their annual dynamics[14] slowed down to 6.1 percent on the back of an approximately 4 percentage point deceleration in manufacturing –, this development was probably short-lived. Such a conclusion is based on the higher figures posted in November than in October, as well as on the unfavourable prospects for short-term demand.

13 Based on seasonally-adjusted data.

14 Based on the labour productivity index calculated by the NIS.

Therefore, in order to avoid cost pressures and thus lay the ground for the inflation rate to return inside the target band over the medium term, it is of the essence to adequately match wage dynamics with those of labour productivity.

Looking at consumer demand, real disposable income further reported moderate dynamics, favouring the resumption of disinflation. In 2012 Q3, real disposable income stayed virtually flat in annual terms, but picked up slightly again in October-November 2012, i.e. 2.2 percent versus the same year-ago period, particularly as a result of higher remittances from abroad.

## 3. Import prices and producer prices

*In 2012 Q3, domestic (agricultural and industrial) producer prices exerted stronger inflationary pressures, mainly following the supply-side shock seen in agriculture both domestically and globally, whereas import prices witnessed steady developments. Given the persistent negative output gap and the fading pressures from the external prices of some commodities, i.e. food commodities and fuels, in 2012 Q4 domestic producer prices are expected to post slower dynamics.*

July through August 2012, import prices saw similar developments to those in Q2, as the unit value index of imports was further slightly below par (99.6 percent) and the domestic currency position versus the major currencies remained broadly unchanged (the depreciation of the leu against the euro lowered somewhat, whereas that against the US dollar saw comparable levels).

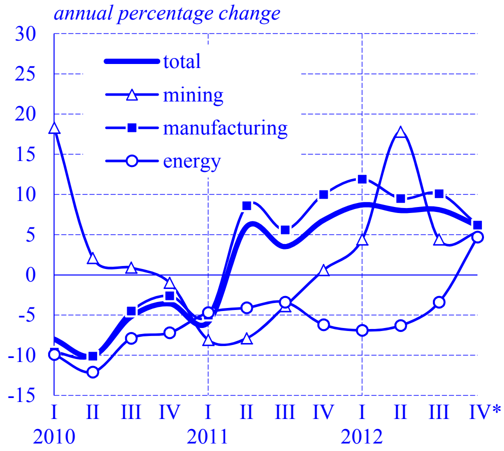
The prices of imported goods holding a large share in the CPI basket witnessed divergent movements – most food prices rose at a faster pace on the back of poorer-than-expected global crops, the unit value of imported pharmaceuticals dropped significantly, i.e. -11.1 percent, and the positive annual growth rate of fuel prices decelerated. In the latter case, mention should be made of the reversal of the downtrend followed by international crude oil prices in Q3, amid the lower output of the main exporting countries (OPEC and the North Sea), a move seen also in the quarterly dynamics of the unit value index of fuels.

Prices of imported intermediate goods and capital goods did not exert any pressures, with metals (amid subdued global demand) and transport means (on the back of the spectacular dynamics of imports of second-hand motorcars, boosted throughout the year by the lower car pollution tax) posting below par unit value indices of imports.

In 2012 Q3, the annual growth rate of industrial producer prices for the domestic market stepped up 0.7 percentage points, to 5.6 percent, as the favourable influence exerted by the negative output gap was offset by the gradual pass-through into prices of finished goods of recently built-up pressures, namely higher utility costs (amid the deregulation of energy prices), the recurrent hikes in fuel prices, and the rise in prices of agri-food commodities.

**Unit Labour Cost in Industry**

*annual percentage change*

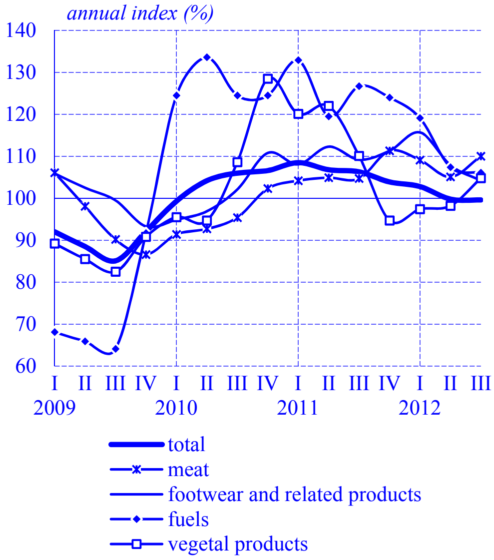



*) Oct.-Nov.

*Source: NIS, NBR calculations*

**Major Inflationary Pressures on the Unit Value Index of Imports**

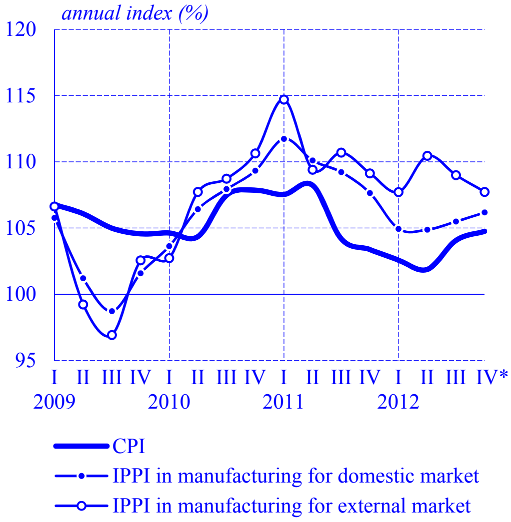
*annual index (%)*




*Source: NIS, NBR calculations*

**Consumer Prices and Industrial Producer Prices**

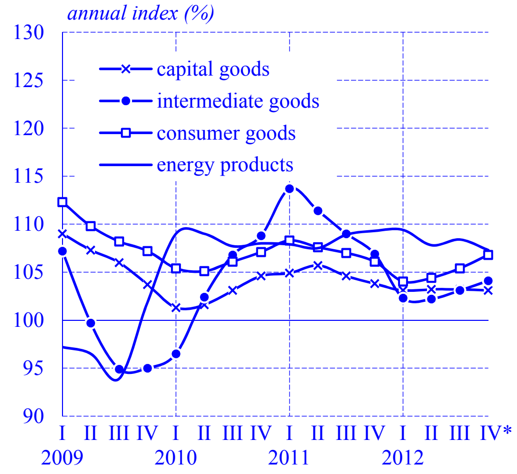
*annual index (%)*




*) Oct.-Nov.

*Source: NIS*

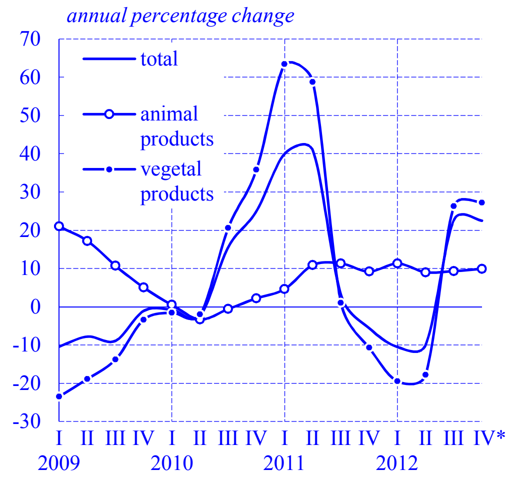
**Industrial Producer Prices for Domestic Market by Industrial Products Group**




*) Oct.-Nov.

*Source: NIS*

**Agricultural Producer Prices**




*) Oct.-Nov.

*Source: NIS*

Producer prices for consumer goods reported the fastest pace of increase, i.e. up 1 percentage point, to 5.4 percent, on the back of the price adjustments performed by food industry companies following the significantly higher costs of agri-food commodities.

The pick-up in the annual dynamics of energy prices, to 8.4 percent, was attributed to the upturn in electricity prices, which was only partly counterbalanced by a favourable base effect becoming manifest in the hydrocarbon processing sub-sector. The higher utility costs, i.e. for electricity and natural gas[15], were reflected by the faster annual growth rate of producer prices for intermediate goods (+0.9 percentage points, to 3.1 percent). Nevertheless, the protracted contraction of sales in metallurgy led to lower prices and to some important producers deciding to temporarily halt the activity of some plants.

In 2012 Q3, agricultural producer prices reverted to annual positive dynamics, i.e. +22.7 percent – a one-year high, against the background of pressures stemming from the fall in domestic vegetal production, given the hostile weather conditions.

Behind this trend stood chiefly vegetable producer prices (up 44.1 percentage points, to 26.3 percent), whereas the pace of growth of prices for animal products saw a marginal change owing to large opposite movements in prices of various types of meat. Thus, given the pressure from the considerably costlier fodder, some farmers resorted to slaughtering their livestock, which exerted a downward impact on the selling price, whereas others allowed additional costs to pass through, to various extents, into consumer prices, i.e. the case of pork and poultry.

In 2012 Q4, the abatement of tensions on the external markets for agri-food commodities (partly thanks to the higher-than-expected exports of the Black Sea region) and energy commodities (on the back of the unfavourable prospects for global economic growth), along with the appreciation trend of the leu versus the major currencies, may impact imported inflation favourably. In the final quarter of 2012, the uptrend followed by producer prices for the domestic market is expected to ease (their annual growth rate decelerated to 5.3 percent in November), as a result of the flagging domestic demand and the slower increase in prices for main commodities.

[15] In the context of the deregulation of energy prices, January through September 2012, natural gas prices added 15.5 percent, whereas electricity prices increased by 8.2 percent. Furthermore, Hidroelectrica's filing for insolvency and the renegotiation of bilateral energy contracts resulted in the latter supplying lower volumes of electricity and in significant hikes in the selling price.

# III. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

## 1. Monetary policy

*October 2012 through January 2013, the NBR kept the monetary policy rate at 5.25 percent per annum and extended the status-quo of the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions*[1]*, while also tightening control over banking system liquidity. The further prudent monetary policy stance was aimed at effectively anchoring inflation expectations and hence consolidating the prospects for the annual inflation rate to return inside the variation band around the medium-term target after the dissipation of the transitory effects of adverse supply-side shocks manifest especially during 2012 Q3.*

In its meeting of 2 November 2012, the NBR Board decided to keep the policy rate unchanged at 5.25 percent per annum and to maintain the existing levels of the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions, while also turning to the firm management of liquidity in the banking system. Such calibration of the monetary policy toolkit was warranted, on one hand, by the considerable worsening of current developments in inflation and its short-term outlook, owing mainly to the rise, starting July 2012, in the prices of processed and unprocessed food, a trend expected to persist into the following quarters, under the impact of costlier global agri-food commodities and of the drop in the 2012 domestic agricultural output. At the same time, significant inflationary risks remained over the very short term. These risks were induced by the potential heightening of the volatility of capital flows and implicitly of the leu exchange rate, amid a possible deterioration of the external environment adding to the domestic general elections context.

On the other hand, the worsening of the current and future inflation performance was anticipated to be only temporary, as the updated quarterly projection pointed to the annual inflation rate reverting along the coordinates of the previous forecasting exercise starting 2014 Q1. Specifically, the 12-month inflation rate was seen returning and then consolidating, in the longer run, inside the variation band around the midpoint of the medium-term target. This outlook was supported by the anticipated dissipation of the impact of higher food prices[2] and by the relatively stronger disinflationary pressures from the negative output gap, given the downward revision of the projected growth rate of the Romanian economy. Furthermore,

[1] 15 percent and 20 percent respectively.

[2] Corroborated with a favourable statistical base effect.

the newly-emerged risk that the magnitude of recent and forecasted increases in food prices may generate second-round effects in the given context was significantly mitigated by the transitory nature of these rises and by prospects of a wider than previously projected negative output gap throughout the forecast interval.

Statistical data released in the run-up to the following NBR Board meeting highlighted that the annual inflation rate had decelerated markedly in October and November 2012 (reaching 4.56 percent from 5.33 percent in September), primarily on account of the somewhat improved developments, also vis-à-vis expectations, in volatile prices and the leu exchange rate. Moreover, against this background, to which added the appreciation path the domestic currency had embarked upon in the closing weeks of 2012, and also amid the possible persistence of subdued economic activity, implying a highly likely widening of the negative output gap, the short-term inflation outlook improved visibly as well, thus consolidating the prospects for the 12-month inflation rate to return inside the target band by end-2013. However, given the ongoing risks and uncertainty surrounding this outlook, stemming from developments in the external environment, capital flows, administered prices and some volatile prices, the NBR Board decided, in its meeting of 7 January 2013, to extend the *status-quo* of the monetary policy rate and of the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions, while also ensuring adequate liquidity management in the banking system.

The likely protracted slowdown in economic activity, also as compared with the previous projection, was primarily hinted at by the recent downward revision by the ECB/EC of the EU and euro area growth forecasts for 2012 and 2013, as well as by further unfavourable developments in/worsening performance of some consumer and investment demand indicators in October 2012. Additional signals in this respect came from the persistence into October and November 2012 of the decline in the annual dynamics[3] of narrow money, with money demand for precautionary purposes remaining somewhat robust, and from the more sluggish annual dynamics of loans to the private sector.

Specifically, the average annual dynamics of loans to the private sector entered negative territory in the first two months of 2012 Q4, to stand at -1.5 percent from 1.6 percent in the previous three months, mainly on the back of the protracted decline in the annual rates of change of both the foreign currency component (-1.5 percent versus 0.5 percent in 2012 Q3, based on readings expressed in euro) and leu-denominated credit (-0.5 percent against 0.4 percent July through September 2012). These developments were also associated with a relative worsening[4] during the period

[3] Unless otherwise specified, indicators are calculated as annual changes expressed in real terms.

[4] Also under the impact of one-off factors, i.e. some statistical influences.

under review of several parameters related to credit demand and supply, as suggested by the results of the November 2012 NBR survey on lending to households and non-financial corporations[5]. Under the circumstances, the annual dynamics of loans to non-financial corporations[6] remained on a downward path, albeit slightly less steep than in 2012 Q3. The decline in the dynamics of leu-denominated corporate credit and especially of the foreign currency component (-2.6 percent versus 0.6 percent July through September, expressed in euro) was mainly ascribable to short-term loans. Loans to households also declined at a faster average annual pace, i.e. 2.9 percent from -1.0 percent in 2012 Q3, owing primarily to the annual dynamics of consumer credit (in both lei and foreign currency) falling deeper into negative territory and to the slower growth rate of housing loans, attributable solely to the leu-denominated component.

In line with these developments, the average annual pace of increase of broad money decelerated further to 1.0 percent October through November 2012, mainly on account of the additional loss of momentum in narrow money (M1) dynamics, largely triggered by the considerable slowdown in the growth rate of corporate overnight deposits. However, the annual pace of increase of household time deposits (including deposits with a maturity of over two years outside broad money) remained somewhat alert at 6.0 percent during October-November 2012, despite continuing to moderate against 2012 Q3 (8.0 percent), amid the ongoing sluggish growth rate of the real net average wage. At the same time, the average share of time deposits in total household deposits widened slightly, hinting at the further robust precautionary demand for money. Yet, similarly to the previous period, the trend was accompanied by households' somewhat keener appetite for foreign currency deposits, most likely prompted by unfavourable expectations on the short-term performance of the leu exchange rate and by relatively higher remittances from abroad.

During 2012 Q4, the NBR reverted to the firm management of money market liquidity in response to the temporary heightening of depreciation pressures on the domestic currency in the run-up to the general elections. Hence, starting 8 October the central bank capped the amounts auctioned off during the weekly repo tenders with a seven-day maturity[7]. Against the background of the relative tightening of liquidity conditions, interbank rates returned in the vicinity of the monetary policy rate in October 2012, before exceeding it in the following months. The RON/EUR exchange

[5] According to the survey, banks anticipated a contraction both in corporate demand for loans and in household demand for real estate credit during 2012 Q4, along with the tightening of specific lending standards. By contrast, no changes were envisaged for consumer credit.

[6] Loans to non-monetary financial institutions declined at an even faster annual pace, i.e. -11.1 percent from -1.3 percent in 2012 Q3.

[7] The volume of these operations was gradually lowered from lei 6 billion to lei 4 billion.

rate saw its volatility abate slightly and then even witnessed a trend reversal in the second ten-day period of December, as the uncertainty surrounding domestic developments visibly subsided (see Section 2.2. Exchange rate and capital flows).

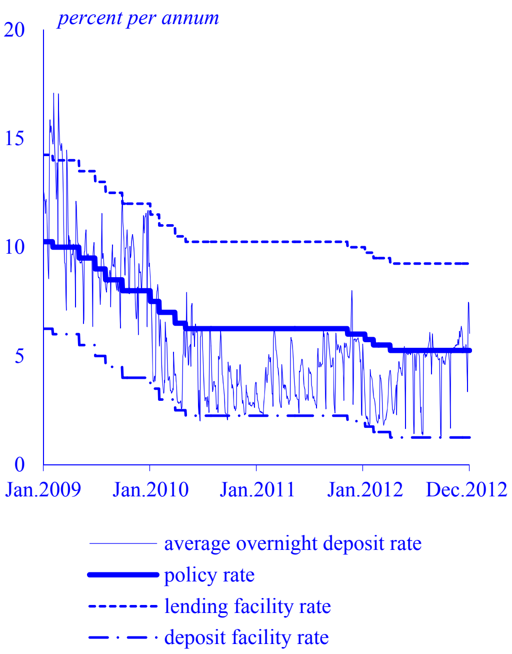
During the period under review, the NBR made another change to the procedures of conducting open market operations by removing the restrictions on the number of options (and hence of eligible asset series) in the bids submitted by credit institutions at fixed- and variable-rate tenders[8].

## 2. Financial markets and monetary developments

*Average interbank money market rates followed a steeper upward path during 2012 Q4. In turn, lending and deposit rates on new business continued to rise September through November 2012, albeit at a slower pace than in the previous period. The RON/EUR exchange rate witnessed relatively frequent shifts, reflecting the fluctuations in investor risk sentiment towards the local financial market. The annual growth rate of broad money decelerated further, mainly as a result of private sector credit dynamics sticking to the downward trend.*

### 2.1. Interest rates

**Interbank Money Market Rates**




Interbank money market rates rose at a faster pace in 2012 Q4 given the central bank's tighter control over liquidity in the banking system. Thus, average interbank rates added 0.83 percentage points from the previous three-month period to stand at 5.47 percent.

After the slight downtrend seen in September, overnight rates on the interbank money market returned in October in the immediate vicinity of the monetary policy rate, as the NBR capped once again the amounts auctioned off during the weekly repo tenders starting 8 October. Overnight rates increased more abruptly in November, on account of the gradual tightening of liquidity conditions, before declining marginally in early December and nearing the policy rate again. Towards the end of the reported quarter, ON rates posted increased, albeit short-lived, volatility owing, *inter alia*, to non-residents' keener demand for domestic currency.

Developments in longer-term interbank rates also reflected the more restrictive liquidity conditions, with 1M-12M ROBOR rates following an upward path throughout November. After a slightly downward adjustment in early December, they remained stable until the end of the period under review, despite the spike in overnight rate volatility. As a result, the average 1M and 3M ROBOR rates rose 0.3-0.4 percentage points in December against September 2012 to 5.98 percent and 6.04 percent respectively, while the average

[8] The change entered into force on 13 November 2012 and does not apply to fixed-rate tenders for foreign exchange swaps and to deposit-taking, in which case the bids will contain a single option.

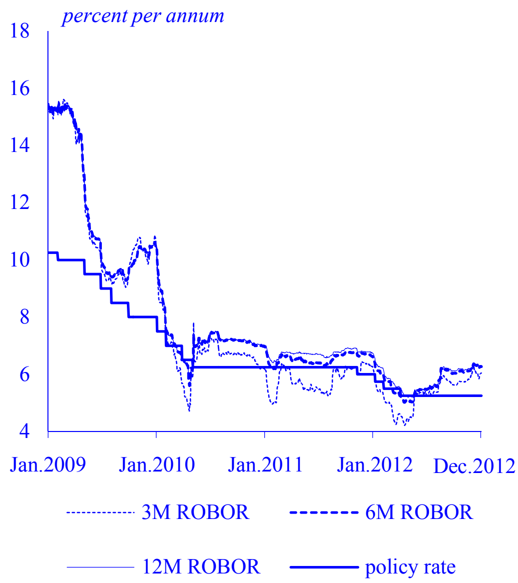
6M and 12M rates edged up 0.2 percentage points to 6.30 percent and 6.33 percent respectively.

Changes in liquidity conditions also affected the primary market for government securities, with investors' requests for higher yields in October prompting the MPF to partly reject the bids submitted at bond auctions. The maximum accepted bid rates remained on an uptrend until mid-November and then stabilised, before embarking on a downward path in mid-December, amid considerably keener demand for leu-denominated government securities, fuelled by non-resident investors, according to interbank forex market developments and evidence. Against this backdrop, the volume of government securities issued by the MPF rose significantly in December 2012[9], while the cumulated volume of debt instruments issued during 2012 Q4 exceeded by far that recorded in the previous quarter. This was accompanied by favourable shifts in the maturity breakdown of newly-issued securities. Specifically, treasury certificates issued October through December 2012 saw their share narrow to 40 percent from 82 percent in 2012 Q3, as the MPF resumed bond issues[10] with three, five and 15-year maturities. In October and November 2012, the MPF also conducted two EUR-denominated bond issues on the domestic market, raising a total of EUR 763.3 million[11].

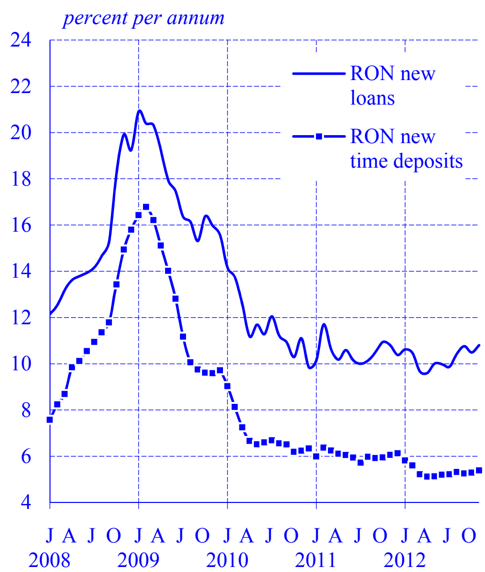
Benchmark rates[12] on government securities on the secondary market moved somewhat in line with primary market rates, the securities with a maturity of over two years seeing their uptrend reverse after the first ten-day period of December. However, in December 2012 the monthly average rates stood above the September readings for the debt instruments with a maturity of up to three years, but were slightly lower in the case of five- and ten-year bonds. The market turnover declined versus the previous quarter, primarily on account of the temporarily lower volume of outright transactions in November.

Average interest rates on new time deposits and new loans continued to rise September through November 2012, although at a slower pace than in the previous three-month period, adding 0.07 percentage points (to 5.39 percent) and 0.37 percentage points (to 10.80 percent) respectively, amid convergent developments across both customer categories. In particular, average lending rates on new business edged up 0.63 percentage points (to 12.26 percent in November) for households, largely as a result of the higher average interest rate on new consumer loans, and 0.15 percentage

**Policy Rate and ROBOR Rates**




**Bank Rates**




9 The volume of securities issued in December was 2.6 times higher than the announced volume.

10 They were met with higher interest also following the announcement of Romania's inclusion, starting 31 March 2013, in the list of countries making up the Barclays Capital Emerging Market Local Currency Government Index.

11 At the same time, the MPF tapped the external market with another bond issue worth EUR 1.5 billion, with a seven-year maturity and a 5.04 percent yield.

12 Average of bid and ask rates.

points (to 10.03 percent) for non-financial corporations. At the same time, the average interest rate on new time deposits inched up a mere 0.03 percentage points (to 5.18 percent) for non-financial corporations, while advancing 0.12 percentage points (to 5.70 percent) for households.

## 2.2. Exchange rate and capital flows

The RON/EUR exchange rate witnessed a steep increase in the early days of 2012 Q4, which was however fully reversed by the end of the first ten-day period of November. Subsequently, the exchange rate stabilised somewhat, before embarking on a sharp downward path in the second ten-day period of December, amid the significant improvement in investor risk perception towards the Romanian economy and financial market and the further favourable global market sentiment.

The upward movement in the RON/EUR exchange rate seen in the first half of October – in contrast to the trend displayed by the leu's regional peers, which at the time were influenced by the persistence of the improved global market sentiment – reflected largely the impact of the decline in autonomous capital inflows[13], as well as that of the relative worsening of expectations on the short-term RON/EUR exchange rate outlook. The latter was fuelled by some of the economic indicators released in October failing to live up to analysts' expectations and by heightened uncertainty associated with the forthcoming general elections.

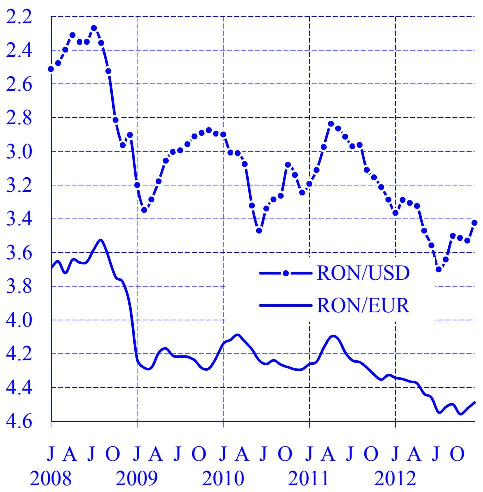
Despite the resurgence in global risk aversion[14] towards end-October, the RON/EUR exchange rate reversed its trend during this time period, due to the subsequent slight abatement of unfavourable expectations of certain categories of operators, driven inter alia by the NBR tightening control over the banking system liquidity and extending the policy rate status-quo (see Section 1. Monetary policy). However, the downtrend in the exchange rate trajectory came to a halt towards the end of the first ten-day period of November, under pressure from the ongoing increase in residents' net demand for foreign currency. The domestic currency re-embarked on a steeper appreciation path after the elections, due to the significant improvement in investor risk sentiment towards the domestic financial market and hence its becoming more attractive. The movement in the exchange rate was spurred by the alleviation in global risk aversion, following mainly the decisions taken by the ECB and the Fed, as well as the announcement of Spain's request for a European bailout of its ailing banks. Under the circumstances, the positive balance of non-residents' foreign

**Key Financial Account Items (balance)**

*EUR million*

| | 2011 11 mos. | 2012 11 mos. |
|---|---|---|
| **Financial account** | **3,956** | **1,855** |
| **Direct investment** | **1,418** | **1,388** |
| - residents abroad | 30 | -52 |
| - non-residents in Romania | 1,388 | 1,440 |
| **Portofolio investments and financial derivatives** | **1,773** | **2,020** |
| - residents abroad | -66 | -105 |
| - non-residents in Romania | 1,839 | 2,125 |
| **Other capital investments** | **388** | **-3,233** |
| - credits and loans from the IMF | 908 | -1,320 |
| - medium- and long-term investments | -400 | 228 |
| - short-term investments | 970 | 189 |
| - currency and short-term deposits | -900 | -2,336 |
| - other | -192 | 6 |
| **NBR's reserve assets, net ("-" increase/"+"decrease)** | **377** | **-1,680** |

**Nominal Exchange Rate**




13 In October, banks' foreign liabilities decreased due mainly to external deposits and financial borrowings; during the same period, the corporate sector made net repayments on the medium- and long-term external loans.

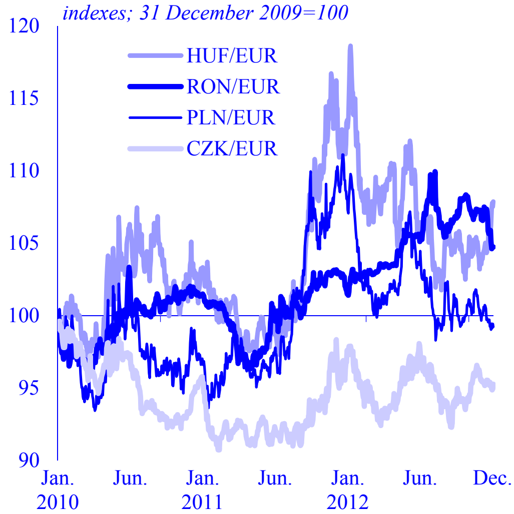
14 As a result of the Spanish government postponing the decision on starting the procedures for receiving external financial assistance, as well as of the delay in the disbursement of a new bailout tranche to Greece.

currency transactions increased considerably in December, most likely reflecting the significant rise in non-residents' holdings of leu-denominated government securities, while the average RON/EUR exchange rate hit a six-month low of 4.4895.

Following these developments, October through December the leu saw its first nominal appreciation versus the euro in the past seven quarters (0.2 percent); in real terms, the leu strengthened at a slightly slower pace against the single currency (1.2 percent versus 1.4 percent recorded in the previous quarter). In relation to the US dollar, which weakened on international markets, the leu gained 2.1 percent in nominal terms and 3.1 percent in real terms. Looking at the average annual dynamics of the exchange rate in 2012 Q4, the domestic currency posted a slower nominal depreciation versus both currencies, and at the same time the first real appreciation against the euro in the past four quarters.

**Exchange Rate Developments on Emerging Markets in the Region**

*indexes; 31 December 2009=100*




*Source: NBR, ECB*

## 2.3. Money and credit

### Money

September through November 2012, broad money (M3) dynamics[15] remained on a downward path (0.8 percent versus 4.9 percent during June-August 2012), in line with the trend displayed by other relevant indicators of economic activity. Similarly to the earlier period, all M3 major components contributed to the slower growth of this monetary aggregate. Thus, the rate of increase of narrow money (M1) and that of time deposits with a maturity of up to two years decelerated, while the pace of decline of marketable instruments gained momentum in annual terms[16].

**Annual Growth Rates of M3 and Its Components**

*real percentage change*

| | 2011 | 2012 | | | | |
|---|---|---|---|---|---|---|
| | IV | I | II | III | Oct. | Nov. |
| | | *quarterly average growth* | | | | |
| M3 | 3.0 | 6.8 | 8.3 | 2.9 | 1.2 | 0.8 |
| M1 | 2.3 | 5.9 | 8.5 | 3.4 | -0.7 | 0.8 |
| Currency in circulation | 7.9 | 13.1 | 15.7 | 9.6 | 3.8 | 3.8 |
| Overnight deposits | -0.5 | 2.3 | 4.8 | 0.2 | -3.1 | -0.8 |
| Time deposits (maturity of up to two years) | 2.7 | 7.7 | 10.2 | 6.4 | 6.0 | 4.3 |

*Source: NIS, NBR*

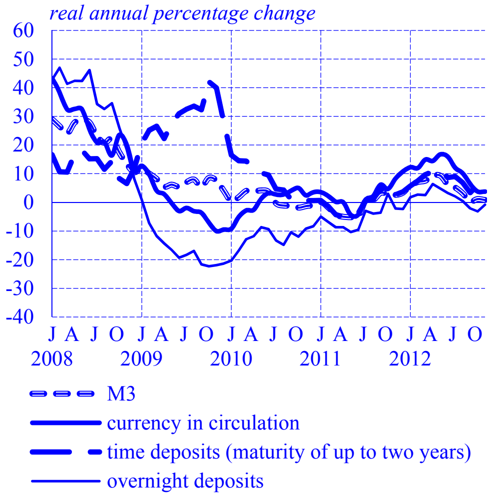
The M3 breakdown by holder reveals that the dynamics of non-financial corporations' placements went deeper into negative territory, amid: (i) lower structural fund disbursements, (ii) the highly likely increase in the volume of bank loan repayments, as well as (iii) the one-off rise in payments to the government budget[17]. All categories of corporate deposits saw their dynamics decline, except for foreign currency-denominated time deposits, whose growth rate (calculated based on readings expressed in euro) re-entered positive territory for the first time in the past two and a half years, on account of both keener corporate demand for foreign currency and a base effect. The pace of increase of M3 household deposits also slowed, despite remaining positive, solely on the back of the leu-denominated component losing steam, partly offset by the faster dynamics of forex deposits, which peaked at a

[15] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2012.

[16] The decline was further ascribable to the changed definition of money market funds, whose impact was partly offset by the increase in non-monetary financial institutions' investments with banks during the period under review.

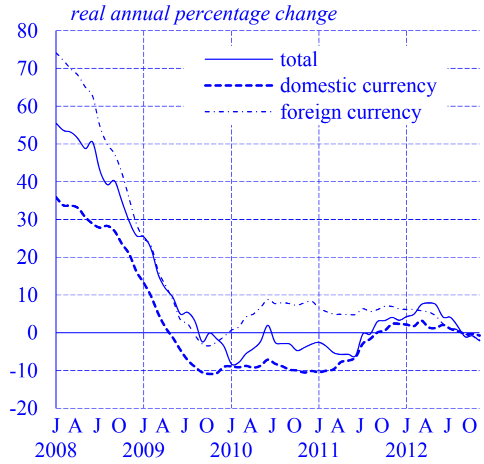
[17] Payments made by mobile telephony operators with respect to the allocation of frequency bands (the equivalent of EUR 204.1 million).

**Main Broad Money Components**




*Source: NIS, NBR*

**Credit to Private Sector by Currency**




*Source: NIS, NBR*

two-year high. The move reflected the divergent effects exerted by higher disbursements for agriculture[18] from the budget/EU funds and larger remittances[19], on one hand, and by the slower growth rate of wages[20] and the partial shift in households' money holdings towards longer-term placements, on the other hand. Against this background, the M3 breakdown by currency continued to worsen, as the average share of foreign currency-denominated deposits widened to a two-year high.

From the perspective of major M3 counterparts, the slower pace of increase of broad money reflected the slacker growth of loans to the private sector and of central government net credit, which were partly offset by the impact of the faster dynamics of net external assets and the more sluggish growth of long-term financial liabilities (amid developments in capital accounts).

## Credit

September through November 2012, the dynamics[21] of loans to the private sector remained on a downward path, reaching 1.3 percent from 3.3 percent during June-August 2012. The decline was associated with larger net credit transfers from banks' balance sheets[22] in the reported period and also reflected the statistical effects exerted by the slower depreciation of the leu in annual terms and by the faster 12-month inflation rate. The dynamics of forex-denominated credit (expressed in EUR) posted a steeper decline and was outpaced by the growth rate of the leu-denominated component for the first time in the past five and a half years. Under the circumstances, the average share of foreign currency-denominated loans in total credit to the private sector continued to narrow.

The breakdown of household loans points to the persistence of the impact exerted by the latest changes to the specific regulatory framework[23]. Thus, consumer credit and other loans declined at a faster pace irrespective of denomination, whereas the growth rate of housing loans in domestic currency stepped up and peaked at a four-year high to the detriment of forex housing loans.

[18] According to press releases by the Agency for Payments and Intervention in Agriculture and the Ministry of Agriculture and Rural Development, during the period under review disbursements were made for: (i) granting the advance payment on farm subsidies per unit of land, as well as for certain crops, (ii) alleviating the effects of the 2012 drought, and (iii) paying the annuities related to the 2011 agricultural year. However, part of these amounts might also have been paid to legal entities.

[19] According to balance-of-payments data, September through November 2012 the average monthly household income from abroad (labour income and private current transfers, expressed in EUR) exceeded that recorded during September-November 2011.

[20] The real average annual growth rate of net wage earnings economy-wide was the slowest in the past 18 months.

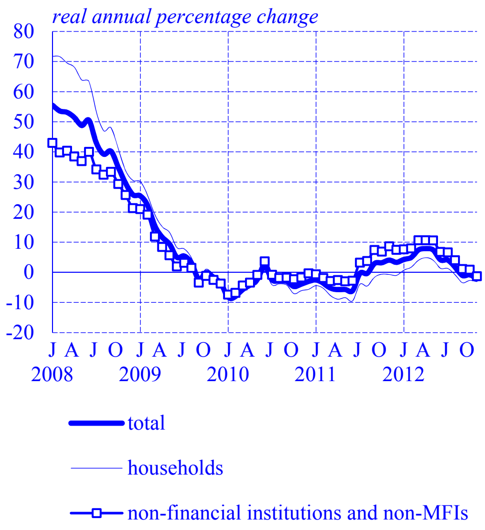
[21] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2012.

[22] Based on monetary statistics data.

[23] NBR Regulation No. 24/2011 on loans to households.

The decline in the pace of increase of loans to non-financial corporations, which reflected banks' expectations of a moderate tightening of lending standards and slightly lower credit demand in 2012 Q4[24], was ascribable to the foreign currency component, whose dynamics dropped also owing to credit lines extended during the reviewed period possibly not being fully used up, as well as to the statistical effect of the faster annual inflation rate, which led to the slower dynamics of leu-denominated credit[25].

**Credit to Private Sector by Institutional Sector**




*Source: NIS, NBR*

[24] According to the latest NBR survey on lending to non-financial corporations and households.

[25] The growth rate of corporate credit in domestic currency picked up in nominal terms.

# IV. INFLATION OUTLOOK

*The baseline scenario of the current projection places the annual CPI inflation rate at 3.5 percent at end-2013, the same as in the November 2012 Inflation Report, and at 3.2 percent at end-2014. While the previous end-2013 inflation forecast is reconfirmed, the contributions from some components of the consumer basket to this forecast have been reassessed. Thus, the anticipated larger contributions from the prices of alcohol and tobacco products, as well as from administered prices are expected to be countered by the more favourable dynamics of the adjusted CORE2 index than in the previous forecast.*

*The current projection envisages the annual inflation rate peaking at 5.9 percent in 2013 Q2, before slowing down considerably until early 2014 and consolidating close to 3 percent over the remainder of the forecast interval.*

*The temporary pick-up in consumer price growth in 2013 Q2 will solely be driven by components exogenous to the monetary policy influence, namely administered prices, prices of volatile food items (VFE), fuels, tobacco products and alcohol. In 2013 H2, given the assumption of a normal agricultural year in the baseline scenario, the resumption of disinflation will be supported by the shift from an adverse base effect to a favourable one, which is expected to have a relatively beneficial influence on the price dynamics of VFE as well as of processed food items included in the adjusted CORE2 index.*

*The projected annual adjusted CORE2 inflation path will run below that in the previous forecast over most of the projection interval, except 2014 Q2 and Q3. The significant downward revision in the first half of the projection interval stems from slower-than-previously-forecasted dynamics of import prices – mainly due to the recent strengthening of the leu –, of processed food prices and of inflation expectations.*

*The adjusted CORE2 inflation rate is seen following a downward path, sliding from 3.3 percent at end-2012 to a 2 percent low at end-2013, before stabilising around 2.2 percent in 2014.*

*The annual core inflation rate is thus projected to return in 2013 H2 to levels seen before last year's adverse shocks on food prices and the leu exchange rate. The forecasted dynamics are indicative of the fading impact of these shocks and gradually adjusting inflation expectations, also as a result of a prudent monetary policy stance. The persistence of a wide negative output gap is expected to further generate disinflationary pressures, albeit relatively softer than in the previous forecasting rounds given a reassessment of the magnitude of the GDP deviation from its potential over the entire reference interval. This reassessment is largely responsible for the expected return of core inflation rate to slightly above 2 percent during 2014.*

*The projected monetary policy stance will further seek to calibrate real broad monetary conditions so as to ensure the inflation rate* *returns and consolidates inside the target band, creating the necessary prerequisites for a gradual recovery of lending to the Romanian private sector, thereby supporting the resumption of sustainable economic growth. For this purpose, special attention will further be paid to the endeavours to anchor inflation expectations to a path converging to the medium-term target.*

*The assessment of the risks to the current inflation rate projection reveals a balance still tilted to the upside, i.e. towards unfavourable deviations from the baseline scenario, but somewhat less skewed than in the previous forecasting round.*

*Over the reference period, the most relevant external risk derives from possibly higher medium-term volatility of capital flows aimed at financing the domestic economic activity, amid the lingering uncertainties on the time span of the recovery process of the EU economy, and of the euro area in particular. Large amounts of volatile capital flowing either in or out of Romania could pose risks to price and financial stability, as well as to a sustainable rebound in economic growth. On the one hand, should a less favourable scenario on EU-wide economic growth materialise, investor sentiment regarding investments in the region's emerging economies would worsen via contagion effects and the demand for Romania's exports would be additionally constrained. This would ultimately result in weaker capital flows to the Romanian economy and in depreciation pressures on the leu, which could entail adverse effects on domestic consumer price dynamics and financing costs for both private and public sectors, also via the wealth and balance sheet channel for unhedged borrowers. On the other hand, against the backdrop of uncertainty surrounding euro area growth prospects, substantial capital inflows, including the flows seeking temporarily higher returns – and therefore inherently unsustainable –, would increase the leu exchange rate volatility and would prevent an orderly unwinding of macroeconomic imbalances.*

*Compared to the previous assessment, the balance of risks is less tilted to the upside due primarily to the fading out of domestic political tensions, which were still present when the November 2012 Inflation Report was released. The domestic environment is, however, posing further risks that could cause the inflation rate post upside deviations from the baseline scenario path, owing to the uncertainty surrounding the firm implementation of the macroeconomic policy mix and the structural reforms agreed with the international institutions (the EU, the IMF and the World Bank). Potential slippages from timely and consistently implementing the above-mentioned commitments might trigger a deterioration of investor sentiment towards the Romanian economy, which could heighten the volatility and costs of its financing sources.*

*Future movements in global commodity prices are a relevant risk factor particularly in the medium term, given that, over this horizon, the persistence or increase of uncertainties regarding the euro area would have a detrimental impact on the dynamics of the EUR/USD* *exchange rate and, consequently, the RON/USD exchange rate. At the same time, risks associated with unfavourable deviations of the CPI inflation rate from the baseline scenario path continue to stem, in this forecasting round as well, from administered price adjustments in Romania, amid the ongoing uncertainty over the timing and magnitude of electricity and natural gas price increases. Moreover, in view of the large share of food items in the consumer basket, any unfavourable deviation from the baseline scenario assumption, i.e. normal agricultural crops in 2013 and 2014, could weigh heavily on the projected inflation path.*

## 1. The baseline scenario

### 1.1. External assumptions

**Expectations on the Developments in External Variables**

*annual average*

| | 2013 | 2014 |
|---|---|---|
| Oil price (USD/barrel) | 108.3 | 102.8 |
| USD/EUR exchange rate | 1.29 | 1.27 |
| 3M EURIBOR interest rate (% p.a.) | 0.14 | 0.28 |
| Effectiv EU economic growth (%) | 0.4 | 1.5 |
| Annual inflation rate in the euro area (%) | 1.85 | 1.92 |

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

The baseline scenario for external demand foresees the real effective EU GDP[1] posting moderate dynamics of 0.4 percent in 2013, before picking up to 1.5 percent in 2014, a modest forecasted recovery, however, judging by historical standards. Compared to the November 2012 Inflation Report, the new external GDP path points towards a downward reassessment of the medium-term economic growth outlook for this area. In 2013, the beneficial influence of export contribution to the effective EU-wide growth is dampened by the ongoing deleveraging in both private and public sectors and is strictly conditional on the absence of any other global financial market tensions. The relative strengthening of economic growth anticipated for next year is ascribed to the envisaged consumption revival and to the first favourable effects of structural reforms expected to materialise. The effective EU GDP gap, the relevant measure for assessing the impact of external demand in the model, has been revised to less negative levels than in the previous projection round[2] and is forecasted to gradually narrow starting with 2013 H2.

The average annual HICP inflation rate in the euro area is projected to stand at 1.85 percent in 2013 and 1.92 percent in 2014, with the bulk of the revision taking place in 2014 (down 0.36 percentage points against the previous projection round). In 2013, the price inflation is seen losing momentum from a year earlier amid the slower dynamics of energy and food sub-components. For 2014, the inflation rate was revised at a lower level than in the previous projection round as a result of declining commodity prices and abating inflationary pressures triggered by the developments in unit labour costs.

In 2013 and 2014, the 3M EURIBOR rate is seen posting, on average, lower levels than in the previous forecasting round, given the weaker-than-previously projected euro area growth and, implicitly, the likely implementation of additional growth-

[1] EU-27 excluding Romania. For details on this indicator, see the box entitled “Incorporation of an effective external demand measure, i.e. effective EU GDP, into the model” in the November 2012 Inflation Report, p. 35.

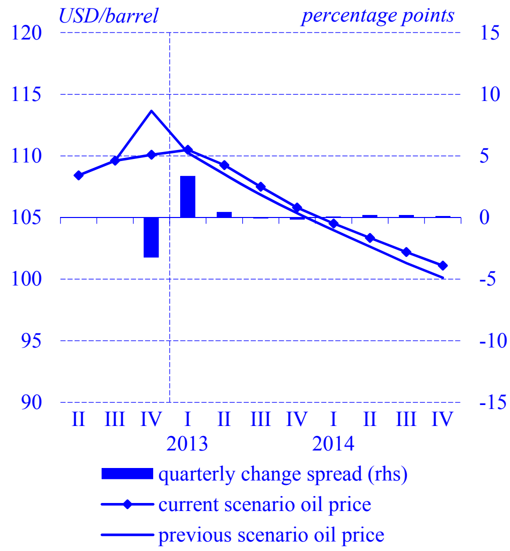
[2] Alongside a downward revision of effective EU GDP growth outlook, the euro area potential real GDP growth was revised downwards.

enhancing measures. 3M EURIBOR is however stuck on an upward path throughout the projection interval.

According to the projection, the euro will soften slightly against the US dollar starting with 2013 Q2 until the forecast horizon. The marginal upward revision of the EUR/USD exchange rate path compared to the previous projection round is attributed to the gradual recovery of economic agents' sentiment as regards the outlook for the euro area.

The international Brent oil price projection is contingent upon futures prices[3] and foresees only a marginal increase in 2013 Q1, ahead of a gradual decline towards the end of the projection interval, down to USD 101.1 per barrel, with higher levels than in the previous projection round.

**Brent oil price scenario**



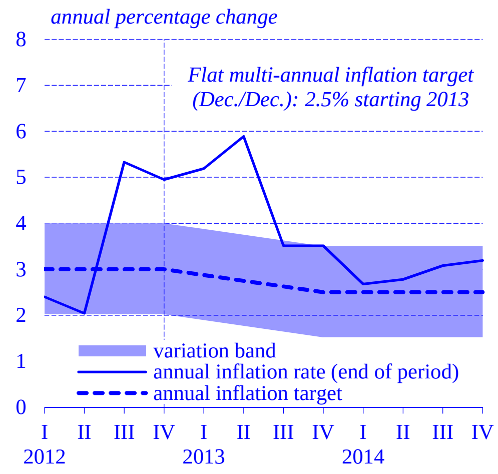

*Source: Energy Information Administration, NBR assumptions based on Bloomberg data*

## 1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the end-2013 annual CPI inflation rate at 3.5 percent, i.e. at the upper bound of the variation band around the central target[4]. At the end of 2014, the annual consumer price growth is envisaged to slow down to 3.2 percent, a level inside the target band. Compared to the November 2012 Inflation Report, the projected end-2013 level was left unchanged, but the contributions from the major consumer basket components to this forecast were reassessed. Thus, the anticipated larger contributions from alcohol and tobacco product prices, as well as from administered prices, are expected to be countered by the more favourable dynamics of the adjusted CORE2 index than in the previous projection round.

The annual consumer price dynamics is forecasted to step up temporarily in the course of 2013 Q2, reflecting solely the evolution of exogenous components in terms of the monetary policy scope, namely administered prices, vegetables, fruit and eggs (VFE) prices, fuel prices, and alcohol and tobacco product prices. The baseline scenario underlying the macroeconomic projection relies on the assumption of normal agricultural crops in 2013. Under these conditions, the annual CPI inflation rate is expected to decelerate more sharply in 2013 H2, mainly due to the favourable developments in prices of VFE and those of processed food items included in the adjusted CORE2 index.

**Inflation Forecast**




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

*Source: NIS, NBR projections*

Although projected on a downward trend until mid-2013 – from 3.3 percent at end-2012 to 2.8 percent in June 2013 –, the annual adjusted CORE2 inflation rate remains at relatively elevated levels against those recorded in the same year-ago period. This evolution is mostly attributed to higher processed food prices, whose inflationary traction occurs with a lag compared to volatile food prices and is expected to persist until this year's crops are harvested, as well as to temporarily inertial inflation expectations of economic agents, as a

[3] Source: Bloomberg.

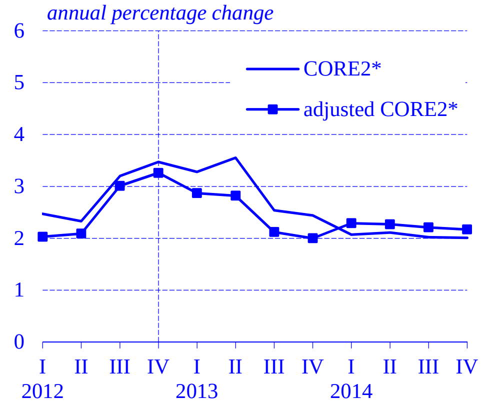
[4] As from 2013, the NBR adopted a flat multi-annual inflation target of 2.5 percent ±1 percentage point.

**Annual Inflation Rate in the Baseline Scenario**

*annual percentage change (end of period)*

| | 2013 | | | | 2014 | | | |
|---|---|---|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| Target | | | | 2.5 | | | | 2.5 |
| Forecast | 5.2 | 5.9 | 3.5 | 3.5 | 2.7 | 2.8 | 3.1 | 3.2 |

**Annual CORE2 Inflation and Annual Adjusted CORE2 Inflation**




*) end of period

*Source: NIS, NBR projections*

result of these hikes and other price increases announced in the first part of 2013 for some components exogenous to the monetary policy influence. Given that no major supply-side shocks are anticipated to materialise over the next quarters of the projection interval and that a prudent monetary policy stance, with a beneficial influence on the inflation expectations of economic agents, will remain in place, the annual adjusted CORE2 inflation rate will embark on a sharper disinflationary course in H2 to reach 2 percent at end-2013. In the course of 2014, this indicator will follow a relatively stable path, at levels close to 2.2 percent, similar to those seen before the supply-side shocks that occurred in 2012 H2.

For this year, the annual adjusted CORE2 inflation rate is expected to follow a trajectory lower than that in the November 2012 Inflation Report, with a 0.9 percentage point revision at end-2013. The slowdown in inflationary pressures exerted on the adjusted CORE2 index by the less pronounced import price increases and the downward revision of the projected processed food price dynamics in 2013 Q1 is only partially countered by the relative abatement in disinflationary pressures from the negative output gap[5]. Towards the end of the projection interval, given the unchanged assessments on the impact of other factors, the lower-than-previously-projected disinflationary impact of the negative output gap places the annual adjusted CORE2 inflation rate 0.1 percentage points higher than in the previous report.

The current forecast envisages a smaller contribution of import price dynamics to the adjusted CORE2 inflation over the entire projection interval, due to the influence of the most recent developments in the unit value index of imports of consumption goods (not including motor spirit and passenger motor cars)[6] and the RON/EUR exchange rate, as well as to an exogenous scenario foreseeing a relative alleviation of relevant external price dynamics in the current round. The updated path of the economic agents' inflation expectations runs below that presented in the November 2012 Inflation Report, due mainly to a softening of the adverse shocks induced by last year's supply deficit in the agricultural sector[7].

The annual alcohol and tobacco product price inflation path was primarily projected in accordance with the changes to the excise

[5] For further details, see Section 1.3. Demand pressures in the current period and over the projection interval.

[6] This indicator is calculated by the Eurostat on a monthly basis starting from the EUR-denominated values of foreign trade in goods and services. It provides, alongside the nominal leu exchange rate movements, insight on the developments in import prices of consumer goods included in the adjusted CORE2 index basket. The latest data available for October 2012 point towards a 0.3 percent drop against the 2012 Q3 average.

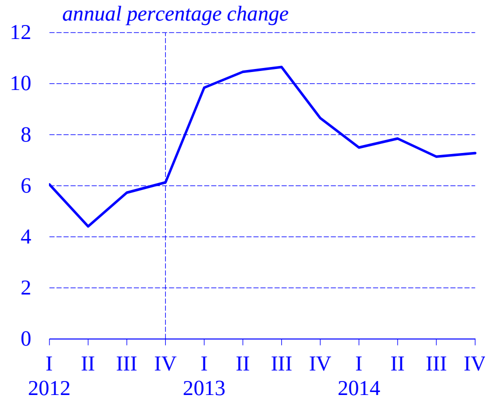
[7] Adverse supply-side shocks that kindled economic agents' inflation expectations in 2012 H2 were basically ascribed to inflationary pressures on the food market following severe weather conditions in Romania. Although these inflationary pressures abated as against the previous projection round, the recently announced substantial hikes in some administered prices (electricity prices in particular) will most likely fuel inflation expectations in the periods ahead as well.

duties in the Tax Code[8], the updated reference exchange rate[9] (to the projected levels) used to calculate their lei equivalent, as well as adjustments reflecting the anticipated persistence over a longer time-span of unfavourable temporary developments that have affected this market since late 2012[10]. On the one hand, earlier implementation of excise duty hikes related to tobacco products, the updated reference exchange rate to be used in 2013, as well as the December 2012 price rises expected to persist in early 2013, and, on the other hand, the increases in excise duties on beer will add 0.4 percentage points to the annual CPI inflation rate in 2013, resulting in a 0.1 percentage point upward revision against the previous report. The cumulated contribution from the "tobacco and alcohol" sub-group to the annual CPI inflation rate is foreseen to be relatively neutral in 2014.

The scenario on administered price developments takes into account both the information released by the Romanian Energy Regulatory Authority and the latest developments in electricity and natural gas prices. Given that administered price inflation posted a significantly higher level than that previously forecasted for end-2012, largely due to the announcement of "green certificates" being incorporated into the household's electricity bill[11], the scenario on administered price developments envisages an inflation rate of 8.7 percent at end-2013, implying a 1.7 percentage point upward revision. For end-2014, provided the ANRE's calendars on the electricity and gas price deregulation remain in place, the scenario was kept unchanged, with a 7.3 percent annual inflation rate of this sub-component.

The scenario on volatile food price (VFE) developments, albeit assuming normal agricultural years in 2013 and 2014, foresees still high dynamics[12] of these prices in 2013 H1 as a result of the persistent impact of the 2012 poor crops on the annual VFE price inflation rate. Starting with 2013 Q3, following a favourable base effect[13], the annual growth rate of VFE prices is expected to slow down markedly until the projection horizon. Under these conditions, the contribution of VFE prices to the annual CPI inflation rate (end of period) is anticipated to be almost zero this year and 0.3 percentage points next year.

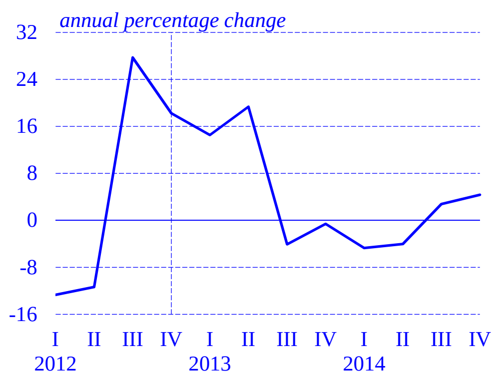
**Administered Prices Annual Inflation***




*) end of period

*Source: NIS, NBR projections*

**Vegetables, Fruit and Eggs Prices Annual Inflation***




*) end of period

*Source: NIS, NBR projections*

[8] The Government Ordinance amending and supplementing Law No. 571/2003 regarding the Tax Code and the regulation of some financial and fiscal measures, published in *Monitorul Oficial al României*, sets forth the earlier implementation of excise duty hikes related to tobacco products for the period 2013-2017 from July to April as well as higher excise duties levied on beer.

[9] Pursuant to the Tax Code, the leu-denominated value of excise duties to the government budget takes into account the exchange rate set by the ECB on the first business day of October a year earlier, as published in the Official Journal of the European Union. For fiscal 2013, the excise duty calculation uses a 4.5223 RON/EUR exchange rate, 5.17 percent higher than in 2012.

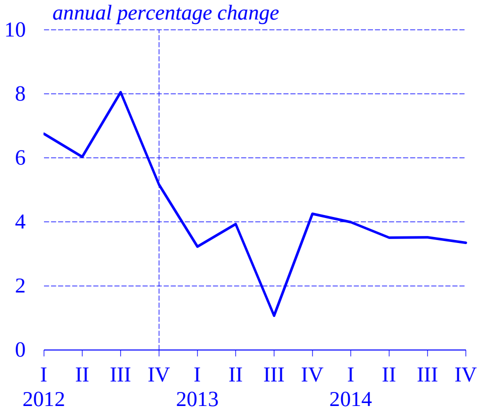
[10] For further details, see Chapter I. Inflation developments.

[11] See the NIS press release on the December 2012 consumer price index.

[12] This trend is even more pronounced as a result of the base effects associated with favourable VFE price dynamics in 2012 H1 and of seasonal factors affecting the annual inflation rate of this consumer basket sub-component.

[13] The favourable base effect is expected to be the strongest in 2014 Q2, reflecting also the assumptions on still high dynamics of VFE prices in 2013 Q1 and Q2.

**Fuel Prices Annual Inflation***




*) end of period

*Source: NIS, NBR projections*

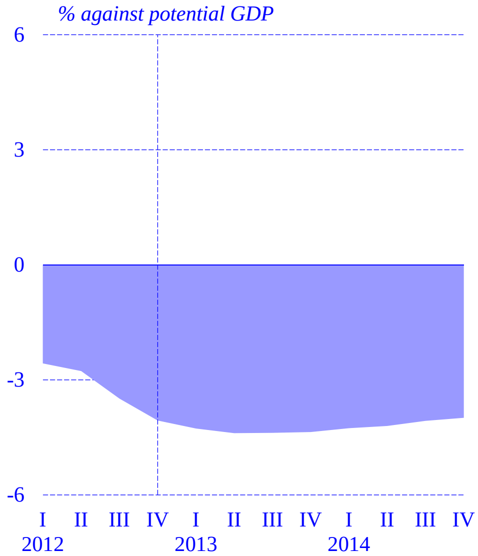
**Components' Contribution to Annual Inflation Rate***

*percentage points*

| | 2013 | 2014 |
|---|---|---|
| Administered prices | 1.5 | 1.3 |
| Fuels | 0.4 | 0.3 |
| VFE prices | 0.0 | 0.3 |
| Adjusted CORE2 | 1.2 | 1.3 |
| Tobacco products and alcohol | 0.4 | 0.0 |

** end of period; contributions based on 2-decimal data add up to CPI inflation*

**GDP Deviation**




*Source: NIS, NBR projections*

The annual fuel price inflation is projected to be lower at end-2013 and end-2014 (4.2 percent and 3.3 percent respectively) than at end-2012 (5.2 percent). This is ascribed to a projected favourable downward path in the global oil price, only partially countered by the projected EUR/USD exchange rate, entailing a more unfavourable influence on the RON/USD exchange rate. The lower starting point in the projection (2013 Q1) and the more favourable dynamics of the RON/USD exchange rate in recent periods, together with the downward revised impact of economic agents' inflation expectations on these prices, place the current inflation path below the previously-released levels.

On the whole, the cumulated contribution of exogenous factors in terms of the monetary policy scope – administered prices, volatile food (VFE) prices, fuel prices, alcohol and tobacco product prices – to annual CPI inflation rate stands at 2.3 percentage points at end-2013 and 1.9 percentage points at end-2014.

## 1.3. Demand pressures in the current period and over the projection interval[14]

### Output gap

In 2012 Q4, real GDP is expected to witness a slower quarterly decline compared with the previous quarter, when a 0.4 percent[15] drop was reported as a result of the poor agricultural performance. The annual growth rate of the real GDP is foreseen to remain in negative territory in 2012 Q4, showing a magnitude similar to that in the previous quarter.

Potential GDP growth and the output gap were revised under a comprehensive process intended to reassess the historical evolution of these components. This process was aimed at incorporating the results of certain in-house analyses by the NBR regarding potential GDP dynamics following the onset of the world financial crisis and the persistence of relatively low real GDP growth rates[16]. Therefore, compared with the previous analysis and forecasting rounds, potential GDP growth rates were generally assessed at lower values in the recent periods, subsequent to the fallout from the financial crisis on to the Romanian economy, as well as in pre-crisis (economic expansion) periods[17]. The output gap was implicitly assessed at higher positive values during the economic expansion and at less ample negative values after the onset of the

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

[15] The recent seasonally-adjusted real GDP data were revised significantly, the real GDP growth rates being generally lower than those recorded in the previous forecasting round.

[16] Given the need to incorporate a wide range of information, analyses or data revisions, the reassessment process of the trend component and of the GDP cyclical component is recurrent.

[17] Similar reassessments of potential GDP dynamics were conducted by various international institutions (IMF, EC, OECD) and central banks for the euro area or countries such as Hungary and Poland.

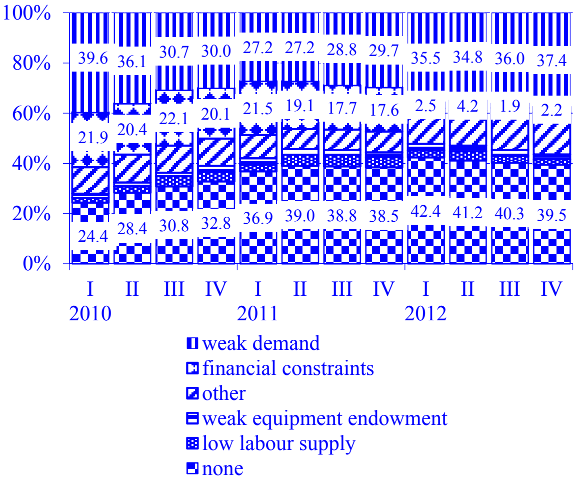
crisis. Further details on reassessing the potential GDP dynamics are included in the box titled "Reassessment of potential GDP dynamics and GDP deviation".

The potential GDP growth for 2013 is seen to be similar to that reported in the previous year, while it is anticipated to improve moderately in 2014. The assessment for 2013 illustrates mainly a relatively lower contribution of total factor productivity, amid further constraints relative to the streamlining of production capacities, including as a result of the still low level of absorption of structural and cohesion funds. Concurrently, the contribution of the capital stock, which increased following the strong rebound in gross fixed capital formation in 2012[18] and the contribution of labour, whose impact is expected to turn slightly positive, have a favourable impact. For 2014, the moderate acceleration of potential GDP dynamics is forecasted under the assumptions of favourable medium-term developments of investor risk sentiment on the international financial markets and hence of restoring investor confidence in the national economy with positive effects on the capital flow dynamics, as well as of the efficient use of production factors.

In 2012 Q4, the negative output gap is expected to have widened compared with the previous quarter, entailing, *ceteris paribus*, stronger disinflationary pressures stemming from aggregate demand. Behind the wider negative output gap in Q4 stand its highly persistent nature and the impact of the external demand shortage, the stimulative effect of the real exchange rate via the net export channel having an opposite impact. Although the pro-cyclical nature of the discretionary component of fiscal policy (approximated by the fiscal impulse) had a direct effect on the widening of the negative output gap, the further fiscal consolidation contributed to the improvement in financial investors' sentiment towards the prospects for the national economy and to the drop in Romania's sovereign risk premium, with favourable effects on external financing. Compared with the previous forecasting round, the GDP deviation in 2012 Q3 is reassessed to be less negative, under the joint effect of the above-mentioned reassessment of the determinants of GDP deviation and potential GDP, of the forecast error in 2012 Q3 and of the revision of the seasonally-adjusted real GDP historical data series by the NIS.

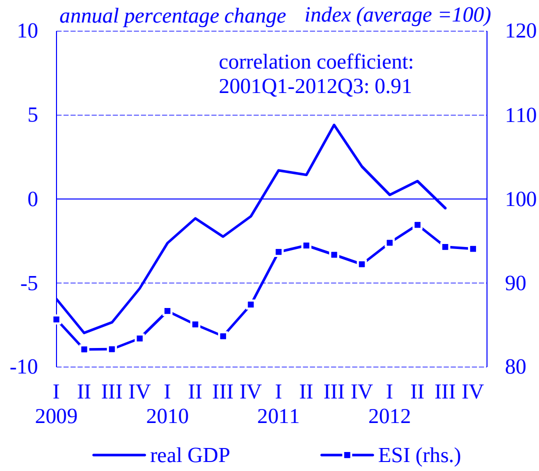
The relative widening of the negative output gap in Q4 is also hinted at by the evolution of several indicators correlated with the cyclical position of the economy. The industrial production index and the retail trade turnover, excluding motor vehicles and motorcycles, fell by 0.6 percent and 1 percent respectively, in the October-November period as compared with 2013 Q3 average. Other indicators such as the rise in the share of respondents citing "insufficient demand" as a factor limiting industrial production and the level of confidence in the economy, measured by the economic sentiment indicator (ESI), exert the same effect. Opposite signals

**Factors Limiting Industrial Production**




*Source: EC-DG ECFIN*

**Economic Sentiment Indicator* and Economic Growth**




*) seasonally-adjusted data

*Source: NIS, EC-DG ECFIN*

[18] In 2012 Q1-Q3, the released data showed notable quarterly growth rates of gross fixed capital formation and another quarterly increase is projected for 2012 Q4.

come from the capacity utilisation rate in industry [19], which went up versus the previous quarter, and from the ILO unemployment rate that inched down to 6.8 percent in November 2012.

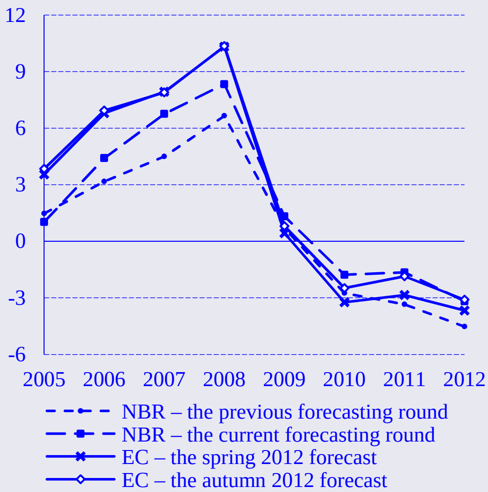
Given the estimated starting point of the indicator and under the impact of the determinants of this indicator, the output gap projected in the following eight quarters shows, compared with the November 2012 Inflation Report, less negative values, yet standing at significant and persistent levels. Following the revision of the deviation of real effective EU GDP from its trend to less negative values[20], external demand is expected to have, in relative terms, a less restrictive impact on domestic economic activity, as well as the discretionary component of fiscal policy, whose impact is seen also less restrictive starting with 2014 Q2, while the repositioning of the real exchange rate following the recent appreciation of the leu against the euro and the USD is foreseen to have a somewhat tighter projected effect.

**Reassessment of potential GDP dynamics and GDP deviation**

Within the model for analysis and medium-term forecasting (MAMTF), trend and cyclical components of macroeconomic variables are subject to recurrent reassessments. For instance, the quarterly revision of the seasonally-adjusted real GDP data series released by the NIS has a bearing on GDP deviation and potential GDP dynamics past values. Against this background, the latest data revision by the NIS (in January 2013) is envisaged to have an unfavourable statistical effect, stronger in recent periods, on the estimated potential GDP growth rate. Moreover, in the event of substantial changes in the information set incorporated in the MAMTF, the reassessment may, via the Kalman filter, lead to significant differences for the unobservable components of some macroeconomic variables, such as trends. In addition, the analysis and forecasting exercise includes regular reassessments of potential GDP dynamics in order to incorporate a broad range of corroborative data and analyses that the model cannot capture.

In the current analysis and forecasting round, the persistence of weak GDP growth rates, amid the high inertia of the fallout from the global financial crisis, suggests a downward revision of potential GDP dynamics compared to the previous rounds. A revision is called for as regards both recent periods and, by reassessing the contribution of economic growth fundamentals, the pre-crisis period (of economic expansion). As a consequence, but also considering the persistent demand-pull inflation in the Romanian economy, GDP deviation is implicitly reassessed to higher positive values during the pre-crisis period and lower negative values in the post-crisis period.

**Output gap (% in potential GDP)**




*Source: European Commission (European Economic Forecast Spring 2012, European Economic Forecast Autumn 2012), NBR assessments*

Similar qualitative reassessments of potential GDP and GDP deviation dynamics were performed by some international organisations (the IMF, the EC, the OECD) and central banks for the euro area or for countries like Hungary and Poland. In particular, for Romania, the EC published on a semi-annual basis, starting with the European Economic Forecast Autumn 2006, recurrent reassessments of potential GDP and GDP deviation. Once the crisis broke out, the magnitude of the positive output gap for the period 2006-2008 was reassessed upwards (implying slower potential GDP dynamics). Over the last two projection rounds of 2012, potential GDP growth rates for the past few years were reassessed downwards and the negative output gap for the period 2010-2012 was slightly compressed.

[19] The indicator capturing the factors limiting industrial production, ESI and the capacity utilisation rate are provided by EC-DG ECFIN surveys.

[20] For further details, see Section 1.1. External assumptions.

**Aggregate demand components**

In 2012 Q4, the positive quarterly dynamics of the actual final consumption of households is expected to slow down, causing the negative deviation from its medium-term trend to widen. The slower growth of this component is the result of the more moderate dynamics of the turnover of market services to households (+3.9 percent in October and November from the Q3 average, after the 4.7 percent rise in the previous quarter) and the relatively flat net real wage (-0.1 percent in October and November from the Q3 average). At the same time, other coincident indicators relevant for the evolution of the actual individual consumption of households give opposite signals, the retail trade turnover, excluding motor vehicles and motorcycles and the flow of real consumer loans posting declines (1 percent in October and November from the Q3 average and -5.1 percent in Q4 compared with the previous quarter respectively). The actual collective consumption of general government is anticipated to increase moderately in 2012 Q4. According to the latest data released by the Ministry of Public Finance, the deficit of the consolidated general government budget for 2012 stood at 2.52 percent of GDP (cash-based methodology), markedly lower than in the previous year (4.29 percent). The reported level exceeds the budget deficit target of 2.2 percent of GDP agreed with the international financial institutions, given the exogenous conditions of the EC temporarily suspending EU fund payments and the downward revision of nominal GDP[21]. Considering the positive developments of actual collective consumption of general government in the previous quarters, the deviation from the medium-term trend is seen as positive.

The positive dynamics of final consumption of households in both years of the projection interval is ascribed to the favourable impact of the envisaged acceleration of wage dynamics in the private sector, amid a further positive annual GDP growth rate and, implicitly, a rebound in labour productivity. In this context, corroborated with the projection of a significant slowdown in the annual CPI inflation rate starting with the latter half of the current year, nominal wage increases are foreseen to contribute, over time, to the rise in the real disposable income[22], with a favourable impact inter alia on consumer spending. After having seen a good performance in 2012 Q3 and taking into account the one anticipated for 2012 Q4, actual collective consumption of general government is envisaged to

[21] According to the MPF Press release of 25 January 2013, "the fiscal consolidation process carried on in 2012, with the budget deficit narrowing by more than 40 percent versus 2011, from 4.3 percent of GDP to 2.5 percent. The budget deficit witnessed further negative influences due to the temporarily discontinued repayment of EU funds as a result of deficiencies reported in the previous years (0.2 percent of GDP) and to the downward revision of nominal GDP (0.1 percent of GDP)".

[22] Nevertheless, the projected growth rates of nominal and real wages are expected to record, during the projection interval, substantially lower figures compared with those registered prior to the fallout from the financial crisis on to the Romanian economy.

follow a path that implies the strengthening of its dynamics during the projection interval.

Gross fixed capital formation is forecasted to witness a further positive, yet significantly slower, quarterly growth in 2012 Q4. High frequency data related to the two investment components (construction and investment in equipment) show mixed signals. Accordingly, the construction works index went up 2.7 percent in October and November from the Q3 average, while construction companies' confidence indicator fell by 4.6 points in Q4 compared with the previous quarter. The turnover volume in the capital goods industry moved up 4.1 percent in October and November from the Q3 average, although new loans (in domestic and foreign currency) granted to non-financial corporations decreased by a real 11.5 percent in Q4 from the previous quarter. Given the sustained growth of gross fixed capital formation in the recent periods, the deviation from its medium-term trend is assessed as slightly positive.

Similarly to the previous forecasting round, gross fixed capital formation is envisaged to maintain a positive growth rate, higher than that forecasted for the individual consumption of households, in both years of the projection interval. The gradual return to positive territory of the projected growth rate of real exports, corroborated with the assumption of further improving the capacity to attract post-accession EU funds and amid the expected persistence of spill-over effects on future investment projects of the favourable dynamics of the component registered in the recent periods, create the conditions for the gross fixed capital formation to make a noticeable contribution to the sustainable rebound of domestic demand.

In 2012 Q4, exports are foreseen to witness a decline, as a result of the restrictive effects stemming from external demand, as well as from the stronger leu in real terms. Imports are foreseen to post a slight increase quarter on quarter, amid modest positive dynamics of the actual individual consumption of households and real exchange rate movements. On the back of the above-mentioned developments, the deviations of exports and imports from the medium-term trends are projected to remain in negative territory. The uncertainty surrounding the forecasted quarterly dynamics of imports and exports in the national accounts is associated in part with the provisional balance of payments data, which revealed substantial increases (2.7 percent for imports and 7.0 percent for exports) in October and November versus the Q3 average, although analytical data indicate that these increases were the result of price effects rather than of volume effects.

Under the constraint of the slow rebound in the effective EU GDP growth, the baseline scenario foresees the export growth to lag behind that of real imports. Due to the support of the gradual domestic demand recovery, real imports are estimated to post a growth rate higher than that estimated for 2012. In 2014, the rate of increase of exports is anticipated to exceed that of imports, against the background of a more consistent rebound expected in the case of external demand. Along with the projected dynamics of export and import prices throughout the forecast interval, the share of the current account deficit in the nominal GDP forecasted for 2013 and 2014 will stay close to the level anticipated for 2012, with the latter being most likely to stand below 4 percent[23].

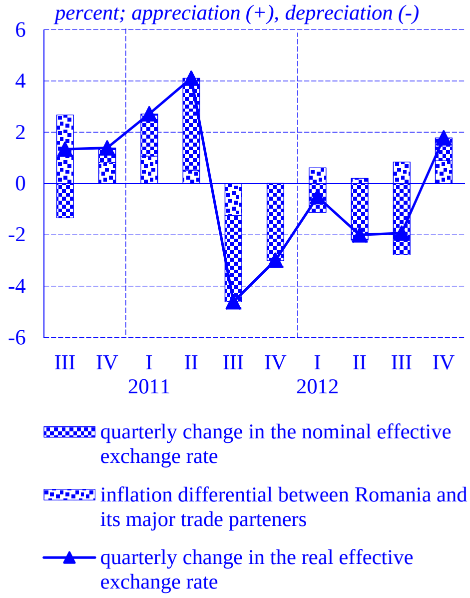
## Broad monetary conditions

Broad monetary conditions capture the impact exerted on the future developments in aggregate demand by the dynamics of real interest rates in lei applied by credit institutions to their non-bank clients and by the real effective exchange rate of the leu[24]. The exchange rate exerts its influence via the net export channel, as well as via the wealth and balance sheet effect[25].

In 2012 Q4, nominal interest rates in lei[26] applied by credit institutions to their non-bank clients increased slightly. Given the low dynamics of the nominal interest rates, the increase in inflation expectations[27] in the fourth quarter mirrored the decline in both real deposit and lending rates. Overall, the deviation of real interest rates versus the medium-term trend has a stimulative impact on future economic activity.

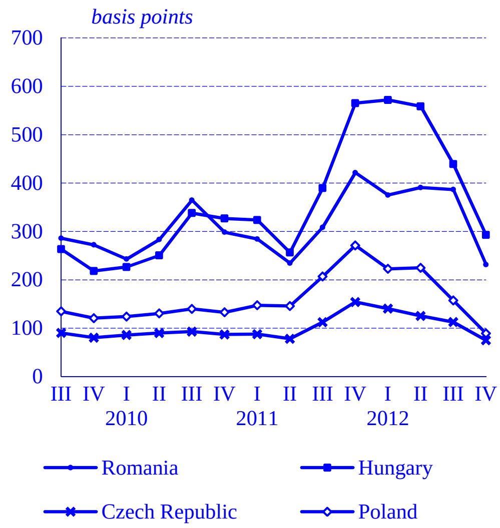
The domestic currency appreciated in both real and nominal terms in the fourth quarter of 2012 as compared with the previous quarter's average, these dynamics being reflected in the deviation of the real effective exchange rate[28] against the medium-term trend. The real appreciation of the leu versus the preceding quarter is attributed to the nominal appreciation of the domestic currency, as well as to the positive inflation differential versus Romania's trading partners. The nominal effective exchange rate developments are the result of the strong appreciation of the leu against the US dollar, given the relatively unchanged RON/EUR exchange rate. Against this background, the smaller positive deviation of the real exchange rate versus the medium-term forecast indicates, *ceteris paribus*, a marginal deterioration of the price competitiveness of the Romanian products compared with 2012 Q3, which caused the stimulative impact on future aggregate demand via the net export channel to decline slightly.

**Quarterly Change in the Effective Exchange Rate**




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

**5-year CDS Spreads for Romania and Other Countries in the Region**




*Source: NBR calculations based on Bloomberg data*

23 Based on the released historical current account deficit figures in January-November 2012, as well as on the projected dynamics of its components until the current year-end.

24 This definition of real broad monetary conditions is used in the model for analysis and medium-term forecasting.

25 The wealth and balance sheet effect of the exchange rate is manifest, in the case of indebted economic agents, by changing the allocation of resources available, on the one hand, for consumption and investment, and for granting and repayment of foreign currency-denominated loans, on the other hand.

26 Nominal interest rates on loans and deposits in lei are calculated as interest rate averages weighted by the volume of new loans/deposits.

27 The information on this indicator has been taken over from the NBR's monthly survey among bank analysts.

28 The exchange rate used in this assessment is based on RON/EUR and RON/USD exchange rates, weighted by the shares of the two currencies in Romania's foreign trade.

In 2012 Q4, investor sentiment towards Romania's sovereign risk improved[29] as compared with the previous quarter's level, reflecting the regional trend as well as the alleviation of tensions specific to the domestic political context in the preceding quarters. The effect of the expected exchange rate developments[30], corroborated with the effect of the real foreign interest rate staying below the medium-term trend, is only partially countered by the risk premium being above the medium-term trend. Therefore, in the fourth quarter, the wealth and balance sheet effect had a more stimulative impact on future economic activity.

According to the NBR assessment, real broad monetary conditions in 2012 Q4 have generated a slightly increasing stimulative effect on future economic activity, which implies, *ceteris paribus*, the attenuation of disinflationary pressures from the negative output gap. This is mainly due to the stimulative impact from the real exchange rate via the net export channel and the wealth and balance sheet effect, enhanced by the stimulative effect of real deposit rates. The real lending rates have exerted a relatively neutral influence versus the medium-term trends.

Over the forecast interval, real broad monetary conditions reflect the reconfiguration of the determinants' impact as compared with their projected dynamics in the November 2012 Inflation Report. Specifically, the repositioning of the real exchange rate as a result of the recent appreciation of the leu against the euro and the US dollar is anticipated to have a more restrictive effect on net exports throughout the projection interval. Furthermore, the path of the monetary policy rate is forecasted to ensure the return and subsequent consolidation of inflation rate inside the target band, as well as the necessary prerequisites for a gradual recovery of sustainable lending to the Romanian private sector, thereby supporting the resumption of sustainable economic growth. In line with the projected trajectory of the monetary policy rate, the cumulative impact of the deviations from the trends of real interest rates applied by financial institutions on leu-denominated loans and deposits is expected to be stimulative for the economic activity throughout the forecast interval. Similarly to the previous forecast, the trend deviation of the real interest rate on the foreign currency loans denominated in lei[31] is expected to have a stimulative impact throughout the forecast interval, with a relatively lower intensity in comparable terms. The main contributor to this development is the slightly less stimulative revision of the real cost of foreign currency-denominated funds raised by financial institutions and expected to be subsequently re-channelled to their potential clients in the form of bank loans.

[29] The risk level associated with investments in the national economy is correlated with developments in CDS (Credit Default Swap) spreads.

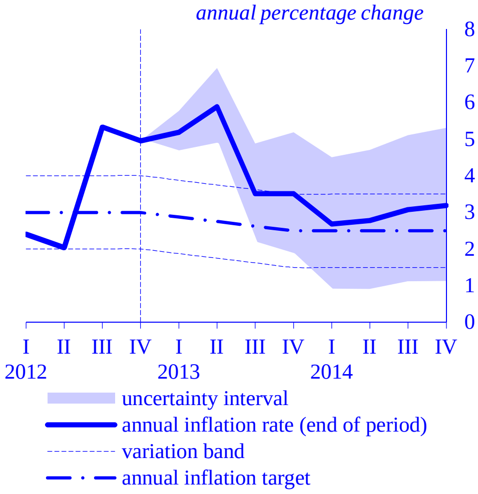
[30] Approximated by the expected change in the real effective exchange rate deviation.

[31] The two components define the wealth and balance sheet effect, a component of the real broad monetary conditions. For certain methodological notes, see footnotes 25 and 30.

## 1.4. Risks associated with the projection

The balance of risks associated with the annual CPI inflation rate path in the baseline scenario is still tilted to the upside, but somewhat less skewed than in the previous forecasting round, due to the fading out of domestic political tensions, which were still present when the November 2012 Inflation Report was released. This assessment is accounted for by both domestic and external factors. Domestically, the main sources of asymmetrical risks relate to the possible delays in the firm and consistent implementation of the macroeconomic policy mix and the structural reforms already agreed with the international institutions, as well as to the magnitude of future administered price adjustments. Externally, they are associated with the persistent uncertainties surrounding the economic and financial developments in the euro area.

**Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario**




Note: The uncertainty interval is calculated based on the forecast errors of the annual CPI inflation rate in the NBR projections during 2005-2012. The forecast errors are proportional to the time horizon they refer to.

*Source: NIS, NBR calculations and projections*

Domestically, similarly to the November 2012 Inflation Report, risks that could cause the inflation rate post upside deviations from the baseline scenario path arise from the uncertainties surrounding the firm implementation of the macroeconomic policy mix and the structural reforms agreed with the international institutions (the EC, the IMF and the World Bank). Despite the efforts made in terms of fiscal consolidation measures for Romania to comply with the targets set in line with the commitments assumed, potential slippages from timely and consistently implementing the above-mentioned commitments might trigger a deterioration of investor sentiment towards the Romanian economy, with a negative impact on the volatility and costs of its financing sources.

Additional risks at the domestic level are posed by the future dynamics of administered prices, given the release by the Romanian Energy Regulatory Authority of the calendar dates of increases in electricity and natural gas prices, yet their magnitude and, consequently, the impact on end-users' prices are uncertain. The risks arising from the dynamics of domestic food prices are relatively balanced in the short run. In the medium term however, they become relevant, considering the large share of food items in the consumer basket, on the one hand, as well as the possible occurrence of adverse weather conditions in the periods ahead and, implicitly, crops weaker than those expected in the baseline scenario, on the other.

Externally, the lingering uncertainties on the time span of the recovery process of the EU economy, and of the euro area in particular, can generate the risk of the higher volatility of capital flows channelled to emerging economies, Romania included. Large amounts of volatile capital flowing either in or out of Romania could pose risks to price and financial stability, as well as to a sustainable rebound in economic growth. On the one hand, a downward revision of the future prospects of the EU economic growth would imply the worsening investor sentiment towards investments in the region's emerging economies and would constrain, inter alia, the demand for Romania's exports. This would ultimately result in weaker capital flows to the Romanian economy and in depreciation pressures on the leu, which could entail adverse effects on domestic consumer price dynamics and financing costs for both private and public sectors, also via the wealth and balance sheet channel for unhedged borrowers. On the other hand, against the backdrop of uncertainties surrounding euro area growth prospects, substantial capital inflows, including the flows seeking temporarily higher returns – and therefore inherently unsustainable –, would increase the leu exchange rate volatility and would render an orderly unwinding of macroeconomic imbalances more difficult.

The balance of the supply-side risk factors (e.g. global commodity prices) is further estimated to be relatively in equilibrium in the short run. In the medium term however, the dynamics of this price category could be accelerated by the possible depreciation of the domestic currency versus the US dollar, fuelled by a potentially unfavourable and volatile EUR/USD exchange rate in the event of lingering uncertainties in the euro area.

## 2. Policy assessment

In line with the central bank's forecasts, in 2012 Q4, the upward trend that the annual inflation rate had re-entered in June came to a halt, with both October and November witnessing significant decreases in the annual inflation rate, followed by an increase in December – ascribable especially to the electricity price hike. In view of the relatively smaller magnitude of this rise, at end-2012, the annual CPI inflation rate (4.95 percent) stood below the level seen at end-Q3. Furthermore, given the relatively better-than-expected evolution of both the annual growth rate of volatile prices and the leu exchange rate, as well as the persistence of the significant negative output gap, the annual inflation rate and implicitly its deviation from the upper bound of the variation band around the central target set for end-2012 went down to slightly lower-than-previously-forecasted values in the second part of Q4.

The forecast of medium-term macroeconomic developments, updated according to the most recent available data and information, reconfirms the prospect for inflation to temporarily accelerate during 2013 H1, with the annual inflation rate being expected to reach even higher-than-previously-forecasted values during this interval, in the context of a significantly stronger-than-previously-projected inflationary impact of administered prices, as well as of a larger impact exerted during this interval by tobacco product prices, mainly as a result of the one-quarter-earlier rise in specific excise duties. Starting with 2013 Q3 however, inflation prospects see an improvement compared to the preceding forecast – only a marginal one during 2013 H2, but a significant one over the subsequent segment of the forecast horizon – followed by a minor deterioration in late 2014, owing solely to supply-side factors. Thus, the forecasted annual inflation rate goes down, sticking throughout 2013 Q4 to the upper bound of the variation band around the medium-term target[4], while in early 2014 it returns inside this variation band, before consolidating at a level close to the central target in the following three quarters.

The relative improvement in the inflation outlook starting with 2013 Q3 – implying a relative acceleration in disinflation which is to be resumed after inflation reaches a peak in June – is bolstered by more favourable developments anticipated for the dynamics of volatile prices[32], and especially for the annual adjusted CORE2 inflation rate, primarily over the intermediary segment of the forecast horizon. In its turn, the improved prospect for core inflation is backed by the resumption of the downward adjustment in inflation expectations, mainly in the near run, as well as by the downward revision of the forecasted annual dynamics of the leu exchange rate and of external consumer prices. Their favourable impact is mitigated only to a small extent by the relative decrease, compared to the previous projection, in the intensity of disinflationary pressures of aggregate demand, stemming from the decline in the estimated size of the negative output gap, in the context of a downward revision of both the potential GDP dynamics and the projected economic growth rate, compared to the previous forecasting rounds. By mid-2013 Q3, the projected annual adjusted CORE2 inflation rate continues, however, to remain at values higher than those posted prior to the onset of the hike in processed food prices, whereas, after the fading out of the adverse effects of supply-side shocks towards the quarter-end, it will undergo a significantly downward correction.

The current forecast of medium-term macroeconomic developments is fraught with marked uncertainties, generating both upside and downside risks to the inflation outlook, with the overall risk balance preserving however an unfavourable asymmetry. Such opposite risks, which are nevertheless relatively balanced in the current context, stem from the external environment, particularly from the developments in the economies and in the banking systems in the euro area and the European authorities' response, as well as from their potential impact on risk aversion and the international financial market liquidity.

The materialisation of these risks would generate inflationary effects, as well as an impact on domestic inflation expectations, mainly via the relative worsening of the leu exchange rate developments which would result from the decline in capital inflows to the Romanian economy, particularly in the form of portfolio investment. The entailed hike in the costs related to the fiscal deficit financing and public debt refinancing, including meeting the fiscal deficit target under tighter constraints, might also generate, directly or indirectly, adverse effects on inflation. In the assumption of a protracted slowdown in the activity of some EU economies, the inflationary impact of the leu exchange rate is however expected to be mitigated in the short run and even offset in the medium run by the relative intensification of the disinflationary pressures from the negative output gap stemming from the significant slowdown in the recovery

32 Fuel prices and prices of vegetables, fruit and eggs.

of the Romanian economy under the impact of a protracted recession/slow-in-coming upturn in the euro area economy.

At the same time, however, one cannot rule out the possibility that, against the backdrop of a possible persistence of/increase in the favourable international financial market sentiment[33], the leu exchange rate may fall to lower-than-expected levels, as a result of the potential spur given to capital inflows into the local market by the Romanian sovereign bonds being included into the Barclays Capital and JP Morgan emerging-market government bond indices[34] as of March 2013, as well as by the likelihood of a relatively higher attractiveness of the return/risk ratio on investments in national currency, in the context of a favourable sentiment of international investors towards emerging economies. The potential consolidation of the improved perception of foreign investors on the national economy outlook is, however, conditional upon the ongoing fiscal consolidation process, the acceleration of structural reforms, as well as upon the intensification of the efforts aimed at raising EU funds, in line with the commitments assumed under the agreements with the EU, the IMF and the World Bank.

The balance of potential risks to the inflation outlook and the inflation expectations in the medium term posed by future developments in the international agri-food commodity and energy prices, including the oil price, is further relatively in equilibrium, at least in the short run. The assessment takes into consideration, on the one hand, the prospect of a further weakening of global economy and the persistence of the related uncertainties, as well as a relatively high probability of an improved performance of the domestic agricultural sector compared to the previous year, that would alleviate the potential adverse effects exerted by the external market on some food prices. On the other hand, unexpected rises in international commodity prices cannot be ruled out, along with a high volatility of the EUR/USD exchange rate.

Nevertheless, the domestic environment continues to pose asymmetric risks to the inflation outlook, owing to the expected reacceleration in inflation in 2013 H1, and particularly as a result of the recently mounting uncertainties on the magnitude of the hike in some administered prices, given the emerging likelihood of additional adjustments in the electricity prices to be implemented in 2013, apart from those already set forth in the approved deregulation calendar[35]. To these add the uncertainties on the potential adverse impact on some administered prices, as well as on other categories of prices exerted by the recent revision of the

[33] Most likely as a result of the potential progress in reducing imbalances, implementing structural and institutional reforms in the euro area and in adjusting the balance sheets of the banks/non-financial sector in the Member States, as well as due to the monetary policy measures implemented by the European Central Bank.

[34] According to the announcements made by Barclays Capital and JP Morgan in November 2012 and January 2013.

[35] According to the commitments assumed under the agreements signed with the EU, the IMF and the World Bank.

fiscal legislation aimed at changing some direct[36] and indirect taxes and fees – with a view to ensuring the continuation of the fiscal consolidation process. Although the risk that these adverse supply-side shocks – either anticipated or potential – may generate second-round effects[37] is further low, given the prospect of a persistent negative output gap in the medium run, maintaining a prudent monetary policy stance is of the essence at the current juncture.

With a view to effectively anchoring inflation expectations and strengthening the prospects for the annual inflation rate to return inside the variation band of the medium term target, once the effects of adverse supply-side shocks, temporarily magnified in 2013 H1 by larger administered price adjustments have faded, the NBR Board has decided in its meeting on 5 February 2013 to keep the monetary policy rate unchanged at 5.25 percent per annum, while ensuring adequate liquidity management in the banking system. Moreover, 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.

[36] Especially in the energy and agriculture sectors.

[37] Via the deterioration of inflation expectations in the medium term.