National Bank of Romania

INFLATION REPORT

August 2013

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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.

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

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Foreword

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 August 2013 and includes data available until 29 July 2013.*

All issues of this publication are available in hard copy, as well as on the NBR website .

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
ON	overnight
OPCOM	Romanian gas and electricity market operator
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-2013 Q2, the annual CPI inflation rate continued to run above the upper limit of the ±1 percentage point variation band around the target set at a flat 2.5 percent as of 2013, mainly as a result of residual effects of transitory adverse shocks. In June 2013, the annual CPI inflation rate stood at 5.37 percent, exceeding by 0.12 percentage points both the level seen at end-Q1 and that forecasted in the May 2013 Inflation Report. At the same time, at end-Q2, both the average annual CPI inflation rate and the annual HICP inflation rate stood below 5 percent, at 4.97 percent and 4.5 percent respectively.

The marginal acceleration posted in 2013 Q2 by the annual growth rate of the consumer price index was induced by supply-side factors. The hike in excise duties on tobacco products in April – anticipated in the previous report – and larger-than-expected pressures on volatile food prices played a decisive role in this respect. Their impact on the annual rate of CPI inflation was mitigated by the deceleration in the annual dynamics of fuel prices, caused by the fall in the international crude oil prices as well as by the appreciation of the leu against the US dollar in the first part of Q2.

In Q2, the pick-up in the annual CPI inflation rate was also moderated by the further decline in the annual adjusted CORE2[1] inflation rate to 2.85 percent (down 0.2 percentage points compared to end-Q1). A significant contribution to the core inflation rate remaining on a downtrend had the gradual dissipation of the adverse impact of the previous year's poor agricultural crop on processed food prices, which is expected to speed up visibly over the following months. The persistence of the negative output gap as well as the improved inflation expectations also had a favourable influence. The effect of these factors is seen deepening in 2013 Q3.

April through May 2013, unit labour costs in industry went down in annual terms, after having risen for eight quarters in a row. The decline was the result of the markedly faster labour productivity dynamics in this period as well as of the slower increase in the average gross wage in this sector, which became visible ever since the beginning of this year. These developments suggest that, in the short run, the industrial sector puts low pressure on inflation through wage costs. In order to consolidate the prospects of inflation rate returning and remaining inside the target band over the medium term, it is of the essence to keep pay rises and labour productivity gains properly matched across the economy.

Monetary policy since the release of the previous Inflation Report

In its meeting on 2 May 2013, the NBR Board decided to leave the monetary policy rate unchanged at 5.25 percent per annum. The updated macroeconomic forecast anticipated improved inflation prospects in the near run compared to that in the February 2013 Inflation Report, with inflation rate returning inside the variation band around the target in the latter half of the year. The NBR Board's decision was aimed at consolidating these prospects by further tailoring monetary policy with a view to effectively anchoring inflation expectations. At the same time, the decision to leave the monetary policy rate unchanged took into account the risks to the new forecast, generated mainly by the volatility of capital flows towards the Romanian economy, in a global context marked by shifts in investor risk sentiment towards emerging market assets, as well as by the

[1] 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), tobacco product and alcohol prices.

persistence of structural rigidities of the domestic economy. Moreover, in order to alleviate the volatility of money market rates and bank rates and consolidate the transmission of the policy rate signal, the NBR Board decided to narrow the symmetrical corridor defined by the interest rates on NBR's standing facilities around the monetary policy rate to ±3 percentage points from ±4 percentage points.

Subsequent to the monetary policy decision, the annual CPI inflation rate rose marginally in May compared to March, against the background of higher volatile food prices and the increase in some excise duties (in the course of April). However, at end-June, the update of the short-term projection reconfirmed the central bank's previous forecasts, anticipating the relatively faster decrease in the inflation rate starting July and its return inside the target band in September/October 2013. In addition, the prospects of a consolidated short-term downward trend of adjusted CORE2 inflation rate were confirmed. The main risks to short-term inflation prospects continued to arise from the volatility of capital flows in the current international context – illustrated also by fluctuating responses of investors in emerging economies to the quantitative easing tapering hints by the Fed Chairman – as well as from the persistence of structural rigidities of the domestic economy. In its meeting on 1 July 2013, after analysing the latest macroeconomic developments, the NBR Board considered that the reconfirmation of short- and medium-term prospects for inflation rate to return and remain inside the target band allowed the gradual easing of the monetary policy stance, while effectively anchoring inflation expectations and paying due attention to domestic and external developments. Consequently, the NBR Board decided to cut the monetary policy rate to 5.00 percent per annum, from 5.25 percent.

Inflation outlook

The forecast envisages the annual CPI inflation rate returning inside the ±1 percentage point variation band around the central target in 2013 Q3 and subsequently remaining within the target band until the end of the projection horizon.

The macroeconomic forecast envisages economic growth to pick up markedly in 2013, after the meagre 0.7 percent advance in 2012. Net exports are expected to be the driving force behind economic growth this year. Their contribution to economic growth is chiefly fostered by the notable year-to-date performance of exports, which is however seen decelerating subsequently, although exports will still significantly outpace imports in the year as a whole. The slower import advance could mainly be attributed to the projected weak contribution of domestic demand to economic growth in 2013, given the quasi-stagnant final consumption and the negative growth of investment. The GDP growth appears set to post a marginal acceleration in 2014, on the back of a significant recovery in key domestic demand components. The rebound in domestic demand will also push import dynamics higher, causing net exports to make a renewed negative contribution to economic growth. The sharp narrowing of the goods and services trade deficit this year is expected to help the share of the balance-of-payments current account deficit to nominal GDP reach sizeably lower levels in both 2013 and 2014 than in 2012. Hence, given the assumptions under the baseline scenario of the projection, no significant corrective pressure on the leu exchange rate arising from the external position is foreseen until the projection horizon. The negative output gap remains high and persistent, but it has been revised for the entire forecast interval to levels entailing relatively weaker-than-previously-projected disinflationary pressures, with the new national accounts data released by the NIS making a contribution as well. The strength of these pressures is nevertheless anticipated to abate relatively slowly over the medium term, which implies a negative output gap until the projection horizon.

The baseline scenario of the current projection places the annual CPI inflation rate at 3.1 percent at end-2013 and end-2014, 0.1 and 0.2 percentage points respectively below the May 2013 Inflation Report projected rates.

The updated inflation forecast entails reassessments of the contributions from the price dynamics of the main consumer basket items. Thus, compared to the previous round, for both 2013 and 2014, the downward revision of the end-of-year projections is ascribed to the lower contributions from administered price dynamics and the adjusted CORE2 inflation, as well as from fuel price dynamics for end-2014. In 2013, the impact of factors having a more favourable contribution to inflation developments than previously projected is foreseen to be partly offset by upward revisions of the growth rates of prices of volatile food items (VFE), fuel prices and excise duties (on tobacco products and alcohol).

The projection foresees the fast curbing of the annual inflation rate to 3.0 percent in September 2013 from 5.37 percent in June. Inflation rate is subsequently envisaged to be no higher than 3.1 percent by the end of 2014, touching a 2.1 percent low in 2014 Q1. For 2015 H1, inflation rate is projected to rise slightly to 3.3 percent, thus remaining inside the target band.

The projected significant disinflation over the first part of the projection interval is based on the assumption, included in the baseline scenario, of normal crops in 2013, compared to the terribly weak harvest of 2012. This implies the gradual fading-out of detrimental supply-side shocks manifest last year and the shift from an adverse statistical base effect to a favourable one, which is anticipated to have a beneficial influence on the price dynamics of VFE and of processed food items included in the adjusted CORE2 index. An additional key contributor to the curbing of inflation will be the slowdown in the annual rates of increase of administered prices and tobacco product prices expected by the end of 2014 Q1.

The adjusted CORE2 inflation rate is projected to stick to the downward path it embarked upon in 2013 H1 and bottom out at 1.8 percent in 2013 Q3 and Q4. Apart from the already mentioned fading-away of the adverse supply-side shocks manifest in 2012, but still related to it, the slowdown in core inflation will be underpinned by a gradual improvement in inflation expectations as a result of pursuing an adequate monetary policy stance over the next eight quarters.

The core inflation projection foresees below-2-percent rates by mid-2014. For the remaining part of the reference period, assuming the consolidation of economic activity in Romania, reflected by a slight abatement of disinflationary pressures coming from the negative output gap, and amid a gradual fading of the favourable base effects of 2013, the adjusted CORE2 inflation rate is expected to go up and remain at levels slightly above 2 percent.

Compared to the previous projection, the adjusted CORE2 inflation rate was revised downwards for most of the forecasting interval (by -0.2 and -0.1 percentage points for end-2013 and end-2014 respectively) considering slower projected growth rates for import prices and processed food prices, and lower inflation expectations. The persistence of the negative output gap is further seen generating disinflationary pressures, albeit lower than in the previous forecasting round, against the background of the revision of the GDP deviation from its potential to less negative levels.

The projected monetary policy stance will further seek to prudently calibrate real broad monetary conditions so as to ensure that inflation rate returns and consolidates inside the target band, while also paving the way for a gradual recovery of lending to the private sector and a sustainable resumption of economic growth. According to the NBR Board assessment, to fulfil these goals in the near run is compatible with a gradual easing of the monetary policy stance conditioned on an effective anchoring of inflation expectations and the absence of domestic or global adverse shocks in the short term.

The assessment of risks associated with the current inflation rate projection points to a balance tilted to the downside in the short term, i.e. towards downward deviations from the baseline scenario, whereas upwards deviations appear to be somewhat more pronounced over the medium term.

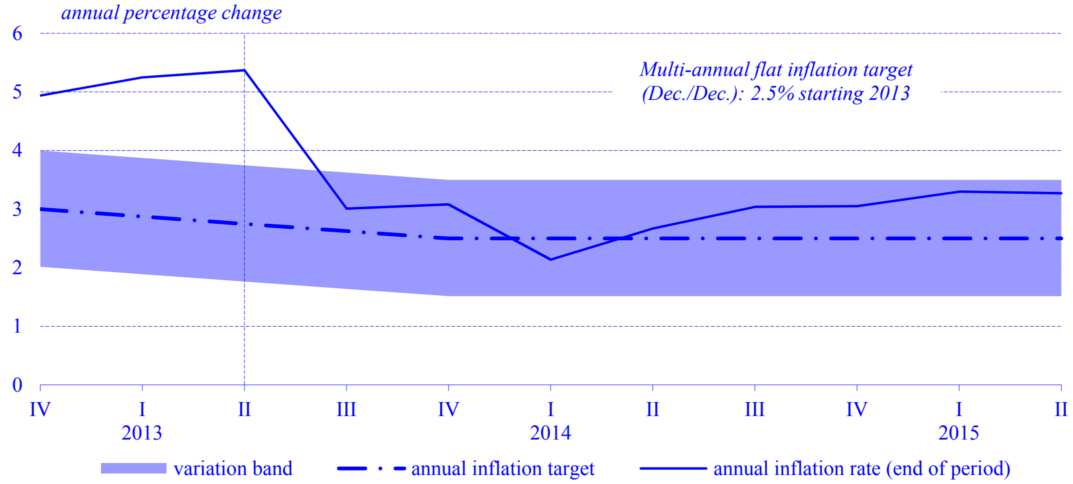
In the near run, inflation rate may fall lower than projected, in view of the incoming information after the macroeconomic forecast was completed and therefore left out of the baseline scenario. Special mention deserve the signals on domestic bumper crops of volatile food items (VFE) and of some raw materials for processed foodstuffs, as well as the government's announcement on cutting the VAT rate applied to flour and bread as of 1 September 2013.

The external environment is still saddled with uncertainty and therefore remains the source of risks which, if they were to materialise, could trigger adverse shocks on inflation. These risks are mainly associated with possibly higher volatility of capital flows channelled towards the Romanian economy in the broader context of shifts in investors' risk appetite relative to the emerging economies as a whole. A major uncertainty source is the time horizon needed for a recovery in the GDP dynamics of Romania's major EU trade partners, given the repeated downward revisions of the EU Member States' economic growth forecasts and the persistence of sovereign debt sustainability issues and those related to the quality of banks' balance sheets in some euro area countries. Unfavourable deviations of external demand from the path shown in the baseline scenario would dampen domestic economic growth. This would cause investor sentiment vis-à-vis Romania's economic outlook to worsen, which is likely to have a negative impact on the risk premium attached to non-residents' investment in local currency, and put a damper on the capital flows aimed at financing the domestic economy. In addition, the uncertainty about the magnitude and timing of the Fed tapering its quantitative easing across the US financial system could, via the declining global risk appetite, add to the threat of diminished capital flows to emerging economies, Romania included. Regardless of their origin, if substantial cuts in financing resources for economic growth were to materialise, the leu could face depreciation pressure, entailing negative effects on price and financial stability.

On the domestic front, the persistent structural rigidities across the Romanian economy prevent the adjustment of economic factors from more effectively mitigating the consequences of adverse shocks stemming from either external or domestic sources. Consequently, any delay in achieving a consistent mix of structural reforms, such as that embedded in the arrangement concluded by the Romanian authorities with international institutions (the EU, the IMF and the World Bank), brings about spillover risks and could even magnify the unfavourable shocks on inflation and economic growth.

Given the updated baseline scenario assumptions, the balance of risks to the developments in administered prices in the reference period appears to be relatively in equilibrium. The future dynamics of global commodity prices continue, in this forecasting round as well, to be a relevant risk factor especially over the medium term, ahead of which global demand is unlikely to see a solid recovery.

Inflation Forecast



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

Source: NIS, NBR projections

Monetary policy decision

Considering the prospects for the annual inflation rate to witness a sustainable return inside the band around the flat target at the end of 2013 Q3, as well as the higher likelihood for it to post a downward deviation from the forecasted path in the period ahead, the NBR Board decided in its 5 August 2013 meeting to lower the monetary policy rate by 0.50 percentage points to 4.50 percent per annum. The NBR Board also decided to pursue an adequate liquidity management in the banking system and to leave unchanged the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

I. INFLATION DEVELOPMENTS

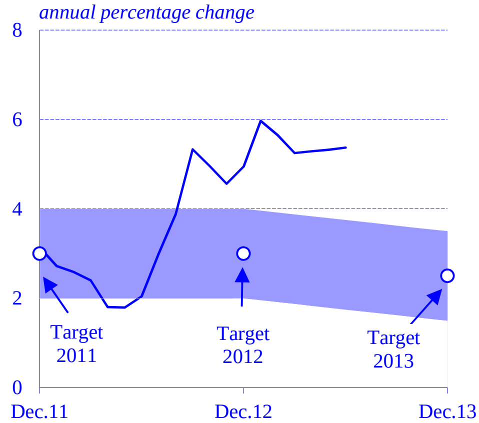
At end-2013 Q2, the annual CPI inflation rate was 5.37 percent, further staying above the variation band of ±1 percentage point around the 2.5 percent central target, as a result of the joint impact of previous and current adverse supply-side shocks. The annual inflation rate was 0.12 percentage points higher than at the end of Q1, as the anticipated inflationary effect of the increase in some excise duties in April was accompanied by short-lived pressures from volatile food prices, which were however offset by the slower dynamics of fuel prices. Unlike headline inflation, adjusted CORE2 inflation remained on a downtrend, i.e. 2.85 percent in June 2013, mirroring the persistently negative output gap, the generally favourable impact exerted by the prices of agri-food commodities on processed food prices and the relatively lower inflation expectations.

At the end of the reviewed period, the annual growth rate of volatile prices was similar to that reported in March 2013, on the back of the opposite movements of the two sub-groups. Thus, food prices (VFE) witnessed a 3.4 percentage point swifter pace of increase owing to the atypical hikes in external prices for “citrus and other southern fruit”, on the one hand, and to the fading-out of some favourable base effects, on the other hand. The deceleration of the annual dynamics of fuel prices to levels close to zero for the first time in almost four years had the opposite impact. Behind this development stood mainly the drop in crude oil prices on international markets[1], whose influence was amplified by the appreciation of the domestic currency versus the US dollar in the first part of 2013 Q2.

Unlike the picture seen in the previous quarter, administered prices saw overall small adjustments, coming from increases in prices of certain services (water, sewerage, waste disposal and urban transport services). Nevertheless, the annual change in administered prices remained high, i.e. 10.4 percent at end-2013 Q2, and contributed around a third of the CPI inflation rate, especially as a result of the pick-ups in prices for electricity and natural gas July 2012 through January 2013.

The annual growth rate of tobacco prices also exceeded 10 percent (up 3.2 percentage points in the reviewed period), following the earlier implementation (in April instead of July) of excise duty hikes related to tobacco products. The increase in excise duty on

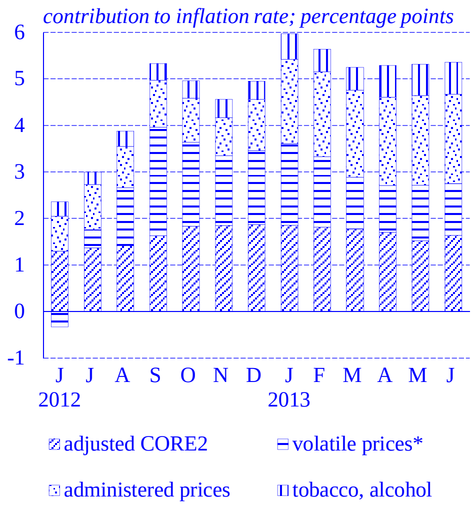
Inflation Developments



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

Source: NIS, NBR calculations

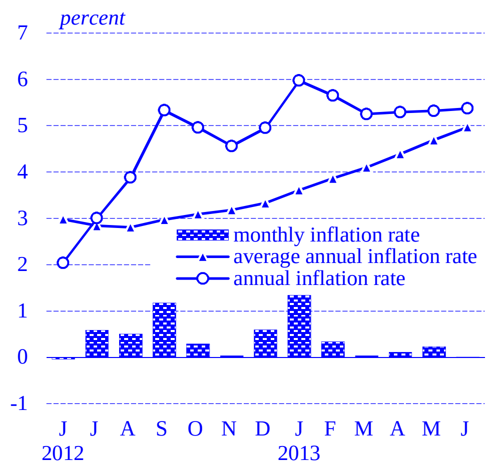
Annual Inflation Rate



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

Source: NIS, NBR calculations

Inflation Rate



Source: NIS

[1] Brent crude oil price stood, on average, at around USD 103/barrel in the three months under review, down from USD 109.7/barrel in March 2013, with the key determinants including – according to OPEC’s Monthly Oil Market Reports – the prospects for modest dynamics of global economy (the ongoing economic weakness in the euro area and the slower growth in China in particular) and the larger crude oil supply.

beer made a far smaller contribution to the annual inflation rate and had in fact been passed through to consumer prices partly in advance in March.

The adverse impact exerted by the developments in exogenous components on headline CPI inflation was mitigated by the annual pace of growth of the adjusted CORE2 index – the relevant inflation measure in terms of monetary policy scope – slowing down by another 0.2 percentage points. Besides the persistently negative output gap, it was mainly food market specific factors that led to the reduction in core inflation, namely the generally favourable trends in agri-food commodity markets (grains, sugar, sun flower oil, whereas poultry and pork made an exception) and the optimistic outlook for the 2013 harvest.

The dynamics of the other two groups of core inflation saw marginal changes. The annual growth rate of non-food items further stood on a slightly upward path, driven however by different determinants as compared to the previous quarter. Specifically, inflationary pressures were no longer visible in a sole category of goods (i.e. books, newspapers and periodicals), but across most non-food items, particularly non-durables, in line with the pick-up in external prices[2]. The exchange rate of the domestic currency posted uneven developments[3] in the reviewed quarter, supporting the fall in core inflation only in the first two months – via both imported inflation and the products with EUR-expressed prices –, whereas in June the leu depreciation against the main currencies discontinued this trend. Nevertheless, the annual dynamics of market services prices inched down at end-2013 Q2 as compared to March, largely due to the adjustment in insurance premiums.

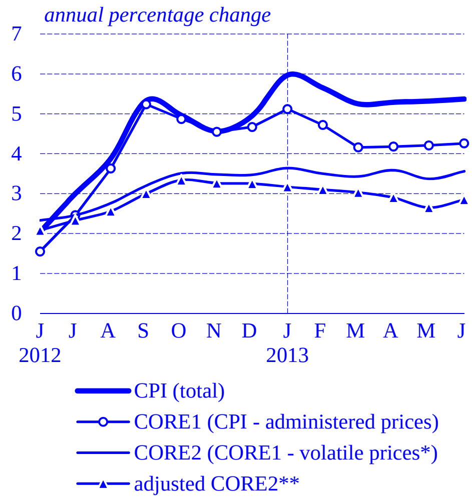
Economic agents' inflation expectations improved somewhat in 2013 Q2 versus the previous quarter, as shown by opinions of trade and services managers, consumers and financial analysts. An exception was industry, where the marginal change in the balance of answers (on average) masked the divergent expectations in the main industrial sub-sectors.

In 2013 Q2, the average annual HICP inflation rate remained on an uptrend (+0.6 percentage points to 4.5 percent), in contrast with the drop in the average inflation of the three best performing EU Member States. Amid these developments, the differential from the corresponding Maastricht criterion widened to 2 percentage points. The deviation from the EU average was also larger (i.e. 2.3 percentage points), against the backdrop of the numerous

[2] Approximated by EU-15 industrial producer prices for consumer goods for the non-domestic market.

[3] Even though the appreciation of the domestic currency in the first part of the period under review was followed by a sharper depreciation, in annual terms the latter was moderated by a favourable base effect.

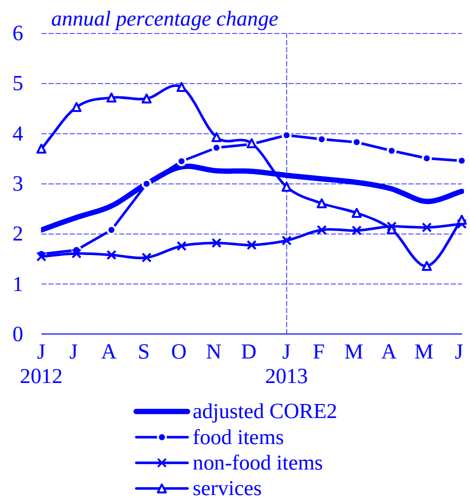
Headline Inflation and CORE Inflation



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

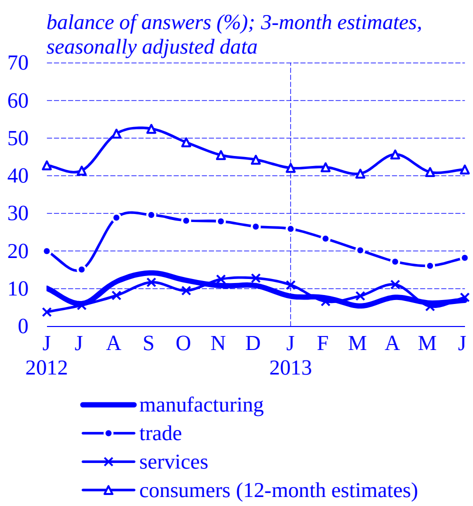
Source: NIS

Adjusted CORE2 Components



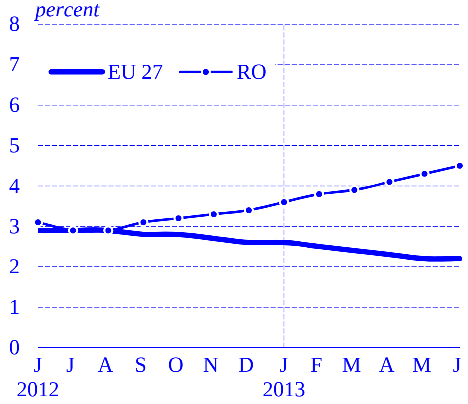
Source: NIS, NBR calculations

Inflation Expectations of Economic Agents



Source: EC-DG ECFIN

Average Annual HICP Inflation Rate*



*) 12-month average rate of change

Source: Eurostat

supply-side shocks that have impacted the trajectory of the inflation rate in Romania in the past two years, as well as of the slow pace of recovery of the EU economic activity.

At end-2013 Q2, the annual CPI inflation rate was 0.1 percentage points higher than the projected level in the May 2013 Inflation Report. The difference can be accounted for by the slightly faster than expected growth rates of volatile prices and adjusted CORE2 index, partly as a result of the unforeseen weakening of the leu against the main currencies in June, which influenced fuel prices and market services prices, respectively.

II. ECONOMIC DEVELOPMENTS

1. Demand and supply

The beginning of 2013 saw a faster annual growth rate of real GDP than in 2012 Q4 (from 1.1 percent to 2.2 percent), due both to the currently positive quarterly dynamics, i.e. 0.6 percent[1], and a base effect.

In 2013 Q1, economic growth was underpinned solely by net external demand (with a 4.4 percentage point contribution) amid the rebound in exports of goods and services. Following seven quarters of positive contributions to real GDP dynamics, domestic absorption shrank by 2.2 percent, especially in the case of capital investment and, to a smaller extent, consumer demand.

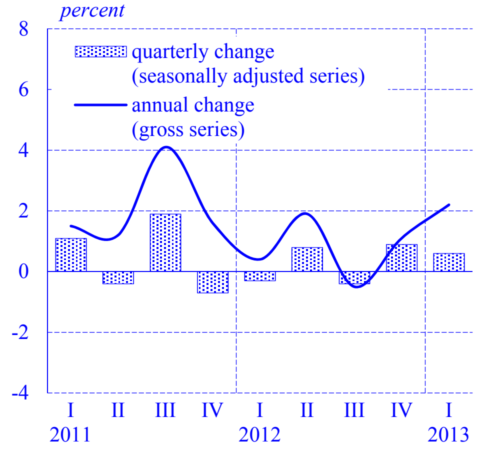
As to the quarterly developments in real GDP, net exports were the sole driver of growth as well. Their 2.6 percentage point positive contribution owed chiefly to the trade balance, as exports of goods reported a nearly four times swifter pace of increase than imports, i.e. 8.5 percent. Domestic absorption followed an even steeper downtrend (-1.4 percent versus -0.6 percent in 2012 Q4), equal contributions coming from the fall in consumer demand, investment demand and inventories. All economic sectors posted faster gross value added dynamics than in the previous quarter, to 0.2 percent in the services sector and 1 percent in industry and the construction sector, except for agriculture, in whose case GVA lost 0.6 percent. Nevertheless, the step-up did not pass through to real GDP, whose quarterly growth rate slowed down by 0.3 percentage points, mainly on account of the residual item ("statistical discrepancy").

1.1. Demand

In 2013 Q1, private final consumption shrank by 0.3 percent in annual terms. Behind this development stood, on the one hand, households' lesser recourse to services, mainly travel agency, tour operator and other reservation service and related activities and other recreational activities (down 5.7 percent and 26.3 percent, respectively, in terms of the turnover volume), and, on the other hand, a possible decline in self-consumption and purchases on the agri-food market, whose trend is in line with that of agriculture. In the period under review, the volume of retail purchases was similar to that posted in 2012 Q1, given that the pick-up in durables purchases (except for motorcars) was offset by non-durables sales remaining on a slightly downward path (owing chiefly to fuel trade) and the renewed contraction in the car market. Turning to the funding sources of consumer demand, 2013 Q1

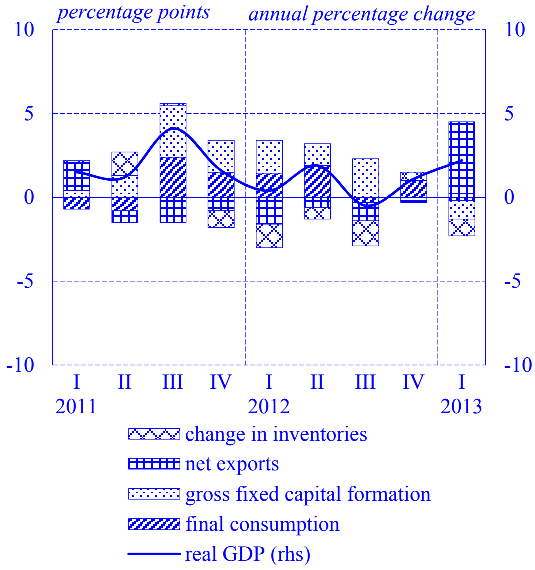
[1] Unless otherwise indicated, the growth rates in this section are annual percentage changes in real terms, calculated based on unadjusted data series. Current developments refer to quarter-on-quarter changes and are calculated based on seasonally-adjusted data series.

Real Gross Domestic Product



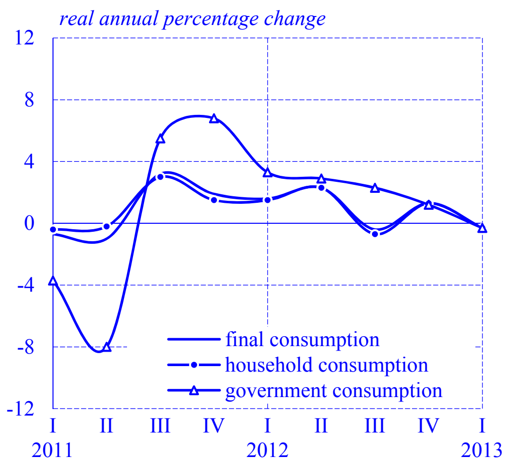
Source: NIS

Contribution of Demand Components to GDP Growth



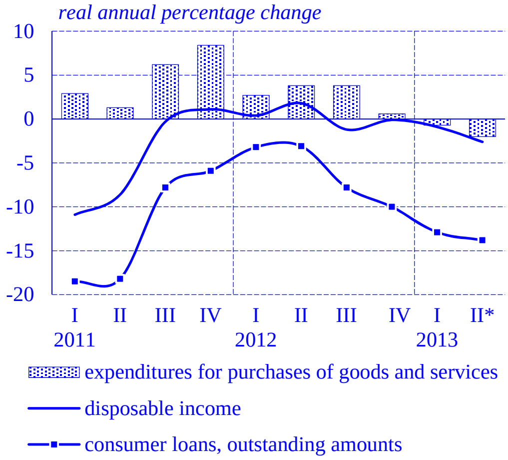
Source: NIS, NBR calculations

Actual Final Consumption



Source: NIS

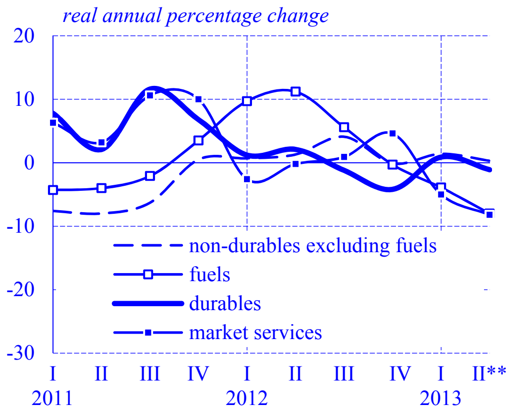
Household Consumption and Main Financing Sources



*) Apr.-May

Source: NIS, MPF, NBR calculations

Purchases of Goods and Services*

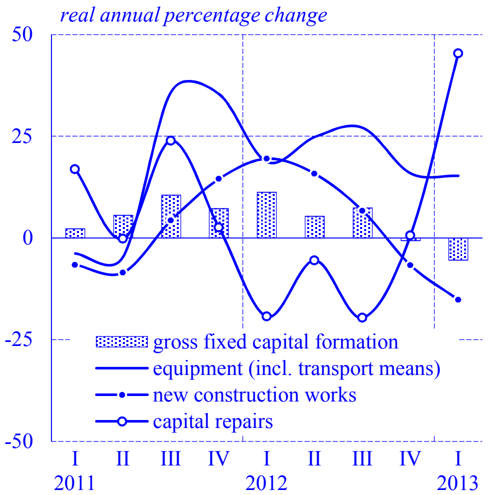


*) based on data on the turnover volume of retail trade and market services to households

**) Apr.-May

Source: NIS, NBR calculations

Investment



Source: NIS, NBR calculations

saw no trend reversals, as both household disposable income[2] and consumer loans further went down, i.e. by 0.9 percent and over 12 percent, respectively.

Similarly to household consumer demand, government final consumption witnessed a trend reversal, losing 0.3 percent in real terms versus +1.2 percent in 2012 Q4.

In 2013 Q1, the general government deficit stood at lei 4,189 million, i.e. 0.7 percent of GDP[3], above that posted in the same year-earlier period, which amounted to lei 3,388 million and accounted for 0.6 percent of GDP. Thus, the improvement in budget execution seen previously came to a halt as, on the one hand, the negative dynamics of total budget revenues[4] accelerated to -2.5 percent from -1.2 percent in the previous quarter, including against the backdrop of the faster annual contraction in profit tax collections and the annual change in EU funds entering negative territory. On the other hand, the annual pace of decrease of public expenditure decelerated to -1.1 percent from -5.6 percent in 2012 Q4, reflecting largely the swifter growth rate of the public wage bill, i.e. 13.6 percent versus 6.8 percent in the prior quarter, amid the last stage of the reversal of the budgetary sector pay cuts of 2010[5]. The latter's impact was only partly offset by the significantly slacker dynamics of expenditure for projects financed from non-repayable external loans (-48.2 percent).

Nevertheless, the fall in domestic absorption can be ascribed mostly to gross fixed capital formation, which reported a faster decline, i.e. to -5.4 percent in the period under review from -0.6 percent in 2012 Q4. Behind the move stood both the current contraction (by 2.2 percent) and the base effect associated with the 3.4 percent advance in 2012 Q1.

Capital investment by the public sector further followed a downtrend, as the budget execution data indicated, for the fourth quarter in a row, a drop in capital expenditure (down 9.7 percent in real terms), attributed, to a large extent, to the 24 percent decrease in new engineering construction works. The signals conveyed by construction companies point to a low probability of an investment rebound in the aforementioned sector until end-2013, the main factors incriminated being the blocking of a significant number of publicly-funded works, the difficulties in implementing EU-funded projects, and the decline in investment tenders in the current year.

2 Approximated by the sum of incomes from net wages, social transfers (state social security, unemployment benefit and health insurance) and workers' remittances from abroad.

3 The analysis relied on the operational data and the nominal GDP reading for 2013 released by the MPF relative to the end-March 2013 general government budget execution.

4 Unless otherwise indicated, percentage changes refer to the annual growth rates expressed in real terms.

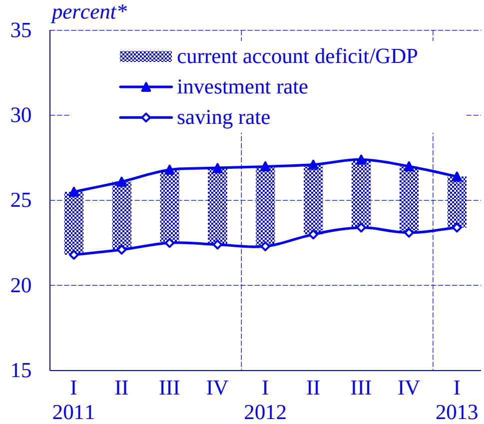
5 The 7.4 percent rise in the budgetary sector wages in nominal terms occurred in December 2012. The payments were reflected in the 2013 budgetary execution.

Household and corporate investment followed the opposite trend. Nevertheless, the step-up in these sectors only managed to offset the adverse impact of the public sector, which accounts for approximately two thirds of the value of construction works under new construction works and capital repairs. Available statistical data show a more than 30 percent rise in residential investment versus 2012 Q1, in line with the higher stock of real estate loans taken by households (up 15.1 percent in real terms)[6]. The increased interest in the "First Home" government programme made a substantial contribution to this development, amid uncertainties surrounding its extension (either in the old format or in the "New Home" version), given that the loans thus granted have the advantage of requiring a relatively low advance (5 percent) versus 25 percent in the case of EUR-denominated standard loans and 15 percent in that of lei-denominated loans, respectively.

The uptrend posted by corporate investment demand was bolstered, on the one hand, by the streamlining expenditure (including for transport means purchased by companies and institutions), which saw a renewed hike (up 15 percent), and, on the other hand, by the ongoing increase in non-residential construction works (new construction works and capital repairs), albeit at a significantly slower pace than in 2012 Q4. These developments were accompanied by moderate rises in loans, i.e. up 4.8 percent in the case of loans for equipment and 1.7 percent in that of real estate loans[6], respectively. By contrast, foreign direct investment provided less support – the growth of overall flows to the non-bank sector over the last four quarters came to a halt, as equity stakes (less net losses) halved.

The contribution made by net external demand to GDP dynamics re-entered positive territory on account of, on the one hand, the rebound in exports of goods (+4.7 percent in 2013 Q1 against -5.7 percent in the prior quarter) and, on the other hand, the fast pick-up in receipts from services[7]. With respect to destination markets, EU sales[8] – in whose case the downward trend followed by their physical volume throughout 2012 came to a halt (up 1.5 percent) – made a positive contribution to the faster increase in exports. However, the major driver behind this development were non-EU sales (+12.2 percent), which account for approximately three fourths of the real dynamics of total exports, with sales of transport means and equipment, chemical products and electrical machinery and equipment ranking first.

Investment Rate and Saving Rate

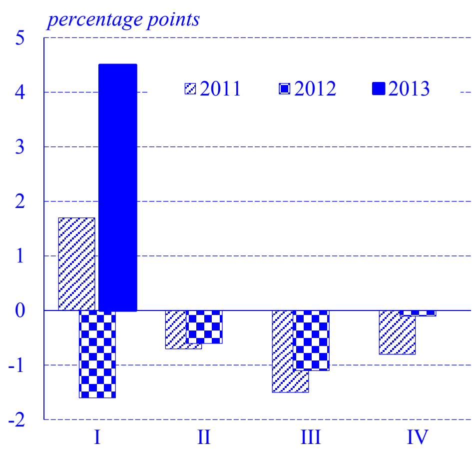


*) last 4 quarters' average

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



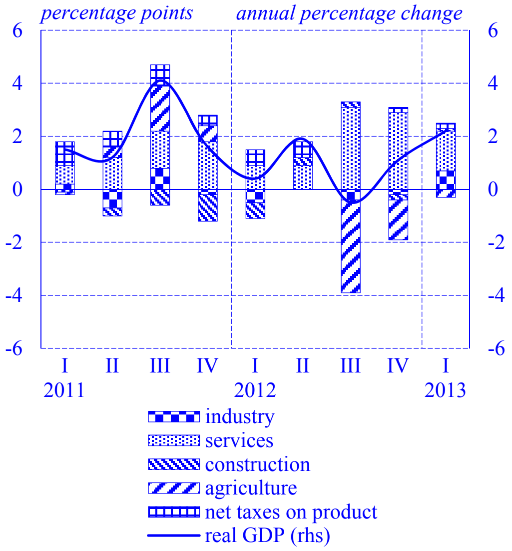
Source: NIS, NBR calculations

6 Calculations based on the data supplied by the Central Credit Register.

7 The 38.7 percent rise in the volume of these receipts reflects the results of the first quarterly survey on international trade in services, which has been conducted by the National Bank of Romania in collaboration with the National Institute of Statistics as of 2013.

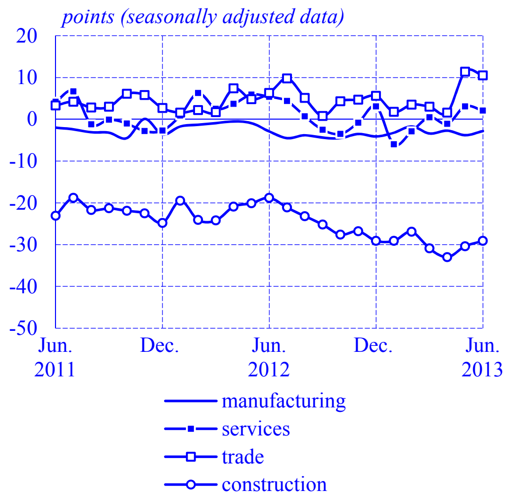
8 The breakdown by destination market/market of origin and by group of goods of the physical volume of exports and imports is based on the series of trade balance data and international trade-related unit value indices released by the Eurostat.

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

Corporate Sector: Confidence Indicators for the Next 3 Months



Source: EC-DG ECFIN

The decline in imports of goods seen in the last two quarters of 2012 came to a halt (+0.2 percent in 2013 Q1) as a result of the recovery of EU purchases (to the detriment of non-EU imports), particularly in the case of intermediate goods and consumer goods.

1.2. Supply

In 2013 Q1, economic growth was mainly underpinned by industry and services, whereas gross value added in agriculture further shrank, although the pace decelerated to one third of the previous quarter's reading, i.e. -8 percent, and gross value added in the construction sector made a modest contribution (+0.1 percentage points).

Gross value added in industry witnessed a trend reversal, with the 2.6 percent advance in 2013 Q1 owing solely to the larger volume of export orders. Positive dynamics were reported by the production of intermediate goods (electrical equipment, chemicals and construction materials recorded fast increases ranging between 11 percent and 16 percent), capital goods (transport means saw significantly swifter growth rates – over 10 percent on average) and consumer goods (both durables and non-durables).

Services were, for the third quarter in a row, the fastest-moving economic sector (+3 percent), although their annual pace of growth posted a renewed deceleration as compared to the previous quarter. All the sub-sectors witnessed increases in gross value added, with two of them showing even swifter dynamics, namely financial intermediation services and real-estate transactions (+2.6 percent in each case).

2. Labour market

March through May 2013, the uptrend in staff numbers seen in the last 24 months flattened out and private companies' hiring expectations for the coming months receded somewhat. The relatively weaker signals from labour demand were also reflected in the higher estimated ILO unemployment rate (whereas the registered unemployment rate stayed flat) and the ongoing moderate annual dynamics of net wage earnings. Nevertheless, in industry the significant rebound in labour productivity seen, on average, April through May led to lower unit labour costs, following eight consecutive quarters of positive annual growth rates.

Available statistical data on labour market indicators[9] provide mixed information with respect to current developments, owing largely to their different scope. Thus, although the number of vacancies remained within the range of quarterly average readings posted as of 2010 Q1 and layoffs decreased[10], the dynamics of personnel numbers reported by employers economy-wide

[9] Seasonally-adjusted data.

[10] Source: NEA.

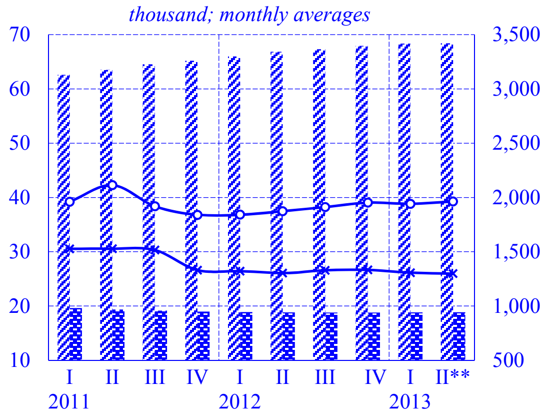
suggest slower labour absorption. The latter characterised all mainly private economic sectors[11], whereas the budgetary sector followed the opposite trend. Moreover, unemployment indicators further posted uneven developments. Specifically, the registered unemployment rate stabilised at 5.3 percent (due partly to some unemployed, chiefly high school and college graduates, whose unemployment benefit period had expired, choosing to no longer renew their applications for registration with the NEA). By contrast, the estimated ILO unemployment rate was revised upwards by around 0.4 percentage points in 2013 Q1 and kept on increasing to 7.5 percent in May. Managers' employment expectations for the coming months show stability in trade and relatively unfavourable prospects for industry, services and particularly the construction sector[12].

Under the circumstances, the indications of slower annual dynamics of nominal gross wages in the private sector that were visible in early 2013 were subsequently confirmed. Thus, after the acceleration posted in April – due to the different timing of the Easter bonuses versus the previous year and their slightly higher level in the current period –, the annual growth rate of the private sector gross wage decelerated to 2.6 percent in May, marginally lower than the readings reported January through February 2013. The dynamics of wages in private services witnessed the sharpest slowdown, amid the sluggish trade and the financial system's concern to regain its profitability, with a possible additional explanation lying in the expansion of the informal sector. The annual pace of increase of budgetary sector wages further stood at around 17 percent, the level posted in December 2012, as the reversal of the pay cuts of July 2010 came to an end. Therefore, the faster tempo at which the average gross wage economy-wide rose April through May 2013, i.e. 6.3 percent versus 5.5 percent in Q1, owed solely to the Easter volatility and proved to be short-lived.

In industry, the annual increase in wages exerted a clearly lower impact on unit labour costs than that of labour productivity. The latter's swifter annual dynamics, i.e. from 2.6 percent in 2013 Q1 to 7.1 percent, on average, in April-May 2013, caused the annual growth rate of unit labour costs to re-enter negative territory, following eight consecutive quarters of positive readings, with mining and manufacturing (food industry, crude oil processing, machinery and equipment, electrical equipment and the automotive industry) witnessing significant adjustments.

Looking at consumer demand, April through May 2013 the negative annual dynamics of real disposable income accelerated to -4.2 percent, favouring disinflation. Behind this development stood the large contraction in workers' remittances from abroad and, to a

Labour Force Demand Measures*

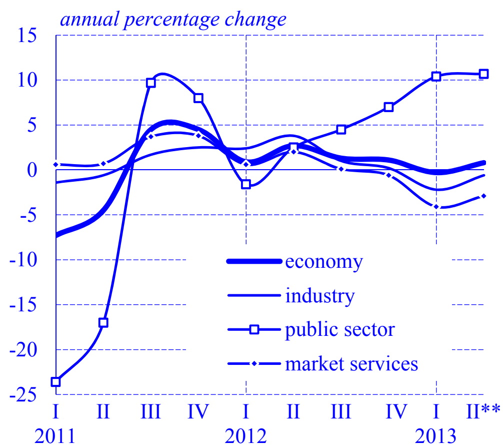


*) seasonally adjusted data
**) Apr.-May
Source: NEA, NIS, NBR calculations

Unemployment Rate*

*) seasonally adjusted data
**) Apr.-May
Source: NIS, NBR calculations

Net Real Wage*

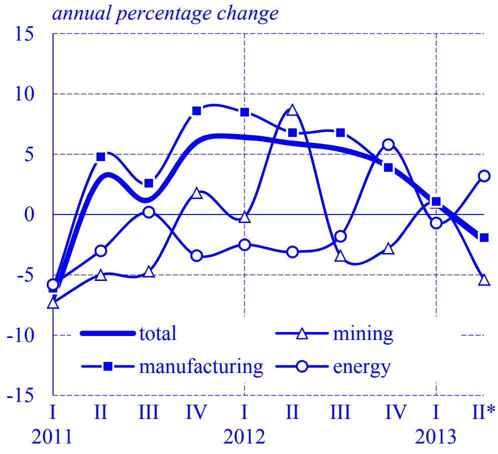


*) deflated by CPI
**) Apr.-May
Source: NIS, NBR calculations

11 The monthly growth of staff numbers slowed down in private services, came to a halt in industry and posted a reversal in the construction sector.

12 See the DG ECFIN/NIS survey and the Manpower Employment Outlook Survey.

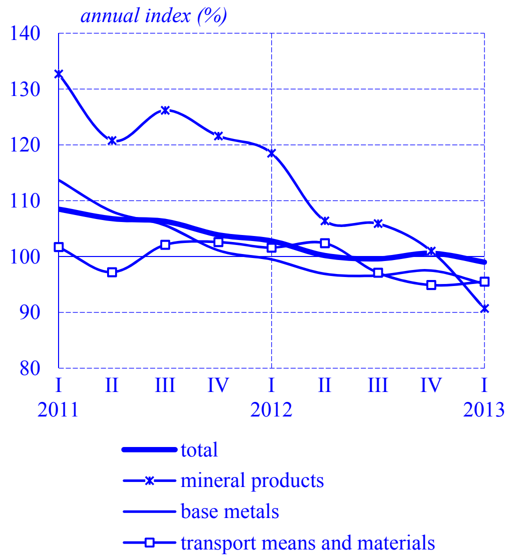
Unit Labour Cost in Industry



*) Apr.-May

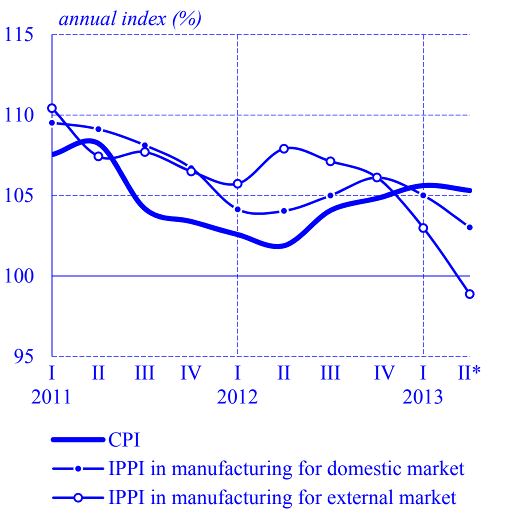
Source: NIS, NBR calculations

Items reporting declines in import unit value index in 2013 Q1



Source: NIS, NBR calculations

Consumer Prices and Industrial Producer Prices



*) Apr.-May

Source: NIS

lower extent, the decline in social transfers, whereas wage income further moderated its growth in annual terms.

3. Import prices and producer prices

In 2013 Q1, import prices and agricultural producer prices exerted lower inflationary pressures, mainly on account of the subdued global demand and the favourable domestic and international prospects for the agricultural year. Although the annual growth rate of producer prices for the domestic market accelerated as a whole, this owed solely to energy prices, while prices for other groups of goods followed a downtrend. Looking ahead at the following quarter, the favourable outlook for domestic and international commodity markets is likely to entail decelerations in the annual growth rates of prices for the three segments.

In the first quarter of 2013, the annual unit value index of imports reverted to below par values (99.01 percent from 100.64 percent in 2012 Q4), the decline in imported inflation being sharpened by the considerably slower depreciation of the leu versus both the euro and the US dollar.

Most imported goods holding a large share in the CPI basket saw a slowdown in their annual price dynamics, with fuel prices posting the fastest pace of deceleration (the unit value index of imports went below par after three years of positive values). Behind this stood mainly the drop in oil prices, as a result of the lower demand from some European refineries which had overhaul works scheduled for March 2013. Similar developments were posted by food prices, against the background of the favourable prospects regarding the 2013 crops, as well as by non-food prices (footwear, wearing apparel) except for pharmaceuticals.

Furthermore, the absence of inflationary pressures was obvious in the case of prices for intermediate goods and capital goods. Thus, the unit value index of imports of metals followed a sharper downtrend, as a result of large stocks and weak global demand, while that of imports of road transport means remained below par, which may be attributed to the increase in imports of second-hand cars[13].

In 2013 Q1, the annual growth rate of producer prices for the domestic market picked up 1 percentage point to 6.4 percent as compared with the previous quarter, yet this increase was ascribable solely to the regulated electricity prices. Overall, the annual growth rates of market prices slowed down, given the downtrend in prices of main commodities, the slower depreciation of the domestic currency in annual terms and the weak demand[14].

[13] In January-March 2013, according to the data released by the Ministry of Internal Affairs, the number of imported car registrations grew by 47 percent versus the same year-ago period.

[14] In 2013 Q1, the turnover volume in manufacturing for the domestic market (deflated by industrial producer prices) contracted by 5.4 percent in annual terms.

Therefore, energy was the only group of goods whose annual price dynamics accelerated by 4 percentage points to 8.8 percent, on the back of the production and supply of electricity and heating, given the ANRE decision to incorporate electricity producers' higher costs into the electricity bill[15] as of January 2013. In addition, the annual dynamics of producer prices in hydrocarbon processing slowed down to 0.2 percent from 9.3 percent in 2012 Q4, with the drop in international oil prices playing a significant part.

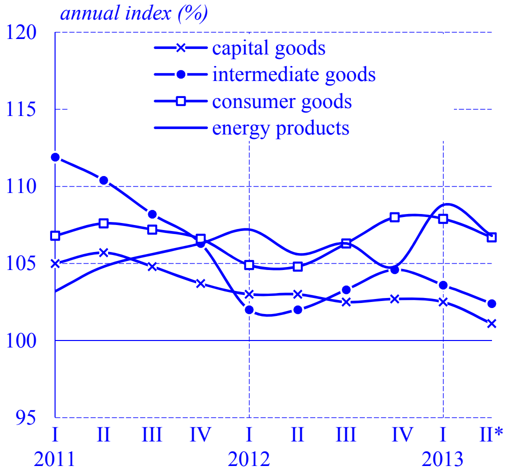
Decelerations were reported by the annual growth rates of producer prices for the other groups of industrial goods, which were sharper in the case of intermediate goods (down 1 percentage point), mainly as a result of price decreases in metallurgy. This sub-sector faced not only the weakness of demand, but also price competitiveness losses associated with high energy costs (which characterised the EU as a whole) vis-à-vis countries benefitting from the large volume of energy resources and/or government support.

The annual dynamics of producer prices for consumer goods slowed down marginally, i.e. by 0.1 percentage points to 7.9 percent, following the divergent developments across the main sub-groups. The highest annual growth rate of prices was recorded in food industry, yet the optimistic estimates on the agricultural crops (both domestically and globally) indicate a downtrend in the next quarters. In fact, the favourable outlook for this year's crops triggered the marked decline in the annual growth rates of agricultural producer prices in the first quarter of 2013 (by more than 8 percentage points versus the preceding quarter to 19.5 percent) in the case of both vegetable products (grains in particular) and animal products.

Looking ahead at the following quarter, the persistent downtrend in external prices of commodities, as well as the appreciation of the domestic currency against the major currencies in annual terms, will further contribute to abating the imported inflation pressures on domestic prices. The slowdown in the annual growth rate of producer prices for the domestic market seen in April-May 2013 (down to 4.9 percent) is likely to persist throughout the quarter, against the decline in prices on the deregulated electricity market[16] and the favourable prospects regarding the grain production both domestically and regionally (Russia, Ukraine)[17].

Industrial Producer Prices for Domestic Market by Industrial Products Group

annual index (%)

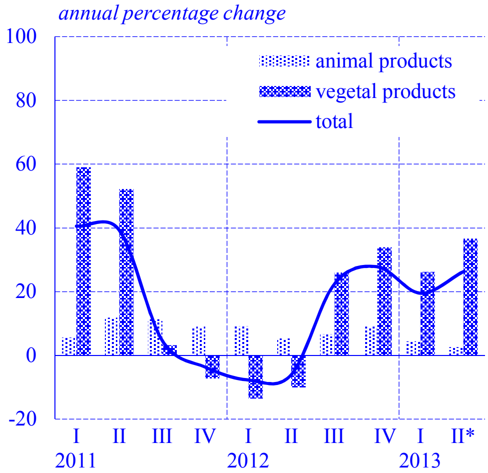


*) Apr.-May

Source: NIS

Agricultural Producer Prices

annual percentage change



*) Apr.-May

Source: NIS

15 Up 17 percent for Nuclearelectrica and 76 percent for Hidroelectrica, respectively.

16 In the context of further opening of the electricity market for industrial consumers, the average trading price on OPCOM stood 32 percent lower in May 2013 than in the similar year-ago period.

17 The acceleration in the first two months of the quarter is associated with an atypical increase in vegetable prices in May, the available information indicating a subsequent correction.

III. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In light of the improved inflation outlook, mainly over the short-term, the NBR embarked on a gradual adjustment of the monetary policy conduct as of 2013 Q2 so as to ensure the effective anchoring of inflation expectations. Specifically, the corridor defined by interest rates on the standing facilities around the policy rate was narrowed in May 2013. This measure, which was implemented amid the ongoing adequate management of liquidity in the banking system, was followed in July – in line with the central bank's forward guidance – by a 0.25 percentage point cut in the monetary policy rate, which had been kept at 5.25 percent for 15 months.

In its meeting of 2 May 2013, the NBR Board decided to extend the status quo of the monetary policy rate. At the same time, in order to moderate interest rate volatility on the interbank money market and consolidate the transmission of the policy rate signal, the NBR Board decided to narrow the corridor defined by interest rates on the standing facilities around the policy rate to ±3 percentage points from ±4 percentage points previously.

The decision to keep the policy rate unchanged at 5.25 percent was warranted by the need to counter the risks to inflation expectations stemming from the current[1] and forecasted annual inflation rates remaining significantly above the upper bound of the flat target band until the fading out of adverse supply-side shocks. Nevertheless, according to the updated projection of medium-term macroeconomic developments[2], the 12-month CPI inflation rate was expected to return inside the target band two quarters earlier than previously projected, namely towards the end of 2013 Q3, primarily on account of the more favourable contribution of supply-side factors[3]. At the same time, the forecasted annual inflation rate was seen remaining inside the flat target band in the longer run, similarly to the previous projection, driven mainly by the anticipated consolidation of the annual adjusted CORE2 inflation rate at levels below the midpoint of the target band, amid the protracted disinflationary pressures from the negative output gap (despite

[1] The annual inflation rate rose up to 5.97 percent in January 2013 from 4.95 percent in December 2012, under the impact of the electricity price hike and higher excise duties (given the change in the reference exchange rate used for their calculation), before declining slightly during the following months and to stand at 5.25 percent in March.

[2] The projection saw the annual inflation rate falling to 3.2 percent at end-2013, i.e. visibly lower than in the previous medium-term forecast (3.5 percent).

[3] Thanks to the downward revision of the anticipated annual dynamics of volatile prices and administered prices.

the downward revision[4] of its estimated size). Moreover, the risks to the inflation outlook posed by short-term developments in international agri-food commodity and energy prices, as well as by administered price adjustments, had subsided. The balance of risks to inflation associated with the evolution of capital inflows to the domestic economy had become relatively balanced, given that – depending on external economic and financial developments, and hence on shifts in global market sentiment, as well as on changes in investor perception towards the Romanian financial market – these inflows could put upward/downward pressure on the leu.

The subsequent maintenance of the inflation rate along the forecasted coordinates and especially the reconfirmed prospects, in light of the updated short-term projection, of a resumption in disinflation in July 2013 and a return of the 12-month inflation rate inside the flat target band in September/October warranted the resumption, in early 2013 H2, of the policy rate-cutting cycle discontinued in May 2012. Thus, the NBR Board decided in its meeting of 1 July to lower the monetary policy rate by 0.25 percentage points to 5.00 percent. Behind this decision stood also the steeper downtrend in the annual adjusted CORE2 inflation rate in the first two months of 2013 Q2 (2.7 percent in May versus 3.0 percent in March 2013), as well as the relative improvement in its short-term outlook, amid the expected fadeout of the influence of adverse supply-side shocks enabling the manifestation of the disinflationary impact exerted by the aggregate demand deficit. Although revised downwards vis-à-vis previous projections, the estimated size of the negative output gap remained significant, given the prospects of a slow recovery of the domestic economy owing to the protracted euro area recession and to the ongoing/faster deleveraging both at home and abroad. Domestic deleveraging was reflected by the annual dynamics of credit to the private sector[5] falling deeper into negative territory[6], the same as the annual rate of change of broad money.

The further drop in the average annual dynamics of credit to the private sector, to -7.2 percent from -5.2 percent in 2013 Q1, resulted from the swifter rates of decline of the leu-denominated component (-1.4 percent against -1.1 percent during the previous three months) and especially of foreign currency credit (-3.9 percent versus -3.1 percent in the first quarter of the year, based on readings expressed in euro), to which added the statistical effect of exchange rate developments. The breakdown by recipient was in line with the results of the May 2013 NBR survey on lending to households and non-financial corporations, according to which banks anticipated that the fall in corporate and household demand for loans would continue/resume in 2013 Q2, along with

4 Following the upward revision of historical data and especially of the forecasts on GDP dynamics.

5 Annual changes in real terms, unless otherwise indicated.

6 April through May 2013.

the renewed tightening of most lending standards. However, unlike the previous periods, the most visibly affected were non-financial corporations, with their annual credit dynamics plunging deeper into negative territory, i.e. -6.9 percent April through May versus -3.6 percent in 2013 Q1. Behind this stood the ongoing decline in the dynamics of the foreign currency component (-6.3 percent against -4.2 percent in the previous three months, based on readings expressed in euro) and the markedly slower growth rate of leu-denominated credit (2.3 percent from 4.5 percent in 2013 Q1). The annual rate of change of household loans also contracted further, albeit at a somewhat slower pace, standing at -7.5 percent versus -6.2 percent in the first quarter of the year. The annual dynamics of consumer credit followed a relatively less steep downward path, while the annual growth rate of housing loans slowed further. Nevertheless, the latter was exclusively due to the statistical effect of the stronger domestic currency in annual terms, given that the leu-denominated component of housing loans continued to expand at a considerably quicker pace (24.2 percent against 18.9 percent in the previous three months) and the growth rate of the foreign exchange component (expressed in euro) edged up marginally.

In line with these developments, the annual dynamics of broad money reverted to a downward trajectory (-2.3 percent on average April through May), after the relative improvement seen at the end of 2013 Q1 (-1.1 percent in March). The deterioration was ascribable, on the one hand, to the annual dynamics of narrow money (M1) re-embarking on a downward path and, on the other hand, to the decline in the annual rate of change of time deposits with a maturity of up to two years, especially in the households sector. The behaviour of household deposits was only to a small extent linked to developments in the average real net wage, its potential determinants being households' keener appetite for investment in other financial assets (shares included) during the reported period and the highly likely increase in the volume of loan repayments.

The central bank continued to pursue adequate management of liquidity during 2013 Q2, in line with the decisions taken by the NBR Board. In particular, the monetary authority accommodated credit institutions' liquidity needs through one-week repos conducted via auctions without a ceiling, namely with full allotment. Amid the further easing of liquidity conditions, also on account of the relative increase in liquidity injections generated by autonomous factors, interbank rates stuck to their downtrend, with longer-term market rates seeing a steeper decline. In the latter part of the quarter under review, overnight rates returned to somewhat higher readings, following the temporary trend reversal in autonomous liquidity factors. These developments were accompanied by lower ON rate volatility, as a result of narrowing the corridor defined by interest rates on the standing facilities around the policy rate. Longer-term rates also trended upwards, although remaining below the monetary policy rate, as the central bank's forward guidance led to the adjustment of expectations on the policy rate path in the period ahead.

2. Financial markets and monetary developments

Average interbank money market rates continued to shrink in 2013 Q2, the same as most lending and time deposit rates on new business March through May 2013. The EUR/RON exchange rate witnessed heightened volatility April through June, amid larger fluctuations in global risk appetite. The decline in the annual dynamics of broad money temporarily came to a halt, exclusively on the back of higher budget expenditures and larger disbursements from European funds, while the annual rate of change of credit to the private sector stuck to its downward trend.

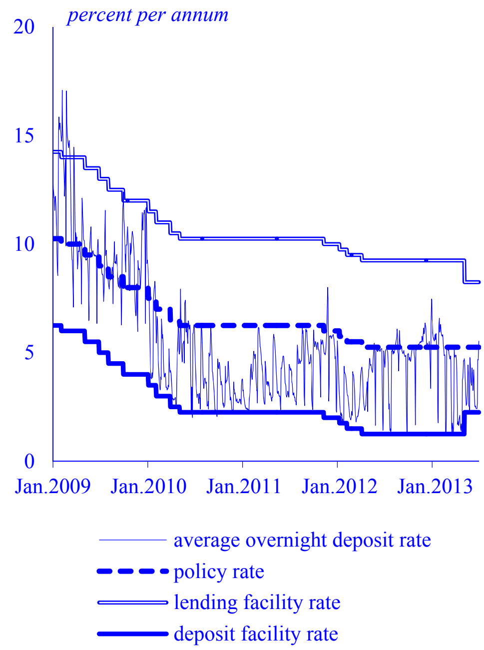
2.1. Interest rates

Interbank money market rates remained on a steep downtrend in the first part of 2013 Q2, with their monthly average dropping to a historical low[7] of 2.81 percent in April. Afterwards, these rates witnessed a slight correction and returned in the vicinity of the monetary policy rate. However, looking at the second quarter overall, average interbank rates stood below the previous quarter's reading, i.e. 3.42 percent versus 4.81 percent.

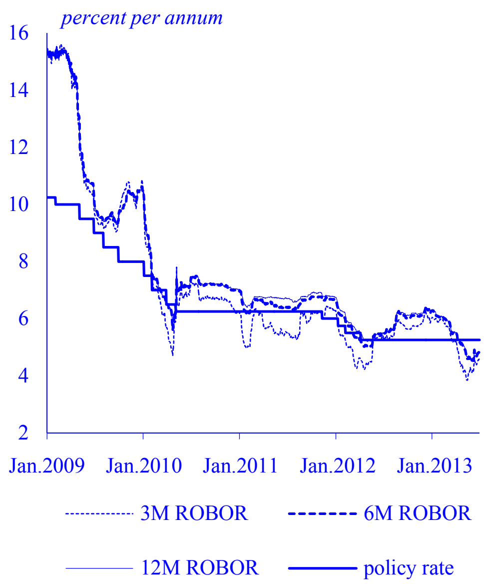
Overnight rates fluctuated in the first part of the period under review close to the lower bound of the corridor defined by interest rates on the central bank's standing facilities around the policy rate. This reflected the persistent easing of money market liquidity conditions, also underpinned by the central bank further conducting repo tenders without a ceiling, via weekly operations with full allotment. Nevertheless, the volume of these operations shrank during the reported quarter compared to the previous period, given the net liquidity injection resulting from autonomous factors. In the latter part of the quarter, overnight rates on the interbank money market trended upwards towards the monetary policy rate, amid the temporary renewed rise in liquidity absorptions by the Treasury and in non-residents' demand for domestic currency. However, overnight rate volatility abated, on account of the narrower corridor defined by interest rates on the standing facilities around the monetary policy rate.

All longer-term interbank rates, including at the longer end of the maturity spectrum, declined in April below the policy rate. Their downward path steepened in May, given the adjustment of credit institutions' expectations on the outlook for liquidity conditions and the policy rate path. Subsequently, ROBOR rates recorded a slight increase, before stabilising towards the end of the quarter at levels

Interbank Money Market Rates



Policy Rate and ROBOR Rates

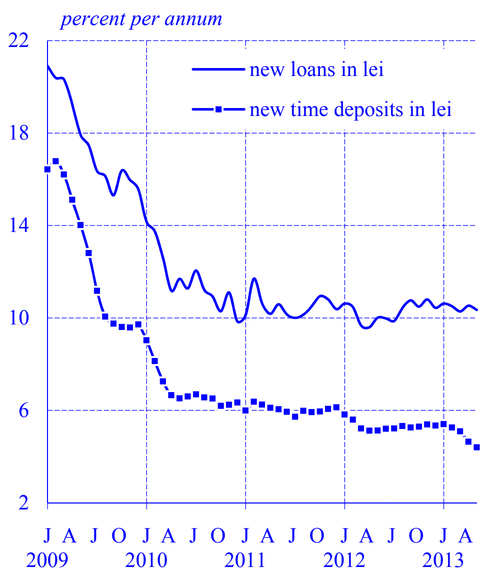


[7] The data series spans the past 20 years.

around 0.4-0.6 percentage points below the monetary policy rate. Hence, average 3M ROBOR rates came in at 4.45 percent in June, 0.91 percentage points shy of the March reading, while average 6M and 12M ROBOR rates witnessed declines of a somewhat similar magnitude, to stand at 4.72 percent and 4.77 percent respectively.

In turn, the path followed by government security yields reflected both the impact exerted by the persistently loose liquidity conditions and by the adjustment of credit institutions' expectations on the policy rate outlook and investors' further keen interest in this type of investment. Against this background, the maximum accepted bid rate on the primary market for government securities continued to drop until mid-May. Afterwards, it posted an upward correction[8], broadly in line with other emerging markets, owing mainly to the significant deterioration in global risk appetite, implying a fall in non-resident investors' demand for bonds (according to interbank forex market developments and evidence). Therefore, after the volume of securities issued had stayed in the vicinity of the announced volume in April and May, the ratio of the two volumes dropped below par in June, when the MPF fully rejected – for the first time in the past ten months – the bids submitted at several auctions for government securities. Nonetheless, the total volume of securities issued during 2013 Q2 as a whole, i.e. lei 8.4 billion (as compared with lei 18.4 billion in Q1), exceeded the volume of maturing debt instruments, with bonds further holding the largest share, namely 85 percent of the issued volume (against 74 percent in the first quarter of the year).

Bank Rates



Benchmark rates on the secondary market for government securities moved in step with primary market rates, witnessing a trend reversal in mid-May, yet without exceeding the March 2013 readings. The volume of transactions rose compared to 2013 Q1, primarily on the back of the larger volume of outright transactions in April and May.

In line with the downward trend of ROBOR rates, average interest rates on new time deposits and new loans continued to drop March through May 2013, by 0.86 percentage points (to 4.40 percent in May) and 0.16 percentage points (to 10.35 percent in May) respectively, with convergent developments across the major customer categories. Specifically, average time deposit rates on new business contracted both for non-financial corporations (down 1.18 percentage points to 3.86 percent) and for households (down 0.39 percentage points, to 5.14 percent in May). At the same time, the average lending rate on new business to households shed 0.81 percentage points (to 11.84 percent in May), reflecting the downward adjustments across the major loan categories. The average interest rate on new loans to non-financial corporations also recorded a decline, albeit of a lower magnitude

[8] Despite remaining considerably below the December 2012 readings.

(down 0.12 percentage points, to 9.46 percent in May), while posting volatile monthly developments, due *inter alia* to the relatively larger share of low-value new loans (up to 1 million EUR equivalent, at an above-average lending rate) in total new business to corporates.

2.2. Exchange rate and capital flows

The EUR/RON exchange rate witnessed sudden and frequent trajectory shifts during 2013 Q2, owing exclusively to heightened volatility of global risk appetite, amid a sequence of mixed signals on the outlook for the monetary policy stance of the major central banks. On the other hand, domestic factors exerted a steadily favourable influence on the exchange rate.

The EUR/RON exchange rate embarked on a downward path in April, thanks to the higher global risk appetite, underpinned by (i) Bank of England's decision to continue the asset purchase programme and especially by (ii) Bank of Japan announcing new stimulus measures, *inter alia* via doubling its purchase of government bonds, as well as by (iii) ECB rate cut expectations. The stronger domestic currency was also driven by the relatively good performance – vis-à-vis analysts' expectations – of some relevant indicators released in April, namely 2012 Q4 GDP (provisional data), the trade balance and current account balance for January and February 2013, industrial output and retail sales as of February 2013.

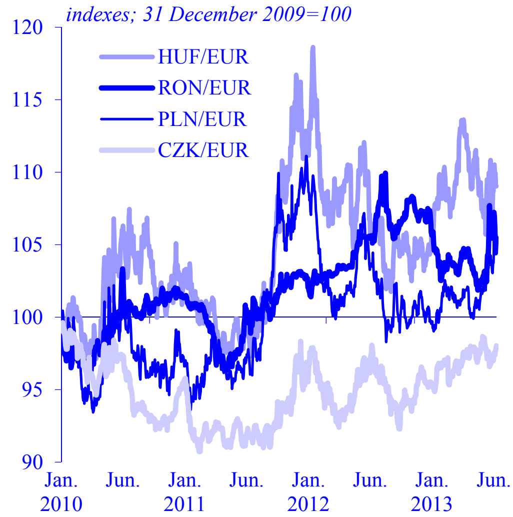
After hitting a low for this year so far on 29 April 2013, the EUR/RON exchange rate re-entered an upward path in May, with the other currencies in the region weakening versus the single currency as well, owing to the adverse impact exerted on global financial market sentiment by (i) Fed officials' statements/ comments on a possible adoption in the following months of a decision to scale back the asset purchasing programme, and possibly by (ii) worsening expectations on the performance of the euro area economy, following the larger-than-expected contraction in 2013 Q1. However, the depreciation pressure on the leu was less intense than on its regional peers[9], thanks to investors' further keen interest in leu-denominated financial assets, prompted by (i) the ongoing attractive yields of government securities in domestic currency, (ii) better-than-expected developments in several indicators released during the reported period[10], as well as by (iii) the Commission's recommendation to abrogate the excessive deficit procedure for Romania.

Key Financial Account Items (balance)

EUR million

	2012 5 mos.	2013 5 mos.
Financial account	**564**	**-1,289**
Direct investment	**619**	**347**
- residents abroad	-37	-67
- non-residents in Romania	656	414
Portofolio investments and financial derivatives	**1,336**	**4,117**
- residents abroad	-261	-388
- non-residents in Romania	1,598	4,504
Other capital investments	**1,247**	**-4,075**
- credits and loans from the IMF	0	1,813
- medium- and long-term investments	448	-1,588
- short-term investments	-741	-222
- currency and short-term deposits	-1,118	488
- other	164	-938
NBR's reserve assets, net ("-" increase/"+"decrease)	**-145**	**-1,679**

Exchange Rate Developments on Emerging Markets in the Region

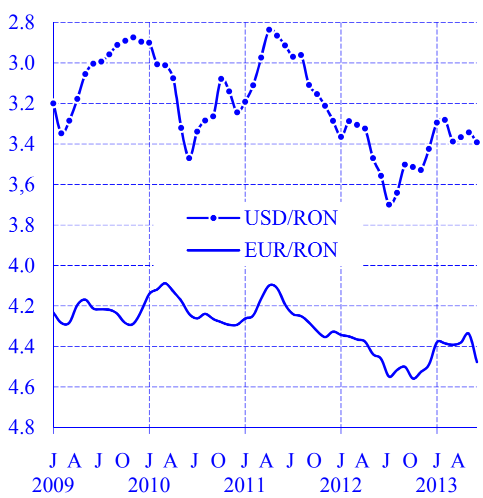


Source: NBR, ECB

9 The domestic currency depreciated versus the euro at a relatively slow pace in May, so that the average EUR/RON exchange rate stood 1.0 percent lower than in April. At the same time, the Polish zloty and the Czech koruna weakened in nominal terms against the single currency by 1.0 percent and 0.2 percent respectively.

10 Current account balance and GDP for 2013 Q1 – flash estimate, along with the industrial output volume recorded in March.

Nominal Exchange Rate



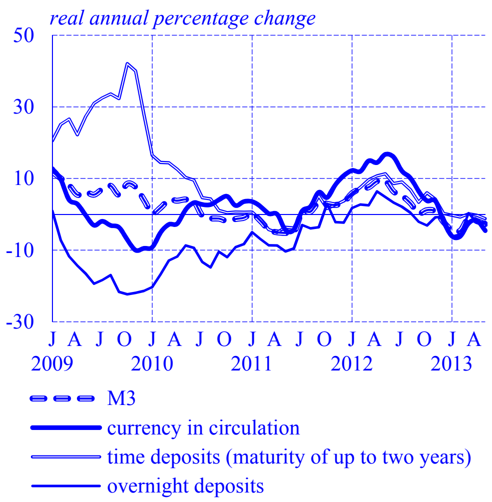
Annual Growth Rates of M3 and Its Components

real percentage change

	2012			2013		
	II	III	IV	I	Apr.	May
	quarterly average growth					
M3	8.3	2.9	-0.1	-3.3	-1.9	-2.7
M1	8.5	3.4	-0.4	-4.2	-2.1	-3.0
Currency in circulation	15.7	9.6	1.8	-4.9	-1.7	-4.6
Overnight deposits	4.8	0.2	-1.6	-3.8	-2.3	-2.1
Time deposits (maturity of up to two years)	10.2	6.4	3.5	-0.3	-0.2	-1.2

Source: NIS, NBR

Main Broad Money Components



Source: NIS, NBR

The daily fluctuations of the EUR/RON exchange rate increased in June, with the domestic currency posting relatively large depreciation episodes, amid the considerable rise in the volatility of capital flows, especially towards emerging economies, induced by the exacerbated sensitivity of the global financial markets to potential hints on the Fed's upcoming policy decisions[11]. Against this backdrop, non-residents' excess demand for foreign currency on the interbank forex market picked up, reflecting *inter alia* a possible reduction in their holdings of leu-denominated government securities, while the average EUR/RON exchange rate went up 3.1 percent.

April through June, the domestic currency weakened versus the euro by 1.9 percent in nominal terms and 1.6 percent in real terms. In relation to the US dollar, the leu weakened by a mere 0.1 percent in nominal terms, while strengthening 0.2 percent in real terms, given the former's depreciation on global financial markets. Looking at the average annual exchange rate dynamics in 2013 Q2, however, the domestic currency appreciated vis-à-vis both currencies.

2.3. Money and credit

Money

March through May 2013, broad money (M3) dynamics[12] posted less negative readings, i.e. -1.9 percent versus -3.7 percent December 2012 through February 2013, due to higher budget expenditures and to the March increase in disbursements from European funds, as well as to potential corporate portfolio shifts from government securities and deposits with a maturity of over two years to M3 deposits. These influences more than offset the unfavourable impact on liquidity exerted by the ongoing decline in the dynamics of private sector credit – owing to balance sheet adjustments across various categories of economic agents, banks included – and by the statistical impact of the change in the EUR/RON exchange rate.

The slower rate of decline of M3 was ascribable to the improved performance of narrow money, whose negative dynamics decelerated as a result of the contribution of currency in circulation and leu-denominated overnight deposits of both households and companies. By contrast, time deposits with a maturity of up to two years contracted at a slightly faster pace, owing exclusively to the decline in the rate of change of household deposits, which entered negative territory for the first time in the past seven and a half years.

[11] Such as the US job market report in June, the Fed meeting and Chairman Ben Bernanke's statements during the 19 June press conference.

[12] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March through May 2013.

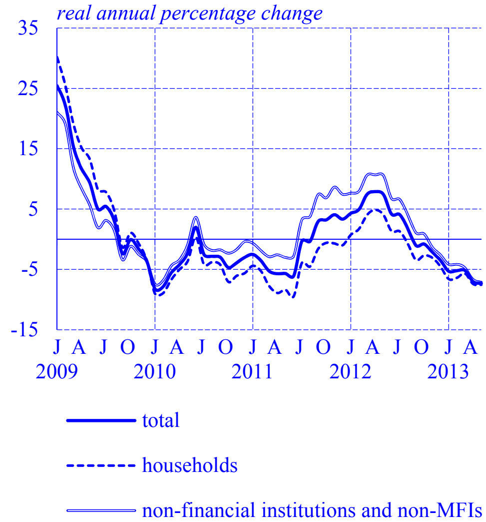
The M3 breakdown by holder shows a pick-up in the dynamics of corporate deposits, both in the case of non-financial corporations and that of non-monetary financial institutions, on account of (i) the increase in some budget expenditures and in the volume of disbursements from structural funds[13], (ii) these entities' more visible shift towards investments in deposits, and (iii) the higher mandatory contributions to Pillar II of the pension system. Conversely, the pace of increase of M3 household deposits slowed further, possibly due to portfolio shifts from deposits to share holdings[14] and to larger repayments on bank loans. Looking at the M3 breakdown by currency, the average share of foreign currency-denominated deposits narrowed slightly, given the statistical effect of the EUR/RON exchange rate and the relative improvement in the rate of change of leu-denominated deposits.

From the perspective of major M3 counterparts, the improved dynamics of broad money reflected the slower pace of decline of central government net credit and the more sluggish growth rate of long-term financial liabilities (capital accounts included). These influences were partly offset by the unfavourable impact of the slacker dynamics of credit to the private sector and of net foreign assets of the banking sector.

Credit

March through May 2013, the dynamics[15] of credit to the private sector plunged deeper into negative territory, reaching -6.5 percent from -4.7 percent during December 2012-February 2013. The decline was manifest for both households and companies and was associated with the ongoing subdued demand for loans and the tighter credit supply conditions[16]. The currency breakdown shows that the dynamics of both components stuck to a downward path, although somewhat less steep for forex-denominated credit (expressed in euro). Along with the statistical effect of the

Credit to Private Sector by Institutional Sector



Source: NIS, NBR

[13] According to press releases by the Ministry of European Funds and the Agency for Payments and Intervention in Agriculture, the period under review saw additional expenditures on disbursements in agriculture, repayments of outstanding amounts to recipients of structural and cohesion funds, clearing of local governments' debt arrears, as well as disbursements from the national healthcare fund.

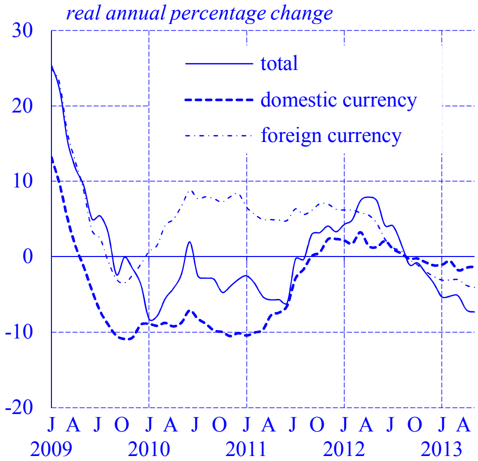
[14] According to the BSE press release, April 2013 saw the secondary public selling offer for 15 percent of state-owned Transgaz shares, a large part of which was purchased by households, which were offered a discount on the selling price; moreover, according to a press release by Banca Transilvania, shareholders subscribed a large part of the convertible bonds issued in May 2013.

[15] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March through May 2013.

[16] According to the latest NBR survey on lending to households and non-financial corporations, credit demand held steady in 2013 Q1, except for demand for consumer loans, which witnessed a decline. At the same time, lending standards became much more restrictive, particularly in the case of loans to non-financial corporations and housing loans. Banks expected most of these trends to persist into 2013 Q2.

Credit to Private Sector by Currency

real annual percentage change



Source: NIS, NBR

EUR/RON exchange rate, this resulted in the average share of foreign currency credit in total credit to the private sector remaining at a two-year low.

The dynamics of household loans declined further – although at a slightly slower pace than in the previous period – on the back of consumer loans in foreign currency and other loans. However, the rate of change of consumer credit in domestic currency posted less negative readings for the first time in the past year, thanks to banks extending their promotional offers. In turn, the pace of increase of housing loans picked up further, largely on account of the leu-denominated component, most likely as a result of the NBR regulations governing household loans[17].

By contrast, the pace of decline of credit to non-financial corporations remained somewhat unchanged – amid the lower volume of new business[18] – reflecting the faster contraction of short-term loans. Both the foreign currency component and the leu-denominated one saw their dynamics decline, with the latter following a steeper path.

[17] NBR Regulation No. 24/2011 on lending to households.

[18] Based on Central Credit Register data referring to loans in excess of lei 20,000 approved in the period under review compared to the same year-earlier period reading.

IV. INFLATION OUTLOOK

The baseline scenario of the current projection places the annual CPI inflation rate at 3.1 percent at end-2013 and end-2014, 0.1 and 0.2 percentage points respectively below the May 2013 Inflation Report projected rates.

The updated inflation forecast entails reassessments of the contributions from the price dynamics of the main consumer basket items. Thus, compared to the previous round, for both 2013 and 2014, the downward revision of the end-of-year projections is ascribed to the lower contributions from administered price dynamics and the adjusted CORE2 inflation, as well as from fuel price dynamics for end-2014. In 2013, the impact of factors having a more favourable contribution to inflation developments than previously projected is foreseen to be partly offset by upward revisions of the growth rates of prices of volatile food items (VFE), fuel prices and excise duties (on tobacco products and alcohol).

The projection foresees the fast curbing of the annual inflation rate to 3.0 percent in September 2013 from 5.37 percent in June. Inflation rate is subsequently envisaged to be no higher than 3.1 percent by the end of 2014, touching a 2.1 percent low in 2014 Q1. For 2015 H1, inflation rate is projected to rise slightly to 3.3 percent, thus remaining inside the target band.

The projected significant disinflation over the first part of the projection interval is based on the assumption, included in the baseline scenario, of normal crops in 2013, compared to the terribly weak harvest of 2012. This implies the gradual fading-out of detrimental supply-side shocks manifest last year and the shift from an adverse statistical base effect to a favourable one, which is anticipated to have a beneficial influence on the price dynamics of VFE and of processed food items included in the adjusted CORE2 index. An additional key contributor to the curbing of inflation will be the slowdown in the annual rates of increase of administered prices and tobacco product prices expected by the end of 2014 Q1.

The adjusted CORE2 inflation rate is projected to stick to the downward path it embarked upon in 2013 H1 and bottom out at 1.8 percent in 2013 Q3 and Q4. Apart from the already mentioned fading-away of the adverse supply-side shocks manifest in 2012, but still related to it, the slowdown in core inflation will be underpinned by a gradual improvement in inflation expectations as a result of pursuing an adequate monetary policy stance over the next eight quarters.

The core inflation projection foresees below-2-percent rates by mid-2014. For the remaining part of the reference period, assuming the consolidation of economic activity in Romania, reflected by *a slight abatement of disinflationary pressures coming from the negative output gap, and amid a gradual fading of the favourable base effects of 2013, the adjusted CORE2 inflation rate is expected to go up and remain at levels slightly above 2 percent.*

Compared to the previous projection, the adjusted CORE2 inflation rate was revised downwards for most of the forecasting interval (by -0.2 and -0.1 percentage points for end-2013 and end-2014 respectively) considering slower projected growth rates for import prices and processed food prices, and lower inflation expectations. The persistence of the negative output gap is further seen generating disinflationary pressures, albeit lower than in the previous forecasting round, against the background of the revision of the GDP deviation from its potential to less negative levels.

The projected monetary policy stance will further seek to prudently calibrate real broad monetary conditions so as to ensure that inflation rate returns and consolidates inside the target band, while also paving the way for a gradual recovery of lending to the private sector and a sustainable resumption of economic growth. According to the NBR Board assessment, to fulfil these goals in the near run is compatible with a gradual easing of the monetary policy stance conditioned on an effective anchoring of inflation expectations and the absence of domestic or global adverse shocks in the short term.

The assessment of risks associated with the current inflation rate projection points to a balance tilted to the downside in the short term, i.e. towards downward deviations from the baseline scenario, whereas upwards deviations appear to be somewhat more pronounced over the medium term. In the near run, inflation rate may fall lower than projected, in view of the incoming information after the macroeconomic forecast was completed and therefore left out of the baseline scenario. Special mention deserve the signals on domestic bumper crops of volatile food items (VFE) and of some raw materials for processed foodstuffs, as well as the government's announcement on cutting the VAT rate applied to flour and bread as of 1 September 2013.

The external environment is still saddled with uncertainty and therefore remains the source of risks which, if they were to materialise, could trigger adverse shocks on inflation. These risks are mainly associated with possibly higher volatility of capital flows channelled towards the Romanian economy in the broader context of shifts in investors' risk appetite relative to the emerging economies as a whole. A major uncertainty source is the time horizon needed for a recovery in the GDP dynamics of Romania's major EU trade partners, given the repeated downward revisions of the EU Member States' economic growth forecasts and the persistence of sovereign debt sustainability issues and those related to the quality of banks' balance sheets in some euro *area countries. Unfavourable deviations of external demand from the path shown in the baseline scenario would dampen domestic economic growth. This would cause investor sentiment vis-à-vis Romania's economic outlook to worsen, which is likely to have a negative impact on the risk premium attached to non-residents' investment in local currency, and put a damper on the capital flows aimed at financing the domestic economy. In addition, the uncertainty about the magnitude and timing of the Fed tapering its quantitative easing across the US financial system could, via the declining global risk appetite, add to the threat of diminished capital flows to emerging economies, Romania included. Regardless of their origin, if substantial cuts in financing resources for economic growth were to materialise, the leu could face depreciation pressure, entailing negative effects on price and financial stability.*

On the domestic front, the persistent structural rigidities across the Romanian economy prevent the adjustment of economic factors from more effectively mitigating the consequences of adverse shocks stemming from either external or domestic sources. Consequently, any delay in achieving a consistent mix of structural reforms, such as that embedded in the arrangement concluded by the Romanian authorities with international institutions (the European Union, the International Monetary Fund and the World Bank), brings about spillover risks and could even magnify the unfavourable shocks on inflation and economic growth.

Given the updated baseline scenario assumptions, the balance of risks to the developments in administered prices in the reference period appears to be relatively in equilibrium. The future dynamics of global commodity prices continue, in this forecasting round as well, to be a relevant risk factor especially over the medium term, ahead of which global demand is unlikely to see a solid recovery.

1. Baseline scenario

1.1. External assumptions

The scenario for external economic growth foresees the effective EU GDP[1] to decline by 0.19 percent in 2013 and to increase by 1.40 percent in 2014, with both values being revised downwards compared with the previous Report[2]. For this year, the revision is attributed to the further expected reduction in the indebtedness of the private sector in some countries and the still low levels of business confidence. The projection of a slight economic recovery

Expectations on the Developments in External Variables

annual average

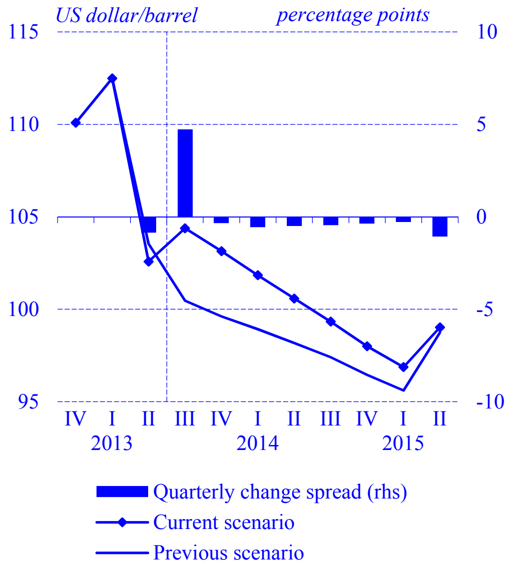
	2013	2014
Brent oil price (USD/barrel)	105.7	99.9
USD/EUR exchange rate	1.30	1.27
3M EURIBOR interest rate (% p.a.)	0.20	0.33
Effective EU economic growth (%)	-0.19	1.40
Annual inflation rate in the euro area (%)	1.49	1.48

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

1 EU-28 excluding Romania. The indicator is calculated based on Romania's exports breakdown by EU country. Starting with this projection round, Croatia was included among EU Member States, which did not have, however, a material influence on the revision of the effective EU GDP growth.

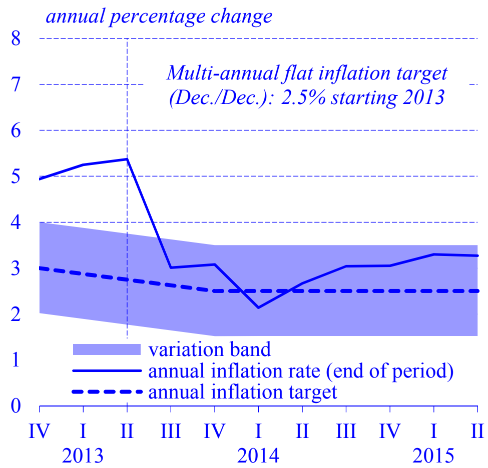
2 The new figures suggest a more restrictive impact of the effective EU output gap on the deviation of domestic GDP from its trend compared to the previous forecast.

Brent oil price scenario



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

Inflation Forecast



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

Source: NIS, NBR projections

Annual Inflation Rate in the Baseline Scenario

annual percentage change (end of period)

	2013		2014				2015	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Target		2.5				2.5		
Forecast	3.0	3.1	2.1	2.7	3.0	3.1	3.3	3.3

in 2014 is based on the improvement, over this horizon, anticipated for both the global demand for euro area exports and the euro area domestic demand as a result of the ECB's accommodative monetary policy, which is expected to be kept in place.

The annual HICP inflation rate in the euro area is foreseen to drop considerably versus 2012 and stay below the 2 percent benchmark for price stability, i.e. at 1.5 percent in both 2013 and 2014. This decline is attributed to the expected deceleration in the energy price dynamics, corroborated with the persistence of disinflationary pressures anticipated to stem from the negative output gap throughout the forecast interval, as well as with the firm anchoring of economic agents' inflation expectations to low levels.

The 3M EURIBOR rate is seen falling to a historical low in 2013, under the influence of the ECB's monetary policy conduct, before increasing marginally in 2014. In line with the downward revised outlook for economic growth in the EU and the euro area, the euro is expected to depreciate slightly versus the US dollar and reach 1.27 USD/EUR in 2014 Q2, a level assumed to be kept unchanged, with very small fluctuations, until the projection horizon.

The scenario on the international Brent oil price, based on futures prices[3], envisages a gradual decline starting with 2013 Q4[4], ahead of resuming positive growth rates at the end of the projection horizon, owing to the progressive pick-up in the global economic growth over this horizon.

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 3.1 percent at end-2013 and end-2014, i.e. inside the variation band around the central target[5]. Compared to the May 2013 Inflation Report, the projected values are marginally lower, i.e. by 0.1 percentage points and 0.2 percentage points respectively at the end of 2013 and 2014. For end-2013, the downward revision of the annual CPI inflation rate is ascribed to the lower contributions from administered prices and the adjusted CORE2 inflation, given the relatively faster dynamics of volatile food prices (VFE), fuel prices and excise duties on tobacco products and alcohol. Administered prices and the adjusted CORE2 inflation, along with fuel prices, are expected to further spur disinflation during 2014, whereas the annual dynamics of the other CPI subcomponents are seen to have contributions relatively similar to those previously forecasted.

[3] Source: Bloomberg (futures prices as at 9 July 2013).

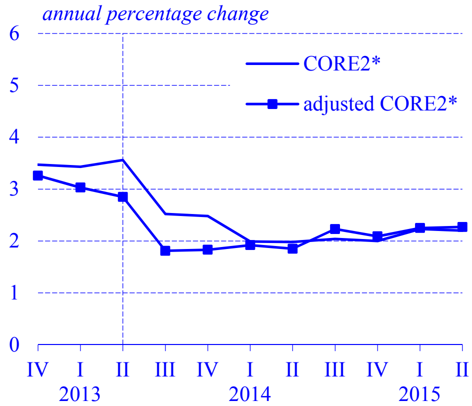
[4] In the assumption of non-escalating geopolitical tensions in the Suez Channel area.

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

Against the background of the developments supportive of disinflation in all CPI components, the annual price dynamics are foreseen to slow down markedly in the first part of the projection interval, returning inside the variation band around the central target in 2013 Q3 and falling into the lower half of the variation band in 2014 Q1. The major contributors to the significant deceleration in the annual CPI inflation are VFE prices and processed food prices included in the adjusted CORE2 index, due to the fading-out of the adverse supply-side shocks related to the weak harvest of 2012 and based on the increasingly plausible assumption of normal crops in 2013. Under the favourable influence of the base effects associated with the alleviation of these shocks, which is foreseen to contribute to the economic agents' inflation expectations heading downwards[6], the annual adjusted CORE2 inflation rate is projected to decline to 1.8 percent in September 2013 and remain close to this level until the end of 2013. In 2014, under the impact of the consolidation of economic activity in Romania, reflected by a slight abatement of disinflationary pressures coming from the negative output gap, and amid a gradual fading of the favourable base effects, the annual dynamics of adjusted CORE2 inflation rate are expected to accelerate somewhat to reach 2.1 percent at year-end[7].

Compared to the May 2013 Inflation Report, the projected path of the annual adjusted CORE2 inflation rate was revised downwards by 0.2 percentage points and 0.1 percentage points respectively at the end of 2013 and 2014. To this contribute the lower inflation expectations of economic agents[8], the downward revision of the processed food price dynamics and the slower projected growth rates for import prices. The import price dynamics have a stronger disinflationary impact throughout the reference period, given that the lower unit value index of imports of consumer goods[9] in 2013 Q1 is anticipated to persist in the following quarters, being underpinned by the assumption of decelerating external price dynamics as compared with the previous projection round. Over the projection horizon, the revision of the output gap to less negative levels as compared with the previous forecasting round is seen to exert relatively less favourable influences on the annual dynamics of the adjusted CORE2 inflation.

Annual CORE2 Inflation and Annual Adjusted CORE 2 Inflation



*) end of period

Source: NIS, NBR projections

The scenario for the alcohol and tobacco product price inflation path was primarily assessed based on the 2013 Tax Code stipulations

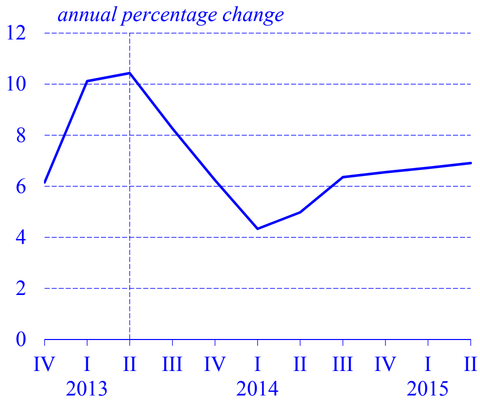
6 Due to the non-anticipation of significant supply-side shocks over the following quarters of the reference period, as well as to the maintenance of a prudent monetary policy stance.

7 A level similar to that recorded by the adjusted CORE2 inflation in 2012 Q2, before the supply-side shock associated with that year's weak crops was manifest.

8 Mainly on account of the increasingly low likelihood of significant adverse shocks to become manifest over the following quarters.

9 The unit value index of imports of consumer goods (excluding motor vehicles and fuels) decreased by 1.3 percent in 2013 Q1 versus 2012 Q4, against the background of relatively low external inflation rates.

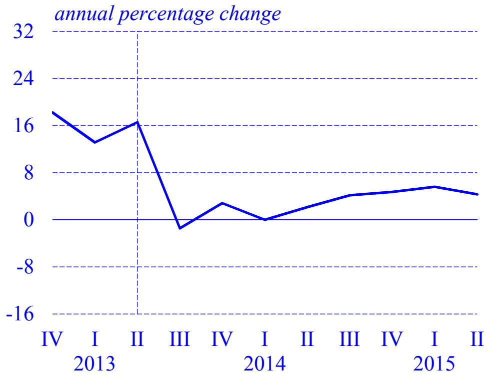
Administered Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

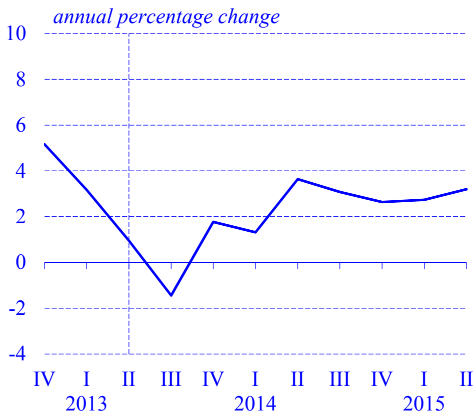
Vegetables, Fruit and Eggs Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

Fuel Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

regarding the change in excise duties and on the updating of the reference exchange rate (to the projected levels) used to calculate their lei equivalent. Compared with the previous projection, the contribution of this component to CPI inflation at end-2013[10] was revised only marginally upwards and remained unchanged for end-2014.

The scenario for administered price dynamics includes the information on the calendars for the deregulation of electricity and natural gas prices approved by the ANRE, the indications provided by the OPCOM electricity prices and the latest developments in these price categories. The annual dynamics of administered prices are projected to stand at 6.2 percent in December 2013 and 6.6 percent at end-2014, i.e. below the levels foreseen in the previous forecasting round by 2.2 percentage points and 0.7 percentage points respectively. This reassessment was solely attributable to the revision of assumptions on electricity price developments, given the slower-than-expected price growth in 2013 Q2 and the similar developments forecasted for the subsequent quarters[11].

In the increasingly plausible assumption of normal crops in 2013, the annual VFE inflation rate is expected to go down markedly during 2013 Q3, amid the fading-out of the unfavourable impact from the weak harvest of 2012. Over the remaining part of the projection interval, the annual VFE inflation rate is foreseen to post relatively stable dynamics, marked by seasonal effects specific to these consumer basket items. This component makes a 0.2 percentage point contribution to the annual CPI inflation rate in December 2013, i.e. 0.4 percentage points higher than in the previous round[12], while the contribution for 2014 is expected to remain at about 0.3 percentage points.

Starting from the low levels recorded in 2013 Q2, the annual fuel price inflation is projected to rise to 1.8 percent at end-2013 and to 2.6 percent at end-2014[13]. Compared with the previous forecasting round, the projections were revised upwards by 0.8 percentage points in 2013 and downwards by 0.7 percentage points in 2014. Behind the reconfiguration of the fuel inflation path

10 By about 0.1 percentage points due to higher-than-previously-expected retail prices of such products in 2013 Q2.

11 Extrapolating the short-term data provided by OPCOM electricity prices. These prices indicate lower values than those assessed in line with the information on the deregulation of electricity prices, being influenced by a wider range of determinants, such as the development of the alternative energy markets or the weakening world demand for conventional energy in favour of renewable energy.

12 As a result of the relatively less favourable developments recorded in 2013 Q2 triggered by the atypical increases in external prices for "citrus and other meridional fruit", on the one hand, and by the gradual fading-out of the favourable base effects, on the other.

13 Given a scenario envisaging a rise in the international Brent oil price in 2013 Q3, its influence being heightened by the recent depreciation of the leu versus the US dollar.

stood the less favourable level of the international Brent oil prices in 2013 Q3 and more favourable developments in such prices over the remaining reference period, the projected EUR/USD exchange rate movements with a more unfavourable impact on the USD/RON exchange rate[14] throughout the forecast interval, as well as the marginal downward revision of economic agents' inflation expectations.

On the whole, the cumulative contribution of components exogenous to the monetary policy influence – namely administered prices, prices of volatile food items (VFE), prices of fuels and prices of tobacco products and alcohol – to the annual CPI inflation rate stands at 2 percentage points at end-2013 and 1.8 percentage points at end-2014.

Components' Contribution to Annual Inflation Rate*

percentage points

	2013	2014
Administered prices	1.1	1.2
Fuels	0.1	0.2
VFE prices	0.2	0.3
Adjusted CORE2	1.1	1.2
Tobacco products and alcohol	0.6	0.1

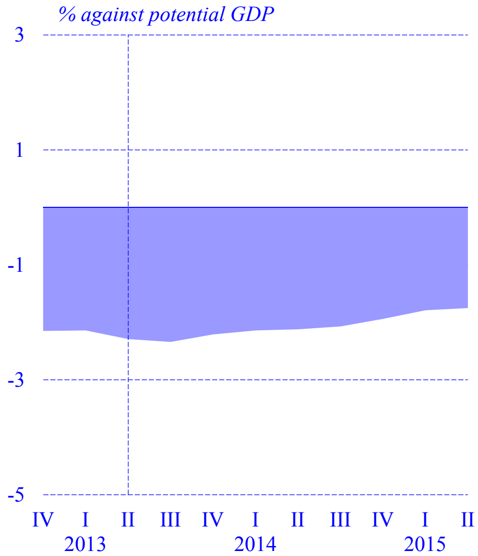
** end of period; contributions based on 2-decimal data add up to CPI inflation*

1.3. Demand pressures in the current period and over the projection interval[15]

Output gap

As compared with the previous forecasting round, the dynamics of real GDP for the last quarters underwent revisions, among which the upward revision in 2012 Q4[16] stands out. Based on the latest data series released by the NIS, in 2012 Q4 and 2013 Q1, real GDP saw notable quarterly increases (0.9 percent and 0.6 percent respectively), which, along with the main monthly macroeconomic indicators, support the formulation of a positive quarterly forecast, yet slightly lower in 2013 Q2.

GDP Deviation



Source: NIS, NBR projections

The potential GDP projection is based mainly on the positive contributions of the capital stock[17] and total factor productivity, while labour makes only a marginal positive contribution amid the anticipated slower recovery of the labour market. Thus, the potential GDP growth for the current year is expected to be slightly larger than in the previous year, when bad weather conditions affected domestic economic activity, and a moderate additional increase is foreseen for 2014. This rise is projected amid the gradual improvement of the absorption rate of EU structural and cohesion funds and of the anticipated gradual strengthening of investor sentiment towards Romania's economy, with positive effects on the capital flow dynamics, especially foreign direct investment and, implicitly, on the efficiency of the production factors. The marginal contribution of labour is the result of several unfavourable factors,

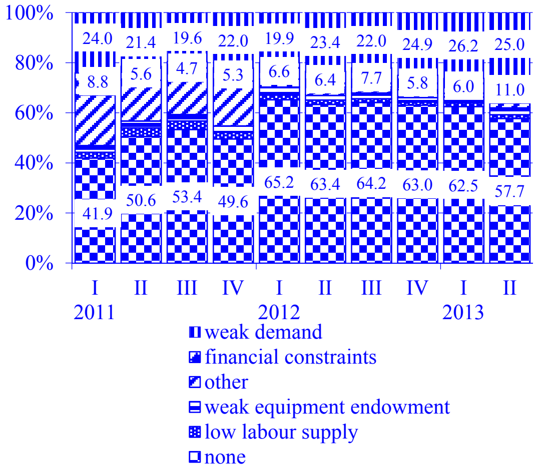
[14] The fuel prices charged by the main domestic operators depend on the international Brent oil prices expressed in USD. The nominal USD/RON exchange rate is relevant for the conversion of such prices into lei.

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

[16] NIS Press Release No. 160 of 4 July 2013.

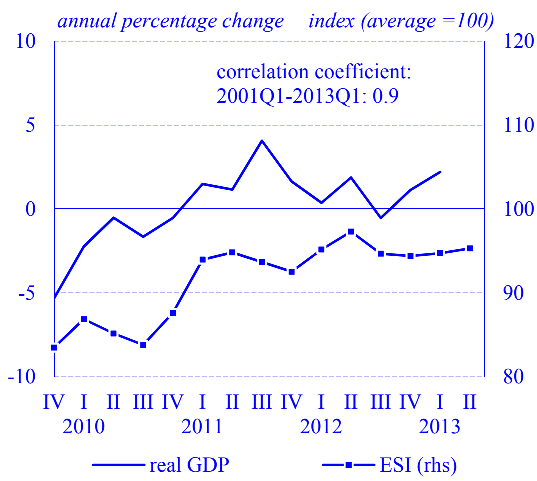
[17] The rise in capital stock during the projection interval is backed by the anticipated gradual improvement in gross fixed capital formation.

Factors limiting the industry production



Source: EC-DG ECFIN

Economic Sentiment Indicator* and Economic Growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

mainly the anticipated decline in the working age population (15-74 years)[18], while the persistence, in Q2, of the effects of the higher ILO unemployment rate in early 2013[19] is expected to reverse subsequently.

The negative output gap in 2013 Q2 is assessed to have widened slightly compared with Q1, which implies, ceteris paribus, a marginal intensification of disinflationary pressures from aggregate demand. However, compared with the previous forecasting round, in the context of the upward revision of the seasonally-adjusted real GDP historical data series by the NIS, the GDP deviation in 2013 Q1 is significantly less negative. The change includes the cumulative effect stemming from the reassessment of the determinants for this variable[20], as well as the effect of the forecast error coming from the underestimation in the previous round of the GDP dynamics for 2013 Q1. In 2013 Q2, the negative output gap cumulates its relatively high persistence, the further significant influence of the external demand deficit, the pro-cyclical nature of the discretionary component of fiscal policy, as well as the slightly restrictive effect of the real exchange rate in the previous quarter via the net export channel; all these factors are only marginally offset by the slight stimulative impact of real interest rates applied by banks in the previous quarter that produce macroeconomic effects starting with the quarter under review.

The widening of the negative output gap in 2013 Q2 is only partly supported by the evolution of other monthly indicators correlated with the cyclical position of the economy. Signals pointing to this development come from the ILO unemployment rate slightly exceeding the medium-term trend and from the unfavourable dynamics of the stock of consumer loans in real terms over the past quarters. The favourable developments in industrial output[21] and the narrower share of respondents citing “insufficient demand” as a factor limiting industrial production provide opposite signals.

During the projection interval, the output gap is foreseen to remain in negative territory, yet to follow a narrowing tendency. The revision of the historical output gap values, the broad monetary conditions – expected to show a slightly accommodative nature for the most part of the projection interval – and the likely impact of an

18 The assumption of a decline in the working age population is consistent with that included in the European Economic Forecast – Spring 2013. The estimates released by the NIS for April and May might be subject to revisions after the release of the actual data on employment and unemployment for 2013 Q2, on 20 September 2013.

19 ILO unemployment witnessed successive increases in the past 5 months, from 6.7 percent in December 2012 to 7.5 percent in May 2013.

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

21 In April-May, industrial output picked up 0.8 percent compared with the average for 2013 Q1, amid highly volatile monthly rates.

absorption rate of the EU funds higher than in 2012[22] act towards the narrowing of the negative output gap. The fiscal policy stance (pro-cyclical behaviour for most of the projection interval) and the restrictive nature of external demand act in an opposite direction, namely towards the widening of the negative output gap. Overall, compared with the May 2013 Inflation Report, the negative output gap is less pronounced, illustrating less strong disinflationary pressures.

The forecast envisages a significantly faster economic growth over the projection interval, compared with 2012, supported also by the switch from negative to positive territory of the contribution of gross value added in agriculture. For 2013, given the relatively modest development of domestic demand, net exports are seen as the main source of economic growth. The economic upturn projected for 2013 benefits from a significant carry-over effect, assessed at 0.7 percentage points[23]. For the coming year, against the background of positive developments in the labour market[24] with a favourable impact on household disposable income, domestic demand is seen to become the main determinant of real GDP growth.

[22] In 2012 several operational programmes were suspended from payment.

[23] For further details, see the Box entitled "The impact of the carry-over effects on average annual real GDP growth rate".

[24] The further growth of employment, albeit at a pace expected to remain relatively slow, as well as the moderate advance of real wage economy-wide.

The impact of the carry-over effects on average annual real GDP growth rate

The calculation of the average annual real GDP growth rate in a given year includes contributions from both the quarter-on-quarter dynamics of the indicator in the reported year and those recorded in the previous year (hereinafter referred to as 'base year'). The statistically-determined impact that the real GDP dynamics in a base year have on the average annual growth rate in the following year is the carry-over effect. Conceptually, it denotes the average annual growth rate that would result in a given year ($\Delta(\%)GDP_{t/t\text{-}1}$), if the level of real GDP reached in the fourth quarter of a base year ($GDP^{Q4}_{t\text{-}1}$) were to remain constant throughout the subsequent year. For example, the average annual growth of real GDP may be calculated as:

$$\Delta(\%)GDP_{t/t\text{-}1}=\frac{\overline{GDP}_t-\overline{GDP}_{t\text{-}1}}{\overline{GDP}_{t\text{-}1}}\cdot 100=\frac{\overline{GDP}_t-GDP^{Q4}_{t\text{-}1}+GDP^{Q4}_{t\text{-}1}-\overline{GDP}_{t\text{-}1}}{\overline{GDP}_{t\text{-}1}}\cdot 100=\frac{GDP^{Q4}_{t\text{-}1}-\overline{GDP}_{t\text{-}1}}{\overline{GDP}_{t\text{-}1}}\cdot 100+\frac{\overline{GDP}_t-GDP^{Q4}_{t\text{-}1}}{\overline{GDP}_{t\text{-}1}}\cdot 100$$

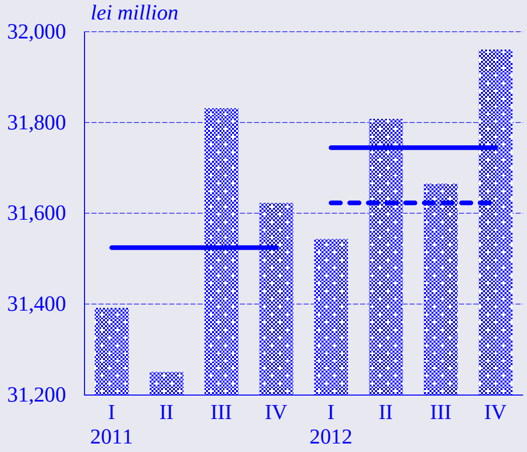
where ($GDP^{Q4}_{t\text{-}1}$) is the level of seasonally-adjusted real GDP in Q4 of the base year (t-1) and ($\overline{GDP}_t$) is the annual average in that year.

The first term in the last part of the equation is the carry-over effect that measures the percentage change of real GDP in the fourth quarter (Q_4) of the base year (t-1) against average GDP for the year as a whole ($\overline{GDP}_{t\text{-}1}$). According to this equation, if the level of real GDP in the fourth quarter of a year ($GDP^{Q4}_{t\text{-}1}$) rises above the annual average, the carry-over effect in the subsequent year will be positive.

The second term of the sum measures the average real GDP growth rate in the current year ($\overline{GDP}_t$) relative to the last quarter of the previous year ($GDP^{Q4}_{t\text{-}1}$) expressed in percent-to-GDP in the base year ($\overline{GDP}_{t\text{-}1}$). Against this backdrop, the contribution from real GDP dynamics in the course of the four quarters of the current year to the average annual real GDP growth will be the difference between its average annual growth rate ($\Delta(\%)GDP_{t/t\text{-}1}$) and the carry-over effect.

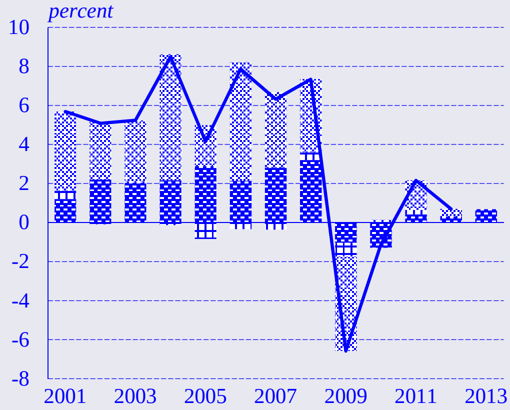
In order to underscore the importance of the carry-over effect in explaining the annual dynamics of real GDP in 2012, the quarterly levels of seasonally-adjusted real GDP in 2011 and 2012 are presented in Chart A. Solid lines show the average levels of real GDP in each of the two years and the dotted line traces the average level of real GDP that would have been recorded in 2012 if it had remained constant in the course of the year at the level reached in 2011 Q4. The percentage change between the levels in the solid lines quantifies the average annual real GDP growth rate in 2012 ($\Delta(\%)GDP_{2012/2011}= 0.7\%$), whereas the percentage change between the level in the dotted line and that in the solid line in 2011 is the carry-over effect equal to approximately one-half of the average annual GDP growth in 2012.

Chart A. Real GDP in 2011 and 2012



Source: NIS, NBR calculations

Chart B. Average annual real GDP growth and the carry-over effect



Source: NIS, NBR calculations

Chart B sets out the carry-over effect on the average annual real GDP growth rates in the period 2001-2012. The chart also depicts the carry-over effect in 2013, calculated solely based on NIS-published historical GDP data for 2012. In Chart B, the years that were marked by negative carry-over effects were 2009 and 2010. The carry-over effect contributed, on average, 1.4 percentage points to the economic growth in the reported period, i.e. more than one-third of the average annual GDP growth.

The carry-over effect on the 2013 economic growth equals 0.7 percent[1], which is lower than the historical average but significant, given that GDP growth rebounded strongly into positive territory in the final quarter of the previous year[2].

[1] This assessment is based on the provisional GDP figures published by the NIS on 4 July 2013 and is surrounded by uncertainty, as the quarterly seasonally-adjusted real GDP levels reached in 2012 can be significantly affected by further data revisions in the NIS-compiled National Accounts. For example, according to NIS estimations on the GDP released on 2 April 2013, the estimated carry-over effect for 2013 was 0.4 percent.

[2] After having contracted by 0.4 percent in 2012 Q3, real GDP rose at a quarter-on-quarter rate of 0.9 percent in 2012 Q4.

Aggregate demand components

After recording a negative quarterly change in 2013 Q1 (-0.6 percent), the actual final consumption of households is expected to improve slightly in 2013 Q2, causing the negative deviation from its medium-term trend to narrow. This is supported by some household disposable income indicators; in April-May, compared with the 2013 Q1 average, net real wage rose by 2.3 percent[25] and new consumer loans by 51.6 percent. These developments seem to reflect only partly on consumer spending, given that retail trade turnover, except for motor vehicles and motorcycles posted a 1.3 percent drop in April-May compared with the average for the previous quarter, and the consumer confidence indicator fell by 3.1 points in 2013 Q2. The actual collective consumption of general government is anticipated to have witnessed a modest increase in 2013 Q2, further supporting fiscal consolidation[26]; its deviation from the medium-term trend, albeit narrowing, still remains in negative territory.

The individual consumption of households is envisaged to improve in both years of the projection interval, as a result of the higher real disposable income of households, in the context of the anticipated return of the CPI annual inflation rate within the target band and the positive contributions of labour market indicators[27]. On the other hand, however, amid the high indebtedness of the active population and the large share of foreign currency-denominated loans at aggregate level, one should not minimise the impact of the expected persistent lending constraints or the impact of exchange rate fluctuations of the local currency on the resources destined to household consumer spending. Therefore, given the notable contraction in 2013 Q1 and the gradual recovery anticipated for the subsequent quarters, the actual individual consumption of households is expected to increase marginally in 2013 versus 2012, and to rise somewhat faster in the following year. The actual collective consumption of general government is expected to decline slightly in 2013 and to re-enter positive territory in 2014.

The negative quarterly dynamics of gross fixed capital formation recorded lately[28] are forecasted to have slowed down markedly in 2013 Q2. The signals from the indicators correlated with the short-term developments in construction and investment in

[25] As compared with 2013 Q1, the wage hikes in April-May also include a favourable carry-over statistical effect following the one-off wage increases in Q1 (e.g. the rise in the minimum wage economy-wide in February and the granting of occasional bonuses in March), as well as the granting of Easter bonuses or profit sharing.

[26] According to the latest data released by the MPF, the general government deficit stood at 1.06 percent of GDP in June 2013 (cash-based methodology).

[27] Such as the anticipated growth, albeit relatively slow, of employment in the private sector and, at the same time, of labour productivity, with a positive impact on wage dynamics.

[28] For example, gross fixed capital formation saw a 2.2 percent decline in 2013 Q1, mainly on account of lower investment in “General government”.

equipment are mixed. Specifically, April through May compared with the Q1 average, the construction works index fell by 0.6 percent, new building permits moved down 1.7 percent, the turnover of capital goods industry decreased by 1.4 percent, while capital goods production increased by 3.3 percent. Against the unfavourable developments of gross fixed capital formation in the last quarters, its deviation from the trend in Q2 is seen as negative, slightly widening.

The quarterly dynamics of gross fixed capital formation are expected to re-enter positive territory starting with the latter half of 2013, a trajectory foreseen to consolidate subsequently, throughout the projection interval. This development is consistent with the adopted set of assumptions, namely the marginal increase in employment rate, the higher contribution of FDI flows and the authorities' efforts to increase the rate of absorption of EU funds. Moreover, given the monetary policy decisions taken by the NBR, a gradual easing of part of the corporate lending constraints, especially those associated with lending costs is expected over the medium term, being likely to support the resumption and subsequently the consolidation of the dynamics of private sector investment projects. Overall, the growth rate of gross fixed capital formation in 2013 will still be dampened by the effects of the decline at end-2012 and in early 2013; during 2014, the fading-out of these effects and the emergence of the favourable ones of the previously mentioned factors are anticipated to lead to positive annual dynamics.

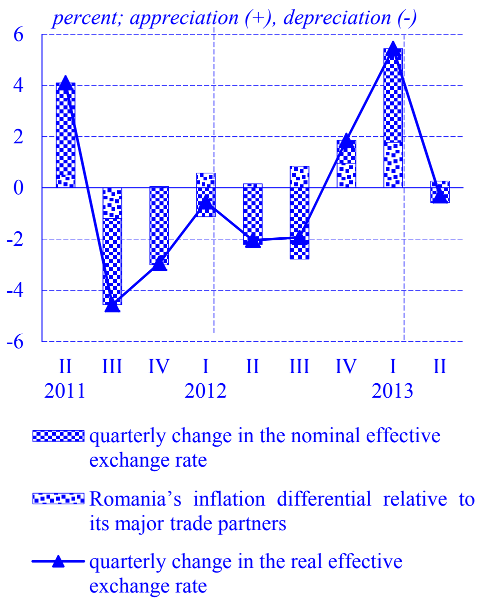
In 2013 Q2, the quarterly growth rate of exports is foreseen to have slowed down (following an exceptional 9.1 percent quarterly increase in Q1). The expected development of this component is supported by the favourable dynamics of exports of goods in the first five months of 2013[29], the larger industrial output in the euro area (1.0 percent in April-May compared with the Q1 average), and by the rise in manufacturing output (4.1 percent in April-May compared with the Q1 average), while the confidence indicator in the euro area economy posted a 0.3 point fall in Q2 versus 2013 Q1. Imports are also expected to have witnessed a positive quarterly change, amid the high import content of exports and the latter's favourable dynamics. In view of the mentioned developments, the deviation of exports from the medium-term trend is assessed as positive, on the rise from the previous periods, while the deviation of imports from the medium-term trend is seen as negative, yet narrowing.

The notable developments of the exports of goods and services in the first part of the year are forecasted to continue in the latter part as well, yet they will post a relatively slower growth, due to the

29 According to NIS Press Release No. 172 of 10 July 2013, in the first five months of 2013, compared with the same year-earlier period, non-EU exports of machinery and transport equipment went up 29.1 percent.

expected persistence of a weak EU external demand for Romanian goods. The positive annual dynamics of exports in 2013, compared with the historical values of the variable, will be most likely supported by the further good performance in "machinery and transport equipment", given the longer-term nature of contracts in this sub-sector, the buoyant non-EU external demand for such goods, as well as the projected gradual improvement in EU external demand. The orientation of Romania's exports of machinery and transport equipment towards the emerging economies outside the EU increased both directly and indirectly, due to exports to France and Germany, which hold large shares on the relevant non-EU markets. Given the low correlation between the growth rates of imports and exports of goods and services in the first part of the year[30] and the modest dynamics of the anticipated domestic demand for 2013, the baseline scenario envisages for 2013 a slower growth rate for imports than for exports. Having in view the good performance of net exports of goods and services expected for this year concurrently with the anticipation of slightly improved dynamics of income and current transfer balances[31], the projected current account deficit is seen to undergo a larger adjustment than that in 2012. For the year ahead, the positive dynamics of exports are foreseen to moderate under the constraint coming from the slow recovery of the economic activity in the EU, as well as from limitations on domestic production capacities emerging at that time horizon, while the growth rate of imports is envisaged to accelerate somewhat, under the impact of a higher domestic demand. In this context, the current account deficit is projected to widen slightly by the end of 2014, without however generating corrective inflationary pressures from the exchange rate of the leu.

Quarterly Change in the Effective Exchange Rate



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

Broad monetary conditions

Broad monetary conditions capture the impact exerted on future aggregate demand developments 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. The exchange rate exerts its influence via the net export channel, as well as via the wealth and balance sheet effect[32].

In 2013 Q2, nominal interest rates in lei[33] applied by credit institutions to their non-bank clients followed a downward path. The drop in the nominal deposit rates in the second quarter of

[30] The imports of goods and services went up in real terms in 2013 Q1 versus 2012 Q4 at a much slower pace than exports.

[31] Assuming the improved capacity of attracting EU post-accession funds.

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

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

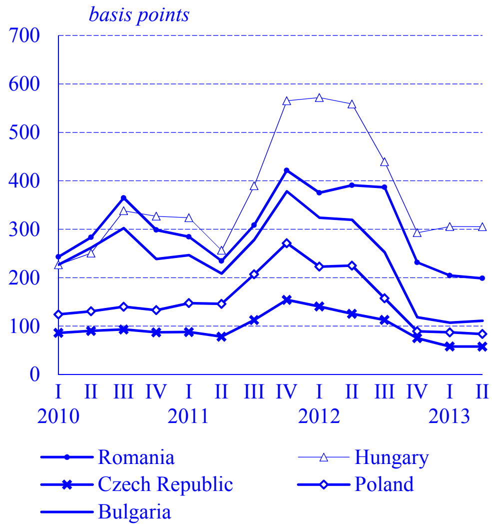
2013, along with the smaller decline in inflation expectations[34], caused a fall in the real deposit rates. Against the background of the marginal reduction in the nominal lending rates, the decrease in inflation expectations translated into a slight increase in the real interest rates on loans. Overall, the deviation of real interest rates versus the medium-term trend is indicative of a stimulative impact on future economic activity, which is relatively higher compared with 2013 Q1.

Compared with the average for 2013 Q1, the domestic currency depreciated in real terms[35] in the second quarter. Behind this stood the nominal depreciation of the leu versus the US dollar and, to a smaller extent, versus the euro, which was mitigated by the dynamics of the inflation differential against the trading partners. Against this background, the deviation of the real exchange rate from the medium-term trend is assessed to have been slightly lower compared with the previous quarter, indicating, *ceteris paribus*, a slightly restrictive and lower impact on future aggregate demand via the net export channel.

In 2013 Q2, the risk level associated with investments in the national economy, correlated with developments in CDS (Credit Default Swap) spreads, remained similar to that recorded in the first quarter of the year, yet reflecting a regional trend apart from fundamentals, in the context of a relatively high volatility of capital flows to the national economy. The foreign interest rate still below the medium-term trend implies a favourable effect, only partially offset by the joint effect of the expectations on exchange rate developments[36] and of the risk premium being slightly above the medium-term trend. Against this background, in 2013 Q2, the wealth and balance sheet effect continues to exert a slightly stimulative effect on future economic activity.

According to the NBR assessment, real broad monetary conditions in 2013 Q2 indicate a relatively neutral effect on the economic activity in the quarters ahead[37]. In the structure of the real broad monetary conditions, the stimulative impact from the real deposit rates and the slightly stimulative impact from the wealth and balance sheet effect are almost completely offset by the somewhat restrictive impact from the real exchange rate via the net export channel, whereas the position of real lending rates versus the medium-term trends further have a relatively neutral effect.

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



Source: NBR calculations based on Bloomberg data

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

35 The relevant exchange rate implies EUR/RON and USD/RON exchange rates, according to the weights of the two currencies in Romania's foreign trade.

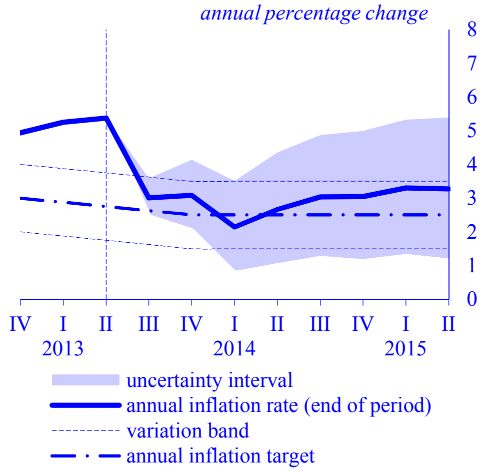
36 Approximated by the expected change in the real effective exchange rate deviation.

37 It should be mentioned that, in 2013 Q3 (1 July), the NBR Board decided to lower the monetary policy rate by 0.25 percentage points.

Broad monetary conditions are expected to have a stimulative impact on the economic activity by the end of 2014 and a relatively neutral effect in the subsequent period, due solely to the anticipated restrictive effect of the real exchange rate on net exports. The wealth and balance sheet effect of the exchange rate is projected to foster the aggregate demand growth throughout the projection interval, to a larger extent than in the previous forecasting round, given that the anticipated dynamics of the current account deficit, as well as the easing, over the past weeks, of the investor sentiment towards the regional risk, with anticipated persistent effects, are not expected to induce significant corrective pressure on the leu exchange rate. The trend deviation of the real interest rate on foreign currency loans further has a stimulative effect throughout the forecast interval, due to the persistently low level of foreign interest rates.

The path of the monetary policy rate is calibrated so as to prompt a gradual downturn in the costs of lei-denominated loans via the pass-through of policy rate impulses to credit institutions' interest rates applicable to their non-bank clients. In addition, the projected monetary policy stance will envisage the return and, subsequently, the consolidation of the inflation rate inside the variation band around the central target via the firm and effective anchoring of inflation expectations, thus contributing to creating the necessary prerequisites for sustainable economic growth in the long run. In line with the projected path of the monetary policy rate, the cumulative impact of the deviations from the trends of real interest rates on leu-denominated loans and deposits is forecasted to maintain its stimulative effect on aggregate demand throughout the forecast interval.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Note: The uncertainty interval was calculated based on the forecast errors in the NBR projections during 2005-2012. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

1.4. Risks associated with the projection

The assessment of the risks associated with the current inflation projection shows that, in the short run, the balance of risks is tilted to the downside compared to the baseline scenario, whereas, in the medium term, risks of upward deviations seem to be slightly more pronounced.

The likelihood that in the near run the inflation rate may be lower than projected is hinted at by the incoming information after the macroeconomic forecast was completed and therefore left out of the baseline scenario. The information refers to the signals on domestic bumper crops of volatile food items (VFE) and of some raw materials for processed foodstuffs, as well as to the government's announcement on cutting the VAT rate applied to flour and bread as of 1 September 2013.

The external environment continues to pose risks to the projected inflation path in the baseline scenario, in the context of potential increases in the volatility of capital flows to emerging economies, including Romania, which might affect both domestic price stability and financial stability. Firstly, the evolving economic patterns of Romania's main trade partners in the EU are prone to downward revisions in the event of a new worsening episode of the sovereign debt sustainability issues in some euro area countries. Apart from the implications of a low demand for Romanian exports on the domestic economic growth, with a moderating effect on the domestic inflationary pressures compared to those in the baseline scenario, the materialisation of this risk would generate an adverse impact on investors' perception of the emerging markets in the region (including Romania) and, implicitly, the depreciation of the domestic currency inducing an opposite effect of a considerably higher magnitude on the projected inflation path. Secondly, the risk of large capital outflows, heavily afflicting especially emerging economies, could be enhanced by a low global risk appetite ascribable to both the significant uncertainty about the magnitude and timing of the Fed tapering its quantitative easing and the concerns over a faster slowdown in China's economic growth, which is likely to prompt investors to diminish their exposure to emerging markets and switch to advanced economies. In addition, the rise in the risk premium related to investments in lei and the concerns over the sustainable financing of Romania's external imbalances would put depreciation pressures on the domestic currency, adversely impacting both the dynamics of import prices and the financing costs for residents, particularly through the wealth and balance sheet effect.

Domestically, given the known structural rigidities of the Romanian economy, in the reference period, the inflation rate may deviate upwards compared to the baseline scenario mainly owing to the delay and/or the incomplete achievement of the structural reforms agreed upon by the Romanian authorities and the international institutions (EU, IMF and the World Bank), which may lead to an increased pass-through of the adverse shocks of either internal or external origin into the inflation rate and economic growth.

The risks arising from administered price developments, conditional on the currently available information, indicate potential both-way deviations from the coordinates of this variable in the baseline scenario: it is difficult to assess the impact stemming from the deregulation of natural gas and electricity prices on consumer prices, on the one hand, and that arising from the government postponing to grant green certificates to renewable energy producers[38] on the electricity price, on the other hand. The balance of risks associated with the dynamics of domestic food prices is deemed more tilted to the downwards compared to the baseline scenario, considering the increasingly plausible assumption, as confirmed by recent

[38] For July 2013-January 2018, according to GEO No. 57/2013.

information[39], of a bumper agricultural crop in 2013, as well as following the recent announcement on cutting the VAT rate applied to flour and bread to 9 percent as of 1 September 2013. In the medium term, however, the risks posed by this source indicate that upward deviations from the baseline scenario coordinates are relatively highly likely, given the large share of food items in the consumer basket and the vulnerabilities specific to the agricultural sector.

In the current forecasting round, the balance of risks associated with international commodity prices seems to be in equilibrium in the short run. In the medium term, the future dynamics of these prices continue to pose significant risks should global demand see a marked rebound exceeding that considered in the baseline scenario at this horizon[40].

2. Policy assessment

In line with the central bank's forecasts, in 2013 Q2, inflation rate saw a quasi-stagnation, with the annual rate coming in at 5.37 percent in June, slightly exceeding the level posted at end-Q1 (5.25 percent). This evolution, implying the annual growth rate of consumer prices remaining above the upper bound of the band around the flat inflation target, was the result of ongoing adverse effects of supply-side shocks which translated mainly into a faster annual growth rate of administered prices and a persistently fast annual dynamics of volatile prices of food items. To this added, in June, the impact of the episodic worsening of the leu exchange rate behaviour – halting temporarily the deceleration trend in core inflation that has recently emerged in the context of a persistent negative output gap and of the moderation of the unfavourable developments in processed food prices.

In this context, the updated forecast of medium-term macroeconomic developments incorporated primarily favourable revisions of its main assumptions, revealing a new improvement in the inflation outlook, particularly on the intermediary forecast horizon. Thus, the configuration of the updated path of the forecasted annual inflation rate is similar to that in the previous projection – with the annual inflation returning to the flat target band at end-Q3 and subsequently remaining inside this band – whereas the inflation level is markedly lower almost throughout the forecast horizon and especially in the first two quarters of 2014, when it tends to

[39] Both the signals on a bumper domestic crop on the segment of volatile price food items and processed foodstuffs and the announcement on cutting the VAT rate applied to flour and bread followed the cut-off date of the baseline scenario of the macroeconomic projection.

[40] Furthermore, the balance of risks in this category may be pushed upwards as a result of some structural changes which might occur at a global level such as: the shift in the agricultural output towards biofuel production to the detriment of food items, or the increase in the emerging economies' demand for commodities.

fall below the central target. Implicitly, the annual inflation rate is expected to be slightly lower than previously forecasted for December 2013 and December 2014, coming in at 3.1 percent at both end-2013 and end-2014.

From the standpoint of monetary policy conducting, it is of utmost importance that the expected evolution of adjusted CORE2 inflation ranks among the major determinants of the return to and subsequent consolidation of the forecasted annual inflation rate inside the target band, as well as of the improvement of its updated trajectory. Thus, the downward correction anticipated for the annual core inflation rate in 2013 Q3 – against the background of the fading out of adverse effects of supply-side shocks on processed food prices – is considerably larger than that in the previous projection, and the core inflation forecasted levels are relatively lower almost throughout the projection horizon, falling towards the lower bound of the target band in 2013 Q4 and thereafter staying below the central target.

The improvement in core inflation outlook is chiefly attributable to inflation expectations sliding within a lower range. This effect, alongside that generated by the deceleration in the forecasted dynamics of import prices particularly in the short run and by other factors more than offsets the opposite effect caused by the relative decrease in the negative output gap-induced disinflationary pressures throughout the forecast horizon. The latter was triggered by the upward reassessment of historical data and particularly of the GDP dynamics forecasts entailing not only a new contraction in the estimated negative output gap, but also a change in its path, suggesting that the negative output gap narrowing trend might start earlier compared to the previous projection.

The uncertainty and risks associated with both the current context and that anticipated by the new medium-term forecast are relatively similar in nature to those outlined in the previous forecasting rounds aimed at configuring the monetary policy response, with a key difference consisting of the marked moderation of risks to short-term inflation expectations induced by the persistence of relatively high annual inflation rates until June 2013. Including against this background, the uncertainty and both-way risks to the inflation outlook stem mainly from the external environment, particularly from the developments across the economies and banking systems in the euro area, implicitly the policies configured by the authorities with a view to sustainably solving their problems, as well as from the economic evolution in the US – pivotal from the standpoint of monetary policy decisions to be adopted by the Fed –, and its potential impact on the confidence and liquidity of international financial markets.

Thus, the recently higher sensitivity of international investors' sentiment towards these developments, likely to amplify the volatility of the global risk appetite, poses in the current context the risk of an episodic intensification of leu depreciation pressures, implicitly inflationary pressures, given that, amid the persistent concerns over the Fed's decisions, investors might react disproportionately to the emergence of economic and financial information viewed as unfavourable and cause contractions in capital inflows/capital outflows in the form of portfolio investment on the regional market, including on the domestic market. The adverse impact on the leu exchange rate, implicitly on inflation, as well as on the costs related to the fiscal deficit financing and public debt, could be heightened by the relatively large volume of lei-denominated government securities currently held by non-residents, and implicitly by the higher likelihood of capital outflows from the domestic market, that may be however contained by the small number of domestic investors in these assets. Such an impact could be also mitigated in the event of the favourable evolution recorded by the current account balance in the early months of 2013 persisting further, mainly on account of the improved goods and services balance. Furthermore, assuming that the economic fundamentals across the EU continue to deteriorate and/or the deleveraging grows more pronounced in the euro area, as well as in Romania, influences contrary to the leu exchange rate inflationary pressures might arise in the short term, and especially in the medium term, from the relative intensification of the negative output gap-induced disinflationary pressures, as a result of the potentially substantial slowdown in the recovery of the Romania economy, in the context of: a prolonged recession/sluggish recovery of the euro area economy, the wealth and balance sheet effect of the exchange rate, as well as of persistently restrictive domestic financing conditions.

Nevertheless, at the same time, one cannot rule out the likelihood that, in the event of a relatively fast and durable easing of the international financial market, the domestic currency may resume its slight appreciation trend manifest before the turbulences, given the potential stimulative effect on capital inflows into the domestic market, as a result of the Romanian sovereign bonds being included into the Barclays and JP Morgan emerging-market local-currency government bond indices, as well as of the further highly attractive investments in the domestic currency. The latter implies, however, preserving foreign investors' favourable perception of the risk associated with the local financial market, which, in turn, is conditioned on the continuation of the fiscal consolidation process, the acceleration of structural reforms, and a higher efficiency in raising EU funds, in line with the goals/guidelines agreed upon in the agreements with the EU, the IMF, and the World Bank.

The balance of risks to the inflation outlook stemming from future developments in the international agri-food commodity and energy prices seems to remain relatively in equilibrium, at least in the short run. The assessment takes into account, on the one hand, forecasts on the recovery pace of global economy and of the demand for such goods, as well as the risks to these forecasts, and, on the other hand, the global output and stocks, particularly in the oil and agricultural sectors, as they are sensitive to international geopolitical tensions and weather conditions, respectively.

In the short run, the risks to the inflation outlook stemming from the future behaviour of domestic food prices, particularly volatile prices, as well as from the administered price adjustment also seem to be relatively in equilibrium, given the improvement year to date in the Romanian agricultural performance and the higher predictability of electricity and natural gas deregulation measures indicated by the specific calendars approved by the authorities in the context of the agreements concluded with the EU, the IMF and the World Bank. In the very near run, however, it is more likely to see a downward deviation of both categories of prices from the forecasted coordinates, considering the emerging premises of a higher-than-expected crop, as well as of the postponement of granting a certain number of green certificates to renewable energy producers. The fall in the annual inflation rate to lower-than-forecasted levels for H2 in the event of such a scenario materialising could be additionally fuelled by the effect stemming from cutting the VAT rate applied to flour and bread as from September, partly mitigated by higher excise duties levied on alcohol and luxury products.

Considering the prospects for a sustainable return of the annual inflation rate inside the band around the flat target at the end of 2013 Q3, as well as the higher likelihood for it to post a downward deviation from the forecasted path in the period ahead, the NBR Board decided in its 5 August 2013 meeting to lower the monetary policy rate by 0.50 percentage points to 4.50 percent per annum. The NBR Board also decided to pursue an adequate liquidity management in the banking system and to leave unchanged the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.