National Bank of Romania

INFLATION REPORT

November 2013

Year IX, No. 34

New series

N O T E

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

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

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ISSN 1582-2931 (print)
ISSN 1584-0948 (online)

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.

The Inflation Report was approved by the NBR Board in its meeting of 5 November 2013 and the cut-off date for the data underlying the macroeconomic projection was 31 October 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
MEF	Ministry of European Funds
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

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SUMMARY

Developments in inflation and its determinants

The annual CPI inflation rate saw a significant deceleration in 2013 Q3, returning inside the ±1 percentage point variation band around the 2.5 percent flat target at quarter-end. In September, the annual CPI inflation rate came in at 1.88 percent, i.e. 3.49 percentage points below the level seen at end-Q2 and 1.1 percentage points lower than that forecasted in the August 2013 Inflation Report. This favourable evolution reflected the materialisation of the anticipated influences mentioned in the balance of risks in the previous report regarding some inflation determinants.

Behind the steep deceleration in the dynamics of the consumer price index stood all its components, especially volatile food prices (VFE[1]) and those included in the adjusted CORE2 index[2]. The annual growth rates of VFE prices and processed food prices saw a noticeable decline, on account of a substantial favourable base effect due to both the bumper crop in 2013 and the dissipation of the negative statistical effect of the low agricultural output in the previous year, to which added the impact of the cut in the VAT rate for some bakery products. The annual rate of change of fuel prices was also negative at end-Q3, with the effect of the leu appreciation against the US dollar prevailing over that exerted by the rise in international oil prices. Slower annual growth rates as compared to the previous quarter were recorded by both administered prices, owing to a base effect arising partly from the reduction in the electricity bill for end-users in July, and tobacco product prices.

The annual adjusted CORE2 inflation rate declined from 2.85 percent at end-Q2 to 0.49 percent at end-Q3. Apart from the factors previously mentioned that shaped the evolution of processed food prices and whose effect is expected to be visible in core inflation on a four-quarter horizon, among the underlying factors of the annual adjusted CORE2 inflation rate, favourable contributions to maintaining it on a downward trend in Q3 had the persistence of the negative output gap, as well as the further improvement in inflation expectations, also due to the gradual incorporation of the recent favourable developments in their backward-looking component.

Unit labour costs in industry continued to decline in annual terms July through August 2013. The fall was slightly more pronounced than that in Q2, with the labour productivity growth rate exceeding that of average gross wage in this sector. Given the moderate evolution of gross nominal wage earnings economy-wide during the same period, the risk of significant inflationary pressures from wage-related costs appears to be low in the short run. Maintaining an adequate correlation between wage increases and labour productivity growth economy-wide in the medium and long run is, however, of the essence for consolidating price stability.

Monetary policy since the release of the previous Inflation Report

In its meeting of 5 August 2013, the NBR Board decided to cut the monetary policy rate by 0.50 percentage points to 4.50 percent per annum. The Board's decision was substantiated by the

[1] Vegetables, fruit and eggs.

[2] 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.

consolidation of the prospects for the inflation rate to return to and remain inside the variation band around the central target as from the second half of 2013. The favourable prospects were revealed by both the downward revision of the forecast as against that in the May 2013 Inflation Report and the revaluation of the associated risks. The latter showed a high probability, as suggested by the information that became available after the completion of the macroeconomic projection, that, at near horizons, the inflation rate might stand below the levels in the baseline scenario. Moreover, in the medium run, the balance of risks appeared to be only slightly tilted to the upside as against the projection, especially on account of the uncertainty surrounding the external environment.

In line with the central bank's forecast, the annual CPI inflation rate entered a pronounced downward trend in July and August. This evolution was mainly supported by the shift from an unfavourable base effect to a favourable one on the dynamics of both volatile food prices and prices of processed food items included in the adjusted CORE2 index. The transitory favourable effects of an above-average agricultural production and of the VAT rate cut for some bakery products, referred to in the risks section of the August 2013 Inflation Report, were incorporated in the updated baseline scenario of the short-term projection submitted to the NBR Board in the meeting of 30 September 2013. The Board's analysis highlighted both a reconfirmation of the outlook for disinflation to accelerate in the short run and the persistence of some risks posed by the faster cross-border deleveraging in the banking system and the volatility in investor risk appetite following international developments. Hence, the NBR Board decided to cut the monetary policy rate to 4.25 percent per annum from 4.50 percent.

Inflation outlook

The forecast sees the annual CPI inflation rate declining temporarily below the lower bound of the ±1 percentage point variation band around the 2.5 percent flat annual target in 2014 H1, before returning inside the band in 2014 Q3 and remaining there until the projection horizon.

The macroeconomic forecast envisages a consolidation of economic growth in 2013, after the meagre advance in 2012. The outstanding performance of exports is expected to be the driving force behind GDP dynamics, along with some components of private consumption, spurred by this year's plentiful supply of agri-food items. Overall, however, private consumption is seen advancing at a slow pace, while investment, despite the recovery envisaged for 2013 H2, is anticipated to make a negative contribution to economic growth throughout the year. Domestic demand dynamics are expected to induce modest import growth. Along with the surging exports, this leads to the anticipation of a significant narrowing of the share of the balance-of-payments current account deficit in GDP. For 2014, given a projected GDP advance similar to this year's forecast, domestic demand will witness a rebound, on the back of both private consumption and investment. This is expected to be driven by the higher real disposable income of households, the recovery in FDI flows, the improved absorption of EU funds, as well as by the gradual adjustment of lending conditions, also on account of the projected configuration of real broad monetary conditions. The rebound in domestic demand will push import dynamics higher, causing the contribution of net exports to economic growth to return to negative values. Hence, the current account deficit as a share in GDP is seen widening moderately versus 2013, before stabilising over the medium term at markedly lower readings than those recorded prior to this year. Against this background, no significant corrective pressure on the leu exchange rate arising from the external position is foreseen until the projection horizon. In light of the updated GDP data, the negative output gap has been revised for the entire forecast interval to levels entailing slightly stronger-than-previously-projected disinflationary pressures. Its negative assessed values, although expected to marginally narrow in the latter half of the reference period, are seen persisting until the projection horizon.

The baseline scenario of the current projection places the annual CPI inflation rate at 1.8 percent at end-2013 and 3.0 percent at end-2014, i.e. 1.3 percentage points and 0.1 percentage point, respectively, below the August 2013 Inflation Report projected rates, which were based on the assumption of a normal agricultural year.

The substantial downward revision of the end-2013 forecast is mainly the result of the materialisation of the risks mentioned in the balance corresponding to the baseline scenario of the previous projection round. Thus, the adjusted CORE2 index and the volatile food prices (VFE) benefited from the VAT rate cut applied to some bakery products as of 1 September 2013 and from the confirmed bumper crop, to which added the base effect of the 2012 low agricultural output.

The updated inflation forecast also involved other reassessments, of a lower magnitude, of the contributions from the aggregate index components. In particular, for end-2013, fuel price dynamics are expected to have a lower contribution to inflation developments, whereas the growth rates of administered prices and prices for tobacco products and alcohol have been revised upwards. For end-2014, the forecast envisages lower contributions from the adjusted CORE2 index and fuel prices and a higher one from administered price dynamics.

The VAT rate cut applied to some bakery products and the very good 2013 agricultural year compared to last year's poor crop, given the standard assumption of a normal agricultural year in 2014, will exert a substantial, albeit transitory, impact on the annual CPI inflation rate.

As a result, the favourable impact of these one-off factors is anticipated to largely fade away during 2014 Q3, which explains the end-2014 projection being revised marginally. The projected trajectory of the CPI inflation rate will fall below the lower bound of the variation band around the central target in 2014 H1, reaching a trough below 1 percent during Q1, before returning inside the band in 2014 Q3. The 12-month inflation rate is then seen stabilising slightly above 3 percent in the latter half of the projection interval, but remaining below the upper bound of the variation band around the target, amid ongoing adjustments at this horizon in several categories of prices beyond the control of monetary policy.

The CPI inflation rate trajectory is largely shaped in the current projection by the path of the annual adjusted CORE2 inflation rate. The latter includes the prices of products for which the VAT rate has been cut and those of processed food items[3] that are impacted with a lag by this year's bountiful crop via prices of agri-food commodities. Largely on account of the base effect associated with these factors, the core inflation projection foresees the annual rate hitting historical lows of below 0.5 percent during the first half of the forecast interval, before reverting close to 2 percent. Compared to the previous projection, the adjusted CORE2 inflation rate was revised downwards for the entire forecasting interval, also due to the revision of inflation expectations and of the negative output gap. In the latter half of the projection interval, the slight

3 Processed food items hold a 50 percent share in the adjusted CORE2 inflation basket.

trend reversal in inflation expectations[4] – as a result of economic agents perceiving the fading away of the aforementioned base effects – and the gradual narrowing of the negative output gap amid the anticipated pick-up in economic activity will put the annual core inflation on a moderately upward path.

The projected monetary policy stance will further seek to calibrate real broad monetary conditions so as to ensure that inflation rate remains inside the variation band around the target over the medium term, while also paving the way for a gradual recovery of lending to the private sector and lasting economic growth.

The assessment of risks associated with the current inflation rate projection points to a balance tilted to the upside. These upward deviations from the baseline scenario may come from both external conditions and the domestic environment.

Risks stemming from the external environment further relate to the uncertainty surrounding the volatility of capital flows channelled to the Romanian economy in the context of the variability of investors' risk appetite towards emerging economies as a whole. Risks are generated by relevant factors in the European and global context, such as: the fragile outlook for economic recovery of Romania's major trade partners amid the ongoing financial fragmentation and cross-border deleveraging; debt sustainability issues related to sovereigns and private banks in some euro area countries; the uncertainty about the magnitude and timing of the Fed tapering its quantitative easing in the US financial system; and the possible significant slowdown in the growth of major emerging economies, China included. The materialisation of any of these risks or a combination thereof would entail unfavourable deviations from the baseline scenario of the macroeconomic projection in terms of both inflation coordinates and economic growth.

Against the background of relatively subdued developments in global commodity prices recently, the risks of an upward deviation from the baseline scenario assumptions are anticipated to be somewhat more pronounced over the medium term, owing to the possible deepening of geopolitical tensions.

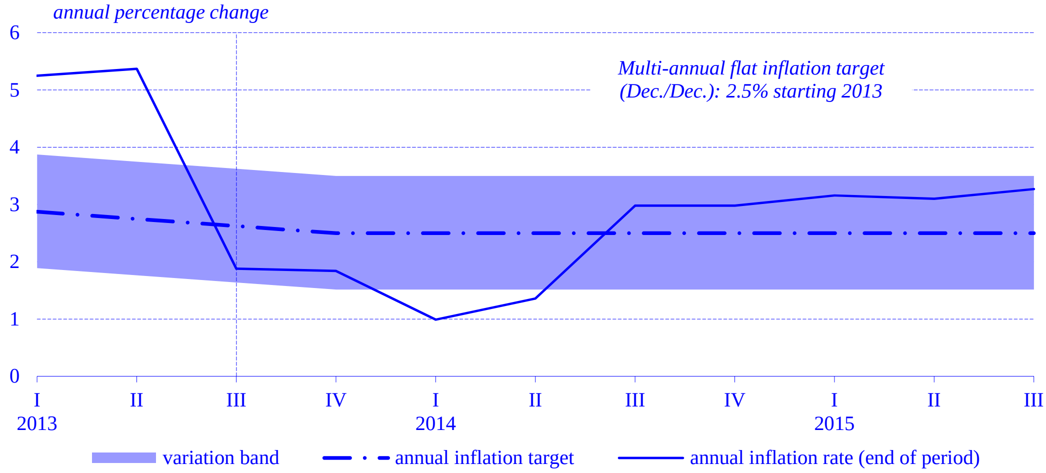
On the domestic front, the balance of risks to the forecasted inflation rate is tilted to the upside owing to information that became available after the completion of the baseline scenario of the macroeconomic projection, referring to increases in excise duties on certain categories of goods, which have been agreed by the Romanian authorities with the EU, the IMF and the World Bank and will most likely be incorporated in the draft budget for 2014.

Structural rigidities stand out as a persistent source of vulnerability, hindering the necessary adjustments across the domestic economy aimed at mitigating the consequences of adverse shocks. In this vein, especially in the context of the busy election calendar for 2014, strict compliance with the provisions of the new financing arrangement concluded with the EU, the IMF and the World Bank – with a focus on pushing forward structural reforms and the measures aimed at augmenting the domestic economy's growth potential – would alleviate, compared to the previous Inflation Report, the risks stemming from this source.

[4] According to the results of the latest NBR survey on inflation expectations of financial analysts.

The balance of risks associated with the baseline scenario assumptions on administered price dynamics shows a relative equilibrium throughout the reference period. Risks related to developments in domestic food prices appear balanced in the short run. However, the large share of food items in the consumer basket and the associated volatility induced to both core inflation and CPI dynamics continue to pose risks to price stability beyond near-term horizons.

Inflation Forecast



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

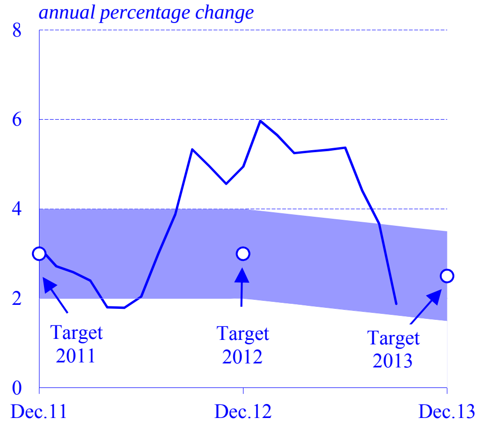
Source: NIS, NBR projections

Monetary policy decision

In light of the prospects for a temporary downward deviation of the annual inflation rate from the 2.5 percent ± 1 percentage point target, followed by its return and consolidation inside the variation band of the target once the impact of this year's crop and the lower VAT rate for some bakery products fades away, the NBR Board decided, in the meeting of 5 November 2013, to cut the monetary policy rate by 0.25 percentage points to 4.0 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

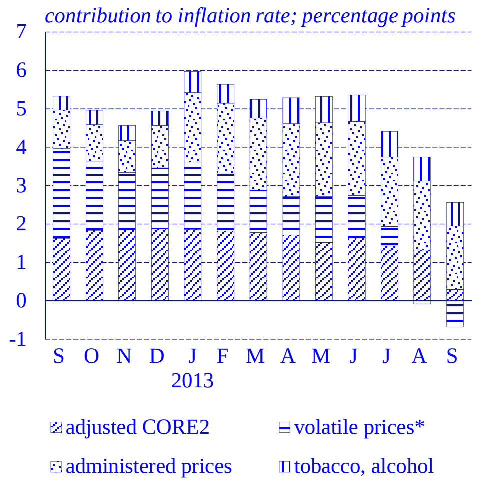
Inflation Developments



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

Source: NIS, NBR calculations

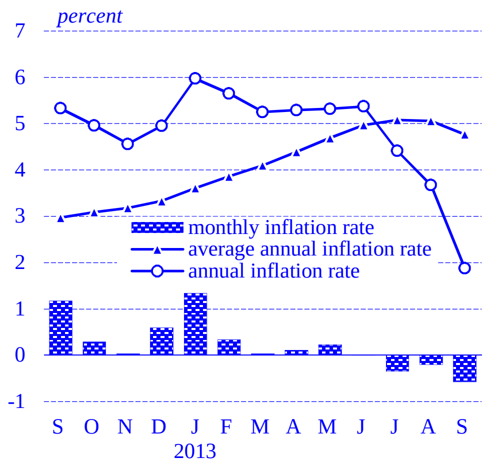
Annual Inflation Rate



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

Source: NIS, NBR calculations

Inflation Rate



Source: NIS

In 2013 Q3, annual CPI inflation rate followed a sharp downward trend, standing at 1.88 percent at quarter-end, within the lower half of the ±1 percentage point variation band around the 2.5 percent central target. The factors taken into consideration by the NBR projection in the August 2013 Inflation Report, namely the fading-out of the effects of the adverse supply-side shocks seen in the latter half of 2012, the gradual improvement in inflation expectations, and the persistence of the negative output gap, made a significant contribution to CPI inflation developments. However, the main favourable influences came from the exceptionally good 2013 agricultural year and the VAT rate cut to 9 percent from 24 percent applied to some bakery products as of September. Following this fiscal measure, adjusted CORE2 inflation hit a 0.49 percent record low.

At end-2013 Q3, volatile prices saw an annual rate of change of -4.5 percent, whose sharp decline from the June 2013 level (i.e. -12.1 percentage points) accounted for around half of the CPI disinflation in the period under review. The deceleration largely stemmed from a favourable base effect, especially in terms of volatile food prices, which had been strongly affected by the severe drop in output of fruit and vegetables in the same year-ago period. Moreover, this year's bumper crops caused faster annual deflation of VFE prices (-7.4 percent). As for fuel prices, they recorded moderate month-on-month movements, with the appreciation of the national currency versus the US dollar offsetting the impact of higher global oil prices[1].

Administered prices saw lower adjustments in 2013 Q3 than in the same year-ago period, their annual dynamics slowing by 1.5 percentage points to 8.9 percent. Prices of water, sewerage and sanitation services posted significant increases, generally as a result of their being inflation-indexed, according to the provisions of ongoing financing agreements concluded by local authorities. In addition, a new stage in the energy market deregulation process took place in July, when the free market component was added to the electricity price for household end-users and natural gas prices were raised by 8 percent. Concomitantly, the cut in the regulated price component and the lower contribution for renewable energy support led to the 2.5 percent fall in the end-user electricity price in July.

[1] Brent crude oil price rose from USD 103.3 per barrel in June 2013 to USD 111.7 per barrel in September, against the background of lower crude oil supply and stronger demand, with the latter explained by seasonal factors and the expansion of some refineries in Asia (Source: OPEC Monthly Oil Market Reports).

The annual rate of increase in tobacco product prices slowed down 1.3 percentage points to 9.3 percent in the reported period, due to the fading-out of the statistical effect coming from the early implementation of the calendar for excise duty hikes (in April instead of July).

While in the last years the third quarter frequently witnessed fiscal changes with an unfavourable bearing on CPI inflation, this year the VAT rate cut for some bakery products (to 9 percent from 24 percent as of 1 September 2013) made a 0.7 percentage point contribution to disinflation. The measure was almost fully[2] mirrored by the prices of the three categories of goods to which it applied, i.e. flour, bread and other bakery products, and had a major effect on the path of adjusted CORE2 inflation, specifically 1.2 percentage points of its decline from 2.85 percent in June 2013 to 0.49 percent in September. Moreover, in 2013 Q3, the group of food items included in core inflation benefited from the drop in agri-food commodity prices, even though the pass-through to consumer prices was lower than that seen in the case of an adverse supply-side shock (edible oil, sugar).

The annual dynamics of market services prices also decelerated significantly, i.e. by 1.3 percentage points to 0.9 percent, largely on the back of the developments in the national currency versus the euro; specifically, the leu appreciated slightly in September against June 2013, in contrast to the depreciation recorded in the similar period of the previous year. The exchange rate movements also had a dampening impact on the group of non-food prices, counteracting the inflationary pressures generated by the rise in external prices[3].

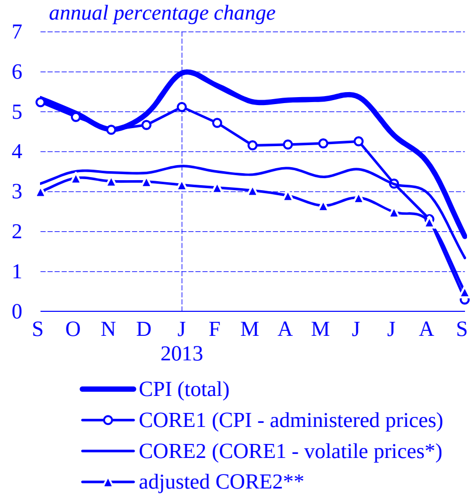
Overall, the persistence of the negative output gap enhanced the visibility of the favourable influences exerted by the aforementioned factors on the three groups of prices included in adjusted CORE2 inflation.

In 2013 Q3, inflation expectations of economic agents (consumers, industrial, construction, trade and services companies, banking analysts) saw a broad-based improvement. Given the highly backward-looking expectations, the recent successive price decreases were most likely the decisive factor in this respect.

Even though the average annual HICP rate resumed a downward path July through September 2013 (down 0.4 percentage points to 4.1 percent), the differential versus the Maastricht criterion on inflation rate remained high, declining only marginally to

Headline Inflation and CORE Inflation

annual percentage change



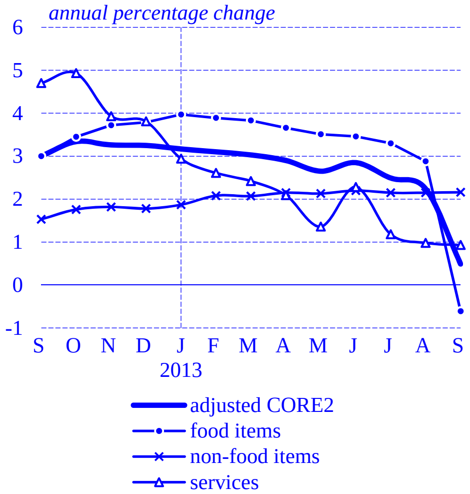
*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

Source: NIS

Adjusted CORE2 Components

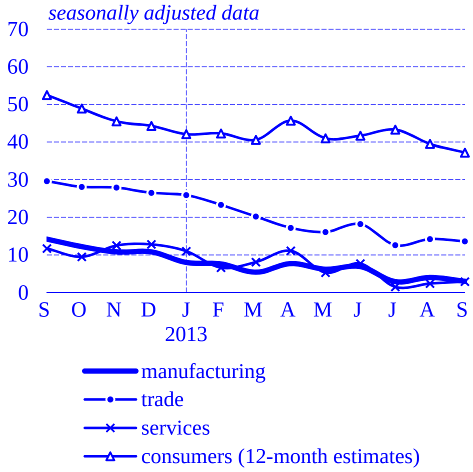
annual percentage change



Source: NIS, NBR calculations

Inflation Expectations of Economic Agents

balance of answers (%); 3-month estimates, seasonally adjusted data

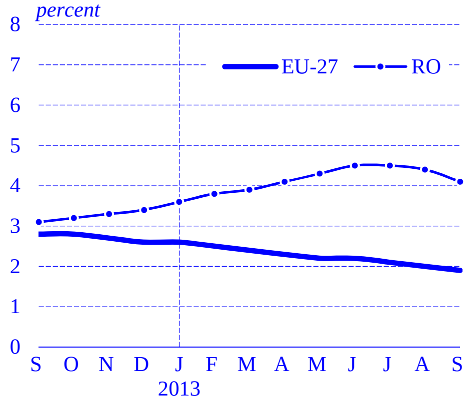


Source: EC-DG ECFIN

2 In a proportion of 93 percent on average.

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

Average Annual HICP Inflation Rate*



*) 12-month average rate of change

Source: Eurostat

1.9 percentage points. The deviation from the EU average inflation rate posted a similar development, standing at 2.2 percentage points in September.

The materialisation of the downward risks associated with the short-term projection in the August 2013 Inflation Report determined a 1.1 percentage point overestimation of the actual annual inflation rate. In particular, some 0.7 percentage points of the forecast error came from the VAT rate cut applied to some bakery products, which was announced after the macroeconomic projection had been finalised. Moreover, the above-average crop – unlike the assumption of a normal agricultural year that was considered in the NBR projection – was mirrored by larger-than-expected corrections in volatile food prices, thereby contributing another 0.4 percentage points to the mentioned deviation.

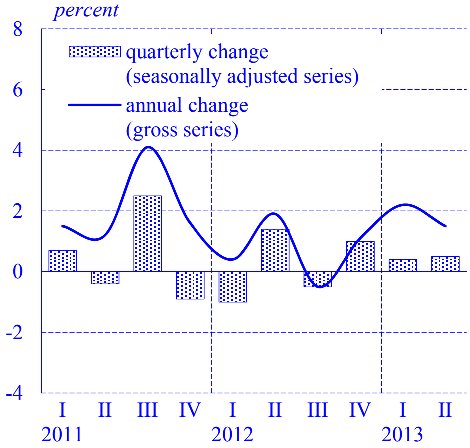
II. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2013 Q2, real GDP remained on an uptrend (+1.5 percent[1]), albeit posting a 0.7 percentage point slower annual growth rate than in Q1. The slacker pace of increase owes solely to a base effect, whereas the real GDP quarterly dynamics slightly accelerated.

Similarly to the picture seen in 2013 Q1, net external demand was the catalyst of economic growth, with its contribution to real GDP advance adding another 1.6 percentage points, to +6.1 percentage points, given the wider positive differential between the dynamics of exports of goods and services and those of imports thereof. By contrast, domestic absorption followed an even steeper downtrend (-4.3 percent versus -2.2 percent in Q1), which however cannot be accounted for by the components with higher shares, since consumer demand saw an improvement and gross fixed capital formation reported a slower pace of decline. The culprit for the deceleration in real GDP dynamics is virtually the "change in inventories", a largely residual item whose contribution stood at -4.1 percentage points.

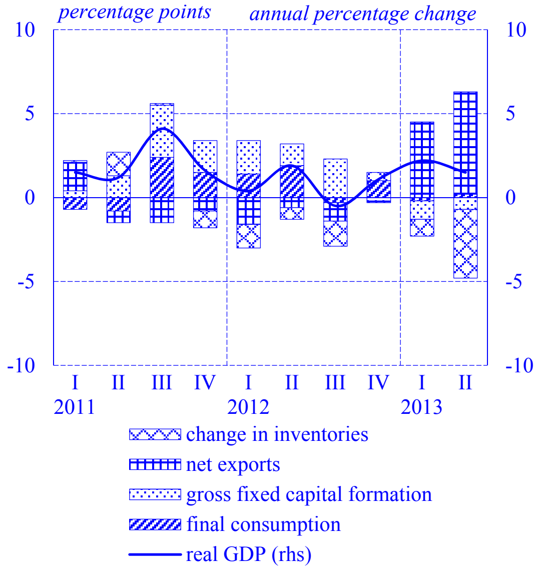
Real Gross Domestic Product



Source: NIS

Turning to real GDP quarterly performance, the analysis of the major demand components points to developments similar to those in 2013 Q1, with net external demand being the driver of the 0.5 percent economic growth. The positive contribution of this item, i.e. 2.2 percentage points, was the result of the increase (albeit slower) in exports of goods and services (up 3.5 percent, accounting for nearly one third of the dynamics posted in Q1), on the one hand, and of the 0.2 percent contraction in imports, on the other hand. Domestic demand shrank by 1.3 percent, yet the same as in the case of the series in annual terms, this decline is not attributable to the items with a larger economic content. Thus, the two major components of domestic absorption witnessed a recovery (final consumption and gross fixed capital formation added 0.5 percent and 0.2 percent respectively), so that their joint contribution to real GDP dynamics stood at 0.5 percentage points, which was nevertheless more than offset by the over 67 percent fall in the "change in inventories". On the supply side, positive contributions to the quarterly advance in real GDP had industry and agriculture, with the rise in gross value added in these sectors, i.e. up 1.8 percent and 4.8 percent respectively, marking the best performance over the last seven quarters. The construction sector and services followed the opposite trend, i.e. down 2.3 percent and 0.2 percent respectively. At aggregate level, the quarterly growth

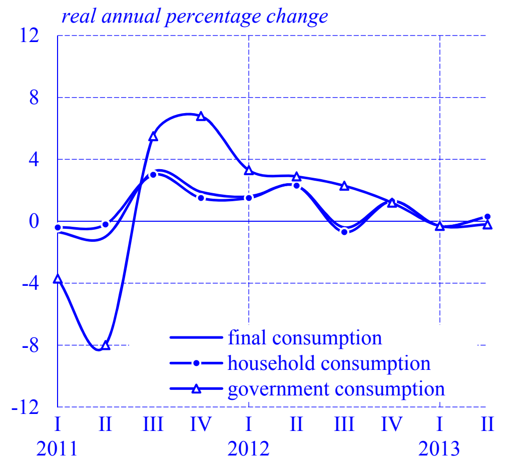
Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

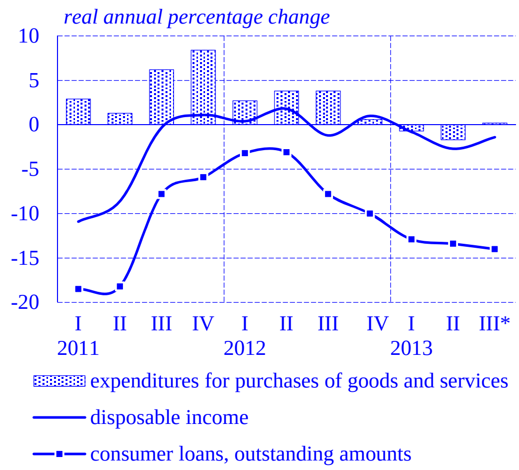
[1] Unless otherwise indicated, the growth rates in this section are annual percentage changes in real terms, calculated based on unadjusted data series. Current developments refer to quarter-on-quarter changes and are calculated based on seasonally-adjusted data series.

Actual Final Consumption



Source: NIS

Household Consumption and Main Financing Sources



*) Jul.-Aug.

Source: NIS, MPF, NBR calculations

rate of GVA (0.6 percent) was faster than that recorded January through March. However, its stimulative impact on the quarterly dynamics of real GDP was slightly mitigated by the steeper downtrend followed by net taxes on products (-2.1 percent versus -0.8 percent in Q1).

1.1. Demand

After three quarters of (small magnitude) declines, the real dynamics of final consumption returned to positive territory (+0.3 percent annual change), with the trend reversal owing to similar developments in household consumer demand, whereas government final consumption further witnessed a marginal drop, i.e. down 0.2 percent. The step-up in private consumption was largely ascribable to the components in correlation with the performance of agriculture (which rebounded strongly in the reviewed period), namely purchases on the agri-food market, self-consumption and household goods industry. By contrast, retail purchases of goods and services, the main segment of household consumer spending, followed an even steeper downward path[2]. Thus, their volume shrank for non-durables (particularly food items and fuels) and motor vehicles, with the latter development occurring also under the impact of a statistical effect triggered by the different timing of the launch of the 2012 and 2013 national car scrapping schemes.

As regards funding sources, the lower demand for goods for private consumption is in line with the developments in household disposable income[3] and with those in consumer loans, with both indicators embarking on steeper downtrends, to -2.7 percent and -13.4 percent respectively.

In 2013 Q2, the general government deficit stood at lei 2,440 million (i.e. 0.4 percent of GDP[4], corresponding to a primary surplus of 0.1 percent of GDP), below that posted in Q1 and in the same year-ago period, respectively, the latter of which amounted to lei 3,406 million[5] and accounted for 0.6 percent of GDP. The resumption of the improved budget execution was the result of the faster annual dynamics of total budget revenues (+1.2 percent[6] versus -2.5 percent in 2013 Q1), bolstered by the favourable

2 Calculations based on the series of indices related to the turnover volume of retail trade and market services rendered to households.

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

4 The analysis relied on the operational data released by the MPF relative to the end-June 2013 general government budget execution. The nominal GDP reading for 2013 took into account the figure published by the MPF relative to the latest budget execution.

5 The 2012 budget execution figures have been recalculated by the MPF to ensure comparability with those for 2013.

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

performance of receipts from the tax related to use of goods, to authorisation of the use of goods or to developing activities[7], as well as of EU funds. Total public expenditure further contracted at a relatively similar pace to that seen in the first three-month period of 2013, i.e. -1.0 percent, mirroring the opposite effects of the substantially slacker annual growth rate of interest repayments, on the one hand, and the slower annual decrease in primary expenditure (-0.1 percent against -1.6 percent in 2013 Q1), on the other hand. The latter development mainly reflected the dynamics of expenditure for projects financed from non-repayable external loans entering positive territory and the lower annual reduction in social payments and the expenditure for projects with repayable funding respectively.

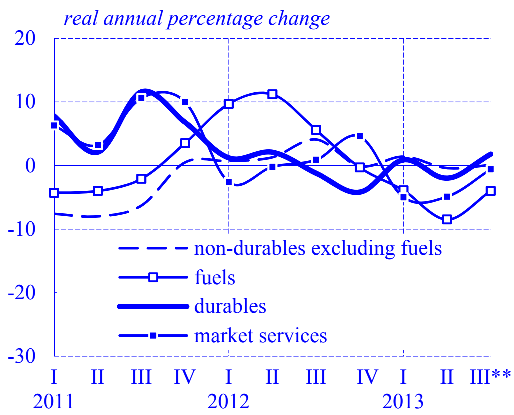
Gross fixed capital formation shrank by 2.9 percent, with the slower annual pace of decline than in Q1 (by 2.5 percentage points) being ascribed to the current rebound (+0.2 percent in Q2 versus -2 percent in the previous quarter). As regards investor categories, behind the lower investment demand stood chiefly the public sector and households, while corporate fixed capital investment remained relatively unchanged in annual terms.

(i) The budget execution data pinpoint a fall in capital expenditure (-11.6 percent) for the fifth quarter in a row. Thus, according to construction firm managers, 2013 has witnessed a delayed launch or even termination of a significant number of publicly-funded road infrastructure contracts, a persistent financial deadlock, as well as sluggishness in implementing EU-funded projects.

(ii) As for household investment, both new residential construction works and capital repairs saw volume decreases, i.e. down 30 percent and 6.1 percent respectively. Under the circumstances, the rise seen in the real stock of household real estate loans in Q2 as well (up 20.5 percent[8]) mainly owes to the pick-up in real estate transactions, a significant contribution coming from larger purchases of old housing units under the "First Home" programme, given the (uncertain) prospects for turning the latter into the "New Home" programme. Yet, mention should be made that, in terms of the investment flow, purchases of finished housing units have a bearing merely via the expenditure for services related to ownership transfer.

(iii) Companies further showed marked appetite for purchases of equipment (including transport means), whose volume added 14.9 percent, with banks[9] providing some of the underlying funds. Outlays related to segments with lower shares in the corporate investment value – construction works (new

Purchases of Goods and Services*

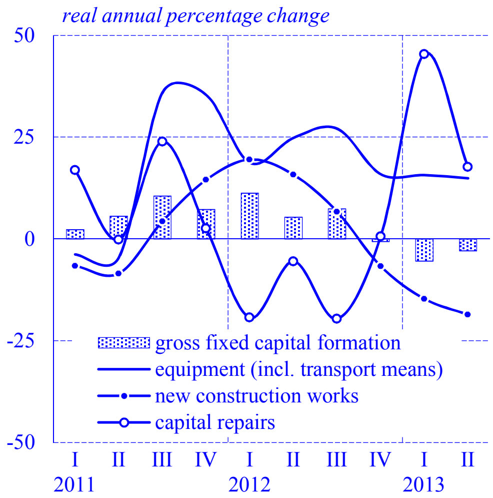


*) based on data on the turnover volume of retail trade and market services to households

**) Jul.-Aug.

Source: NIS, NBR calculations

Investment



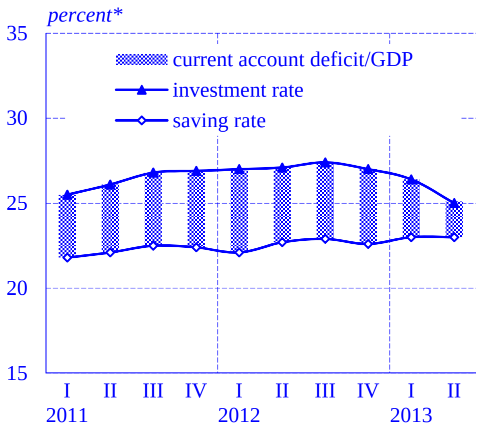
Source: NIS, NBR calculations

[7] Following the collection of licence fees whereby rights to use radio frequencies are granted.

[8] Calculations based on the data supplied by the Central Credit Register (CCR).

[9] The stock of loans for equipment purchases remained on a slight uptrend (+3.1 percent in real terms; data supplied by the CCR).

Investment Rate and Saving Rate

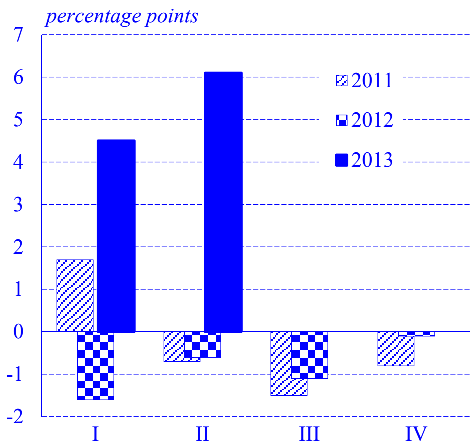


*) last 4 quarters' average

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

non-residential construction works and capital repairs) and lease purchases of motor vehicles and equipment – followed the opposite trend, with their real paces of decline ranging between 11 percent and 29 percent. As for the support provided by foreign direct investment to the non-bank sector, the rise in cumulated flows over the last four quarters came to a halt, since the threefold increase in net inflows of intra-group loans was offset by the nearly 60 percent fall in equity stakes (consolidated with the net loss).

The improved performance of the external sector was ascribable to the trade in goods, as in 2013 Q2 exports reported a more than two times faster annual growth rate (to 11 percent), on the one hand, and the volume of imports recorded a 1.5 percent drop, on the other hand.

The EU trade[10] was the driver of the faster rise in the sale volume of goods (8.3 percent in 2013 Q2 versus 1.1 percent in the previous three-month period), due to developments in exports of intermediate goods, consumer goods and motor vehicles. Exports to non-EU countries also stayed on an uptrend, albeit reporting a slower pace of growth (7.9 percent against 11.1 percent in Q1), chiefly on account of intermediate goods and, to a lower extent, consumer goods. Exports of capital goods and transport means to non-EU countries witnessed a swifter-paced advance than in the first quarter. The rise in total exports of motor cars in 2013 Q1 and Q2 (19.1 percent and 42.3 percent[11] respectively) owed both to the extensive renewal of Dacia's car models and to the popularity enjoyed by Ford B-MAX, which was declared the best-selling compact MPV on the European car market in 2013 H1.

The drop in imports of goods was the result of the steeper downtrend followed by purchases on the non-EU markets, whose physical volume fell by around 18 percent versus -5.9 percent in 2013 Q1, mainly in the case of energy commodities, amid the fall in the activity of energy intensive companies and the wider recourse to renewable resources. The move was partly offset by the swifter rise in imports from EU countries (+1.9 percent), mostly on the back of intermediate goods.

1.2. Supply

As regards GDP formation, the culprit for the GDP slower annual dynamics in the quarter under review was the 3.8 percent contraction in net taxes on products, the main reason being the decrease in VAT receipts against the backdrop of the weak domestic absorption, the larger production for external markets

[10] The breakdowns of the physical volume of exports and imports (by destination market/market of origin and by group of goods according to the Broad Economic Categories classification) are based on the series of trade balance data and international trade-related unit value indices released by the Eurostat.

[11] According to the Automotive Manufacturers and Importers Association.

and the significant contribution made by agriculture – a sector with low tax yields – to support economic growth. By contrast, gross value added remained on a moderate uptrend (2.4 percent annual change), with a slightly upward slope as compared with 2013 Q1.

Industry made the largest contribution to economic growth, as GVA in this sector added 5 percent (up 2.4 percentage points from the first quarter), solely on account of external demand, whereas the developments in the turnover volume in industrial output for the domestic market (-9.4 percent in the reviewed period against -6.9 percent January through March) hint at the protracted decline of this component. Particularly the production of motor vehicles and of machinery and electrical equipment, as well as the food industry and the light industry, saw faster paces of increase, to which added the rebound in oil processing (annual changes ranged between 6.8 percent and 21.5 percent).

Another sector that made a positive contribution to real GDP dynamics was agriculture, whose GVA witnessed a trend reversal (from -8 percent to +17.7 percent), on the back of the favourable weather conditions.

The annual growth rate of services decelerated for the third quarter in a row, with GVA moving up 0.4 percent. Trade and transportation, as well as information and communication, reported a weaker performance than in the similar year-ago period (-2.1 percent and -1.2 percent respectively), while the other sub-sectors stayed on a slight uptrend, with real estate transactions posting the swiftest dynamics, i.e. 3.6 percent.

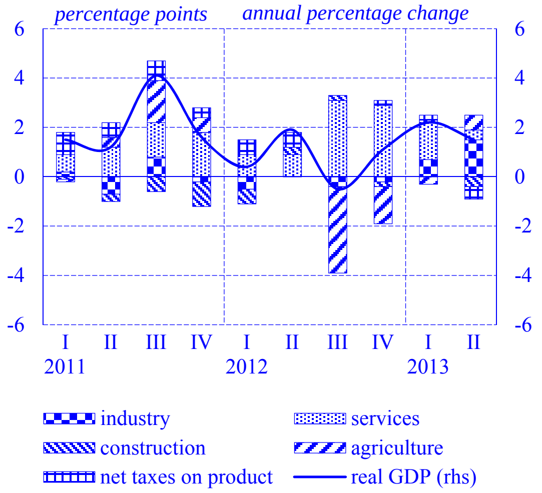
GVA in the construction sector lost 4.5 percent, given that the rise in capital repair works on civil engineering structures and the advance in current repair works proved insufficient to offset the ongoing decrease in new construction works, the main component of the aforementioned sector.

2. Labour market

The period June-August 2013 provided new hints at the recovery trend in labour market conditions coming to a halt[12], as the flagging domestic demand led to the persistence of slow-paced hires, the ILO unemployment rate standing higher than the average for the past four years and the worsening employment expectations of companies. Under the circumstances, in terms of price stability, the risks associated with the labour market are further low – the annual dynamics of wage earnings in the private sector remained moderate, there were no pay rises in the budgetary sector in the current year and unit labour costs in industry kept on decreasing as compared with the same year-earlier period.

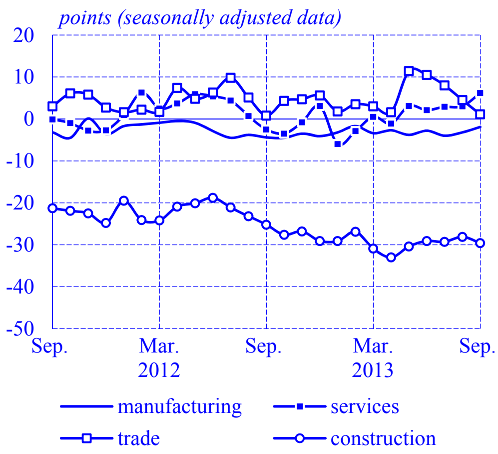
12 The analysis is based on seasonally-adjusted data.

Contribution of Supply Components to GDP Growth



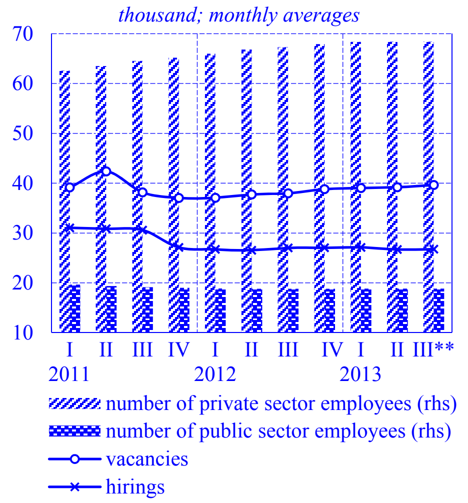
Source: NIS, NBR calculations

Corporate Sector: Confidence Indicators for the Next 3 Months



Source: EC-DG ECFIN

Labour Force Demand Measures*



*) seasonally-adjusted data

**) Jul.-Aug.

Source: NEA, NIS, NBR calculations

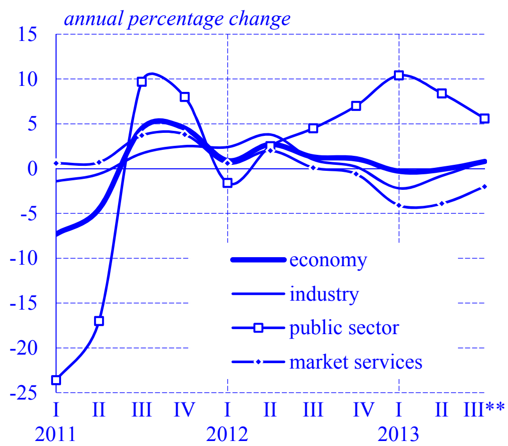
Unemployment Rate*

*) seasonally adjusted data

**) Jul.-Aug.

Source: NIS, NBR calculations

Net Real Wage*

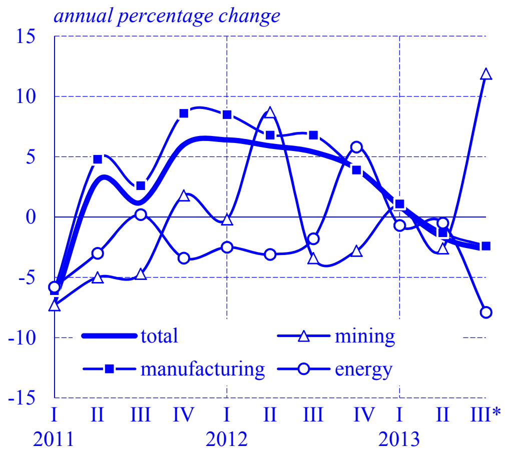


*) deflated by CPI

**) Jul.-Aug.

Source: NIS, NBR calculations

Unit Labour Cost in Industry



*) Jul.-Aug.

Source: NIS, NBR calculations

The modest developments in labour demand translated into the number of vacancies identified by the NEA and the personnel numbers reported by employers economy-wide remaining broadly flat. Despite exports of industrial goods performing well, economic operators in industry downsized their staff, with layoffs particularly in the chemical industry and the light industry. At aggregate level, this influence was offset by the hires in the market services sector (namely administrative and support service activities, accommodation and food service activities, information and communication), while staff numbers in the budgetary sector were further relatively unchanged. At the same time, the excess labour supply increased, as June through August 2013 the ILO unemployment rate stood at 7.5 percent, one of the highest readings posted since the outbreak of the economic crisis. Moreover, the relatively stable registered unemployment rate, i.e. approximately 5.2 percent, owed exclusively to the marked fall in the number of employees not receiving unemployment benefits, associated with the 2012 high school graduates choosing to no longer renew their applications for registration with the NEA. Managers' employment expectations[13] until end-2013 point to the persistence of conditions adverse to labour absorption in most economic sectors and especially in the construction sector.

In the period July-August 2013, the annual growth rate of nominal gross wage earnings (5 percent) slowed down by 0.4 percentage points economy-wide as compared with 2013 Q2 owing solely to a base effect, via the fading out of the impact exerted by the June 2012 budgetary sector pay rise. In the private sector, gross wage dynamics saw a short-lived acceleration under the influence of occasional bonuses and the increase in the minimum gross wage economy-wide from lei 750 to lei 800 in July. However, the aforementioned dynamics remained moderate, i.e. 3.7 percent, with wages in market services further reporting the lowest growth rates.

In industry, labour productivity gains fully made up for the faster annual pace of increase of the average gross wage, leading to the further reduction in unit labour costs. Thus, the latter's annual dynamics fell deeper into negative territory, from -1.7 percent in 2013 Q2 to -2.7 percent in July-August. This development was visible in energy and manufacturing, to which contributed the chemical industry, the automotive industry and machinery and equipment, as well as the rebound in the light industry.

The absence of inflationary pressures is hinted at by both the lower unit labour costs and the further negative readings reported by the annual rate of change of real disposable income, with the impact of the modest rise in wage incomes being offset July through August (similarly to the picture seen in 2013 Q2) by the marked contraction in workers' remittances from abroad and the moderate decrease in social transfers.

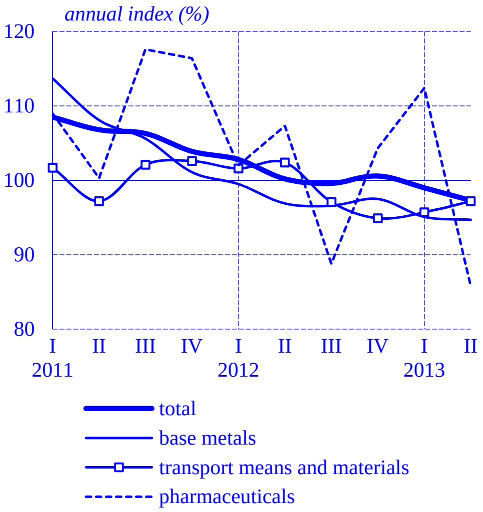
[13] See the DG ECFIN/NIS survey and the Manpower Employment Outlook Survey.

3. Import prices and producer prices

In 2013 Q2, the favourable developments on the external commodity markets and the appreciation of the domestic currency versus the major currencies underpinned the decline in import prices and the abatement of inflationary pressures exerted by industrial producer prices. The faster pace of growth of agricultural producer prices owed solely to certain atypical influences on the part of vegetable products. In 2013 Q3, the aforementioned trend might persist in the case of import prices and industrial producer prices, but will reverse in that of agricultural producer prices, amid the record crop in the current year.

April through June 2013, behind the favourable contribution of import prices to the dynamics of domestic prices stood both the external component (as the annual unit value index of imports further dropped to 97.3 percent) and the exchange rate movements in relation to the major currencies (strengthening of the leu versus the euro and particularly the US dollar).

Items Reporting Declines in Import Unit Value Index in 2013 Q2



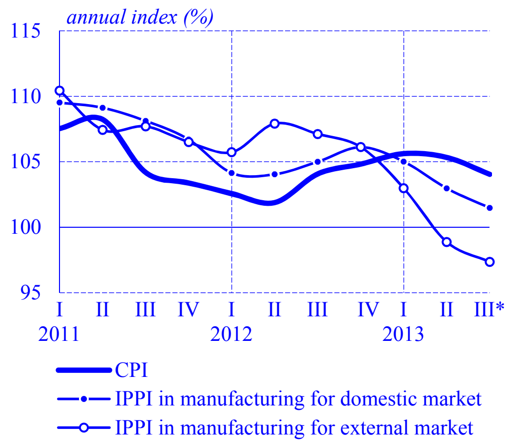
Source: NIS, NBR calculations

The analysis of price dynamics of imported goods holding a large share in the CPI basket highlights mixed developments. Thus, lower import prices were recorded by fuels, amid the uncertainties surrounding global demand, the rising supply and the large stocks, and pharmaceuticals, possibly on the back of the shift in consumption to generic medicines, which are significantly cheaper than the original ones. By contrast, higher import prices were posted by certain food items (meat and fruit), wearing apparel – in line with the rise in prices for raw materials in the early months of 2013 – and footwear.

As regards the other groups of goods (intermediate goods and capital goods), the unit value index of imports remained below par in the case of both metals and transport means (amid the further rise in imports of used motor cars to the detriment of new ones).

In 2013 Q2, the annual dynamics of industrial producer prices for the domestic market decelerated to 4.9 percent, down 1.5 percentage points from the previous quarter. The trend was manifest across all groups of goods and was favoured by the lower external/domestic commodity prices, the appreciation of the leu versus the major currencies and the persistent dampening effect of domestic demand contraction, as shown by the developments in the turnover volume and in new orders.

Consumer Prices and Industrial Producer Prices



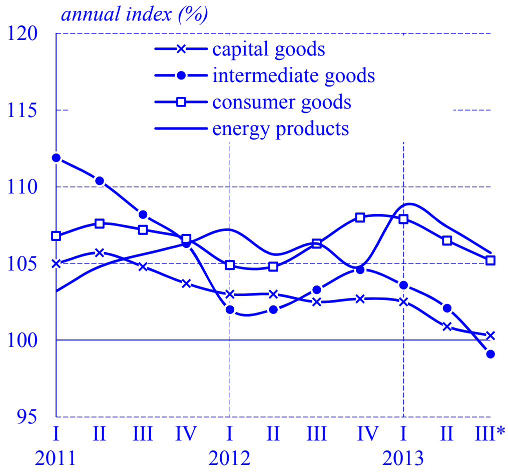
*) Jul.-Aug.

Source: NIS

Under the joint impact of the aforementioned factors, the annual growth rate of producer prices for intermediate goods and capital goods kept on slowing down to 2.1 percent and 0.9 percent (the lowest reading over the past three years) respectively.

The annual pace of increase of energy prices also decelerated by 1.4 percentage points following the drop in international crude oil

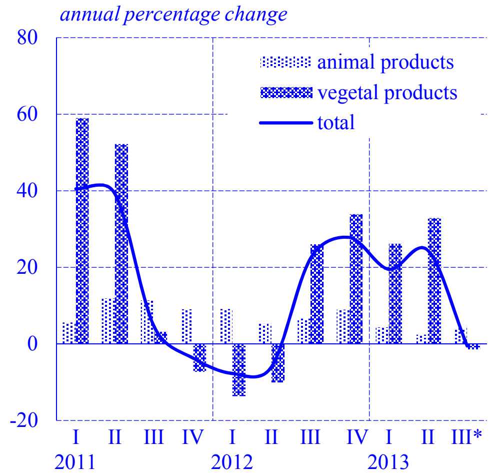
Industrial Producer Prices for Domestic Market by Industrial Products Group



*) Jul.-Aug.

Source: NIS

Agricultural Producer Prices



*) Jul.-Aug.

Source: NIS

prices, down to 7.4 percent, the swiftest annual dynamics among the analysed groups. Mention should as well be made in this case of the favourable bearing of the deregulation of electricity prices, with the electricity market openness standing at 45 percent in April (against 30 percent in 2013 Q1), along with the decrease in the average trading price for the electricity traded on the OPCOM platform.

The slower annual growth rate of producer prices for consumer goods (down 1.4 percentage points, to 6.5 percent) was ascribed to the food industry, which benefitted from the lower costs of commodities against the backdrop of an optimistic outlook for the current year's crops.

Even though most prices of grains declined in the period under review, the annual dynamics of producer prices for vegetal production as a whole picked up by 6.7 percentage points to 32.9 percent in 2013 Q2, solely on the back of the transitory hike in vegetables prices.

The annual changes in producer prices for animal products further fell to 2.4 percent, with the lower fodder costs making the largest contribution to this development, as their annual growth rate halved as compared with the previous three-month period, coming in at 4.6 percent.

In 2013 Q3, the stronger appreciation of the domestic currency versus the major currencies and the favourable performance of external agri-food commodity prices point to the dynamics of import prices remaining in the negative territory. Nevertheless, an adverse impact might exert the recent rise in external metal prices, particularly as a result of the positive economic signals sent by China, and the resumed advance in crude oil prices. As for domestic producer prices, another significant influence comes from the ongoing deregulation of electricity prices[14], against the background of the persistent downtrend followed by the average trading price on the deregulated market. Under the circumstances, the deceleration of the annual dynamics of producer prices in the period July-August (to 2.3 percent in the latter month) is likely to persist over the whole quarter. Moreover, harvesting a record crop[15] in 2013 will lead to a trend reversal in agricultural producer prices.

[14] Starting July 2013, 65 percent of the electricity supplied to non-residential consumers has come from the deregulated market, with the above-mentioned share rising to 85 percent in September.

[15] For the first time ever, Romania ranks first in the EU with respect to its sunflower production, while those of wheat and rye saw the highest readings in the past eight years.

III. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

The rate-cutting cycle gained momentum in August and was extended into September 2013, with the central bank thus bringing the monetary policy rate down to 4.25 percent. At the same time, the NBR preserved the adequate management of banking system liquidity and kept in place the existing levels of minimum reserve requirement ratios on credit institutions' leu – and foreign currency-denominated liabilities. The ongoing gradual adjustment of monetary conditions - warranted by the sizeable downward correction anticipated for the annual inflation rate in 2013 Q3 – was aimed at effectively anchoring inflation expectations, while paving the way for the revival of lending and restoring confidence and thus contributing to the recovery of the domestic economy.

The NBR Board decided, in its meeting of 5 August 2013, to accelerate the rate-cutting pace, lowering the monetary policy rate by 50 basis points to 4.50 percent per annum. Behind this decision stood the anticipated fast downturn in the annual inflation rate during 2013 Q3 and its return inside the variation band of the flat target in September, amid positive base effects becoming visibly manifest. At the same time, the baseline scenario of the updated projection (prepared in the context of the August 2013 Inflation Report) revealed the renewed improvement in the outlook for both headline inflation throughout the policy-relevant horizon and core inflation, underpinned by the relatively steeper downward adjustment of inflation expectations and the anticipated persistence of the wide negative output gap. In addition, disinflationary factors prevailed in the balance of risks to the inflation outlook over the near-term projection horizon, considering the emerging premises of this year's significantly higher-than-expected agricultural output and the government's announcement on cutting the VAT rate applied to some bakery products as of 1 September 2013.

In its meeting of 30 September, the NBR Board decided to cut the monetary policy rate by an additional 25 basis points, prompted by incoming data that confirmed the forecasts on fast-paced disinflation in July and August[1] and revealed the prospects for a steeper-than-expected fall in inflation rate in the following two quarters; this fall would be driven by the transitory impact of the VAT rate cut applied to some bakery products[2] and by this year's

[1] The annual inflation rate fell successively to 4.41 percent and 3.67 percent respectively from 5.37 percent in June.

[2] Starting 1 September 2013.

much better agricultural output, with relatively more favourable effects on the dynamics of food prices, volatile prices in particular. As a matter of fact, the performance of agriculture was expected to be the almost exclusive determinant of the relative improvement in short-term economic growth prospects, implying the maintenance of the negative output gap at previously-projected levels[3], given the anticipated slow recovery of key domestic demand components[4], also in the context of the real annual dynamics of private sector credit remaining deep in negative territory.

The downtrend in the annual dynamics of credit to the private sector[5] extended into July and August (-7.3 percent from -6.9 percent in 2013 Q2), mainly on account of the swifter rate of decline of the leu-denominated component (-3.2 percent against -1.9 percent April through June 2013), with the dynamics of foreign currency credit remaining relatively unchanged at -3.9 percent (based on readings expressed in euro). The breakdown by recipient points to developments in line with the results of the August 2013 NBR survey on lending to non-financial corporations and households, according to which banks anticipated that the fall in corporate demand for loans would continue in 2013 Q3, along with the renewed tightening of relevant lending standards. The evidence was mixed in the case of households, as respondents anticipated a return of demand for real estate credit onto an upward path and a standstill in the demand for consumer loans, in the context of lending standards remaining unchanged[6]. Against this background, the annual dynamics of credit to non-financial corporations contracted further and reached -7.7 percent in the first two months of 2013 Q3 versus -6.7 percent a quarter earlier, reflecting the steeper decline in the annual rate of change of leu-denominated corporate credit[7] (-1.7 percent in July and August, compared to 1.5 percent in 2013 Q2), to which added the dynamics of the foreign currency component remaining in negative territory at almost the same level. The most heavily impacted were short-term loans, with the dynamics of leu-denominated credit plunging deeper into negative territory (-13.0 percent from -5.7 percent in Q2), correlated with the sharper decline in new business and the possible increase in the volume of repayments. By contrast, the annual rate of change of household loans saw its decline come to a halt (-6.8 percent July through August versus -7.1 percent in Q2), also due to the renewed pick-up in the growth rate of housing loans (4.3 percent against

3 August 2013 Inflation Report.

4 Excluding self-consumption.

5 Unless otherwise specified, indicators are calculated as average annual changes expressed in real terms.

6 After having been tightened over the past seven quarters and two quarters respectively.

7 Which thus consolidated into negative territory, after two years of positive readings.

3.5 percent in the previous quarter), largely driven by the domestic currency component (30.1 percent compared to 24.7 percent April through June 2013). However, the annual dynamics of consumer credit remained on a downward path (-14.0 percent from -13.4 percent in 2013 Q2).

Developments in private sector credit were mirrored only partly by broad money, whose rate of decline slowed to -0.8 percent in July and August against -1.6 percent in 2013 Q2, due to the statistical effect of the lower annual inflation rate, but also to the impact of the considerably higher amounts from European funds against the same year-ago period. The latter fuelled primarily the more liquid component of broad money (M1), which therefore witnessed a relative recovery in terms of growth rate during July-August (0.6 percent from -1.5 percent in Q2), with corporate overnight deposits in domestic currency making the largest contribution. Conversely, the annual rate of change of time deposits with a maturity of up to two years sank further into negative territory (-1.7 percent versus -0.7 percent in the second quarter of the year), as a result of the marked decline in the annual dynamics of corporate deposits (also due to a base effect) and the only modest advance in the growth rate of household time deposits, ascribable particularly to the aforementioned statistical influences.

The ongoing downtrend of the monetary policy rate and the expectations for the rate-cutting cycle to continue in the forthcoming period, along with anticipations of the NBR further pursuing an adequate management of liquidity in the banking system, have supported the easing of liquidity conditions on the interbank money market. A major contribution also had banks' net liquidity position returning to positive territory in August and then consolidating at relatively high values, under the impact of the renewed increase in liquidity injections generated by autonomous factors. The trend reversal resulted into a significant decline in banks' demand for reserves August through September 2013 and hence into a marked reduction in both the number of participants and the volume of bids submitted during the central bank's repo auctions[8]. These developments were accompanied by credit institutions' increased resort to the deposit facility, so that the daily average of amounts placed with this facility exceeded the previous quarter's reading. Against this backdrop, longer-term average money market rates – used as benchmarks in setting lending rates on new business – fell in August and September, after having remained somewhat stable in July, slightly below the monetary policy rate.

[8] Given the systematic absence of bids in the tenders organised in the latter half of August and in the first part of September, repos were temporarily suspended during 16-27 September.

2. Financial markets and monetary developments

Average interbank money market rates continued to shrink in 2013 Q3, the same as lending and time deposit rates on new business June through August 2013. The EUR/RON exchange rate saw its downtrend come to a halt in July, before embarking on a slightly upward path amid the episodes of heightened global risk aversion during this period. The annual dynamics of credit to the private sector contracted further during June-August 2013, while the annual rate of decline of broad money slowed on the back of larger disbursements from European funds and higher budget expenditures.

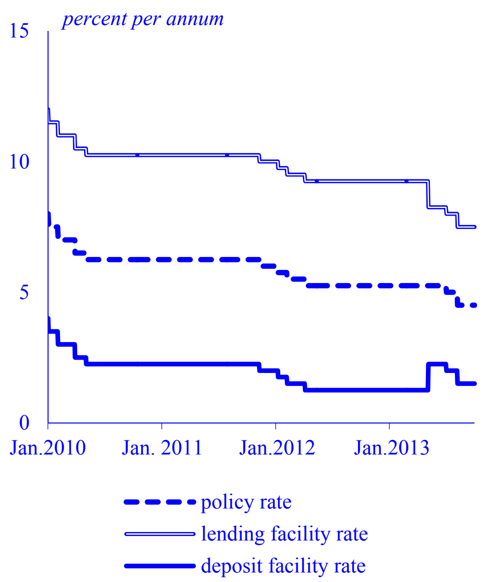
2.1. Interest rates

After having temporarily come close to the monetary policy rate in the first part of 2013 Q3, interbank money market rates fell in the latter part of the period under review in the lower half of the corridor defined by interest rates on the central bank's standing facilities around the policy rate. Hence, monthly average interbank rates hit a new historical low in August (2.68 percent)[9], while the quarterly reading shed 0.16 percentage points to 3.26 percent.

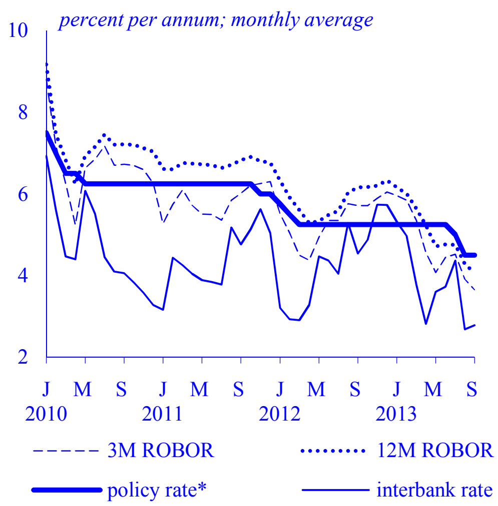
The decline in overnight rates reflected the easing trend of money market liquidity conditions, induced mainly by the liquidity injections generated by Treasury operations, which resulted into the net liquidity position returning to positive territory in the closing two months of 2013 Q3. In this context, after the relative increase seen in July, banks' demand for reserves witnessed significant adjustments, reflected by the sharp reduction and the absence respectively of bids submitted by credit institutions during the one-week repo tenders conducted by the NBR[10]. Against this background, overnight rates dropped in the lower part of the corridor defined by interest rates on the central bank's standing facilities around the policy rate, exhibiting in August and September a pattern of somewhat steep declines to the lower bound of the corridor, alternating with returns to slightly higher readings at the onset of reserve maintenance periods, under the impact of transitory liquidity absorptions by the Treasury.

Longer-term interbank rates remained relatively stable in July, slightly below the monetary policy rate, reflecting credit institutions' expectations on the NBR continuing the rate-cutting cycle and the further favourable outlook for liquidity conditions. In August, longer-term rates embarked on a downward path, which steepened as a result of the central bank exceeding expectations

Policy Rates



Policy Rate and ROBOR Rates



*) end of period

9 The data series spans the past 20 years.

10 Given the short-lived spikes in excess liquidity across the banking system, weekly repo tenders were discontinued during 16-23 September and 23-30 September.

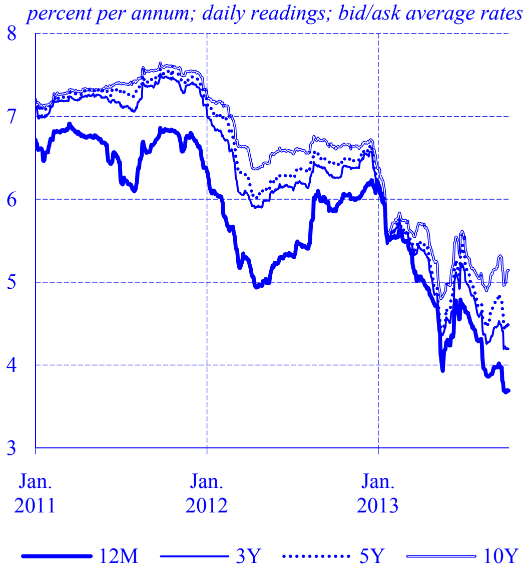
with its policy rate cut. Afterwards, interest rates across the entire maturity spectrum stabilised somewhat, before re-entering a sharp downtrend in the latter half of September. Consequently, average 3M ROBOR rates came in at 3.65 percent in September, 0.80 percentage points below the June reading, while average 6M and 12M ROBOR rates witnessed declines of a similar magnitude (down 0.70 percentage points), to stand at 4.02 percent and 4.07 percent respectively.

The maximum bid rate on the primary market for government securities re-embarked on a downward path in July, reflecting the marked increase in demand for securities[11], underpinned, inter alia, by the favourable developments in liquidity conditions on the interbank money market, as well as by the relatively large volume of maturing debt instruments (lei 3.8 billion in July). Hence, the maximum bid rate on five-year bonds fell to a historical low of 4.30 percent at mid-August, 0.96 percentage points below the June reading. In the closing 10-day period of August, however, the maximum bid rate re-entered an upward trend, as demand for securities came under the impact of heightened global risk aversion. Nevertheless, the adverse effects of external developments were mitigated by the ongoing favourable trend in domestic economic fundamentals and the further loose liquidity conditions, which helped preserve to a certain extent the relative attractiveness of local market investments. Thus, yields returned on a downtrend at mid-September, with the maximum bid rate on 12M securities dropping below 4 percent (3.9 percent) for the first time ever. By contrast, the maximum bid rate on 10-year bonds rose in September to a level comparable to that recorded in April (5.28 percent).

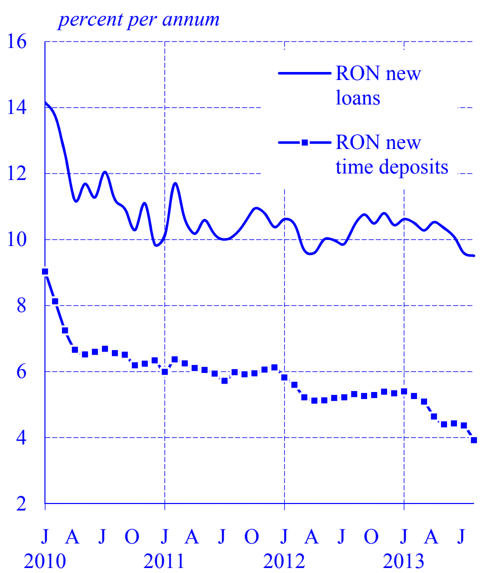
Benchmark rates on the secondary market for government securities moved in step with primary market rates, their downward path coming only to a short-lived halt in the closing 10-day period of August and the first 10-day period of September.

Reflecting the downward movement of both the policy rate and interbank rates, average interest rates on new time deposits and new loans continued to drop June through August 2013, by 0.48 percentage points (to 3.92 percent in August) and 0.83 percentage points (to 9.51 percent) respectively, thus reaching historical lows[12]. The two customer categories further posted similar developments throughout the period under review, although lending rates on new business witnessed a more pronounced decline. In particular, the average interest rate on new loans to households shed 0.77 percentage points, to a historical low of 11.07 percent in August, while that on new loans to non-financial

Reference Rates on the Secondary Market for Government Securities



Bank Rates



11 Demand for securities in July exceeded 4.4 times the announced volume, following the 1:1.9 ratio seen in June.

12 In 23 years.

corporations edged down 0.72 percentage points to 8.74 percent in August, slightly above the previous month's historical low of 8.63 percent. At the same time, average time deposit rates on new business contracted by around 0.5 percentage points both for non-financial corporations (to 3.38 percent) and for households (to a historical low of 4.59 percent).

2.2. Exchange rate and capital flows

During 2013 Q3, similarly to the exchange rates of other currencies in the region, the EUR/RON came under the impact of the successive episodes of heightened global risk aversion generated by the persistent uncertainty surrounding the timing of the Fed tapering its asset purchase programme. However, the massive portfolio shifts triggered in this context had a somewhat smaller influence on the local financial market, as the positive developments in some domestic fundamentals helped preserve non-resident investors' favourable risk perception vis-à-vis the Romanian market.

The downward path in the EUR/RON exchange rate manifest at the end of 2013 Q2 came to a halt in early July, amid heightened volatility on global financial markets, due primarily to (i) better-than-expected performance of a number of US economic indicators, including those relating to the labour market, which fuelled investor fears over a likely tapering of the Federal Reserve's asset purchase programme starting September, and (ii) the downward revision of the IMF's forecast on global economic growth during 2013-2014.

Subsequently, global financial markets were somewhat appeased by Chairman Bernanke's statements and therefore the domestic currency strengthened versus the euro during 17-26 July. However, the EUR/RON exchange rate returned to an upward trend in August, which steepened temporarily in the first part of September[13], given that international market participants' rekindled expectations on the forthcoming tapering of the Fed's quantitative easing triggered a new wave of heightened global risk aversion[14].

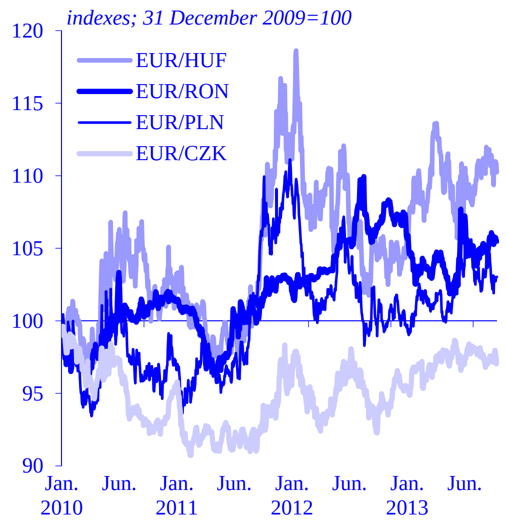
The worsening market sentiment was associated with investors attaching increased importance to local/regional fundamentals when deciding on portfolio shifts. As a result, similarly to other emerging CEE markets[15], the local financial market was better insulated against the adverse effects of the deteriorating sentiment,

Key Financial Account Items (balance)

EUR million

	2012 8 mos.	2013 8 mos.
Financial account	**2,772**	**-1,414**
Direct investment	**1,783**	**1,047**
– residents abroad	38	-71
– non-residents in Romania	1,745	1,118
Portofolio investment and financial derivatives	**684**	**3,156**
– residents abroad	-385	-482
– non-residents in Romania	1,069	3,638
Other capital investment	**-2,005**	**-4,255**
– credits and loans from the IMF	-667	-2,992
– medium- and long-term investment	499	-1,219
– short-term investment	-505	-277
– currency and short-term deposits	-1,548	-1,299
– other	217	-1,067
NBR's reserve assets, net ("-" increase/"+"decrease)	**-2,260**	**-1,362**

Exchange Rate Developments on Emerging Markets in the Region



Source: ECB, NBR

13 Ahead of the FOMC meeting of 18-19 September.

14 Towards end-August, fears related to the Syrian conflict added to the volatility on global financial markets.

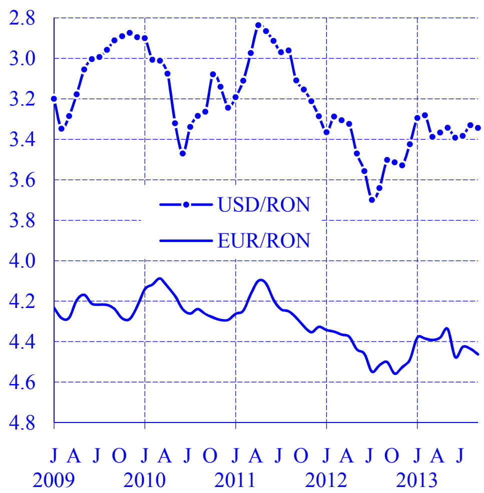
15 By contrast, owing to worsening expectations vis-à-vis the economic performance of emerging markets in Asia and South America, compounded by concerns over their ability to raise the necessary external funding, countries such as Turkey, India, Indonesia and Brazil were faced with massive capital flight.

most likely thanks to the steadily good performance of relevant macroeconomic indicators[16] and the successful talks over a new arrangement with the EU, the IMF and the World Bank. In addition, in light of the Fed's decision to keep the asset purchase programme in place in the near run, the EUR/RON exchange rate saw its upward movement come to a halt and then witnessed moderate both-way fluctuations.

Reflecting these developments and seasonal influences, interbank forex market liquidity remained high in July, before diminishing in the following months. At the same time, the liquidity shortfall widened gradually, driven by keener net demand for foreign currency of non-residents (August) and residents (September) respectively.

July through September[17], the domestic currency strengthened versus the euro by 0.3 percent in nominal terms and weakened 0.8 percent in real terms. In relation to the US dollar, the leu appreciated 1.5 percent in nominal terms and 0.3 percent in real terms, given the former's depreciation on global financial markets. Looking at the average annual exchange rate dynamics in 2013 Q3, the domestic currency strengthened both against the euro and especially against the US dollar.

Nominal Exchange Rate



2.3. Money and credit

Money

June through August 2013, broad money (M3) dynamics[18] further posted less negative readings, i.e. -0.7 percent versus -1.9 percent March through May 2013, primarily due to the increase in disbursements from European funds[19] and to higher budget expenditures[20,21]. These influences more than offset the

Annual Growth Rates of M3 and Its Components

real percentage change

	2012		2013			
	III	IV	I	II	Jul.	Aug.
	quarterly average growth					
M3	2.9	-0.1	-3.3	-1.6	-2.3	0.6
M1	3.4	-0.4	-4.2	-1.5	-1.5	2.8
Currency in circulation	9.6	1.8	-4.9	-2.4	-3.8	-0.3
Overnight deposits	0.2	-1.6	-3.8	-0.9	-0.2	4.5
Time deposits (maturity of up to two years)	6.4	3.5	-0.3	-0.7	-2.7	-0.7

Source: NIS, NBR

16 The GDP and industrial output volume data released during the period under review exceeded analysts' expectations; at the same time, exports FOB peaked at EUR 4,482 million in July, while the current account balance posted a surplus of EUR 489 million January through July 2013 versus a EUR 3,041 million deficit in the same year-earlier period.

17 During the same period, the Hungarian forint and the Czech koruna weakened vis-à-vis the single currency by 1.4 percent and 0.1 percent respectively, whereas the Polish zloty appreciated by 1.0 percent.

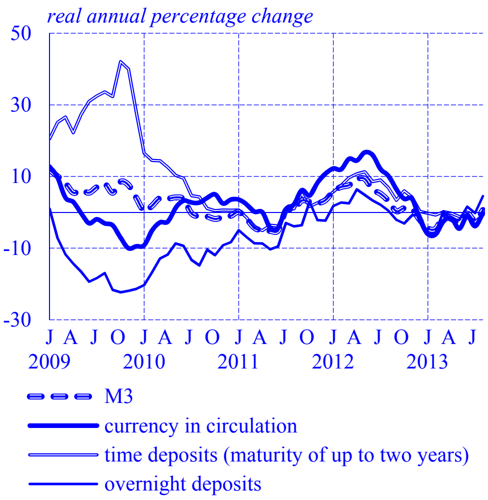
18 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2013.

19 Based on data on the MEF website, also as a result of settling the projects funded through the Operational Programme "Transport", for which payments were unfrozen in June.

20 According to press releases by the National Agency for Fiscal Administration, the volume of VAT repayments hit an 18-month high during the period under review. At the same time, the State Treasury granted loans to managing authorities of operational programmes for the payment of invoices to beneficiaries of European funds.

21 Some base effects also had a favourable impact on M3 dynamics.

Main Broad Money Components



Source: NIS, NBR

unfavourable impact on liquidity exerted by the ongoing balance sheet adjustments across various categories of economic agents and by the potential shifts from monetary assets into other types of financial instruments. The slower rate of decline of M3 was further ascribable to the improved performance of narrow money, whose growth rate re-entered positive territory, as a result of the contribution of corporate overnight deposits and currency in circulation. A positive impact also had the less negative readings posted by the dynamics of marketable instruments, amid the fading away of the base effect of last year's methodological changes in statistics. By contrast, the dynamics of time deposits with a maturity of up to two years went deeper into negative territory, reflecting the slower growth of the foreign currency component, seen for both main customer categories. Against this background, the M3 breakdown by currency continued to improve.

The M3 breakdown by holder shows an ongoing decline in the dynamics of household deposits and a further pick-up in the dynamics of corporate deposits. As regards the former, however, developments were largely ascribable to the statistical impact of the EUR/RON exchange rate. This impact left aside, M3 household deposits witnessed a slower rate of decline, most likely associated with the rise in certain income categories[22]. An opposite effect, albeit of a lower magnitude, had the possibly larger repayments on bank loans and portfolio shifts from M3 instruments to forex time deposits with a maturity of over two years. The faster growth rate of M3 corporate deposits was driven exclusively by non-financial corporations, on account of the increase in some budget expenditures and in the volume of disbursements from structural funds. This more than offset the impact exerted by the one-off rise in payments to the government budget[23] and by higher repayments on companies' external loans[24]. Conversely, the dynamics of M3 deposits declined for both non-monetary financial institutions and local governments; this was due to dividend payments by Fondul Proprietatea[25] and portfolio shifts to government securities and bank bonds[26], in the former case, and the keener appetite for time deposits in domestic currency with a maturity of over two years, in the latter.

22 Payments of amounts following court decisions in favour of historical wage claims made by public sector employees.

23 Payment of the second instalment of the mobile telephony license fee.

24 According to balance-of-payments data, the average volume of non-banks' net repayments on external debt June through August 2013 peaked at an 18-month high.

25 Fondul Proprietatea distributed dividends worth lei 550 million (according to the press release), which impacted the value of its deposits with banks.

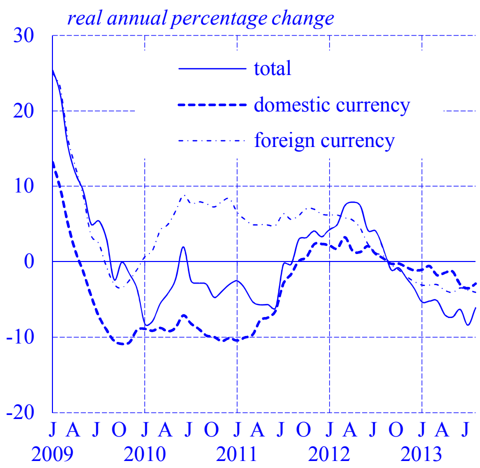
26 Unicredit Țiriac issued bonds worth lei 550 million in June, with buyers including "other financial intermediaries", according to the bank's press release; moreover, Raiffeisen Bank issued bonds in the amount of lei 225 million in July, the majority of which were purchased by local investors, as indicated in the bank's press release.

From the perspective of major M3 counterparts, the improved dynamics of broad money reflected the slower pace of decline of banks' government security holdings and the more sluggish growth rate of long-term financial liabilities (capital accounts included). An opposite influence came from the slight reduction in the dynamics of credit to the private sector and from the faster rate of change of leu-denominated Treasury deposits, while the other counterparts posted mutually-offsetting dynamics.

Credit

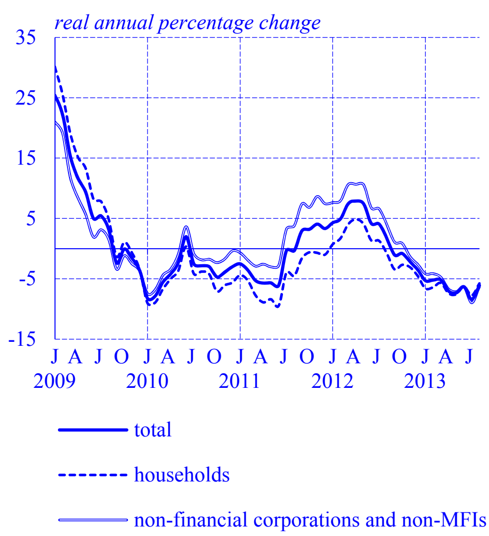
June through August 2013, the annual rate of change of credit to the private sector contracted further[27], reaching -6.9 percent from -6.5 percent during March-May 2013, albeit at a somewhat slower pace than in the previous period. The slower decline reflected the statistical effect of the lower annual inflation rate and the influence of the foreign currency component, whose annual dynamics followed a markedly less steep downward path. Against this backdrop, the average share of forex-denominated credit in total credit to the private sector remained unchanged at a two-year low. Credit breakdown by customer reveals that household loans declined at a slightly slower pace, while corporate credit contracted at a faster pace. However, developments in household loans were particularly driven by the statistical effect of the lower annual inflation rate. Expressed in nominal terms, household loans saw a reduction in their dynamics across both the leu- and the foreign currency-denominated components, the culprits being consumer credit in the former case and loans for all purposes, in the latter. The explanation for these developments lies with the still high restrictiveness of lending standards[28] and, to a certain extent, with the larger net transfers of household loans from banks' balance sheets[29]. The decline in the dynamics of corporate credit was induced solely by loans to non-financial corporations and was manifest for both the leu-denominated component (to a higher extent than in the previous period) and the foreign currency one (expressed in euro); in both cases, the decline was particularly visible for short-term credit. Overall, developments were associated with the relative drop in the volume of new business, reflecting the ongoing tightening of lending standards and the contraction in non-financial corporations' loan demand respectively. Under the circumstances, household loan dynamics outpaced those of corporate credit for the first time in the past three and a half years.

Credit to Private Sector by Currency



Source: NIS, NBR

Credit to Private Sector by Institutional Sector



Source: NIS, NBR

27 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2013.

28 According to the August 2013 NBR survey on lending to non-financial corporations and households.

29 Based on monetary statistics data on transfers, acquisitions and cancellations of loans in banks' balance sheets.

IV. INFLATION OUTLOOK

The baseline scenario of the current projection places the annual CPI inflation rate at 1.8 percent at end-2013 and 3.0 percent at end-2014, i.e. 1.3 percentage points and 0.1 percentage point, respectively, below the August 2013 Inflation Report projected rates, which were based on the assumption of a normal agricultural year.

The substantial downward revision of the end-2013 forecast is mainly the result of the materialisation of the risks mentioned in the balance corresponding to the baseline scenario of the previous projection round. Thus, the adjusted CORE2 index and the volatile food prices (VFE) benefited from the VAT rate cut applied to some bakery products as of 1 September 2013 and from the confirmed bumper crop, to which added the base effect of the 2012 low agricultural output.

The updated inflation forecast also involved other reassessments, of a lower magnitude, of the contributions from the aggregate index components. In particular, for end-2013, fuel price dynamics are expected to have a lower contribution to inflation developments, whereas the growth rates of administered prices and prices for tobacco products and alcohol have been revised upwards. For end-2014, the forecast envisages lower contributions from the adjusted CORE2 index and fuel prices and a higher one from administered price dynamics.

The VAT rate cut applied to some bakery products and the very good 2013 agricultural year compared to last year's poor crop, given the standard assumption of a normal agricultural year in 2014, will exert a substantial, albeit transitory, impact on the annual CPI inflation rate.

As a result, the favourable impact of these one-off factors is anticipated to largely fade away during 2014 Q3, which explains the end-2014 projection being revised marginally. The projected trajectory of the CPI inflation rate will fall below the lower bound of the variation band around the central target in 2014 H1, reaching a trough below 1 percent during Q1, before returning inside the band in 2014 Q3. The 12-month inflation rate is then seen stabilising slightly above 3 percent in the latter half of the projection interval, but remaining below the upper bound of the variation band around the target, amid ongoing adjustments at this time horizon in several categories of prices beyond the control of monetary policy.

The CPI inflation rate trajectory is largely shaped in the current projection by the path of the annual adjusted CORE2 inflation rate. The latter includes the prices of products for which the VAT rate *has been cut and those of processed food items[1] that are impacted with a lag by this year's bountiful crop via prices of agri-food commodities. Largely on account of the base effect associated with these factors, the core inflation projection foresees the annual rate hitting historical lows of below 0.5 percent during the first half of the forecast interval, before reverting close to 2 percent. Compared to the previous projection, the adjusted CORE2 inflation rate was revised downwards for the entire forecasting interval, also due to the revision of inflation expectations and of the negative output gap. In the latter half of the projection interval, the slight trend reversal in inflation expectations[2] – as a result of economic agents perceiving the fading away of the aforementioned base effects – and the gradual narrowing of the negative output gap amid the anticipated pick-up in economic activity will put the annual core inflation on a moderately upward path.*

The projected monetary policy stance will further seek to calibrate real broad monetary conditions so as to ensure that inflation rate remains inside the variation band around the target over the medium term, while also paving the way for a gradual recovery of lending to the private sector and lasting economic growth.

The assessment of risks associated with the current inflation rate projection points to a balance tilted to the upside. These upward deviations from the baseline scenario may come from both external conditions and the domestic environment.

Risks stemming from the external environment further relate to the uncertainty surrounding the volatility of capital flows channelled to the Romanian economy in the context of the variability of investors' risk appetite towards emerging economies as a whole. Risks are generated by relevant factors in the European and global context, such as: the fragile outlook for economic recovery of Romania's major trade partners amid the ongoing financial fragmentation and cross-border deleveraging; debt sustainability issues related to sovereigns and private banks in some euro area countries; the uncertainty about the magnitude and timing of the Fed tapering its quantitative easing in the US financial system; and the possible significant slowdown in the growth of major emerging economies, China included. The materialisation of any of these risks or a combination thereof would entail unfavourable deviations from the baseline scenario of the macroeconomic projection in terms of both inflation coordinates and economic growth.

Against the background of relatively subdued developments in global commodity prices recently, the risks of an upward deviation

1 Processed food items hold a 50 percent share in the adjusted CORE2 inflation basket.

2 According to the results of the latest NBR survey on inflation expectations of financial analysts.

from the baseline scenario assumptions are anticipated to be somewhat more pronounced over the medium term, owing to the possible deepening of geopolitical tensions.

On the domestic front, the balance of risks to the forecasted inflation rate is tilted to the upside owing to information that became available after the completion of the baseline scenario of the macroeconomic projection, referring to increases in excise duties on certain categories of goods, which have been agreed by the Romanian authorities with the EU, the IMF and the World Bank and will most likely be incorporated in the draft budget for 2014.

Structural rigidities stand out as a persistent source of vulnerability, hindering the necessary adjustments across the domestic economy aimed at mitigating the consequences of adverse shocks. In this vein, especially in the context of the busy election calendar for 2014, strict compliance with the provisions of the new financing arrangement concluded with the EU, the IMF and the World Bank – with a focus on pushing forward structural reforms and the measures aimed at augmenting the domestic economy's growth potential – would alleviate, compared to the previous Inflation Report, the risks stemming from this source.

The balance of risks associated with the baseline scenario assumptions on administered price dynamics shows a relative equilibrium throughout the reference period. Risks related to developments in domestic food prices appear balanced in the short run. However, the large share of food items in the consumer basket and the associated volatility induced to both core inflation and CPI dynamics continue to pose risks to price stability beyond near-term horizons.

1. Baseline scenario

1.1. External assumptions

The baseline scenario for the effective EU GDP[3] foresees a slight contraction of -0.15 percent in 2013, followed by a return to positive growth next year (1.23 percent), especially on the back of the steadily increasing contribution of domestic demand, which is expected to be fostered by the accommodative monetary policy stance and a less tight fiscal policy. In line with the tendency seen in the past projection rounds, the growth outlook for the region was revised downwards for most of the projection interval[4], hinting

Expectations on the Developments in External Variables

annual average

	2013	2014
Effective EU economic growth (%)	-0.15	1.23
Annual inflation rate in the euro area (%)	1.50	1.45
3M EURIBOR rate (% p.a.)	0.21	0.38
USD/EUR exchange rate	1.32	1.29
Brent oil price (USD/barrel)	108.6	104.2

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

3 EU-28 excluding Romania. The indicator is calculated based on Romania's exports breakdown by EU Member State.

4 It mirrors the impact of tepid global economic activity as well as somewhat tighter financing conditions than in the previous projection round, following the uncertainty surrounding the magnitude of the next monetary stimulus in the United States.

at a more restrictive impact of foreign demand on the domestic output gap than in the preceding quarter.

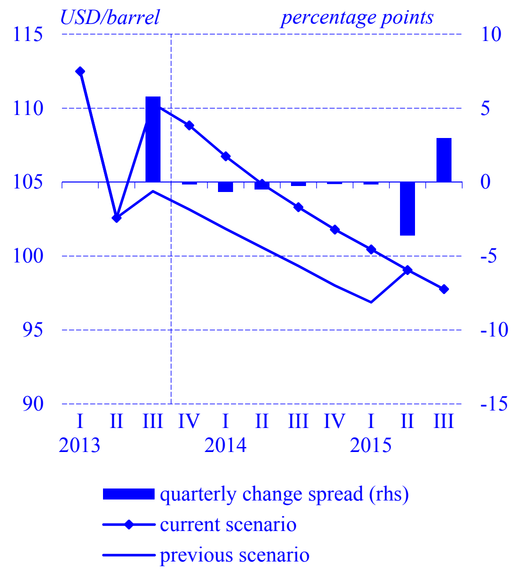
The average annual increases in the Harmonised Index of Consumer Prices (HICP) for the euro area are projected to remain below the 2 percent price stability benchmark, at 1.50 percent in 2013 and 1.45 percent in 2014, following the persistence of the negative output gap[5] and the keeping in place of the assumption regarding a further slowdown in energy price dynamics, reflecting the expected downward path in the oil price.

The nominal 3M EURIBOR rate is projected to follow an upward path towards the end of the projection interval, averaging out at 0.21 percent and 0.38 percent in 2013 and 2014 respectively, being only marginally revised as against the previously projected levels.

The scenario for the EUR/USD exchange rate performance envisages a slight softening of the euro versus the US dollar to 1.265 in 2014 Q4 due to the downward revision, for most of the period under review, in the economic growth prospects for the EU, the euro area in particular. This level will subsequently persist until the end of the projection interval.

The scenario on the international Brent oil price is based on futures prices[6] and foresees, given the still feeble global demand, a gradual decline over the projection interval.

Brent Oil Price Scenario

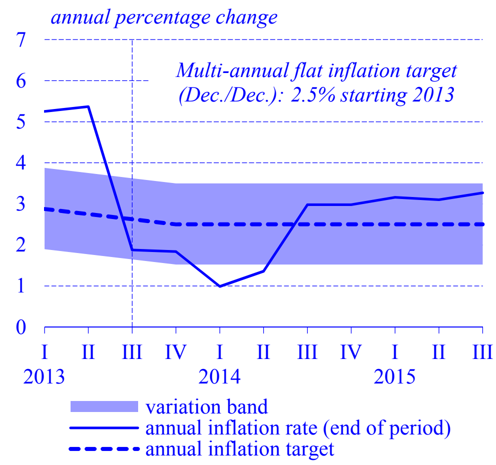


Source: Energy Information Administration, NBR assumptions based on Bloomberg data

1.2. Inflation outlook

The baseline scenario places the annual CPI inflation rate at 1.8 percent at end-2013 and 3.0 percent at end-2014, i.e. inside the variation band around the central target[7]. For the two year-ends, the projected annual inflation rate is 1.3 percentage points and 0.1 percentage points respectively lower than in the August 2013 Inflation Report. The end-2013 projection was substantially revised due mainly to the favourable developments in the adjusted CORE2 index and volatile food prices (VFE), amid the materialisation of risks relative to the bumper crops and the cut in the VAT rate for some bakery products, which were described as having a high probability to occur in the previous Inflation Report. The more favourable dynamics of fuel prices also contribute, albeit to a lower extent, to the downward revision, whereas the projected slightly faster growth rates of administered prices as well as of alcohol and tobacco product prices act in the opposite direction. The revision of the end-2014 projection is ascribed to expectations

Inflation Forecast



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

Source: NIS, NBR projections

5 Inducing disinflationary pressures.

6 Source: Bloomberg (futures prices as at 10 October 2013).

7 As from 2013, the NBR adopted a multi-annual flat inflation target of 2.5 percent ±1 percentage point. The target was subject to discussions with government officials.

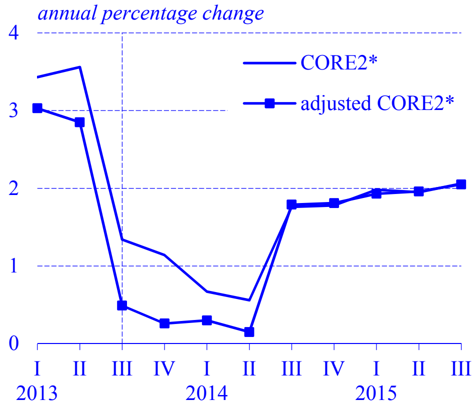
Annual Inflation Rate in the Baseline Scenario

annual percentage change (end of period)

	2013	2014				2015		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Target	2.5				2.5			
Forecast	1.8	1.0	1.4	3.0	3.0	3.2	3.1	3.3

Annual CORE2 Inflation and Annual Adjusted CORE2 Inflation

annual percentage change



*) end of period

Source: NIS, NBR projections

of more favourable contributions from the adjusted CORE2 index and fuel prices, whereas administered prices are anticipated to exert somewhat stronger inflationary pressures and the annual dynamics of the other CPI components will have relatively similar contributions to those foreseen previously.

Given the presence of one-off factors such as the bumper crop, the cut in the VAT rate for some bakery products in September and the fading away of the adverse effect associated with the adjustment of some administered prices in early 2013, the projected annual inflation rate will temporarily run below the lower bound of the variation band around the central target in 2014 H1. The projection foresees the annual inflation rate returning inside the variation band in 2014 Q3, when a sizeable base effect associated with the fading away of the favourable supply-side shocks of 2013 Q3 is anticipated to become manifest. The annual inflation rate is then expected to stay inside the variation band around the central target throughout the projection interval.

Similarly to the annual CPI rate, the adjusted CORE2 index dynamics will remain low over the following quarters, reaching 0.3 percent in December 2013 and 0.2 percent at the end of 2014 Q2, amid the effects of the recent supply-side shocks[8], which are expected to be visible on a four-quarter horizon. These influences will fade in 2014 Q3, entailing a significant base effect and sending the indicator's annual dynamics up to 1.8 percent. Subsequently, the annual core inflation rate is projected to follow a slightly upward path, amid the gradual reduction in the disinflationary influence exerted by the negative output gap and stronger inflation expectations than in 2014 H1[9]. The annual adjusted CORE2 inflation is estimated to come in at 1.8 percent at end-2014 and 2.1 percent at the end of the projection interval.

Compared to the previous Inflation Report, the path of the annual adjusted CORE2 inflation rate is subject to a downward revision throughout the projection interval. The favourable supply-side shocks in 2013 Q3 are the main determinant of the noticeable revision of the core inflation forecast during the second half of this year and the first half of 2014. Apart from the above-mentioned supply-side shocks, and in relation thereto, the downward revision

8 The adjusted CORE2 index comprises the bakery products for which the VAT rate was cut in September 2013 as well as the processed food items whose prices reflect, with a lag, the persistent effects of lower prices for some agri-food commodities incorporated in their production, amid this year's bumper crops.

9 Compared to the previous forecasting round, inflation expectations are estimated to be significantly lower at the end of 2013. Further on, the baseline scenario envisages inflation expectations to follow a slightly upward path starting with 2014 Q1, also as a result of the gradual fading of favourable effects on the annual CPI inflation rate stemming from the recent supply-side shocks (this year's bountiful agricultural output and the cut in VAT rate applicable to some bakery products starting September 2013).

of the path of the adjusted CORE2 inflation is also ascribable to the economic agents' lower inflation expectations as well as to the output gap being projected at slightly more disinflation-supportive levels[10]. A contrary influence is exerted by the upward revaluation of the projected contribution of import prices in 2014 H1, mostly on the back of the recent developments in the leu exchange rate, whereas for the remainder of the projection interval imported inflation was revised to marginally lower levels, amid the slightly more favourable developments in external prices than in the preceding round.

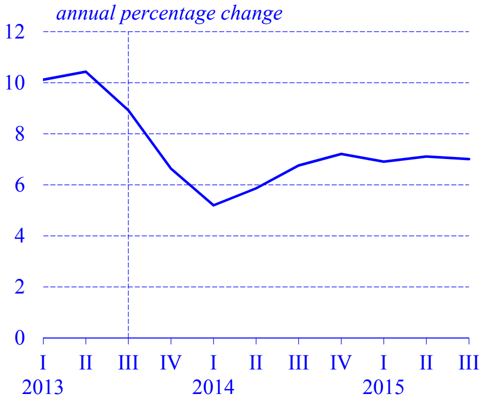
The scenario for the developments in tobacco product and alcohol prices is largely shaped by the 2013 Tax Code provisions regarding the change in the excise duties levied on such products, along with the updated reference exchange rate to be used for calculating their lei equivalent[11]. The contributions of these prices to CPI inflation at end-2013 and end-2014 are similar to those anticipated in the prior forecasting round.

The scenario for administered price growth includes the information on the calendars for the deregulation of natural gas and electricity prices released by the ANRE and the indications provided by the OPCOM electricity prices. The annual dynamics of administered prices are projected to stand at 6.6 percent in December 2013 and 7.2 percent at end-2014, i.e. above the levels foreseen in the previous forecasting round by 0.4 percentage points and 0.7 percentage points respectively[12].

In light of this year's bumper crops, VFE prices are seen following a deflationary path (in annual terms) until mid-2014. For the remainder of 2014, these prices are expected to reverse their trend, in line with the assumption of a normal agricultural year in 2014 and the ensuing base effect which will be strongest in 2014 Q3 (September 2014). 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. The contribution of this indicator to the annual CPI inflation rate in December 2013 is projected to stand at -0.1 percentage points, down 0.3 percentage points from the previous projection round, and to remain at approximately 0.3 percentage points in 2014.

Annual dynamics of fuel prices are projected to reach 0.6 percent in December 2013 and 2.2 percent in December 2014, i.e. below the levels presented in the previous forecasting round

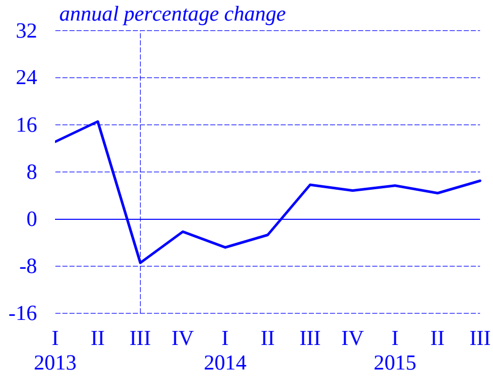
Administered Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

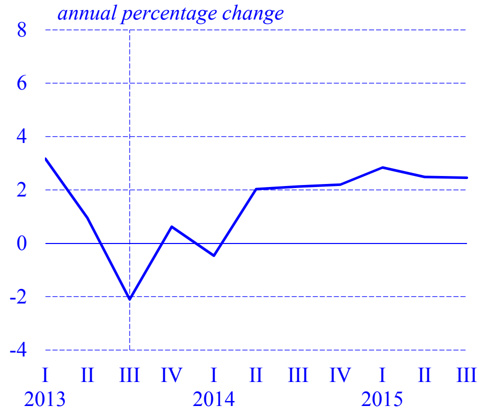
VFE Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

Fuel Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

[10] For further details, see Section 1.3. of this chapter.

[11] The EUR/RON exchange rate used for calculating the excise duties for fiscal 2014 was updated to EUR/RON 4.4485, as released by the ECB on 1 October 2013 (versus EUR/RON 4.5223 on 1 October 2012).

[12] This reassessment is mainly attributable to the revision of assumptions on electricity price dynamics, given the less-favourable-than-previously-expected developments in these prices in 2013 Q3.

Components' Contribution to Annual Inflation Rate*

percentage points

	2013	2014
Administered prices	1.2	1.3
Fuels	0.0	0.2
VFE prices	-0.1	0.3
Adjusted CORE2	0.1	1.1
Tobacco products and alcohol	0.6	0.1

**) end of period; figures are rounded to one decimal place*

by 1.1 percentage points and 0.4 percentage points respectively. The updated inflation forecast considers the assumption of a faster deceleration in the Brent oil price, lower inflation expectations and the changes in the EUR/RON exchange rate used for calculating the excise duty in 2014. A contrary, albeit softer, influence derives from the developments in the EUR/USD exchange rate with an unfavourable impact on the USD/RON rate[13].

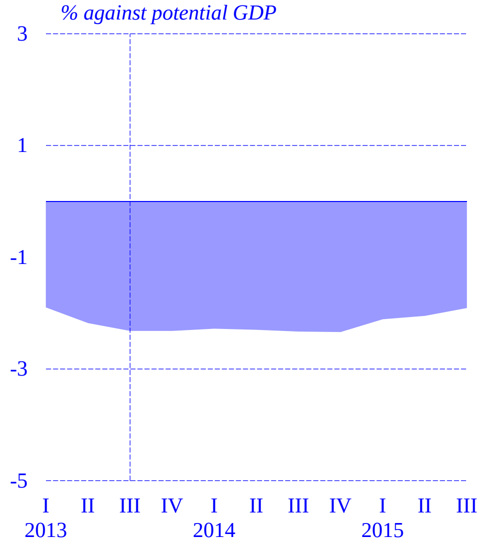
The cumulative contribution of components exogenous to the monetary policy influence, namely administered prices, prices of volatile food items (VFE), fuel prices and tobacco product and alcohol prices, to the annual CPI inflation rate runs at 1.7 percentage points at end-2013 and 1.9 percentage points at end-2014.

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

Output gap

Output Gap

% against potential GDP



Source: NIS, NBR projections

In the period since the publication of the previous Inflation Report, the NIS released[15] the revised seasonally-adjusted real GDP data series for 2000 Q1-2013 Q1. According to the NIS press release, in the first two quarters of 2013, the seasonally-adjusted real GDP saw quarterly increases of 0.4 percent and 0.5 percent respectively. For 2013 Q3, the performance of some high-frequency indicators[16], corroborated with an exceptionally good harvest, suggests the persistence of positive quarterly GDP dynamics, expected to be faster than those in 2013 H1.

The potential GDP growth for the projection interval is ascribable to the positive contributions of all production factors. In 2013, potential GDP growth rate is assessed to be higher than in 2012, as a result of the advance in total factor productivity, owing particularly to the performance of agriculture. For the periods ahead, the dynamics of gross fixed capital formation are seen to be reflected in a relatively steady contribution of the capital stock, whereas the anticipated favourable developments in ILO unemployment rate and the activity rate, partially offset by the reduction in the working age population (15-74 years), will entail a marginally

13 The fuel prices charged by the leading 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. The current scenario for the EUR/USD rate foresees a somewhat sharper appreciation of the US dollar than in the preceding forecasting round.

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

15 NIS Press Release No. 241 of 7 October 2013.

16 The improved economic sentiment (up 0.9 points) in July-September 2013 and the larger volume of new (total leu- and foreign currency-denominated) loans to households in real terms (up 6.0 percent) July through August versus the Q2 average.

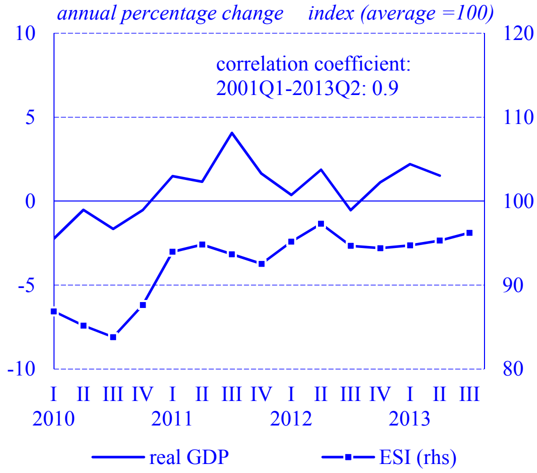
positive contribution of labour force. Total factor productivity is anticipated to gradually improve in 2014-2015 in the assumption of more strenuous efforts to increase the absorption rate of structural and cohesion funds and the expectations on the consolidation of corporate and household balance sheets. These assumptions are however surrounded by the uncertainty associated with capital flow dynamics and the developments in (foreign and domestic) investor sentiment towards Romania's economy in the period ahead.

The assessment of the negative output gap in 2013 Q3 shows its marginal widening versus the previous quarter. However, as compared with the previous forecasting round, in the context of the NIS revisions of the historical data series of the seasonally-adjusted real GDP, the output gap was slightly less negative in 2013 Q2. The marginal change in the GDP deviation in 2013 Q2 includes the joint effect of the reassessment of its determinants[17], and that of the forecast error, in the sense of a slight undervaluation, in the previous forecasting round, of the GDP dynamics in 2013 Q2. In 2013 Q3, the negative output gap further cumulates its relatively high persistence, the significant influence, albeit on a decline versus Q2, of the external demand deficit, as well as the slightly restrictive effect of the real exchange rate deviation in the previous quarter via the net export channel; all these are only marginally mitigated by the slightly stimulative joint effect of real bank rates in the previous quarter which produce macroeconomic effects starting with the quarter under review, whereas the influence of the discretionary component of the fiscal policy becomes relatively neutral.

The dynamics of the negative output gap in 2013 Q3 are only partly supported by the evolution of other high-frequency indicators correlated with the cyclical position of the economy. Signals pointing to the widening of the negative output gap come from the ILO unemployment rate exceeding the medium-term trend and the decline in industrial output (down 0.3 percent) during July-August versus the second quarter average, whereas opposite signals are provided by the increase in retail trade, except motor vehicles and motorcycles (up 2.3 percent) in the same period compared with the average for the previous quarter.

During the projection interval, the negative output gap is foreseen to follow a slightly narrowing tendency, yet remaining at significant and persistent levels particularly in the first part of the interval. Real broad monetary conditions, external demand (consistent with the gradual economic growth recovery across the EU) and the likely impact of a higher European fund absorption rate than in the previous year act towards the slight alleviation of

Economic Sentiment Indicator* and Economic Growth



*) seasonally-adjusted data

Source: NIS, EC-DG ECFIN

17 Given the need to incorporate a wide range of information, analyses or data revisions, the trend and cyclical GDP components are subject to frequent reassessments.

the disinflationary pressures exerted by the negative output gap. In contrast, the discretionary component of fiscal policy[18] acts towards the widening of the negative output gap, its restrictive impact being anticipated to persist until the end of 2014[19], given the ongoing fiscal consolidation, although at a relatively slower pace than in the previous years.

Compared to the August 2013 Inflation Report, the negative output gap is indicative of higher disinflationary pressures on the adjusted CORE2 inflation. The revision of the output gap in the current quarter, the more restrictive external demand[20] for the most part of the forecast interval, as well as the discretionary component of fiscal policy, whose impact is more restrictive in 2014, set the direction for the output gap reassessment. The real broad monetary conditions, exerting a more stimulative impact in relative terms, act towards the narrowing of the negative output gap.

The baseline scenario of the projection foresees a significant rebound in economic growth in 2013 versus 2012, underpinned by the remarkable performance of net exports since the beginning of the year[21], on the one hand, and by the anticipated rebound in the actual individual final consumption of households starting with the latter half of 2013, owing chiefly to the favourable effect exerted by the exceptional agricultural year on self-consumption, on the other hand. For the next two years, domestic demand is expected to become again the main driver of economic growth due to the foreseen favourable developments[22] in the real disposable income of households and the dynamics of the investment projects carried out by the private sector.

Aggregate demand components

The quarterly growth rate of the actual individual final consumption of households is expected to accelerate[23] in 2013 Q3, due largely to the favourable effect of the exceptional agricultural year on self-consumption, the deviation from its medium-term trend being however not affected by the dynamics of self-consumption and, thus, remaining in negative territory. Signals indicating the

[18] Measured based on the fiscal impulse.

[19] The fiscal policy stance is expected to be slightly countercyclical in 2015.

[20] Approximated by the deviation of the real effective EU GDP from its trend.

[21] These are foreseen to further post positive dynamics in the periods ahead, but most likely at a slower pace on the back of the slow recovery in external demand, on the one hand, and the gradual fading-out of the favourable effects of this year's plentiful agricultural output on exports, on the other hand.

[22] Given the anticipated improvement in the main labour market indicators, the steep decline in the annual CPI inflation until mid-2014 and its remaining inside the variation band around the target in the subsequent period, as well as the stimulative effect on economic growth arising from the projected set of real broad monetary conditions.

[23] In 2013 Q2, the actual individual consumption of households rose by 0.3 percent quarter on quarter.

rebound in the quarterly growth of the actual individual final consumption of households came from the net real wage and the retail trade turnover, except for motor vehicles and motorcycles (up 2.5 percent[24] and 2.3 percent respectively in July-August versus the Q2 average). Actual collective consumption of general government is envisaged to see a moderate increase in 2013 Q3, further supporting fiscal consolidation[25], the deviation from its medium-term trend yet narrowing, remaining in negative territory.

The actual individual consumption of households is foreseen to go up in 2013 as a whole compared with 2012, mainly on the back of the anticipated favourable contribution of self-consumption in Q3, with further effects in the final quarter as well. Starting 2014, the dynamics of this component will gain speed, on the back of the rise in the real disposable income of households, given the low inflation in the first part of the projection interval, the anticipated favourable developments in labour market indicators[26], and the expected easing of lending conditions. The latter is foreseen to occur including as a result of the pass-through with a certain time lag of the monetary policy rate cuts in 2013 to credit institutions' interest rates applicable to their non-bank clients[27]. The actual collective consumption of general government is projected to maintain its positive dynamics throughout the projection interval.

In 2013 Q3, the quarterly dynamics of gross fixed capital formation are forecasted to pick up slightly, being upheld by the signals from the indicators correlated with their development. Specifically, July through August compared with the Q2 average, new construction works rose by 12.2 percent, new building permits moved up 4.5 percent, while industrial production of capital goods grew by 1.7 percent. Against the background of the anticipated developments in gross fixed capital formation, its deviation from the medium-term trend is seen as negative, yet on a decline, versus the preceding quarter.

Although the favourable developments in gross fixed capital formation envisaged for 2013 Q3 are anticipated to continue in the fourth quarter of the year, the overall dynamics of this component

[24] This increase was also ascribed to the rise to lei 800 in the minimum wage economy-wide as of 1 July 2013.

[25] According to the latest data released by the Ministry of Public Finance, the consolidated general government budget deficit stood at 1.3 percent of GDP in September 2013 (cash-based methodology).

[26] Labour productivity is envisaged to recover starting with the current year, being particularly underpinned by the swifter domestic economic activity, which is expected to have a positive impact on wage dynamics. To this adds the projected, relatively slow-paced rise in private sector employment, which is seen to contribute to the increase in household disposable income.

[27] The speed at and the extent to which the pass-through of monetary policy rate cuts actually occurs depend, to a large extent, also on the lending terms and conditions established by commercial banks, so that the net effect on credit institutions' interest rates applicable to their non-bank clients may differ substantially, in terms of magnitude, from that of the policy rate cuts.

in 2013 will be hampered by the contractionary effects seen in the first year half[28]. As of 2014, the fading-out of these effects, the increase in foreign direct investment flows, the improved absorption of EU funds, as well as the anticipated gradual easing of financial constraints associated with lending costs[29] are expected to foster the medium-term consolidation of the positive dynamics anticipated for the second half of 2013 in the case of private companies' investment activity and, in the context of a rebound in public sector investment at this time horizon, of the gross fixed capital formation as a whole.

For 2013 Q3, exports of goods and services are expected to see a quarterly increase, yet at a slower pace than in the previous quarters[30]. The anticipated performance of this component is upheld by the favourable dynamics of exports of goods and services in the balance of payments (up 2.9 percent in July-August versus the Q2 average) and by the improved confidence indicator at EU level (up 6.8 points in Q3). The quarterly dynamics of imports of goods and services are foreseen to return to positive territory in 2013 Q3, due to the favourable export performance and the high import content of exports, as well as to the anticipated rebound in domestic demand. Behind this stands the growth of imports of goods and services in the balance of payments (5.8 percent in July-August versus the previous quarter's average). In view of the above-mentioned developments, the deviation of exports from the medium-term trend is assessed as positive, on an increase compared with the previous quarters, while in the case of imports, the deviation from the medium-term trend is negative, yet on a decline.

Following the marked advance seen in the current year, the good performance of exports of goods and services is foreseen to continue in the period ahead, amid the steady improvement in their structure[31] and assuming the faster absorption of EU funds aimed at boosting competitiveness. Nevertheless, the dynamics of Romanian's exports are anticipated to slow down somewhat in the medium run, under constraints from a slow recovery of the economic activity in the EU and limitations on domestic production

28 According to NIS Press Release No. 241 of 7 October 2013, gross fixed capital formation decreased by 3.9 percent in real terms in 2013 H1 versus the same year-ago period. For further details on recent developments in gross fixed capital formation, see Chapter 2.

29 With favourable effects on the dynamics of investment projects carried out by the private sector.

30 In 2013 Q1 and Q2, exports of goods and services expanded by 9.6 percent and 3.5 percent respectively, quarter on quarter.

31 Apart from the higher value of exports, it is also to be noted the larger share of high value-added goods in total exports and the diversification of their markets, including by entering non-EU markets. At present, the exports of machinery and transport equipment hold 42 percent of total and products of light industry, metallurgy and woodworking account for 33.4 percent of total exports.

capacities emerging at that time horizon[32]. Although in 2013 a shift in Romanian's exports towards non-EU emerging markets was manifest, the largest share of these exports is further destined to the EU markets[33], which are seen to recover only gradually during the projection interval. The strong annual dynamics of exports in 2013 will most likely be supported by the further positive developments of "machinery and transport equipment"[34]. Over the medium term, however, maintaining the dynamics of exports of this sub-sector[35] at levels comparable with those reported in the current year hinges on the main exporters developing new production capacities.

Given the low correlation between the growth rates of imports and exports of goods and services since the turn of the year[36] and the anticipated modest dynamics of domestic demand for 2013, the current baseline scenario envisages a markedly slower growth of imports than of exports in 2013. Having in view the good performance of net exports of goods and services expected for this year, concurrently with the anticipation of slightly more favourable dynamics of income and current transfer balances, chiefly following the expected improvement in the capacity of attracting EU post-accession funds, the current account deficit is projected to undergo a large downward adjustment in 2013 versus 2012. Starting with 2014, amid the foreseen slowdown in the positive dynamics of exports and the projected stepped-up growth of imports[37], the current account deficit is envisaged to widen moderately, which is not, however, likely to induce corrective inflationary pressures from the exchange rate of domestic currency.

32 For example, in 2013, Automobile Dacia S.A. entered new markets (the United Kingdom), increased its market shares on traditional foreign markets (France and Germany) and intends to expand spare parts sales to new markets (Russia).

33 During January-August 2013, exports to EU countries took 70.1 percent of total exports, slightly down from 70.5 percent in the same year-earlier period.

34 According to balance-of-payment data, the EUR-denominated exports of this category posted a 13.5 percent rise during January-August 2013 year on year. The good performance of exports in this category is not foreseen to reverse suddenly, given the longer-term contracts specific to this industrial sub-sector, the buoyant non-EU external demand for such goods and the projected gradual improvement in EU external demand.

35 According to Standard International Trade Classification, Revision 4.

36 These developments are illustrated by the analysis of both national accounts data and balance-of-payments data. According to national accounts data, in 2013 H1, imports of goods and services remained flat in real terms year on year, while exports of goods and services witnessed an 11.9 percent increase during the same period. According to balance-of-payments data, EUR-denominated imports of goods and services declined by 0.1 percent January through August 2013 year on year, while EUR-denominated exports of goods and services moved up 10.3 percent during the same period. Behind this development stood both the sharp drop in imports of energy products (natural gas and oil), most likely as a result of the base effects associated with the unfavourable weather conditions in early 2012 and the low domestic demand in 2013 H1.

37 Imports of goods and services are expected to rise faster especially under the impact of a higher domestic demand anticipated for this time horizon.

Broad monetary conditions

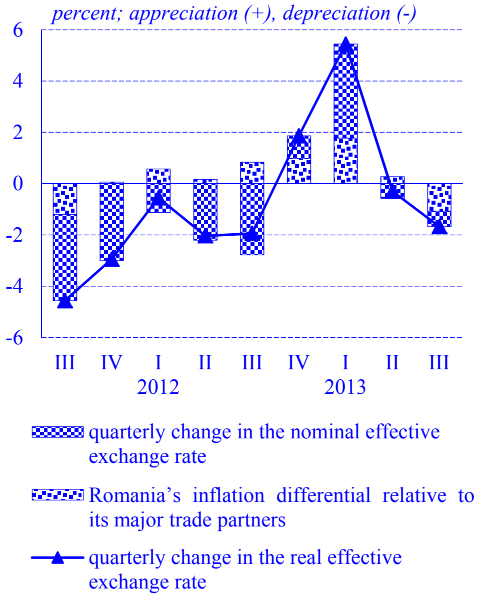
Broad monetary conditions capture the impact exerted on future aggregate demand developments by the dynamics of real interest rates in lei applied by credit institutions to their non-bank clients and by the real effective exchange rate of the leu. The exchange rate exerts its influence via the net export channel, as well as via the wealth and balance sheet effect[38].

In 2013 Q3, nominal interest rates[39] applied by credit institutions to their non-bank clients followed a downward path, also as a result of the impulse sent by the NBR Board's lowering the monetary policy rate during this quarter. The slight drop in the nominal deposit rate and the larger fall in inflation expectations[40] pushed real deposit rate higher in Q3. The moderate decline in nominal lending rate was only partly offset by the lower inflation expectations, resulting in a real decline as well. Overall, real interest rate deviations from the medium-term trends are seen to have a stimulative impact on economic activity in the following quarter, slightly stronger than in 2013 Q2, the favourable effect exerted by the real deposit rate being partly offset by the further restrictive effect of the real lending rate.

In 2013 Q3, the domestic currency weakened moderately in real terms[41], due to both the nominal depreciation (given the depreciation of the leu versus the euro, partly alleviated by the appreciation of the leu versus the US dollar) and the narrower inflation differential against the trading partners. Against this background, the deviation of the real effective exchange rate from the medium-term trend points, *ceteris paribus*, to a slightly stimulative impact on aggregate demand in Q4 via the net export channel.

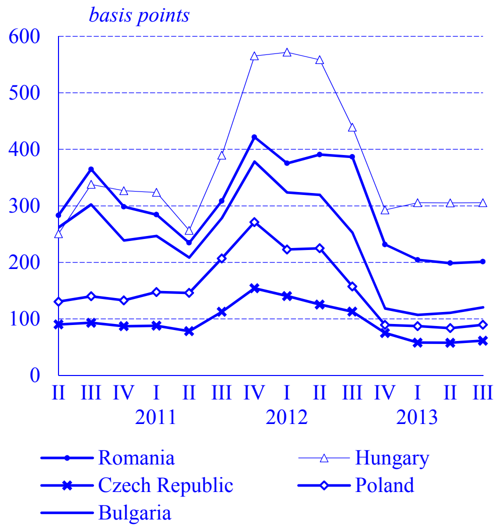
The risk level associated with investments in the national economy, correlated with developments in CDS (Credit Default Swap) spreads, remained similar to that recorded in the previous quarters, illustrating a common regional trend supported by fundamentals. The stimulative effect induced by the foreign real interest rate remaining below the medium-term trend is only partly offset by the restrictive impact of the risk premium being slightly above the medium-term trend, amid a small change in the expectations

Quarterly Change in the Effective Exchange Rate



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

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



Source: NBR calculations based on Bloomberg data

38 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 for consumption and investment, on the one hand, and for granting and repaying of foreign currency-denominated loans, on the other hand.

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

40 The information on this indicator has been taken from the NBR's monthly survey among financial analysts.

41 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.

on exchange rate developments[42]. Against this background, the wealth and balance sheet effect in 2013 Q3 exerts an increasingly stimulative effect on economic activity in the following quarter.

Real broad monetary conditions in 2013 Q3 are assessed to be somewhat stimulative for the economic activity in Q4, resulting, *ceteris paribus*, in the marginal alleviation of disinflationary pressures generated by the aggregate demand deficit. In the structure of the real broad monetary conditions, the stimulative impact is exerted by the deviations of the real exchange rate (via the net export channel) and of the real deposit rate from medium-term trends, as well as by the wealth and balance sheet effect, while the real lending rate has a relatively neutral effect.

Broad monetary conditions are anticipated to support[43] economic activity throughout the projection interval, under the cumulative impact of the heterogeneous action of its determinants. The impact of the real exchange rate via the net export channel is slightly stimulative for the real broad monetary conditions in the first part of the projection interval[44], while for the remaining part of the interval it is expected to reverse its influence, exerting, however, at this time horizon, a less restrictive effect compared with the previous round. The deviation of the real interest rate on foreign currency loans from the trend further has a stimulative effect throughout the forecast interval, due to the persistently low level of foreign interest rates. The wealth and balance sheet effect of the exchange rate is anticipated to have a favourable impact on economic activity, its intensity exceeding that in the previous forecasting round over most of the projection interval, amid foreign investors' improved perception of the risk associated with the national economy[45].

Similarly to the previous round, the path of the monetary policy rate is calibrated so as to maintain, in the medium run, the inflation rate inside the variation band around the central target, via the effective anchoring of economic agents' inflation expectations, thus contributing to creating the necessary prerequisites for a sustainable rebound in lending to the private sector, restoring confidence and achieving a sustainable long-term economic growth. In line with the projected path of the monetary policy rate, the cumulative impact of the deviations of real interest rates on leu-denominated loans and deposits from their medium-term trend is forecasted to

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

43 To a larger extent compared with the August Inflation Report.

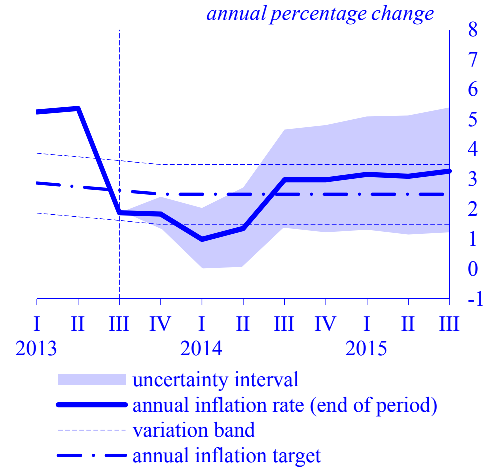
44 Particularly in the context of a significant reduction in the inflation differential relative to the trade partners, expected for this projection interval.

45 Both in a regional context, amid favourable prospects for the revival of economic activity in most EU emerging countries, and on the back of an anticipated notable adjustment of the current account deficit and the further low budget deficit.

maintain its stimulative effect on aggregate demand throughout the forecasting interval, yet at a lower intensity in the first part of the projection interval compared with the previous round, given the persistence at this time horizon, of the slightly restrictive nature of the real lending rate.

1.4. Risks associated with the projection

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



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

Source: NIS, NBR calculations and projections

Over the last months, part of the risks identified in the previous Inflation Report as having a relatively high probability to become manifest in the short run – namely those associated with the agricultural output, as well as the VAT rate cut for some bakery products[46] as of 1 September 2013 – materialised. Their materialisation led to significant downward deviations from the previously-projected inflation rate dynamics, which makes the risks of new similar deviations from the current baseline scenario path to be relatively low in the short run.

Under the circumstances, the balance of risks to the projected inflation path in the baseline scenario is tilted to the upside. Sources of asymmetry may be associated with external developments and some domestic factors.

The most significant risk sources arising from the external environment refer to the economic outlook in the European Union, as well as to the short- and medium-term developments in investors' perception of regional and global economy. In the context of the recent successive downward revisions of the configuration of the real GDP growth scenario of Romania's main trading partners, the coordinates of the economic environment in the European Union pose a significant risk to the macroeconomic projection. In the event of such a risk materialising, the domestic economy would be impacted through the trade channel (the demand for Romanian exports) and the confidence channel (investors' varying risk appetite for exposures to emerging economies in the region). Furthermore, the uncertainty surrounding the magnitude and timing of the Fed tapering its quantitative easing program across the US financial system could enhance the adverse effects on the Romanian economy via the financial channel (the shift in capital flows from emerging economies to advanced economies, in general, and to the USA, in particular, probably stimulated by further low related risks). A potential decline in the capital flows destined to Romania would have an unfavourable effect on the leu exchange rate against the major currencies, on inflation rate, funding costs, lending conditions and, therefore, on the domestic economic activity.

[46] Measure announced by the government subsequent to the completion of the coordinates of the previous macroeconomic projection baseline scenario.

International commodity prices are expected to generate risks to the inflation path in the baseline scenario that are relatively balanced in the short run. However, in the medium term, there is the risk of the dynamics of this category of prices to accelerate (for instance, new rises in energy prices), against the background of potential geopolitical tensions or some unfavourable developments in the agricultural product prices, based on the weather conditions during the projection interval.

On the domestic front, the balance of risks to the forecasted inflation rate is tilted to the upside owing to information that became available after the completion of the baseline scenario of the macroeconomic projection, referring to increases in excise duties on certain categories of goods, which have been agreed by the Romanian authorities with the EU, the IMF and the World Bank and will most likely be incorporated in the draft budget for 2014.

The firm and consistent implementation of the structural reform package, in compliance with the calendar agreed upon with the international institutions (the EU, the IMF and the World Bank), is further of the essence, especially in the context of the elections in 2014. Any deviation from the structural reforms assumed through the financing arrangements concluded with the international institutions is likely to induce a deterioration of investors' perception of domestic economy, adversely impacting the volume and volatility of capital flows destined to Romania and, implicitly enhancing the effects of the unfavourable domestic or external shocks on both inflation rate and economic growth.

Relatively balanced risks to the CPI inflation rate path stem from administered prices, in the context of persistent uncertainty surrounding the assessment of the impact generated on consumer prices by the deregulation of natural gas and electricity prices, on the one hand, and by the government postponing to grant a certain number of green certificates to renewable energy producers[47], on the other.

Under the impact of the recent favourable weather conditions and the VAT rate cut for some bakery products, it can be assumed that the decreases in the prices of some food items, previously mentioned as possible, have largely materialised, in which context the risks to inflation expected to arise from this source in the coming period are seen to be balanced. Nevertheless, in the medium run, the balance of risks remains tilted to the upside, given the large share of food items in the CPI basket and the associated volatility induced both to core inflation and the dynamics of the consumer price index.

47 For July 2013 – March 2017, according to Government Emergency Ordinance No. 57/2013.

2. Policy assessment

In line with the central bank's forecasts, in 2013 Q3, the annual inflation rate saw a large downward adjustment, falling to 1.88 percent[48] in September, from 5.37 percent in June. The magnitude of the decrease reflected the emergence of favourable base effects overlapping the disinflationary impact of the bumper agricultural production in 2013 – first exerted through volatile food prices and then through processed food prices –, as well as the impact from the cut in the VAT rate on some bakery products in the last month of the third quarter. Looking at underlying factors, the persistence of the negative output gap and the further improvement in inflation expectations contributed to the fast-paced deceleration in the adjusted CORE2 inflation, the annual rate of which reached a historical low (0.49 percent).

Under these circumstances, which also entail the prevailing influence from the downward revisions of some of its main assumptions, the updated forecast of medium-term developments shows the annual inflation rate remaining below the mid-point of the flat target in the following four quarters and even falling below the lower bound of the variation band around the target in the first part of 2014. The significant deviation of these forecasts from the previously projected coordinates is ascribable to the materialisation of the downside risks to short-term inflation identified in the previous forecasting round[49]. After the fading out of the temporary effects of these factors, the forecasted annual rate inflation is seen going up, while remaining, however, at levels marginally lower than previously anticipated, and implicitly inside the variation band of the flat target over the entire policy-relevant horizon[50].

The projected trajectory of the annual adjusted CORE2 inflation rate shows a relatively similar configuration. The downward inflection in the short run is, however, more pronounced[51], and subsequently core inflation is expected to return to significantly lower levels than in the previous forecast, therefore supporting the relative improvement in the inflation outlook throughout the projection horizon. Apart from the transitory impact of the cut in the VAT rate on some bakery products – to which it is highly sensitive – the anticipated behaviour of core inflation illustrates the more favourable dynamics of import prices expected for the second half of the projection interval, as well as lower inflation expectations and marginally more pronounced disinflationary pressures generated by the negative output gap throughout the

48 In the lower half of the variation band of the 2.5 percent ±1 percentage point flat target.

49 August 2013 Inflation Report.

50 The current forecast indicates for end-2014 an inflation rate of 3 percent as against the previous projection of 3.1 percent.

51 In 2013 Q4, the forecasted average level of the annual adjusted CORE2 inflation rate falls to 0.1 percent.

projection horizon, in the context of a slightly upward revision of its estimated/forecasted level.

Such an outlook for both headline inflation and core inflation, as well as its determinants can provide the central bank with more room for adjusting the monetary policy stance, while maintaining its time consistency and prudent nature. Nevertheless, the size of the room for manoeuvre available to the central bank, as well as its utilisation – assumed to be beneficial from the perspective of its impact on the reinvigoration of lending and the restoration of confidence, implicitly on the economic recovery – continue to be conditional upon meeting the commitments relative to fiscal policy, structural reforms and EU fund raising, assumed in the agreements concluded with the EU, the IMF and the World Bank, which should ensure a consistent macroeconomic policy mix. This requirement, along with the central bank's concern for preventing the de-anchoring of medium-term inflation expectations and a too sudden a drop in bank deposit rates, as well as for enhancing the impact on longer-term interest rates, advocates the maintenance of the gradual adjustment of the parameters of monetary policy instruments, while relatively synchronising this process with the monetary policy cycles in the region and the advanced countries, including in the euro area.

An additional reason in favour of such an approach is the persistence of some uncertainty surrounding the forecast of medium-term macroeconomic developments, carrying the potential to generate risks to the inflation outlook. In the current context, the external environment continues to be a major risk source, more specifically the developments across the economies and banking systems in the euro area/EU, including the configuration and effectiveness of the policies implemented with a view to sustainably solving their problems, as well as the economic and financial developments in the US – which are pivotal to Fed's monetary policy decisions, with a major impact on the international financial market liquidity and sentiment – and those in the main emerging countries.

Thus, in terms of the future evolution of domestic inflation and inflation expectations, the most significant risk associated with external developments is further posed by their potential adverse impact on the leu exchange rate behaviour, namely the possible significant/repeated intensification of depreciation pressures of the domestic currency. In the very short run, such a risk appears to be considerably mitigated by the recent increase in the global risk appetite based on expectations of Fed preserving the current monetary quantitative stimulus, but, as the moment approaches when the Fed decides on starting tapering it, the probability of this risk to materialise might increase considerably, particularly in the event of a further high sensitivity of international investors' sentiment relative to the potential unfavourable events/developments that might occur across the globe/at regional level in the future. The resumption, against this background, of the portfolio reallocation – likely to affect sovereign debt financing costs too – would induce adverse effects on the emerging markets which could be, however, less intensely felt on the local financial market, in the assumption of financial investors making further alternative decisions based on the quality of fundamentals, alongside the potential persistence of favourable developments in certain sectors of domestic economy, including in the current account balance, as well as the maintenance of the relative attractiveness of investments in domestic currency. The latter implies, however, preserving foreign investors' favourable risk perception towards the local financial market, which, in turn, is conditional upon meeting the objectives/guidelines agreed upon in the arrangements concluded with the EU, IMF and the World Bank, crucially important being those related to structural reforms.

The probability of a materialisation of the risks to the leu exchange rate, and implicitly to inflation, could also be heightened by a possible delay in the recovery of EU economies or by a possible protraction/intensification of the deleveraging process in the euro area and implicitly in Romania, as well as by a potential reaggravation of sovereign debt sustainability or financial stability issues in some euro area countries. Assuming such scenarios materialise, influences running counter to the exchange rate inflationary ones might arise in the short run, and especially in the medium run, as a result of the relatively stronger disinflationary pressures from the negative output gap, amid the likely sluggish recovery of the Romanian economy under the adverse impact of the external environment[52], as well as following a possible halt/reversal in the easing trend of domestic financing conditions.

The balance of risks to the inflation outlook induced by the future evolution of international agri-food commodity and energy prices appears to be relatively in equilibrium, at least in the short run. The fundamentals of this assessment build further on the forecasts on the pace of recovery in the global economic activity and in the demand for such goods – which are significantly influenced by the outlook for emerging economies – on the one hand, and, on the other hand, on the present and expected developments in the global output and stocks, especially across the oil and agricultural sectors, which are in turn sensitive to geo-political tensions, and to weather conditions, respectively.

The risks to the inflation forecast generated by the future behaviour of domestic prices of food items, especially volatile prices, as well as by the administered price adjustments appear to be further relatively balanced at least in the near run, given that the forecasts

[52] Through the foreign trade, financial and confidence channels, as well as through the wealth and balance sheet effect of the exchange rate.

for the former category of prices were accordingly revised in line with the outstanding agricultural output in 2013, and the forecasts for the latter category build mainly on the deregulation of electricity and natural gas prices set forth in the calendars agreed upon in the arrangements with the EU, the IMF and the World Bank. On the domestic front, the balance of risks to the inflation outlook posts, however, a deterioration, given the very likely implementation in 2014 of the measures recently announced regarding the increase in some excise duties and the extension of the tax base.

In light of the prospects for a temporary downward deviation of the annual inflation rate from the 2.5 percent ±1 percentage point target, followed by its return and consolidation inside the variation band of the target once the impact of this year's crop and the lower VAT rate for some bakery products fades away, the NBR Board decided, in the meeting of 5 November 2013, to cut the monetary policy rate by 0.25 percentage points to 4.00 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 the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.