National Bank of Romania

INFLATION REPORT

May 2014

Year X, No. 36

New Series

N O T E

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

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

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

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Foreword

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

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

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

The Inflation Report was approved by the NBR Board in its meeting of 6 May 2014 and the cut-off date for the data underlying the macroeconomic projection was 30 April 2014.

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

Abbreviations

ANAF	National Agency for Fiscal Administration
ANRE	Romanian Energy Regulatory Authority
APIA	Agency for Payments and Interventions in Agriculture
CCR	Central Credit Register
CPI	Consumer Price Index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
ESI	Economic Sentiment Indicator
EU	European Union
Eurostat	Statistical Office of the European Union
GDP	Gross Domestic Product
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MARD	Ministry of Agriculture and Rural Development
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
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
3Y	3 years
5Y	5 years
10Y	10 years

Contents

SUMMARY

Developments in inflation and its determinants

In 2014 Q1, the annual CPI inflation rate fell temporarily below the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target, remaining around 1.05 percent throughout the period under review. The March reading stood 0.5 percentage points below the end-2013 figure, albeit marginally above (+0.1 percentage points) that forecasted in the February Inflation Report. The recent low annual inflation levels were fostered by the overlapping in 2013 of some favourable supply-side shocks, whose effects are expected to be manifest over approximately four quarters: the bumper crop and the cut in the VAT rate for some bakery products from 24 percent to 9 percent as of 1 September 2013. Behind the faster disinflation seen in 2014 Q1 stood also the base effect that affected the annual increase in administered prices, while the dynamics of the other components of the aggregate consumer price index had a roughly neutral net impact thereon. The annual inflation rate is expected to re-enter the variation band of the target once the effects of supply-side shocks have faded out.

In March 2014, the annual adjusted CORE2 inflation rate[1] recorded a marginally negative value for the sixth straight month, mainly on account of the effects of the above mentioned supply-side shocks on processed food prices. Apart from these transitory effects, the overall favourable evolution of the adjusted CORE2 index was further driven by fundamentals, i.e. the persistence of the negative output gap and the inflation expectations remaining inside the variation band of the target. However, the overall annual decrease in the prices included in this index was somewhat slower at end-2014 Q1 than at end-2013 Q4 (-0.03 percent versus -0.15 percent). Behind this stood the marginal depreciation of the leu against the euro and the relative moderation in the disinflationary pressures induced by the negative output gap following the recent acceleration of economic growth.

Among the index components particularly affected by supply-side factors, administered prices made the largest contribution to the decline in CPI inflation rate in 2014 Q1. The marked deceleration of their annual growth was entailed by the fading of the statistical effect stemming from the significant rise in the electricity price in early 2013. The faster decrease in volatile food prices (VFE[2]), especially on account of a base effect, has also contributed to the decline in the CPI inflation rate. An opposite influence came from the dynamics of fuel prices, which returned to positive values in Q1, as a result of the higher leu-expressed fuel excise duty.

The decreasing trend in unit labour costs in industry observed as of 2013 Q2 was further manifest in January-February 2014, with the growth rate of labour productivity exceeding markedly that of average gross nominal wage in this sector. Across the economy as a whole, the pick-up in gross nominal wage earnings slightly gained momentum, as a result of the new increase in the minimum wage, but, apart from this, the NBR estimated that wage rises were moderate. Consequently, the risk of significant inflationary pressures stemming from wage-related costs appears to be low in the near run. Economy-wide, maintaining an adequate match between wage increases and labour productivity gains over the medium and long term remains however of the essence for consolidating price stability.

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

2 Vegetables, fruit and eggs.

Monetary policy since the release of the previous Inflation Report

In its meeting of 4 February 2014, the NBR Board decided to cut the monetary policy rate by 0.25 percentage points to 3.50 percent per annum. According to the updated macroeconomic forecast, in the short run, the inflation rate was seen falling steeply, albeit temporarily, amid the transitory impact of the bumper crop in 2013 and the cut in the VAT rate for some bakery products. The inflation rate was expected to remain inside the variation band of the central target in the medium term. The risks to the forecast stemmed from capital flow volatility in the context of the variability of investors' risk appetite and the changes in exposure to emerging economies, against the background of the decisions taken by major central banks across the world and the ongoing cross-border deleveraging in the banking system. On the domestic front, the scheduled 2014 elections also implied risks related to the pace of implementing structural reforms, mitigated somewhat by the compliance with the calendar of commitments that the authorities assumed under the precautionary financing agreement signed with the international institutions. In this context, the Board's decision to continue to gradually adjust the monetary policy stance was aimed at consolidating price stability in the medium run and ensuring the prerequisites for a sound recovery of lending to the private sector as well as economic growth.

Subsequent to these decisions, the macroeconomic developments confirmed the ongoing disinflation, in line with the path forecasted by the central bank, alongside the recovery of economic activity. The annual inflation rate reached historical lows in January and February. At the same time, the reassessment of risks to the medium-term inflation outlook pointed to the prevalence of those related to external developments, following the recent escalation of geopolitical and regional tensions. In its meeting of 28 March 2014, the NBR Board considered that the adjustment of the monetary policy stance in the recent months contributed to the strengthening of the transmission mechanism amid the effective anchoring of inflation expectations. The analysis led also to the view that, in the given macroeconomic context, the current monetary policy stance is adequate for both maintaining price stability in the medium term in line with the 2.5 percent flat annual target and sustainably bolstering lending in order to achieve balanced and lasting economic growth. Consequently, the NBR Board decided to keep the monetary policy rate at 3.50 percent per annum.

Inflation outlook

The projection sees the annual CPI inflation rate returning inside the ±1 percentage point variation band of the target in 2014 Q3 and remaining there until the projection horizon.

The macroeconomic forecast envisages a build-up in economic growth in 2014 and 2015. However, unlike 2013, when GDP growth relied primarily on the remarkable developments in net exports, alongside the agricultural sector performance – with the modest increase in consumption being largely the result of the plentiful supply of this sector – in the current and next year domestic demand is anticipated to gradually become the key driver of economic advance. Among the envisaged contributors to this evolution are: the rise in households' real disposable income, further progress in EU fund absorption, the gradual recovery of foreign direct investment flows, as well as the phased adjustment of lending conditions, also as a result of the projected configuration of real broad monetary conditions.

The consolidation of consumption growth is seen preceding investment recovery. As for the latter, following the unfavourable developments recorded in 2013 and estimated for early 2014, the rebound is expected to occur gradually during the current year, with a significant positive contribution of investment to economic growth being envisaged starting 2015. Stronger domestic demand will also cause imports to pick up at a relatively faster pace, implying a negative contribution of net exports to growth in 2015. After narrowing significantly in 2013, the current account deficit is expected to remain in 2014 close to the previous year's level and to post a moderate rise in 2015, with its share in GDP stabilising over the medium term below 2 percent, at significantly lower readings than those recorded prior to 2013. Given these premises of the baseline scenario of the projection and the preservation of international reserves, while most of Romania's debt incurred under the 2009 borrowing agreement with the IMF has been repaid, no significant corrective pressure on the leu exchange rate arising from the external position is foreseen until the projection horizon.

The negative output gap has been revised for the entire forecast interval to levels entailing relatively softer-than-previously-projected disinflationary pressures, due to the NIS revision of the seasonally-adjusted historical series of real GDP, faster-than-anticipated economic growth in 2013 Q4 and to the reassessment of the real broad monetary conditions, which are seen to be more stimulative during the reference period. The deviation of GDP from its potential level is foreseen declining gradually, but remaining at negative values throughout the projection interval.

The baseline scenario of the current projection places the annual CPI inflation rate at 3.3 percent at both end-2014 (0.2 percentage points below the level forecasted in the February 2014 Inflation Report) and end-2015 (0.1 percentage points above the previously-forecasted level).

The current projected path of the annual dynamics of consumer prices is relatively similar to that in the previous round for both CPI inflation and the adjusted CORE2 index. In the current round, the projection revisions for the two indices are quasi-identical and somewhat larger in the first half of the forecast interval, pointing to more favourable readings, except for 2015 Q4.

The annual adjusted CORE2 inflation rate is seen remaining at a slightly negative value at end-2014 Q2, before accelerating to 1.4 percent in Q3. To this will contribute the fading of the transitory statistical effects exerted by the cut in the VAT rate for some bakery products as of 1 September 2013 and by the bumper crop in 2013, which favourably impacted the prices of processed food items[3] via the agri-food commodity prices. Starting 2014 Q4, the expected path of core inflation will be largely shaped by its fundamental factors: the gradual narrowing of the negative output gap, the rise in inflation expectations in the first part of the interval and their improvement thereafter, and the progressively slower dynamics of import prices. Under the joint impact of these factors, the annual adjusted CORE2 inflation rate is forecasted on an upward path, reaching 2.3 percent in 2015 Q2 and remaining quasi-stable at this level until the projection horizon. The slight deviations from the previous projection are mainly ascribable to reassessing the negative output gap and imported inflation to relatively lower readings. The net effect of these diverging influences on core inflation has been a downward revision of its projection over most of the reference period.

The cumulative contribution of the exogenous CPI components in terms of the monetary policy scope remains at the previously-projected levels. In particular, the positive contribution of the dynamics of administered prices to CPI inflation has been revised downwards, given the updated scenarios on electricity and natural gas prices, in line with the latest developments and regulations in the field. The projected dynamics of volatile food prices have also been revised downwards, based on the favourable trend that was visible during 2014 Q1. Under the standard assumption of normal agricultural years during the projection interval, their annual inflation is expected to return to positive territory in 2014 Q3 once the effects of the 2013 plentiful harvest have faded away.

Less favourable contributions than in the previous round have been projected for the dynamics of fuel prices and tobacco product prices. In both cases, the revision was primarily the result of steeper-than- projected increases recorded in early 2014. Given the hike in the fuel excise duty by

3 Processed food items account for 50 percent of the adjusted CORE2 inflation basket.

7 eurocents per litre as of 1 April, as well as some base effects, fuel price inflation is seen picking up until end-2014, before witnessing a trend reversal. Projected developments in tobacco product prices point to markedly positive annual rates of change in 2014, slightly negative in 2015 and moderately positive in early 2016. The fluctuating dynamics owe mainly to the conversion of the EUR-denominated excise duties levied on these goods into lei, in line with the legal methodology in force.

Given the projected dynamics of core inflation and of the exogenous components in terms of monetary policy scope, according to NBR forecasts, the CPI inflation rate is envisaged to follow an upward path until end-2014 after the low values, albeit transitory, seen in the first quarter of this year. Its return inside the variation band of the central target is anticipated for 2014 Q3, on account of the aforementioned statistical effects associated with core inflation and volatile food prices. The annual inflation rate is then seen stabilising above 3 percent, yet below the upper bound of the variation band of the target, over the remainder of the projection interval. At the same time, the average annual inflation rate will stick to a downward path until 2014 Q3, hitting a trough of 1.6 percent, before embarking on an uptrend and peaking at 3.3 percent at the end of the reference period.

The projected monetary policy stance will seek to calibrate the set-up of real broad monetary conditions so as to ensure that inflation rate remains inside the variation band of the target over the medium term, thus paving the way for a gradual recovery of lending to the private sector, particularly of the leu-denominated loans, and for a lasting consolidation of economic growth.

The assessment of risks to the current inflation forecast still points to a balance tilted to the upside, albeit to a lower extent than anticipated in the previous round.

External risks are seen as somewhat balanced, amid relatively heightened uncertainty. They relate to the variability of investors' risk appetite towards emerging economies as a whole, owing to the potential escalation of recent regional and geopolitical tensions, the ongoing cross-border deleveraging in the banking system and the possible monetary policy stance adjustments by major central banks. The materialisation of such risks would entail changes in investor exposure to emerging markets as a whole, as well as reallocations among these markets. Thus, in the near run, some emerging economies, such as Romania, might face significant one-off capital inflows, inherently reversible over longer horizons, when investors' portfolio shifts away from Central and Eastern Europe, should the regional tensions persist, might outstrip the capital inflows directed towards other segments of assets of these economies, after taking into account the differences among the economic fundamentals of the competing market segments.

The higher volatility of capital flows channelled to the Romanian economy would bring about excessive fluctuations in the leu exchange rate and deviations of both inflation and economic growth from the baseline scenario of the macroeconomic projection. Given the investors' relative preference, in the medium and long term, for more resilient economies, the recent improvement in Romania's economic fundamentals and the still lower and diversified investor exposures in comparison with those to other emerging economies carry the potential to mitigate to some extent the risk associated with unfavourable effects of global or regional portfolio shifts. Moreover, assuming no significant worsening occurs (with spill-over effects), the recent geopolitical developments in the region are not seen as having a major bearing on the balance of risks via the net export channel[4]. Other risks relate to the "common lender" channel, considering the exposures to Ukraine and/or the Russian Federation of cross-border financial institutions operating also in Romania.

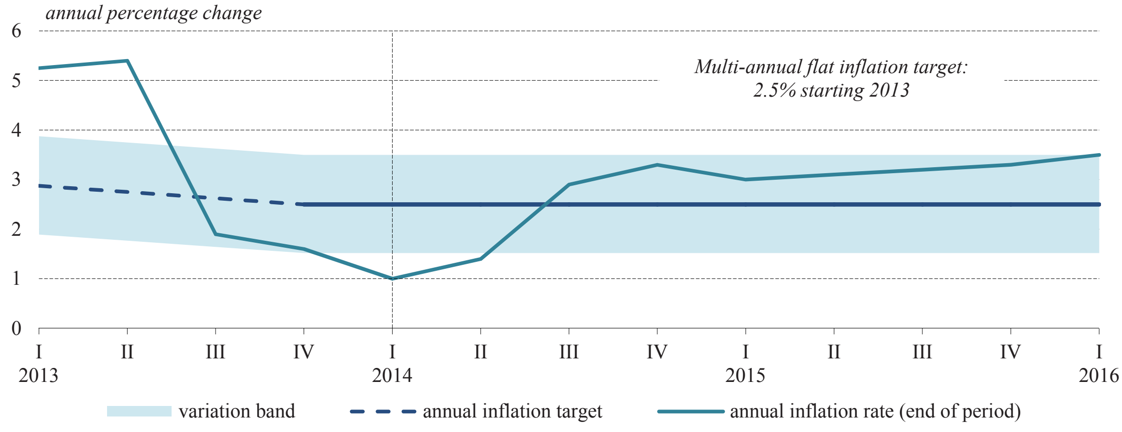
[4] Trade-wise, Romania's economy is the least exposed to the Russian Federation and Ukraine among the Central and Eastern European countries.

However, in Romania, the vulnerability to such risks is assessed to be lower than in other Central and Eastern European countries, given the good performance of the Romanian banking system in terms of solvency, liquidity and provisioning indicators.

Nevertheless, external risks remain relevant given the persistence of structural rigidities on the domestic front, which hinder the necessary adjustments across the local economy aimed at mitigating the effects of adverse shocks. From this perspective, the uncertainty surrounding the firm and consistent implementation of the set of structural reforms agreed with international institutions (EU, IMF and the World Bank) remains a cause of concern, particularly in the context of this year's elections, as any delay and/or failure to fully comply with the assumed commitments might lead to enhanced effects of the unfavourable domestic or external shocks on the inflation rate and economic growth.

Other relevant risks during the reference period stem from the specific uncertainty surrounding the dynamics of aggregate consumer price index components that are mainly impacted by supply-side shocks. In the case of administered prices, uncertainties relate to the implementation of the deregulation calendars on the natural gas and electricity markets, as well as to the effects of those measures. Significant deviations from the inflation projected in the baseline scenario may occur as a result of developments in prices of food items, given their large share in the consumer basket and in the adjusted CORE2 inflation basket in terms of processed food prices. The future dynamics of these prices are subject to the inherent uncertainty associated with weather conditions, affecting the domestic and external supply of agri-food items and commodities. Over the medium term, developments in prices of other commodities on international markets are associated with higher upside risks than in the baseline scenario, in the event of heightening of the recent regional and geopolitical tensions.

Inflation Forecast



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

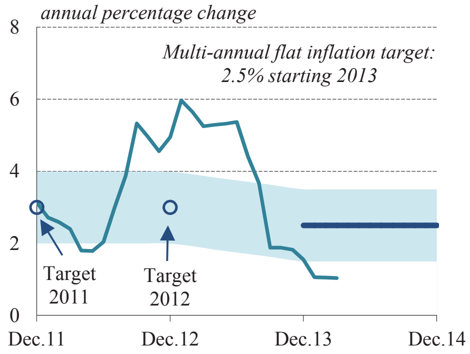
Source: NIS, NBR projections

Monetary policy decision

In view of the reconfirmation of the outlook for the annual inflation rate returning in 2014 Q3 to the upper half of the variation band of the flat target and remaining there subsequently, after running below the lower bound of the band in 2014 H1, amid the transitory impact of 2013 positive supply-side shocks, the NBR Board decided in its 6 May 2014 meeting to keep the monetary policy rate unchanged at 3.50 percent per annum. The NBR Board also decided to continue to pursue adequate liquidity management in the banking system and to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

I. INFLATION DEVELOPMENTS

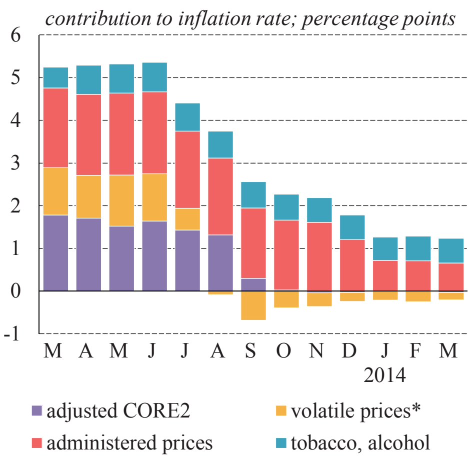
Inflation Developments



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

Source: NIS, NBR calculations

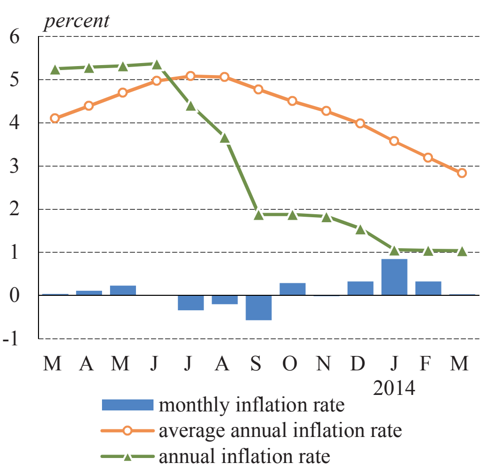
Annual Inflation Rate



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

Source: NIS, NBR calculations

Inflation Rate



Source: NIS

In January 2014, the annual CPI inflation rate fell below the lower bound of the ±1 percentage point variation band of the 2.5 percent target and hovered around 1.05 percent throughout 2014 Q1 (down 0.5 percentage points versus end-2013). The decline was almost entirely attributable to the base effect associated with the marked rise in the electricity price in January 2013. The subsequent stabilisation of the annual inflation rate was due to the continued favourable influence of the large supply of agri-food items on consumer prices and to the absence of pressures via the expectations channel. In the opposite direction acted the depreciation of the local currency against the euro and the contraction of the negative output gap, which led to the slowdown in the annual deflation of the adjusted CORE2 inflation rate (to -0.03 percent).

Similar to the picture seen in the previous quarter, the prevailing contribution to CPI disinflation during January-March 2014 was made by the significant slowdown in the annual pace of increase of administered prices (-3 percentage points, to 3.4 percent), following the complete fading out of the statistical effect generated by the massive rise in the electricity price in December 2012 (7 percent) and January 2013 (10 percent). Even though the start of 2014 marked a new stage of the energy market deregulation calendar, the price increases were moderate: the adjustment of natural gas prices was lower than that initially anticipated by the ANRE (1.2 percent compared with 2 percent), and the impact of the opening of the electricity market on the electricity bill for household end-users[1] was alleviated by the smaller cogeneration contribution.

The annual deflation rate of volatile prices changed marginally in 2014 Q1 (+0.1 percentage points, to -1.3 percent) amid the divergent developments of fuel and food prices. The growth rate of fuel prices re-entered positive territory (+0.6 percentage points, to 0.2 percent), following the rise in the lei-denominated level of the excise duty for fuels[2], whereas the pace of increase of VFE prices declined by 0.4 percentage points to 3 percent, mainly on account of a base effect.

Even though the higher lei-denominated level of excise duties also affected the tobacco product and alcoholic beverage prices, the

[1] As of January 2014, the share of electricity purchased on the deregulated market and delivered to household end-users rose to 20 percent (versus 10 percent in the previous period).

[2] With the exchange rate set for the first working day of October 2013 lower than a year earlier, in 2014 the EUR-denominated level of the excise duty was indexed by the average annual inflation rate recorded in September 2013 (the change in the mechanism used to set the lei-denominated level of the excise duty is included in the budget for 2014).

impact was similar to that seen in the previous year, so that the annual inflation rate for this group of goods remained relatively unchanged (-0.2 percentage points, to 7.6 percent).

In 2014 Q1, the annual deflation rate related to the adjusted CORE2 index slowed down to -0.03 percent (compared with -0.15 percent at end-2013), against the background of a significantly narrower negative output gap and of the action of several supply-side factors generating both upside and downside influences, which set different trends for the sub-components: a faster growth rate for services prices, slower dynamics of prices of non-food items and the acceleration of negative growth rate of food prices.

The annual rate of increase of market services prices stepped up in 2014 Q1 (+1.7 percentage points, to 2.8 percent) under the impact of the depreciation of local currency against the euro and of the pass-through of higher reinsurance costs paid by insurers in the previous year into the Civil Auto Liability insurance policy price.

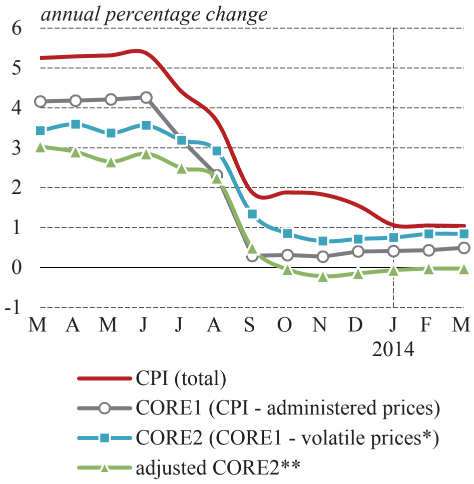
As for the prices of non-food items, the impact of the upturn in demand and of the depreciation of the exchange rate was offset by the favourable developments in external prices[3]. Therefore, this group witnessed a slight deceleration in 2014 Q1 (-0.2 percentage points, to 1.6 percent).

The annual deflation of food prices accelerated during the period under review (-0.4 percentage points, to -2.2 percent), due to the low costs of agricultural produce, as well as the promotion by the hypermarkets of their own brands of food products, which are cheaper. The cut in the VAT rate applied to some bakery products as of 1 September 2013 further made a contribution (-2.4 percentage points) to the highly negative dynamics of these food prices.

Overall, economic agents' inflation expectations recorded benign developments during January-March 2014, most sectors (industry, construction and services) posting a balance of answers close to zero; retailers were an exception, as they further expected prices to go up. Financial analysts' inflation expectations remaining within the variation band around the central target set by the NBR at a level comparable to that seen at end-2013 and the persistent downward path in consumers' expectations confirm the absence of inflationary pressures via this channel during the period under review.

The average annual HICP rate further stuck to a downward path in 2014 Q1 (-0.9 percentage points, to 2.3 percent), which led to the additional narrowing of the differential versus both the inflation

Headline Inflation and CORE Inflation

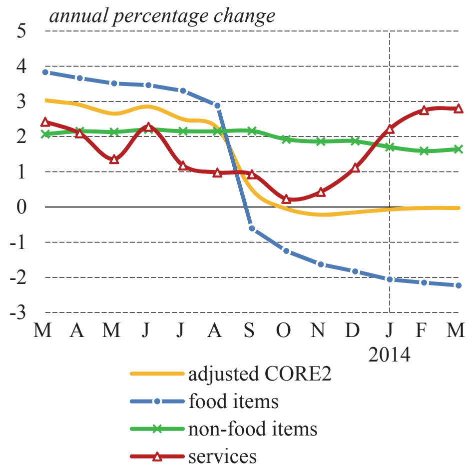


*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

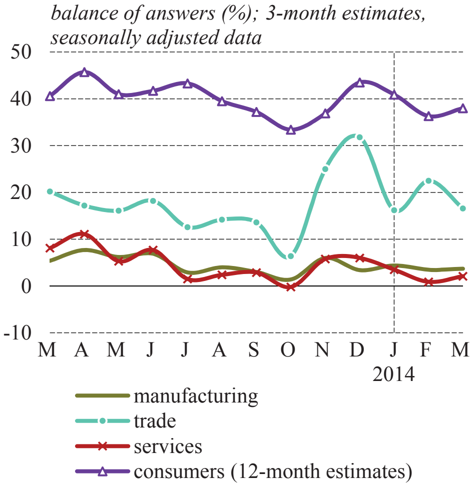
Source: NIS, NBR calculations

Adjusted CORE2 Components



Source: NIS, NBR calculations

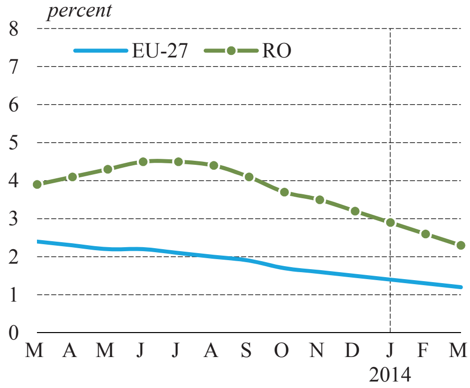
Inflation Expectations of Economic Agents



Source: EC-DG ECFIN

[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

rate criterion laid down in the Maastricht Treaty and the EU average inflation (to 1.1 percentage points in both cases).

At end-2014 Q1, the actual annual inflation rate stood 0.1 percentage points higher than the projection in the February 2014 Inflation Report. The difference resulted from the underestimation of the impact of the electricity market deregulation and of the magnitude of the local currency depreciation against the euro.

II. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2013, for the third year in a row, real GDP posted positive annual dynamics, i.e. 3.5 percent, well above those reported in 2011 and 2012, with significantly positive quarterly growth rates that ranged between 0.8 percent and 1.8 percent[1] throughout the year. The rebound in industry, driven by external demand, accounted for approximately two thirds of the economic growth. The other third stemmed from the faster-than-expected pace of increase of agricultural production, on the back of the favourable weather conditions in the period under review, as well as of the very poor crop seen in 2012.

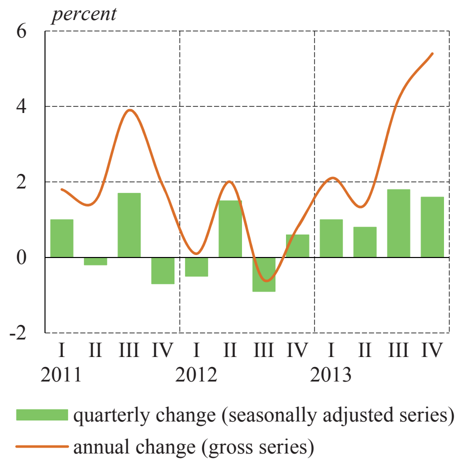
In 2013 Q4, the annual growth rate of real GDP peaked at a 4-year high, i.e. 5.4 percent, up 1.2 percentage points from that recorded in the previous three-month period. Although economic growth was further driven mainly by net exports (+4 percentage points), the positive contribution made by domestic absorption (1.4 percentage points), due solely to the upturn in consumer demand, cannot be overlooked either.

1.1. Demand

Household final consumption saw a significantly faster annual pace of increase (from 0.9 percent to 2.9 percent), following both the pick-up in retail purchases[2] and the advance in the components whose path is in line with the performance of agriculture – purchases on the agri-food market, self-consumption and household goods industry. The receipts from market services followed the opposite trend (as a result of the contraction in travel, owing possibly to the delayed opening of the ski season).

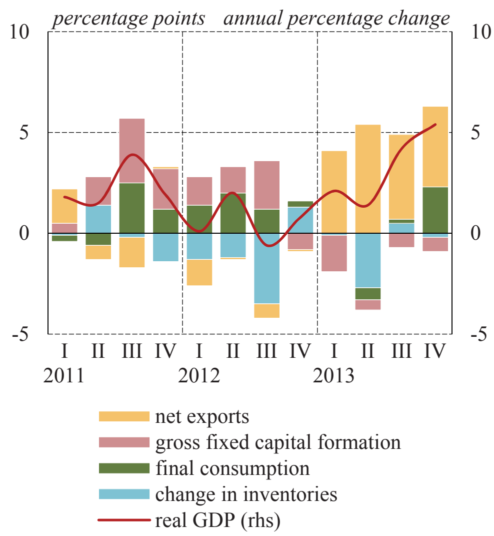
The swifter dynamics of purchases of goods were supported by non-durables (following mainly the slight rebound in foodstuffs sales and the declines in fuel trade coming to a halt) and durables alike. In the latter case, the largest contributor was further the car market, whose components posted the same developments as in Q3, albeit of a higher magnitude. Thus, the volume of sales followed an uptrend for both new motorcars (which peaked at end-2013, with the car market enjoying its best December[3] in three years) and used motorcars, the latter movement leading to the

Real Gross Domestic Product



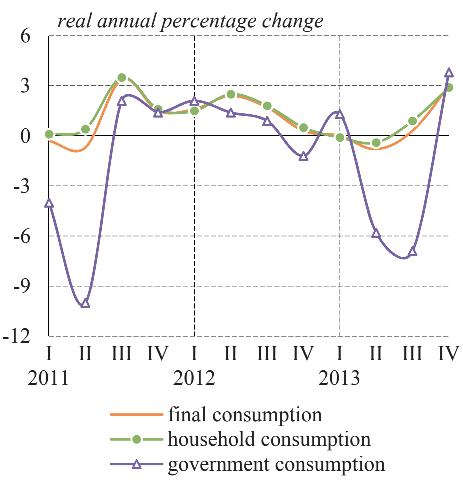
Source: NIS

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

Actual Final Consumption



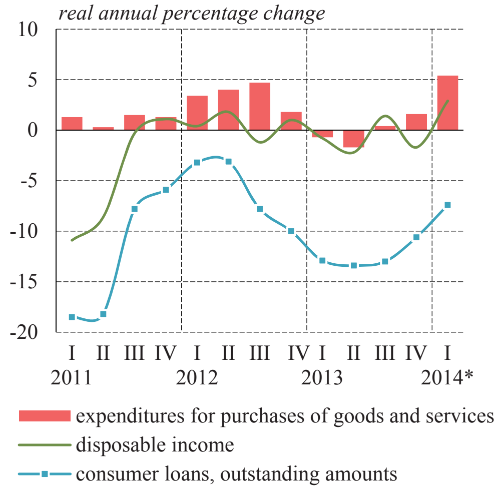
Source: NIS

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.

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

3 According to the Automotive Manufacturers and Importers Association.

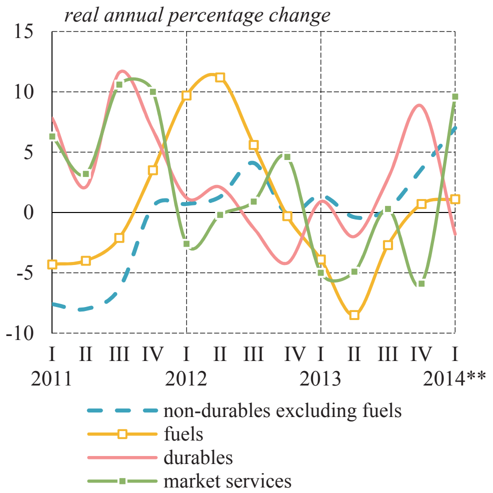
Household Consumption and Main Financing Sources



*) Jan.-Feb.

Source: NIS, MPF, NBR calculations

Purchases of Goods and Services*

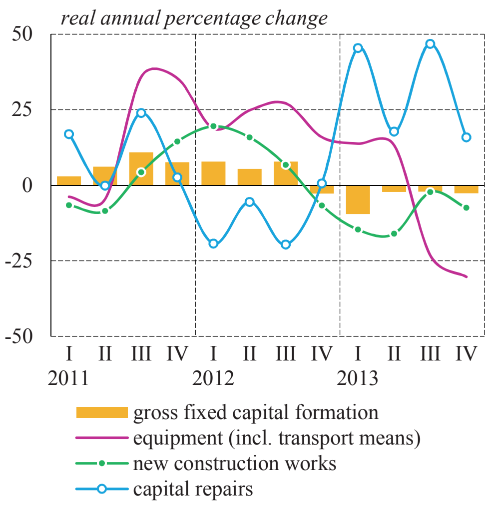


*) based on data on the turnover volume of retail trade and market services to households

**) Jan.-Feb.

Source: NIS, NBR calculations

Investment



Source: NIS, NBR calculations

further step-up in purchases of spare parts and accessories. Sales of IT&C equipment and electronics witnessed larger volumes as well, with market information indicating that in 2013 Q4 they marked a 5-year high. At European level, only Hungary[4] recorded faster IT&C equipment and electronics market dynamics than those in Romania in 2013 as a whole. According to retailers, the attractive deals offered by many of them in late 2013 (including the more than a week extension of Black Friday deals) and the less expensive consumer loans enabled the resumption of purchases of high-value household appliances, as well as the acquisition of cutting-edge technology IT&C devices, such as tablets and smartphones.

In 2013 Q4, the general government deficit stood at lei 7,628 million (i.e. 1.2 percent of GDP[5], corresponding to a primary balance of -0.9 percent of GDP), close to that posted in the same year-ago period, which amounted to lei 7,602 million and accounted for 1.3 percent of GDP. The improved dynamics of the budget balance versus 2013 Q3 resulted from the annual decline in total public expenditure (-0.6 percent against +2.5 percent in Q3), on the back of the slower growth rate of government spending on goods and services (10 percent as compared with 18 percent in the previous quarter), the annual change in interest expenses and other transfers entering negative territory, i.e. -17.9 percent versus +19.1 percent and -37.9 percent against +1.4 percent respectively, as well as of the faster annual decrease in subsidies (-49.2 percent as compared with -28.4 percent). A contrary, albeit softer, impact derived from the slower rate of change of total budget revenues (-0.4 percent versus +0.3 percent in Q3), whose major determinants were a statistical base effect[6] and the slacker dynamics of VAT receipts (-2.9 percent against +4.0 percent) and non-tax revenues (-15.7 percent as compared with -12.4 percent).

Gross fixed capital formation further shrank (by 2.6 percent, 0.5 percentage points deeper into negative territory compared to the fall in 2013 Q3), with corporate and household investment respectively reporting significant contractions. In the first case, equipment purchase (including transport means purchased by companies and public institutions) posted the sharpest decline, i.e. down 30.3 percent, new construction works and capital repairs on non-residential buildings, as well as lease purchases of motor vehicles and equipment also witnessing negative real dynamics. As for household investment, both new housing construction works and capital repairs on existing buildings showed decreases.

4 GfK Temax Romania, March 2014.

5 The analysis relied on the operational data released by the MPF relative to the December 2013 general government budget execution. The GDP readings released by the NIS were used for 2012 and 2013.

6 Associated with the developments in receipts from the tax related to use of goods, to authorisation of the use of goods or to developing activities in 2012 Q4.

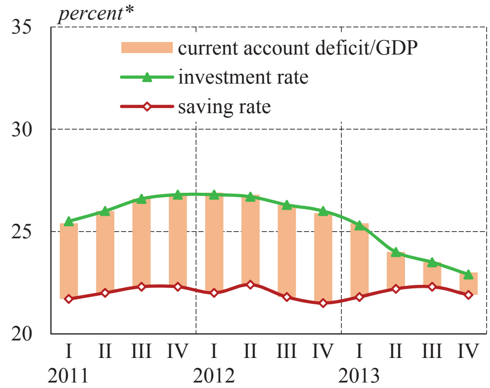
The poor performance of corporate and household investment alike was largely counterbalanced by the rebound in publicly-funded investment, as gross fixed capital formation in this sector saw a substantial trend reversal[7].

In 2013 Q4, net external demand was further the major contributor to real GDP dynamics, with net exports of goods making an even larger contribution than in the previous three-month period (from 3.2 percentage points to 4.1 percentage points), given that exports reported a more than three times faster pace of increase than imports.

Sales of goods to external markets climbed by 20.8 percent in annual terms, the evolution of exports to the two destination markets – the EU and the non-EU countries[8] – being similar to that in Q3. Thus, the real dynamics of sales to the European market (albeit slightly faster than those in the prior quarter, i.e. 14.6 percent) were well below those observed on non-EU markets (24.2 percent), with the share held by exports to these countries in total exports standing marginally above 30 percent. Sales of machinery, equipment and transport means stood almost 15 percent higher in terms of value, accounting for some 46 percent of the advance in external sales in 2013 Q4. The second group of goods in terms of the contribution to exports dynamics – around 25 percent – was that of agrifoodstuffs, which however included mainly commodities and low-value added goods. Mention should be made that the bumper crops in 2013 drove the first trade surplus in agrifoodstuffs over the past two decades, i.e. EUR 325 million (as compared with a deficit of approximately EUR 745 million in 2012), given the narrower trade deficit with the EU (by about 14 percent) and particularly the wider trade surplus with Romania's non-EU trade partners (to EUR 1.2 billion, four times larger than the previous year's figure)[9].

The volume of imports of goods rose by 6.3 percent in Q4, the annual dynamics slowing down somewhat against the previous quarter with respect to both the EU and non-EU markets. This was largely the result of the deceleration in purchases of intermediate goods and commodities, on the back of the downtrend followed by the import content of exports, seen chiefly in the automotive industry.

Investment Rate and Saving Rate

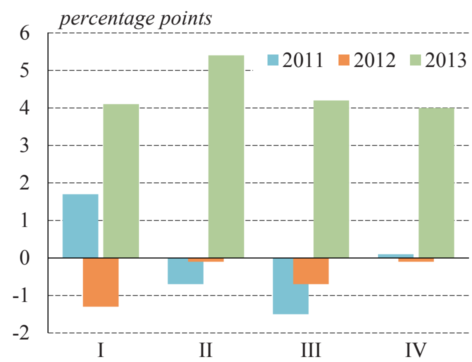


*) last 4 quarters' average

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

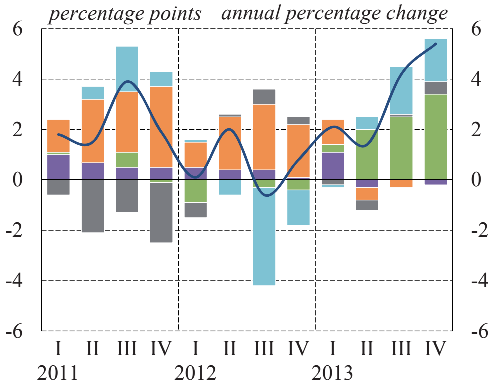
[7] In nominal terms, its dynamics stood at +29 percent in Q4 versus -17 percent in the prior quarter (source: Eurostat).

[8] 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.

[9] The agrifoodstuffs trade balance data are based on the 16 March 2014 press release issued by the Ministry of Agriculture and Rural Development.

1.2. Supply

Contribution of Supply Components to GDP Growth



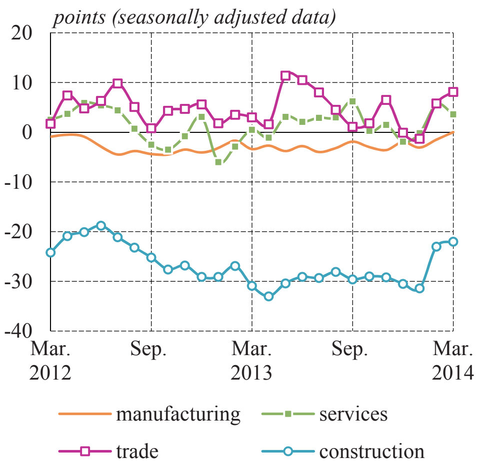
Source: NIS, NBR calculations

All the economic sectors, except for services, whose gross value added remained virtually flat, reported positive annual growth rates in Q4, with agriculture showing the best performance – GVA increased by 38.2 percent, a rate 17.1 percentage points faster than in Q3, primarily on account of the larger corn harvest (in 2013 Q3, corn production went up 9 percent year on year, whereas in the last three months of 2013 it was more than three times higher).

Non-agricultural sectors further recorded faster growth rates as well, cumulated gross value added standing 3.9 percent higher than in 2012 Q4 (+1.3 percentage points compared with the previous quarter). With an annual increase in gross value added of 12.2 percent, industry consolidated its position as the main contributor to GDP dynamics (+3.4 percentage points). Even though the less sharp downward path of industrial output for the domestic market in the latter half of the year cannot be overlooked (from -9.4 percent in Q2 to -2.4 percent in Q4[10]), external demand remained the catalyst of growth in this sector, the turnover volume in industry for the non-domestic market exceeding by 18.6 percent the level recorded in 2012 Q4. The fastest growth rates of output (ranging between 11 percent and 22 percent) were reported by transport means, machinery and electrical equipment, food industry, building materials and furniture.

Gross value added in the construction sector also witnessed positive annual dynamics, i.e. 3.7 percent, clearly swifter than those in Q3 (up 2.6 percentage points). Nevertheless, the series of construction works volume indices paint a different picture, as in 2013 Q4 this activity re-embarked on a downward path (down 1.5 percent). A breakdown of construction works shows trend reversals in both residential (down 7.5 percent) and non-residential building works (down 21.8 percent), partly offset by the 9.8 percent rise in civil engineering – particularly road infrastructure works.

Corporate Sector: Confidence Indicators for the Next 3 Months



Source: EC-DG ECFIN

After slightly decreasing for two quarters, gross value added in services stood at a level similar to that recorded in 2012 Q4, as the ongoing declines in financial intermediation and insurance services and public services were counterbalanced by: (i) the recovery in "trade and transportation" (from -2.9 percent to +3 percent on the back of the step-up in purchases of goods by households and the pick-up in wholesale trade and transport of goods, under the impact of favourable developments in industrial and agricultural output and retail trade); (ii) a further increase in real estate transactions (mainly office rentals and land transactions for office buildings and shopping centres), as well as in "information and communication" services, with the mobile phone market witnessing a possible behaviour change related to the shift from voice services to data services in 2013.

[10] Calculations based on the series of turnover volume indices of the industrial output for the domestic market.

2. Labour market

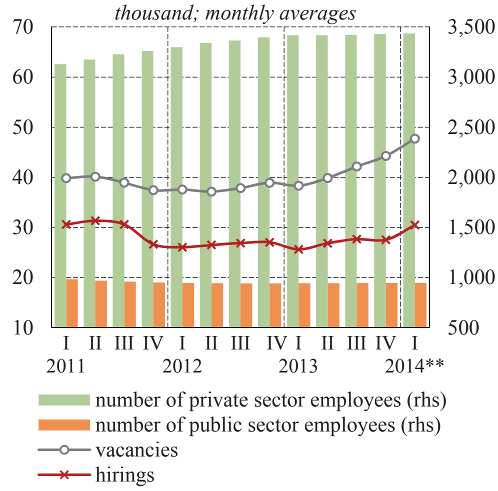
In early 2014, the labour market further saw moderate developments[11], showing, however, signs of a rebound in labour demand. The significantly faster annual growth rate of wages in the private sector was the result of the rise in the minimum gross wage economy-wide, with companies remaining cautious with respect to wage bargaining. Similar to the picture seen in the previous quarters, in industry wage increases were fully offset by productivity gains, the annual dynamics of unit labour costs further staying in negative territory. Given that the annual inflation rate fell temporarily below the lower bound of the variation band of the central target, the annual pace of increase of real disposable income re-entered positive territory, boosting consumption.

After having inched up in 2013 Q4, the number of employees economy-wide posted a similar level in early 2014, chiefly on the back of the relative stability in the construction and services sectors. Industry as a whole saw a marginal advance, driven particularly by the hirings in industries manufacturing computers, electronics, electrical equipment and motor vehicles. On the other hand, the number of vacancies identified by the NEA remained on an upward trend, suggesting a rebound in labour demand and implicitly a lagged upturn in the number of employees. As a matter of fact, recent survey[12] results support this statement, reflecting favourable employment prospects in industry and the construction sector in 2014 Q2. At the same time, the fall in layoffs contributed to the indicators on excess labour supply staying virtually flat – both the registered unemployment rate and the ILO unemployment rate remained unchanged, i.e. 5.5 percent and 7.3 percent respectively.

January through February 2014, the annual dynamics of nominal gross wage earnings accelerated to 5 percent (from 4.3 percent in 2013 Q4), mainly following the entry into force of a new stage of increase in the minimum gross wage economy-wide (from lei 800 to lei 850), which benefitted a substantial number of employees (more than 15 percent of total employees[13]) this time. According to NBR estimates, except for this adjustment, pay rises were moderate, mirroring the persistence of the negative output gap and consequently the slow-paced recovery of the labour market, the further cautious wage policy in the budgetary sector[14], as well as the low inflation expectations.

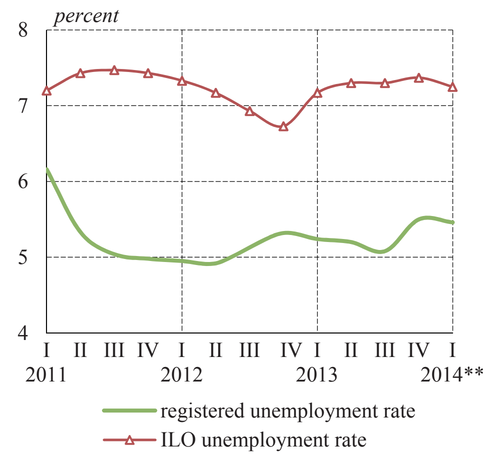
In industry, the increase in productivity gains caused the annual change in unit labour costs to remain in the negative territory

Labour Demand Measures*



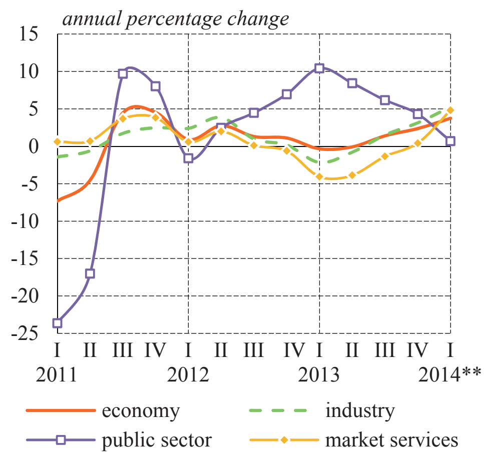
*) seasonally adjusted data
**) Jan.-Feb.
Source: NEA, NIS, NBR calculations

Unemployment Rate*



*) seasonally adjusted data
**) Jan.-Feb.
Source: NIS, NBR calculations

Net Real Wage*



*) deflated by CPI
**) Jan.-Feb.
Source: NIS, NBR calculations

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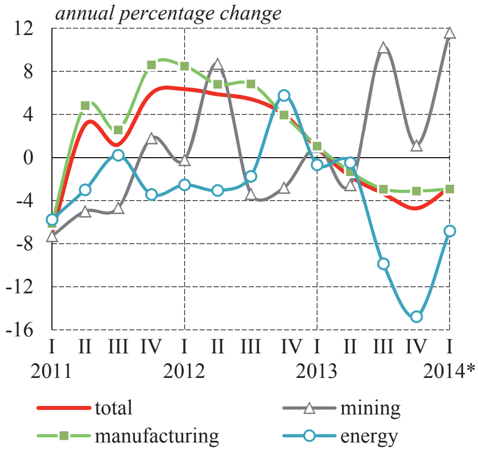
11 The analysis is based on seasonally adjusted data.

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

13 NBR calculations.

14 In the period under review, the annual growth rate of gross wages in the budgetary sector dropped to 1.9 percent.

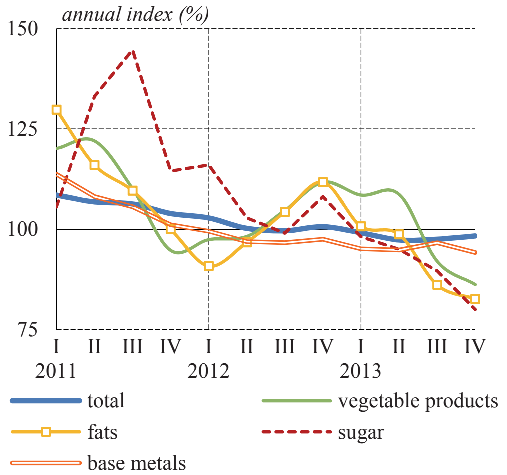
Unit Labour Cost in Industry



*) Jan.-Feb.

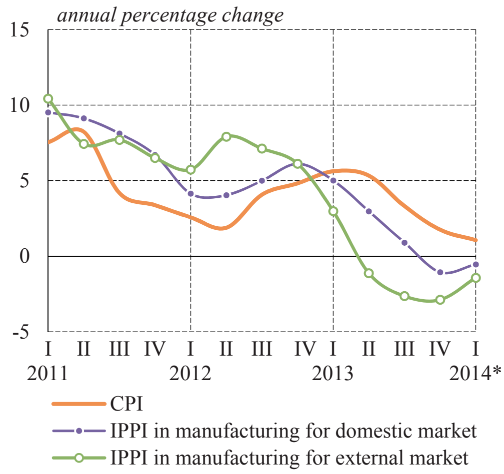
Source: NIS, NBR calculations

Items Reporting Declines in Import Unit Value Index in 2013 Q4



Source: NIS, NBR calculations

Consumer Prices and Industrial Producer Prices



*) Jan.-Feb.

Source: NIS

January through February 2014 (-2.8 percent versus -4.7 percent in 2013 Q4), despite the 1.5 percentage point faster annual growth rate of gross wages. The favourable developments owed solely to manufacturing, with crude oil processing, electronics and metallurgy posting substantial adjustments. By contrast, in the automotive industry, the significantly slacker dynamics of productivity were not matched by a corresponding deceleration in the pace of increase of wage earnings.

As concerns demand-side factors influencing the inflation rate, in January 2014 the annual change in real disposable income re-entered positive territory, after standing at -1.7 percent at end-December 2013, on the back of the contraction in workers' remittances from abroad. The latter's markedly slower decline, the rise in social transfers and wages, as well as the historical lows reported by the inflation rate subsequently caused the annual growth rate of real disposable income to accelerate to 4 percent.

3. Import prices and producer prices

In 2013 Q4, import prices and industrial and agricultural producer prices further posted favourable developments, on the back of the appreciation of the domestic currency versus the major currencies, the lower prices of (particularly agri-food) commodities and the decrease in electricity prices. As for 2014 Q1, the fewer factors exerting a positive impact on import prices and agricultural producer prices suggest trend reversals in these prices. Industrial producer prices are expected to record negative dynamics, driven by a strong base effect in energy prices.

In 2013 Q4, import prices continued to have a benign influence on the rate of change of domestic prices, given the further below par annual unit value index of imports (98.27 percent versus 97.51 percent in the prior three-month period) and the appreciation of the domestic currency versus the major currencies.

The external prices of imported goods holding a large share in the CPI basket saw favourable developments only in the case of agri-food items (fruit, vegetable products, meat), whereas most non-durable non-food items followed the opposite trend.

Similar to the picture in 2013 Q3, the external prices of capital goods remained relatively flat in annual terms, as the positive impact of the sharper drop in metal prices was eroded by the influence of the higher demand for wind power equipment, as well as by the stronger preference for imports of new motorcars to the detriment of used ones[15], with the annual unit value index of imports of transport means turning positive in the period under review.

15 According to the Ministry of Foreign Affairs data, in 2013 Q4 the annual growth rate of imports of used cars decelerated to 3.6 percent from 38 percent in the previous three-month period.

In 2013 Q4, the annual growth rate of industrial producer prices for the domestic market was stuck to a downward path (to 0.9 percent, down 1.7 percentage points from the previous quarter average), to which contributed all groups of goods. The main determinants were: (i) the ongoing fall in electricity prices, (ii) the oil prices re-embarking on an downtrend, (iii) the marked decline in domestic prices for agri-food commodities (particularly grains), as well as (iv) the appreciation of the domestic currency versus the major currencies.

The annual pace of increase of producer prices for consumer goods reported the most significant slowdown (-2.9 percentage points, to 1.5 percent), in line with the negative change in food prices (-3.4 percent).

Energy prices posted slacker annual dynamics as well (-1.5 percentage points, to 4.1 percent). Together with the faster deflation in the hydrocarbon processing sub-sector (to -8.0 percent), behind this development stood the production of electricity and heating (5.2 percent annual change against 7.3 percent in 2013 Q3), following the lower electricity prices on the deregulated market. The drop in the average trading price on the OPCOM exchange owed both to the larger share held by green energy (which is cheaper, as a result of the government's renewable energy sources support scheme) in the national power system and to the weaker demand for electricity, given the reduction in the energy intensity of the economy.

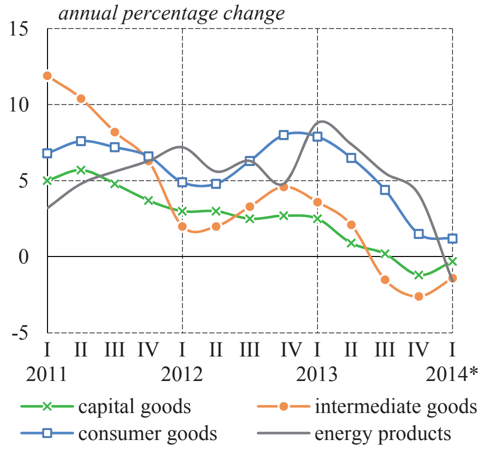
The faster negative annual change in producer prices for intermediate goods (to -2.6 percent) was driven chiefly by the developments in the chemical industry (amid the subdued domestic demand) and in the manufacture of other non-metallic products, against the backdrop of the measures to raise energy efficiency taken by one of the most important market operators.

Producer prices for capital goods recorded annual deflation as well (-1.2 percent versus 0.2 percent in 2013 Q3), as a result of the stronger dampening effect of domestic demand.

In 2013 Q4, the annual rate of change of agricultural producer prices fell deeper into negative territory (from -1.8 percent in 2013 Q3 to -12.6 percent), due to both a base effect becoming manifest and the currently favourable performance of animal and vegetal production alike, the latter of which exerted however the larger impact, as the annual dynamics of these prices shed 13.7 percentage points, to -16.4 percent, on the back of the 2013 bumper crops.

As for animal products, the lower fodder costs (down 22.1 percent in annual terms) led to the slower-paced dynamics of prices of most meat types, as well as milk and eggs.

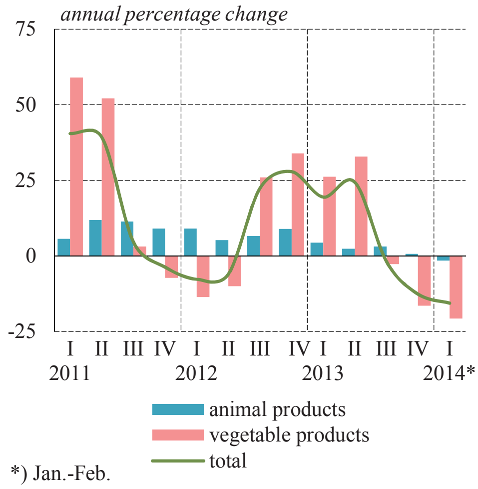
Industrial Producer Prices for Domestic Market by Industrial Products Group



*) Jan.-Feb.

Source: NIS

Agricultural Producer Prices



*) Jan.-Feb.

Source: NIS

In 2014 Q1, the price hikes on external agri-food commodity markets (owing to the adverse weather conditions in the USA and the geopolitical tensions between the Russian Federation and Ukraine) may result in trend reversals in both domestic vegetal production prices and import prices. In the latter case, the movement will be boosted by the depreciation of the domestic currency versus the euro and its slacker pace of appreciation against the US dollar. After having entered negative territory January through February 2014, the annual growth rate of producer prices (which hit a 4-year low in the aforementioned period) is expected to post negative readings throughout 2014 Q1, on the back of a favourable base effect in energy prices.

III. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In February 2014, the NBR lowered the monetary policy rate by another 0.25 percentage points (thus marking the sixth consecutive rate cut in the past eight months, cumulating 1.75 percentage points), before keeping it unchanged at 3.50 percent per annum in March. At the same time, the central bank maintained the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions and further pursued adequate liquidity management in the banking system. The measures were aimed at calibrating real broad monetary conditions so as to safeguard price stability and anchor inflation expectations in line with the flat inflation target, while also paving the way for the sustainable revival of lending.

The NBR extended the rate-cutting cycle into February 2014. The decision to lower the monetary policy rate to 3.50 percent (from 3.75 percent) was warranted by the continued slowdown in inflation in the latter part of 2013 and by the broad reconfirmation of the coordinates of the central bank's previous quarterly forecast[1]. Specifically, in December 2013, the annual inflation rate fell close to the lower bound of the variation band of the flat target, reaching a 24-year low of 1.55 percent. Against this background, the updated forecast of medium-term macroeconomic developments reconfirmed the prospects of the annual inflation rate declining in the first part of 2014 to values beneath the lower bound of the variation band of the target – under the protracted transitory impact of favourable supply-side shocks[2], overlapping the effects exerted by fundamentals (the persistence of the negative output gap and the inflation expectations remaining inside the variation band of the target) –, before returning and subsequently consolidating at levels in the upper half of the band. However, the 12-month inflation rate forecasted for end-2014 was slightly higher than previously anticipated, nearing the upper bound of the variation band of the target[3], owing mainly to the upward adjustment of the projected dynamics of tobacco product and alcoholic beverage prices, as well as of fuel prices, following changes in the excise duty regime for these products[4].

1 November 2013 Inflation Report.

2 The major impact of the 2013 bumper crop on food prices and the cut in the VAT rate for some bakery products as of 1 September 2013.

3 From 3.0 percent to 3.5 percent.

4 These developments had been previously flagged by the central bank as a source of upside risks to the projected inflation path.

In its March meeting, the NBR Board decided to keep the monetary policy rate unchanged at 3.50 percent, a level considered adequate in view of the inflation outlook and hence of attaining the objective of maintaining price stability in the medium term. Thus, in line with central bank expectations, the annual inflation rate continued to drop in the first two months of 2014, reaching a new post-1990 low of 1.05 percent in February. Furthermore, the coordinates of the new near-term inflation projection were compatible with the longer-term inflation outlook revealed by the latest NBR quarterly forecast, which saw the 12-month inflation rate returning in 2014 H2 in the upper half of the variation band of the flat target and remaining there afterwards. The major determinants of this path were the foreseeable gradual fading of the favourable effects of previous supply-side shocks and the anticipated persistence of the negative output gap. Nevertheless, both the current and the expected magnitude of the gap over the short term were envisaged to be lower, given the considerably faster GDP growth in 2013 Q4[5] and the persistence into early 2014 of the robust dynamics of high-frequency economic indicators relevant for the behaviour of consumer and investment demand, implying the upward revision of growth prospects in the first two quarters of the current year.

At the same time, the annual rate of decline of credit to the private sector[6] slowed further January through February 2014, i.e. -3.1 percent versus -5.4 percent in 2013 Q4, reflecting not only the statistical effect of the 12-month inflation rate and of the exchange rate, but also the visibly improved performance of the leu-denominated component, whose annual dynamics returned to positive readings, coming in at 0.8 percent from -0.4 percent in the previous three months. An opposite effect, albeit of a lower magnitude, had the protracted downtrend in the annual rate of change of foreign currency credit, i.e. -7.0 percent against -6.0 percent in 2013 Q4 (based on readings expressed in euro). The breakdown by recipient points to developments only partly in line with the results of the latest Bank Lending Survey[7] conducted by the NBR, according to which credit institutions anticipated, on one hand, the broad preservation of the status quo of lending standards in relation to non-bank clients in 2014 Q1 – thus consolidating the assumption of a wrap-up of the tightening cycle – and, on the other hand, a contraction in corporate demand for loans during the same period, along with a standstill in household credit demand. However, the average annual dynamics of credit to non-financial corporations continued to improve (-5.3 percent compared to -7.0 percent in 2013 Q4), reflecting the pick-up in the annual rate of change of the leu-denominated component (0.2 percent from -0.2 percent in 2013 Q4) – fuelled primarily by its long-term

[5] 5.2 percent.

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

[7] February 2014.

component (5.7 percent against 2.2 percent in the last three months of 2013) – as well as the statistical effect of the weaker domestic currency. By contrast, the annual dynamics of foreign currency credit to non-financial corporations remained on a downward path. Moreover, the annual rate of decline of household credit slowed to -1.1 percent, 2.8 percentage points above the 2013 Q4 average, on account of the markedly faster growth rate of housing loans in domestic currency (104.5 percent from 71.7 percent in the closing quarter of 2013), to which added the less negative readings of consumer credit annual dynamics, especially of the leu-denominated component.

The annual growth rate of broad money continued to gain momentum January through February (9.0 percent against 5.3 percent in 2013 Q4), largely due to the faster dynamics of its liquid component (M1 advanced 16.4 percent in annual terms compared to an average of 9.5 percent in the fourth quarter), driven both by base effects and by the relatively keener money demand for transactions, linked to the highly likely consolidation of economic growth. Specifically, the M1 breakdown shows that corporate and households' overnight deposits in domestic currency posted the most significant advances in their rates of increase, followed by currency in circulation. The annual growth of time deposits with a maturity of up to two years also edged up (4.3 percent from 2.4 percent in 2013 Q4), spurred by the dynamics of leu-denominated time deposits of both households and companies.

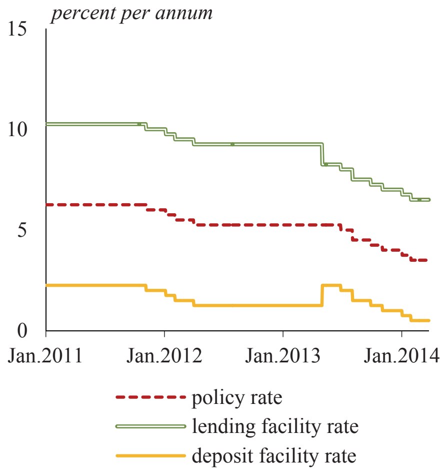
The continuation of the monetary policy rate-cutting cycle and especially the stronger expansionary impact of autonomous liquidity factors, to which added expectations of a further large liquidity surplus – as a result of the NBR's decision to cut the minimum reserve requirements on leu-denominated liabilities[8] –, prompted in January a protracted downtrend in interbank money market rates, with longer-term ROBOR rates hence continuing to decline. However, starting in the closing days of January, their values witnessed a correction, given that the abrupt reversal of the impact of autonomous liquidity factors (reflecting, inter alia, larger liquidity absorptions by the Treasury) – resulting in the re-emergence of temporary liquidity shortfalls – alongside non-residents' keener demand for domestic currency (in a context of heightened tensions on the financial markets of several emerging economies and further portfolio shifts) fundamentally changed liquidity conditions and expectations on their specifics over the period ahead. Against this backdrop, 3M-12M ROBOR rates returned in the vicinity of the monetary policy rate (see Section 2.1. Interest rates).

[8] The NBR Board decided in its January meeting to cut the minimum reserve requirements ratio on leu-denominated liabilities starting with the 24 January-23 February 2014 maintenance period.

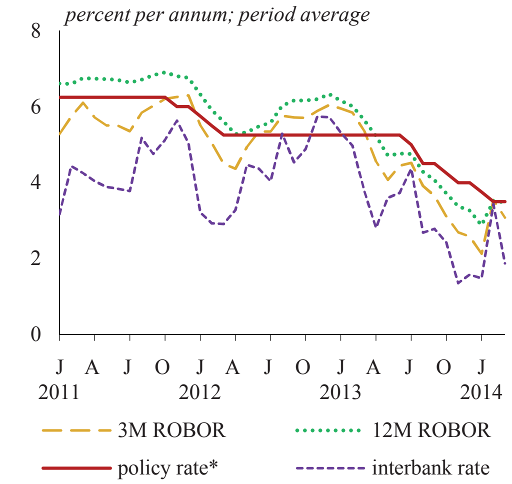
2. Financial markets and monetary developments

Average interbank money market rates edged up in 2014 Q1, amid the temporary change in liquidity conditions. The EUR/RON exchange rate witnessed heightened volatility, as markets in the region were faced with a renewed worsening of investor sentiment toward emerging economies, compounded by escalating geopolitical tensions in Ukraine. The annual rate of decline of credit to the private sector slowed further, whereas the pace of increase of broad money consolidated, primarily on the back of disbursements from European funds.

Policy Rates



Policy Rate and ROBOR Rates



*) end of period

2.1. Interest rates

Interbank money market rates continued to decline in early 2014 Q1, before embarking on an upward path and returning in the vicinity of the monetary policy rate. In the latter part of the period under review, interbank rates trended downwards again, although their quarterly average January through March (2.41 percent) exceeded by 0.58 percentage points that recorded in 2013 Q4.

Banks' net liquidity surplus posted uneven developments during the reported period, with its widening trend – in the context of lower reserve requirements and of injections generated by Treasury operations (associated with the use of amounts from the MPF's foreign currency-denominated account with the NBR) – being brought to a halt by the reversal of the joint impact of autonomous liquidity factors, which resulted into temporary liquidity shortfalls. These developments, alongside non-residents' sporadically keener demand for domestic currency, affected the overnight rates on the interbank money market, which spiked at end-January from the lower bound towards the median of the corridor defined by interest rates on the central bank's standing facilities around the policy rate, where they fluctuated over the following month. ON rates then reverted to lower levels, driven by larger Treasury injections.

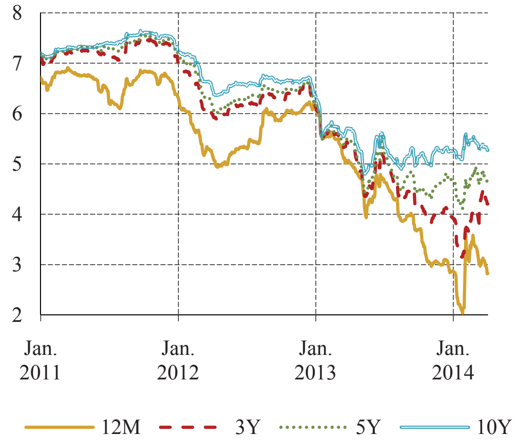
Longer-term interbank money market rates (3M-12M ROBOR) also came under the impact of changes in liquidity conditions and banks' expectations on their near-term prospects, standing in the vicinity of the monetary policy rate at end-January, before witnessing slight downward adjustments (more visible for 3M rates) in the latter part of the quarter under review. Against this background, in March 2014, average 3M ROBOR rates came in at 3.08 percent (0.49 percentage points above the December 2013 reading), while 6M and 12M ROBOR rates averaged out at 3.46 percent (up 0.39 percentage points from December) and 3.48 percent (up 0.22 percentage points) respectively.

Developments on the government securities market reflected the mixed influences exerted by changes in the specifics of liquidity conditions on the interbank money market and by heightening tensions on some emerging markets January through February 2014, which spilled over, to a certain extent, to financial markets in the region (the local one included) in the context of investors' strategy/portfolio shifts. Thus, maximum bid rates at primary market auctions declined more visibly in January, on the back of robust demand for securities. Their downward path reversed in February, when investors' higher bid rates prompted the MPF to reject all bids submitted during two securities auctions, but resumed in March. Hence, the last auction held during this period for one-year Treasury certificates ended at a maximum bid rate of 2.92 percent, the same as in December 2013. However, the maximum bid rates on securities with residual maturities of two and five years (3.91 percent and 4.99 percent respectively) exceeded slightly the December 2013 readings. Under the circumstances, during the quarter under review, the MPF issued government securities worth lei 9.6 billion[9], i.e. 89 percent of the announced volume, with an average maturity of 3.8 years (compared with 3.4 years in 2013 Q4). Benchmark rates on the secondary market for government securities[10] moved somewhat in step with primary market rates, reverting to higher levels in the closing part of January and in February, before re-embarking on a downward trend (steeper in the case of 6-month and 12-month maturities).

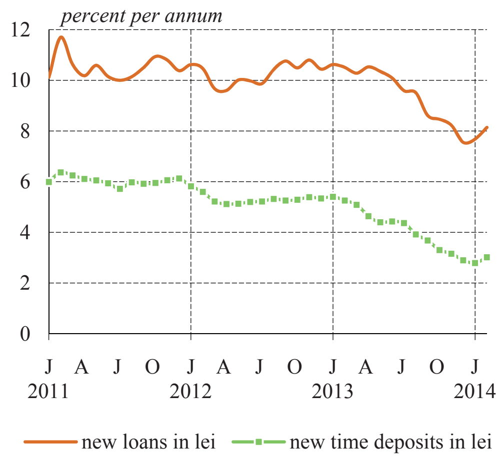
Average interest rates on new time deposits and new loans posted a slower downtrend December 2013 through February 2014, shedding 0.14 percentage points (to 3.02 percent) and 0.09 percentage points (to 8.14 percent) respectively, while the monthly developments across the two customer categories were less homogenous. In particular, the average interest rate on new time deposits of households declined steadily in each of the three months under review, to stand at 3.57 percent in February, 0.50 percentage points below the November reading, whereas average lending rates on new business to households contracted in December and January (to 8.85 percent), before witnessing a marginally upward adjustment to 8.86 percent, 0.44 percentage points lower than in November 2013. At the same time, average time deposit and lending rates on new business to non-financial corporations, which are more responsive to changes in ROBOR rates, edged down during the first two months of the period under review (to 2.15 percent and 6.79 percent respectively), before increasing in February to 2.66 percent and 7.53 percent, up 0.28 percentage points and 0.02 percentage points respectively from November 2013.

Reference Rates on the Secondary Market for Government Securities

percent per annum; daily readings; bid/ask average rates



Bank Rates



9 At the same time, the MPF issued foreign currency-denominated bonds both on the domestic and external markets. The government borrowed EUR 678 million via three bond issues with a five-year maturity on the local market. There were two bond issues on the external market worth USD 1 billion each, one with a 10-year maturity and a 5.02 percent yield and the other over a 30-year period, at a yield of 6.26 percent.

10 Bid/ask average.

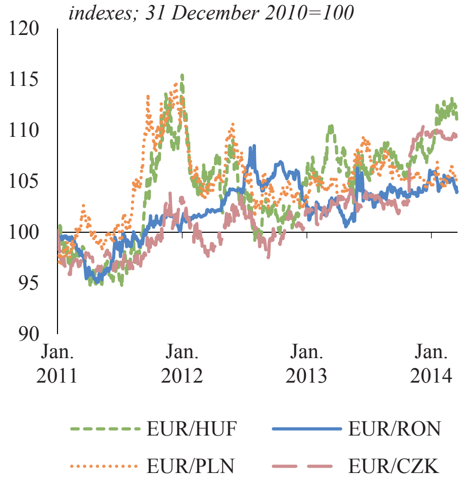
Key Financial Account Items (balance)

EUR million

	2013 2 mos.	2014 2 mos.
Financial account	**90**	**-1,494**
Direct investment	**175**	**293**
- residents abroad	-34	10
- non-residents in Romania	208	282
Portofolio investment and financial derivatives	**3,286**	**783**
- residents abroad	-147	-50
- non-residents in Romania	3,432	832
Other capital investment	**-2,264**	**-3,450**
- credits and loans from the IMF	-620	-1,033
- medium- and long-term investment	-475	-408
- short-term investment	-551	-398
- currency and short-term deposits	-366	-1,510
- other	-251	-102
NBR's reserve assets, net ("-" increase/"+"decrease)	**-1,108**	**883**

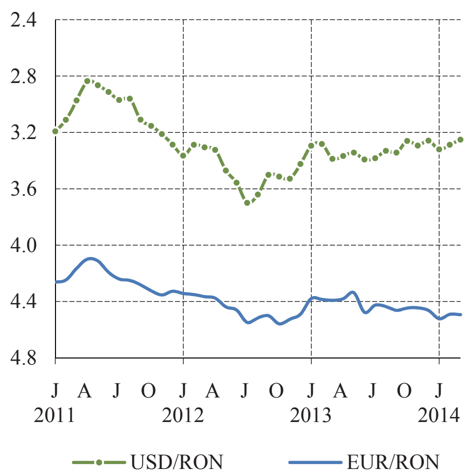
Exchange Rate Developments on Emerging Markets in the Region

indexes; 31 December 2010=100



Source: ECB, NBR

Nominal Exchange Rate



2.2. Exchange rate and capital flows

During 2014 Q1, the path of the EUR/RON exchange rate was shaped – similarly to the exchange rates of other currencies in the region – by the impact of worsening investor sentiment towards emerging financial markets and, subsequently, by the influences of heightening tensions in Turkey and Ukraine. However, the massive portfolio reallocations in the period under review affected the local financial market to a smaller extent, as investors' perception vis-à-vis the Romanian economy was further underpinned by the favourable performance of domestic economic fundamentals.

The domestic currency weakened versus the euro at a faster pace in January[11], given that investor sentiment towards emerging financial markets, already depressed by the Fed's decisions to taper its bond-buying programme, deteriorated significantly that month owing to heightened concerns over the outlook for the Chinese economy and developments in Argentina. Against this backdrop, some emerging economies (e.g., Turkey, Brazil, South Africa and the Russian Federation) grappled with massive capital withdrawals, as portfolio shifts seemed to be driven by the size/dynamics of the current account deficit and the presumed impact of its adjustment on inflation and economic growth, as well as by the authorities' capacity/determination to address macroeconomic imbalances in a sustainable manner.

Tensions on these emerging markets affected, to a certain extent, regional financial markets as well, the domestic financial market included, which led to a significant increase in the turnover on the interbank forex market and in the negative balance of transactions conducted by non-residents.

The decisions/statements by several central banks[12] in January, in response to the pressure on their domestic currencies, temporarily abated the turbulences on the respective markets and hence the ripple effects onto the exchange rates of the currencies in the region. Nevertheless, the latter re-embarked on an upward path the second week into February, when tensions resurfaced on CEE financial markets in the wake of Standard&Poor's downgrading Turkey's credit rating outlook and the escalating geopolitical tensions in Ukraine.

The exchange rate of the domestic currency followed the regional trend, without however reaching the January peak[13], given that investor sentiment towards the Romanian financial market and the domestic economy was underpinned by the more favourable

[11] The average EUR/RON exchange rate went up 1.3 percent, similarly to the Hungarian forint, which depreciated 0.8 percent in relation to the euro, while the Polish zloty weakened 0.1 percent vis-à-vis the single currency in the period under review.

[12] The central banks of Brazil, Argentina, Indonesia, South Africa, India and Turkey raised the monetary policy rate.

[13] The average exchange rate went down 0.7 percent.

performance – relative to analysts' expectations – of some relevant indicators released in February[14] and by the improved Commission forecast on Romania's GDP growth for 2014 and 2015.

The pressure on the exchange rates of the currencies in the region softened following the Crimea referendum, with the EUR/RON witnessing a slight downtrend in the latter part of March.

January through March, the domestic currency weakened versus the euro by 0.7 percent[15] in nominal terms and strengthened 0.5 percent in real terms. In relation to the US dollar, the leu appreciated 0.2 percent in nominal terms and 1.4 percent in real terms, given the former's depreciation on global financial markets. Looking at the average annual exchange rate dynamics in 2014 Q1, the domestic currency posted the first nominal depreciation against the euro and the lowest nominal appreciation versus the US dollar in the past four quarters.

2.3. Money and credit

Money

December 2013 through February 2014, broad money (M3) dynamics[16] remained on an upward path and reached an 18-month high of 8.4 percent, compared with 3.8 percent September through November 2013. The same as in the previous period, the main driver fuelling liquidity in the economy were disbursements from MPF accounts (European funds included), whose influence more than offset the impact exerted by portfolio shifts towards other types of financial instruments and by the continued balance sheet adjustments across various categories of economic agents.

The component for current transactions (M1) was further the engine of faster M3 dynamics. Specifically, the former's rate of change peaked at a five-year high, on account of the favourable performance of both its components. In turn, the dynamics of time deposits with a maturity of up to two years posted the highest reading in the past year. These developments were accompanied by the further consolidation of the share of leu-denominated deposits in M3, which peaked at an 18-month high of 70.1 percent, driven mainly by corporate deposits.

The M3 breakdown by holder shows both a pick-up in the dynamics of household deposits, after 18 months of decline, and a further acceleration in the rate of increase of corporate

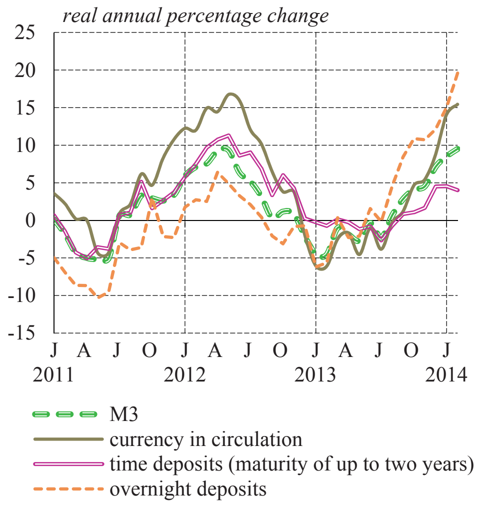
Annual Growth Rates of M3 and Its Components

real percentage change

	2013				2014	
	I	II	III	IV	Jan.	Feb.
	quarterly average growth					
M3	-3.3	-1.6	0.4	5.3	8.5	9.5
M1	-4.2	-1.5	2.3	9.5	14.7	18.1
Currency in circulation	-4.9	-2.4	-1.0	6.3	14.1	15.4
Overnight deposits	-3.8	-0.9	4.3	11.2	15.1	19.6
Time deposits (maturity of up to two years)	-0.3	-0.7	-0.9	2.4	4.5	4.0

Source: NIS, NBR

Main Broad Money Components



Source: NIS, NBR

[14] GDP for Q4 and 2013 - flash estimate -, trade and current account deficits in 2013, as well as industrial output in December 2013.

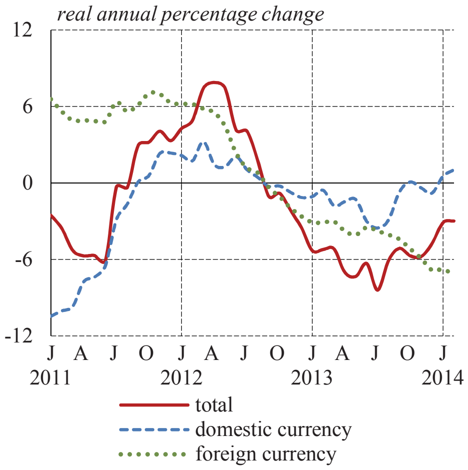
[15] The Polish zloty posted similar developments in the same period, weakening by 0.5 percent, while the Hungarian forint depreciated 3.6 percent in relation to the euro.

[16] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2013 – February 2014.

deposits, prompted largely by portfolios of non-financial corporations, whose growth rate peaked at a 5½-year high. In the case of households, developments were ascribable to higher disbursements for agriculture – mainly from European funds[17] –, higher wage earnings[18], as well as to the statistical effects of the lower inflation rate, on one hand, and of changes in the EUR/RON exchange rate, on the other. The impact of these factors more than offset the effect exerted by households' shift towards financial instruments not included in M3, i.e. time deposits with a maturity of over two years and shares issued by investment funds. The most likely drivers behind the faster growth rate of M3 deposits of non-financial corporations were the increase in budget expenditures[19] and the larger volume of foreign investment, to which added the relatively lower repayments on external loans of the non-banking sector[20]. An opposite impact had the partial shift of non-financial corporations towards other categories of financial instruments, i.e. leu-denominated time deposits with a maturity of over two years and government securities.

From the perspective of major M3 counterparts, broad money developments reflected the faster dynamics of credit to the public sector, the less negative readings posted by the rate of change of credit to the private sector, as well as the slower growth rate of central government deposits. An opposite influence came from the lower dynamics of banks' net foreign assets and the faster pace of increase of long-term financial liabilities (capital accounts included).

Credit to Private Sector by Currency



Source: NIS, NBR

Credit

December 2013 through February 2014, credit to the private sector further recorded a slower rate of decline[21] (-3.6 percent versus -5.5 percent September through November 2013), due to the faster dynamics of the leu-denominated component and to the statistical impact of the weaker domestic currency, on one hand, and of the lower annual inflation rate, on the other. Against this backdrop, the average share of forex-denominated credit in total credit to the private sector continued to narrow and reached a four-year low.

17 According to MARD and APIA press releases, farmers received disbursements from European funds and from the government budget, including payments per hectare.

18 The average dynamics of net wage earnings economy-wide peaked at a two-year high, also as a result of the increase in the minimum wage.

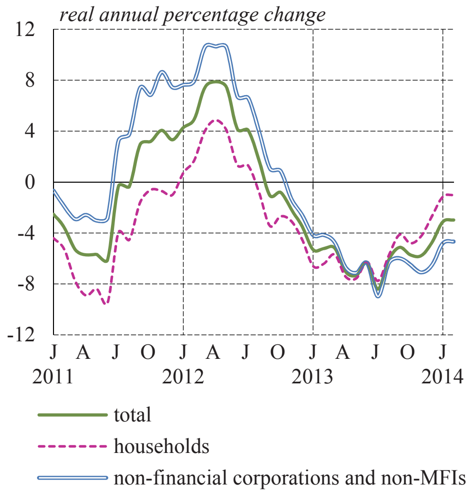
19 The dynamics of goods and services-related expenditures peaked at a one-year high, the average level of VAT refunds peaked at a two-year high during the period under review, and the Treasury extended a new loan for invoice payment to the beneficiaries of sectoral operational programmes (according to budget execution data and ANAF/MEF press releases).

20 According to balance-of-payments data, the average monthly volume of direct investment in the non-banking sector peaked at an 18-month high; at the same time, the average volume of non-banks' net repayments on external loans posted the lowest reading in the past 18 months.

21 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2013 – February 2014.

Credit breakdown by customer reveals that the negative dynamics of both household credit and loans to non-financial corporations[22] continued to improve, amid banks halting the lending standards tightening cycle[23] and the overall downtrend of lending rates on new business. The improved dynamics were further more visible for household loans. Specifically, against the background of larger flows of new business[24] in domestic currency, leu-denominated housing loans became for the first time the key driver of the faster dynamics of household credit. At the same time, the rate of change of consumer credit in domestic currency posted the least negative reading in the past two years. Looking at loans to non-financial corporations, the pace of decline was the slowest in the past year, the performance being associated with: (i) the statistical effect of changes in the EUR/RON exchange rate; (ii) the faster rise in the long-term leu-denominated component, and (iii) firms' increased resort to overdrafts and revolving loans. An opposite effect, albeit of a lower magnitude, had the increase in the net flow of loans removed from banks' balance sheets[25].

Credit to Private Sector by Institutional Sector



Source: NIS, NBR

22 The growth rate of credit to non-monetary financial institutions continued to gain momentum, but the share of this component in total private sector credit remained low.

23 According to the February 2014 Bank Lending Survey conducted by the NBR, credit institutions kept lending standards unchanged in 2013 Q4; at the same time, banks anticipated for 2014 Q1 a status quo on lending standards applicable to companies and housing loans, along with an easing of lending standards on consumer credit.

24 According to CCR data referring to loans in excess of lei 20,000 granted during the respective month.

25 Based on monetary statistics data on transfers and cancellations, on one hand, and acquisitions, on the other hand, of loans by banks.

IV. INFLATION OUTLOOK

The baseline scenario of the current projection places the annual CPI inflation rate at 3.3 percent at both end-2014 (0.2 percentage points below the level forecasted in the February 2014 Inflation Report) and end-2015 (0.1 percentage points above the previously-forecasted level).

The current projected path of the annual dynamics of consumer prices is relatively similar to that in the previous round for both CPI inflation and the adjusted CORE2 index. In the current round, the projection revisions for the two indices are quasi-identical and somewhat larger in the first half of the forecast interval, pointing to more favourable readings, except for 2015 Q4.

The annual adjusted CORE2 inflation rate is seen remaining at a slightly negative value at end-2014 Q2, before accelerating to 1.4 percent in Q3. To this will contribute the fading of the transitory statistical effects exerted by the cut in the VAT rate for some bakery products as of 1 September 2013 and by the bumper crop in 2013, which favourably impacted the prices of processed food items[1] *via the agri-food commodity prices. Starting 2014 Q4, the expected path of core inflation will be largely shaped by its fundamental factors: the gradual narrowing of the negative output gap, the rise in inflation expectations in the first part of the interval and their improvement thereafter, and the progressively slower dynamics of import prices. Under the joint impact of these factors, the annual adjusted CORE2 inflation rate is forecasted on an upward path, reaching 2.3 percent in 2015 Q2 and remaining quasi-stable at this level until the projection horizon. The slight deviations from the previous projection are mainly ascribable to reassessing the negative output gap and imported inflation to relatively lower readings. The net effect of these diverging influences on core inflation has been a downward revision of its projection over most of the reference period.*

The cumulative contribution of the exogenous CPI components in terms of the monetary policy scope remains at the previously-projected levels. In particular, the positive contribution of the dynamics of administered prices to CPI inflation has been revised downwards, given the updated scenarios on electricity and natural gas prices, in line with the latest developments and regulations in the field. The projected dynamics of volatile food prices have also been revised downwards, based on the favourable trend that was visible during 2014 Q1. Under the standard assumption of normal agricultural years during the projection

[1] Processed food items account for 50 percent of the adjusted CORE2 inflation basket.

interval, their annual inflation is expected to return to positive territory in 2014 Q3 once the effects of the 2013 plentiful harvest have faded away.

Less favourable contributions than in the previous round have been projected for the dynamics of fuel prices and tobacco product prices. In both cases, the revision was primarily the result of steeper-than-projected increases recorded in early 2014. Given the hike in the fuel excise duty by 7 eurocents per litre as of 1 April, as well as some base effects, fuel price inflation is seen picking up until end-2014, before witnessing a trend reversal. Projected developments in tobacco product prices point to markedly positive annual rates of change in 2014, slightly negative in 2015 and moderately positive in early 2016. The fluctuating dynamics owe mainly to the conversion of the EUR-denominated excise duties levied on these goods into lei, in line with the legal methodology in force.

Given the projected dynamics of core inflation and of the exogenous components in terms of monetary policy scope, according to NBR forecasts, the CPI inflation rate is envisaged to follow an upward path until end-2014 after the low values, albeit transitory, seen in the first quarter of this year. Its return inside the variation band of the central target is anticipated for 2014 Q3, on account of the aforementioned statistical effects associated with core inflation and volatile food prices. The annual inflation rate is then seen stabilising above 3 percent, yet below the upper bound of the variation band of the target, over the remainder of the projection interval. At the same time, the average annual inflation rate will stick to a downward path until 2014 Q3, hitting a trough of 1.6 percent, before embarking on an uptrend and peaking at 3.3 percent at the end of the reference period.

The projected monetary policy stance will seek to calibrate the set-up of real broad monetary conditions so as to ensure that inflation rate remains inside the variation band of the target over the medium term, thus paving the way for a gradual recovery of lending to the private sector, particularly of the leu-denominated loans, and for a lasting consolidation of economic growth.

The assessment of risks to the current inflation forecast still points to a balance tilted to the upside, albeit to a lower extent than anticipated in the previous round.

External risks are seen as somewhat balanced, amid relatively heightened uncertainty. They relate to the variability of investors' risk appetite towards emerging economies as a whole, owing to the potential escalation of recent regional and geopolitical tensions, *the ongoing cross-border deleveraging in the banking system and the possible monetary policy stance adjustments by major central banks. The materialisation of such risks would entail changes in investor exposure to emerging markets as a whole, as well as reallocations among these markets. Thus, in the near run, some emerging economies, such as Romania, might face significant one-off capital inflows, inherently reversible over longer horizons, when investors' portfolio shifts away from Central and Eastern Europe, should the regional tensions persist, might outstrip the capital inflows directed towards other segments of assets of these economies, after taking into account the differences among the economic fundamentals of the competing market segments.*

The higher volatility of capital flows channelled to the Romanian economy would bring about excessive fluctuations in the leu exchange rate and deviations of both inflation and economic growth from the baseline scenario of the macroeconomic projection. Given the investors' relative preference, in the medium and long term, for more resilient economies, the recent improvement in Romania's economic fundamentals and the still lower and diversified investor exposures in comparison with those to other emerging economies carry the potential to mitigate to some extent the risk associated with unfavourable effects of global or regional portfolio shifts. Moreover, assuming no significant worsening occurs (with spill-over effects), the recent geopolitical developments in the region are not seen as having a major bearing on the balance of risks via the net export channel[2]. Other risks relate to the "common lender" channel, considering the exposures to Ukraine and/or the Russian Federation of cross-border financial institutions operating also in Romania. However, in Romania, the vulnerability to such risks is assessed to be lower than in other Central and Eastern European countries, given the good performance of the Romanian banking system in terms of solvency, liquidity and provisioning indicators.

Nevertheless, external risks remain relevant given the persistence of structural rigidities on the domestic front, which hinder the necessary adjustments across the local economy aimed at mitigating the effects of adverse shocks. From this perspective, the uncertainty surrounding the firm and consistent implementation of the set of structural reforms agreed with international institutions (EU, IMF and the World Bank) remains a cause of concern, particularly in the context of this year's elections, as any delay and/or failure to fully comply with the assumed commitments might lead to enhanced effects of the unfavourable domestic or external shocks on the inflation rate and economic growth.

2 Trade-wise, Romania's economy is the least exposed to the Russian Federation and Ukraine among the Central and Eastern European countries.

Other relevant risks during the reference period stem from the specific uncertainty surrounding the dynamics of aggregate consumer price index components that are mainly impacted by supply-side shocks. In the case of administered prices, uncertainties relate to the implementation of the deregulation calendars on the natural gas and electricity markets, as well as to the effects of those measures. Significant deviations from the inflation projected in the baseline scenario may occur as a result of developments in prices of food items, given their large share in the consumer basket and in the adjusted CORE2 inflation basket in terms of processed food prices. The future dynamics of these prices are subject to the inherent uncertainty associated with weather conditions, affecting the domestic and external supply of agri-food items and commodities. Over the medium term, developments in prices of other commodities on international markets are associated with higher upside risks than in the baseline scenario, in the event of heightening of the recent regional and geopolitical tensions.

1. Baseline scenario

1.1. External assumptions

The positive performance recorded by the dynamics of effective EU GDP[3] in the latter half of 2013 is expected to strengthen over the projection interval. The major driving force of the projected economic activity growth is expected to be the gradual rebound in domestic demand across the European Union economies, on the back of the accommodative monetary policy stance, the phased improvement in financing conditions and less tight fiscal policies. Nevertheless, the sustainable resumption of domestic demand growth appears set to occur only gradually, given the persistent financial fragmentation and the still high corporate indebtedness. At the same time, growth prospects will also be supported during the forecast interval by foreign demand, which is anticipated to benefit from the gradual pick-up in global economic recovery, yet with significant uncertainties triggered by the potential escalation of recent regional and geopolitical tensions. Compared to the February 2014 Inflation Report, the projections were revised upwards, with the negative deviation of the effective EU GDP from its potential[4] being foreseen to exert a relatively less restrictive, albeit still significant, impact on domestic economic activity.

Expectations on the Developments in External Variables

annual average

	2014	2015
Effective EU economic growth (%)	1.55	1.90
Annual inflation rate in the euro area (%)	0.91	1.30
3M EURIBOR rate (% p.a.)	0.31	0.41
USD/EUR exchange rate	1.35	1.31
Brent oil price (USD/barrel)	106.4	102.0

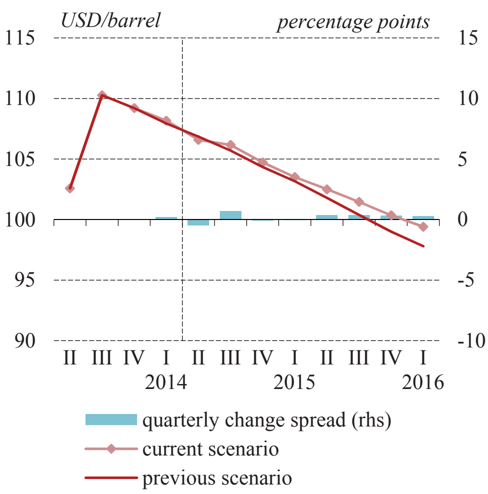
Source: NBR assumptions based on data provided by the European Commission, Consensus Economics and futures prices

The HICP inflation rate for the euro area is anticipated to remain below the 2 percent price stability benchmark, under the combined impact of lower energy prices amid the expected downtrend in the

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

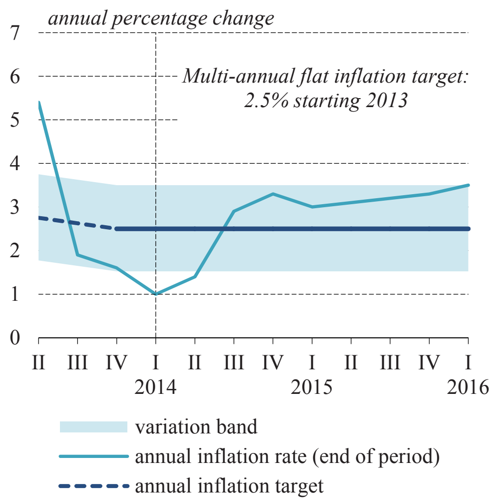
4 A relevant measure used as a proxy in the NBR's model estimating the impact of foreign demand on Romanian exports.

Brent Oil Price Scenario



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

Inflation Forecast



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

Source: NIS, NBR projections

Annual Inflation Rate in the Baseline Scenario

annual percentage change

	2014			2015				2016
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Forecast*	1.4	2.9	3.3	3.0	3.1	3.2	3.3	3.5

* *end of period*

oil price and the persistence of the negative output gap. Against this backdrop, as a reflection of the expected accommodative monetary policy conduct in the euro area, the nominal 3M EURIBOR rate is forecast to stay at low levels throughout the projection interval.

The scenario for the EUR/USD exchange rate envisages a slight softening of the euro versus the US dollar until the second half of 2015. Against the previous projection round, the path of the exchange rate was marginally revised upwards, on the back of the current trend of dwindling foreign investor exposure to the emerging markets, with capital flows being partly redirected to the euro area.

The scenario for the international Brent oil price is based on oil futures and foresees a decline over the projection interval, due to the envisaged rise in global oil production, together with the maintenance of global demand at relatively low levels.

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 3.3 percent both at end-2014 and end-2015, i.e. inside the variation band of the target. In 2014 Q2, the inflation rate is foreseen rising as against the previous quarter[5], moving marginally below the lower bound of the variation band of the target, due largely to the fuel excise duty being raised by 7 eurocents per litre as of 1 April 2014. In 2014 Q3, the 12-month CPI inflation rate is anticipated to witness a significant leap of about 1.5 percentage points, basically as a result of fading effects of favourable supply-side shocks[6] of 2013 Q3, when volatile food prices (VFE) and the adjusted CORE2 index posted deflation. The annual inflation rate is seen stabilising above 3 percent, yet below the upper bound of the variation band of the target, over the remainder of the projection interval. The average annual inflation rate will remain on a downtrend over the following two quarters before reversing its trend and running in the lower half of the variation band of the target by the end of this year and in its upper half by the end of next year.

Compared to the February 2014 Inflation Report, headline inflation is foreseen to stand 0.2 percentage points lower at end-2014. This is the direct effect of projecting more favourable contributions from administered price, VFE and adjusted CORE2 inflation, whereas slightly higher contributions are foreseen for fuel and

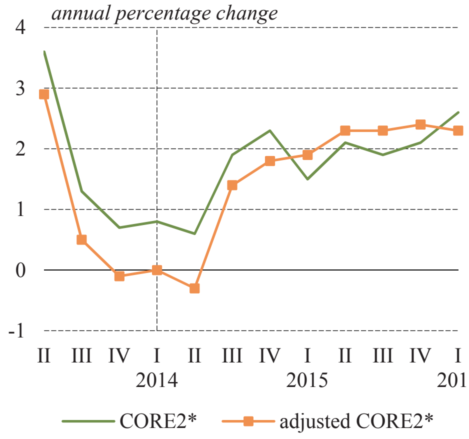
[5] Annual CPI inflation rate hit a record low of 1.04 percent at end-2014 Q1. For further details, see Chapter I. Inflation developments.

[6] Consisting in the higher-than-expected agricultural output in 2013 and the cut in the VAT rate for some bakery products from 24 percent to 9 percent as of 1 September 2013.

tobacco product price inflation[7]. For the end of 2015, given the more unfavourable impact stemming from the adjusted CORE2 inflation and the fuel price dynamics mitigated by the projected rates of increase of VFE and tobacco product prices, the annual CPI inflation rate is envisaged to be 0.1 percentage points higher than previously forecasted.

The annual adjusted CORE2 inflation is projected at a slightly negative value at the end of 2014 Q2. Starting with 2014 Q3, its forecasted path will be affected by the base effects associated with the fading away of the transitory favourable influences of the cut in the VAT rate for some bakery products effective as of 1 September 2013 and last year's bumper harvest via processed food prices included in this index. Under the impact of the fading away of the above-mentioned effects, which is also expected to drive economic agents' inflation expectations upwards[8] and given the narrowing negative output gap as a result of the expected domestic demand consolidation, the annual adjusted CORE2 inflation rate is projected to climb to 2.3 percent by mid-2015 and thereafter stabilise around this level until the projection horizon. Compared to the February 2014 Inflation Report, the forecasted annual adjusted CORE2 inflation for end-2015 was revised slightly upwards (by 0.1 percentage points) against the background of the relatively less disinflationary influence of the negative output gap, which is likely to be partly counterbalanced by the slower growth in import prices while the impact of other factors was assessed to remain unchanged.

Annual CORE2 Inflation and Annual Adjusted CORE2 Inflation



*) end of period

Source: NIS, NBR projections

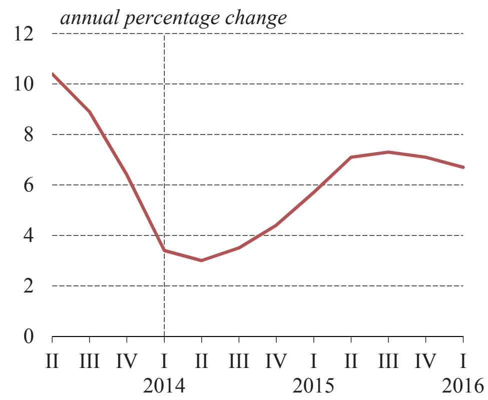
The price dynamics of tobacco products and alcoholic beverages are largely shaped by the calendar for the change in the EUR-denominated excise duties on these goods included in the current Tax Code, with the methodological changes regarding the conversion of their EUR equivalent into lei weighing heavily thereon[9]. The expected contribution of tobacco product and alcoholic beverage prices to the annual CPI inflation rate is 0.4 percentage points for the end of 2014, being revised marginally upwards against the

7 The weights used to calculate the contributions of CPI basket items to the annual dynamics of consumer prices are those released by the NIS in February 2014, subsequently to the publication of the previous Inflation Report. Compared to the values used in the preceding forecasting round, the current ones were revised only marginally, pointing to larger shares of fuel and tobacco product prices and slightly smaller shares of the other items in the CPI basket. Overall, the weight of exogenous components in terms of the monetary policy influence, i.e. administered prices, VFE prices, fuel prices and tobacco product and alcoholic beverage prices, rose by about 0.17 percentage points, whereas that of the adjusted CORE2 index was compressed accordingly.

8 Inflation expectations are expected to post only a temporary rise by the end of this year and to remain inside the variation band of the target throughout the reference interval.

9 Pursuant to Government Emergency Ordinances Nos. 102/2013 and 111/2013. For further details, see Chapter I. Inflation developments.

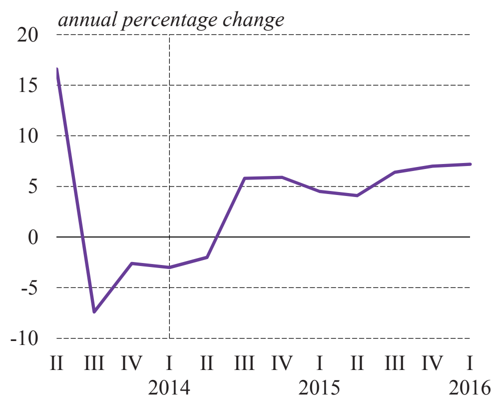
Administered Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

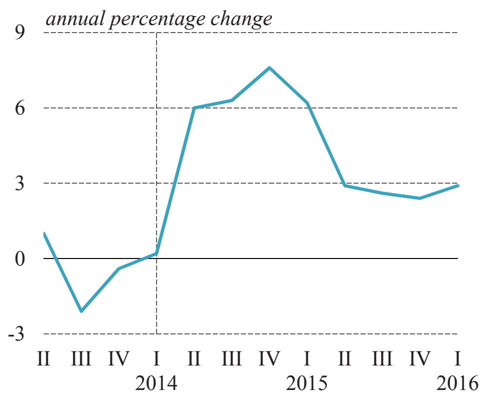
VFE Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

Fuel Prices Annual Inflation*



*) end of period

Source: NIS, NBR projections

previous projection round, and almost nil for the end of 2015, the same as the previously forecasted value.

The scenario on developments in administered prices incorporates the information in the calendars for the deregulation of the natural gas and electricity markets released by the ANRE, the latest developments relating to the larger share of electricity from renewable sources in the energy consumer basket, as well as the most recent legislative amendments to electricity billing[10]. The group's annual dynamics are projected to stand at 4.4 percent at end-2014 and 7.1 percent at end-2015. This year's forecast was revised downwards by 1.2 percentage points, mainly due to the reassessed assumptions on movements in natural gas prices[11] in Q2 and electricity prices[12] in Q2 and Q3, and only marginally upwards (0.1 percentage points) for next year.

Following the bountiful harvest of 2013, the annual inflation of volatile food prices is expected to remain in negative territory by mid-2014 amid favourable base effects. The deflationary dynamics is subsequently forecast to reverse, given the assumption of normal agricultural years in 2014 and 2015. Thus, the group's contribution to the annual CPI inflation rate is seen at 0.4 percentage points at end-2014 and 0.5 percentage points at end-2015, being revised downwards by 0.1 percentage points only for the end of this year, assuming the favourable trend manifest in Q1 persists into the following quarters.

The annual fuel price inflation rate will follow an upward path starting with 2014 Q2 to reach 7.6 percent at end-2014[13], given that the excise duty levied on fuels was raised by 7 eurocents per litre as of 1 April 2014, the projection incorporates an EUR/USD

[10] In March 2014, Law No. 23/2014 amending Law No. 134/2012 on setting the system to promote energy from renewable sources entered into force. The newly-enacted law sets forth that electricity bills must take into account the ruling price of green certificates rather than the weighted average for the past three months of trading, as the former methodology indicated. Considering that the green certificates are currently traded at the lower bound of the legally-stipulated variation interval (according to Law No. 220/2008, the trading price of a green certificate for 2008-2014 lies within a range of between EUR 27 and EUR 55), the impact on electricity rates is expected to be significantly lower than the previously projected one. The low-priced trading in green certificates is mainly attributed to the fact that the annual level of the mandatory quota for producing electricity from renewable sources, as set by the ANRE, has been reached, amid the increasing share of such energy sources in total sources available.

[11] According to the calendar for the deregulation of the natural gas market released by the ANRE, the impact on the consumer price is 2 percent in April 2014. In view of the latest available information, this increase is expected to be offset by the lower gas distribution tariffs applied by operators in the field, as regulated by the ANRE.

[12] Given that a markedly lower impact of green certificate prices is anticipated.

[13] This value was revised upwards by 2.2 percentage points against the previous Inflation Report amid both the weaker developments in 2014 Q1 and following a stronger impact expected to come from the higher fuel excise duty in 2014 Q2.

exchange rate with an unfavourable impact on the exchange rate of the leu versus the US dollar[14] and inflation expectations are foreseen on an uptrend by the end of this year. Over the latter half of the reference interval, on the back of the fading away of these unfavourable effects and the expected further decrease in the global oil price, the group's annual dynamics are foreseen to slow to 2.4 percent in December 2015.

The cumulative contribution of exogenous components in terms of the monetary policy influence, i.e. administered prices, prices of volatile food items (VFE), fuel prices and tobacco product and alcoholic beverage prices, to the annual CPI inflation rate runs at 2.3 percentage points at end-2014 and 1.9 percentage points at end-2015.

Components' Contribution to Annual Inflation Rate*

percentage points

	2014	2015
Administered prices	0.8	1.3
Fuels	0.6	0.2
VFE prices	0.4	0.5
Adjusted CORE2	1.1	1.4
Tobacco products and alcohol	0.4	-0.1

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

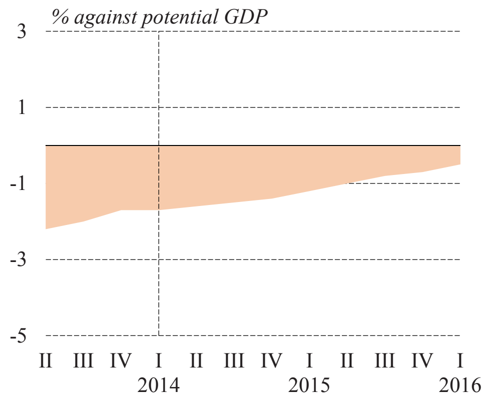
1.3. Demand pressures in the current period and over the projection interval[15]

Output gap

According to the latest NIS press release[16], seasonally-adjusted real GDP saw a 1.6 percent advance in quarterly terms in 2013 Q4, its annual dynamics standing at 5.4 percent[17]. As compared to the February 2014 Inflation Report, the quarterly dynamics of the seasonally-adjusted real GDP data series were substantially revised over the entire historical period, the adjustments being generally positive in recent periods. For 2014 Q1, the performance of some high-frequency macroeconomic indicators[18] suggests the persistence of positive quarterly GDP growth, albeit slower than that in the preceding quarter when it was also boosted by the plentiful agricultural supply.

The 2013 remarkable performance of the agricultural sector has considerable effects on assessing potential GDP dynamics for both recent periods and the projection interval. According to

Output Gap



Source: NIS, NBR projections

[14] Fuel prices applied by leading domestic market operators depend on the USD-denominated international Brent oil prices. When converted into the local currency, the nominal RON/USD exchange rate is relevant.

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

[16] NIS Press Release No. 80 of 2 April 2014.

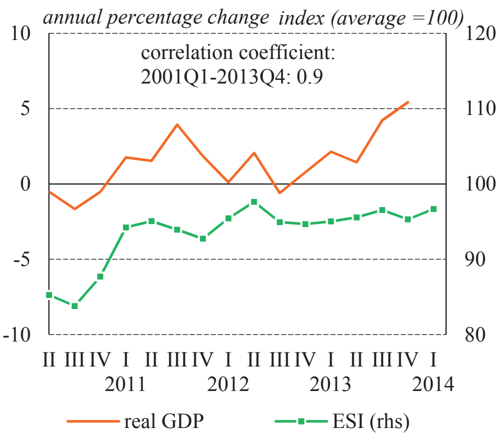
[17] Real GDP saw the highest annual increases in 2013 Q3 and Q4 (4.2 percent and 5.4 percent respectively, calculated based on non-seasonally adjusted data) after the outbreak of the global financial crisis.

[18] The industrial production index and the retail trade turnover, excluding motor vehicles and motorcycles, rose by 1.8 percent and 3.9 percent respectively in the January-February period as compared with 2013 Q4 averages and the economic sentiment indicator (EC-DG ECFIN survey) grew by 1.4 points in 2014 Q1 versus 2013 Q4. On the other hand, the dynamics of total leu- and foreign currency-denominated credit to the private sector (stocks) stayed in negative territory (-2.0 percent in real terms in 2014 Q1 compared with 2013 Q4 average).

assessments, in 2014, the contribution of labour force is envisaged to remain relatively unchanged from a year earlier[19], whereas the smaller positive contribution of the capital stock, following the recent negative quarterly developments in gross fixed capital formation, is more than offset by the higher contribution of total factor productivity, spurred by the impact of weather conditions favourable to agricultural output in 2013. For 2015, the baseline scenario also assumes a positive contribution of production factors, given the anticipated favourable labour market developments and the positive dynamics of gross fixed capital formation, with an impact on capital stock. Concurrently, total factor productivity is expected to grow further on the back of the efforts to increase the absorption rate of European structural and cohesion funds and to consolidate corporate and household balance sheets. However, this scenario is fraught with the uncertainties surrounding external developments and the dynamics of capital flows to economies in the region, with a potentially opposite effect on factor productivity.

The negative output gap in 2014 Q1 is assessed at a level similar to that corresponding to the previous quarter, indicating, *ceteris paribus*, the similar intensity of disinflationary pressures stemming from aggregate demand. However, as compared with the previous forecasting round, the output gap in 2013 Q4 is assessed as being relatively less negative, the change including the joint effect of the NIS revisions of the historical data series of the seasonally-adjusted real GDP, the near-term forecast error related to the real GDP quarterly growth in 2013 Q4, as well as the reassessment of its determinants' impact[20]. The aggregate demand deficit in 2014 Q1 maintains its persistence, to this adding the unfavourable contribution of external demand deficit, which was relatively lower than that assessed for 2013 Q4. The restrictive effects of these factors are offset by the stimulative influence of the wealth and balance sheet effect and, to a lower extent, of the real effective exchange rate (via the net export channel) and the joint impact of real bank rates. The discretionary component of the fiscal policy is assessed to exert a slightly restrictive effect in 2014 Q1.

Economic Sentiment Indicator* and Economic Growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

The mixed signals conveyed by several high-frequency indicators correlated with the cyclical position of the economy indicate that the negative output gap posted in 2014 Q1 a level similar to that recorded in 2013 Q4. Thus, while the ILO unemployment rate is close to the medium-term trend, favourable signals come from increases in industrial output and the capacity utilisation rate in

[19] In the assumption of working hours remaining unchanged over the projection interval, the joint favourable effect of the modest contraction in unemployment rate and the slight increase in the economic activity rate is partly offset by the reduction in the working age population (EC forecast).

[20] 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.

industry[21] (up 1.8 percentage points in January-February 2014 as compared with 2013 Q4 average and up 1.1 percentage points in 2014 Q1 versus 2013 Q4, respectively). On the other hand, the quarterly change in total leu- and foreign currency-denominated credit to the private sector (stocks) remained slightly negative, i.e. -2.0 percent in real terms in 2014 Q1 as compared with 2013 Q4 average[22].

The negative output gap is foreseen to decline gradually throughout the projection interval, exerting lower disinflationary pressures on the adjusted CORE2 inflation. The stimulative impact of the real broad monetary conditions and the anticipated impact of the efforts to increase the absorption rate of EU funds[23] are expected to entail the narrowing of the negative output gap. At the same time, the fiscal impulse[24] is anticipated to have a marginally restrictive impact on the output gap in 2014 and become slightly stimulative in early 2015, suggesting a counter-cyclical fiscal policy stance over this horizon. In addition, in line with the anticipated economic rebound in the EU, external demand is expected to have a lower restrictive impact on the domestic output gap. Compared to the February 2014 Inflation Report, the negative output gap is projected at levels implying relatively lower disinflationary pressures. This stems from the substantial revisions of real GDP historical data series by the NIS and the short-term forecast error, both having implications on the assessment of GDP deviation in 2014 Q1 and Q2, the reassessment of real broad monetary conditions (more stimulative throughout the projection interval) as well as the less restrictive, yet further significant, impact of external demand.

According to the baseline scenario of the projection, the annual economic growth rate in 2014 is foreseen to remain close to that recorded in the previous year, under the favourable influence of the domestic demand dynamics reverting to positive territory and the ongoing good performance of net exports. These assessments rely on the anticipated swifter dynamics of the real disposable income of households[25], the further decline in the cost of leu-denominated loans (also fostered by the previous policy rate cuts), as well as the improved absorption of the EU funds. For 2015, amid the

21 EC-DG ECFIN survey.

22 Leu-denominated credit to the private sector increased by a real 3.3 percent year on year in March 2014, whereas foreign currency-denominated credit dropped 8.3 percent (in terms of stocks).

23 The 2014-2015 period will see the overlapping of EU funds of 2007-2013 and 2014-2020 financial years, due to the activation of the exit rule (T+2) applicable to the funds allotted during 2013 financial year.

24 It quantifies the impact of the discretionary component of the fiscal policy in the NBR model.

25 Due to the improvement in the main labour market indicators, minimum wage increases (according to the updated Fiscal strategy for 2014-2016) and the annual CPI inflation rate staying below the upper bound of the variation band of the flat target over the projection interval.

persistence of the favourable conditions mentioned above, domestic demand (in the structure of which the investment component is anticipated to see a gradual recovery) is expected to make a higher positive contribution to economic growth.

Aggregate demand components

The quarterly growth rate of the actual individual final consumption of households is expected to decelerate slightly[26] in 2014 Q1. The further positive quarterly dynamics of this component is supported by the increase in retail trade turnover, except for motor vehicles and motorcycles (up 3.9 percent during January-February 2014 versus the previous quarter's average). In addition, the consumer confidence indicator rose by 0.9 points in 2014 Q1 compared with 2013 Q4. Nevertheless, contrary signals come from the stock of consumer loans, which dropped 2.6 percent in real terms in 2014 Q1 versus 2013 Q4 average. Given these developments, in 2014 Q1, the negative deviation of the actual individual final consumption of households from the medium-term trend is envisaged to narrow compared with the previous quarter. The actual collective consumption of general government is expected to see a moderate increase in 2014 Q1, in line with fiscal consolidation[27], the deviation from its medium-term trend, albeit on a decrease, remaining in negative territory.

The dynamics of the actual individual consumption of households is foreseen to pick up during the projection interval, supported by the further easing of lending conditions and the expected, yet relatively gradual, improvement in employment in the private sector. These developments are corroborated with the expected progress in the absorption of EU structural and cohesion funds, particularly those related to the operational programmes which are expected to improve labour productivity and, implicitly, with a certain time lag, wage dynamics in the private sector, with anticipated favourable effects on the dynamics of household disposable income. Despite the persistence of post-crisis shocks that affected the credit supply of financial institutions, lending conditions are expected to ease gradually, also as a result of the pass-through, with the specific time lag, of the NBR's monetary policy decisions on credit institutions' interest rates applicable to their non-bank clients[28]. On the other

[26] In 2013 Q4, actual individual final consumption of households increased by 1.5 percent quarter on quarter.

[27] According to the latest data released by the MPF, the ratio of the consolidated general government budget deficit to GDP stood at 0.14 percent in March 2014 (cash-based methodology).

[28] The speed and the extent to which monetary policy decisions are passed on to financial institutions' interest rates applicable to their customers largely depend also on the lending terms and standards set by commercial banks, so that the net effect on the dynamics of bank interest rates may differ, in terms of magnitude, from the signals sent by the changes in the NBR's key interest rate.

hand, the consolidation of household financial balance sheets is envisaged to continue, in line with the similar trends seen at EU and international levels, which will constrain the total volume of household demand for new loans. An additional favourable impact on the actual individual consumption of households stems from the anticipated increase in real disposable income, underpinned, particularly in the first part of 2014, by the relatively low projected CPI inflation rates. The actual collective consumption of general government is expected to pick up moderately throughout the forecast interval.

In 2014 Q1, gross fixed capital formation is expected to fare better than in the previous quarter, despite its quarterly rate of change remaining in negative territory. The dynamics of this component are supported by certain coincident indicators. Specifically, January through February 2014 compared with 2013 Q4 averages, the turnover volume of capital goods industry rose by 9.6 percent, while the production of capital goods increased by 5.9 percent. On the other hand, new construction works and capital repairs went down by 13.6 percent and 28.4 percent in the January-February 2014 period compared with the previous quarter's average. Against the background of the anticipated developments in gross fixed capital formation, its deviation from the medium-term trend is assessed to remain in negative territory, slightly larger versus the preceding quarter.

The quarterly dynamics of gross fixed capital formation are expected to improve gradually, reverting to positive territory in 2014 Q2. Nevertheless, the average annual growth rate of gross fixed capital formation is anticipated to be negative in 2014, being statistically hampered by the declines recorded during 2013 (carry-over effect[29]). For 2015, the annual dynamics of this component are expected to revert to positive territory. This pick-up is supported by the improving trend in energy efficiency, the automation and optimisation of industrial production units following the streamlining and modernisation of equipment. These factors will have a positive impact on the capital endowment economy-wide and hence on labour productivity growth, particularly in industry. To these developments add the foreseen improvement in raising EU structural and cohesion funds[30], with spillover effects on the investment sector as well, and the anticipated gradual easing of financial constraints, proxied by lending costs, with a favourable influence on the consolidation of private sector activity.

For 2014 Q1, exports of goods and services are foreseen to report a new quarterly growth, yet at a slightly slower pace than in the

[29] For further details, see the August 2013 Inflation Report (p. 40).

[30] The official draft of the 2014-2020 Partnership Agreement submitted by the Ministry of European Funds to the European Commission on 31 March 2014 mentions the indicative financial allocation for the Large Infrastructure Operational Programme, which is expected to boost investment projects.

latter half of 2013[31], correlated with the high uncertainties induced by recent regional and geopolitical tensions. The forecasted performance of this component is upheld by the anticipated increase in euro area industrial production (0.4 percent in January-February versus 2013 Q4 average) and the ongoing favourable dynamics of the economic sentiment indicator at EU level (up 2.3 points in 2014 Q1). The quarterly dynamics of imports of goods and services are expected to revert to positive territory in 2014 Q1, due to the anticipated rebound in domestic demand and the spillover effect of the forecasted favourable performance of exports. In view of the above-mentioned developments, the deviation of exports from the medium-term trend is assessed to remain positive and increasing, while that of imports is expected to be negative, yet declining, compared with the previous quarter.

The positive growth of exports is expected to continue over the projection interval, largely on account of the gradual recovery in the effective external demand and the persistent effects of the favourable developments seen by exports of both “machinery, equipment and transport means” and “agri-food products”. Nevertheless, apart from the above-mentioned uncertainties, the dynamics of Romania’s exports are anticipated to slow down in the period ahead, under constraints from domestic production capacity reaching the upper limits in some cases and in the assumption of normal agricultural years in 2014 and 2015.

The increase in imports of goods and services is expected to pick up moderately over the projection interval[32], amid the gradual rebound in domestic demand, supported by the faster dynamics of final consumption and the progressive recovery of gross fixed capital formation.

In the context of the anticipated good performance of net exports of goods and services, partly offset by the slightly unfavourable dynamics of the income and current transfer balances[33], in 2014 the current account deficit is not expected to change significantly as compared to the 2013 reading (1.1 percent). In the medium run, amid the forecasted slowdown in the positive dynamics of exports and the projected stepped-up growth of imports, the current account deficit is envisaged to widen moderately, being however expected to remain below 2 percent of GDP. Nevertheless, against the background of maintaining international reserves unchanged while repaying most of the IMF loan taken in 2009, the projection of a

[31] In 2013 Q3 and Q4, exports of goods and services rose by 7.4 percent and 2.5 percent respectively quarter on quarter.

[32] The signs of this swifter pace of increase were reflected by the developments seen in January-February 2014, when imports of goods grew by 9.4 percent year on year (EUR-denominated values).

[33] Mainly on account of the wider negative contribution of the income balance, while the balance on current transfers is similar to that recorded in 2013.

relatively stable external position is likely to diminish Romania's vulnerabilities in the context of capital volatility affecting emerging economies and, thus, it is not expected to induce corrective inflationary pressures from the exchange rate of domestic currency over the projection interval.

Broad monetary conditions

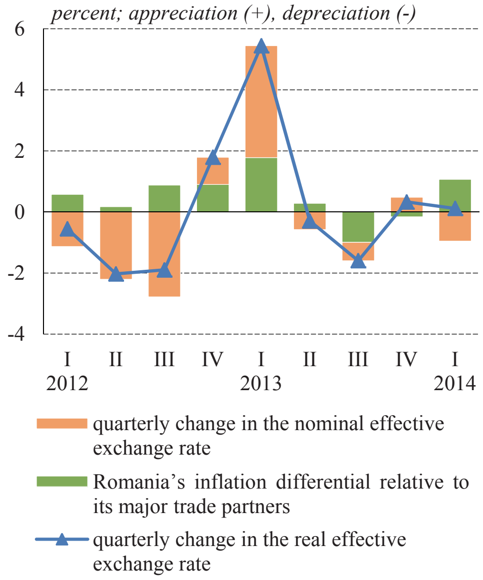
Broad monetary conditions capture the impact exerted on the future developments in aggregate demand by the dynamics of real interest rates in lei applied by credit institutions to their non-bank clients and by the real effective exchange rate of the leu. The exchange rate exerts its influence via the net export channel, as well as via the wealth and balance sheet effect[34].

In 2014 Q1, nominal interest rates[35] applied by credit institutions to their non-bank clients stayed on a downward path, also as a result of the impulse sent by the NBR Board's successive monetary policy rate cuts. The drop in the nominal interest rates, concomitantly with the slight increase in inflation expectations[36], caused the decline in real interest rates on both loans and deposits. The cumulative impact on the economic activity in the next quarter of the deviations of real interest rates from the medium-term trend is stimulative, the favourable effect of the real deposit rate being slightly mitigated by the marginally restrictive impact of the real lending rate.

The domestic currency depreciated marginally in nominal terms versus both the euro and the US dollar in 2014 Q1 compared with the previous quarter. However, the leu saw a slight quarterly real appreciation[37], due to the dynamics of the inflation differential versus Romania's trade partners. Against this background, the deviation of the real effective exchange rate from the estimated medium-term trend points, *ceteris paribus*, to a slightly stimulative impact on aggregate demand in 2014 Q2 via the net export channel.

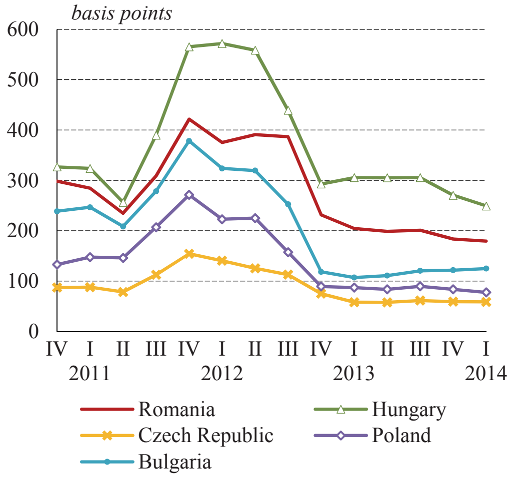
In 2014 Q1, in the context of similar regional developments, the risk associated with investments in the national economy, correlated with developments in CDS (Credit Default Swaps) quotations, declined slightly, the trend being supported by fundamentals. The stimulative effect exerted by the foreign real interest rate

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

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

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

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

37 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.

remaining below the medium-term trend, corroborated with the slight stimulative effect of the risk premium staying below the medium-term trend and amid a small change in the expectations on exchange rate developments[38], causes a higher stimulative influence of the wealth and balance sheet effect in 2014 Q1 on economic activity in the following quarter.

Real broad monetary conditions in 2014 Q1, with an impact on economic activity in the following quarter, are assessed to be stimulative, resulting, *ceteris paribus*, in the moderation of disinflationary pressures generated by the aggregate demand deficit. In the structure of the real broad monetary conditions, the stimulative impact exerted by the deviation of the real deposit rate and the wealth and balance sheet effect, underpinned by the slightly stimulative effect (via the net export channel) of the real effective exchange rate deviation, is somewhat mitigated by the marginal restrictive effect induced by the deviation of the real lending rate.

Broad monetary conditions are anticipated to have a favourable effect on economic activity over the projection interval[39], under the different influences of determinants. The stimulative impact of financial institutions' real interest rates on leu-denominated loans and deposits, combined with the wealth and balance sheet effect are enhanced by that of the real exchange rate via the net export channel in the first part of the projection interval. The latter indicator is seen to reverse its influence during the remainder of the interval, yet it is expected to exert, over this horizon, a less restrictive impact compared with that forecasted in the previous round. The persistent stimulative impact of the wealth and balance sheet effect on economic activity is the result of the projected favourable contributions from the foreign interest rate, as well as the exchange rate and the risk premium, in the context of anticipated sustainable levels for both the budget and current account deficit, which are not expected to induce domestic currency depreciation pressures.

The path of the monetary policy rate is calibrated so as to maintain price stability in the medium run, through the effective anchoring of inflation expectations and, at the same time, to create the conditions for a sustainable rebound in lending to the private sector, which is likely to contribute to a balanced and lasting economic growth. In line with the projected path of the monetary policy rate, the deviations of real interest rates on leu-denominated loans and deposits from their medium-term trend are forecasted to have a joint stimulative effect on aggregate demand, which is assessed to be slightly stronger than in the previous round.

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

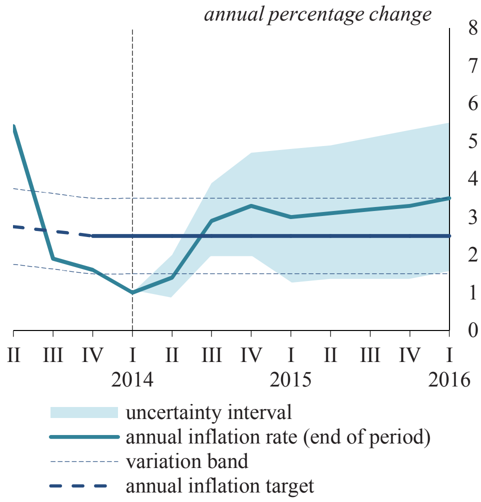
[39] Stronger than in the February 2014 Inflation Report, particularly in the latter part of the projection interval.

1.4. Risks associated with the projection

The balance of risks to the annual inflation rate projection is tilted to the upside compared to its path in the baseline scenario, the asymmetry being lower in the current forecasting round than in the previous one. The identified risks refer to both external and domestic developments.

The balance of relevant risks posed by the external environment appears to be relatively in equilibrium for the projection interval. Such risks refer mainly to a potential increase in the variability of investors' risk appetite for emerging economies, with a likely differentiation among such markets based on the accumulated domestic and/or external macroeconomic imbalances. The coordinates of the baseline scenario may undergo a reconfiguration also owing to the escalation of the recent regional and geopolitical tensions, the persistence and acceleration of the cross-border deleveraging across the banking system, on account of the euro area parent banks' greater needs for additional capital and liquidity with a view to meeting Basel III requirements and those deriving from the comprehensive assessment[40] of bank assets, as well as following the potential adjustments of the monetary policy stances by the major central banks. The materialisation of the risks generated by any of these sources would lead to changes in investors' exposures to the emerging economies overall, with net effects that could, in the short run, entail significant one-off capital inflows channelled to the Romanian economy, inherently reversible over longer horizons. In the medium and long run, investors' portfolio shifts away from Central and Eastern Europe, should the regional tensions persist, might outstrip the capital inflows directed towards other segments of assets of the emerging economies, after taking into account the differences among the economic fundamentals of the competing market segments. In this context, unforeseen fluctuations in the leu exchange rate would bring about deviations of both inflation and economic growth from the coordinates of the baseline scenario of the macroeconomic projection. In the medium and long run, in the context of the recent improvement in Romania's economic fundamentals and of investors' lower and diversified exposures in comparison to those to other emerging economies, the potential shifts in investors' global or regional exposure in favour of more resilient economies would not generate notable adverse effects on the Romanian economy. Moreover, assuming no significant worsening occurs (with spill-over effects), the recent geopolitical developments in the region are not seen as having a major bearing

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 2005-2013. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

40 Including the stress tests carried out by the ECB in collaboration with the European Banking Authority.

on the balance of risks via the net export channel[41], yet they could entail more noticeable effects via “the common lender” channel, should the exposures to Ukraine and/or the Russian Federation of cross-border financial institutions operating also in Romania be affected. However, considering the good performance of the Romanian banking system in terms of solvency, liquidity and provisioning indicators, the vulnerability to such financial risks is assessed to be lower than in other Central and Eastern European countries.

On the domestic front, the uncertainty surrounding the firm and consistent implementation of the set of structural reforms agreed with international institutions (EU, IMF and the World Bank) remains a cause for concern, particularly in the context of this year’s elections, as any delay and/or failure to fully comply with the assumed commitments might lead to enhanced effects of the unfavourable domestic or external shocks on the inflation rate and economic growth.

Relatively balanced risks to inflation in the short run, conditional upon the information available so far, stem from administered prices. However, in the medium run, uncertainties remain regarding the assessment of the impact to be exerted by the stages of the deregulation of the natural gas and electricity markets on consumer prices, as well as concerning the fulfilment of the calendars of these stages.

The domestic developments in food prices are subject to the inherent uncertainty associated with weather conditions, possibly affecting the supply of agricultural products and materialising – given the significant share of these goods in the consumer basket, as well as that of processed food items in the structure of the adjusted CORE2 index – into CPI inflation rate deviations from the path projected in the baseline scenario.

The balance of risks posed by commodities on the international markets is deemed to be in equilibrium in the near run. Nevertheless, over the medium term, the risks of a faster growth rate of this price category cannot be excluded (new increases in the energy price for instance) amid the possible heightening of the recent regional and geopolitical tensions or the developments in the prices of weather-dependent agricultural products.

[41] Trade-wise, Romania’s economy is the least exposed among the Central and Eastern European countries, its annual exports to the Russian Federation and Ukraine accounting for only 1.6 percent of nominal GDP when expressed in euro in 2013 (with a share of 4.7 percent in total Romanian exports for the same year), and imports standing at 2 percent of nominal GDP (5 percent of total Romanian imports in 2013).

2. Policy assessment

In line with the expectations, in January 2014, the annual inflation rate fell below the lower bound of the variation band of the flat target and thereafter remained on a slightly downward trend, reaching 1.04 percent (a new historical low in 24 years) in the last month of Q1. Inflation continued to decelerate, mainly as a result of the protraction of the favourable base effects arising from administered price developments and the dynamics of food prices. The latter, alongside the persistence of the transitory influence from the cut in the VAT rate for some bakery products, made also a decisive contribution to the annual adjusted CORE2 inflation rate sticking to a marginally negative value, while short-term inflation expectations were relatively stable, domestic currency saw a marginal annual depreciation, and disinflationary pressures from the negative output gap tended to moderate in relative terms.

Against this background, the updated forecast of the medium-term macroeconomic developments reconfirms the major coordinates of the previous quarterly inflation projection[42]. Thus, based on the new projection, the forecasted annual inflation rate continues to stay below the lower bound of the variation band of the flat target until mid-2014, before moving up at end-Q3 and consolidating subsequently above the mid-point of the target, yet remaining inside the variation band of the target. Nevertheless, the upward correction of the annual inflation rate anticipated for the last months of 2014 – once the transitory effects of the positive supply-side shocks in 2013[43] have faded out – is less notable, the annual CPI inflation rate being expected to come in at 3.3 percent in December versus the previous projection of 3.5 percent. Implicitly, during most of the second segment of the projection horizon, the path of the annual inflation dynamics is anticipated to be slightly lower than in the previous projection – but still remaining in the upper bound of the variation band of the flat target – with a switch being expected only for end-2015, when annual inflation is seen rising again to 3.3 percent, i.e. marginally above the previously-forecasted level (3.2 percent)[44].

Given that the contribution of the main exogenous components to the inflation outlook remained quasi-constant – owing to the modest and both-way revisions in their projections – the slight change in the coordinates of the anticipated path of the annual CPI inflation rate from the previous forecasting round is almost entirely ascribable to the alterations in the forecasted evolution of the adjusted CORE2

[42] February 2014 Inflation Report.

[43] The significant expansion of the agricultural output and the cut in the VAT rate for some bakery products.

[44] In line with the current path of the forecasted annual inflation rate, the average annual inflation rate is seen reaching 2 percent at end-2014 and 3.1 percent at end-2015.

inflation. Thus, compared to the previous forecast, the projected trajectory of the annual core inflation rate posts a less pronounced upward inflection[45] towards end-2014, and the levels at which it remains subsequently are marginally below or identical to the previously-forecasted one, except for end-2015, when it is seen standing slightly higher, yet remaining lower than the mid-point of the flat inflation target. The main explanation behind the change in the forecasted pattern of the adjusted CORE2 inflation rests with the assumed disinflationary impact of its persistent factors which are seen intensifying relatively in the first part of the projection horizon, chiefly on account of the more significant contribution of inflation expectations, and easing somewhat towards end-2015, in the context of a more visible trend in the gradual narrowing of the negative output gap. This outlook is based, among other, on the assumption that the stimulative nature of real monetary conditions will persist, with an impact on the domestic demand dynamics, and that the economic growth in the euro area/the EU will witness a relative pick-up.

The tailoring of the monetary policy stance to the characteristics of the updated inflation projection, while keeping the time consistency of this policy – which aims at consolidating medium-term inflation expectations in line with the flat target, concurrently with laying the groundwork for lending revival, that would contribute to the sustainable recovery of the economy – continues to be conditional on the consistent pursuit and fulfilment of the objectives agreed with the EU, the IMF and the World Bank relative to fiscal consolidation, structural reforms and EU fund absorption, which are of the essence for ensuring the consistency of the macroeconomic policy mix. Among the major factors taken into account when substantiating monetary policy decisions in the present context are further the potential uncertainty surrounding the inflation outlook, the nature and probability of risks to inflation to materialise, and especially their capacity to cause a de-anchoring of medium-term inflation expectations that could negatively impact the inflation evolution in the longer run.

From this perspective, at the present juncture, the uncertainty and risks to the medium-term inflation outlook remain relevant, but their potential to cause durable deviations of inflation from the projected path, and implicitly from the flat target, appears to be lower than in the previous forecasting round, although the uncertainty related to the escalation of recent regional and geopolitical tensions is more substantial. Given the recent increase in the number of its potential sources, the widening of upward/downward fluctuations of the leu exchange rate, implying possible both-way deviations from its anticipated coordinates, seems to be further the most

[45] Amid the fading out of the effects generated by supply-side shocks in 2013.

significant risk to the inflation outlook, owing also to the relatively high sensitivity of inflation and inflation expectations to the euro-leu movements. At present, such a risk continues to be posed by the persistence of the uncertainty surrounding the recovery pace of global economy and especially of the euro area economy, as well as of that concerning the unfolding of the deleveraging and restructuring of some banking systems in the euro area/EU, which may influence, directly or through the fluctuations in the global risk appetite, the capital flows channelled to the Romanian market and economy. In the present context, however, the scenario more likely to materialise is that built on the assumption of a relatively delayed economic upturn in the euro area – possibly as a result of a potential worsening of the implications of the conflict in Ukraine – together with the protraction of the deleveraging and restructuring of the European banking systems, i.e. the adverse scenario that would primarily trigger depreciation pressures on the national currency. Nevertheless, under such circumstances, the relative intensification of the disinflationary pressures stemming from the negative output gap is expected to generate effects opposite to the inflationary effects exerted by the exchange rate, particularly in the medium term, given the high probability of a slowing, amid this backdrop, in the recovery of the Romanian economy, under the adverse impact of external developments[46].

Another source of both-way risks to the leu exchange rate evolution originates in the possibly divergent impact exerted on financial investors' reaction/the international financial market sentiment by the monetary policy decisions anticipated to be taken by the major central banks[47], which, alongside the exposure to other emerging economies, could also affect the regional financial market, and implicitly the local market, through further portfolio shifts – based on the quality of fundamentals, correlated also with the relative attractiveness of investments in domestic currency. Similar influences could also arise from the potential escalation of the recent regional and geopolitical tensions. Thus, in the near run, some economies, such as Romania, might face significant one-off capital inflows, inherently reversible over longer horizons, when investors' portfolio shifts away from Central and Eastern Europe, should the regional tensions persist, might outstrip the capital inflows directed towards other segments of assets of these economies, after taking into account the differences among the economic fundamentals of the competing market segments.

The domestic environment also poses such risks to the exchange rate, given the persistence of uncertainty surrounding the pace of implementing structural reforms agreed with the EU, the IMF

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

[47] In conjunction with/conditional on other global/regional developments.

and the World Bank, as well as the potential developments on the political scene in the context of this year's elections, that could have either a favourable or adverse bearing on foreign investors' sentiment towards the risk to the economy and local financial market.

The balance of risks to the inflation outlook induced by the future evolution of international agri-food commodity and energy prices remains relatively in equilibrium, at least in the short run, given that these prices might see both upward and downward deviations from the anticipated path, under the impact of potential changes in either global demand, or world output and inventories of such goods, especially in the oil and agricultural sectors. The risks associated with the outlook for domestic food prices, mainly volatile food prices, and with future adjustments in administered prices also remain relatively balanced for the time being, as the forecasts for the former category of prices are based on the assumption of normal agricultural years over the projection horizon, and the forecast for the latter category builds mainly on the calendars[48]/ specific measures agreed upon in the arrangement with the EU, the IMF and the World Bank. Furthermore, the persistence of the negative output gap in the medium term, albeit on a decline, is expected to help anchoring medium-term inflation expectations against potentially adverse influences exerted by the possible upward deviation of the developments in these price categories from the projected coordinates.

In view of the reconfirmation of the outlook for the annual inflation rate returning in 2014 Q3 to the upper half of the variation band of the flat target and remaining there subsequently, after running below the lower bound of the band in 2014 H1, amid the transitory impact of 2013 positive supply-side shocks, the NBR Board decided in its 6 May 2014 meeting to keep the monetary policy rate unchanged at 3.50 percent per annum. The NBR Board also decided to continue to pursue an adequate liquidity management in the banking system and to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

[48] Calendars on the deregulation of electricity and natural gas prices.