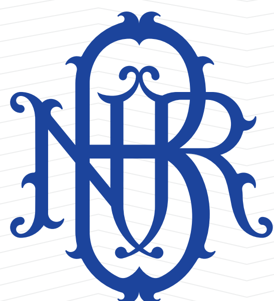

National Bank of Romania

Inflation Report

August 2016

Year XII, No. 45

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NOTE

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

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

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Foreword

The primary objective of the National Bank of Romania is to ensure and maintain price stability, with monetary policy being implemented under inflation targeting starting August 2005. In this context, active communication of the monetary authority to the public at large plays a key role, and the major tool that the central bank uses to this end is the Inflation Report.

Apart from analysing the most recent economic, monetary and financial developments and explaining the rationale and the manner of implementing monetary policy in the previous period, the Report includes the National Bank of Romania's quarterly projection on inflation over an eight-quarter horizon, including the associated uncertainties and risks, and a policy assessment built upon the recent and future macroeconomic context from the perspective of the monetary policy decision.

By drafting and publishing the Inflation Report on a quarterly basis, in accordance with the frequency of the forecasting cycle, the National Bank of Romania aims to provide all those interested with the opportunity of best comprehending its analytical framework and hence the reasons underlying the monetary policy decisions. Securing a transparent and predictable monetary policy is meant to strengthen monetary policy credibility and thus help achieve an effective anchoring of inflation expectations and lower the costs associated with ensuring and maintaining price stability.

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

The Inflation Report was approved by the NBR Board in its meeting of 4 August 2016 and the cut-off date for the data underlying the macroeconomic projection was 29 July 2016.

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

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SUMMARY

Developments in inflation and its determinants

At end-2016 Q2, the annual inflation rate was further negative (-0.7 percent), yet posting a substantial increase (+2.3 percentage points) against March. This still negative value is mainly attributable to the persistence of the effect induced by the decision to lower the standard VAT rate from 24 percent to 20 percent in January 2016, whereas the pick-up at end-Q2 is accounted for by the dropping out of the first-round effect of broadening the scope of the 9 percent reduced VAT rate to all food items in June 2015. At the same time, however, the persistent downward trend in import prices – consumer goods and commodities –, as well as some monthly reductions in administered prices, placed the annual inflation rate in June 0.3 percentage points below that forecasted in the previous report. The average annual HICP inflation rate[1] continued its decline, reaching a historical low of -1.7 percent in June.

Excluding the first-round effects of the VAT rate cut, the annual inflation rate decelerated from 1.2 percent in March to 0.7 percent in June, i.e. below the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target. Behind this trend stood the external developments, namely the persistent excess food supply in the EU and the large falls in commodity prices (wheat, metals, natural gas). Except for adjusted CORE2 inflation and fuel prices, whose rates of change stagnated from end-Q1, the other categories of the aggregate index posted either decelerations in their positive dynamics (administered prices, tobacco) or switched from positive to negative growth rates (VFE).

In June, the annual adjusted CORE2[2] inflation rate re-entered positive territory (+0.4 percent in annual terms), given the drop out of the direct effect of the VAT rate cut in June 2015 from its calculation. Net of the transitory effects generated by the VAT changes in 2015 and 2016, the annual adjusted CORE2 inflation rate saw marginal fluctuations April through June (around 1.3 percent) amid divergent developments across its main drivers: the output gap is assessed to have recorded positive readings ever since 2016 Q1, also owing to the fast increase of wage costs in the economy, while import price dynamics and inflation expectations of economic agents continued to put disinflationary pressures.

The annual growth rate of unit wage costs in industry remained fast in Q1 (8.7 percent, up 0.9 percentage points compared to 2015 Q4). Subsequently, in April-May, it saw a slight deceleration (to 8.2 percent), amid the dynamics of labour productivity in industry returning to positive values. In the context of the successive hikes in public sector wages, as well as in private sector wages (including as a result of the raise in the economy-wide minimum wage), their aggregate growth rate across the economy accelerated further, significantly exceeding labour productivity dynamics. Looking at consumer prices, the influence of external factors is prevalent for the time being, although the wage cost pressures that have been building up are already reflected in the faster dynamics of industrial producer prices for consumer goods, usually passed through into core inflation in one year's time.

[1] Calculated as the average price change in the last 12 months compared to that in the previous 12 months.

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

Monetary policy since the release of the previous Inflation Report

In its meeting of 5 May 2016, the NBR Board decided to leave the monetary policy rate unchanged at 1.75 percent per annum. The new quarterly forecast anticipated the annual inflation rate to stay further in negative territory until July 2016, following transitory first-round effects of the VAT rate cut and the decrease in other indirect taxes, as well as of the fall in some administered prices (energy). Subsequently, the projection pointed out a gradual return of the inflation rate inside the variation band of the target and its positioning within the upper half of the variation band at the end of the forecasting horizon.

The risks associated with the projection stemmed from both the domestic and the external sources, amid high uncertainties. The external environment was fraught with increasing concerns about global economic growth, a new deterioration of the situation in Greece and the coming referendum in the United Kingdom. To these uncertainties added concerns about the volatility of financial markets, geopolitical tensions, the divergence between monetary policy stances of the world's major central banks and the oil price evolution. On the domestic front, the risks stemmed from the fiscal and income policy stance, as well as from the adverse effects generated by the changes in financial legislation.

Subsequent to the decision taken in early May, the statistical data revealed the annual inflation rate remaining in negative territory alongside a pick-up in economic growth solely on account of stronger domestic demand. The annual GDP growth gained momentum, coming in at 4.3 percent in 2016 Q1 versus 3.8 percent in the previous quarter. The rapid rise in the final consumption of households, amid their higher real disposable income and the wider action of fiscal stimuli, led also to a significant advance in imports. The fast-paced import dynamics caused a deterioration of the trade balance, which, together with a relative contraction in EU fund inflows, reflected in the current account position. This evolution was partly offset by the consolidation of the trade in services surplus. The latest data and surveys indicated the further expansion of consumer demand and a fast pace of increase of unit labour costs in industry.

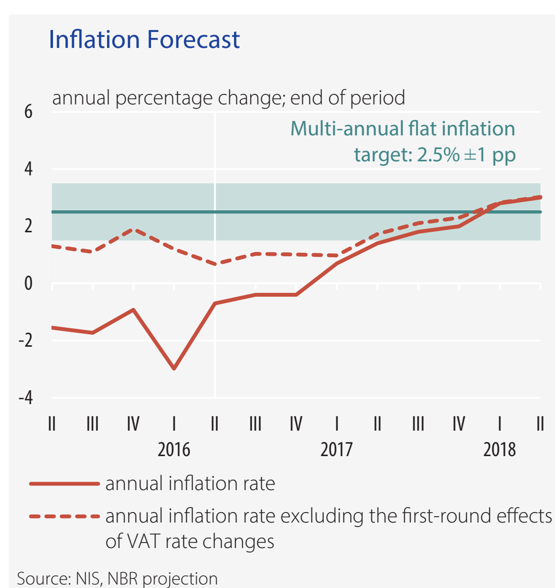
In its meeting of 30 June 2016, the NBR Board reviewed the reassessment of the near-term inflation rate outlook, which anticipated further negative readings, albeit considerably lower in absolute value, owing to the dropping out of the direct impact of broadening the scope of the reduced VAT rate to all food items in June 2015. The prospects for inflation to gradually return to positive territory were surrounded by both domestic and external risks, under highly uncertain circumstances. The external environment continued to feature low inflation levels, while volatility on global financial markets was visibly higher, in the context of the UK's vote to leave the EU. On the domestic front, the risks continued to stem from the fiscal and income policy stance, as well as from the adverse effects generated by changes in the banking and financial legislation that occurred between the two decisions. In this context, the NBR Board decided to leave the monetary policy rate unchanged at 1.75 percent per annum.

Inflation outlook

Under the current baseline scenario, the annual CPI inflation rate is projected to reach -0.4 percent and 2.0 percent at end-2016 and end-2017, being revised downwards compared to the previous report by 1 percentage point and 0.7 percentage points respectively. The major driver behind the revision was the persistently low-inflation global environment, the ensuing developments being likely to counter the movements in domestic prices. The projected levels of CPI inflation reflect the effects of both domestic measures related to fiscal easing, income policy or to the Law on debt discharge and external factors, associated primarily with the outcome of the UK referendum.

The annual CPI inflation rate will post negative values until the end of 2016, then positive values, but below the 2.5 percent mid-point of the target in the course of 2017, reaching 3 percent at the projection horizon, i.e. 2018 Q2. The alternative

measure of the annual CPI inflation rate calculated by excluding the transitory first-round effects of the successive VAT rate cuts shows that the end-2015 figure (1.9 percent) would be surpassed no sooner than in 2017 H2, amid the persistence of strongly disinflationary effects relating to the external environment throughout this interval. At the end of 2017, the difference between the two inflation measures is expected to run at 0.3 percentage points, before they overlap again starting January 2018.



Source: NIS, NBR projection

The baseline scenario envisages faster economic growth in 2016 than in 2015, before slowing down in the course of 2017, which reflects, *inter alia*, a deceleration in GDP dynamics for Romania's main trading partners, against the background of the fallout from the Brexit referendum. Consumption and, to a smaller extent, investment will be the main drivers of brisk GDP dynamics. The actual individual consumption of households will expand swiftly, supported by pay rises scheduled for the public sector and those expected for the private sector, also on the back of improvements in economic activity and labour productivity. At the same time, gross fixed capital formation will strengthen its positive contribution to GDP growth, in spite of slightly slower rates of increase in 2016 and 2017 than in 2015, amid the only gradual progress anticipated in the absorption of EU structural and cohesion funds under the Multiannual Financial Framework 2014-2020. An additional impact on the future dynamics of household consumption and investment could come from the effects of the Law on debt discharge, their assessment being further marked by some uncertainty. On the other hand, the set of real monetary conditions is foreseen to have a stimulative influence throughout the reference interval.

With domestic demand projected to rise significantly, particularly this year, imports of goods and services are seen expanding at a faster pace than exports, implying a negative contribution of net exports to GDP dynamics in 2016, which will tend to decrease next year. Therefore, the current account deficit-to-GDP ratio is expected to edge up during the reviewed period, before stabilising somewhat around 2.5 percent over the medium term. In the short run, international reserves and, generally, the anticipated sources of financing for current account deficit are deemed to be adequate and favourably distributed in terms of the shares of non-debt-creating versus debt-creating flows. Nevertheless, the reopening of the negative current account balance due to a wider fiscal deficit and a speed-up in consumption might amplify Romania's vulnerabilities to shocks, jeopardising the preservation of domestic macroeconomic equilibria.

In view of the higher-than-expected first-quarter GDP growth, the cyclical position of the Romanian economy is estimated to have already shifted from a negative to a positive output gap in 2016 Q1, implying an earlier-than-previously-assessed occurrence of demand-pull inflationary pressures. Under the impact of the expansionary income and fiscal policy stance, as well as of the stimulative broadly-defined real monetary conditions, excess demand is seen picking up gradually until the projection horizon, when it is expected to stand at around 2 percent. Opposite pressures come from calibrating a more restrictive influence on the part of foreign demand for Romanian products following the UK referendum, with an adverse impact on GDP dynamics of trading partners in the EU, whereas in the case of the Law on debt discharge, effective mid-May 2016, its effects are still at an early stage of assessment.

According to the baseline scenario of the projection, the 12-month CPI inflation rate was revised to lower levels than the previously-forecasted ones over the entire reference interval. These revisions imply lower contributions from the CPI basket components, whose dynamics are directly or indirectly linked[3] to the developments in a global environment still marked by very low inflationary pressures.

Annual adjusted CORE2 inflation rate is expected to reach 0.4 percent at the end of 2016 and 2.8 percent at the end of 2017, before standing at 3.4 percent at mid-2018, close to the upper bound of the variation band. Among its determinants are the fiscal measures with a transitory impact on the annual inflation rate, i.e. the cuts in the standard VAT rate, and strong disinflationary pressures from import prices[4], on the one hand, and the wider excess demand and inflation expectations following an uptrend over the medium term, the latter remaining however in line with the mid-point of the inflation target, on the other hand. Net of the first-round effects of the lower VAT rate, the adjusted CORE2 inflation rate is projected to reach 1.3 percent and 2.9 percent at end-2016 and end-2017 respectively.

Given the build-up of large inflationary pressures from domestic price dynamics, the significant downward revision – compared with the May 2016 Inflation Report – of the projected annual adjusted CORE2 inflation rate at end-2016 and end-2017 reflects the higher relative importance of disinflationary pressures from the external environment. They pass through to final prices via direct channels of imported consumer goods and indirect channels via low production costs (commodities purchased from external markets). Downward revisions of projected inflation rates have been seen for most central banks across the European Union and elsewhere and reflect multiple supply-side shocks, which carry the potential of entailing strong volatility and inherent drops in macroeconomic forecast accuracy.

3 Adjusted CORE2 inflation rate, VFE and administered prices.

4 Against the backdrop of the persistently low-inflation global environment and the agri-food oversupply on the European market deriving from Russia's embargo.

The projected monetary policy stance is shaped with a view to ensuring price stability over the medium term in a manner conducive to achieving lasting economic growth and preserving macroeconomic stability.

Despite the materialisation of some of the shocks mentioned in the previous Inflation Report, especially those related to the UK referendum and some downward adjustments in administered prices, the balance of risks to the annual inflation projection continues to be tilted to the downside compared to the path in the baseline scenario.

On the domestic front, in the context of the elections to be held during the projection period and of the absence of agreements with the international financial institutions, heightened risks are associated with the fiscal component of the policy mix, in the context of wage hikes scheduled for the second half of this year[5], as well as other potential future rises. They could affect the manner of financing the fiscal deficit, which is already expected to widen sizeably in 2016 from 2015, following the implementation of the previous measures in the Tax Code. These risks are quite relevant for the future path of inflation in an economic environment already characterised by wage increases well above labour productivity gains both at sectoral level and economy-wide. The implementation of the Law on debt discharge remains a matter of concern in terms of the inherent uncertainty surrounding the assessment of its impact on the domestic macroeconomic environment.

On the external front, the uncertainty surrounding the recent events associated with the results of the UK referendum has become increasingly relevant, especially as regards the period of time needed to clarify this country's status in relation to the European Union, as well as the political situation in Turkey, both generating, to varying degrees, volatility on global financial markets. At the same time, risks associated with the path of global economic growth stem from the uncertainties about

5 Pursuant to Government Emergency Ordinance No. 20/2016 amending and supplementing Government Emergency Ordinance No. 57/2015 on public sector employees' pay in 2016, effective 9 June 2016.

the developments in the economic activity of China and other major emerging economies, as well as from the management of the Greek sovereign debt over the long term. An additional source of risk that emerged in the current round relates to the difficulties facing the Italian banking system. In an external environment characterised by an increasing number of risk sources, whose materialisation could imply, with increased likelihood, the overlapping and hence the compounding of their effects, it is necessary to strengthen the progress achieved over the recent years in rooting out major macroeconomic imbalances and improving the resilience to shocks of the domestic economy by adequately implementing consistent macroeconomic policies.

As for administered prices, seen as one of the main sources for the downward revision of the CPI inflation projection in the current baseline scenario, the balance of risks remains tilted to the downside, given that price cuts similar to the recent ones could be implemented in the future as well. A balance of risks tilted to the downside is also envisaged for the trajectory of global commodity prices (food items) and energy prices (natural gas, oil, coal) that remain, except some irrelevant and largely incidental cases, at historical lows amid an oversupply of such goods combined with sluggish global demand.

Monetary policy decision

Considering the features of the projected path of the annual inflation rate and its determinants, as well as the related risks arising from the future fiscal and income policy stance and from the uncertainty surrounding global economic growth and euro area economic recovery, the Board of the National Bank of Romania decided, in its meeting of 4 August 2016, to keep unchanged the monetary policy rate at 1.75 percent per annum. Moreover, the Board decided to further 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.

1. INFLATION DEVELOPMENTS

The annual dynamics of consumer prices picked up markedly at end-2016 Q2 (+2.3 percentage points, to -0.7 percent) as a result of the dropping-out of the first-round effect of broadening the scope of the 9 percent reduced VAT rate to all food items in June 2015. This still negative value is entirely attributable to the persistence of the effect induced by the decision to lower the standard VAT rate from 24 percent to 20 percent, adopted in early 2016. However, even in the absence of these indirect tax changes, the annual inflation rate would have run below the lower bound of the ±1 percentage point variation band of the 2.5 percent target in 2016 Q2, to stand at an estimated 0.7 percent in June 2016 versus 1.2 percent in March 2016. This downward trend was underpinned by the disinflationary effects of external prices and the weak inflation expectations, to which added the pronounced deceleration in the growth rate of administered prices in the reported period. The joint action of the above-mentioned factors offset the inflationary pressures generated by the reversal of the cyclical position of the economy (Chart 1.1).

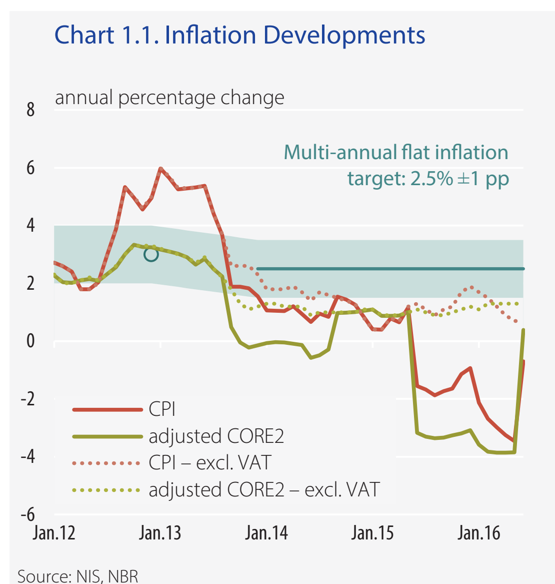
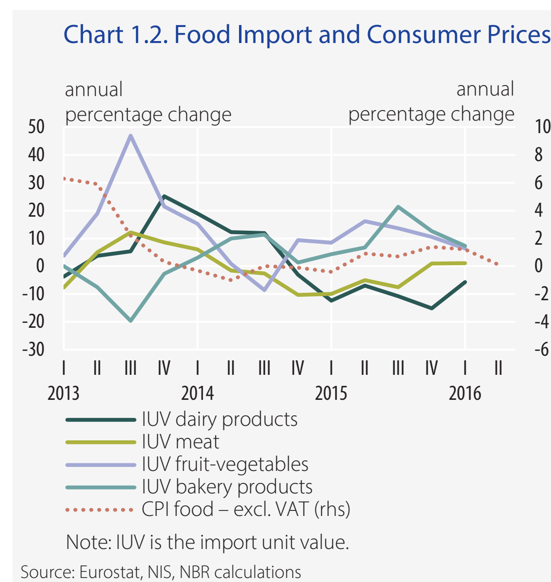


Chart 1.1. Inflation Developments

Source: NIS, NBR

The subdued growth rate of consumer prices (excluding the impact of fiscal changes) owed mainly to external factors (Box 1), of which the build-up of excess food supply across the EU (particularly vegetables, fruit, milk, meat – covering a fifth of the CPI basket) made an important contribution in the period under review. The oversupply generated ever since 2014 H2 by the loss of an important export market for European producers as a result of Russian's ban on imports has recently increased following the extension of trade restrictions to Turkey, starting January 2016 (Chart 1.2). Moreover, the large falls in main commodity prices on international markets (ranging between around -15 percent for wheat and metal and -45 percent for natural gas in 2016 Q2 as a whole) further dampened domestic price increases. The effects were passed through both directly (as is the case of fuels[6], whose prices reflect immediately and almost entirely a change in the world oil price) and indirectly, via costs along the production chain.

Chart 1.2. Food Import and Consumer Prices



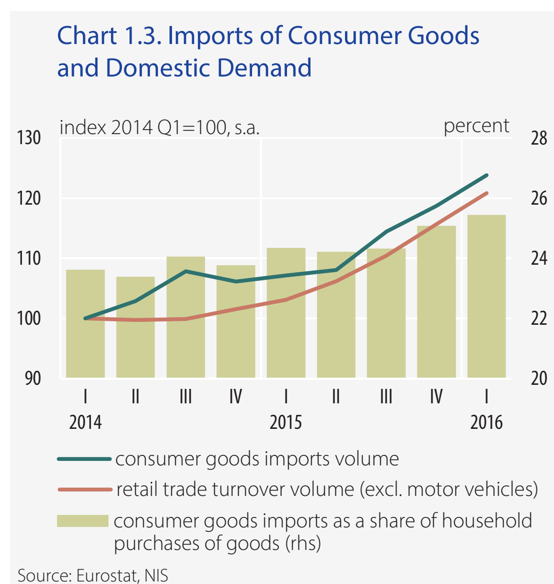
Note: IUV is the import unit value.

Source: Eurostat, NIS, NBR calculations

[6] Annual rate of change came in at -6.7 percent in June 2016 (-5.5 percent excluding the effect of the VAT rate cut).

Apart from the said external influences, the downward inflation trajectory, considering flat taxes, was also driven by a domestic exogenous component, namely the decline by -0.4 percentage points in the annual dynamics of administered prices. This was prompted by the fall in electricity price in April 2016, on account of developments in the competitive market component and of the slacker rate of increase of other utility prices, a trend typically seen in election years.

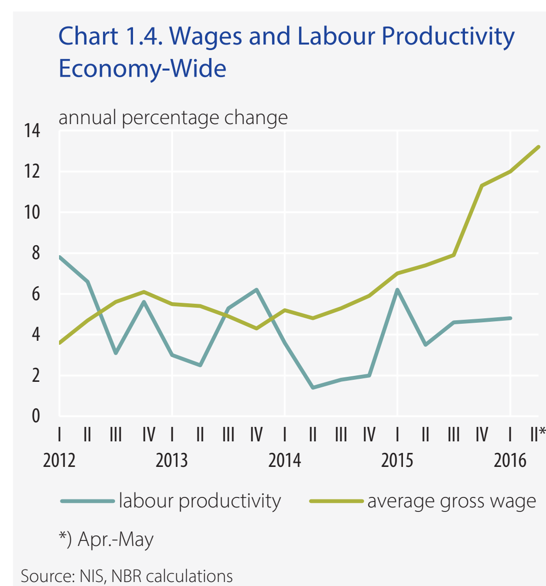
Chart 1.3. Imports of Consumer Goods and Domestic Demand



Source: Eurostat, NIS

At the same time, inflationary pressures continue to build up on the domestic front, amid the reversal of the cyclical position of the economy, the output gap having entered positive territory as early as 2016 Q1. Nevertheless, given domestic producers' limited competitiveness, the expansion of consumer demand is largely accommodated via imports, increasing the role of imported inflation in domestic price setting (Chart 1.3). As to producer prices, pressures come from wage costs, whose fast dynamics (on average 13.2 percent in annual terms April through May) exceed markedly those of labour productivity (Chart 1.4). This increasingly wider mismatch is fuelled by the gradual tightening of the labour market, the cyclical influence being accompanied by the action of some structural factors likely to lead to a progressively higher discrepancy between candidates' skills and companies' requirements. Such frictions on the labour market restrain productivity gains and reinforce wage growth. Moreover, current wage developments mirror the direct and indirect effects of institutional measures concerning minimum wage and public sector pay. The above-mentioned influences are already reflected in the faster dynamics of industrial producer prices for consumer goods (compared with other groups of industrial goods), usually passed through into core inflation in one's year time.

Chart 1.4. Wages and Labour Productivity Economy-Wide



Source: NIS, NBR calculations

With the dropping-out of the transitory effect of the first VAT rate cut implemented in June 2015, core inflation re-entered positive territory at end-2016 Q2 (+0.4 percent in annual terms). In the absence of the fiscal measures, it would have reported minor fluctuations April through June (around 1.3 percent), the upward pressures from domestic sources being offset for the time being by the low imported inflation. Subdued expectations on future price dynamics also contributed to the benign behaviour of adjusted CORE2 inflation.

Financial analysts' inflation expectations showed a downward trend across all horizons (one year ahead, two years ahead, at end-2016 and, respectively, 2017). As for economic agents, however, opinions are mixed, prospects varying from a relatively stable outlook on prices in services, construction and industry to upward expectations recently reported by consumers and trade companies.

The average annual HICP inflation rate continued to decline in 2016 Q2 before bottoming out at an all-time low of -1.7 percent at the end of the

quarter. Hence, the negative gap versus the EU-wide average inflation widened to -1.7 percentage points. However, June marks a turning point, the average rate being expected to witness a trend reversal once the observations impacted by the first-round effect of the 2015 and 2016 VAT rate cuts have dropped out of its calculation.

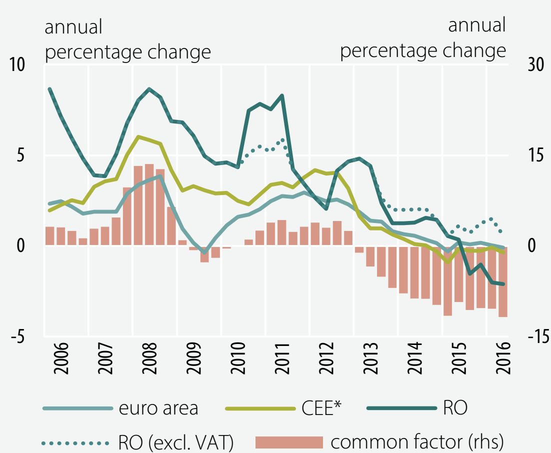
The annual rate of change of consumer prices at end-2016 Q2 stood 0.3 percentage points below the level forecasted in the May 2016 Inflation Report, basically on account of weaker-than-expected monthly changes in vegetable and fruit prices amid a plentiful supply on the EU market.

Box 1. The relevance of external factors to domestic inflation dynamics

In recent years, the international context has been marked by a steep fall in prices of main commodities to levels close to historical lows. This downtrend was relatively quickly mirrored, both directly and indirectly, by the consumer price dynamics, prompting inflation rates to decline across the board at global level. At the same time, persistently low inflation rates have raised concerns over the potential medium- and long-term effects of these shocks, given the risk of de-anchoring of economic agents' inflation expectations at this horizon.

The topic of the external environment influence on domestic developments is not new to economic literature. Specifically, the last decade saw the concept of "global inflation" taking shape against the background of globalization gradually strengthening the impact of international factors on inflation due to the growing exposure of national markets to foreign competition. This generated a vast body of literature that proves empirically that several common external factors affect inflation developments in many countries (e.g. Ciccarelli and Mojon (2005) for 22 OECD countries; Ball (2006) for the US; Mumtaz and Surico (2008) for the G7, Australia, New Zealand and Spain; Conti, Neri and Nobili (2015) and Ciccarelli (2015) for the euro area).

Chart A. Common Factor and HICP Inflation in the Euro Area and Selected CEE Countries



*) inflation in Bulgaria, Czech Republic, Hungary, Poland – aggregated based on nominal GDP

Source: Eurostat, NBR estimates and calculations

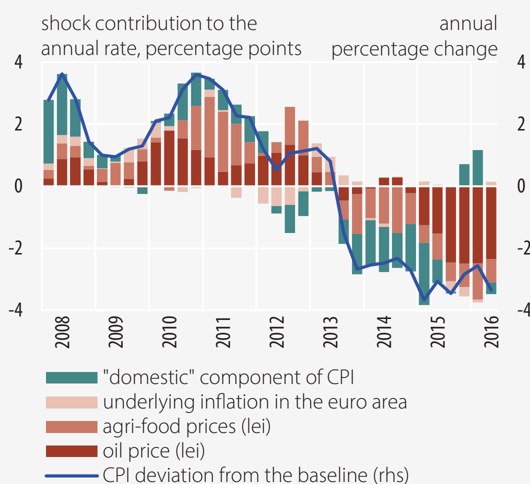
In line with the trend manifest on the international front, the annual inflation rate stood at low levels in Romania as well (even excluding the direct effects of the successive VAT rate cuts in June 2015 and January 2016), despite the significant rise in unit wage costs and the swift closing of the negative output gap in the economy. Against this background, Box 1 looks at the extent to which recent price developments in Romania owe to the direct and indirect influences of specific external shocks that have occurred in recent years.

In-house estimates confirm the existence of a common factor, which basically accounts for the similar paths of inflation in Romania, the euro area, as well as other new Member States (Bulgaria, Hungary, Poland, and the Czech Republic). Hence, the dynamics of this "common component"[7] explain approximately 60 percent of the change in the inflation rate in the countries under review. Consistent with expectations, the change in this "common factor" is highly correlated with that in commodity prices (oil price in particular). As shown in Chart A, the contribution of this common component to the slowdown in consumer price dynamics on the domestic front has gradually increased recently.

[7] Calculated based on the principal component analysis.

The decomposition of the external factor's impact by shock sources and transmission channels[8] reveals a high short-term sensitivity of price changes in Romania to developments in oil and other commodity prices. Thus, the inflation rate has systematically run at lower values[9] under the unanticipated occurrence of these external influences (Chart B). The large adjustment of crude oil prices on international markets as of 2014 H2 was rapidly and strongly reflected by the CPI inflation excluding administered prices (CORE1), particularly via the fuel component. There were, however, substantial indirect effects that were passed through to adjusted CORE2 inflation via energy and transportation costs (Chart C). At the same time, an additional negative shock prompting a steeper inflation decline in the period under review stemmed from agri-food commodity prices, while the subdued core inflation in the euro area, largely associated with the persistent negative output gap, proved to make a less significant contribution to this downtrend. What is not clearly formalised in the model employed can be put down to the "domestic" inflation component, which results from idiosyncratic demand- and supply-side shocks. Hence, recent developments in this component's contribution to core inflation[10] seem consistent with the NBR's assessment of the cyclical position of the economy, namely the closing of the negative output gap in the first part of 2016.

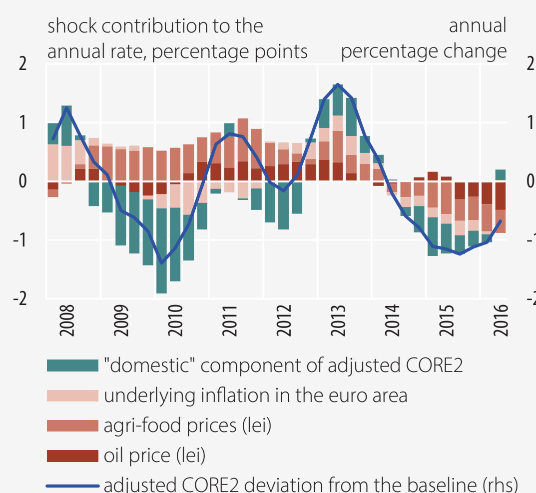
Chart B. Historical Decomposition of CPI Annual Dynamics*



*) excluding administered prices and the effects of VAT rate changes

Source: Eurostat, IMF, NIS, NBR estimates and calculations

Chart C. Historical Decomposition of Adjusted CORE2 Annual Dynamics*



*) excluding the effects of VAT rate changes

Source: Eurostat, IMF, NIS, NBR estimates and calculations

Moreover, the accuracy of core inflation forecasts included in the sample analysed[11] was tested using the VAR methodology. For the post-crisis period, forecasts were successively conditioned on the actual values of variables associated with the domestic real economy, on variables related to the external environment, and, respectively, on a set of financial conditions reflecting mainly credit cost elements. The results pointed to the model's improved predictive power as of 2014, conditioning on developments in the external environment to the detriment of other factors related to the domestic setting.

The higher relative importance of external factors in determining the path of the inflation rate in recent periods was also confirmed by a series of recursive estimates of the hybrid neo-Keynesian Phillips

[8] The tool employed is a VAR model highlighting the interaction between developments in domestic prices, global commodity prices (oil and agri-food commodities), as well as a measure of underlying inflation in the euro area (HICP excluding energy, food items, tobacco and alcohol). The model was initially estimated for CPI inflation (excluding administered prices), in order to quantify the total (direct and indirect) impact, and then for adjusted CORE2 inflation, so as to identify the indirect impact of the above-mentioned shocks.

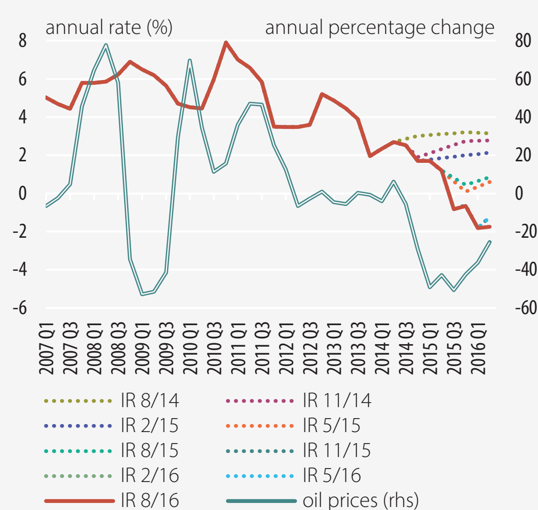
[9] Compared to the trajectory projected by the model in the absence of shocks (baseline).

[10] The adjusted CORE2 index reflects to a larger extent the impact of aggregate demand shocks, unlike the aggregate consumer price index, whose dynamics are often affected by severe supply-side shocks and the like (changes in excise duties, significant changes in the supply of vegetables and fruits on the domestic market, discretionary adjustments in administered prices).

[11] The total sample included in the analysis covers the period from 2004 Q1 to 2016 Q2.

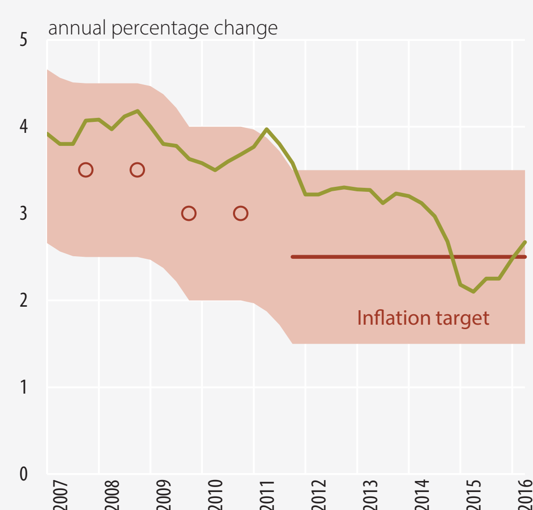
curve[12], adapted to an open economy. In analysing how the relation between inflation and its underlying factors has changed in recent years, various measures were used to reflect inflationary pressures coming from domestic aggregate demand[13] (the output gap, the gap of ILO unemployment rate, unit labour costs), as well as those stemming from the external environment (the dynamics of the unit value index of consumer goods imports, excluding fuels and motor vehicles, adjusted for the nominal EUR/RON exchange rate dynamics, the euro area export deflator dynamics or the effective external inflation).

Chart D. Inflation Expectations and Oil Price



Source: NBR survey among financial analysts, Bloomberg, NBR calculations

Chart E. Inflation Expectations 2 Years Ahead



Source: NBR survey among financial analysts

Apart from the above-mentioned direct and indirect first-round effects, the impact of the decline in commodity prices on economic agents' inflation expectations cannot be overlooked. The recurrent supply-side shocks (linked to the fall in oil, metal and agri-food commodity prices) have intensified starting with 2014 H2, favouring persistently low inflation rates and leading to the downward revision, between successive projection rounds, of the economic agents' inflation expectations, especially on the short term (Chart D). However, there are no signs that a de-anchoring of medium-term inflation expectations might occur, given that, over the 2-year horizon, these have remained inside the variation band of the inflation target since 2012 and have recently converged towards the mid-point of the target (Chart E).

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[12] Compared to the original form of the neo-Keynesian Phillips curve, the hybrid version additionally incorporates a degree of persistence based, at microeconomic level, on price adjustments linked to the inflation rate in previous periods.

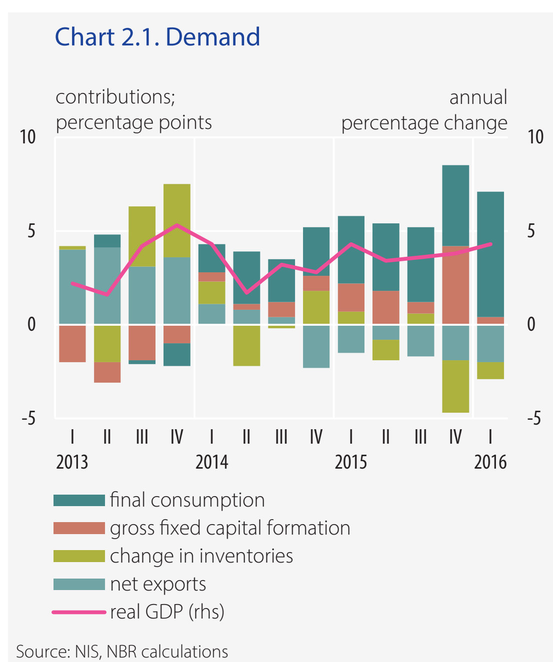
[13] Using alternative measures to estimate domestic inflationary pressures gives robustness to the results. This aim was to avoid reaching conclusions solely based on the output gap, which – although an unobservable variable and, therefore, inherently subject to measurement errors – is the indicator most commonly used by the central banks to capture inflationary pressures.

2. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2016 Q1, economic growth gained momentum from 2015 Q4, up to 4.3 percent (annual change), driven by the considerable increase in domestic absorption. Exports also rose, yet at a pace markedly slower than that of imports, which were boosted by the swift advance in consumer demand (Chart 2.1). In this context, about half of real GDP growth owed to the pick-up in trade and transportation, the tertiary sector becoming the fastest-rising component on the supply-side (Chart 2.2).

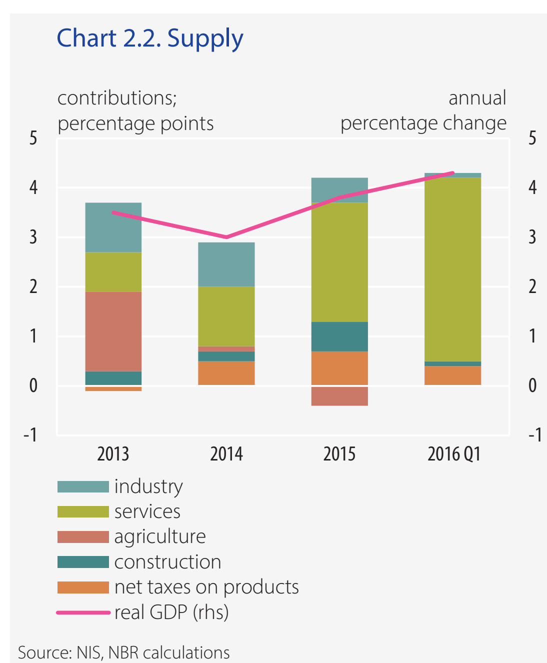
Chart 2.1. Demand



Source: NIS, NBR calculations

The expansion in domestic absorption in 2016 Q1 (by 6.3 percent, a record high for the post-crisis period) was mainly due to household consumption. This was bolstered by the pay rises implemented in the previous year and the downtrend in consumer prices resulting primarily from the two VAT rate cuts (June 2015 and January 2016).

Chart 2.2. Supply



Source: NIS, NBR calculations

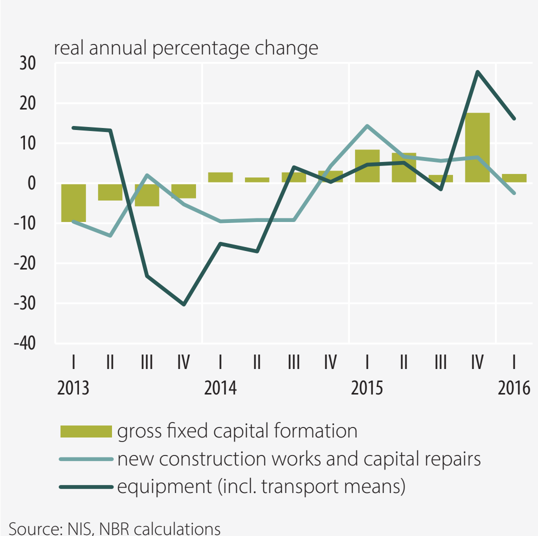
In addition, households' appetite for consumption was stimulated by a series of measures that major retailers had been taking in order to gain market share. Specifically, 2016 has witnessed the ongoing expansion of the distribution networks of large, modern retailers and their more intensive promotional activity, especially on the food segment, given that households' appetite for price discounts seems not to have been dampened by their larger purchasing power. At the same time, the main fast-moving consumer goods companies tried to respond also to changes in household behaviour, namely an enhanced preference for diversity, i.e. for more sophisticated types of products[14]. Robust increases in consumer demand are expected in the period after 2016 Q1 as well, additional boosts coming from the new wage hikes and the launch,

[14] The assessments of consumption behaviour are based on the latest findings of GfK analyses.

at end-2016 Q2, of the vehicle fleet renewal programme, which will lead to heftier automotive sales, used car purchases being already on the rise. In fact, the April-May 2016 data on retail turnover volume confirm this trend (annual increase of around 18 percent), with sales of food items further making the largest contribution. However, there was also strong demand for durables, correlated with the recovery of residential investment.

The asymmetry of the general government budget execution pattern, specific to the beginning of the year, became slightly larger in 2016. Thus, in 2016 Q1 the general government budget moved to a surplus worth lei 3.01 billion (0.4 percent of GDP[15]), after the 2015 Q4 budget deficit amounting to lei 16.5 billion (2.3 percent of GDP)[16]. This occurred against the backdrop of the slacker annual dynamics of budget revenues and public expenditure alike. In the former's case, the lower rate of change (down to 3.8 percent[17] from 10.9 percent in 2015 Q4) was chiefly driven by the relative decline in disbursements from the EU, the slowdown in the growth rate of VAT receipts (0.9 percent versus 13 percent)[18] and the steeper fall in property tax collections (-17.9 percent[19] against -6.6 percent)[20]. As for public expenditure, the less brisk pace of increase (down to 7.8 percent from 15.8 percent) was mainly the result of the slower dynamics of expenditure for projects financed from non-reimbursable external funds (to 18 percent from 86 percent). In the opposite direction worked the swifter growth of the public wage bill[21] (11 percent versus -2.4 percent) and of social payments (up to 9.7 percent from 8.9 percent).

Chart 2.3. Investment



Source: NIS, NBR calculations

Unlike consumer demand, investment grew at a somewhat modest pace, i.e. 2.3 percent in annual terms (Chart 2.3). During the recent period, the developments in investment have been marked by increased volatility, driven largely by one-off factors related particularly to the "civil engineering works" component – the coming to an end, on 31 December 2015, of the eligibility period for expenditure made by beneficiaries of EU funds under the Multiannual Financial Framework 2007-2013 and the local elections set for 2016 Q2 respectively. Therefore, after having increased significantly towards the end of 2015, government spending remained relatively flat in January-March 2016 and gathered momentum again in April-May 2016, when the annual growth rate of civil engineering works neared 19 percent. For the period ahead, signals point to a further favourable performance, spurred also by the holding of parliamentary elections in 2016 Q4, yet possibly dampened by a slower absorption of EU funds for infrastructure projects following the delayed completion of the new procedural framework 2014-2020. In the first quarter of 2016,

[15] The analysis relied on the operational data related to the March 2016 budget execution, as published by the MPF.

[16] In 2015 Q1, the budget execution resulted in a surplus worth lei 4.9 billion (0.7 percent of GDP), whereas in 2014 Q4 it generated a deficit amounting to lei 11.9 billion (1.8 percent of GDP, final data being used for 2014, as published by the MPF in the report on the December 2015 budget execution).

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

[18] Amid the cut in the standard VAT rate to 20 percent from 24 percent as of 1 January 2016.

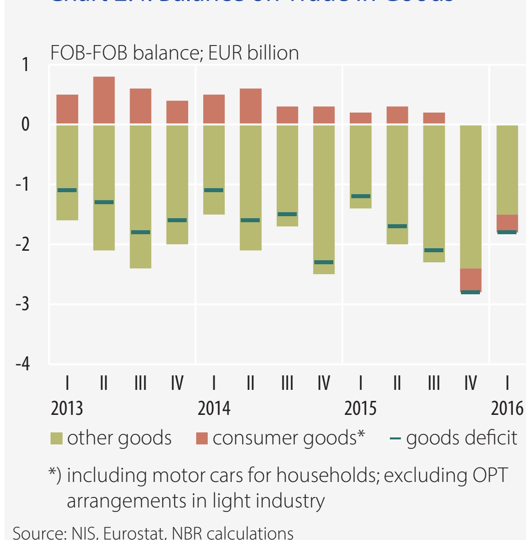
[19] Also on the back of the postponement until 30 June 2016 of the first deadline for payment of the tax on land and buildings and the motor vehicle tax.

[20] The faster paces of increase of receipts from the corporate income tax (up to 29.6 percent from 20.6 percent) and from social security contributions (up to 8.0 percent from 5.6 percent) had opposite effects.

[21] It mirrors the impact of the public sector pay rises in the latter half of 2015 and the base effect associated with the early payment – at end-2014 – of amounts for 2015 provided for in the writs of execution issued to budgetary sector staff with regard to salary rights.

the construction of buildings witnessed a slight recovery on account of the residential component, associated with the sharp upward trend in housing loans. Nevertheless, there are mixed signs about developments in the coming period. On the one hand, the larger construction area stipulated in building permits in the first five months of 2016 suggests the persistence of the aforementioned trend, yet, on the other hand, the tighter credit standards as a result of the adoption of the Law on debt discharge will most likely prompt a slowdown in the demand for housing loans. The less optimistic outlook is also mirrored by the results for Q2 of the NBR's Bank Lending Survey and it is correlated with the lower confidence of construction managers (the NIS/DG ECFIN survey). Equipment purchases show clearer unfavourable signals for the period ahead, with the deceleration in their annual pace of increase in Q1 being likely to persist, amid the slacker dynamics of equipment loans in April-May 2016. In addition, despite the efforts made particularly by manufacturers of electrical equipment and transport equipment (including spare parts), the manufacturing sub-sector as a whole expressed negative expectations of investment in the coming 12 months (according to the NIS/DG ECFIN survey of March-April 2016).

Chart 2.4. Balance on Trade in Goods

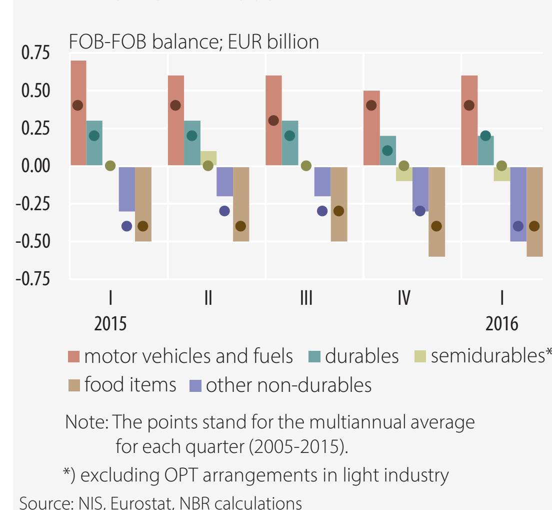


*) including motor cars for households; excluding OPT arrangements in light industry

Source: NIS, Eurostat, NBR calculations

The rise in domestic absorption in 2016 Q1 brought about a two-digit annual growth rate of imports of goods, so that net external demand further made a negative contribution to real GDP growth. Nevertheless, the evolution was partially countered by the rebound in exports of goods, in line with the greater EU demand. The upward path of sales abroad may persist in the period ahead, given the expected economic growth in the euro area, while a Brexit-induced economic slowdown is anticipated rather for 2017. The pressure put by the trade deficit was further alleviated by the trade in services surplus, the fastest-rising sub-sector being that of creative services, where ICT services account for the largest share.

Chart 2.5. Balance on Trade in Consumer Goods



Note: The points stand for the multiannual average for each quarter (2005-2015).

*) excluding OPT arrangements in light industry

Source: NIS, Eurostat, NBR calculations

Behind the worsening of the trade balance in 2016 Q1 stood mainly consumer goods, including motor cars (Chart 2.4), given that the slight recovery in their export volume – bolstered largely by wearing apparel and furniture exports – was more than offset by the advance in imports of both non-durables and durables (Chart 2.5). The deterioration in the balance on trade in consumer goods mirrored the rather limited capacity of local producers to capitalise on the significant rise in aggregate demand, not only on account of a wider price/cost competitiveness gap but also for reasons related to non-price competitiveness. Thus, in the early months of 2016 most consumer goods industries faced increasingly clearer pressures from larger unit wage costs. In the case of the food industry, to the aforementioned influences add the intense competition from cheap imports (particularly of meat and dairy products) and the low efficiency in capacity utilisation. In the

light industry, outward processing or integrated production for external trading partners further prevails, so that, despite the progress made by local manufacturers in developing their own brands, meeting domestic demand largely depends on imports. The pharmaceutical industry reports low specialisation as well, given that this sub-sector focuses on producing generics, while external supply covers domestic consumers' needs of innovative drugs. The worsening of the balance on trade in automotive products may be accounted for by domestic demand rising faster than external demand and by consumers' preference for foreign brands, which has caused imports of motor cars to outpace exports thereof.

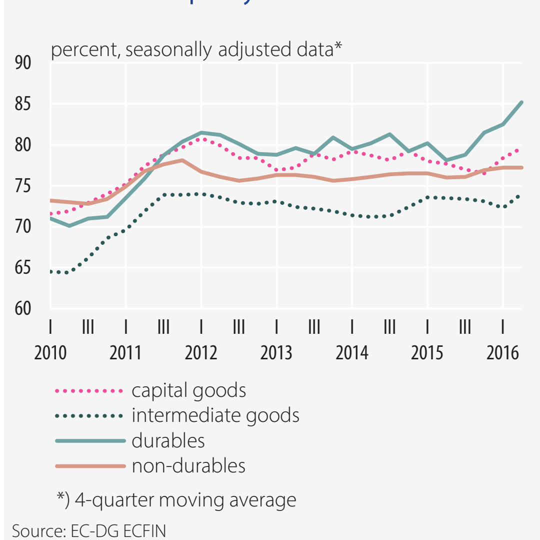
Intermediate goods also posted a deterioration in the trade balance, to which trade in chemical products made a major contribution, since the domestic supply of fertilizers has further been affected by the closure of some production capacities in 2015. Nevertheless, over the recent period the local chemical industry has shown signs of recovery, visible in certain important companies, which translated into the completion of large technology investments and better financial results. Most goods included in "machinery and transport equipment" continued to increase their shares in an expanding European market (for instance, the market share of electrical equipment nears 3 percent). This development mirrors new competitiveness gains, as this sub-sector is further the main receiver of foreign direct investment inflows across manufacturing, in spite of the difficulties facing specialised companies with respect to labour availability.

Labour productivity

The pick-up in economic growth in 2016 Q1 was underpinned by some labour productivity gains visible in trade, construction and, to a lower extent, industry. Nevertheless, the evolution was further marked by the cyclical component, whereas the continued structural constraints on human capital hint at a moderate progress in persistent factors.

Although industrial activity witnessed modest developments in the first five months of 2016, there was however a marginal rebound in productivity, chiefly on account of the higher capacity utilisation rate in intermediate and capital goods industries (Chart 2.6). The hydrocarbon processing sub-sector, the chemical industry, the manufacture of electrical equipment, the automotive industry and the manufacture of other transport equipment reported the largest productivity gains. In the recent period, most of the said industries have benefitted from substantial investment in the extension/creation of production capacities or in streamlining their activities. The latest data are indicative of ongoing positive FDI dynamics in 2016 Q2, with the potential to support labour productivity in industry re-embarking on an upward path over the year as a whole, after recording a modest performance in 2015, particularly in manufacturing. A significant constraint on the positive trend of investment extending into the future is the gradual labour market tightening, especially since foreign direct investment remains clustered in the same regions (Centre and West) and industrial sub-sectors, i.e. automotive and related industries (Chart 2.7).

Chart 2.6. Capacity Utilisation Rate



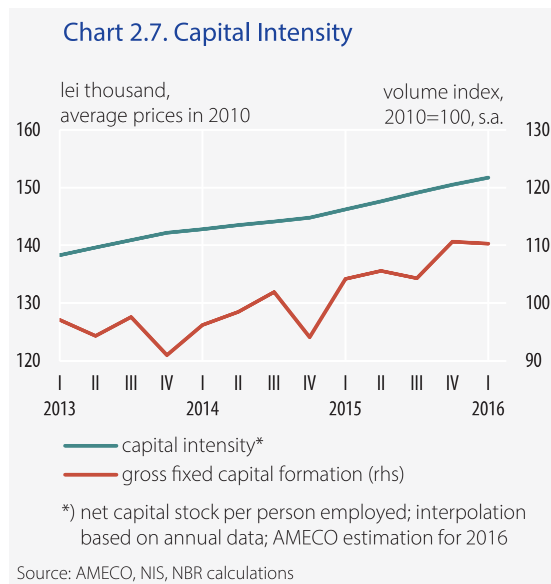
Source: EC-DG ECFIN

In fact, the economic operators in Romania have been facing increasingly pressing difficulties in finding suitably-skilled labour, as seven in ten recruiters stated that they found it hard or extremely hard to match the right candidates to available job vacancies[22]. In addition, emigration further

[22] According to a survey conducted by Millward Brown together with the Coalition for Romania's Development and Ejobs.

reduces the pool of available labour, with emigrants currently targeting not only developed countries in Western Europe, but also countries in the region, such as the Czech Republic, Poland or Hungary.

Chart 2.7. Capital Intensity



*) net capital stock per person employed; interpolation based on annual data; AMECO estimation for 2016

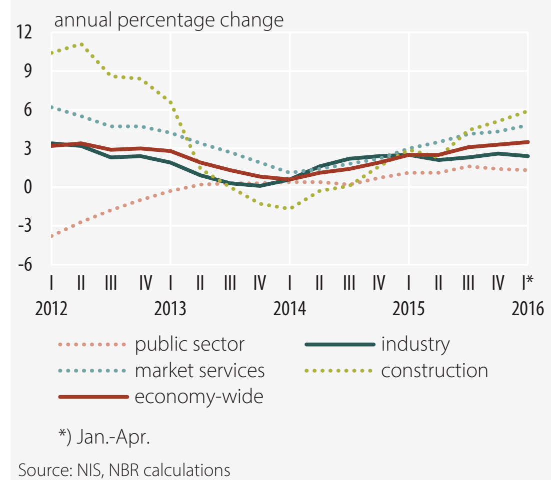
Source: AMECO, NIS, NBR calculations

Labour market developments[23]

January through April 2016, the number of employees economy-wide continued to increase, its annual growth rate, i.e. 3.5 percent, standing higher than those posted in the pre-crisis period. The swifter pace of hiring was ascribable to construction and market services, particularly the ICT sub-sector and administrative and support service activities (where payrolls expanded by around 50 percent as compared with the pre-crisis levels), against the backdrop of investments undertaken in these areas. By contrast, the dynamics of the number of employees in industry have come to a near standstill over the recent period, this being the case in most sub-sectors, except for the manufacture of electrical equipment and furniture (Chart 2.8).

Amid the increased capacity of the economy to absorb available labour, both unemployment rates fell January through May 2016. Specifically, the registered unemployment rate and the ILO unemployment rate reached 4.7 percent (-0.1 percentage points) and 6.5 percent (-0.2 percentage points) respectively. The inherent tightening of the labour market once with the fast-paced improvement in the cyclical position of the economy is further reinforced by the recruitment difficulties faced by employers given that emigration, the still low (yet rising of late) internal mobility and the inadequacy of the education system result in a decline in the eligible workforce (Chart 2.9).

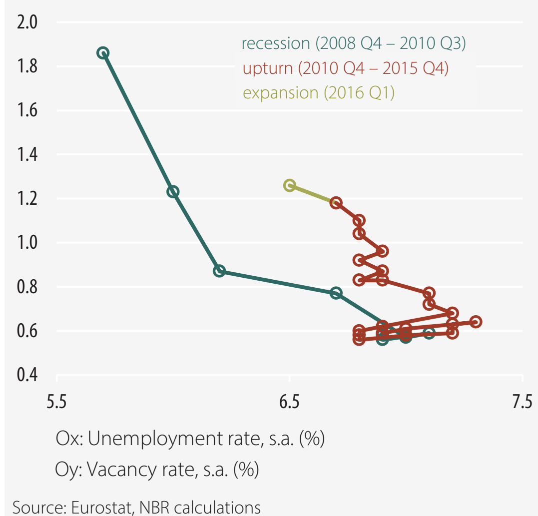
Chart 2.8. Number of Employees Economy-Wide



*) Jan.-Apr.

Source: NIS, NBR calculations

Chart 2.9. The Beveridge Curve



Ox: Unemployment rate, s.a. (%)
Oy: Vacancy rate, s.a. (%)

Source: Eurostat, NBR calculations

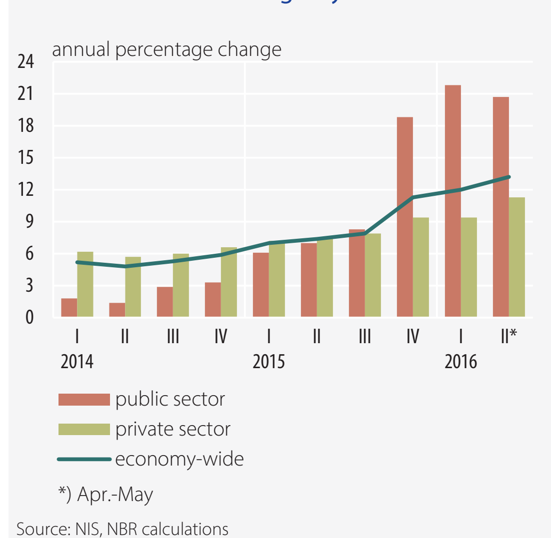
For June-September 2016, both the Manpower Employment Outlook Survey and the NIS/DG ECFIN survey show strong employment intentions in industry and services, as well as relatively stable prospects in construction. Contrariwise, there are

[23] The analysis is based on seasonally adjusted data.

mixed signals for trade, with a deterioration in hiring expectations being noticed only in the case of the DG ECFIN survey for May-June 2016. This development seems to mirror the negative reaction of large retailers after the approval of the law setting forth that 51 percent of certain food items (meat, eggs, vegetables, fruit, dairy and bakery products) should be purchased from producers in the short supply chain.

January through May 2016, the annual growth rate of the net average wage earnings remained high, up by 1.2 percentage points from 2015 Q4, to 12.5 percent (Chart 2.10). On the one hand, the faster dynamics own to the private sector (up 0.8 percentage points), on the back of the 19 percent hike in the gross minimum wage economy-wide as of May 2016, seen particularly in the sectors that account for significant shares of minimum wage earners, i.e. construction, trade, accommodation and food service activities. On the other hand, the pick-up also reflects a statistical effect in the budgetary sector, some of the stages of wage hikes (namely in education and public administration) affecting only December 2015 and not 2015 Q4 as a whole. Looking ahead, the annual pace of increase of the average wage is expected to accelerate further, amid the public sector pay rises announced for August, especially in education and healthcare.

Chart 2.10. Gross Wage Dynamics



Source: NIS, NBR calculations

2. Import prices and producer prices

Even though international prices of main commodities have reported increases over recent months, they still run below the levels recorded in the same year-ago period and are unlikely to show steep hikes in the next period given the persistently large global stocks. In this context, the annual dynamics of both import prices and producer prices on the domestic market remained in negative territory also in the first part of 2016, external factors further offsetting, at aggregate level, the build-up of wage cost pressures on the domestic front. Moreover, a notable contribution to the decline in imported inflation came from the significantly slower pace of depreciation of the leu versus the US dollar, the domestic currency reporting a relatively stable performance against the euro.

2.1. Import prices

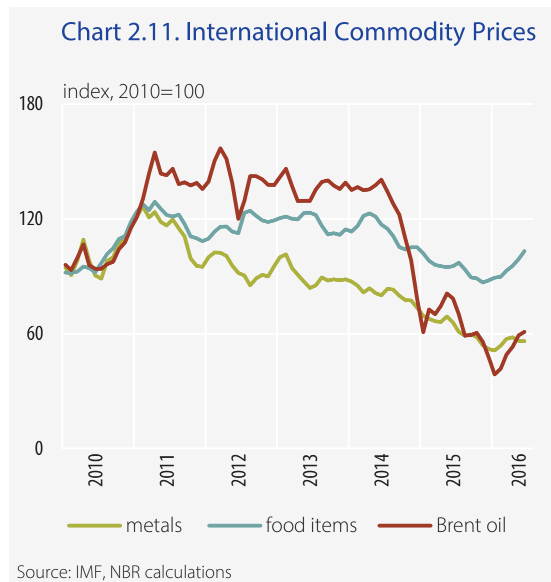
In line with the downward trend in global commodity prices in late 2015 and early 2016, the unit value index (UVI) of imports fell at a faster pace in 2016 Q1, to 96.8 percent (-1.2 percentage points versus the previous quarter). The considerably slower depreciation of the leu versus the US dollar enhanced the deflationary impact of external prices on the domestic front.

Starting February 2016, oil and metal prices have recovered from the lows reached at the onset of 2016, broadly reflecting the anticipated narrowing of excess supply, as well as a slight rebound in demand. The general market sentiment on commodity prices bottoming out in early 2016 was also mirrored by a rise in agri-food commodity prices (wheat and corn) as of March 2016, despite optimistic estimates regarding global harvest in 2016 (Chart 2.11).

However, in 2016 Q1, most prices remained significantly below the levels reported in the same year-ago period, the UVI of mineral products, chemicals and base metals further posting below-one readings. Moreover, the import prices of most food

items continued to witness negative annual changes or significantly lower rates of increase. Sugar was an exception, as its UVI rose by 7.2 percentage points against the previous quarter to stand at 108 percent, on account of adverse weather conditions affecting the output of major producers (Brazil, India and Thailand).

Chart 2.11. International Commodity Prices



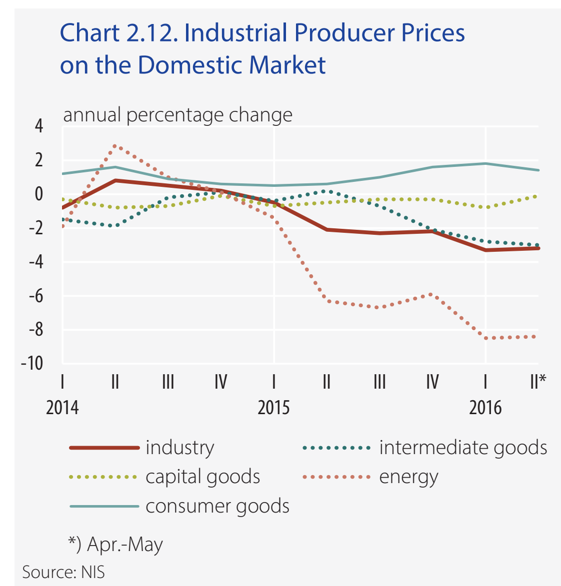
Source: IMF, NBR calculations

2.2. Producer prices

In January-March 2016, the annual dynamics of industrial producer prices on the domestic market went deeper into negative territory (-3.3 percent, compared to -2.2 percent in the previous quarter), this being the case of most groups of goods, except for consumer goods (Chart 2.12). Behind this trend stood primarily imported inflation, with the annual rate of decline of industrial producer prices on the external market in the euro area accelerating to -2.7 percent.

Strongly negative annual rates of change of producer prices were further reported by industries directly impacted by commodity price developments, in particular crude oil processing, chemicals, metallurgy and fabricated metal products. In addition, the production and supply of electricity and heating made a significant contribution to the downtrend in aggregate producer prices, as a result of the lower electricity distribution tariffs starting 1 January 2016, and of the fall in electricity prices on the deregulated market in the first part of the current year, given the higher relative importance of electricity from renewable sources.

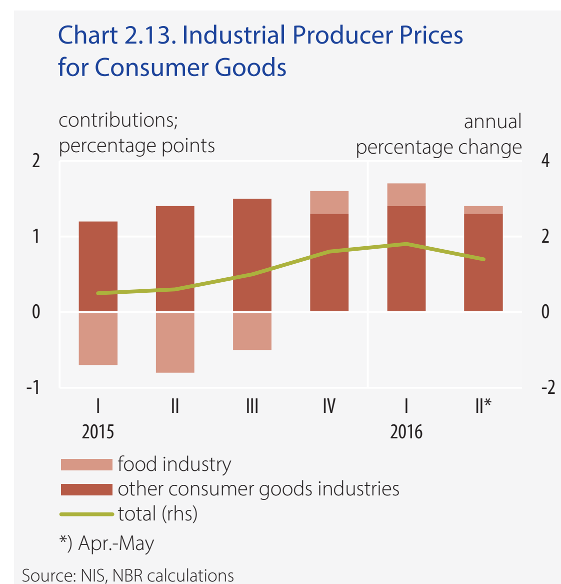
Chart 2.12. Industrial Producer Prices on the Domestic Market



*) Apr.-May

Source: NIS

Chart 2.13. Industrial Producer Prices for Consumer Goods



*) Apr.-May

Source: NIS, NBR calculations

The annual growth rate of consumer goods prices picked up to 1.8 percent (+0.2 percentage points compared to 2015 Q4), with the data available for April-May 2016 pointing to slower dynamics prompted by developments in the food industry (Chart 2.13). In this case, the anticipated bumper harvest led to lower agri-food commodity prices on the domestic market. Moreover, producer price dynamics are dampened by competition pressures

from cheap imports (especially meat, milk and products thereof). However, the other sub-groups further reported robust positive growth rates (of around 3 percent on average), reflecting domestic inflationary pressures (higher unit wage costs amid successive increases in the minimum wage and the gradual labour market tightening).

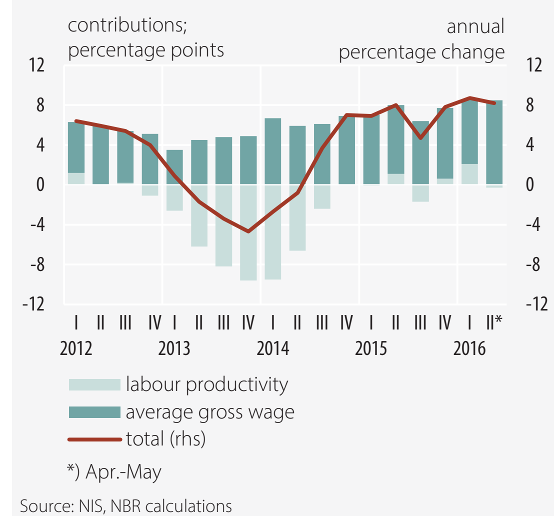
In 2016 Q1, the annual rate of increase of agricultural producer prices slowed down markedly (-5.9 percentage points, to 3.7 percent), the favourable signals on the agricultural output in 2016 leading to slacker annual dynamics of prices for vegetal products (-6.7 percentage points, to 8.4 percent). At the same time, in a European context marked by oversupply, animal product prices declined further also on the domestic market (-5.5 percent in annual terms).

For the period ahead, producer prices on the domestic market are very likely to remain lower in annual terms, yet they are expected to display a slacker rate of decline in light of the recent increases in commodity prices and the build-up of domestic inflationary pressures. In fact, economic agents in industry anticipate a rise in aggregate producer prices, the balance of answers of the DG ECFIN survey advancing to 2.6 percent June through August 2016 (+1 percentage point compared to the expectations for the previous quarter).

Unit wage costs

The annual growth rate of unit wage costs in industry remained high in 2016 Q1 as a whole (8.7 percent, up by 0.9 percentage points versus 2015 Q4), but declined slightly to 8.2 percent in April-May 2016 (Chart 2.14) due to labour productivity dynamics returning to positive territory in March 2016.

Chart 2.14. Unit Wage Costs in Industry



Source: NIS, NBR calculations

This downward trend was visible in crude oil processing, the food industry, the chemical industry and the manufacture of electrical equipment. By contrast, some manufacturing sub-sectors saw higher pressures from unit labour costs, as is the case of the automotive industry and the rubber related industry, where the difficulty to recruit skilled workers is increasingly pressing.

3. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

During 2016 Q2, the NBR kept the monetary policy rate unchanged at the historical low of 1.75 percent. Moreover, the central bank further pursued adequate liquidity management in the banking system and maintained the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions (at 8 percent and 12 percent respectively). This calibration of the monetary policy toolkit was aimed at ensuring price stability over the medium term, in line with the flat target of 2.5 percent ±1 percentage point, in a manner conducive to achieving sustainable economic growth.

Behind the NBR Board's decision in May 2016 to extend the policy rate status quo stood the temporary nature of the inflation deceleration in the early months of 2016[24] and the reconfirmed divergence – in the context of the new projection exercise – between short-term inflation developments and the medium-term outlook, amid a downward revision of the forecasted annual inflation rate path[25]. In particular, the updated projection of medium-term macroeconomic developments saw the annual inflation rate extending its stay in negative territory beyond mid-2016 and remaining thereafter below the lower bound of the variation band of the flat target until December 2016 included and thus below the previously-projected level (0.6 percent, compared to 1.4 percent in the February projection). In January 2017, however, once the transitory impact of the first round of the standard VAT rate cut faded out, the annual inflation rate was seen posting a large upward correction, returning inside the variation band of the target, before exceeding slightly the mid-point of the target in December[26]; furthermore, once the influence of the additional indirect tax cuts scheduled for January 2017[27] faded out, the annual inflation rate path was forecasted to witness a renewed upward adjustment in 2018 Q1 and reach a level of 3.3 percent at the end of the projection horizon.

Underlying the divergence in the forecasted inflation path were the inflationary pressures anticipated to emerge from the reversal of the cyclical position of the economy[28] and from the subsequent widening of the positive output gap[29], as well as from the upward readjustment of inflation expectations and the sustained increase in unit wage costs, having as major premises and assumptions: (i) the recent and expected easing of the fiscal and income policy stances; (ii) the further hike in the economy-wide gross minimum wage in 2016; (iii) the rise in the household real disposable income, also following the successive indirect tax cuts and the persistently low oil price, and (iv) the preservation of stimulative real monetary

[24] Under the impact of the cut in the standard VAT rate from 24 percent to 20 percent in January 2016, the annual inflation rate moved deeper into negative territory, to -2.98 percent in March (from -0.93 percent at end-2015), in line with the NBR forecast.

[25] Against the projection in the February 2016 Inflation Report.

[26] To stand at 2.7 percent, compared with 3.4 percent in the previous projection. Recalculated net of the anticipated one-off impact of the standard VAT rate cut planned for January 2017, the annual inflation rate was forecasted at 2.9 percent.

[27] The cut in the standard VAT rate to 19 percent and the removal of the special excise duty on fuels.

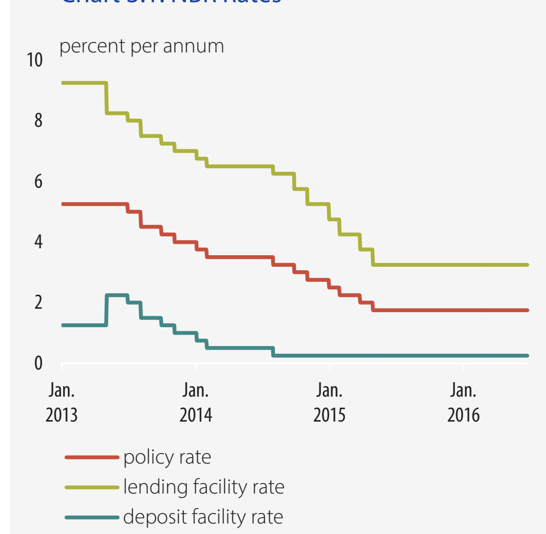
[28] Anticipated to occur in the latter half of 2016, with a slight delay compared to the previous projection.

[29] Relatively slower, however, compared to the previous forecast, as a result of the entry into force of the Law on debt discharge and of the worsening economic growth outlook for the euro area/the EU.

conditions. The new inflation forecast was further characterised by particularly high risks, stemming from the fiscal and income policies, the legislative changes in the financial field, as well as from the uncertainties surrounding the pace of recovery of the euro area/EU economy and the rate of global economic growth[30].

Subsequently-released statistical data showed the annual inflation rate going deeper into negative territory in the early months of 2016 Q2[31], primarily on account of the steeper year-on-year decline in volatile prices. The data also pointed to a significant pick-up in economic growth in the first quarter of the year[32], largely due to the quick rise in private consumption – spurred by the increase in household income and the faster advance in lending to households, as well as by the extended fiscal stimulus action –, but also to a surge in imports, conducive to the worsening of the trade balance. At the same time, the new assessments hinted at the ongoing robust dynamics of consumer demand in the near run and further elevated unit labour costs in industry, to which added the outlook for the annual inflation rate to stay in negative territory over the short term, albeit at considerably less negative readings due to the fading out in June of the direct impact of broadening the scope of the reduced VAT rate to all food items. Risks to these forecasts were compounded, in the given context, by the uncertainty about the implications of the outcome of the UK referendum and by heightened volatility on global financial markets, as well as by the still subdued inflation in the euro area/worldwide, also amid persistently low commodity prices. Against this background, the NBR Board decided in its meeting of 30 June 2016 to keep unchanged the monetary policy rate at 1.75 percent per annum (Chart 3.1) and to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

Chart 3.1. NBR Rates



Private sector credit dynamics[33] continued to pick up April through May, prompted exclusively by the contribution of the domestic currency component, whose share in total credit thus peaked in May at a 19-year high of 54.0 percent; however, the pick-up was less pronounced (6.3 percent from 5.4 percent in 2016 Q1[34]), as a result of stepped-up operations to remove non-performing loans from credit institutions' balance sheets and of the reduction in the annual dynamics of new loans. Developments across main customer categories were divergent and were correlated only in part with the results of the May 2016 Bank Lending Survey conducted by the NBR, which pointed to (i) expectations of keener demand for corporate and consumer loans in 2016 Q2, as well as to (ii) an outlook of further tightening of credit standards for mortgage loans and an increase, during this period, in the restrictiveness of standards applicable to consumer credit. Specifically, the annual pace of increase of household credit gained further momentum to 9.0 percent April through May versus 7.9 percent in 2016 Q1[35], driven by the ongoing fast advance of housing loans and the deceleration in the annual rate of decline of consumer credit and other loans.

[30] Given the weakening of the Chinese economy and of other major emerging economies, the geopolitical tensions, the situation in Greece and the forthcoming UK referendum.

[31] The 12-month inflation rate dropped in April and May to -3.25 percent and -3.46 percent respectively.

[32] Annual GDP dynamics hit a post-crisis high of 4.3 percent.

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

[34] In nominal terms, the pace of increase of credit to the private sector stepped up only marginally.

[35] Also reflecting the influence of the more negative annual inflation rate (in nominal terms, the advance in the dynamics was much slower).

By contrast, the annual dynamics of loans to non-financial corporations slowed during this period to 1.7 percent from 2.1 percent in 2016 Q1, as a result of the aforementioned operations and of the year-on-year decline in new business to corporates in May (attributable, however, at least in part, to a base effect). The deceleration in corporate credit growth was visible for short- and medium-term loans, whereas long-term ones saw their dynamics pick up in the analysed period.

Broad money grew at a faster pace April through May (15.7 percent on average, against 12.7 percent in Q1), due mainly to the increase in liquidity injections by the MPF, also related to EU funds. The quicker dynamics of M3 were ascribable to its most liquid component, whose growth rate continued to accelerate (33.2 percent versus 28.2 percent in 2016 Q1), amid the rebound in the pace of increase of currency in circulation and the protracted uptrend in the rate of change of household and corporate overnight deposits. The stronger preference for liquidity was correlated with the pick-up in economic growth and the decline in the opportunity cost of holding liquid monetary assets. Against this backdrop, the advance in the dynamics of time deposits with a maturity of up to two years was more modest (0.6 percent from -0.8 percent in Q1), underpinned by both household deposits, whose rate of change turned positive at 0.4 percent against -0.4 percent in the previous three months, and corporate deposits, the growth rate of which stood at 1.4 percent, i.e. 2.9 percentage points above the 2016 Q1 average.

The NBR continued to pursue adequate liquidity management during 2016 Q2, which – given the persistence of the net liquidity surplus in the banking system – meant further mopping up excess liquidity via the central bank's deposit facility. The reserve surplus fluctuated (decline in April, followed by an increase in May, both attributable primarily to the influence of Treasury operations) and stood – during the period as a whole – at high levels, albeit below those recorded January through February 2016. Under the circumstances, interbank money market rates, longer-term ROBOR rates included, witnessed only minor fluctuations around the historical lows hit in 2016 Q1; their volatility rose slightly towards the end of the analysed period, following the announcement of the UK referendum result.

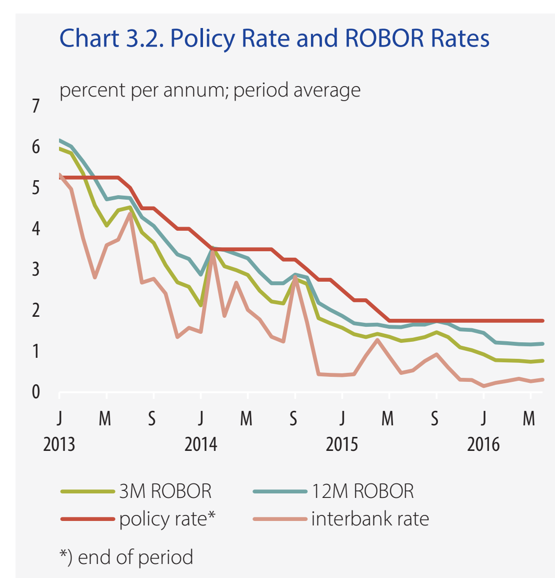
2. Financial markets and monetary developments

The average interbank money market rate remained largely unchanged in 2016 Q2, while the EUR/RON exchange rate followed a generally upward path and posted marginally higher volatility. The annual growth rate of broad money gained traction March through May 2016, due mainly to the increase in liquidity injections by the MPF, also related to EU funds, as well as to the further step-up in the annual dynamics of private sector credit.

2.1. Interest rates

After the upward correction witnessed in the latter part of Q1, the daily average interbank money market rate remained marginally above the deposit facility rate April through June. Hence, the quarterly average interbank deposit rate edged up 0.09 percentage points from the previous quarter and reached 0.31 percent (Chart 3.2).

Chart 3.2. Policy Rate and ROBOR Rates

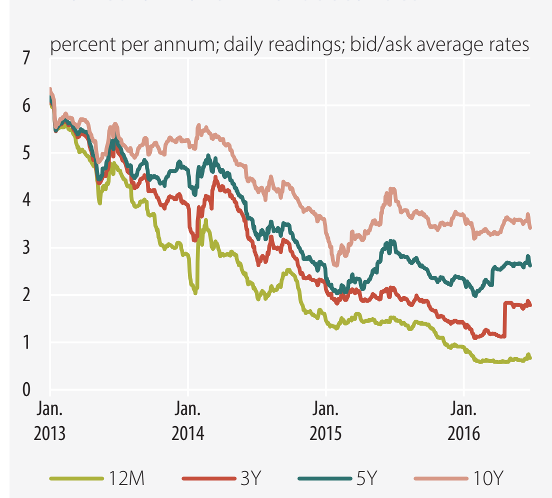


This evolution reflected primarily the performance of overnight rates, which stuck to the lower bound

of the corridor defined by interest rates on the central bank's standing facilities around the policy rate, amid uneven developments in the liquidity surplus – further narrowing in April, for the third consecutive month, followed by a renewed widening prompted by the resumption of Treasury injections, although remaining significantly below the readings posted at the onset of the year.

In turn, longer-term (3M-12M) ROBOR rates remained throughout the period under review around the historical lows[36] hit in mid-Q1. The exception was end-June, when these rates saw a temporary rise (of up to 0.09 percentage points), owing to the strong tensions emerging on international markets in response to the outcome of the UK referendum. However, in June, average ROBOR rates stood close to their March readings, with the 3M rate coming in at 0.77 percent and the 6M and 12M rates at 1.02 percent and 1.19 percent respectively.

Chart 3.3. Reference Rates on the Secondary Market for Government Securities



Yields on short-term government securities followed a similar path, with that on one-year Treasury certificates remaining virtually unchanged in June versus March both on the primary market (an average of 0.70 percent) and on the secondary one (Chart 3.3). By contrast, yields at longer maturities (5 to 10 years), which are somewhat more sensitive to the influence of global factors, witnessed a more sizeable increase in the second part of April, before fluctuating above the levels prevailing in the previous quarter, in correlation with (i) the movements of similar yields in the US and the euro area (reflecting successive shifts in expectations on the timing of the next hike in the Fed's policy rate and on its trajectory), as well as with (ii) the uncertainty surrounding the fiscal and income policy conduct and the Law on debt discharge. These yields rose abruptly in the wake of the UK referendum, followed by a quick correction, in tandem with yields in developed markets. Against this background, the average accepted rates at the June auctions for 7- and 11-year bonds respectively stood by up to 0.15 percentage points higher than in March, at 3.09 percent and 3.98 percent respectively. In turn, average benchmark rates on the secondary market exceeded in June their March readings by up to 0.23 percentage points in the case of the 10-year maturity, so that the slope of the yield curve steepened slightly.

The evolution of yields and developments in the quantitative indicators of the primary market for government securities reflected the successive shifts in investor interest in government bonds during the period under review. In particular, investor appetite shrank somewhat in the first part of the reported quarter (in which context the MPF partly rejected the bids submitted at several auctions for government securities), before tending to recover gradually, so that both the demand-to-supply ratio and the average maturity of issued securities April through June were similar to those in 2016 Q1[37].

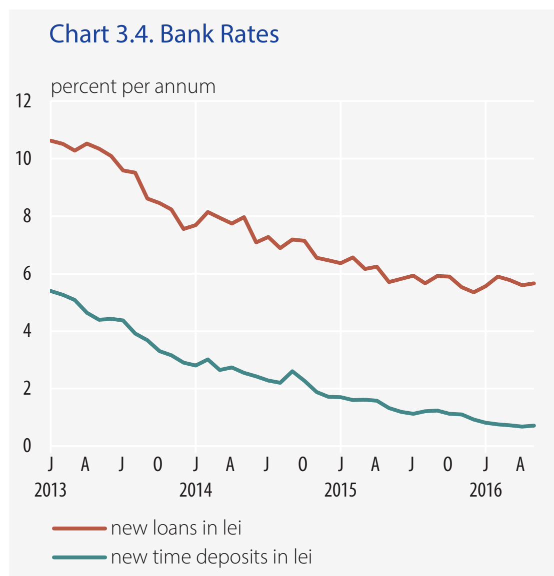
Credit institutions' average interest rates on new loans and new time deposits of non-bank clients saw their downtrend extend into March-May 2016, shedding 0.24 percentage points (to 5.66 percent) and 0.05 percentage points (to 0.71 percent) respectively (Chart 3.4). The steeper decline in the former case was attributable to developments across both customer categories. Specifically, the average lending rate on new business to non-financial corporations dropped 0.34 percentage points (to a new post-1990 low of

[36] Data series available since August 1995.

[37] Moreover, in May, the MPF reopened the books on a EUR-denominated bond issue on the external market, by putting into circulation securities worth EUR 1 billion, with a 12-year maturity and at a 2.99 percent rate.

4.01 percent), with the downward path visible for interest rates on both large-value loans and lower-value ones. Looking at the average lending rate on new business to households, the decline (by 0.28 percentage points, to 6.58 percent) was exclusively due to housing loans. The average remuneration of new time deposits from households also stuck to a downward trend, edging down 0.13 percentage points to a post-1990 low of 1.09 percent. Conversely, the average interest rates on new time deposits from non-financial corporations remained unchanged at 0.46 percent.

Chart 3.4. Bank Rates

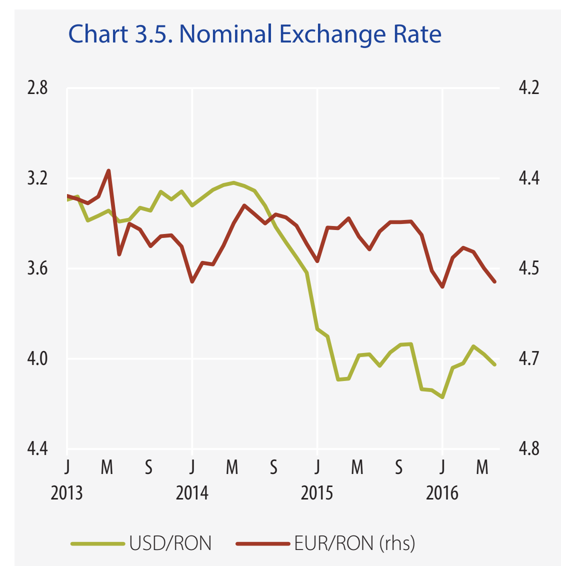


2.2. Exchange rate and capital flows

In 2016 Q2, the EUR/RON exchange rate followed an upward, albeit discontinuous and relatively fluctuating path and exceeded this year's peak, posted in January, only marginally and on a single day towards the end of the quarter (Chart 3.5).

The EUR/RON embarked on an uptrend in mid-April, in a domestic environment marked by persistent/increased uncertainties regarding the fiscal and income policy stance, as well as the enforcement of the Law on debt discharge, likely to affect foreign investor perception of the Romanian economy and financial market. The upward path subsequently steepened, reflecting, similarly to the exchange rates of the other currencies in the region, the impact of the worsening in early May of the global financial market sentiment, owing to renewed concerns over economic growth worldwide and, in particular, in China, as well as to heightened uncertainty about the outcome of talks between Greece and its main international lenders. During the same month, the short-lived increase in the likelihood attached by investors to an earlier key interest rate hike by the Fed also contributed to the depreciation of the domestic currency.

Chart 3.5. Nominal Exchange Rate



The subsequent calming of global markets due to the Eurogroup-IMF deal on Greece's financial assistance programme and to investors reconsidering the prospects for the Fed's policy rate hike cycle to continue[38] had an effect on the domestic market as well, with the leu exchange rate seeing its uptrend come to a halt and its fluctuations diminish in the early days of June. However, the resurgence in global risk aversion both on the eve and in the wake of the UK referendum led to a renewed depreciation of the domestic currency[39], although of a lower magnitude than that of its regional peers; the upward move in the exchange rate was also brief and was almost fully corrected towards the end of the quarter, amid the alleviation of financial market concerns following the signals given by the major central banks[40].

[38] Following the Fed Chair's forward guidance and the underperformance of the US labour market.

[39] On 16 June, the EUR/RON exchange rate peaked at a 29-month high of 4.5396 and on 24 June the CDS quotes for Romania reached a 9-month high.

[40] They showed their readiness to provide additional liquidity in order to counter any financial market tensions.

The balance of non-residents' transactions on the interbank forex market turned negative again, in line with developments in portfolio investment[41] and the current account balance in April and May (Table 3.1). Residents' foreign currency transactions resulted, however, in monthly surpluses[42], albeit on the wane, which limited the widening of the overall interbank forex market deficit.

Table 3.1. Key Financial Account Items

EUR million

	5 mos. 2015			5 mos. 2016		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	-2,097	-5,466	3,369	2,506	812	1,694
Direct investment	154	1,071	-917	275	1,347	-1,072
Portfolio investment	-184	-1,703	1,519	244	1,046	-802
Financial derivatives	-7	0	-7	29	0	29
Other investment	676	-4,834	5,510	1,303	-1,581	2,884
– currency and deposits	97	-1,513	1,610	172	-1,708	1,880
– loans	176	-3,320	3,496	847	-303	1,150
– other	403	-1	404	284	430	-146
NBR's reserve assets, net	-2,735	0	-2,735	654	0	654

*) "+" increase / "-" decrease

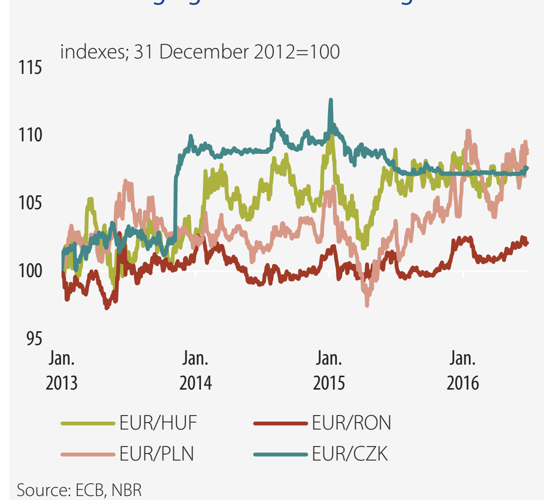
In 2016 Q2 as a whole, the domestic currency depreciated against the euro by 1.2 percent in nominal terms[43] and 1.3 percent in real terms. In relation to the US dollar, the leu depreciated by 0.1 percent in nominal terms and 0.2 percent in real terms, given the former's weakening against the euro (Chart 3.6). Looking at the average annual exchange rate dynamics in 2016 Q2, the domestic currency saw its nominal depreciation versus the euro pick up slightly and posted the first nominal appreciation against the US dollar in the past seven quarters.

[41] Except for the influence of the MPF's bond issue on the external market in May.

[42] Unlike the first three months of the year, when residents' net demand for foreign currency recorded a surplus.

[43] The Hungarian forint posted somewhat similar developments (0.9 percent depreciation), whereas the Polish zloty weakened by 2.4 percent in relation to the single currency.

Chart 3.6. Exchange Rate Developments on Emerging Markets in the Region



Source: ECB, NBR

2.3. Money and credit

Money

March through May 2016, broad money (M3) dynamics[44] picked-up (a 7½-year high of 14.9 percent, as opposed to 11.7 percent December 2015 through February 2016), under the impact of larger MPF disbursements related to EU funds (Table 3.2).

Table 3.2. Annual Growth Rates of M3 and Its Components

real percentage change

	2015			2016		
	II	III	IV	I	Apr.	May
	quarterly average growth					
M3	7.5	10.1	10.0	12.6	14.5	16.8
M1	20.1	25.6	26.4	28.6	32.3	34.0
Currency in circulation	16.8	18.8	18.9	17.8	20.8	20.5
Overnight deposits	22.0	29.4	30.4	34.4	38.4	41.3
Time deposits (maturity of up to two years)	-1.5	-1.7	-3.0	-0.8	-0.7	1.8

Source: NIS, NBR

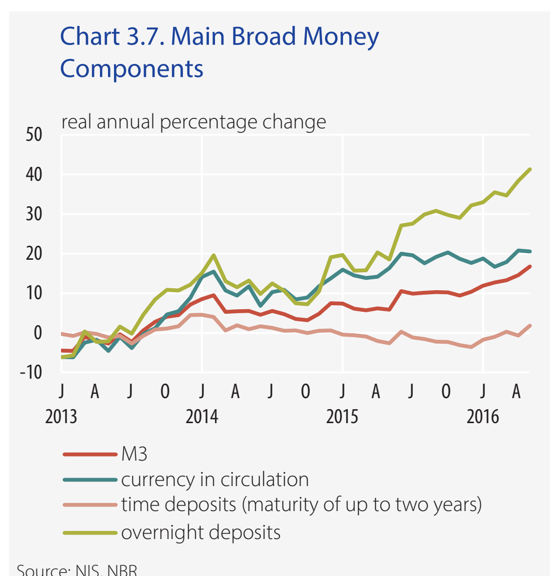
From the perspective of M3 components, the fast increase of narrow money (31.7 percent[45], 3.6 percentage points above the previous three

[44] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms March through May 2016.

[45] Similar values were last recorded in the summer of 2008.

months' reading) continued to be the major driver, correlated with the step-up in economic activity and the lower opportunity cost of holding liquid assets. Both major components of M1 contributed to this development, with their annual growth rates reaching 8-year highs in the period under review (Chart 3.7). Time deposits with a maturity of up to two years also had a minor contribution to M3 growth, as their dynamics re-entered positive territory in the reported period (0.5 percent compared with -2.1 percent in the previous three months).

Chart 3.7. Main Broad Money Components



Source: NIS, NBR

The M3 breakdown by holder reveals a rebound in the advance of household deposits in this period, along with an ongoing uptrend in non-financial corporations' deposits, under the joint effect of the increase in certain budget expenditure categories[46], higher disbursements for agriculture from European funds[47] and the step-up in retail purchases by households[48], also due to the wage hike[49]. Adding to these in the period under review were also certain portfolio shifts from alternative financial instruments (government securities and deposits with a maturity of over two years of the non-banking sector) to M3 components.

From the perspective of M3 counterparts, behind the evolution of broad money stood the rebound in the dynamics of loans to the public sector, the ongoing upward trend in the rate of change of loans to the private sector, as well as the renewed loss of momentum of long-term financial liabilities[50]. The slowdown of the year-on-year decline in leu-denominated deposits of the MPF[51] had an opposite effect.

Credit to the private sector

March through May 2016, the growth rate of credit to the private sector[52] continued to pick up (6.2 percent versus 4.7 percent in the previous three months; Chart 3.8), albeit more slowly, given the stepped-up operations to remove non-performing loans from credit institutions' balance sheets[53], as well as the relatively slower rise in the volume of new loans (partly due to a base effect). The average annual dynamics of the leu- and foreign currency-denominated components witnessed increasingly divergent paths, the former picking up to 24.2 percent (from 22.5 percent in the previous three months) and the latter (based on readings expressed in euro) falling deeper into negative territory (-13.2 percent versus -11.9 percent). Under the circumstances, the share of the leu-denominated component in total private

[46] According to budget execution data, March through May 2016, the real average annual growth of monthly expenditure for goods and services was faster than in the prior two quarters, while that of monthly capital expenditure was the highest in the past four years.

[47] According to APIA press releases, in April 2016 disbursements were made for the 2015 agricultural campaign, while May 2016 saw disbursements for climate- and environmentally-friendly agricultural practices and for the compensatory sub-measures in the National Rural Development Programme related to Measure 13, along with funds earmarked for the agricultural access infrastructure in Sub-measure 4.3A. Moreover, March through April 2016, the subsidies for the excise duty on diesel used in agriculture were provided, and in April-May 2016 the MPF granted the Ministry of Agriculture and Rural Development two loans for stimulating the pace of EU agricultural fund absorption (Government Decisions No. 174/2016 and No. 377/2016). The breakdown of these amounts by group of recipients is not possible.

[48] March through May 2016, the average annual growth rate of retail trade turnover (except motor vehicles and motorcycles) was the highest since 2008 Q3.

[49] The real average annual growth rate of net wage earnings during March-May 2016 was the highest since 2007 Q3, while the minimum wage economy-wide was raised in May 2016.

[50] Capital accounts included.

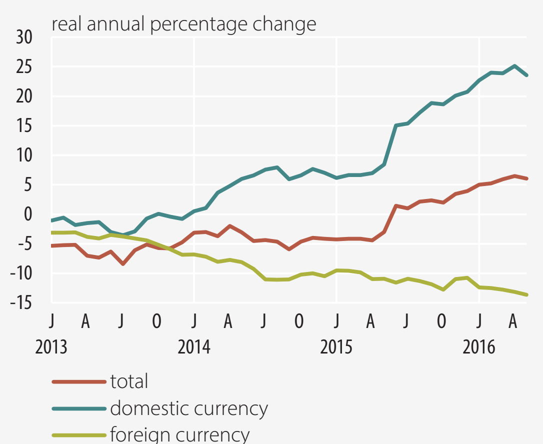
[51] The effect generated by the increase in MPF forex deposits, following the settlement of the MPF bond issue on external markets, was offset by the impact exerted by the corresponding rise in banks' net foreign assets.

[52] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms March through May 2016.

[53] Calculated based on monetary statistics data.

sector credit gradually increased to 54.0 percent (the highest reading since January 1997) in the last month of the period under review.

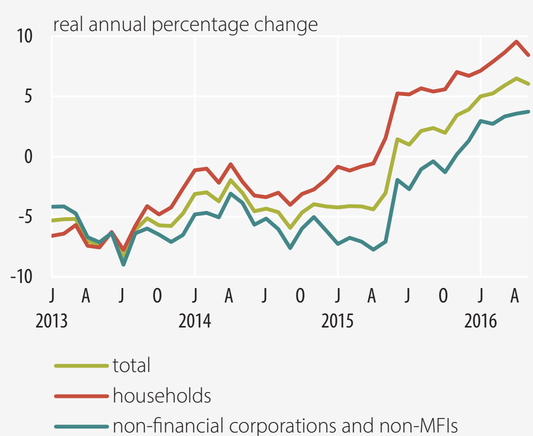
Chart 3.8. Credit to the Private Sector by Currency



Source: NIS, NBR

Developments across the major institutional sectors were somewhat contrasting. Loans to households saw stronger dynamics, which peaked at a seven-year high, and hence the average share of loans to this segment in total private sector credit became prevalent for the first time since 2009 (Chart 3.9). Behind this stood (i) the pick-up in the annual growth rate of housing loans, underpinned by the persistence of the fast dynamics of new business in lei, especially under the "First Home" Programme[54] and (ii) the faster pace of increase of consumer credit and other loans in domestic currency[55], due to further low interest rates, higher household incomes and the promotional offers of

Chart 3.9. Credit to the Private Sector by Institutional Sector



Source: NIS, NBR

credit institutions. The dynamics of loans to non-financial corporations also posted a rise, despite the much weaker momentum[56], given the stepped-up operations to remove non-performing loans from credit institutions' balance sheets and the lower volume of new business (also due to a base effect) in annual terms. Against this background, the growth rate of leu-denominated corporate loans declined (although remaining high when looking at the last seven and a half years), while the rate of change of foreign currency loans (expressed in euro) went further into negative territory. The breakdown of loans to non-financial corporations shows a pick-up in the growth rates of automatically renewable loans and of overdraft loans. The reduction in the dynamics of other medium-term loans in lei and of short-term loans in foreign currency, respectively, had an opposite impact.

[54] The guarantee ceiling for loans under the "First Home" Programme was raised in May 2016 by Government Decision No. 366/2016.

[55] Consumer credit, other loans and business development loans have been analysed as a single indicator, with a view to eliminating the effect of statistical methodological changes introduced as of January 2015.

[56] In nominal terms, the dynamics of loans to non-financial corporations fell deeper into negative territory.

4. INFLATION OUTLOOK

The annual CPI inflation rate is projected to reach -0.4 percent and 2.0 percent at end-2016 and end-2017 respectively, being revised significantly downwards compared to the previous report, amid the persistently low-inflation global environment. The projected levels of CPI inflation reflect the effects of both domestic measures related to fiscal easing, income policy or the Law on debt discharge and external factors, associated primarily with the outcome of the UK referendum. At the projection horizon, i.e. mid-2018, inflation rate will run in the upper half of the variation band of the target, chiefly due to the gradual build-up of inflationary pressures reflected by the adjusted CORE2 index. They will come from the expected increase in excess demand and the import prices resuming faster dynamics, as well as from the dropping out, in early 2018, of the first-round effects of indirect tax cuts in January 2017. The balance of risks to the annual inflation projection is tilted to the downside compared to the path in the baseline scenario, with risks stemming from both domestic and external sources.

1. Baseline scenario

1.1. External assumptions

External demand[57] is envisaged to further recover during the projection interval. The growth rates of the effective indicator (Table 4.1) are, nonetheless, lower than those anticipated in the May 2016 Inflation Report, considering that the risk of UK's leaving the EU following the 23 June referendum has materialised and given the elevated uncertainty about the ensuing negotiations, as reflected by heightened volatility on financial markets. Risks to economic growth across the EU may stem from adverse developments in some major emerging economies, China included. Euro area economic growth is supported by domestic demand, further benefiting from the ECB's standard and non-standard monetary policy measures, the pass-through of effects from low oil price, an improvement in labour market conditions, although this is seen lagging behind the developments in economic activity, and from a slight fiscal easing in 2016. The positive dynamics of private consumption are foreseen, however, to lose momentum, mainly on the back of a slower rise in real disposable income, reflecting widely the trend in energy prices, the oil price in particular, which were revised upwards compared with the previous round. The negative effective EU GDP gap[58] will gradually narrow over the forecast interval, exerting a dwindling contractionary impact on domestic economic activity.

Table 4.1. Expectations on the Developments in External Variables

annual averages

	2016	2017
Effective EU economic growth (%)	1.67	1.59
Annual inflation rate in the euro area (%)	0.24	1.40
Annual CPI inflation rate in the USA (%)	1.28	2.33
3M EURIBOR interest rate (% per annum)	-0.28	-0.40
EUR/USD exchange rate	1.11	1.09
Brent oil price (USD/barrel)	44.4	52.4

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

The annual HICP inflation rate in the euro area is projected at levels similar to those expected in the previous report almost throughout the forecast interval, remaining below 2 percent. For the first part of the projection interval, annual CPI inflation in the USA was revised slightly upwards compared with the previous projection round, owing to higher energy prices and non-energy import prices.

[57] As proxied by the effective EU GDP (EU-28 excluding Romania).

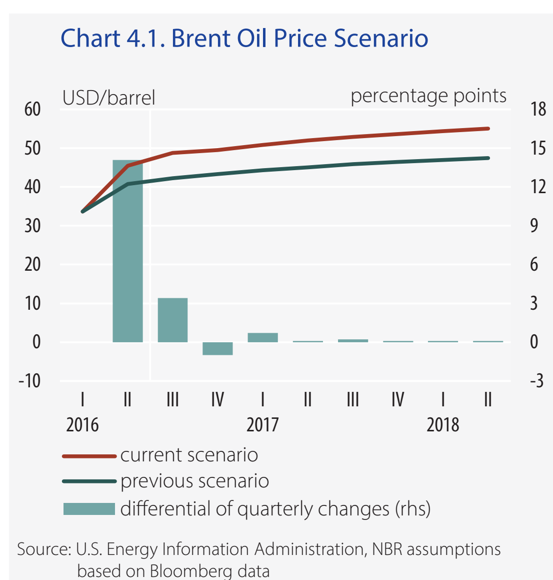
[58] A relevant measure to approximate the external demand impact on Romania's exports within the NBR model.

Annual inflation rate in the USA is foreseen running at higher levels than that in the euro area over the entire projection interval.

The nominal 3M EURIBOR rate is anticipated to stay in negative territory until the projection horizon, amid expectations of persistently accommodative ECB monetary policy. If the stimulative monetary policy measures are extended because of the Brexit vote, EURIBOR may fall even lower. The path of the EUR/USD exchange rate is expected to stabilise somewhat at USD 1.10 per euro at the end of the forecasting interval.

The scenario for the international Brent oil price is based on futures prices and foresees a continuous uptrend, starting as early as 2016 Q2, before hitting USD 55 per barrel at the projection horizon (Chart 4.1). The short-lived disruptions in production in some oil-exporting countries, Canada in particular, amid the recent wildfires, caused supply to decline, while demand remained relatively steady. Quarterly dynamics are marginally higher than those anticipated in the previous report for most of the forecast interval.

Chart 4.1. Brent Oil Price Scenario



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

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at -0.4 percent at end-2016 and 2.0 percent at end-2017, which are below the lower bound of and inside the ±1 percentage point variation band of the 2.5 percent flat target respectively (Table 4.2). Compared to the previous report, the projected values were revised downwards by 1 percentage point for the end of this year and 0.7 percentage points for the end of next year.

Table 4.2. The Annual Inflation Rate in the Baseline Scenario

annual percentage change; end of period

	2016		2017				2018	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	-0.4	-0.4	0.7	1.4	1.8	2.0	2.8	3.0
CPI projection*	1.0	1.0	1.0	1.7	2.1	2.3	2.8	3.0

*) excluding the first-round effects of VAT rate changes

These revisions implied smaller contributions from the adjusted CORE2 inflation rate, administered prices, volatile food (VFE) and fuel prices, in a persistently low-inflation global environment (Box 2). The projected path of the annual inflation rate will continue to be affected by the fiscal easing[59] and income increasing measures, as well as by the estimated effects of the enactment of the Law on debt discharge, the assessment of which is however riddled with inherent uncertainties. The implementation of this law is expected to weigh on domestic demand dynamics, exerting, *caeteris paribus*, disinflationary pressures throughout the period under review. A slight disinflationary impact is likely to become manifest in 2017 also following the result of the UK referendum. In this context, the annual CPI inflation rate will post negative values until the end of the current year, then positive values, but below 1.5 percent by mid-2017, before re-entering and remaining in the variation band of the target until the projection horizon, i.e. mid-2018. In January 2018, once the first-round effects of the indirect tax cut, effective 1 January 2017, have faded out, CPI inflation will jump into the upper half of the variation band of the target.

[59] Especially by those concerning the two-step cut in the standard VAT rate, by 4 percentage points in January 2016 and by one percentage point in January 2017, as well as the scrapping of the special excise duty on fuels in January 2017.

Box 2. Revisions of inflation projections of some central banks

Over the last years, central banks have repeatedly revised their inflation projections amid shocks with global spill-over effects (Chart A). Under the circumstances, the broad-based persistence of inflation rates at levels below the reference levels used in defining price stability was attributed to the overlapping of significant falls in international commodity prices (starting with the second half of 2014), simultaneously with the slow recovery of aggregate demand in the post-crisis period. Despite these globally reaching shocks, the magnitude of revisions and, implicitly, that of forecast errors were also influenced by idiosyncratic aspects – the specific channels whereby shocks are passed through on the domestic front, also against the background of the heterogeneous structure of CPI baskets across different economies. Over the same period of time, however, region-specific shocks added to global ones. For instance, across EU countries, an additional disinflationary impulse was generated by the persistent excess supply of agri-food items created on this market following Russia's ban in 2014 extended subsequently to Turkey in 2016.

In both Romania and Poland, idiosyncratic aspects caused annual CPI inflation rate to post negative levels at end-2015, while in case of other countries (Hungary, the Czech Republic, the USA or the euro area) the indicator remained positive or was almost nil. The negative CPI inflation values implied, *caeteris paribus*, wider deviations of actual inflation from the central targets for the two economies (Table B).

In spite of the high sensitivity of the domestic consumer price dynamics in Romania (and Poland) to changes in energy and food prices (Table A) – categories of prices directly affected by global shocks –, the negative inflation in the Romanian economy was attributed to certain domestic developments whose effects occurred at the same time and acted in the same direction as those on international markets.

Table A. Shares in CPI in 2015

percent

	Food items and non-alcoholic beverages	Energy
Romania	36.3	18.3
Poland	24.4	17.6
Hungary	21.3	16.0
Czech Republic	18.1	13.4

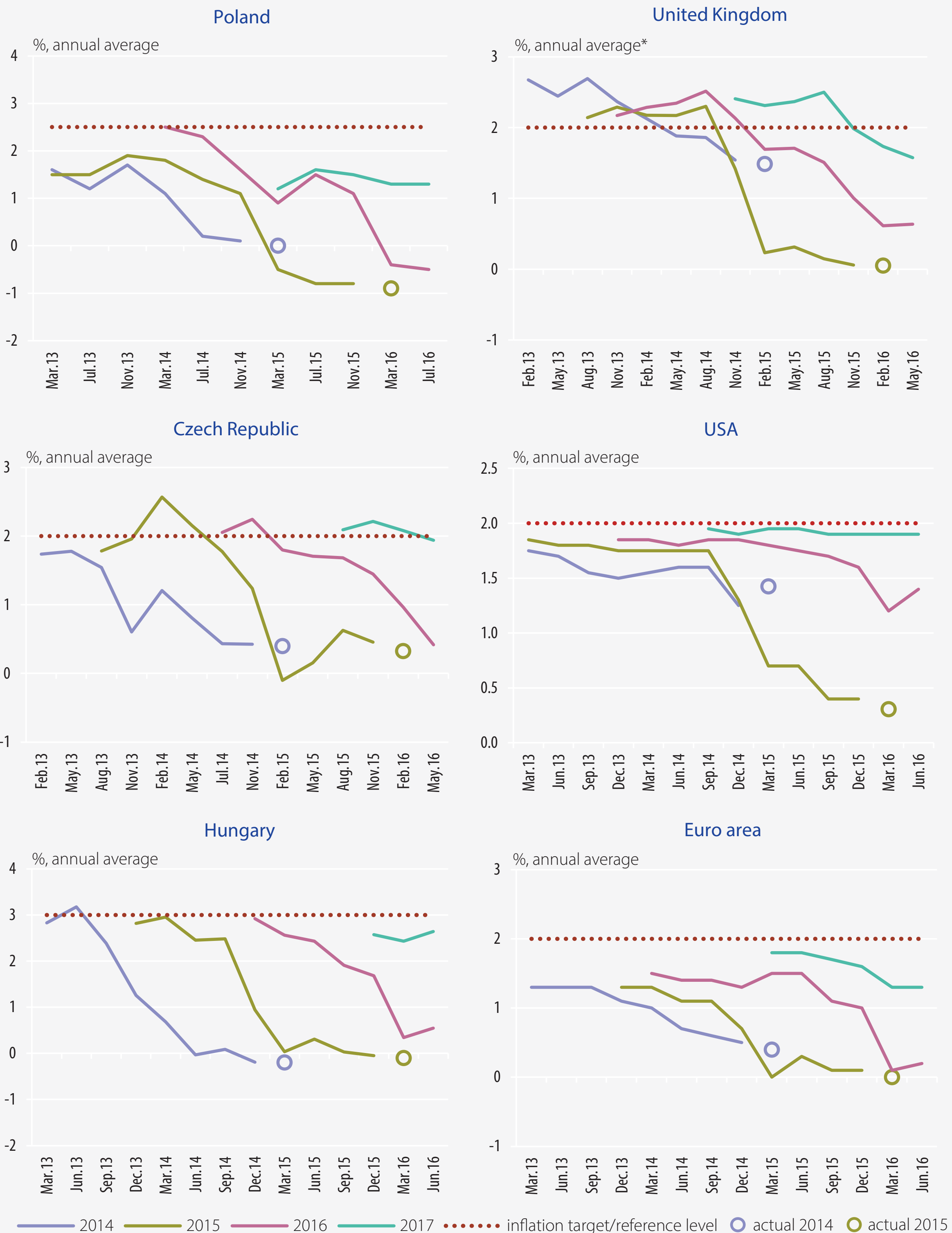
Source: OECD, NIS, NBR calculations

Thus, in the period under review, fiscal authorities proceeded to successively cutting VAT rates in September 2013, June 2015 and January 2016, ahead of another cut scheduled for January 2017. Removing the first-round effect associated with broadening the scope of the reduced VAT rate as of 1 June 2015[60] – given its transitory nature[61] –, the annual CPI inflation rate at end-2015 would have been positive and would have fallen inside the variation band of the target. Even under the circumstances, the consecutive revisions of inflation projections would have followed a downward trend (Chart B) amid an increasing spillover of disinflationary shocks from the external environment. In other words, under a hypothetical scenario assuming the absence of the mentioned fiscal measures, in Romania, the actual inflation path would have been below the central target (2.5 percent) both in 2014 and 2015, as a result of the global disinflationary factor and in line with all countries under review (in Chart A, the actual inflation rates were significantly lower than the reference levels used in defining price stability, showing a tendency to persist at low levels in the future as well).

[60] The measure envisaged the broadening of the scope of the reduced VAT rate to all food items, non-alcoholic beverages and food service activities and entailed a first-round impact assessed by the NBR at -2.8 percentage points.

[61] Effects which are manifest in the annual CPI inflation rate for a 12-month period.

Chart A. Revisions of Inflation Projections of Some Central Banks Starting 2014

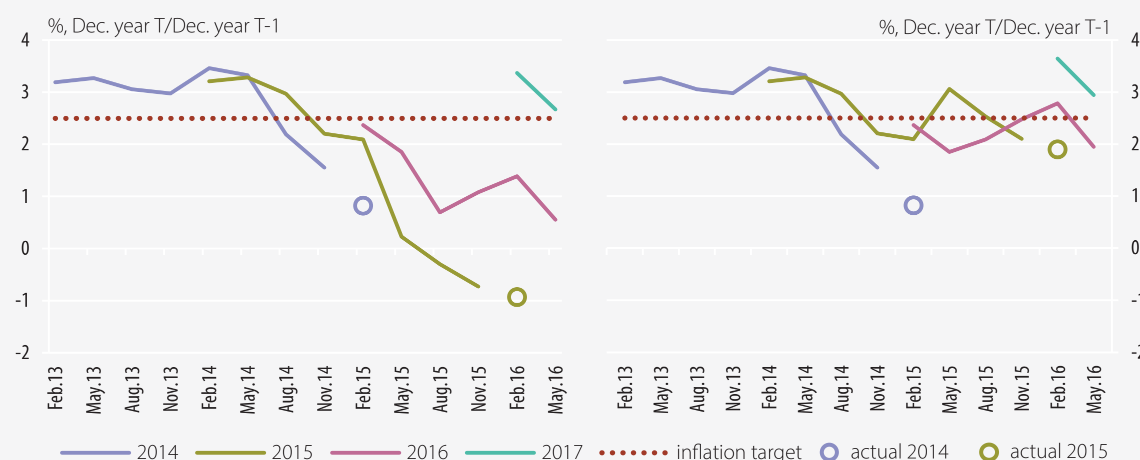


*) approximated by averaging quarterly forecasts

Note: The line corresponding to one year stands for a central bank's successive forecasts for that particular year.
The Ox axis features the forecast release dates.

Source: AMECO, central banks, NBR calculations

Chart B. Revisions of the NBR's Projections of CPI Inflation (left-hand panel) and of CPI Inflation Net of the First-round Effect of VAT Rate Changes (right-hand panel) Starting 2014



Source: NIS, NBR calculations

Except Romania, the only country among the Central and Eastern European countries covered by this analysis which proceeded to cutting indirect taxes in the period under review was the Czech Republic in early 2015, when a second reduced VAT rate of 10 percent was implemented for medicines, books and irreplaceable infant food. However, the extremely low impact of this measure on the annual CPI inflation rate (approximately -0.1 percentage points[62]) is not likely to reconfigure the direction and magnitude of revisions made to the inflation forecasts presented in Chart A.

Table B shows the deviations of the inflation rates from central targets recorded by several central banks in 2014 and 2015 (years significantly affected by external disinflationary shocks). For Romania, the deviation seen in 2014 reflected, apart from the influence of external shocks on fuel and food prices, the evolution of administered prices in 2014, in the context of legislative changes in the field that were implemented in the second half of the year. For 2015, looking at the annual inflation rate net of the effect of the VAT rate cut, the deviation from the central target was still negative, but, in absolute value, stood below the average deviation shown in the panel (-2.0 percentage points).

Table B. CPI Inflation Deviation from the Reference Level

	2014	2015
Romania	-1.7	-3.4
Romania*	-1.7	-0.6
Hungary	-3.2	-3.1
Czech Republic	-1.6	-1.7
Czech Republic*	-1.6	-1.6
Poland	-2.5	-3.4
UK	-0.5	-1.9
Euro area	-1.6	-2.0
USA	-0.6	-1.7

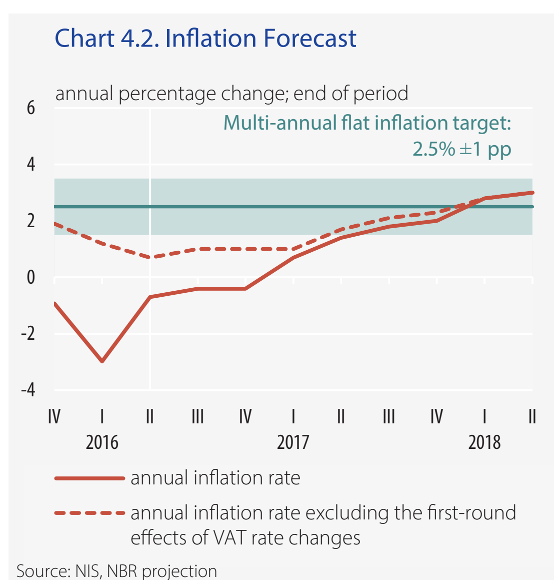
* calculations made for CPI inflation excluding the direct impact of VAT rate changes

To sum up, the materialisation of strong and persistent supply-side shocks, which are difficult to predict, is likely to induce high volatility in both the actual inflation and the central banks' forecasts. The high volatility diminishes the accuracy of projections, thereby also affecting the quality of information provided to monetary-policy makers.

[62] According to Inflation Report II/2015 available on the Czech National Bank's website.

The annual CPI inflation rate, recalculated by excluding the first-round effects of the VAT rate cuts that are beyond the scope of the monetary authority, is expected to return inside the variation band of the target in 2017 Q2 and to remain therein until the projection horizon (Chart 4.2). This measure of inflation reflects better the gradual build-up of aggregate demand pressures, also stimulated by the fast-paced wage earnings growth, which is far quicker than labour productivity economy-wide.

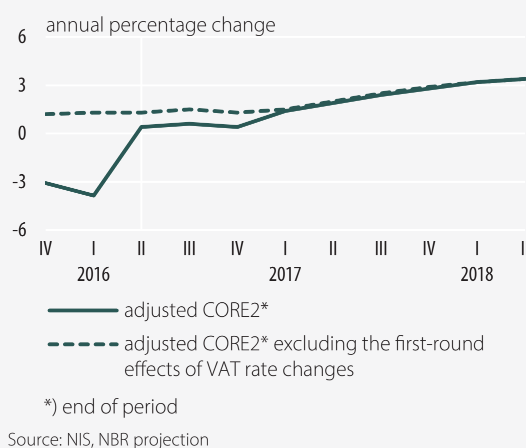
Chart 4.2. Inflation Forecast



Source: NIS, NBR projection

Annual adjusted CORE2 inflation rate is expected to reach 0.4 percent at the end of 2016 and 2.8 percent at the end of 2017, before standing at 3.4 percent at mid-2018, close to the upper bound of the variation band of the target (Chart 4.3). This path is determined by a series of factors with diverging influences and different persistencies. On the one hand, under the impact of the transitory first-round effects of the successive standard VAT rate cuts and low inflationary pressures from import prices – against the backdrop of the persistently low-inflation global environment and the agri-food oversupply on the European market deriving from Russia's ban on imports of such goods – core inflation will stay beneath the lower bound of the variation band of the target until 2017 Q1. Inflation expectations are anticipated to act in the same direction in the first quarters of the forecast, rising only gradually under the effect of the persistently-low CPI inflation. On the other hand, core inflation will post faster dynamics due to the

Chart 4.3. Annual Adjusted CORE2 Inflation and Adjusted CORE2 Excluding the First-round Effects of VAT Rate Changes



Source: NIS, NBR projection

successive dropping-out of the first-round statistical effects of the standard VAT rate cuts one year after implementation[63] and given the steady build-up of underlying inflationary pressures. The latter are expected to be generated by the widening of the positive output gap, along with a pick-up in the growth rate of unit wage costs[64], by the gradual increase in import price dynamics, assuming the medium-term convergence of external inflation towards the targets and, under the impact of these factors, by the upward trend in inflation expectations. Core inflation rate net of the first-round effects of VAT rate changes is seen standing at 1.3 percent and 2.9 percent at end-2016 and end-2017 respectively (Table 4.3).

Table 4.3. Annual Adjusted CORE2 Inflation Rate in the Baseline Scenario

annual percentage change; end of period

	2016		2017				2018	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Adjusted CORE2	0.6	0.4	1.4	1.9	2.4	2.8	3.2	3.4
Adjusted CORE2*	1.5	1.3	1.5	2.0	2.5	2.9	3.2	3.4

*) excluding the first-round effects of VAT rate changes

[63] In January 2017 and January 2018.

[64] Given the public sector pay rises implemented late last year, the successive increases in the gross minimum wage economy-wide and the ones to be enforced in August 2016 in accordance with Government Emergency Ordinance No. 20 of 8 June 2016.

Compared to the May 2016 Inflation Report, the projected path of the annual adjusted CORE2 inflation rate was revised downwards by similar magnitudes in the current and next year, i.e. 0.5 percentage points at end-2016 and 0.6 percentage points at end-2017. This is due to the downward revision of import price pressures amid the persistently low inflation rates in Romania's main trade partners, which also led to a decline in inflation expectations of economic agents. The build-up of a stronger excess demand over most of the projection interval has an opposite effect.

The cumulative contribution of components exogenous to the monetary policy influence, namely administered prices, volatile food (VFE) prices, fuel prices, and tobacco product and alcohol prices, to the annual CPI inflation rate is -0.6 percentage points at the end of 2016 and 0.4 percentage points at the end of 2017, being revised by -0.7 percentage points and -0.2 percentage points respectively against the previous projection (Table 4.4).

Table 4.4. Components' Contribution to Annual Inflation Rate*

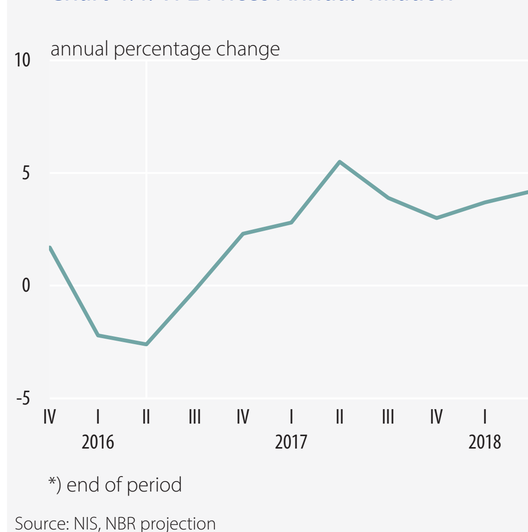
percentage points

	2016	2017
Administered prices	-0.8	0.4
Fuels	-0.1	-0.2
VFE prices	0.1	0.2
Adjusted CORE2	0.3	1.6
Tobacco and alcohol	0.2	0.0

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

The dynamics of volatile food (VFE) prices are under the influence of the assumption of normal crops on the domestic front in both 2016 and 2017, along with the ongoing oversupply of food products on the European market, which also has disinflationary effects on domestic retail prices (Chart 4.4). Under these circumstances, VFE prices will rise at an annual pace of 2.3 percent at the end of 2016 and 3 percent at the end of 2017 following a downward revision compared to the previous report.

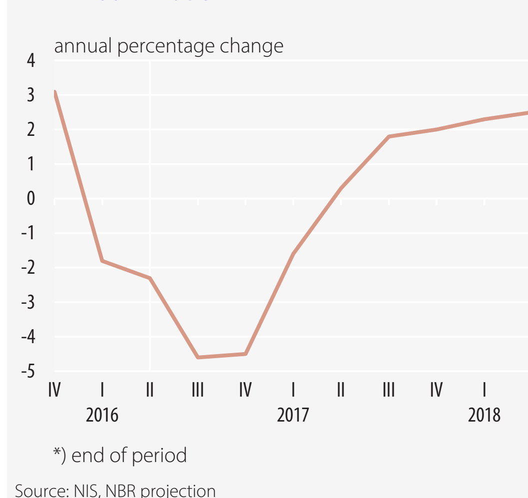
Chart 4.4. VFE Prices Annual Inflation*



*) end of period

Source: NIS, NBR projection

Chart 4.5. Administered Prices Annual Inflation*



*) end of period

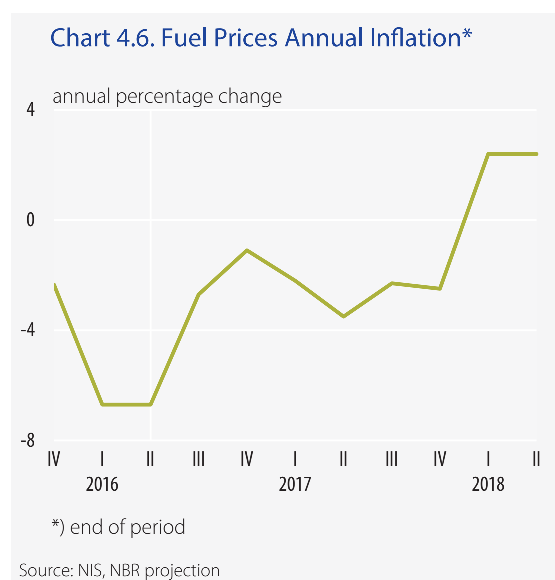
Source: NIS, NBR projection

The annual dynamics of administered prices are anticipated at -4.5 percent at end-2016 and 2 percent at end-2017 (Chart 4.5). For the current year, the 2.3 percentage point downward revision comes from the update of the assumption communicated by the Regulatory Authority for Energy in Romania (ANRE) regarding the reduction of the average electricity price in July, due to a decline in competitive market component prices, transportation and system service prices and to the contribution for high efficiency cogeneration applied in 2016 H2. Moreover, the assumption on the dynamics of the "natural gas" sub-group was

also revised downwards based on the most recent information supplied by the authorities[65].

The expected path of the annual inflation rate for tobacco products and alcoholic beverages is shaped by the pieces of legislation setting the levels of excise duties on such goods and by the latest information, and is marked by the 2016 and 2017 standard VAT rate cuts as well. For 2016, the projected level is 2.3 percentage points higher following the stronger-than-previously-expected increases in retail prices of such products in recent months, whereas for 2017 the forecasted level is similar to that in the previous report.

Chart 4.6. Fuel Prices Annual Inflation*



*) end of period

Source: NIS, NBR projection

The annual dynamics of fuel prices will witness negative levels almost throughout the forecast interval, reaching -1.1 percent at end-2016 and -2.5 percent at end-2017. The values are revised downwards by 1.7 percentage points and 0.6 percentage points respectively. The revision was made primarily amid the lower-than-previously-forecast dynamics in recent months for the prices of petrol and the "non-petrol-diesel" component amid persistently low prices of main commodities (e.g. oil, natural gas) on global markets and weaker inflation expectations affecting this CPI basket category as well (Chart 4.6). The major factors exerting downward pressures on these prices are the two-step cut in the standard VAT rate and the removal of the special excise duty on fuels, while opposite, albeit softer, influences come chiefly from the higher oil price envisaged for the entire projection period.

1.3. Demand pressures in the current period and over the projection interval[66]

Output gap

In 2016 Q1, seasonally-adjusted real GDP saw a marked increase (1.5 percent) compared to the previous quarter[67], against the background of a rise in domestic demand. In 2016 Q2 and Q3, the quarterly real GDP growth is expected to remain in positive territory, albeit on the wane. The analysis of high-frequency macroeconomic indicators underpins the above-mentioned forecasts. In particular, the economic sentiment indicator inched up by 0.4 points in 2016 Q2 (Chart 4.7), while the volumes of retail trade turnover (excluding motor vehicles) and industrial production increased by 1.4 percent and 0.8 percent, respectively, April through May 2016 compared to the preceding quarter average. By contrast, market services to households fell by a real 1.3 percent over the reported period. An additional impact on short-term forecasts of economic growth comes from the effects of the Law on debt discharge, their assessment being further marked by some uncertainty.

Over the forecast period, the potential GDP growth mirrors the developments in capital stock and labour, incorporating the favourable paths of investment and unemployment rate, respectively. Total factor productivity dynamics are seen to stay in positive territory, showing however no signs of acceleration. This projection reflects the prudent

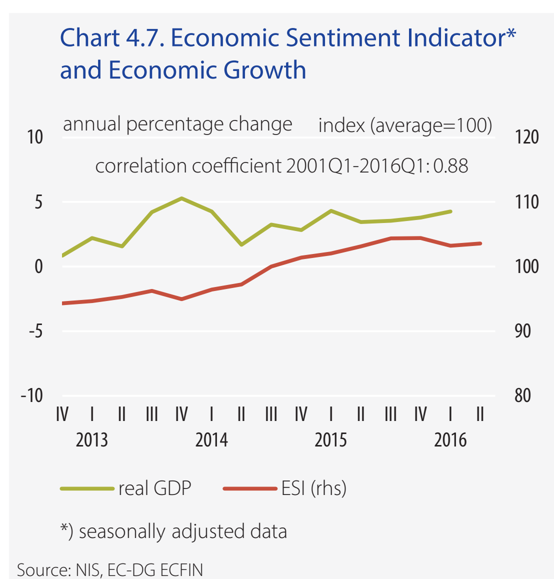
[65] For further details, see the press release issued by the Regulatory Authority for Energy in Romania on 30 June 2016 concerning the regulated prices for natural gas supply (http://www.anre.ro/ro/presa/comunicate/comunicat-30-06-2016-preturi-reglementate-furnizare-gaze-naturale) (Romanian only) and on 23 June 2016 regarding regulated electricity prices (http://www.anre.ro/ro/presa/comunicate/comunicat-23-06-2016-tarife-reglementate-ee-incepand-cu-01-07-2016) (Romanian only).

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

[67] NIS Press Release No. 174 of 08 July 2016. In 2016 Q1, economic growth came in at 4.3 percent in annual terms.

assumption of economic agents' further limited capacity to use funds (including structural and cohesion funds) for R&D programmes, coupled with the carry-over effect in the current year of the modest 2015 agricultural output. The anticipated dynamics of production factors are fraught with uncertainty surrounding the external environment and, implicitly, the potential volatility of capital flows to the emerging economies in Europe.

Chart 4.7. Economic Sentiment Indicator* and Economic Growth



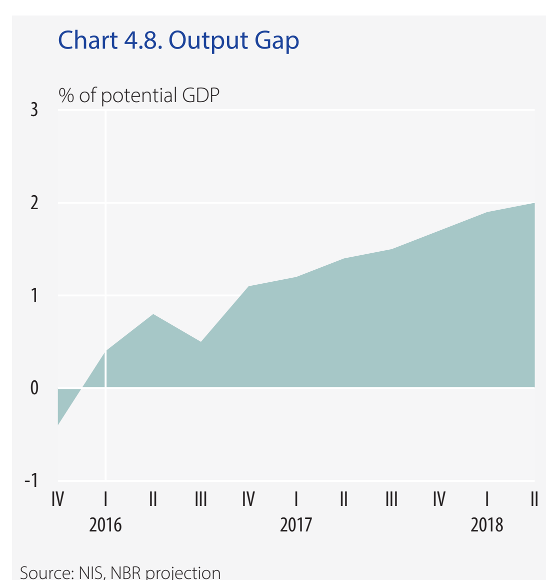
*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

In 2016 Q1, the output gap was revised at positive values as compared to the previous forecasting round, implying, *caeteris paribus*, the earlier emergence of demand-driven inflationary pressures. The revision was mainly due to higher-than-expected GDP growth in 2016 Q1. The assessment of the recent output gap trajectory relies on high-frequency macroeconomic indicators such as the ILO unemployment rate or the capacity utilisation in industry.

The positive output gap is anticipated to widen gradually until the projection horizon (2018 Q2) (Chart 4.8), with upward pressures on consumer prices. This development owes to fiscal easing and public wage policy measures (with demonstration effects on private sector wages), as well as to the progressive closing of the external demand deficit and the stimulative set of real broad monetary conditions. Towards narrowing the positive output gap acts the adverse impact of Brexit (via the effective external demand), whereas in the case of the Law on debt discharge, in force as of mid-May 2016, its effects are still at an early stage of assessment. Compared with the May 2016 Inflation Report, the reassessment of the projected output gap mirrors: (i) the substantially higher GDP dynamics in the first part of the current year; (ii) the slightly less stimulative fiscal policy (via the fiscal impulse), mainly towards the end of the projection interval; (iii) the Brexit unfavourable impact, albeit marked by inherent uncertainty surrounding its assessment, and (iv) the real monetary conditions, which are foreseen to have a somewhat more stimulative influence.

Chart 4.8. Output Gap



Source: NIS, NBR projection

The baseline scenario envisages the economy to advance at a fast pace in 2016, before witnessing a slowdown in the course of 2017. The GDP dynamics owe mostly to consumption, but also to investment. The positive contributions of these components are seen to be mitigated by the expected unfavourable effects of the Law on debt discharge. Given the significant advance in domestic demand, imports of goods and services are expected to rise faster than exports, thus also contributing to the pass-through of the low external prices to domestic prices. Hence, the contribution of net exports to GDP growth is forecasted to be negative, albeit diminishing, over the projection interval.

Aggregate demand components

In 2016 Q1, the actual individual consumption of households picked up 2.9 percent from the previous

quarter, amid the cut in the standard VAT rate. The estimates on the dynamics of this component show further positive growth rates in 2016 Q2 and Q3, albeit decelerating slightly from the first quarter. Household consumption is supported by the continued rise in real disposable income, under the impact of wage hikes (real increase of 2.6 percent in the average net wage economy-wide in April-May 2016 versus the Q1 average). Positive signals also came from retail trade (excluding motor vehicles and motorcycles) and the consumer confidence indicator, which rose by 1.4 percent in April-May and 0.9 points in Q2 respectively as compared with the first quarter average.

Over the forecast interval, the actual individual consumption of households is anticipated to expand swiftly. The forecast shows the impact exerted on the real disposable income of households by fiscal easing and public wage policy measures, as well as by the pay rises expected in the private sector on the back of improvements in economic activity and labour productivity. On the other hand, the implementation of the Law on debt discharge is estimated to have an adverse influence, weighing on household disposable resources, given the changes made by financial institutions to the lending conditions applicable to this category of borrowers. Over the forecast interval, the gap of actual individual consumption of households is assessed to stay in positive territory, under the stimulative impact of fiscal and income policy measures.

The actual collective consumption of general government is forecasted to see positive quarterly growth rates in 2016 Q2 and Q3, yet its increase is assessed to remain consistent with keeping the budget deficit within the target agreed with the European Commission for the current year[68]. Over the projection interval, the actual collective consumption of general government is anticipated to see positive average annual dynamics in both 2016 and 2017.

[68] The 3 percent threshold is also provided for by the nominal convergence criteria in the Maastricht Treaty.

Gross fixed capital formation (GFCF) decreased marginally in 2016 Q1 from the previous quarter, i.e. down 0.3 percent. The dynamics of this indicator are foreseen to revert to positive, albeit modest, values in 2016 Q2 and Q3. This assessment is surrounded by heightened uncertainty, due also to the frequent and significant revisions of the seasonally adjusted historical series. Positive signals on the GFCF dynamics are sent out by new construction works and the turnover of capital goods for the domestic market, which expanded by 3 percent and 7.3 percent respectively in April-May 2016 versus the first quarter average. The decline in the confidence indicator in construction (down 1.5 points in 2016 Q2 from Q1) is seen putting a damper on the GFCF growth.

The projection foresees the GFCF posting further favourable developments throughout the forecast interval, although this indicator will lose momentum in 2016 and 2017, compared to the levels seen in 2015. These dynamics are anticipated in the context of (i) the rise in private investment, particularly by exporters, in response to the medium-term recovery trend in the economic activity of Romania's trading partners and (ii) the improved absorption in the medium run of EU structural and cohesion funds under the Multiannual Financial Framework 2014-2020, with spillover effects on investment. In addition, some fiscal measures, such as the cut in dividend tax and the removal of the tax on special constructions, could release the resources that can be channelled to investment programmes. The persistence of these measures over the medium term is, however, surrounded by uncertainties, particularly in a scenario envisaging the overshooting of budget deficit targets assumed by Romania. On the other hand, this component could be affected depending on the effects, albeit still uncertain, of the Law on debt discharge, owing particularly to the impact exerted on construction. In this context, the recently-opened positive deviation of GFCF against the equilibrium levels over the medium term is anticipated to widen gradually over the forecast interval.

In 2016 Q1, exports of goods and services grew by 2.9 percent quarter on quarter. In 2016 Q2

and Q3, the growth rate of exports of goods and services is estimated to stay in positive territory, yet to decelerate as compared with the first quarter. These dynamics are supported by the favourable prospects for the medium-term economic growth of Romania's trading partners, under the influence of factors such as the persistence of the ECB's quantitative easing measures and the low oil price. Exports of goods and services are anticipated to record positive dynamics over the forecast interval, which will further reflect the persistence of structural improvements seen in recent years[69]. The forecast assumes the gradual recovery of external demand, which is however surrounded by high uncertainty, given the anticipated weaker influence of favourable factors that have been previously manifest (low oil price, the weaker euro at the beginning of 2016 and the fiscal incentives). The real effective exchange rate will have an additional stimulative effect on the forecasted growth rate of exports via price competitiveness. The Brexit spillover effects, the fragile global economic growth and geopolitical tensions are stronger risk factors for external demand in the current forecasting round. Against this background, the deviation of exports of goods and services from the medium-term trend is assessed to see low positive values over the projection interval.

In 2016 Q1, imports of goods and services grew by 3.7 percent quarter on quarter. For 2016 Q2 and Q3 and over the remainder of the forecast interval, imports are forecasted to further record positive dynamics, outpacing those of exports, amid the significant rise in domestic demand. An additional upward influence is exerted by the anticipated favourable evolution of exports of goods and services, through their import content. Against this background, the deviation from the medium-term trend of imports of goods and services is assessed to further see significant positive values.

[69] In the post-crisis period, the share of machinery, apparatus, equipment and transport means in Romania's total FOB exports stayed at levels of at least 40 percent, while services had an increased positive contribution. For the following years, it becomes relevant that domestic production might reach full capacity utilisation in the former sector, the performance of which is conditional on factors such as the expansion of productive capacities and the improvement in the related infrastructure.

In 2015, the balance-of-payments current account deficit rose to 1.1 percent of nominal GDP, on account of the wider deficits on primary income and trade in goods. Behind the increase in the latter case stood the step-up in domestic demand. Over the forecast interval, the current account deficit is expected to widen further. The main determinant of this evolution will be the fast-paced dynamics of imports of goods and services, amid the swift increase in domestic demand, supported by fiscal easing and income increasing measures. In this context, the current account deficit-to-GDP ratio is forecasted to stand at around 2.5 percent over the medium term.

In the short run, international reserves and, generally, the anticipated sources for current account deficit financing are deemed to be adequate and favourably distributed in terms of the nature of capital flows, i.e. non-debt-creating versus debt-creating flows. However, the reopening of the negative current account balance owing to a wider fiscal deficit and the speed-up in consumption could augment Romania's vulnerabilities to a potential rise in the volatility of capital flows to the emerging economies, thus jeopardising domestic macroeconomic equilibria.

Broad monetary conditions

Broad monetary conditions capture the impact exerted on future developments in aggregate demand by the real interest rates in lei applied by credit institutions to their non-bank clients and by the real effective exchange rate[70] of the leu. The exchange rate exerts its influence via the net export channel, as well as via the effects on wealth and balance sheets of economic agents, although the share of foreign currency-denominated credit to the private sector followed a sharp downward trend in recent periods.

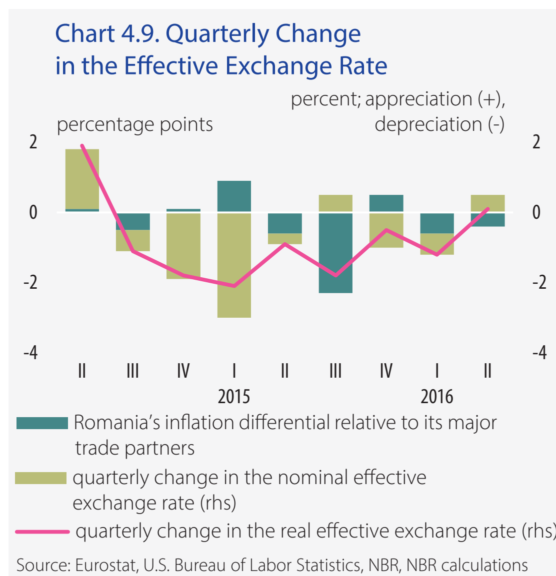
The average nominal interest rates applied by credit institutions to non-bank clients are anticipated to decline marginally in 2016 Q2 and Q3 in the case of leu-denominated new loans and to remain at a

[70] The relevant exchange rate for the NBR's quarterly projection model relies on the EUR/RON and USD/RON exchange rates, according to the weights of the two currencies in Romania's foreign trade.

level slightly lower than that recorded in the first quarter for leu-denominated new time deposits. The cumulative impact on economic activity in the period ahead generated by deviations of real interest rates from their trends is projected to be further stimulative.

In quarter-on-quarter comparison, in 2016 Q2 the domestic currency strengthened slightly in real effective terms, mainly as a result of the nominal appreciation versus the US dollar, while the EUR/RON rate posted small fluctuations (Chart 4.9). The quarterly inflation differential in trading partner countries versus Romania was positive, but on the wane. Overall, the impact of the real effective exchange rate on aggregate demand (via the export price competitiveness) in the periods ahead is assessed to remain stimulative.

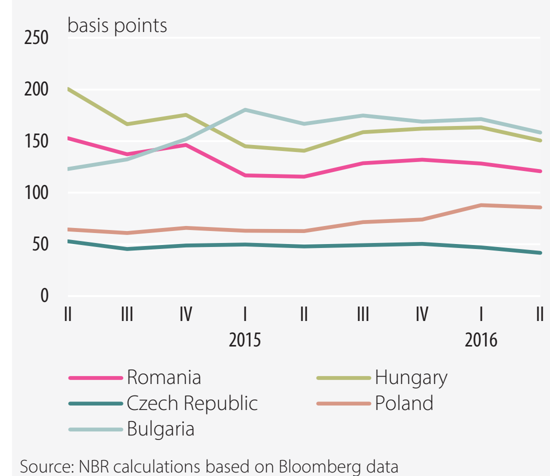
Chart 4.9. Quarterly Change in the Effective Exchange Rate



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

In terms of the wealth and balance sheet effect, in 2016 Q2 and Q3 stimulative influences on future aggregate demand come mostly from the real foreign interest rate standing below the equilibrium level, given the anticipated slightly fluctuating real effective exchange rate. The sovereign risk premium is assessed to stand close to the medium-term trend, exerting a relatively neutral effect. On average, the CDS (Credit Default Swap) quotes for Romania decreased somewhat in 2016 Q2 versus Q1, yet they followed an uptrend towards end-June, amid heightened volatility on global financial markets against the background of the fallout from the Brexit referendum (Chart 4.10). On the one hand, there are persistent uncertainties surrounding the global economic outlook, heightened by those related to the geopolitical implications and the international macroeconomic effects of the UK status in relation to the EU. On the other hand, the ECB's further accommodative monetary policy stance and the Fed's prudent approach to monetary policy tightening contribute to lowering the risk perception. On the domestic front, the risk premium dynamics are further affected by the uncertainty surrounding the fiscal and income policy conduct in the context of this electoral year, as well as by the implications of the Law on debt discharge.

Chart 4.10. 5-year CDS Spreads for Romania and Other Countries in the Region



Source: NBR calculations based on Bloomberg data

Overall, real broad monetary conditions in 2016 Q2 and Q3 are assessed to exert a stimulative impact on economic activity in the following quarters, thus contributing to the increase in inflationary pressures generated by the positive output gap. By component, the stimulative impact stemming from the real effective exchange rate (via export price competitiveness) is prevalent. Additional stimulative contributions come from the wealth and balance sheet effect and the gaps of real interest rates on leu-denominated loans and deposits.

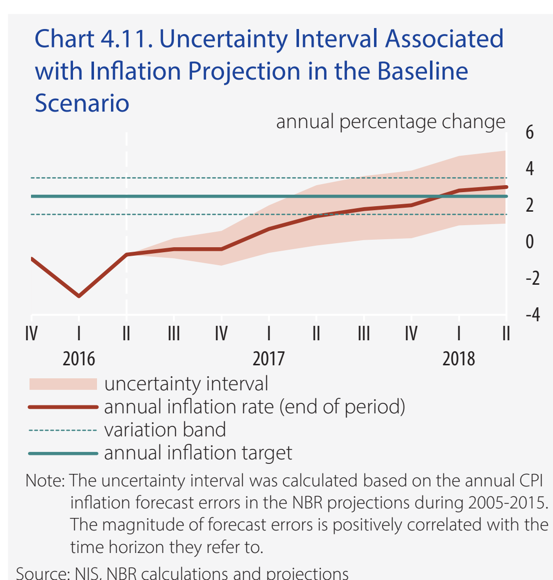
Real broad monetary conditions are forecasted to continue having a stimulative effect on economic activity throughout the projection interval. The prevailing stimulative effect is further exerted by the real effective exchange rate via the export price

competitiveness channel. An additional contribution in the same direction will make the wealth and balance sheet effect, given the low foreign interest rate levels amid the persistence of the quantitative easing programme implemented by the ECB.
The projected path of the monetary policy rate aims to ensure and safeguard price stability over the medium term, in a manner conducive to sustainable economic growth. The prudent monetary policy conduct and the adequate dosage of all its available tools, together with the precautionary measures in the field of prudential supervision of credit institutions, will be calibrated so as to strengthen the resilience to shocks of the domestic economy.

1.4. Risks associated with the projection

Some of the risk factors mentioned in the previous report have recently materialised, especially those associated with the referendum in the United Kingdom (Box 3) and the implementation of administered price adjustments by the relevant authorities, with both factors inducing lower values for the projected inflation (Chart 4.11). However, the balance of risks to the annual inflation rate projection is further assessed as being tilted to the downside compared to the path in the baseline scenario, with risks stemming from both the domestic and external environment.

Chart 4.11. 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 2005-2015. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

The external risk factors became more relevant than in the previous forecasting round. The results of the UK referendum and the higher uncertainties surrounding the period of time needed to clarify this country's status in relation to the European Union, the political situation in Turkey, as well as the difficulties facing the Italian banking system are conducive, to varying degrees, to a pick-up in the volatility of global financial markets. Other sources of risk associated with the external environment which have remained relevant refer to the future evolution of global economic growth, fuelled mainly by the uncertainties about future developments in the economic activity of China and other major emerging economies, as well as by the Greek sovereign debt management over the long term.

Should some scenarios related to such risk sources materialise, the Romanian economy could be affected mostly via indirect channels, considering the impact that such developments could actually have on the effective external demand from the EU, Romania's main trading partner. At the same time, given the adverse consequences on investors' confidence and the rise in global risk aversion[71], this could trigger significant portfolio shifts regionally and/or globally and, implicitly, unpredictable leu exchange rate swings. The latter can lead to a reconfiguration of the inflation path compared to that in the baseline scenario, especially in the context of investors discriminating economies based on their fundamentals. For these reasons, it is necessary to maintain and strengthen the progress achieved over the last years in rooting out major macroeconomic imbalances and improving the resilience to shocks of the domestic economy by adequately implementing consistent macroeconomic policies.

On the domestic front, in the context of the elections to be held during the projection period and of the absence of agreements with the international financial institutions, uncertainties

[71] A slight slowing of capital flows to emerging economies has been recently noticed, in the wake of the UK referendum, indicating a potential heightening of uncertainties worldwide and the deterioration of investor confidence relative to these countries' economic growth prospects.

persist concerning the implementation of an adequate macroeconomic policy mix for ensuring sustainable economic growth and preserving macroeconomic stability. The fiscal policy stance is deemed to be the most significant component of this mix; in this respect, equally relevant is the financing of the public deficit, which is expected to increase considerably in 2016 versus 2015, following the implementation of the Tax Code measures. Other risks stem from the possible implications on the future configuration of fiscal parameters from wage hikes already implemented[72], the increases scheduled for the second half of the current year[73], as well as other potential future rises in the context of the forthcoming elections. Furthermore, the demonstration effects of these hikes on private sector wage dynamics might deepen even more the recent mismatch between pay rises economy-wide and labour productivity gains, thus exerting additional inflationary pressures.

Such risks are even more relevant should structural reforms and public investment be postponed, or should EU funds be insufficiently capitalised upon, triggering direct effects on the growth potential and competitiveness of the Romanian economy. An additional source of risks, highlighted in the previous Inflation Report as well, is the implementation of the Law on debt discharge, in light of the inherent uncertainty surrounding the assessment of its impact on the domestic macroeconomic environment.

Lacking any clear and timely information from the relevant authorities relative to the scale and timing of future adjustments in end-user natural gas and electricity prices, the balance of risks is tilted to the downside, given the possibility that these categories of prices may be in the future subject to cuts similar to those recently implemented. Domestic food price developments are surrounded by inherent uncertainties arising from weather conditions which carry the potential to influence the agricultural produce supply in both ways. A new risk to the annual inflation rate is the impact that the Law setting forth that large retailers should trade 51 percent of the food items from the short food supply chain[74] may have on the CPI basket.

The balance of risks induced by the future path of international commodity prices (food and energy included) to the inflation outlook is seen to be tilted to the downside. The assessment builds on the levels close to record lows of commodity price inflation, which may persist in the future amid an oversupply of such goods[75] combined with sluggish global demand[76] and the removal, in the medium run, of the adverse effects which impacted world supply, especially that of petroleum products. At the same time, depending on the direction and magnitude of the reconfiguration of the future monetary policy stances pursued by the world's major central banks, the EUR/USD exchange rate developments could have different effects on the USD/RON exchange rate from those in the baseline scenario and, hence, on the oil price expressed in domestic currency.

[72] Public sector wage hikes (by 25 percent in October 2015 in the health sector, by 15 percent in December 2015 across-the-board in the education sector and by 10 percent in December 2015 in the public sector except education and public health sectors), as well as the increase by RON 200 in the minimum wage in May 2016.

[73] Pursuant to Government Emergency Ordinance No. 20/2016 amending and supplementing Government Emergency Ordinance No. 57/2015 on public sector employees' pay in 2016, effective since 9 June 2016.

[74] Law No. 150/2016 amending and supplementing Law No. 321/2009 on the trade of food items.

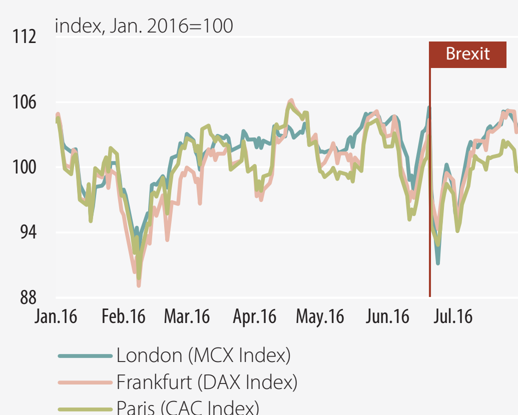
[75] For instance, the agri-food oversupply on the EU market following Russia's ban on such imports.

[76] Among the factors that can lead to a pick-up in the international oversupply of oil are the likely persistence of the effects caused by the measure to lift the economic sanctions against Iran – a country ranking fourth worldwide in terms of reserves –, the economic prospects for emerging economies, particularly China and the problems facing the capital market in this country, as well as the further large crude oil stocks in the USA given OPEC's abandoning its current system of fixed crude oil production quotas.

Box 3. The impact of the Brexit referendum result on macroeconomic developments in Romania

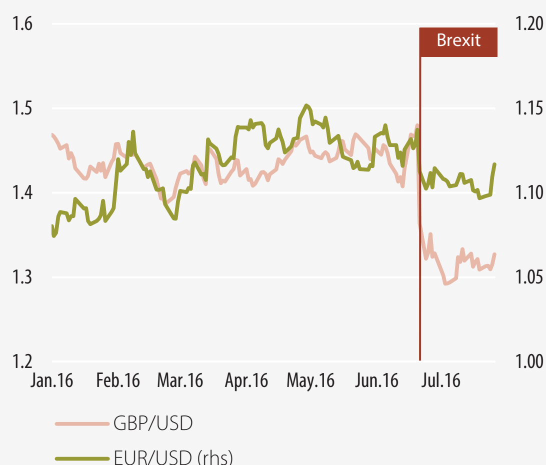
On 23 June 2016, the United Kingdom voted to leave the EU, an event with highly uncertain geopolitical and economic implications worldwide. This decision fallout is currently difficult to assess, given the numerous unknowns, all the more so as this is an unprecedented process in EU history. The most plausible scenario sees Britain's separation from the EU taking relatively long to complete, namely about two years from the moment Article 50 of the European Union Treaty is cited.

Chart A. Main Stock Exchange Indices in Europe



Source: London Stock Exchange, Börse Frankfurt, Euronext, NBR calculations

Chart B. GBP and EUR Exchange Rates



Source: Federal Reserve System

The immediate effects, that occurred amid the increase in risk aversion, referred to falls in the main stock exchange indices in Europe (Chart A) and the shift in some financial capital flows to safe haven countries, such as the USA or Switzerland, which triggered the substantial depreciation of the pound sterling and, to a lower extent, of the euro versus the major international currencies (Chart B). Although these evolutions saw a correction subsequently it is possible that they re-emerge in the future, depending on the manner negotiations are carried out during the separation process. No major adverse impact has been felt so far on financial markets in Romania.

Looking ahead, Romania's economy can be affected both directly and indirectly. Direct influences can be passed through via: trade, the financial channel, labour migration and remittances; indirect channels refer to possible contagion effects coming from a worsening of the political and economic context in the EU. The latter effects may have a relatively stronger impact, as the likely adverse bearing on the United Kingdom's main trading and financial partners in the EU (especially in the context of a worsening of investor sentiment) carries the potential to affect the Romanian economy too, given its high integration with the European bloc.

The risks arising from direct economic relationships are rather low. Accordingly, in 2015, exports to the United Kingdom accounted for 4.35 percent of Romania's total exports of goods, while imports from the UK carried 2.5 percent of total imports. Moreover, the local economy's exposure to the value added absorbed in the United Kingdom (calculated based on the fact that goods imported by this country can incorporate value added created in Romania, without their being subject to a direct trade relationship) is limited, namely below 2 percent of GDP. Consequently, both the worsening of the British economy's outlook and the likely tariff hikes or imposition of non-tariff barriers to trade with this country are expected to have a modest impact on Romania's trade via the direct channel.

The analysis of financial ties between Romania and the United Kingdom covers several aspects. Thus, the market share of Romanian credit institutions with British capital is insignificant, implying a low direct exposure of the Romanian banking system to that in the UK, although indirect exposure via the EU banking system is quite important. At the same time, according to the latest statistics[77], foreign direct investment in Romania by British entities held only 2.5 percent of total FDI and 1 percent of GDP (EUR 1.5 billion) at end-2014. Therefore, UK's exit from the EU does not pose a significant risk for such capital to be withdrawn from Romania, given also the higher resilience of these categories of financial flows. Financing from EU sources will not be affected for as long as the United Kingdom continues to be an EU Member State with full rights (over the next two years at least). Subsequently, the amount of EU funds earmarked for Romania will depend on the manner in which the United Kingdom will negotiate its financial position towards the EU[78] – limiting the contributions of this state to the EU budget has become relevant for Romania in the context of the recent improvement in the absorption rate (up to 75 percent for the 2007-2013 financial period), even if absorption is still lower than in other new Member States (90 percent in Poland and Hungary).

Based on Eurostat data, the number of Romanian immigrants in the United Kingdom amounted to approximately 178,000 in 2015, accounting for about 6.7 percent of total Romanian immigrants in Europe, trailing behind countries such as Italy, Spain or Germany. Depending on future events, should part of Romanian immigrants with residence permits in the United Kingdom return to Romania, the economic impact would be positive, but rather low. Relative to future developments of emigration to the United Kingdom, this would have dropped in the medium run even in the absence of Brexit, since on the occasion of the European Council meeting of 18-19 February 2016, a decision was taken to restrict new EU immigrants' access to social benefits for a seven-year period as of 2020[79]. Following the British labour market opening in 2014, remittances[80] were on a strongly upward trend, coming in at roughly EUR 500 million in 2015 (one fifth of total remittances by Romanian workers abroad and approximately 0.3 percent of Romania's GDP).

Looking at indirect influences, various studies and surveys among financial analysts (for instance, *Consensus Economics*) suggest that the actual Brexit, leaving aside other domino effects on the EU, would depress the economic growth rate across the EU by up to 0.4 percentage points until the macroeconomic projection horizon in the baseline scenario. In this case, the NBR's in-house assessments hint at an economic slowdown in Romania by approximately 0.2 percentage points via the trade channel for 2017 and a fall by about 0.1 percentage points in the CPI inflation rate for the end of the same year.

Should Brexit trigger a weakening of the European project across EU institutions, the contagion effects on the new non-euro area Member States could be stronger – large capital outflows, sharper exchange rate volatility, the materialisation of shocks on financial systems as a result of the deterioration of investor sentiment vis-à-vis these economies, a slowdown in local economic activity via the trade channel.

[77] *Foreign Direct Investment in Romania in 2014*, the National Bank of Romania.

[78] Based on the settlement negotiated with the EU, the United Kingdom could contribute further to the EU budget or grant non-repayable assistance to the new EU Member States.

[79] This settlement would have taken effect if the United Kingdom had remained in the EU.

[80] Comprising net inflows from "compensation of employees" and "workers' remittances from abroad" in the balance of payments.

2. Policy assessment

In line with the forecast, the annual inflation rate went deeper into negative territory in the first part of 2016 Q2, reaching -3.5 percent in May[81], before witnessing a steep upward correction in June, amid the fade-out of the direct impact of broadening the scope of the reduced VAT rate to all food items[82], to stand at -0.7 percent. The sharper decline in the annual inflation rate and its subsequent stay in negative territory were almost entirely due to the two categories of volatile prices[83] and to administered prices, whose annual dynamics posted more negative readings/remained unchanged at negative levels during this period. By contrast, the annual adjusted CORE2 inflation rate returned to positive territory (0.4 percent) in June, after having recorded a more negative reading April through May (-4.9 percent). Aside from the stronger base effect associated with the 2015 broadening of the scope of the reduced VAT rate, the developments in core inflation reflected the influences of the reversal of the cyclical position of the economy in 2016 Q1, as well as the significant opposite effects generated by the subdued/negative dynamics of consumer prices and some producer prices in the euro area – also against the background of higher imports – and by the downward readjustment of inflation expectations. Hence, net of the one-off impact of the cut in the standard VAT rate, the annual adjusted CORE2 inflation rate remained unchanged in June versus March at 1.3 percent, whereas the annual headline inflation went down from 1.2 percent to 0.7 percent, when recalculated in a similar manner.

In this context, the update of the forecast of medium-term macroeconomic developments – by incorporating the latest available data and information – points to a markedly lower-than-previously-anticipated annual inflation rate path, which, however, preserves the same divergent nature as in the earlier projection rounds.

[81] The standard VAT rate was lowered from 24 percent to 20 percent as of 1 January 2016.

[82] June 2015 had seen the broadening of the scope of the 9 percent reduced VAT rate to all food items, non-alcoholic beverages and food service activities.

[83] Volatile food prices and fuel prices.

In particular, the inflation rate trajectory is seen remaining over the short term comfortably below the lower bound of the variation band of the flat target – staying in negative territory, around -0.4 percent, until December 2016[84] –, before climbing to the upper half of the band in 2018 and reaching 3 percent at the end of the projection horizon, only slightly below the previous forecast's reading of 3.3 percent. According to the updated developments, the average annual inflation rate is expected to fall to -1.5 percent (from -1.0 percent previously) and to 1.4 percent (from 2.2 percent) in 2016 and 2017 respectively.

With the expected impact of the successive cuts in the standard VAT rate across the projection horizon remaining unchanged[85], the key role in reshaping the forecasted inflation pattern is played by supply-side/cost-push global disinflationary shocks, consisting in large and persistent declines in international commodity prices, particularly of energy and agricultural produce; in the context of the updated projection, they have stronger direct and indirect effects on the domestic front via a multitude of channels, including through imports of consumer and intermediate goods, anticipated to rise and therefore widen the trade deficit.

The strengthening of these effects is primarily reflected by the projections for the main exogenous CPI components – fuel prices, volatile food prices and administered prices –, which witness significant downward adjustments in the current projection, especially over the short term. The updated forecast of core inflation is also affected to a larger extent by global disinflationary shocks, *inter alia* amid the persistence of a negative output gap in the euro area/the EU, and by the relatively lower inflation expectations, albeit on an upward trend. However, their impact is partly counterbalanced by the stronger inflationary pressures anticipated to emerge from the faster widening of the positive output gap across the projection horizon – given

[84] Recalculated net of the one-off impact of the standard VAT rate cut at the beginning of 2016, the annual inflation rate is forecasted to end the current year at 0.8 percent, versus 1.9 percent in the previous projection.

[85] The new Tax Code sets forth the cut in the standard VAT rate to 19 percent and the removal of the special excise duty on fuels as of 1 January 2017.

the early reversal of the cyclical position of the economy[86] – and from the fast dynamics of unit wage costs extending over the short term. Aside from the recent step-up in economic growth, this outlook has as premises and assumptions the further easing of the fiscal and income policy stance – mainly via indirect tax adjustments and public sector pay rises[87] – and the preservation of stimulative real monetary conditions, which are seen offsetting the opposite influences expected to be exerted by the Law on debt discharge and the persistence of modest economic growth in the euro area, also as an effect of the UK vote. Key premises on the domestic front also include the recently manifest labour market tightening trend, as well as the pick-up in the dynamics of broad money, fuelled by the quick rise in its most liquid component (M1); against this background, the updated path of the forecasted annual adjusted CORE2 inflation rate falls considerably from the previously projected readings, yet the upward trend that it enters starting in 2017 Q1 becomes steeper, to reach 2.8 percent in December 2017 (versus 3.4 percent in the previous forecast) and 3.4 percent at the end of the projection horizon (against 3.7 percent previously).

The new configuration of the inflation outlook and its determinants warrant the preservation, at this juncture, of the current monetary policy stance with a view to ensuring price stability over the medium term, in a manner conducive to achieving sustainable economic growth, relatively consistent with the monetary policy cycles of central banks in the region and the euro area. Such an approach is also warranted by the dual nature of the high uncertainties about developments in inflation fundamentals – posing two-way risks to the longer-term inflation outlook –, as well as by the relatively low capacity of recent/future supply-side shocks to have a lasting effect on medium-term inflation expectations, and hence on CPI performance over a longer time span.

[86] In 2016 Q1.

[87] According to Government Emergency Ordinance No. 20/2016 amending and supplementing Emergency Ordinance No. 57/2015 on public sector employees' pay in 2016.

In particular, the inflation forecast is further marked, on one hand, by the significant uncertainty surrounding the future fiscal and income policy stance, generating upside risks to the medium-term inflation outlook, given the nature of the recently-implemented measures – in the areas of taxation, public sector wages and social benefits – and especially of the measures that might still be approved in the context of the electoral year. The relevance of these risks is enhanced by the uneven pace of carrying out public investment and structural reforms, by the relatively weaker absorption of EU funds amid the new multiannual financial framework, as well as by some structural features of the labour market, which may affect the growth potential and competitiveness of the domestic economy if they persist. Against this backdrop, an additional easing of fiscal and income policies would carry the potential to increase, across the projection horizon, both the inflationary pressures stemming from the positive output gap and the unit wage costs in the corporate sector, via demonstration effects, while also leading to a further widening of the current account deficit. This could entail the worsening of investor sentiment vis-à-vis the Romanian economy and the local financial market, with a detrimental impact on foreign financing costs and the behaviour of the leu exchange rate, especially in a volatile international environment.

On the other hand, the forecast continues to be surrounded by heightened uncertainty about global economic growth and the euro area economic recovery. Initially fuelled by the weakening of the Chinese economy and of other major emerging economies and recently compounded by the outcome of the UK referendum, as well as by geopolitical tensions and challenges to the European banking system, this uncertainty generates substantial downside risks to the inflation outlook, which might materialise both through import prices and especially through the additional contractionary effects exerted on the cyclical position of the Romanian economy[88] over the medium term. Similar effects might also stem from

[88] Mainly via the foreign trade, financial and confidence channels.

the Law on debt discharge – assuming a stronger-than-expected impact on lending, and hence on domestic demand dynamics across the forecast horizon –, as well as from other legislative initiatives designed to regulate the banking and financial areas through retroactive intervention in the contracts between banks and clients, should these initiatives be passed.

Supply-side factors also generate primarily disinflationary risks over the short projection horizon, mainly due to a potentially protracted period of global commodity prices – oil prices in particular – staying below expectations. Such a context might translate into renewed downward deviations of domestic inflation from the forecasted coordinates, *inter alia* through pass-through effects onto the prices of other import categories, as well as through direct/indirect influences on administered price adjustments. As an exception, the potential coming into force of the law setting forth that large retailers should trade 51 percent of the food items from the short supply chain[89] is seen as a source of upside risks to the inflation forecast over the short term, which are however likely to be cushioned in 2016 by a better-than-expected agricultural output.

Considering the features of the projected path of the annual inflation rate and its determinants, as well as the related risks arising from the future fiscal and income policy stance and from the uncertainty surrounding global economic growth and euro area economic recovery, the Board of the National Bank of Romania decided, in its meeting of 4 August 2016, to keep unchanged the monetary policy rate at 1.75 percent per annum. Moreover, the Board decided to further 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.

[89] Law No. 150/2016 amending and supplementing Law No. 321/2009 on the retail trade of food items.

Abbreviations

APIA	Agriculture Payments and Intervention Agency
CEE	Central and Eastern Europe
CPI	consumer price index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
EU	European Union
Eurostat	Statistical Office of the European Union
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
ILO	International Labour Office
IMF	International Monetary Fund
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
OECD	Organisation for Economic Co-operation and Development
ROBOR	Romanian Interbank Offer Rate
UVI	unit value index
VAT	value added tax
VFE	vegetables, fruit, eggs
1W	1 week
3M	3 months
12M	12 months
3Y	3 years
5Y	5 years
10Y	10 years

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