NATIONAL BANK OF ROMANIA

Inflation Report

November 2016

Year XII, No. 46

Inflation Report
November 2016

Year XII, No. 46

N O T E

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

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

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

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

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 November 2016 and the cut-off date for the data underlying the macroeconomic projection was 31 October 2016.

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

Contents

SUMMARY

Developments in inflation and its determinants

At end-2016 Q3, the annual inflation rate remained negative at -0.6 percent, up from -0.7 percent at end-Q2. The still negative value is attributable to the persistence of the effect induced by the decision to lower the standard VAT rate from 24 percent to 20 percent – with an impact on the prices of most CPI basket components (except for food prices). At the same time, in September 2016, the annual CPI inflation rate stood marginally below the value forecasted in the previous *Report* amid the larger decrease in volatile food (VFE) prices and the relative appreciation of the domestic currency in July-September. The average annual HICP inflation rate[1] rose in Q3 (to reach -1.3 percent in September) as the annual changes affected by broadening the scope of the reduced VAT rate as of June 2015 gradually dropped out of its calculation.

Excluding the first-round effects of the VAT rate cut, the annual inflation rate entered a slightly upward path, climbing from 0.7 percent in June to 0.8 percent in September, but remained below the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target. Behind this evolution stood the higher positive values of the annual adjusted CORE2 inflation rate[2] and of the annual dynamics of tobacco product prices, as well as the significantly slower annual rates of decline of fuel prices and volatile food prices. The developments in administered prices were the only notable source of disinflation over the same period.

At end-2016 Q3, the annual adjusted CORE2 inflation rate came in at 0.5 percent, against 0.4 percent in June. The path is in line with the increase in excess demand in the economy and the relative mitigation in the disinflationary influence generated by the external environment, in the context of an upward trend in main commodity prices (of oil, agri-food products). Net of the impact of the VAT rate change, the annual core inflation rate followed the same moderately upward trend in June to September (reporting a cumulative 0.1 percentage point increase) to reach 1.4 percent at end-Q3.

In 2016 Q2 as a whole, the annual growth rate of unit wage costs in industry remained fast-paced, at 8.6 percent, similarly to the previous quarter, given that the step-up in the wage dynamics, attributed primarily to the hike in the gross minimum wage in May, was offset by the current more favourable developments in labour productivity. The persistence of high unit wage costs over the last quarters hints at a build-up of inflationary pressures, as well as at the potential erosion of domestic producers' external competitiveness, especially in labour-intensive industries.

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

In its meeting of 4 August 2016, the NBR Board decided to keep the monetary policy rate at 1.75 percent per annum. The quarterly forecast anticipated the inflation rate to remain on an upward path, amid inflationary pressures stemming from the positive output gap and unit labour costs. Thus, the projected annual inflation rate trajectory was seen staying in negative territory until end-2016 and then returning inside

[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.

the variation band of the target during 2017 to stand in the upper half thereof at the projection horizon (2018 Q2).

The risks associated with the projection stemmed from both the domestic and the external environment. On the domestic front, the risks related to the fiscal and income policy stance. The external environment was fraught with high uncertainties concerning the global economic growth and the euro area economic recovery, amplified by the anticipated effects of the referendum in the United Kingdom, the geopolitical tensions and the difficulties facing the EU banking system.

Subsequent to the decision taken in early August, the statistical data revealed a rise in the annual CPI inflation rate, in line with expectations, whereas core inflation saw only a moderate pick-up. The annual economic growth was above expectations in 2016 Q2 (6 percent), on account of the advance in household consumption and investment.

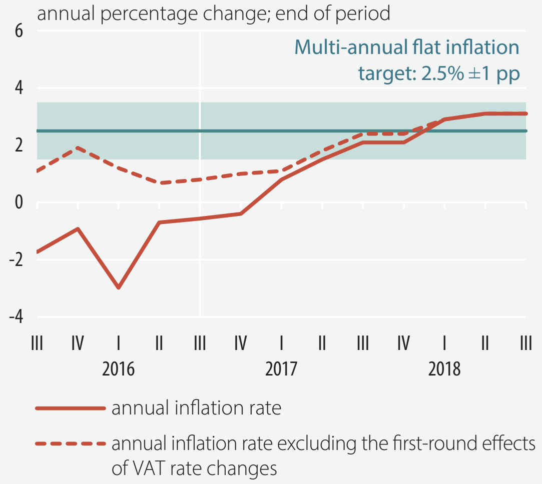
In the Board meeting of 30 September 2016, the updated short-term outlook on inflation reconfirmed its remaining in negative territory until year-end. The inflation rate was anticipated to climb gradually thereafter and return inside the variation band of the flat target in 2017 H2. The risks to the inflation outlook were further high, originating in both the domestic and the external environment.

Based on the data available at that time and in the context of these heightened uncertainties, the NBR Board decided to keep the monetary policy rate at 1.75 percent per annum and to further pursue adequate liquidity management in the banking system. At the same time, given the contraction in foreign currency lending, the consolidation of the adequate level of forex reserves and their improved composition, the NBR Board decided to cut the minimum reserve requirements ratio on foreign currency-denominated liabilities of credit institutions to 10 percent from 12 percent starting with the 24 October – 23 November 2016 maintenance period. The minimum reserve requirements ratio on leu-denominated liabilities was kept at 8 percent.

Inflation outlook

The annual CPI inflation rate is seen on the rise throughout the forecast interval, from -0.4 percent at end-2016 to 2.1 percent at the end of 2017 and 3.1 percent at the projection horizon, i.e. 2018 Q3. Compared to the previous *Report*, the projection has been revised upwards by 0.1 percentage points for year-end 2017, amid stronger anticipated inflationary pressures from domestic fundamental drivers of adjusted CORE2 index. The projected levels of CPI inflation will further be marked by the fiscal easing measures, by the higher disposable income, partly due to the income policy, as well as by developments in main commodity prices on international markets.

Inflation Forecast



Source: NIS, NBR projection

The alternative measure of the annual CPI inflation rate, calculated by excluding the transitory first-round effects of the successive VAT rate cuts, which are beyond the scope of the monetary authority, is projected to reach 1 percent at end 2016 and 2.4 percent at the end of 2017. The two inflation measures will overlap as of January 2018, once the transitory effects of fiscal measures have faded out.

The baseline scenario envisages faster economic growth this year. For 2017, economic growth is anticipated to further outpace the potential GDP dynamics, albeit recording lower levels than in 2016, once the impact of the wage and fiscal stimuli on domestic demand components has abated and amid the effects of the Brexit on external demand for Romanian products. Consumption and investment will remain the key drivers of economic growth. The forecasted dynamics of the actual individual consumption of households will reflect the diminishing impact exerted on real disposable income by fiscal easing and public wage policy measures, as well as by the anticipated pay rises in the private sector, in correlation with the projected dynamics of labour productivity. At the same time, the upbeat performance of gross fixed capital formation is seen consolidating throughout the forecast interval, given: (i) the further absorption of EU structural and cohesion funds, the loss of momentum during 2017[3] notwithstanding, and (ii) the favourable lending conditions, supportive of the advance in private sector investment. A positive influence will also come from the set of real monetary conditions, foreseen to be stimulative throughout the reference interval.

With domestic demand projected to rise, particularly this year, imports of goods and services are seen expanding at a faster pace than exports, thereby contributing to the current account deficit stabilising at around 2.5 percent of GDP over the medium term. International reserves and, generally, the anticipated sources of financing the current account deficit, mainly non-debt-creating flows (foreign direct investment and capital transfers), are deemed to remain adequate. Nevertheless, the reopening of the current account deficit due to the speed-up in consumption and to a wider fiscal deficit holds the potential, in the event of rising volatility of capital flows to the emerging economies, to jeopardise Romania's macroeconomic equilibria.

In view of the stronger-than-expected GDP growth in 2016 Q2, the positive output gap has been revised to higher readings than in the previous forecasting round. Excess demand will increase until the projection horizon, under the impact of the expansionary fiscal policy stance, higher private sector income, gradual narrowing of the external demand deficit, as well as of the stimulative real broad monetary conditions.

Annual adjusted CORE2 inflation rate is expected to reach 0.5 percent at the end of 2016 and 3 percent at end-2017, before standing at 3.7 percent at the end of 2018 Q3. The dynamics of this component primarily mimic those of the output gap, as well as the upward trajectory of economic agents' inflation expectations and the softer disinflationary pressures from import prices. Net of the first-round effects of the VAT rate changes, the annual core inflation rate is projected to reach 1.4 percent and 3.1 percent at end-2016 and end-2017 respectively.

The upward revision – compared with the previous forecasting round – of the projected annual adjusted CORE2 inflation rate mainly reflects stronger inflationary pressures anticipated from aggregate demand and faster expected increases in processed food prices, given the latest developments on this segment across Europe.

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

The balance of risks to the annual inflation rate projection is assessed to be in equilibrium amid the relatively divergent influences associated with risks stemming from the domestic and external environment.

On the domestic front, uncertainties persist with regard to the consistent implementation of the macroeconomic policy mix required for preserving macro-stability and ensuring lasting economic growth. Risks are associated, on one hand, with the possibility that this year's budget execution might differ from that assumed in the baseline scenario and, on the other hand, with the uncertainty surrounding the future building of the budget over the forecast interval. From this perspective, a source of concern is the impact that the legislative acts already adopted or in the process of being

[3] Amid moving into the new Multiannual Financial Framework (2014-2020).

adopted, which aim to implement further fiscal stimuli or income policy measures, might have on the future building of fiscal parameters. In this context, the possible sluggishness of public investment and structural reforms would entail a deterioration of the growth potential and competitiveness of the domestic economy. In addition, a reversal of fiscal consolidation and therefore the worsening of the external position could prompt foreign investors to reassess the degree of risk associated with the Romanian economy.

On the external front, the uncertainty surrounding the implementation of the Brexit procedure carries the potential – alongside the uncertainties about the future developments in the economic activity of emerging markets – to weigh on global demand and hence on EU demand for Romanian products. In the event that these external risks materialise, all the more so in a simultaneous manner, the cyclical position of the domestic economy would be negatively affected, inducing downward pressures on inflation. Looking at the financial sector, there are persistent uncertainties about tackling the challenges facing the European banking system, the Italian one in particular, to which adds the impact – difficult to quantify – of the potential issues with Deutsche Bank (a global systemically important financial institution). Moreover, a possible increase in the divergence between the Fed's and the ECB's monetary policy stances is further relevant, with adverse effects on global financial market volatility. Thus, portfolio shifts that might occur regionally and/or globally and the ensuing unpredictable leu exchange rate swings could exert an opposite, upward impact on the inflation path projected in the baseline scenario.

Against this background, it is essential to maintain and consolidate the progress achieved over the recent years in rooting out major economic imbalances and improving the resilience of the domestic economy by adequately implementing consistent macroeconomic policies.

Turning to administered prices, in the absence of any clear information from the relevant authorities concerning the scale and timing of future adjustments in natural gas and electricity prices for end-users, the balance of risks is tilted to the downside, given the price cuts implemented in 2016 and the possibility of applying a reduced VAT rate on these goods.

The balance of risks envisaged for the trajectory of international commodity prices (food items) is tilted to the downside, reflecting the possibility of persistent agri-food oversupply following Russia's ban, if the support measures for producers shut out of this market generate more muted effects than anticipated in the baseline scenario. As for energy commodity prices, the potential implementation of the agreement among OPEC members to cut oil production is likely to prevent future downward adjustments in oil prices.

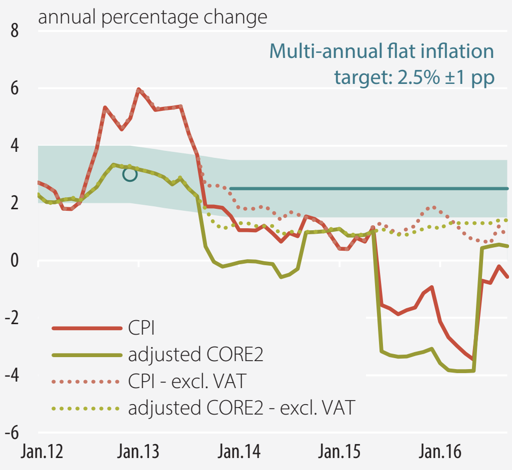
Monetary policy decision

Considering the characteristics of the projected path of the annual inflation rate and its determinants, as well as the related risks and uncertainties, arising from the building of the 2017 budget and from the outlook for global economic growth and euro area economic recovery, the Board of the National Bank of Romania decided, in its meeting of 4 November 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

In 2016 Q3, the annual inflation rate posted less negative values, reaching -0.57 percent. Although still running below the lower bound of the ±1 percentage point variation band of the 2.5 percent target, the annual dynamics of consumer prices (excluding the direct effect of the VAT rate cut in early 2016) halted their decline, recently embarking on a slightly upward path (+ 0.1 percentage points, to 0.8 percent in September). This trend is supported by emerging first signals of waning disinflationary influences exerted by the external environment, with a gradually weaker potential to offset upward pressures building up on the domestic front (as excess demand increases). Moreover, a slight upward adjustment of inflation expectations was visible towards end-quarter. In this context, adjusted CORE2 inflation (net of the direct effect of fiscal changes) climbed to 1.4 percent at the end of the period under review (Chart 1.1).

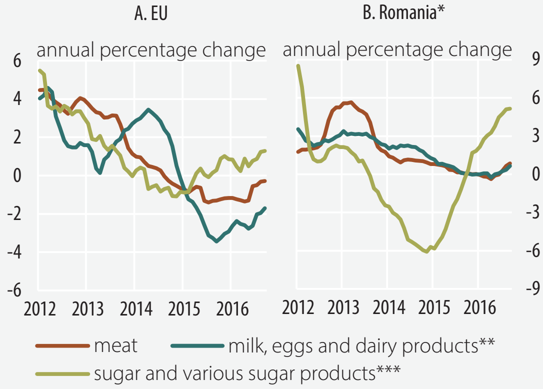
Chart 1.1. Inflation Developments



Source: NIS, NBR

Food items reported more pronounced price increases in annual terms, especially for some processed staples such as sugar, milk and dairy products, meat. Prices of these products actually saw a reversal in their downward trend at EU level as well, amid the gradually manifest effects of the narrowing oversupply (milk, meat) or even of a shortfall (sugar), owing partly to the implementation across the EU in recent years of a support scheme for producers directly and indirectly affected by the closing of the Russian market (Chart 1.2).

Chart 1.2. Staple Food Prices



*) annual changes net of first-round effects of the VAT rate cut

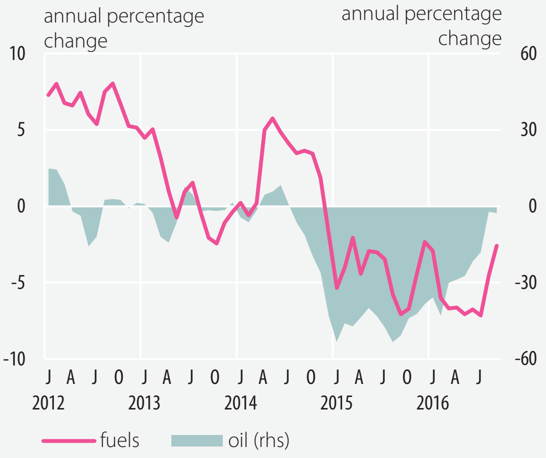
**) RO: excluding eggs

***) EU: broader range of products in line with Eurostat methodology

Source: Eurostat, NIS, NBR estimates

At the same time, following the steady decline in recent years, developments in international prices of most commodities point to a recovery, their annual rate of change increasing from two-digit contractions at end-Q2 (-22 percent for oil) to near-zero values in September. This was directly mirrored in the domestic prices of petrol and diesel, entailing a markedly slower decline in fuel prices (+4.2 percentage points, to -2.6 percent). Looking ahead, depending on the persistence of recent trends, this significant disinflationary influence that has so far helped in offsetting domestic inflationary pressures is seen to fade (Chart 1.3).

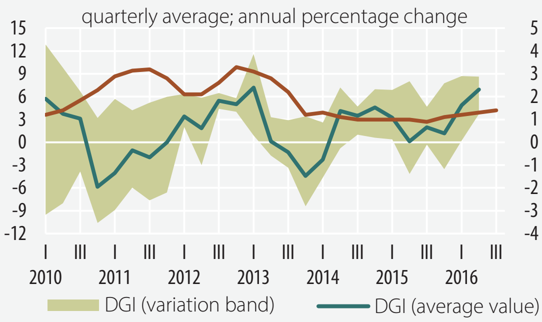
Chart 1.3. Domestic Fuel Prices and International Oil Prices



Source: Bloomberg, NIS, NBR calculations

On the domestic market, the positive output gap has been widening further, pointing to upward price pressures building up. The various measures of the domestically generated inflation (DGI), namely unit labour costs economy-wide, unit wage costs in industry, as well as the GDP deflator, that basically reflect the developments in companies' costs and profit margins, have recently witnessed an upward trend, with growth rates ranging between 3.7 percent and 8.6 percent in 2016 Q2 (Chart 1.4). Hence, given the empirically-observed connection between these measures and the adjusted CORE2 index[4], consumer prices are also expected to eventually mirror recent trends. 2016 Q3 saw incipient signs of a rise in core inflation (+ 0.1 percentage points to 0.5 percent, and 1.4 percent respectively, net of the direct impact of the latest VAT rate cut in January 2016). The breakdown shows a gradual broadening of the range of non-food items whose prices tend to pick up at a (thus far slightly) faster pace than that reported in the previous quarter – wearing apparel and footwear, books, newspapers and periodicals, and some medical items. As regards food items, a significant contribution to the recent price increases, apart from the stronger domestic consumption, came also from the above-mentioned supply-side factors. Conversely, market services prices fell marginally, in line with the strengthening of the domestic currency against the euro July through September.

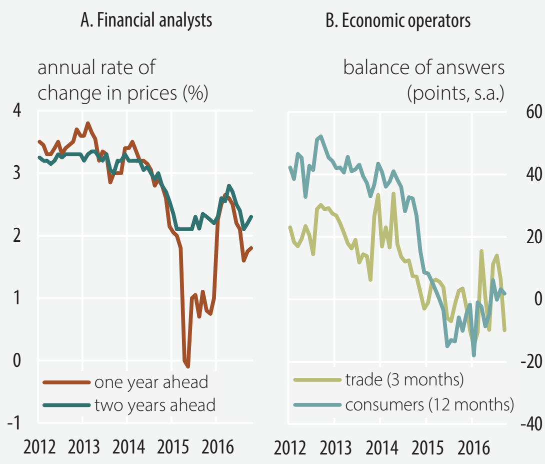
Chart 1.4. Domestically Generated Inflation* (DGI) and Adjusted CORE2



*) calculated based on the annual dynamics of the unit labour cost economy-wide (based on the number of persons employed and the number of hours worked respectively), the unit wage cost in industry and the GDP deflator

Source: Eurostat, NIS, NBR calculations

Chart 1.5. Price Expectations



Source: NBR survey among financial analysts, DG ECFIN/NIS Survey

In 2016 Q3 as a whole, developments in administered prices were the sole notable source of disinflation. Their annual dynamics fell deeper into negative territory (down 2.5 percentage points to -4.7 percent) under the impact of the change in energy prices in July. Behind this stood the shift in market conditions leading to the freeze in implementation of the natural gas market deregulation calendar until March 2017

[4] Positive relationship between developments in the various DGI measures and the future dynamics of adjusted CORE2 index over a roughly one-year horizon (confirmed by the statistically significant correlation coefficients and the Granger-causality tests).

and the decline in transportation costs. To these added the lower electricity price, the impact of further market deregulation being offset by a new downward adjustment in the competitive market price, as well as by the decline in the contribution for high-efficiency cogeneration and in transmission tariffs.

The downtrend in financial analysts' inflation expectations came to a halt in 2016 Q3, as they have recently witnessed rises, excluding those for the very near term (current year-end). Thus, over the latter horizon, economic agents in industry, construction and services sectors maintain their expectations of relative price stability. On the other hand, no clear trend can be inferred from the opinions of trade companies, which likely reflects the high degree of uncertainty in the period prior to the actual implementation of the latest changes to the legislation in this field. Over a longer time span (12 months), the balance of consumers' answers is further moderately positive (Chart 1.5).

The average annual HICP inflation rate returned on an upward path in Q3, as the first annual changes affected by the first-round effect of the VAT rate cut as of June 2015 dropped out of its calculation, rising to -1.3 percent in September. The negative differential versus the EU average narrowed to -1.4 percentage points, this movement being partly offset by the higher inflation across Europe, on the back of oil price developments.

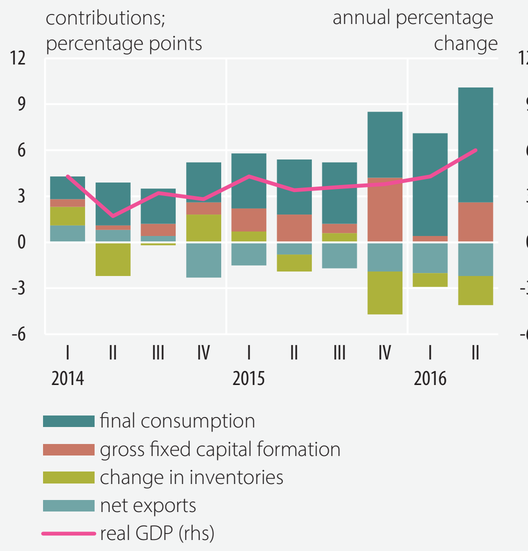
The annual rate of change of consumer prices stood 0.17 percentage points below the level forecasted in the August 2016 *Inflation Report*. Behind this development stood mainly the larger decrease in volatile food (VFE) prices and the relative appreciation of the domestic currency in July-September.

2. ECONOMIC DEVELOPMENTS

1. Demand and supply

The stronger domestic absorption in 2016 Q2 (+8.2 percent) led to a further acceleration in the annual growth rate of economic activity, to 6 percent (Chart 2.1). The advance in demand was ascribable particularly to households and was only partly accommodated by domestic supply, given that consumer behaviour and the relative price movements gave an additional boost to imports. Nevertheless, the erosion effect on real GDP dynamics was cushioned by the pick-up in exports of goods, coupled with the rise in receipts from external services.

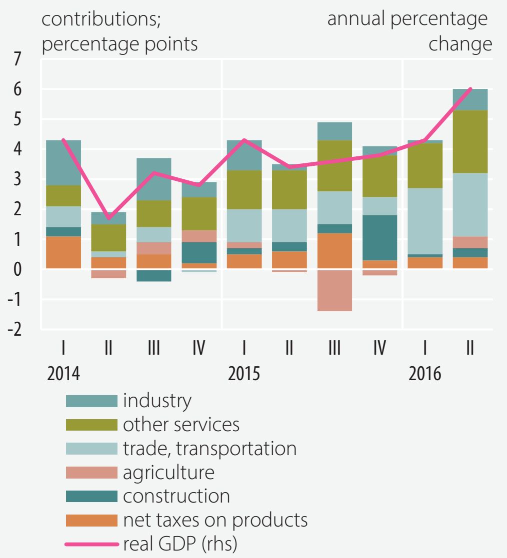
Chart 2.1. Demand



Source: NIS, NBR calculations

The major contributor to economic growth was, this time too, consumer demand, fostered by the ongoing increase in households' purchasing power, amid the recent wage hikes and consumer price developments. Therefore, the trade turnover volume maintained its positive momentum, the slower annual dynamics of food items than in 2016 Q1 – chiefly attributed to the fading-out of the base effect associated with the broadening of the scope of the reduced VAT rate (June 2015) – being largely countered by the step-up in motor vehicle sales, once the vehicle fleet renewal programme had resumed (Chart 2.2). Consumer demand is expected to further trend upwards in the latter half of 2016 as well, albeit at a less pronounced pace. The declining levels posted by retail trade and services confidence indicators in September-November 2016 (as shown by the NIS/EC-DG ECFIN survey) suggest the persistence of the slowdown in the growth rate of trade receipts seen in July-August 2016.

Chart 2.2. Supply



Source: NIS, NBR calculations

In 2016 Q2, the general government budget execution pointed to a deficit worth lei 6.9 billion[5] (i.e. 0.9 percent of GDP[6]), after the 2016 Q1 budget

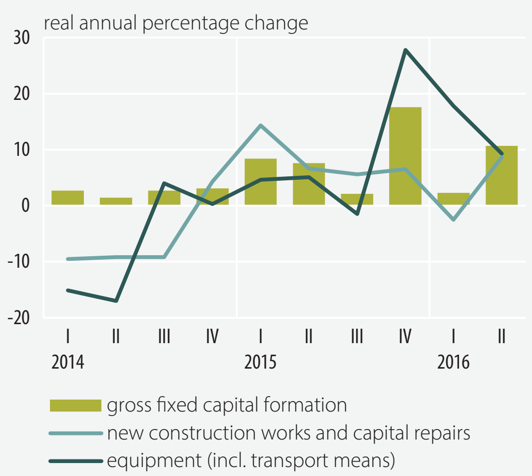
[5] The analysis relied on the operational data related to the June 2016 budget execution, as published by the MPF. The GDP reading in the latest budget execution released by the MPF was used for 2016.

[6] Corresponding to a primary deficit of 0.3 percent of GDP.

surplus amounting to lei 3.01 billion (0.4 percent of GDP). The change in the budget execution pattern[7] was basically the result of the annual dynamics of budget revenues falling into negative territory (-2.7 percent[8] versus a 3.8 percent advance in the prior quarter), mainly following the contraction in VAT receipts (-15.1 percent against 0.9 percent). The relatively slacker rates of change of disbursements from the EU, non-tax revenues and corporate income tax revenues acted in the same direction. In its turn, public expenditure reported a faster growth rate (to 8.6 percent from 7.8 percent), on the back of the developments in capital expenditure (45.7 percent as compared with 15.8 percent) and in certain current expenditure categories (the public wage bill, subsidies, other expenditure in the form of transfers); the impact of these increases was partly offset by the decline in the expenditure for EU funded projects.

In 2016 Q2, a significant contribution to the stronger domestic demand was also made by investment demand, whose annual pace of increase accelerated to 10.7 percent from 2.3 percent; the said positive performance may persist into the latter half of 2016 as well (Chart 2.3). Equipment purchases further recorded swift dynamics, i.e. over 9 percent, as the automotive and related industries continued to post significant capital investment, amid the higher external demand and their close integration in the global value chains. Manufacturers of certain consumer goods were also involved in similar pursuits, aiming to better capitalise on both the increase in domestic demand over the past year and the stronger external demand for such goods (especially in the EU). Construction works followed an upward path as well, the main contributor being civil engineering works – albeit mostly due to a one-off factor, i.e. the election calendar, whose impact was felt in Q2 (a rebound of up to 13.4 percent in annual terms, linked with the local elections) and may also mark public investment performance in the latter part of 2016. Building construction further saw a modest increase, i.e. 0.5 percent, largely amid the uncertainty surrounding the Law on debt discharge. Nonetheless, prospects appear favourable for 2016 H2, given that January through August 2016 the construction area stipulated in residential building permits rose by approximately 8 percent and the real estate market estimates for the latter half of 2016 point to the delivery of a larger number of new facilities, particularly retail and logistics units. Turning to residential investment, there are encouraging signs for financing sources too. Thus, the government approved a rise in the 2016 guarantee ceiling for loans under the "First Home" programme first in May, and then again in September. Moreover, following the tightening of financing conditions as a result of the enforcement of the Law on debt discharge, there are signs of easing credit standards and terms for loans for house purchase other than those under the said programme, in view of the recent decision of some credit institutions to lower the minimum required down payment.

Chart 2.3. Investment



Source: NIS, NBR calculations

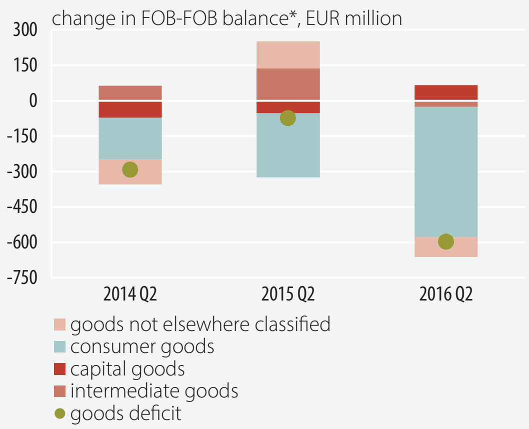
As in the previous quarters, local supply accommodated only partly the advance in domestic demand, the change in consumer behaviour (namely households' enhanced

[7] In the same year-ago period, the general government budget deficit amounted to lei 0.7 billion, corresponding to a primary surplus of 0.5 percent of GDP.

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

preference for diversity and more sophisticated products) and the relative price movements (owing to both external conditions and domestic pressures coming from labour costs) leading to the fast growth of imports of consumer goods. Consequently, the balance on trade in consumer goods continued to deteriorate (especially in the case of non-durables), remaining the channel for the worsening of the balance on trade in goods in 2016 Q2 too; the deficits on trade in intermediate goods and capital goods respectively witnessed marginal changes[9] (Chart 2.4).

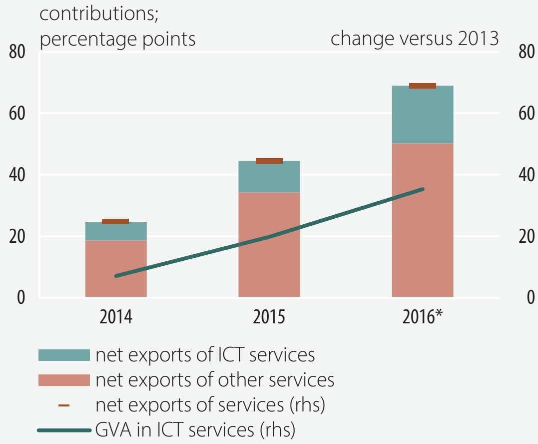
Chart 2.4. Change in Goods Balance versus the Same Year-Ago Period



*) excluding goods under OPT arrangements
Source: Eurostat, NBR calculations

The adverse impact of imports was, to a certain extent, offset by the pick-up in exports of goods (to 8.9 percent, real annual change), particularly on the back of the advance in EU demand. Exports are expected to remain on an upward path in the coming months, yet their annual growth rate is unlikely to accelerate further, amid the lower confidence of economic operators in the European Union following the uncertainty generated by the outcome of the UK referendum. This time too, the greatest contributors were sales of electrical equipment (whose volume added about 18 percent in annual terms for the fourth quarter in a row) and of motor vehicles (including parts thereof), which saw an almost 10 percent rise in the period under review. These industries strengthened their leading position among Romania's exports – currently accounting for around one third of the total sales abroad – and have continued to report increases in their EU market shares, despite the constraints generated by the shortage of skilled workers and the modest infrastructure.

Chart 2.5. ICT Services



*) calculated based on the annual growth rate in 2016 H1
Source: NIS, NBR

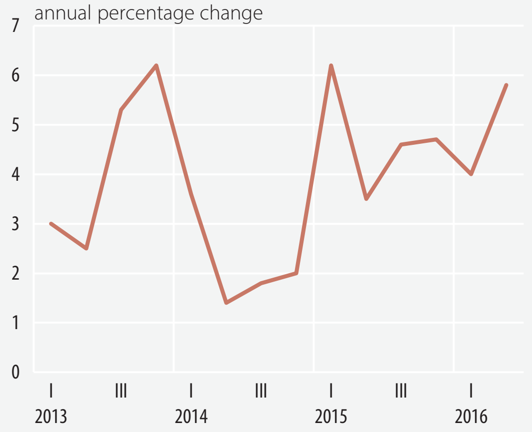
Similarly to the previous quarters, the substantial receipts that the domestic companies received for the services rendered to foreign partners dampened the adverse influence of the trade deficit, with ICT services making a very important contribution hereto. The said sub-sector keeps on expanding, as the advantages of the Romanian ICT market – one of the fastest internet connection speeds in the world and the competitiveness of the human capital in terms of skills versus wage costs – sustain the interest of multinationals to open new software development and IT services facilities (Chart 2.5). Despite the increasing efforts of the local companies to invest in modern technology, the ICT sub-sector is further mostly export-oriented, as software outsourcing services are its main component.

Labour productivity

In 2016 Q2, labour productivity made a positive contribution to economic growth, mostly due to trade and construction (Chart 2.6).

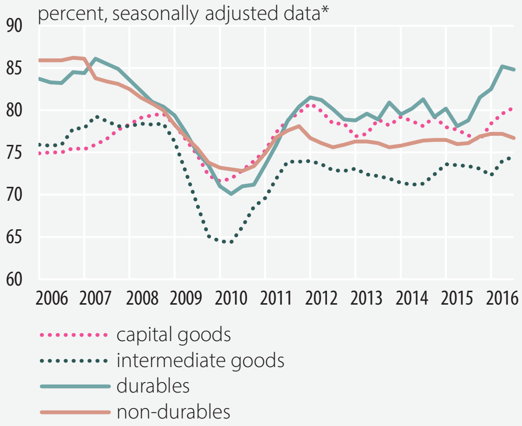
[9] Assessment based on the data series on international trade by broad economic categories (source: Eurostat).

Chart 2.6. Labour Productivity Economy-Wide



Source: NIS, Eurostat

Chart 2.7. Capacity Utilisation Rate



*) 4-quarter moving average

Source: EC-DG ECFIN

In addition, the negative annual rate of change of labour productivity in industry slowed down from the previous three-month period (nearing zero), which can be largely ascribed to cyclical factors, as shown by the higher capacity utilisation rate in most manufacturing sub-sectors (+0.7 percentage points, to 77.9 percent, 4-quarter moving average, Chart 2.7). Apart from the said influences, there are signals in the economy that point to a positive contribution of persistent factors too, on the back of the recent stronger appetite for investment of the companies in the consumer goods industry, as well as in sub-sectors such as the chemical industry and metallurgy, which underwent a shake-up and improved their (primarily energy) efficiency at the same time. Likewise, manufacturers of road transport means and electrical equipment further showed interest in making investments, witnessing productivity gains along with additional hires.

The consolidation of the positive developments in labour productivity dynamics in industry in 2016 Q3 is uncertain, as the sharp drop seen in July that was basically attributable to a calendar effect on production (which impacted not only domestic companies, but also some key foreign partners) was only partly reversed in August.

Looking ahead, several recently adopted measures are likely to stimulate the interest in innovation and increased efficiency, with potential labour productivity gains. These include the personal income tax exemption for workers in applied research and development or technological development activities and measures aimed at unlocking and loosening the labour market.

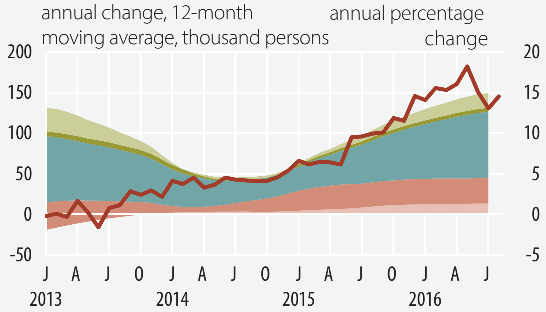
Labour market developments[10]

The number of employees economy-wide continued to increase at a relatively robust tempo also in April-July 2016, i.e. 3.4 percent in annual terms. This time too, firms in market services, particularly professional, scientific, technical, administration and support service activities, as well as accommodation and food service activities, were engaged in a stronger hiring activity. Likewise, the pace of hiring in ICT services stood over 20 percent, similarly to the past two years[11]. By contrast, hiring slowed down in construction and industry, yet continued to post strong growth rates in the automotive industry and in the manufacture of electrical equipment and of rubber respectively (Chart 2.8).

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

[11] In the context of the investments made in this area, the number of payrolls was approximately 15 times larger than in 2000.

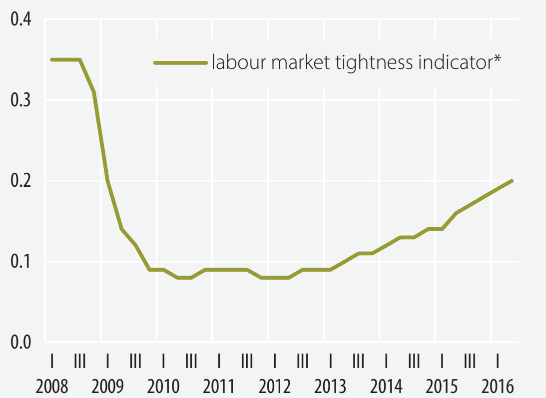
Chart 2.8. Number of Employees Economy-Wide and Gross Wage



employees in construction
employees in agriculture
employees in market services
employees in industry
public sector employees
real gross wage economy-wide (rhs)

Source: NIS, NBR calculations

Chart 2.9. Labour Market Tightness



*) calculated as the ratio of the job vacancy rate to ILO unemployment rate

Source: Eurostat, NBR calculations

The higher labour absorption capacity of the economy was also mirrored by the ILO unemployment rate falling by 0.3 percentage points to a post-crisis low of 6.1 percent. Under the circumstances, companies – whose demand for labour is on the rise – find it increasingly difficult to identify suitable candidates, the process being hindered by the persistence of structural problems too. Specifically, the long-term unemployed continue to account for a significant share of the total unemployed (about a half) and young people fail to meet labour market requirements (in their case, the unemployment rate remains at over 20 percent, ranking among the highest in the EU). Therefore, labour market conditions have further tightened, rendering it all the more necessary to take broader active labour market measures (support for internal mobility and professional retraining programmes), as well as to match the skills provided by the education system with firms' requirements (Chart 2.9). In that vein, internal mobility may improve following the granting, as of December 2016, of a larger relocation allowance to the unemployed who find a job that requires resettlement and of a greater financial support for companies that hire unemployed people.

For September-December 2016, both the Manpower Employment Outlook Survey and the NIS/EC-DG ECFIN survey show strong employment intentions in industry and market services. On the other hand, there are mixed prospects in construction, with stable or lower expectations, and trade, which witnesses even higher uncertainty. Specifically, respondents to the NIS/EC-DG ECFIN survey are rather pessimistic, whereas those to the Manpower survey anticipate the most robust labour market in the past four years.

April through August 2016, the annual growth rate of net average wage earnings economy-wide accelerated to 13.4 percent, up 1.4 percentage points from that in 2016 Q1. The step-up was due solely to the swifter pace of increase of private sector wages, which exceeded the 10 percent threshold for the first time in the post-crisis period. To this contributed the 19 percent hike in the gross minimum wage economy-wide in May 2016, to RON 1,250, with a 2 percentage point estimated influence on private sector wages. The measure had a stronger impact on wages in construction, accommodation and food service activities, transportation and trade, as more than 40 percent of the employees in these sub-sectors were directly affected.

2. Import prices and producer prices

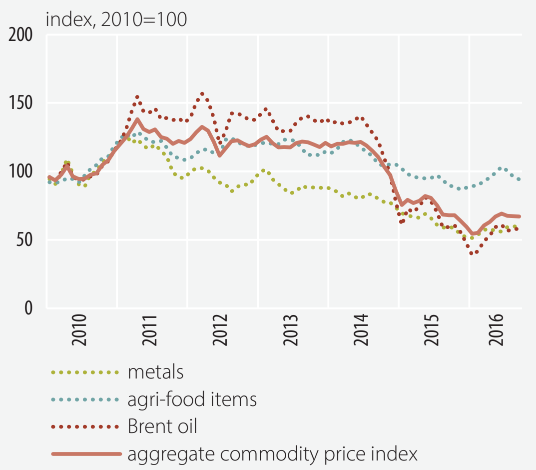
In 2016, the upward trend in main commodity prices favoured the gradual slowdown in the annual rate of decline of producer prices on the domestic market, an influence that was partly offset by the US dollar depreciation. The strengthening of this trend is likely to limit the part played by external prices over the recent period in cushioning the domestic pressures that continue to build up on account of the fast dynamics in unit wage costs.

2.1. Import prices

Most commodity prices seemed to have bottomed out in early 2016, as indicated by the subsequent emerging uptrend (Chart 2.10). Although oil and metal prices still reported strongly negative annual rates of change in 2016 Q2 (two-digit negative values), these declines diminished at a faster tempo in the following months until they nearly faded out[12]. In the case of metals, the development owed largely to China's economic slowdown coming to a halt under the impact of significant incentives provided by the authorities (lower interest rates, higher government spending for infrastructure projects, softer fiscal burden on small enterprises). Looking at the oil price, world supply has increased at a considerably slower pace since early 2016 and major producers have also recently attempted to reach an agreement on capping oil production. Agri-food price dynamics returned to positive territory as early as 2016 Q2, subsequently slowing down amid favourable signals related to grain crops worldwide. At the same time, sugar prices stayed on a strong upward trend on the back of the supply shortfall generated by the unfavourable weather conditions in Brazil and India.

The further low levels of main commodity prices were mirrored by the persistent negative annual dynamics of import prices in 2016 Q2. Hence, the unit value index (UVI) of imports[13] remained below one (95.4 percent), reporting a value even lower than that in the previous quarter (by 1.6 percentage points), owing partly to the strengthening of the euro against the US dollar. As for the EUR/RON exchange rate, it posted relatively stable developments in the period under review.

Chart 2.10. International Commodity Prices



Source: IMF, NBR calculations

Mineral products and base metals witnessed the largest contractions in 2016 Q2 as well. Moreover, on the food industry segment, most products recorded negative annual growth rates, favoured by the persistent oversupply at European level, also as a result of Russia extending trade restrictions to Turkey in early 2016. The only groups of goods whose UVI remained above one in Q2 were sugar, wearing apparel, footwear and accessories, as well as transport means.

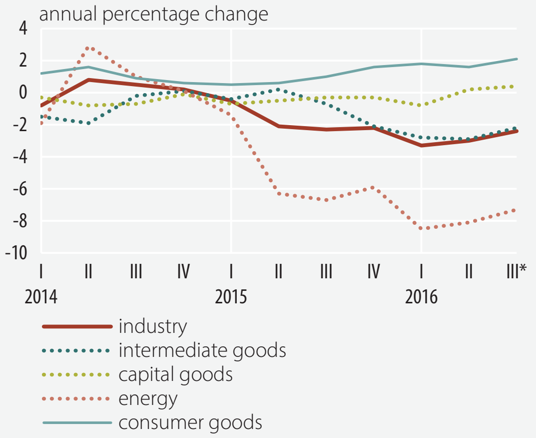
2.2. Producer prices

In line with the trend in commodity prices, industrial producer prices on the domestic market also posted a slower annual rate of decline of -2.4 percent July through August 2016 (compared to -3.2 percent in 2016 H1). All groups of goods reported higher rates of change, which were still negative only for energy and intermediate goods (Chart 2.11).

[12] September saw annual changes of -1.2 percent for metals and -2.2 percent for oil.

[13] Calculated based on EUR-denominated data.

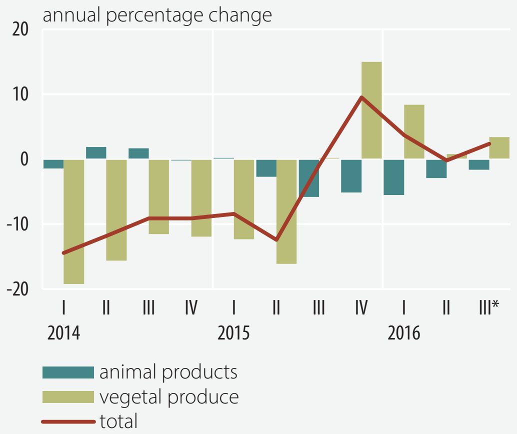
Chart 2.11. Industrial Producer Prices on the Domestic Market



*) Jul.-Aug.

Source: NIS

Chart 2.12. Agricultural Producer Prices



*) Jul.-Aug.

Source: NIS

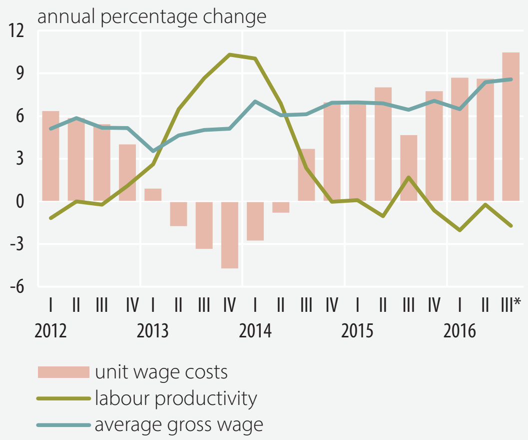
The annual growth rate of producer prices for consumer goods rose to 2.1 percent (+0.4 percentage points versus 2016 H1), chiefly on account of higher food industry prices (+1 percentage point, to 1.6 percent). This development was associated with stronger domestic consumer demand, as well as to rising external prices for some agri-food commodities, also under the impact of measures implemented at EU level in recent years for supporting producers hit by the closing of the Russian market (easier access to new markets, financial aid for capping output). Moreover, consumer goods industries have further been most strongly affected by the pressure stemming from unit wage costs, as they are especially vulnerable to hikes in the minimum wage.

The annual dynamics of agricultural producer prices temporarily entered negative territory in 2016 Q2 – given a statistical effect coming from higher increases on the vegetal produce segment during the same year-ago period – before reverting to positive values in July-August (2.4 percent). At the same time, animal product prices continued to decline in annual terms, albeit at a slower pace, also as a result of the impact of measures implemented at EU level, more visible in the case of pork products (Chart 2.12).

Unit wage costs

In 2016 Q2 as a whole, the annual growth rate of unit wage costs in industry remained fast-paced, at 8.6 percent, similarly to the previous quarter (Chart 2.13), owing to the current more favourable developments in labour productivity, which offset the step-up in the wage dynamics, generated primarily by a new hike in the gross minimum wage economy-wide. The breakdown by sub-sector points to a slowdown in the growth rate of unit wage costs in some industries, which may be attributable to restructuring and cost-efficiency measures (energy sector), as well as to streamlining of activity, possibly in the context of automation operations (automotive industry and the related industry of manufacture of electrical equipment, the food industry).

Chart 2.13. Unit Wage Costs in Industry



*) Jul.-Aug.

Source: NIS, NBR calculations

However, some sub-sectors saw higher pressures from unit labour costs following the rise in the minimum wage, in the absence of corresponding productivity gains – manufacture of wood and wearing apparel. The sharp fall in labour productivity across industry in July 2016, largely prompted by a calendar effect, led to a short-lived hike in unit wage costs (to 13.4 percent). Their dynamics witnessed a significant correction in August 2016 (to 7 percent), once the above-mentioned statistical effect had reversed its influence on industrial output.

3. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

The NBR Board kept the monetary policy rate unchanged at 1.75 percent during its meetings of August and September 2016. Moreover, during Q3, the central bank maintained the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions (at 8 percent and 12 percent respectively) and pursued adequate liquidity management in the banking system. The measures continued to be 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.

The NBR Board decision in August was warranted primarily by the further downward revision of the forecasted annual inflation rate path, in the context of the quarterly exercise of medium-term macroeconomic projections, as well as by the reconfirmed divergence of the inflation trajectory. Specifically, according to the new forecast, the annual inflation rate was seen remaining in negative territory[14] until end-2016[15] and below the lower bound of the variation band of the flat target in 2017 H1[16], 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[17]. Behind the reshaping of the forecasted inflation pattern stood, on one hand, the stronger direct and indirect effects expected to be exerted, via a multitude of channels[18], by supply-side/cost-push global disinflationary shocks, consisting in large and persistent declines in international commodity prices, particularly of energy and agricultural produce. On the other hand, it reflected stronger inflationary pressures anticipated to emerge from the faster widening of the positive output gap across the projection horizon, given the early reversal of the cyclical position of the economy[19], as well as from the fast dynamics of unit wage costs extending over the short term and inflation expectations following an uptrend[20]. This outlook had as major premises and assumptions (i) the step-up in economic growth in the first part of 2016 and the further easing of the fiscal and income policies, mainly via indirect tax adjustments and public sector pay rises, (ii) the preservation of stimulative real monetary conditions, which were 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, and (iii) the recent labour market tightening trend.

[14] The 12-month inflation rate went deeper into negative territory in the first months of 2016 Q2, reaching -3.5 percent in May, before witnessing an upward correction in June (-0.7 percent), amid the fade-out of the first-round impact of broadening the scope of the reduced VAT rate to all food items.

[15] Coming in at -0.4 percent in December (versus the previously-projected figure of 0.6 percent). Recalculated net of the one-off impact of the standard VAT rate cut at the beginning of 2016, the annual inflation rate was forecasted to end the current year at 1.0 percent, against 1.9 percent in the previous projection.

[16] The annual inflation rate was seen at 2.0 percent at end-2017 (2.7 percent in the earlier forecast).

[17] According to the updated forecast, the average annual inflation rate was 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.

[18] Including through imports of consumer and intermediate goods, anticipated to rise and therefore widen the trade deficit.

[19] In 2016 Q1.

[20] Albeit at a lower level.

The NBR Board decision was also warranted by the two-way risks and uncertainties surrounding the inflation outlook, stemming from the future stance of the fiscal and income policies[21] and from legislative changes in the financial area, as well as from the characteristics of global economic growth and of euro area economic recovery[22].

Subsequently-released statistical data showed that the annual inflation rate had risen to -0.2 percent[23] in August 2016, in line with NBR forecasts, remaining in negative territory due solely to the transitory effect of lowering the standard VAT rate from 24 percent to 20 percent as of 1 January 2016[24]. The data also pointed to faster than-expected second-quarter economic growth – primarily underpinned by the expansion in private consumption, as well as by the rebound in investment –, conducive to a more sizeable widening of the positive output gap, including in the near term. To these added evidence of the ongoing widening of the current account deficit, along with the still high annual dynamics of unit wage costs in industry.

Credit to the private sector continued to grow in real annual terms July through August, albeit at a slower pace than in Q2, owing exclusively to non-performing loan sales and to the statistical effect of the pick-up in the annual inflation rate. The dynamics of leu-denominated loans remained high, although decelerating against the previous three months (to 15.5 percent), while the annual rate of change of the forex component further stayed deeply in negative territory (-12.7 percent, based on readings expressed in euro), so that the share of the domestic currency component in total credit peaked in August at a post-1996 high of 55.9 percent. The dynamics of both household and corporate credit decelerated (6.4 percent versus 8.0 percent in the previous three months and -4.5 percent against 0 percent in Q2 respectively), mainly ascribable to the two factors mentioned above, to which added the relatively slower rise in the flow of housing loans and of credit to non-financial corporations. Developments in new business were correlated only in part with the results of the August 2016 Bank Lending Survey conducted by the NBR, which pointed to (i) expectations for a setback in household demand for credit in 2016 Q3, along with a possible moderate rise in corporate loan demand, and (ii) a possible renewed tightening, albeit marginal, of credit standards for housing loans, together with a status-quo in standards applicable to other types of loans/customers.

In turn, the robust growth rate of broad money extended into the first two months of Q2, with its slight deceleration versus the previous three months (13.5 percent from 15.1 percent) reflecting solely the statistical influence of the annual inflation rate. Liquidity in the economy was fuelled, inter alia, by disbursements related to structural funds, whereas an opposite impact came partly from portfolio shifts prompted by the new government bond issue for households, as well as from dividend payments to non-residents and/or the central government budget. From the perspective of M3 components, the period under review saw further high annual dynamics of narrow money (26.6 percent), correlated with the economic growth and the low opportunity cost of holding more liquid monetary assets. The rate of change of time deposits also witnessed a renewed advance, although relatively modest (to 0.8 percent, 0.3 percentage points above the previous three months' reading), given the opposite movements in the average dynamics of household and corporate deposits (decline and step-up respectively).

The assessments conducted in this context reconfirmed the outlook for the annual inflation rate to remain in negative territory until end-2016, amid the transitory effects of the standard VAT

[21] 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.

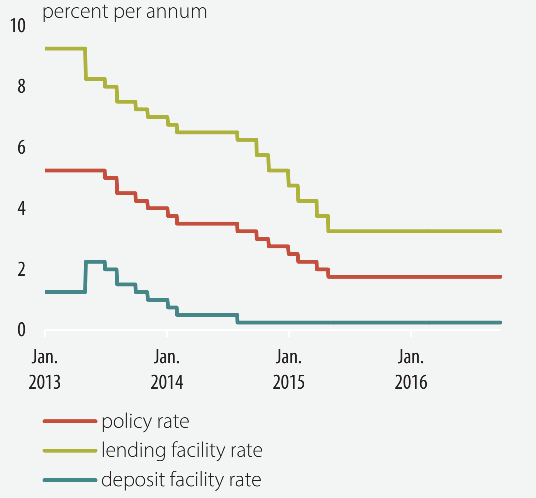
[22] The uncertainty related thereto had initially been fuelled by the weakening of the Chinese economy and of other major emerging economies and then compounded by the outcome of the UK referendum, as well as by geopolitical tensions and challenges to the European banking system.

[23] After having slipped to -0.78 percent in July.

[24] In the absence of which annual inflation would have increased to 1.2 percent against 0.68 percent in June.

rate cut still being manifest. However, the pace of economic growth anticipated for Q3 was revised upwards, implying over the short term a relative widening of the positive output gap and hence strengthening of the ensuing inflationary pressures; according to high-frequency indicators, consumer demand was expected to be the main driver of economic growth, whereas the contribution of investment was seen as positive, yet muted, and that of net exports as still negative.

Chart 3.1. NBR Rates



Against this background, in its meeting of 30 September, the NBR Board decided to keep the monetary policy rate at 1.75 percent (Chart 3.1), to maintain the characteristics of the corridor of interest rates on the NBR's standing facilities, as well as to leave unchanged the minimum reserve requirements ratio on leu-denominated liabilities of credit institutions. Given the ongoing contraction in annual terms in foreign currency lending, the consolidation of forex reserves above the adequate level in the recent period and in the period ahead, as well as their improved composition, the NBR Board decided to cut the minimum reserve requirements ratio on foreign exchange-denominated liabilities of credit institutions to 10 percent from 12 percent[25]; the measure aimed to continue the harmonisation of the minimum reserve requirements mechanism with the relevant standards and practices of the European Central Bank and the major central banks across the European Union.

During Q3 as a whole, real monetary conditions remained stimulative, given that the relevant ROBOR rates tended to fall and subsequently stayed at levels slightly below those seen in the previous period, amid the persistence of a relatively wide net liquidity surplus[26] in the banking system and the adequate liquidity management by the NBR. The EUR/RON exchange rate also dropped to lower readings, in the context of the relative improvement in global financial market sentiment, mostly following the signals conveyed and the decisions taken by major central banks after the Brexit vote.

2. Financial markets and monetary developments

The average interbank money market rate posted minor fluctuations during Q3, while the EUR/RON exchange rate witnessed a downward correction, before tending to stabilise close to its 2016 lows. Broad money further saw robust annual growth June through August, whereas the advance in credit to the private sector (stocks) slowed as a result of credit institutions' stepped-up operations to clean their balance sheets.

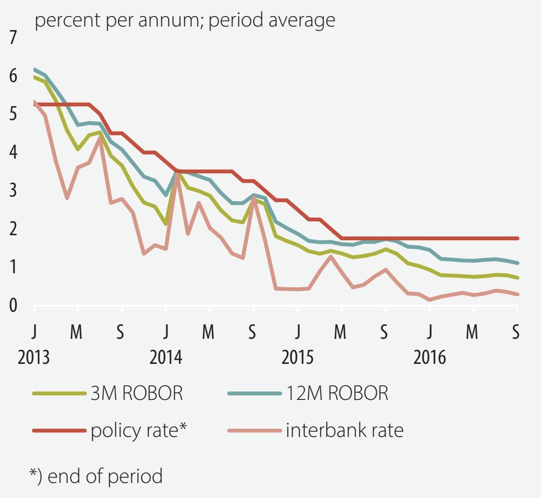
2.1. Interest rates

The daily average interbank money market rate remained in the vicinity of the deposit facility rate for most of the quarter under review, rising slightly only in mid-Q3 (Chart 3.2). Hence, the quarterly average interbank deposit rate edged up 0.04 percentage points from April-June and reached 0.35 percent.

[25] Starting with the 24 October – 23 November 2016 maintenance period.

[26] It witnessed a more visible narrowing in August, which did not impact markedly the behaviour of the relevant ROBOR rates, given its temporary nature.

Chart 3.2. Policy Rate and ROBOR Rates

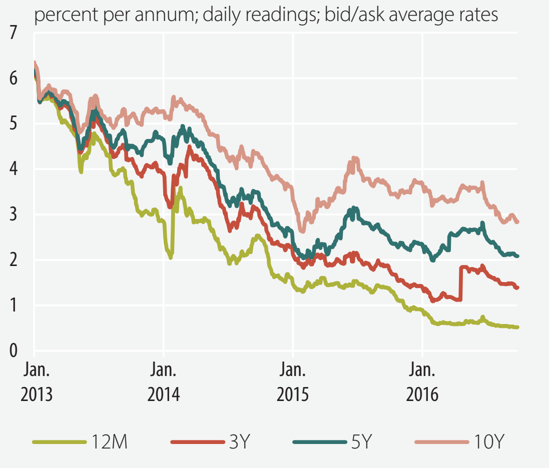


At the onset of the reported quarter, given the persistence of the high net liquidity surplus in the banking system, overnight rates stuck to the lower bound of the corridor defined by interest rates on the central bank's standing facilities around the policy rate. Subsequently, they trended upwards, prompted by the significant pick-up in the Treasury's liquidity absorptions[27], amid the increase in budget collections at end-July and in the volume of net sales of government securities. However, the rise in these rates was limited in terms of size[28] and duration by the anticipated re-widening of the liquidity surplus in the closing month of the quarter, on the back of a significant volume of government securities maturing[29].

Against this background, longer-term (3M-12M) ROBOR rates saw their slightly downward trend persist in the early days of July, after the spike witnessed at end-June owing to global market tensions in response to the outcome of the UK referendum. They remained unchanged into the first part of August, before re-embarking on a slight downtrend – which extended until the end of the quarter – following the release of the NBR's updated medium-term inflation forecast. Therefore, average ROBOR rates hit new historical lows[30] in September, with the 3M rate standing at 0.72 percent (down 0.05 percentage points from June) and the 6M and 12M rates at 0.95 percent (-0.07 percentage points) and 1.11 percent (-0.08 percentage points) respectively.

Yields on short-term government securities followed a similar path (Chart 3.3). By contrast, yields at longer maturities (5 to 10 years) continued to decline at a faster pace July through August, capturing – the same as yields on other markets in the region – the influence of the improved global financial market sentiment due to the major central banks' more accommodative monetary policy stance/forward guidance on extending monetary stimulus. These rates then tended to stabilise, as the slight increase seen in the first part of September was subsequently reversed.

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



Under the circumstances, the average accepted rates at the last auctions in September diminished versus end-Q2 across the entire maturity spectrum by values ranging between 0.14 percentage points (to 0.56 percent) for one-year bonds and 0.85 percentage points (to 3.13 percent) for the 11-year maturity. Yields on 3- and 5-year bonds respectively shed 0.51 percentage points (to 1.39 percent) and 0.65 percentage points (to 2.12 percent) against June. In turn, average benchmark rates on the secondary market stood

[27] A contractionary, albeit lower, impact was also exerted by the further rise in the value of currency outside the NBR.

[28] The daily averages of ON rates inched up to around 0.4 – 0.5 percent.

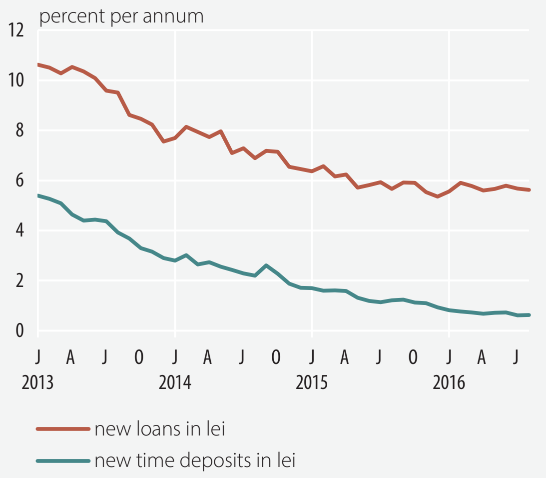
[29] A bond series worth lei 7.2 billion matured on 29 August.

[30] Data series available since August 1995.

in September below their June readings, by 0.08 percentage points in the case of the 6-month maturity and 0.64 percentage points for the 10-year maturity, so that the slope of the yield curve flattened slightly.

Looking at the primary market, investor interest in government securities fluctuated somewhat during Q3, although for the reported period as a whole it exceeded that seen in the previous three months[31]. Hence, the average demand-to-supply ratio went up, as it peaked at a 12-month high in August, while the average maturity of issued securities remained relatively unchanged.

Chart 3.4. Bank Rates

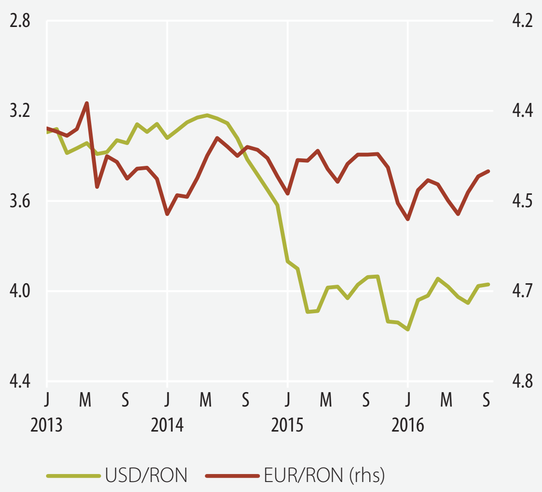


June through August 2016, credit institutions' average interest rates on new time deposits and new loans of non-bank clients posted slight declines, shedding 0.09 percentage points (to 0.62 percent) and 0.03 percentage points (to 5.63 percent) respectively (Chart 3.4). The average remuneration of new time deposits hit new post-1990 lows for both non-financial corporations (down 0.04 percentage points to 0.42 percent) and households (down 0.13 percentage points to 0.96 percent). In turn, the average lending rate on new business to non-financial corporations went down 0.28 percentage points, to a post-1990 low of 3.73 percent, with the downward path visible for interest rates on both major types of loans, i.e. below and above EUR 1 million equivalent. Conversely, the average lending rate on new business to households picked up 0.63 percentage points to 7.21 percent. This was mainly due to the larger share of consumer loans, whereas the overall flow of housing loans diminished.

2.2. Exchange rate and capital flows

In July, the exchange rate of the leu witnessed a downward correction compared to the previous period, the same as the exchange rates of the main currencies in the region, before tending to stabilise close to the 2016 lows (Chart 3.5).

Chart 3.5. Nominal Exchange Rate



The steep decline in the EUR/RON in July, which slightly more than offset the increase accumulated in the previous three months, was ascribable to the restored global risk appetite and the keener investor interest in CEE financial markets. This stemmed from (i) the alleviation of concerns over the immediate global implications of the UK referendum, following signals of extending/increasing the monetary stimulus by the ECB/Bank of England, to which added the above-expectations performance of US labour market and retail trade in June, as well as from (ii) the stronger prospects for a relative slowdown in the tightening of the Federal Reserve's monetary policy stance.

[31] Moreover, in September, 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 2.15 percent rate.

Table 3.1. Key Financial Account Items

EUR million

	8 mos. 2015			8 mos. 2016		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	-1,124	-4,031	2,906	4,757	1,375	3,383
Direct investment	1,151	3,045	-1,893	-14	2,592	-2,606
Portfolio investment	162	-2,047	2,209	182	549	-367
Financial derivatives	-31	0	-31	24	0	24
Other investment	1,001	-5,027	6,029	3,457	-1,766	5,223
– currency and deposits	1,470	-1,795	3,265	1,728	-2,142	3,869
– loans	199	-3,207	3,407	975	-893	1,868
– other	-668	-25	-643	754	1,269	-514
NBR's reserve assets, net	-3,408	0	-3,408	1,109	0	1,109

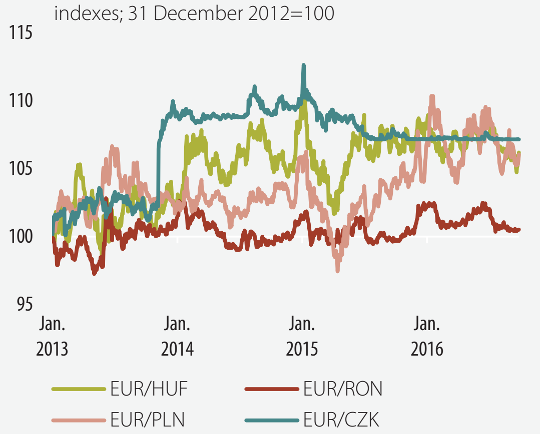
*) "+" increase / "-" decrease

After the downward correction, the EUR/RON exchange rate quasi-stabilised around this year's lows. Its behaviour reflected, on the one hand, the persistence of low volatility on global financial markets in August[32] and, subsequently, the still favourable investor sentiment towards financial markets in the region[33], despite short-lived rises in global risk aversion amid uncertainties regarding additional monetary policy easing by some major central banks. On the other hand, the EUR/RON reflected the mixed domestic influences, given the positive macro developments (higher-than-expected GDP growth in 2016 Q2, according to the flash estimate published by the NIS[34], and the slower increase in the external deficit in July[35], due also to larger EU fund inflows) and the lingering risks/uncertainties associated with the election year (Table 3.1).

On the interbank forex market, the negative balance of non-residents' transactions contracted significantly in July, before re-widening in the following months. This was accompanied by the temporary return into negative territory of the balance on residents' transactions in August, bringing the overall deficit of the interbank forex market to a relatively high level in the second month of the quarter.

In 2016 Q3 as a whole, the domestic currency appreciated against the euro by 1.6 percent in nominal terms[36] and 1.3 percent in real terms. In relation to the US dollar, the leu appreciated by 1.4 percent in nominal terms and 1.1 percent in real terms, given the former's slight strengthening against the euro (Chart 3.6). Looking at the average annual exchange rate dynamics in 2016 Q3, the domestic currency weakened both against the euro and the US dollar.

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



Source: ECB, NBR

[32] As the global risk appetite was further influenced by the recent/expected monetary policy stance of the main central banks. Specifically, the Bank of England and the Bank of Japan adopted monetary stimulus measures on 4 August and 29 July respectively, while expectations on the Fed's next policy rate hike no earlier than December 2016 strengthened.

[33] The MPF capitalised on the favourable environment to raise EUR 1 billion on the external market via a Eurobond issue with a 12-year maturity at the end of September; this marked the reopening of the books on the May 2016 issue.

[34] Confirmed by the provisional data released on 6 September.

[35] In addition, according to the balance-of-payments data published in September, direct investment in the first seven months fully covered the current account deficit.

[36] In the same period, the Hungarian forint strengthened by 1.7 percent and the Polish zloty by 1.8 percent.

2.3. Money and credit

Money

June through August 2016, the growth rate[37] of broad money (M3) decreased to 13.6 percent from 14.9 percent March through May 2016, exclusively due to the significant statistical effect of the increase in the annual inflation rate[38] (Table 3.2). The evolution of liquidity in the economy primarily reflected the opposite influences exerted, on the one hand, by the relatively larger payments from structural funds and, on the other hand, by several companies' distribution of dividends to non-residents and/or shareholders in the government sector, to which added households' partial portfolio shifts toward other financial assets (government securities for this segment).

Table 3.2. Annual Growth Rates of M3 and Its Components

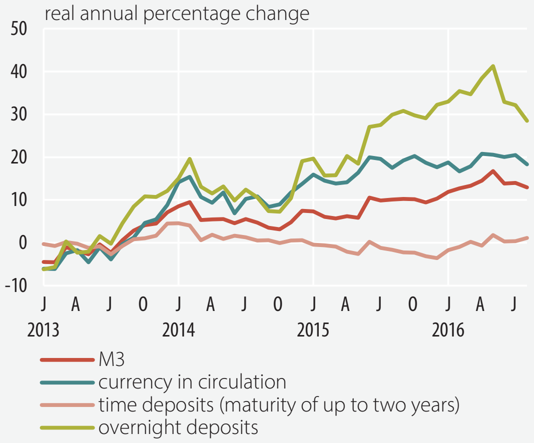
real percentage change

	2015		2016			
	III	IV	I	II	Jul.	Aug.
	quarterly average growth					
M3	10.1	10.0	12.6	15.1	14.0	13.0
M1	25.6	26.4	28.6	31.6	28.2	25.0
Currency in circulation	18.8	18.9	17.8	20.5	20.5	18.3
Overnight deposits	29.4	30.4	34.4	37.5	32.1	28.5
Time deposits (maturity of up to two years)	-1.7	-3.0	-0.8	0.5	0.4	1.1

Source: NIS, NBR

From the perspective of major M3 components, the slower growth was solely attributable to the decrease in the average annual rate of change of narrow money (M1); however, M1 dynamics remained relatively high for the post-crisis period, in correlation with the pace of economic activity and the low opportunity cost of holding liquid assets (Chart 3.7). Behind the evolution of M1 mainly stood the contraction in the annual dynamics of corporate overnight deposits (both in nominal and real terms), partly ascribable to a base effect; the dynamics of household overnight deposits also declined, yet exclusively due to the statistical effect of the inflation rate. The annual rate of change of time deposits with a maturity of over two years was virtually the same[39], given the opposite influences of household and corporate deposits (decrease and increase respectively in their annual dynamics).

Chart 3.7. Main Broad Money Components



Source: NIS, NBR

The M3 breakdown by holder reveals a slower annual rate of increase in household and corporate deposits alike. In the case of households, only the real growth rate witnessed a decline, whereas the nominal one picked up from 7.4 percent to 9.2 percent; this reflected the opposing effects exerted, on the one hand, by higher income – wage-related[40] and from other sources (including dividends) – and, on the other hand, by the strong appetite for government securities issued in this period[41]. Behind the dynamics of corporate deposits stood the additional payments made by these entities to shareholders[42] and the budget[43]

[37] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2016.

[38] In nominal terms, M3 dynamics continued to grow, reaching a 7½-year high.

[39] In nominal terms, it increased from -2.8 percent to 0.1 percent, August being the first month to record positive annual dynamics since December 2014.

[40] The net average wage increased in nominal terms by 13.3 percent June through July (12.9 percent in the previous three months); in real terms, growth slowed from 16.7 percent to 14.2 percent.

[41] In August, the MPF issued government securities worth lei 735 million for households, as part of the Fidelis programme, Centennial edition.

[42] According to press releases, during June-July 2016 dividends were paid, among others, by Transelectrica, Nuclearelectrica, SIF Moldova, Romgaz, Transgaz and Electrica, entities whose major shareholders are the government sector and non-residents.

[43] Including the tax on constructions.

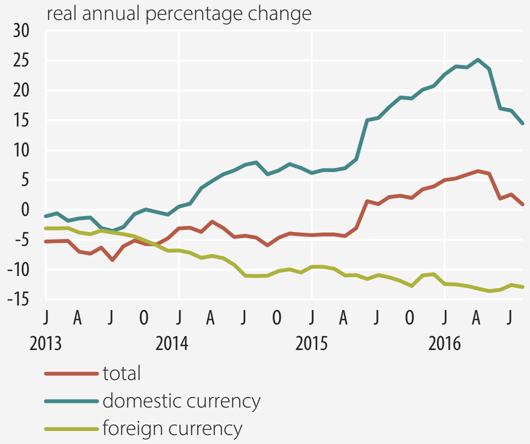
and the possibly lower amounts for the agricultural sector from EU funds. An opposite impact had the rise in disbursements from structural funds and to participants in the national vehicle fleet renewal programme[44], as well as the redemption of bonds issued by Raiffeisen Bank[45].

From the perspective of broad money counterparts, M3 developments reflected the fall in the dynamics of both credit to the private sector and that to the public sector; an opposite, yet weaker impact had the further stronger dynamics of banks' net foreign assets, the lower rate of change of long-term liabilities[46] and the slower annual growth of central government deposits.

Credit to the private sector

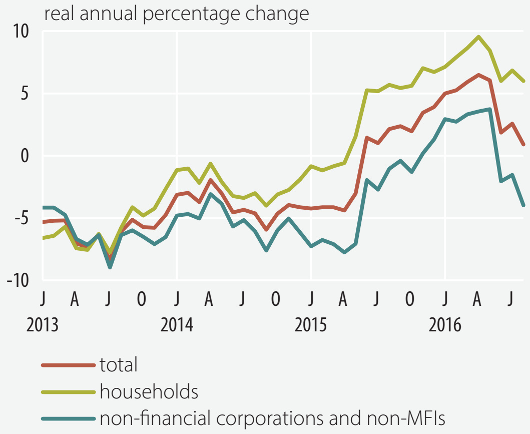
June through August 2016, the growth rate of credit to the private sector[47] decelerated to 1.8 percent, compared with 6.2 percent in the previous three months (Chart 3.8), primarily due to the renewed step-up in operations to remove non-performing loans from banks' balance sheets[48], to which added the statistical influence of the faster annual inflation rate[49]. The loss of momentum was mostly attributable to the leu-denominated component, with a real annual growth rate of 16.0 percent against 24.2 percent in the prior three months, whereas the annual rate of change of foreign currency loans remained almost the same (-13.0 percent versus -13.2 percent March through May, based on values expressed in euro), amid the fade-out of the base effect generated by the conversion into lei of a notable volume of CHF-denominated loans in the previous year. Given the further significant differential between the dynamics of the two components, the share of leu-denominated loans continued to widen, reaching 55.9 percent in August – the highest value since December 1996.

Chart 3.8. Credit to the Private Sector by Currency



Source: NIS, NBR

Chart 3.9. Credit to the Private Sector by Institutional Sector



Source: NIS, NBR

From the perspective of institutional sectors, weaker dynamics were manifest for the two main customer types (Chart 3.9). Across households, the decline[50] was visible both for housing loans and for consumer credit and other loans, due, aside from the aforementioned factors, to the slower growth of new loans, amid the tightening

44 According to the information from the Environmental Fund Administration, the vehicle fleet renewal programme was launched in June 2016, totalling lei 145 million.

45 Leu-denominated bonds amounting to lei 225 million issued in July 2013 and mostly placed with local investors.

46 Capital accounts included.

47 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2016.

48 Calculated based on monetary statistics data.

49 The growth rate of credit to the private sector adjusted by the influence of operations to remove loans from credit institutions' balance sheets and expressed in nominal terms gained traction.

50 However, in nominal terms, the growth rate of loans to households picked up against March-May 2016.

of credit standards applied by credit institutions[51] and the full use of the state guarantees under the "First Home" programme[52]. In the case of non-financial corporations, the loss of momentum was sharper and was the result of the decelerating dynamics of leu-denominated credit and the more negative rate of change of the foreign currency component (expressed in euro). The decline spread across the maturity spectrum, mainly determined by the step-up in operations to remove non-performing loans from credit institutions' balance sheets, to which added, in this period, a decrease in annual terms in the volume of new business.

[51] According to the NBR's Bank Lending Survey published in August 2016, credit institutions had tightened credit standards in 2016 Q2 for both loans for house and land purchase and consumer credit; for 2016 Q3, expectations pointed to the marginal tightening of credit standards for housing loans and a status-quo in the case of consumer credit.

[52] The MPF upped the guarantee ceiling under the "First Home" programme at end-September 2016 (Government Decision No. 703/2016).

4. INFLATION OUTLOOK

The annual CPI inflation rate is seen on the rise throughout the forecast interval, from -0.4 percent at end-2016 to 2.1 percent at the end of 2017 and 3.1 percent at the projection horizon, i.e. 2018 Q3. The upward trend is more pronounced in the case of the adjusted CORE2 inflation rate. As for the latter, the gradual build-up of inflationary pressures will stem mainly from anticipated higher excess demand, to which adds the progressive increase in economic agents' inflation expectations from the currently low levels, as well as from the softer disinflationary pressures induced by import prices. Furthermore, at the beginning of 2017 and 2018, the first-round effects of indirect tax cuts implemented in January 2016 and January 2017 will fade out, contributing to the increase in the annual inflation rate. The balance of risks to the annual inflation projection is assessed to be in equilibrium in relation to the path in the baseline scenario, amid the divergent influences associated with the sources of risks stemming from the domestic and external environment.

1. Baseline scenario

1.1. External assumptions

The scenario on developments in the effective EU GDP (EU-28 excluding Romania) is consistent with the assumption on gradual external demand recovery (Table 4.1). The annual dynamics of this indicator are marginally higher than those projected in the previous *Report*, mainly due to recent, more favourable developments in certain trade partners such as Germany and Spain. Across the euro area, recovery of economic activity is further upheld by developments in domestic demand, amid the ECB's accommodative monetary policy stance, still relatively low oil price, and improved labour market conditions. Even though global financial market volatility in the aftermath of Brexit vote was short-lived and somewhat limited, there are lingering uncertainties as to the potential impact on the euro area's economic prospects in terms of the outcome of EU-UK negotiations[53]. External demand gap[54] is expected to stay in negative territory over most of the projection interval, having a restrictive, albeit gradually lower, impact on domestic excess demand.

Table 4.1. Expectations on the Developments in External Variables

annual averages

	2016	2017
Effective EU economic growth (%)	1.73	1.63
Annual inflation rate in the euro area (%)	0.23	1.30
Annual CPI inflation rate in the USA (%)	1.19	2.23
3M EURIBOR interest rate (% per annum)	-0.27	-0.35
EUR/USD exchange rate	1.11	1.09
Brent oil price (USD/barrel)	44.4	55.1

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

The average annual HICP inflation rate in the euro area is projected to stay on an upward path all through the forecast interval, mostly against the backdrop of waning effects of previous global oil price falls and the labour market improvements. These increases notwithstanding, this inflation measure will run below both the ECB's definition of price stability, i.e. the 2 percent benchmark, and the previously forecasted level. Under the impact

[53] Compared to the August 2016 *Inflation Report*, the UK expressed the option to invoke Article 50 of the Lisbon Treaty to start the process of exiting the EU by the end of March 2017. According to the ruling given by the High Court of Justice in London on 3 November 2016, this cannot be achieved without the permission of the British Parliament.

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

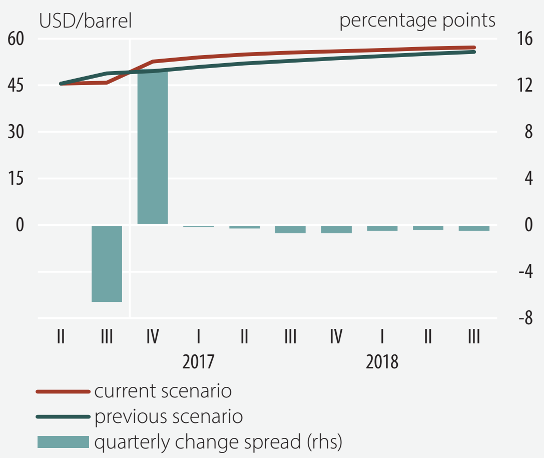
of a set of similar determinants, annual CPI inflation in the USA will, in turn, tend to gain momentum, posting further higher levels than those expected for the euro area.

Against the background of the ECB's persistently accommodative monetary policy, the nominal 3M EURIBOR rate is anticipated to further register negative values throughout the projection interval.

The EUR/USD exchange rate is seen remaining on an almost stable path over the projection interval. Potential deviations could be ascribed to the ECB and Fed's monetary policies veering off from the trajectories expected by financial markets.

The scenario for the Brent oil price is based on futures prices and foresees a further uptrend to reach USD 57.2 per barrel in 2018 Q3 (Chart 4.1). Its outlook is further uncertainty-ridden, given the multiple recent changes on the global oil market, including a possible cap on production by OPEC member countries, a formal decision in this respect being expected for the end of November 2016.

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 and 2.1 percent at end-2016 and end 2017 respectively. At the projection horizon, i.e. 2018 Q3, the forecasted rate will reach 3.1 percent (Table 4.2).

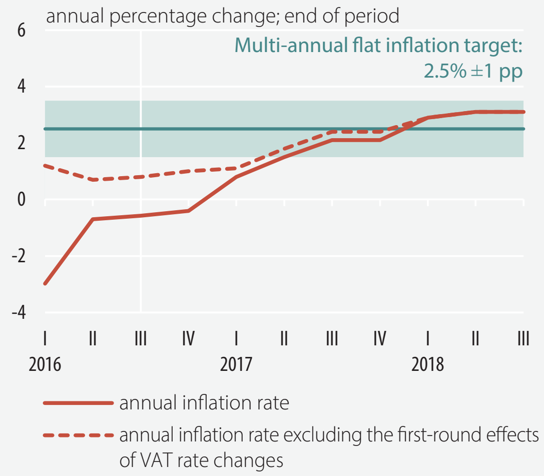
Table 4.2. The Annual Inflation Rate in the Baseline Scenario

annual percentage change; end of period

	2016	2017				2018		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	-0.4	0.8	1.5	2.1	2.1	2.9	3.1	3.1
CPI projection*	1.0	1.1	1.8	2.4	2.4	2.9	3.1	3.1

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

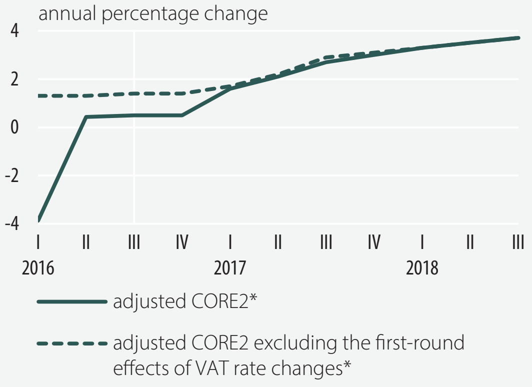
Chart 4.2. Inflation Forecast



Source: NIS, NBR projection

For the end of the current year, CPI inflation is expected to run below the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target (Chart 4.2). The projected level is similar for the end of 2016 to that in the previous round, while it was revised upwards by 0.1 percentage point for the end of 2017. This reassessment is solely due to the contribution of the adjusted CORE2 index, amid the anticipation of stronger-than-previously-projected domestic underlying inflationary pressures. Annual CPI inflation rate is seen stuck in negative territory by the end of 2016, before re-entering the variation band around the target in mid-2017 and remaining there until the projection horizon.

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



Source: NIS, NBR projection

Annual adjusted CORE2 inflation rate is forecasted to reach 0.5 percent at the end of 2016 and 3 percent at the end of 2017, before standing at 3.7 percent at the end of 2018 Q3, above the upper bound of the variation band of the target (Chart 4.3). Its path is shaped by the statistical first-round effects of the standard VAT rate cuts fading out successively[55], on the one hand, and the build-up of underlying inflationary pressures, on the other hand. These pressures will be generated by the widening of excess demand economy-wide, in the context of expansionary fiscal policy stance and higher unit wage costs[56] and, to a smaller extent, by softer disinflationary pressures from import prices, amid the anticipated rises in external prices. As for the latter, most of the global commodity prices are increasingly likely to rebound[57]. Against this backdrop, the forward-looking component of inflation expectations appears set to gain momentum gradually, with its contribution to core inflation entering positive territory in early 2017 and heading upwards thereafter. Core inflation net of the first-round effects of VAT rate change is seen standing at 1.4 percent and 3.1 percent at end-2016 and end-2017 respectively, and, starting January 2018, the two indices will overlap (Table 4.3).

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

annual percentage change; end of period

	2016	2017				2018		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Adjusted CORE2	0.5	1.6	2.1	2.7	3.0	3.3	3.5	3.7
Adjusted CORE2*	1.4	1.7	2.2	2.9	3.1	3.3	3.5	3.7

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

Compared to the August 2016 *Inflation Report*, the projected annual adjusted CORE2 inflation rate was revised upwards by 0.1 percentage points and 0.2 percentage points at the end-2016 and end-2017 respectively, especially in the context of higher excess demand over the entire projection interval and of the anticipated faster pick-up in processed food prices amid the recent developments on European markets. These influences were partly countered by the downward revision[58] of economic agents' inflation expectations.

Table 4.4. Components' Contribution to Annual Inflation Rate*

percentage points

	2016	2017
Administered prices	-0.9	0.4
Fuels	0.1	-0.2
VFE prices	0.0	0.2
Adjusted CORE2	0.3	1.8
Tobacco and alcohol	0.1	0.0

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

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

55 In January 2017 and January 2018.

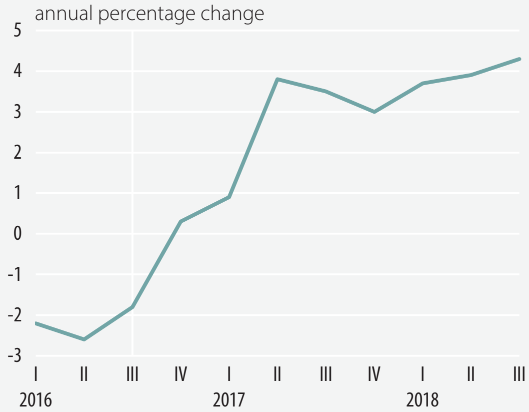
56 Also as a result of public-sector pay rises and successive increases in the gross minimum wage economy-wide.

57 For instance, in the case of processed food items, also as a result of effects from EU-implemented support schemes for the producers hit by Russia's ban starting August 2014. In response, the EC introduced exceptional financial aid of a temporary nature to those producers and its effects are already visible via oversupply contraction.

58 It reflects the lower-than-previously-anticipated inflation rate in September 2016, on the one hand, and the trend set out in the CPI inflation forecast published in the August 2016 *Inflation Report* relative to that in the previous *Report*, on the other hand.

-0.6 percentage points at the end of 2016 and 0.4 percentage points at the end of 2017, which are similar to the levels in the previous projection (Table 4.4). The breakdown shows that higher inflationary pressures from fuel prices for this year-end would be offset by the downward revisions to the dynamics of other exogenous components.

Chart 4.4. VFE Prices Annual Inflation*



*) end of period

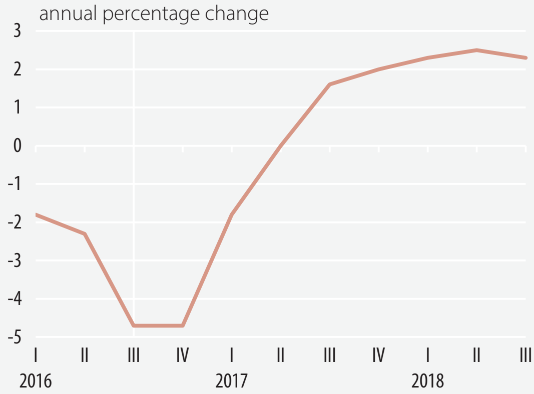
Source: NIS, NBR projection

The dynamics of volatile food (VFE) prices over the projection interval are marked by the assumption of normal agricultural years domestically, together, however, with the gradual fading of the persistent food oversupply on European markets. Under these circumstances, the annual growth rate of VFE prices will pick up from 0.3 percent at the end of 2016 to 3.1 percent at the end of 2017 and 4.3 percent at the projection horizon (Chart 4.4). These rates were revised downwards only for 2016, given their steeper-than-previously-expected drop in 2016 Q3[59].

The annual dynamics of administered prices are anticipated at -4.7 percent at end-2016 and 2 percent at end-2017, before reaching 2.3 percent at the projection horizon (Chart 4.5). For this year, the 0.2 percentage point downward revision of the group's dynamics is attributed to July's developments in energy prices, while the level projected for next year is similar to that in the preceding *Report*.

[59] Owing to domestic crop prices in particular.

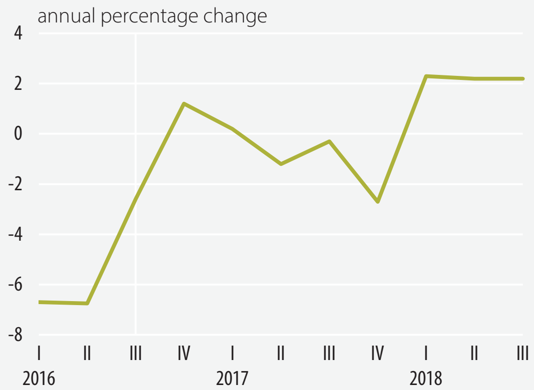
Chart 4.5. Administered Prices Annual Inflation*



*) end of period

Source: NIS, NBR projection

Chart 4.6. Fuel Prices Annual Inflation*



*) end of period

Source: NIS, NBR projection

The annual dynamics of fuel prices are forecasted at 1.2 percent at end-2016, -2.7 percent at end-2017, and 2.2 percent at the projection horizon. This path is significantly marked by the two-step cut in the standard VAT rate and the removal of the special excise duty on fuels[60], on the one hand, and a rising oil price envisaged for the entire projection period, on the other hand (Chart 4.6). Compared to the August 2016 *Inflation Report*, larger revisions of the projected annual dynamics for this group (up 2.3 percentage points) were made for the end of the current year, chiefly

[60] On 1 January 2017, being envisaged to add -0.3 percentage points to the annual CPI inflation rate at the end of next year.

on the back of faster oil price growth, partly offset by weaker inflation expectations, with an impact on this CPI basket component as well.

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 available, and is marked by the 2016 and 2017 standard VAT rate cuts. For 2016, the projected level is 0.5 percentage points lower following the stronger-than-previously-expected reductions in retail prices of such products in recent months. A level similar to that presented in the previous *Report* is anticipated for 2017.

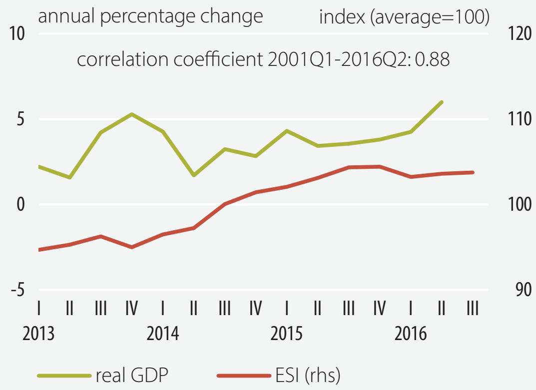
1.3. Demand pressures in the current period and over the projection interval[61]

Output gap

In 2016 Q2, seasonally adjusted real GDP saw a new quarterly increase (1.5 percent[62]), similar to that recorded in the previous quarter. Domestic demand was further the main driver of economic growth. In 2016 H2, real GDP is seen to continue its positive quarterly dynamics, albeit at a slower pace. Favourable signals come from indicators such as the economic sentiment (with a 0.2 point rise in 2016 Q3 – Chart 4.7) or industrial production (+1.1 percent in July-August 2016 versus the Q2 average); on the other hand, the volume of retail trade (excluding motor vehicles and motorcycles) increased by a mere 0.6 percent in the first two months of Q3, while that of new construction works fell by 2.2 percent.

Over the projection interval, potential GDP is anticipated to gradually step up its pace of increase on the back of a higher capital stock contribution (due to recent and forecasted investment dynamics) and a lower unfavourable contribution of labour (underpinned by the evolution of activity rate and unemployment rate). The projected dynamics of total factor productivity (TFP) mirror the assumption of economic agents making further efforts to reap the benefits of the European structural and cohesion funds[63], as well as of the low real interest rates, in their activity streamlining programmes. In the current year, the TFP development is further negatively affected by a carry-over effect linked to the agricultural sector performance in 2015.

Chart 4.7. Economic Sentiment Indicator* and Economic Growth



*) seasonally-adjusted data

Source: NIS, EC-DG ECFIN

The positive output gap for 2016 Q2 was revised to higher values than in the previous forecasting round, mainly on account of the stronger-than-expected GDP growth during this quarter. The assessment of the output gap as at end-2016 relies on high-frequency macroeconomic indicators such as the ILO unemployment rate (on a steady downtrend in 2015 and in 2016 H1) or the rate of capacity utilisation in industry (reporting higher readings in 2016 than in 2015).

Excess demand is projected to increase until the projection horizon (Chart 4.8). These dynamics mirror those of the real disposable income (bolstered by the impact of fiscal easing measures and the expected economy-wide pay rises), as well as the progressive closing of the external demand deficit and the stimulative set of real

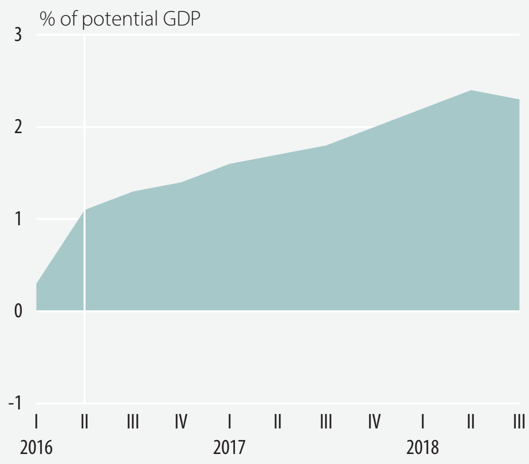
[61] Unless otherwise indicated, percentage changes are calculated based on seasonally-adjusted data series. Source: NBR, MPF, NIS, Eurostat, EC-DG ECFIN and Reuters.

[62] NIS Press Release No. 257 of 7 October 2016. In 2016 Q2, economic growth came in at 6 percent in annual terms.

[63] On 30 September 2016, the actual absorption rate of EU funds under operational programmes for the 2007-2013 financial period stood at 75.7 percent, up from 58.9 percent at end-2015.

broad monetary conditions. Towards narrowing the positive output gap act the effects of the implementation of the Brexit procedure (via the effective external demand[64]) and of the Law on debt discharge[65]. Compared with the August 2016 *Inflation Report*, the reassessment of the projected output gap mirrors, on the one hand: (i) the higher GDP dynamics in the first part of the current year and (ii) the more stimulative fiscal policy (via the fiscal impulse), mainly in 2016 H2[66], and, on the other hand, (iii) the real monetary conditions, which are forecasted to be less stimulative (given the smaller exchange rate contribution via the net export channel).

Chart 4.8. Output Gap



Source: NIS, NBR projection

The baseline scenario envisages faster economic growth in 2016. Throughout the forecast interval, economic growth is anticipated to further outpace the potential GDP dynamics, albeit recording lower levels than in 2016, once the impact of the fiscal stimuli and wage increases on domestic demand components has abated and amid the effects of the Brexit. The main positive contributions to economic growth come from the actual individual consumption of households (favoured by the evolution of their real disposable income) and from investment (given the further absorption of EU structural and cohesion funds). Against the background of the advance in domestic demand, imports of goods and services are expected to further rise faster than exports, thus contributing to the widening of deficit on trade in goods and services. Hence, the contribution of net exports to GDP growth is forecasted to be negative, albeit diminishing, over the projection horizon. This is, however, conditional upon the strengthening of Romania's trading partners' economic activity, and implicitly of external demand for Romanian products.

Aggregate demand components

In 2016 Q2, the actual individual consumption of households picked up to 2.9 percent from the previous quarter, being underpinned by pay rises and a slightly negative inflation rate[67]. This component is assessed to show further positive, albeit decelerating, dynamics in 2016 Q3 and Q4. Household consumption is supported by the continued rise in real disposable income, under the impact of the wage component (real increase of 1.9 percent in the average net wage economy-wide in July-August 2016 compared with the Q2 average). Signals of slower consumption growth come from the volume of retail trade, excluding motor vehicles and motorcycles, which rose by merely 0.6 percent in July-August 2016 versus the Q2 average, and from the consumer confidence indicator (down 1.2 points in Q3).

Over the forecast interval, the actual individual consumption of households is anticipated to expand at swift rates as compared with post-crisis levels, which are seen, however, to slow down. The forecast shows the diminishing impact exerted on the dynamics of real disposable income of households by fiscal and income policies, as well as by the anticipated pay rises in the private sector, in correlation with the dynamics of labour

[64] Over the short term, the EU economic outlook reflects a limited Brexit impact. However, on the medium term, amid uncertainties surrounding the start of negotiations on UK's exit from the EU, economic activity in the EU (Romania's main trading partner) is seen to be adversely affected.

[65] The tightening of credit standards applied by credit institutions in 2016 Q2 on loans to households for house and land purchase was partly offset by a reduction in down-payments for housing loans in Q3.

[66] Given that the cash-based budget execution at end 2016 Q3 points to the budget balance standing significantly below the government deficit target for the whole year (-0.49 percent versus -2.76 percent of GDP).

[67] Under the impact of changes reported by volatile food prices and administered prices in Q2.

productivity. Under the joint stimulative impact of the aforementioned factors, the cyclical component of actual individual consumption of households is assessed to post positive and increasing values throughout the forecast interval.

The actual collective consumption of general government is forecasted to increase in 2016 Q3 and Q4, yet its growth is assessed to remain consistent with keeping the budget deficit in the current year within the 3 percent reference value set forth by the Stability and Growth Pact. Over the projection interval, the actual collective consumption of general government is anticipated to see positive average annual dynamics in both 2016 and 2017.

Gross fixed capital formation (GFCF) rose by 6.6 percent in 2016 Q2 versus Q1, being boosted by both equipment purchases and construction works.

The dynamics of this indicator are also expected to decelerate in 2016 Q3 and Q4. Positive signals on the GFCF growth are sent out by the industrial output of capital goods, which went up 4.4 percent in July-August 2016 as compared with the Q2 average, and by the confidence indicator in construction (up 2.1 points in Q3 from the previous quarter). New construction works, which dropped 2.2 percent in July-August versus the Q2 average, are seen putting a damper on GFCF growth. The assessment of this component's dynamics is surrounded by uncertainty, due also to the revision of seasonally adjusted historical series.

The projection foresees the GFCF posting further favourable developments throughout the forecast interval. Compared to the levels seen in 2015, the GFCF growth will pick up in 2016 and decelerate in 2017. The GFCF dynamics are anticipated in the context of (i) the further absorption of EU structural and cohesion funds, the slight loss of momentum[68] during 2017 notwithstanding, and (ii) the favourable lending conditions, supportive of the advance in private sector investment. In addition, some fiscal measures, such as the cut in dividend tax and the removal of the tax on special constructions, carry the potential to release resources that can be channelled to investment programmes. Overall, the recently-opened positive deviation of GFCF against the trend is anticipated to persist over the forecast interval.

In 2016 Q2, exports of goods and services grew by 3.1 percent quarter on quarter. In 2016 Q3 and Q4, the growth rate of exports of goods and services is estimated to stay in positive territory, yet to decelerate as compared with the second quarter. These dynamics are supported by the prospects for the gradual economic recovery of Romania's trading partners over the medium term, under the influence of factors such as the persistence of the ECB's quantitative easing measures and the lasting low oil price. Exports of goods and services are anticipated to further record positive dynamics over the forecast interval, reflecting the persistence of structural improvements seen in recent years[69]. The forecast assumes that conditions for external demand recovery will remain in place, on the back of further relatively high uncertainty. The real effective exchange rate will have an additional stimulative effect on the forecasted growth rate of exports via price competitiveness. Against this background, the deviation of exports of goods and services from the trend is assessed to see positive, yet gradually lower, values over the projection interval.

In 2016 Q2, imports of goods and services grew by 5.9 percent quarter on quarter. For 2016 Q3 and Q4 and over the remainder of the forecast interval, imports are expected to expand further at a faster pace than exports, amid the rise in domestic demand. An additional upward influence is exerted by the anticipated favourable evolution of exports

[68] Moving into the new Multiannual Financial Framework 2014-2020 is foreseen to imply a possibly slower absorption of EU structural and cohesion funds, which is however expected to recover in the latter half of the forecast interval.

[69] In the post-crisis period, the share of machinery, apparatus, equipment and transport means in Romania's total FOB exports stayed above 40 percent, while services strengthened their 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.

of goods and services, through their import content. Against this background, the deviation of imports of goods and services from the trend is assessed to further see positive values.

In 2015, the balance-of-payments current account deficit rose to 1.2 percent of nominal GDP, on the back of the wider deficits on primary income and trade in goods, with the step-up in domestic demand contributing to the latter development. Over the forecast interval, the current account deficit is expected to widen further. The main determinant of this evolution is the dynamics of imports of goods and services, amid the increase in domestic demand. In this context, the current account deficit is forecasted to stabilise at around 2.5 percent of GDP over the medium term.

International reserves and, generally, the anticipated sources of financing the current account deficit are deemed to be adequate and favourably distributed in terms of non-debt-creating flows (particularly foreign direct investment and capital transfers[70]). Nevertheless, the reopening of the current account deficit due to the speed-up in consumption and a wider fiscal deficit carries the potential, in the event of rising volatility of capital flows to the emerging economies, to jeopardise Romania's macroeconomic equilibria.

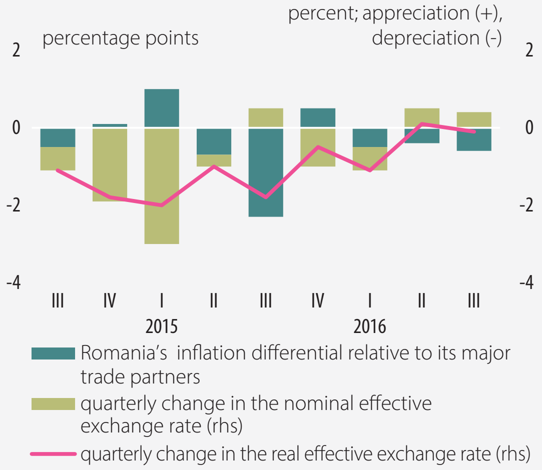
Broad monetary conditions

Broad monetary conditions capture the impact exerted on future developments in aggregate demand by the real interest rates applied by credit institutions on leu-denominated loans and deposits of non-bank clients and by the real effective exchange rate[71] 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[72].

The average nominal interest rates applied by credit institutions to non-bank clients' leu-denominated new loans and time deposits are anticipated to decrease in 2016 Q3. For 2016 Q4, the nominal interest rate for loans is expected to decline further, while that for deposits to remain unchanged from the previous quarter. The cumulative impact on economic activity in the period ahead generated by deviations of real interest rates from their trends is projected to be stimulative.

In 2016 Q3, compared to the previous quarter, the domestic currency strengthened in nominal effective terms, as a result of its appreciation against the euro. However, the leu depreciated in real effective terms, owing to the quarterly inflation differential of Romania versus its trading partners (Chart 4.9). 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

The wealth and balance sheet effect in 2016 Q3 and Q4 exerts stimulative influences on future aggregate demand mostly on account of (significantly negative) real foreign interest rate standing below the equilibrium level. The sovereign risk premium is assessed to stand close to the trend, thus having a neutral effect. On average, the CDS (Credit Default Swap) quotes for Romania decreased in 2016 Q3 versus Q2

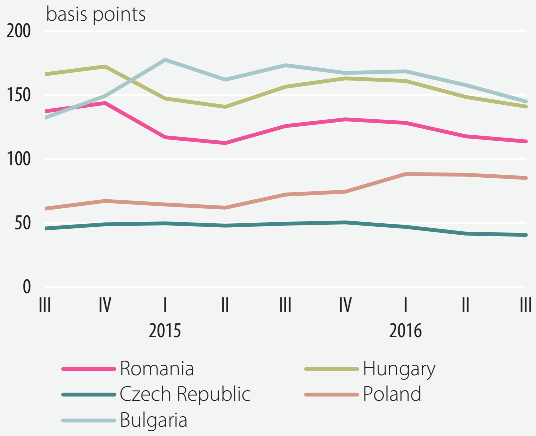
[70] Related to the absorption of EU structural and cohesion funds.

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

[72] The relevance of this channel declined gradually in recent periods, given the increase in the share of leu-denominated loans in total credit to the private sector.

(Chart 4.10). The medium-term prospects for the risk premium are influenced by domestic factors, associated with the build-up of the 2017 budget, as well as by the global economic developments, namely the relationship between the UK and the EU and the divergence between the Fed's and the ECB's monetary policy stances.

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



Source: NBR calculations based on Reuters data

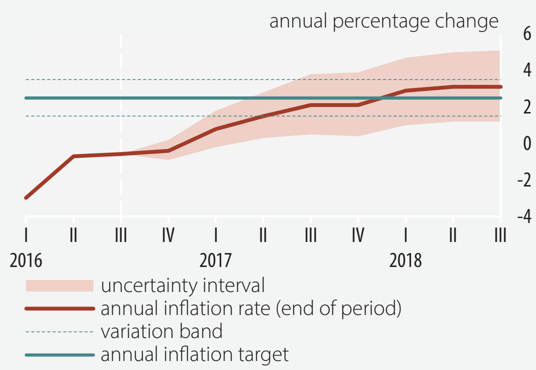
Overall, in 2016 Q3 and Q4, real broad monetary conditions are assessed to exert a stimulative impact on the positive output gap in the following quarters, thus fuelling inflationary pressures. By component, the stimulative impact stemming from the real effective exchange rate (via export price competitiveness) is prevalent.

Real broad monetary conditions are forecasted to continue having a stimulative effect on economic activity throughout the projection interval. The real effective exchange rate will further exert a prevailing stimulative effect via the export price competitiveness channel. An additional contribution in the same direction will have 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 preserve price stability over the medium term, in a manner conducive to sustainable economic growth.

1.4. Risks associated with the projection

The balance of risks to the annual inflation rate projection is assessed to be in equilibrium amid divergent influences associated with risks stemming from the domestic and external environment. Thus, while the risks arising from the domestic environment carry the potential to put additional inflationary pressures, the developments in the external environment variables are likely to generate opposite influences on the path of the inflation rate in the baseline scenario (Chart 4.11).

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 environment continues to pose significant risks to the inflation path in the baseline scenario. Despite the announcement made by the British Prime Minister on the possibility to invoke Article 50 of the Lisbon Treaty for initiating the exit procedure from the EU by end-March 2017, the uncertainty facing economic agents remains high. The volatility recorded on the international financial markets in the aftermath of the UK referendum was short-lived and limited, while developments such as the increase in risk aversion, which caused the deterioration of some stock market indices, unwound subsequently. Under the circumstances, depending on the actual institutional arrangements which will prevail in the EU-UK relationship, global demand might be affected to a different extent, triggering spillover effects on the external demand from the EU. At the same time, challenges persist across the

EU banking system, especially the Italian one, alongside the potential issues with Deutsche Bank[73], a global systemically important financial institution[74].

A source of risk that has become more relevant than in the previous round refers to the increasingly higher likelihood of a manifest divergence between Fed's and ECB's monetary policy stances. More recently, investors' expectations have envisaged a pick-up in Fed funds rate in the period ahead concurrently with the perception of a further accommodative monetary policy stance in the euro area. Other risk sources associated with the external environment which have remained relevant refer to the future evolution of global economic activity, fuelled by the uncertainties about the traction coming from emerging economies (especially China).

Given the Romanian economy's low direct exposure to the mentioned risk factors, in the event of some adverse scenarios materialising, the effects would pass through into the domestic economy mostly via indirect channels, conditional upon the impact that these developments could have on the economic activity of the EU, our main trading partner. These developments would induce downward pressures on the projected inflation rate. At the same time, via the unfavourable consequences on investors' confidence and the rise in global risk aversion, these could trigger portfolio shifts regionally and/or globally and, implicitly, leu exchange rate swings with adverse effects on the inflation path. In an external environment characterised by uncertainties and risks, the overlapping of which would amplify the unfavourable effects on the Romanian economy, it is necessary to maintain and 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.

On the domestic front, uncertainties persist with regard to the implementation of an adequate macroeconomic policy mix required for ensuring sustainable economic growth and preserving macroeconomic stability. Thus, risks are associated, on the one hand, with the possibility that this year's budget execution might differ from that assumed in the baseline scenario. On the other hand, major relevance is attached to the future fiscal and income policy stances. Uncertainties continue to persist as to the building of the 2017 budget, generated also by the legislative acts already adopted or in the process of being adopted by Parliament[75]. Such risks become even more relevant where public investment and structural reforms are postponed, triggering unfavourable direct effects on the growth potential and competitiveness of the Romanian economy. Furthermore, a reversal in the fiscal consolidation process and implicitly the deterioration of the external position will prompt foreign investors to reassess the risk associated with the Romanian economy.

The effects of the implementation of the Law on debt discharge remain a matter of concern in terms of the uncertainty surrounding the assessment of its impact on the domestic macroeconomic environment.

Turning to administered prices, in the absence of any clear 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. Additional disinflationary pressures stem from the potential implementation

[73] Amid the request made by the U.S. Department of Justice for the payment of a substantial fine to conclude the investigation into the sale of mortgage-backed securities.

[74] According to the IMF, *Germany: Financial Sector Assessment Program - Stress Testing the Banking and Insurance Sectors*, June 2016.

[75] These refer to: the increase in the pension indexation point to 40 percent of the economy-wide average gross wage as of 1 January 2017 and to 45 percent as of 1 January 2018, the cut by 5 percentage points in social security contributions of which 3 percentage points payable by employees and 2 percentage points due by employers, the exemption from payment of social health contributions and income tax for pensioners.

of the measure recently adopted by the Senate relative to broadening the scope of the reduced VAT rate to natural gas and electricity prices.

Domestic food price developments are facing imminent risks associated with weather conditions, which carry the potential to influence the agricultural produce supply in both ways. The balance of risks posed by international food commodity prices appears to be tilted to the downside. Specifically, the agri-food oversupply deriving from Russia's ban on imports of such goods may persist if the European Commission's support measures generate more muted effects than anticipated in the baseline scenario.

Relative to the risks posed by energy commodity prices to the inflation outlook, the potential implementation of the agreement between OPEC members to cut the oil production is aimed at ensuring an enhanced resilience to potential future downward adjustments in oil price[76]. 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.

[76] The final decision is to be taken on 30 November 2016 in Vienna.

Abbreviations

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
NIS	National Institute of Statistics
OPEC	Organisation of the Petroleum Exporting Countries
ROBOR	Romanian Interbank Offer Rate
UVI	unit value index
VAT	value added tax
VFE	vegetables, fruit, eggs
3M	3 months
12M	12 months
3Y	3 years
5Y	5 years
10Y	10 years

Tables

Charts