NATIONAL BANK OF ROMANIA

Inflation Report

February 2017

Year XIII, No. 47

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NOTE

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

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

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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 7 February 2017 and the cut-off date for the data underlying the macroeconomic projection was 1 February 2017.

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

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Summary

Developments in inflation and its determinants

In 2016 Q4, the annual CPI inflation rate was relatively stable, remaining in negative territory until end-2016 (-0.54 percent in December versus -0.57 percent in September). At the same time, in December, it stood 0.1 percentage points below the level forecasted in the previous *Report*, reflecting transitory influences (lower prices applied to some tobacco products and the significant cut in the prices of compulsory motor third-party liability insurance policies, with the latter also contributing to the deceleration in the annual rate of adjusted CORE2 inflation). These have largely offset the opposite impact generated by persistent factors – mainly the developments in the positive output gap, but also the dynamics of international commodity prices. The average annual HICP inflation rate continued to post less negative values, standing at -1.1 percent in December, as new annual changes affected by the reduced VAT rate being applied to all food items as of June 2015 were dropping out of its calculation.

The annual inflation rate net of the first-round effects of the VAT rate cut also saw a relatively sluggish evolution, inching up from 0.82 percent in September to 0.85 percent in December and thus remaining below the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target. Turning to the index components, while most of them had disinflationary contributions in the period under review, the dynamics of fuel prices recorded a significant advance amid a global recovery in oil prices and the US dollar's appreciating trend against major currencies and, implicitly, against the leu.

At end-2016, the annual adjusted CORE2 inflation rate stood at 0.3 percent, down from 0.6 percent in September. A similar evolution was posted by the annual core inflation rate, excluding the impact of the VAT rate change, which came in at 1.2 percent at year-end (down 0.2 percentage points against September), also running below the lower bound of the variation band of the flat target. Behind the further low level of core inflation stood mainly developments in external prices (including the impact of a slower annual depreciation of the leu versus the euro in late 2016), offsetting domestic pressures from the gradual widening in the positive output gap.

The second half of 2016 saw no productivity gains in industry, with the revival seen in Q2 having been short-lived. Against this backdrop, July through November, unit wage costs in industry continued to report a robust annual growth rate (8.7 percent). Looking ahead, the hikes announced for 2017 for both public sector wages and the gross minimum wage, alongside the forecasted rises in private sector earnings, are expected to support a fast annual growth rate of unit wage costs in industry and across the economy. For the coming period, the inflationary pressures building up through this channel might be reflected to a larger extent in prices, considering that the potential for the other production cost components to offset these upward pressures is seen to gradually fade in the context of an emerging worldwide uptrend for the main commodity prices (for energy, agri-food products, etc.).

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

In its meeting of 4 November 2016, the NBR Board decided to keep the monetary policy rate at 1.75 percent per annum. The baseline scenario of the forecast reconfirmed the annual inflation rate following an upward trend starting in early 2017 and anticipated its return inside the variation band of the target at mid-2017, to stand in the upper half thereof at the end of the projection horizon. This path reflected both the fading out of the transitory effects of the standard VAT rate cuts and the foreseen gradual dissipation of global disinflationary influences, as well as the inflationary pressures caused by the progressive opening of the positive output gap and by the upward dynamics of unit wage costs.

The risks associated with the projection stemmed from both the domestic and the external environment. On the domestic front, the risks related mainly to the 2017 budget configuration. The risks posed by the external environment arose primarily from the persistent uncertainties surrounding global economic growth and particularly euro area growth, in the context of the slow recovery of major emerging economies, the issues facing the European banking system and the outcome of the referendum in the United Kingdom.

Subsequently, the statistical data revealed a decline in the annual inflation rate in November 2016 to -0.7 percent, slightly below the previously forecasted level, after having reached -0.4 percent in October. This was mainly ascribable to the slower dynamics of tobacco product prices and to the impact of the price cuts for compulsory motor third-party liability insurance policies. The annual core inflation rate followed a relatively similar path, coming in at 0.5 percent in November 2016. The annual economic growth lost momentum in 2016 Q3 amid the sharper-than-expected deceleration in domestic demand growth.

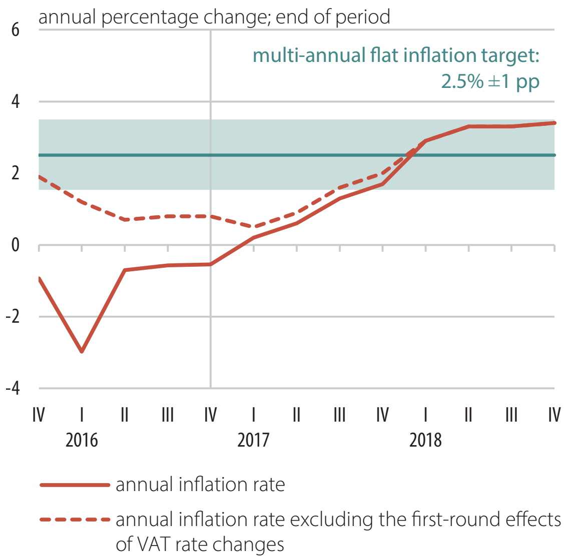
In the Board meeting of 6 January 2017, the latest assessments reconfirmed the prospects for the annual inflation rate to return to positive territory in 2017 Q1, along with resuming an upward course, against the background of persistent inflationary pressures associated with the positive output gap and of higher unit wage costs. The risks to the inflation outlook stemmed from both the domestic and the external environment. On the external front, previously identified risks persisted, to which added that concerning the evolution of the oil price and of other international commodity prices.

Based on available data and in the context of the highlighted risks, the NBR Board decided to keep unchanged the monetary policy rate at 1.75 percent per annum, to further pursue adequate liquidity management in the banking system and to maintain the existing minimum reserve requirement ratios on leu- and foreign currency-denominated liabilities of credit institutions.

Inflation outlook

The annual CPI inflation rate is seen on the rise throughout the forecast interval, from -0.5 percent at the end of 2016 to 1.7 percent at end-2017 and 3.4 percent at the projection horizon, i.e. 2018 Q4. Compared to the previous *Report*, the projected values of annual CPI and core inflation have been revised downwards for this year-end and upwards for the next. On the one hand, the annual adjusted CORE2 inflation rate is impacted by the recently-adopted stimulative fiscal and income measures. On the other hand, this rate will capture, especially in 2017 H1, the effect of a slower-than-previously-projected build-up of inflationary pressures coming from excess demand, whereas the impact from the significant cut in the prices of compulsory motor third-party liability insurance policies on the annual inflation rate will persist until October 2017. Starting from the second part of the forecast interval, mostly on the back of swifter growth in excess demand, core inflation will be the major driver of the level as well as of the upward revision of the annual inflation forecast against the previous round.

Inflation forecast



Source: NIS, NBR projection

The differences related to transitory first-round effects of the VAT rate cut, which are beyond the scope of the monetary authority, are projected to be further manifest until the end of this year, when the annual inflation rate net of these influences is anticipated to reach 2 percent. The two measures of annual CPI inflation will overlap as of January 2018.

Economic growth for 2017 is projected to remain above potential GDP dynamics, yet running below the relatively high levels registered in 2016. On the one hand, the recently-announced fiscal and wage-related stimuli point to a positive fiscal impulse, which is, however, lower than that assessed for 2016. On the other hand, the strengthening of economic activity in Romania's trading partners is expected to be relatively slow. Consumption and, to a smaller extent, investment will continue to be the main drivers of economic growth. The projected dynamics of actual individual consumption of households will reflect the impact exerted on real disposable income by the fiscal easing and public wage policy measures, as well as by the anticipated pay rises in the private sector. Assuming further absorption of EU structural and cohesion funds, the slight loss of momentum during 2017 notwithstanding, the projected rise in gross fixed capital formation is set to slow down somewhat this year, posting a swifter pace in 2018. Both GDP components will benefit from the real broad monetary conditions, foreseen to be stimulative throughout the reference interval.

With domestic demand projected to increase markedly, particularly this year, imports of goods and services are seen expanding faster than exports, thereby contributing to the current account deficit widening and stabilising at around 3 percent of GDP over the medium term. Even though the anticipated sources for current account deficit financing, including their composition, continue to be adequate, a reopening of the current account deficit due to the speed-up in consumption and to a wider fiscal deficit poses a risk to the macroeconomic equilibrium, with a direct impact on capital inflows.

In light of slower-than-expected economic growth in 2016 Q3, the positive output gap over the last year was revised to lower levels than in the previous forecasting round. At the same time, though, under the impact of additional fiscal and wage-related measures, higher growth in private sector income, gradual narrowing of the external demand deficit, and of the stimulative real broad monetary conditions, excess demand is foreseen to expand until the projection horizon and reach, as early as mid-2017, higher-than-previously-forecasted levels.

The current projection places the annual adjusted CORE2 inflation rate at 2.4 percent at end-2017 and 4.3 percent at end-2018. For December 2018, this rate is anticipated to go above the 3.5 percent upper bound of the variation band of the target. The path of this component is largely shaped by the developments in the output gap, to which add the progressive rise in economic agents' inflation expectations and the gradually stronger dynamics of import prices for consumer goods. The anticipated evolution of the annual adjusted CORE2 inflation rate will further be affected by the transitory impact of fiscal measures to cut the standard VAT rate until the end of this year, as well as by the cut in the prices of compulsory motor third-party liability insurance policies until October 2017. Net of the impact of VAT rate change, the annual core inflation rate is projected to reach 2.6 percent in December 2017.

Inflation components beyond the scope of monetary policy, i.e. administered prices, volatile food prices, fuel prices, tobacco product and alcohol beverage prices, are projected to make a cumulated contribution to the annual CPI inflation rate of 0.3 percentage points and 0.8 percentage points at the end of 2017 and 2018 respectively. For 2017, the contribution from these components was revised marginally downwards against the November projection (-0.1 percentage points), but its composition reflects considerably divergent influences: while the contribution associated with the change in administered prices is 0.3 percentage points lower, basically following the authorities' decision to scrap a number of non-tax fees and charges, that of fuels is 0.2 percentage points higher, on the back of faster rising oil price on international markets and the recent strengthening of the US dollar.

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 relatively in equilibrium. At the current juncture, the uncertainties are associated with possibly slower administered price dynamics in the future, on the one hand, and with the opposite influences from the fiscal and income policy conduct, as well as with external environment developments, on the other hand.

On the domestic front, one of the relevant risk factors is the future fiscal and income policy stance. Any deviation from the set of fiscal measures included in the 2017 draft budget on either revenue or expenditure side would have a bearing on public finance sustainability and, implicitly, on the configuration of the baseline scenario underlying the macroeconomic projection. Moreover, a budget spending composition where capital expenditures would be cut in favour of current expenditures could translate into a less sustainable structure of domestic demand over the medium term. This could cause consumer prices to increase faster than projected in the baseline scenario, affecting also the potential growth and the competitiveness of the Romanian economy. Under the circumstances, a general government budget deficit exceeding the 3 percent reference value set forth in the Stability and Growth Pact and, in turn, a worsening external position could prompt foreign investors to reassess the risk regarding the domestic economy.

Downside risks to the inflation outlook are, domestically, further attributed to the components beyond the scope of monetary policy, administered prices in particular. In this respect, the uncertainties about the timing of future energy price adjustments remain relevant, against the backdrop of the recent developments – that may persist over the following quarters – in international energy prices, as well as of the competent authorities' decisions on end-user price components subject to their regulation.

Global developments are still a sizeable source of risks to the inflation path in the baseline scenario. Lingering uncertainties about an increasing divergence between monetary policy stances of the world's major central banks relate to the future configuration of the economic policies pursued by the US Administration. This could imply rolling out a considerable fiscal stimulus stemming from tax cuts, together with increased infrastructure and defence spending, stricter immigration policies and increased trade protectionism. Portfolio shifts that might occur regionally and/or globally due to divergent developments in the major advanced economies could entail unpredictable swings in the exchange rates of emerging economies, including that of the leu, with an impact on the inflation path projected in the baseline scenario.

As for the risks coming from developments in commodity prices, the uncertainties surrounding the anticipated evolution of the oil price are lower relative to the previous round following the agreements reached among OPEC and non-OPEC members to cut the world oil production. In addition, the reshaping of the future monetary policy stance of the world's major central banks could have a different impact than that assumed in the baseline scenario on the EUR/USD exchange rate and, implicitly, on the leu-denominated prices of imported goods.

Monetary policy decision

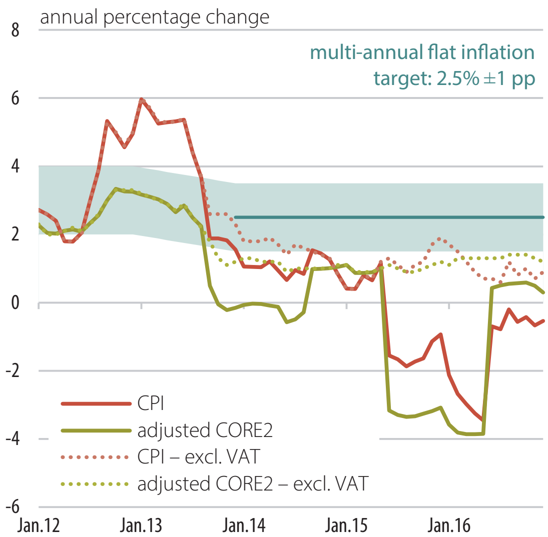
Considering the slower-than-previously-expected rise in annual inflation rate in the short run, as well as the risks to the medium-term inflation outlook stemming from the fiscal and income policy stance and the uncertainties surrounding global economic growth and the euro area economic recovery, the Board of the National

Bank of Romania decided, in its meeting of 7 February 2017, to keep unchanged the monetary policy rate at 1.75 percent per annum. Moreover, the Board decided to preserve the symmetrical corridor of interest rates on standing facilities around the policy rate at ±1.50 percentage points, 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 Q4, the annual CPI inflation rate was relatively stable, remaining in negative territory until end-2016 (-0.54 percent in December). In the absence of the direct effect of the standard VAT rate cut, consumer prices would have risen by about 0.85 percent in annual terms in December, a level below the lower bound of the ±1 percentage point variation band of the 2.5 percent flat target. However, this evolution was the result of transitory factors, which largely offset the opposite impact generated by persistent factors. Specifically, inflationary pressures stemming from the positive output gap and the consolidated uptrend in main international commodity prices were counterbalanced at CPI level by the atypical reduction in prices for some tobacco products and the significant cut in prices of compulsory motor third-party liability insurance policies. Along with the slower annual depreciation of the leu versus the euro, the latter factor made a large contribution to the deceleration in the annual rate of adjusted CORE2 inflation in Q4 (by 0.2 percentage points, to 1.2 percent – value net of the direct effect of fiscal changes; Chart 1.1).

Chart 1.1. Inflation developments



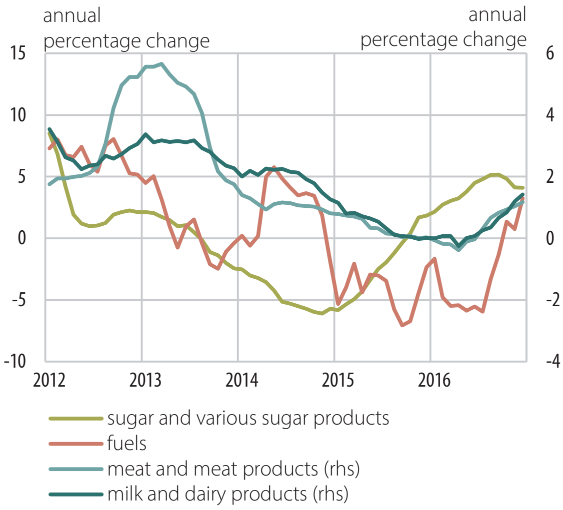
Source: NIS, NBR estimates

2016 Q4 saw stronger signals of a recovery in main international commodity prices (energy, metals and most agri-food products), their annual growth rates gaining broad-based momentum[1] and thus re-entering positive territory towards end-2016. Looking at producer prices, observed developments in commodity prices indicate that a notable source of influence offsetting rising pressures exerted over the past years on wage costs has recently faded almost entirely. Turning to the CPI basket components, an uptrend in prices of some processed foodstuffs (i.e. milk and dairy products, meat and meat products) and in fuel prices is already manifest, the latter's increased dynamics being underpinned also by the strong appreciation of the US dollar against the leu (Chart 1.2).

At the same time, the further positive measures of the domestically generated inflation – DGI (unit labour costs economy-wide, unit wage costs in industry and the GDP deflator) have continued to point to inflationary

[1] With the exception of wheat and sunflower seeds, whose prices fell in annual terms amid larger crops than in the previous year. Worth mentioning is also the significant deceleration in the annual growth rate of sugar prices (from 70 percent in Q3 to 42 percent in Q4), in correlation with the higher-than-expected output in Brazil, the world's top producer, as well as with the depreciation of this country's currency versus the US dollar.

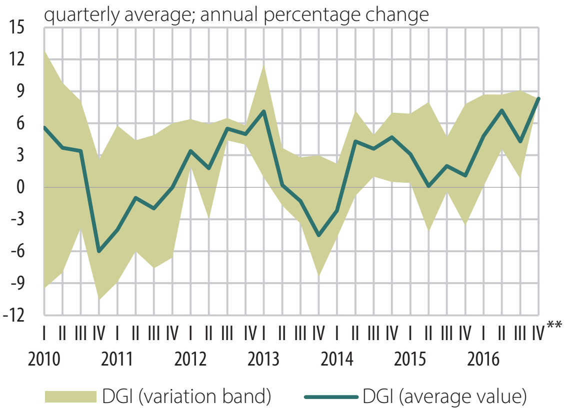
Chart 1.2. Prices for staple food and fuel



Note: Annual changes net of the first-round effects of the VAT rate cut.

Source: NIS, NBR estimates

Chart 1.3. Domestically generated inflation*



*) 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

**) Oct.-Nov.

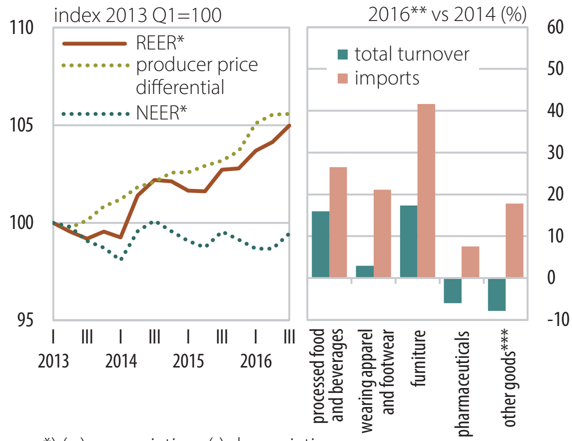
Source: Eurostat, NIS, NBR calculations

pressures building up on the domestic front (Chart 1.3); the alleviation of these pressures in Q3 seems to have been short-lived, the first signals for 2016 Q4 indicating rather a resumed upward path.

The above-mentioned influences were basically offset in Q4 by the impact of some transitory factors – the drop in the price of a representative item for cigarettes and, respectively, the significant cut in prices of compulsory third-party liability insurance policies following the authorities' decision to cap them for six months. The latter measure was actually the main determinant of the decline in annual core inflation rate (adjusted CORE2) in late 2016, another driving factor being the slowdown in the depreciation of the leu against the euro in annual terms, which was directly mirrored by the slacker annual dynamics of some market services prices (telephony services and radio-TV subscriptions). The deceleration in core inflation seen in the latter part of 2016 may also be accounted for, to a certain extent, by some retailers' early incorporation of the lower VAT rate scheduled for January 2017.

From a broader perspective, adjusted CORE2 inflation (net of the effects of the VAT rate cuts) posted a slight uptrend in 2016, reaching a 1.4 percent high in August-October. Behind the further low level of core inflation stood mainly the developments in external prices, acting as a counterbalancing factor for rising domestic pressures from the gradual widening of the positive output gap. In addition, the market share of consumer goods imports in total household purchases of goods has increased steadily over the past years, due to their higher price competitiveness, as well as to the limited capacity of local producers to rapidly adjust their production facilities so as to accommodate the significant hike in consumer demand following the stimulative measures introduced starting June 2015 (Chart 1.4).

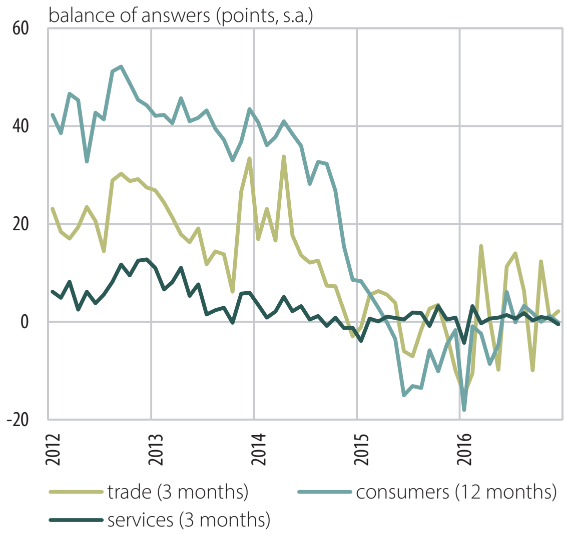
Chart 1.4. Consumer goods: real effective exchange rate (REER) and trade flows



*) (+) appreciation, (-) depreciation
**) 9 months
***) 2015 vs 2014 (the level of disaggregation required for compiling this group is not available for 2016)

Source: NIS, Eurostat, NBR estimates and calculations

Chart 1.5. Economic agents' expectations on price developments



Source: NIS/EC-DG ECFIN Survey

Inflation expectations of financial analysts re-embarked on an upward path starting 2016 H2, at both the one-year and two-year horizons, coming close to the central point of the inflation target (2.5 percent). At the same time, economic agents' answers to the DG ECFIN survey paint a relatively stable picture over the short term (three months) for prices at sectoral level (in industry, construction, trade and services), and among consumers, over the longer-term outlook (12 months; Chart 1.5).

The average annual HICP inflation rate continued to post less negative values, standing at -1.1 percent in December, as new annual changes affected by the reduced VAT rate being applied to all food items as of June 2015 were dropping out of its calculation. Against this backdrop, the differential versus the EU-wide average narrowed to -1.3 percentage points, an opposite impact having the recent step-up in inflation at European level, prompted by crude oil price movements in international markets.

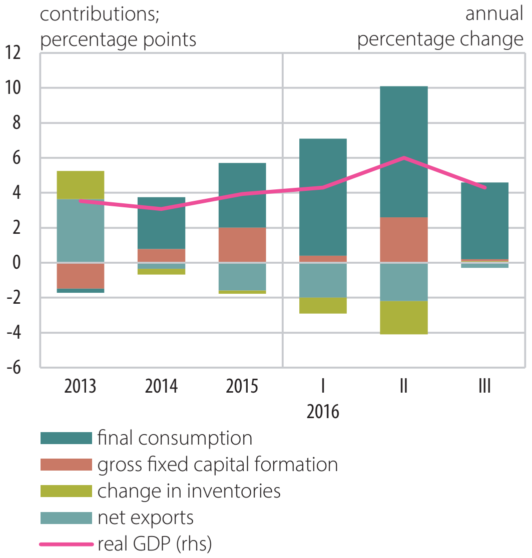
Compared to the November 2016 *Inflation Report*, the annual rate of change in consumer prices stood 0.1 percentage points below the forecasted level, chiefly as a result of the above-mentioned transitory factors.

2. Economic developments

1. Demand and supply

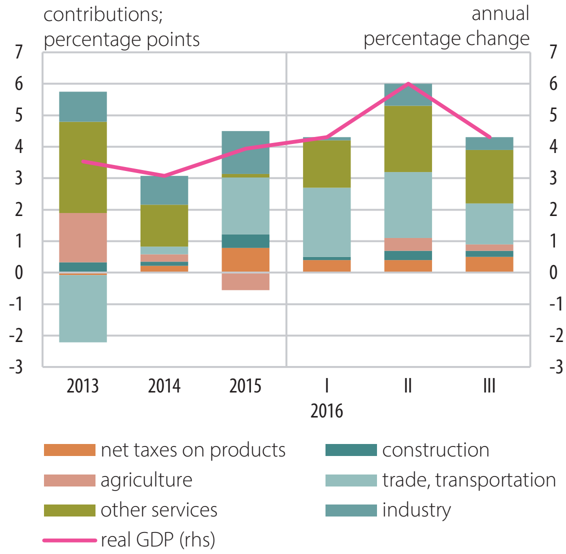
In 2016 Q3, economic activity continued to expand at a rapid pace (4.3 percent in annual terms), so that the advance in real GDP in the first three quarters of 2016 exceeded the 2015 average (4.8 percent versus 3.9 percent), supporting expectations of stronger growth in 2016 (Chart 2.1). Nevertheless, annual dynamics decelerated by 1.7 percentage points versus 2016 Q2, on account of both components of domestic absorption – consumption and investment. This development played a significant part in purchases of imported goods recording a slacker pace of increase and the negative contribution of the external sector to GDP growth was hence corrected almost in full.

Chart 2.1. Demand



Source: NIS, NBR calculations

Chart 2.2. Supply



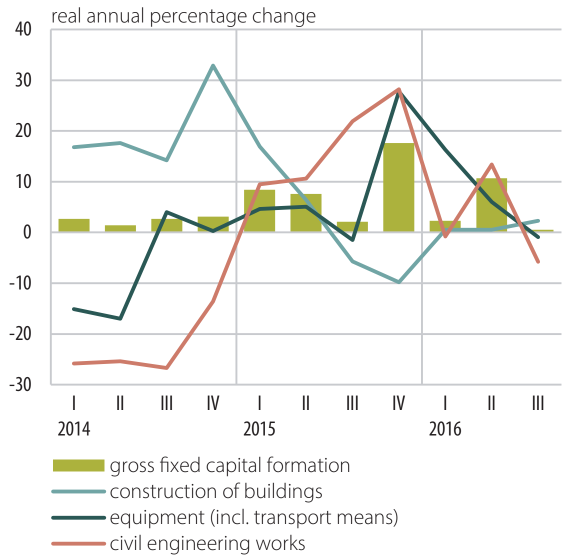
Source: NIS, NBR calculations

The growth rate of household consumer demand eased by 3.4 percentage points compared with 2016 Q2, while remaining however robust (6.1 percent), amid the further swift dynamics of household real income (around 15 percent). The deceleration owed particularly to the fading-out of the first-round effect of the VAT rate change in June 2015, retail sales of food items reporting a slacker annual growth of 7.6 percent. At the same time, motor vehicle sales witnessed a step-up (over 20 percent in annual terms) in the case of both new cars (spurred by the ongoing vehicle fleet renewal programme) and used motor vehicles, leading to further rises in trade in spare parts and in maintenance and repair. The volume of motor fuel purchases also stayed on an upward path, with lower prices making a favourable contribution in the first part of 2016 Q3 (nonetheless, this influence has reversed since September; Chart 2.2). Consumer demand is likely to maintain its robust positive momentum in the coming months as well, the real increase in retail trade turnover seen October through November 2016 (which was however slightly lower than the average annual dynamics in Q3) being expected to persist in Q4 as a whole. A hint in this respect is provided by the consumer confidence indicator, whose average level improved in 2016 Q4 compared with the previous three-month period, on the back of all components – employment, financial situation (savings included), general economic situation. Prospects remain favourable, given the additional increase in households' purchasing power in early 2017, amid the announced pay rises and the standard VAT rate cut from 20 percent to 19 percent as of 1 January 2017.

In 2016 Q3, the general government budget execution was quasi-balanced (a surplus of lei 0.2 billion[2], below that posted in the same year-ago period[3]), after 2016 Q2 saw a deficit of lei 6.9 billion (0.9 percent of GDP). The budget execution result primarily reflected the impact of the notable slip in the expenditure growth rate (to 1.8 percent[4] from 8.6 percent in the previous quarter), which was mainly determined by the sharper decline in spending for projects financed from non-repayable external funds, and, to a smaller extent, by the deceleration in the public wage bill[5], social transfers, and government spending on goods and services[6]. In turn, budget revenues saw a slightly slower decrease (to -1.3 percent against -2.7 percent), mainly due to the relative improvement in the dynamics of VAT receipts and non-tax revenues, along with the faster growth of receipts from the personal income tax, as well as the corporate income tax.

In 2016 Q3, investment demand was stagnant (0.5 percent annual growth rate versus 10.7 percent in the previous quarter; Chart 2.3). A major contribution came from civil engineering works – a series with increased volatility, coupled with the election calendar and the uneven pattern of budget execution (namely the fast rise in expenditure over the latter months of 2016). Specifically, in the quarter under review, civil engineering reported a contraction, largely on account of the fall in the current period, once the stimulus provided by the June local elections had faded out and some EU-funded projects under the 2007-2013 programming period had been completed in 2016 H1. The trend is likely to persist in the coming period as well, as the potential rebound in December 2016

Chart 2.3. Investment



Source: NIS, NBR calculations

2 The analysis relied on the operational data related to the September 2016 budget execution, as published by the MPF.

3 Approximately lei 2 billion (0.3 percent of GDP).

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

5 The developments in the public wage bill and social transfers also show the dropping-out from the annual rate of the impact of last year's hike in public sector wages and state child benefits.

6 The return to positive territory of the annual dynamics of subsidies and other transfers had an opposite impact.

will not suffice to offset the sharper drop in such construction works in the first two months of Q4 against the previous quarter. Purchases of equipment (including motor vehicles bought by companies and public institutions) also recorded an adverse performance, their steadily slower increase in 2016 H1 being followed by a decline in Q3. This is correlated with the subdued developments in the main financing channels since early 2016: (i) the real dynamics of equipment loans gradually lost momentum, and (ii) the self-financing ratio[7] of non-financial corporations in 2016 Q1-Q3 stood below the past years' average. Even though some industrial companies have recently seemed to show increased interest in investments to produce higher value-added goods[8], improved prospects are still uncertain, given that the findings of the latest NIS/DG ECFIN survey on investments in the manufacturing sector point to a 5 percent drop in 2017.

Construction of buildings was the only component following an upward trajectory in 2016 Q3, posting a 2.3 percent annual growth rate, after the near standstill in 2016 H1. January through November 2016, residential construction works reported the stronger increase (around 13 percent in annual terms), with favourable prospects, as suggested by the rise in the construction area stipulated in building permits (up 10.3 percent) over the same period. The Bank Lending Survey conducted by the NBR also provides encouraging signs, in the context of expectations for housing loans in 2016 Q4 converging to the further easing of credit standards by credit institutions, concurrently with the higher household loan demand.

The lower positive contribution of domestic demand to economic growth was partly offset by the performance of the external sector. In this vein, both exports and imports of goods posted slacker annual dynamics, with the deceleration seen by the latter being however more pronounced.

Turning to exports of goods, the slower annual growth rate in the quarter under review (down 1.4 percentage points, to 7.5 percent) was driven chiefly by one-off developments, namely, on the one hand, the technical inspections carried out by some chemical and hydrocarbon processing companies and, on the other hand, the drop in motor vehicle exports, possibly following production line changes amid the launch of new models at the end of Q3. The latest available information indicates that the aforementioned influences faded towards end-2016, given that October through November the annual dynamics of the turnover volume for the external market returned to positive territory for both the hydrocarbon processing sub-sector and the chemical industry and in Q4 the number of exported motor vehicles fell at a slacker annual pace, which was similar to that recorded in 2016 H1[9]. In 2016 Q3, exports of agri-food commodities (cereals and oleaginous plants) reported a notable performance, as their annual growth rate accelerated to 24 percent and 72 percent in real terms respectively, amid a good agricultural year.

7 Calculated as a ratio of gross saving to gross fixed capital formation for non-financial corporations.

8 In sub-sectors such as the manufacture of electrical equipment and spare parts, metallurgy, and the chemical industry, possibly under the influence of the legislative changes that have been adopted lately in order to support research and development – personal income tax exemption for workers in applied research and development and technological development activities, and a 50 percent additional deduction of R&D expenditure from the corporate income tax.

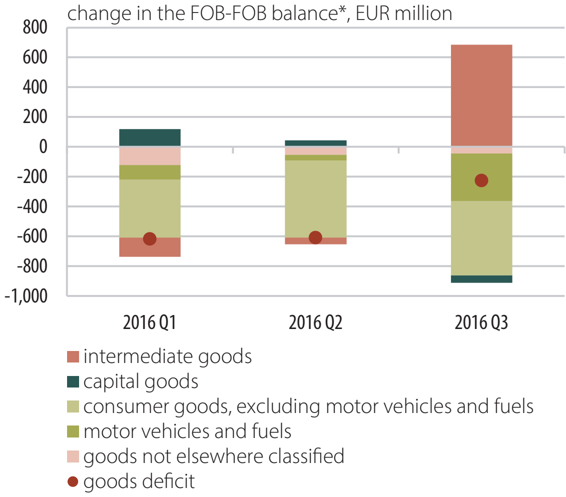
9 According to Automotive Manufacturers and Importers Association data.

Over the year as a whole, the competitiveness of domestic exports remained relatively favourable, the ongoing uptrend in sales abroad being however adversely affected by the heterogeneity of the competitiveness position across manufacturing. Thus, export performance is actually supported by a small number of industries, namely those that are integrated within the global production networks, which benefited from substantial FDI inflows, such as the manufacture of motor vehicle parts and electrical equipment. At the same time, the light industry, the chemical industry and metallurgy (which account for another 14.3 percent of total exports of goods[10]) are less supportive of sales abroad, amid the competition from Asian manufacturers and certain domestic constraints (rising wage cost pressures, decline in production capacities).

Over the short term, exports are expected to post positive developments, bolstered by the prospective consolidation of EU demand, as indicated by the improvement in the economic sentiment indicator (which reached a post-crisis high) and in the consumer confidence indicator in the latter half of 2016. Moreover, some encouraging signs may be observed in metallurgy, amid the recent hikes in international metal prices and the stronger EU measures implemented to protect market operators from the competition of Chinese steel producers.

The slower growth rates of both domestic absorption and exports in 2016 Q3 (driven particularly by base effects and one-off factors) led the annual dynamics of the import volume of goods to decline by half, from 15.1 percent to 7.3 percent. The breakdown shows that relevant contributors were: (i) processed food, following the fading-out of the first-round effect of the VAT rate change in June 2015; (ii) chemicals, taking into account the base effect associated with the closure of a chemical company in 2015; (iii) crude oil, given the said technical inspections; (iv) motor vehicles, which continued to grow however at a two-digit pace; and (v) machinery and equipment.

Chart 2.4. Change in goods balance versus the same year-ago period



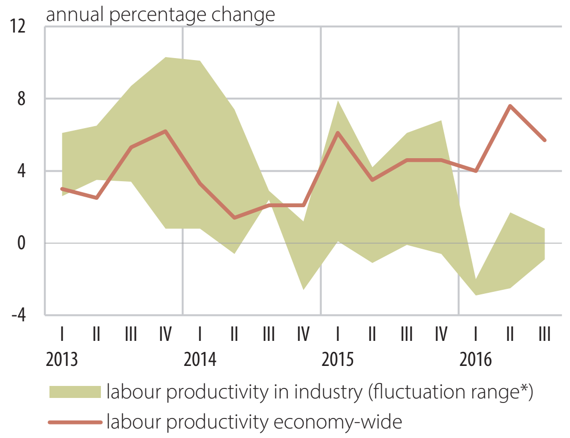
*) excluding goods under OPT arrangements

Source: Eurostat, NBR calculations

Under the circumstances, the balance on trade in goods deteriorated at a markedly slacker tempo than in 2016 H1, namely from approximately EUR 600 million in each of Q1 and Q2 to about EUR 200 million in Q3 (changes versus the same period a year earlier). Looking at the broad economic categories, solely intermediate goods reported a lower trade deficit, against the backdrop of a large agricultural output and of the base effects that marked the developments in such industrial imports (Chart 2.4). Similarly to the previous period, a large share of the trade deficit, i.e. over 80 percent, was offset by net receipts of local companies rendering international services, with the significant dynamics of "ICT and other business services" (above 20 percent) being worth mentioning this time as well.

10 In line with the international trade methodology (source: NIS).

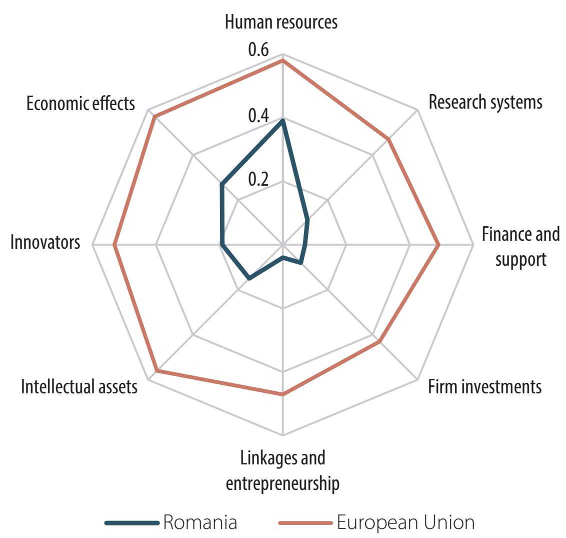
Chart 2.5. Labour productivity



*) calculated depending on labour productivity per employee, based on GVA data in national accounts, and on labour productivity per hour worked and labour productivity per employee in industry respectively, based on monthly industrial output data

Source: Eurostat, NIS, NBR calculations

Chart 2.6. Innovation index components, 2015



Source: European Commission

Labour productivity

In 2016 Q3, labour productivity increased at a slower annual pace in most economic sectors, mirroring the loss of momentum seen by aggregate demand over the period under review. Turning to industry, significant negative contributions to the said development came from the food industry (also on the back of the steady market share losses to imports), the manufacture of construction materials and fabricated metal products (amid subdued demand), as well as from the chemical industry and the hydrocarbon processing sub-sector (following the permanent or temporary shutdown of some production facilities).

Taking a broader view, productivity gains in industry are late in coming, the annual growth rate being close to nil January through November 2016 (Chart 2.5). Looking at persistent factors, this development is attributable to the lack of progress on addressing structural rigidities in the labour market (skilled labour shortage, inadequacy of the education system, low mobility), to modest capital build-up, as well as to the nearly zero interest in innovation. As far as this issue is concerned, according to the latest assessment in the field conducted by the European Commission, Romania further ranks last in the EU with respect to the Summary Innovation Index[11]. Moreover, Romania's relative performance to the EU has worsened over the past years, i.e. from 50 percent of the EU average in 2008 to below 35 percent in 2015 (Chart 2.6).

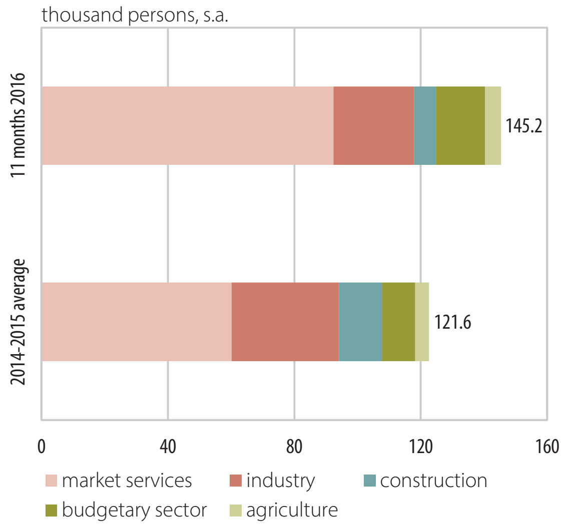
Labour market developments[12]

July through November 2016, the number of employees economy-wide further rose at the relatively robust pace it had posted in 2016 Q2 (+3.4 percent in annual terms). This time too, a significant contributor was the market services sector, where labour absorption gained traction (these services accounted for approximately 65 percent of net job creation in January-November 2016). Specifically, faster annual dynamics of payrolls were recorded in trade, transportation, and accommodation and food service activities (Chart 2.7). By contrast, the capacity of industry to create jobs in the economy shrank, its contribution to a higher number of employees economy-wide falling from about 30 percent on average in 2014-2015 to merely

[11] The European Innovation Scoreboard.

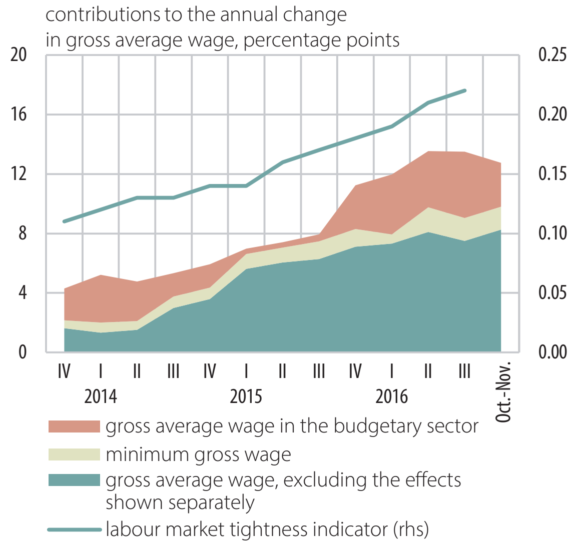
[12] The analysis is based on seasonally adjusted data.

Chart 2.7. Net increase in the number of employees economy-wide



Source: NIS, NBR calculations

Chart 2.8. Labour market tightness and gross average wage economy-wide



Source: Eurostat, NIS, MLSJ, NBR calculations

18 percent at present. Moreover, substantial increases in staffing levels were observed only in industries manufacturing spare parts, whereas companies operating in other industrial sub-sectors had a cautious hiring policy (the food industry, metallurgy) or even resorted to layoffs (the light industry, crude oil processing, mining and quarrying, the energy industry).

In this context, July through November 2016, the total number of employees industry-wide witnessed a modest rise, the annual growth rate staying at around 2 percent. As far as construction is concerned, the slower dynamics of such activity than in 2015 translated into a sharp deceleration in the pace of hiring, so that the growth rate of payrolls halved in annual terms in the course of 2016.

At the aggregate level, the higher labour absorption capacity of the economy brought about a drop in excess supply, so that July through November 2016 both unemployment rates declined. In particular, the ILO unemployment rate decreased by 0.3 percentage points, to 5.8 percent, whereas the registered unemployment rate fell by 0.1 percentage points, to 4.8 percent. Consequently, the July-November 2016 labour market developments confirm the previous assessments on the gradual labour market tightening, the structural rigidities highlighted in the analyses conducted over the past two years adding to the impact of cyclical factors (Chart 2.8).

Looking ahead, for end-2016 and 2017 Q1 both the Manpower Employment Outlook Survey and the EC-DG ECFIN survey show robust employment intentions in services and industry and a relatively stable outlook in construction. Contrariwise, there are divergent prospects in trade. Specifically, the Manpower survey points to the highest employment expectations since 2008 H2, whereas the EC-DG ECFIN survey suggests a significant decline in staff numbers (which is at odds with the expansion of chain stores, as well as with the wage increases and benefits announced by the latter in order to attract employees).

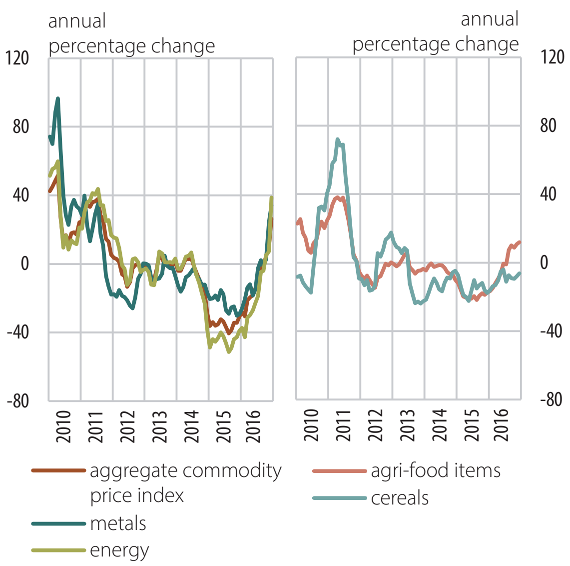
July through November 2016, the annual growth rate of net average wage earnings was around the level posted in 2016 Q2, i.e. 13.4 percent, down 0.2 percentage points. The slight slowdown was attributable to the private sector (11.5 percent), specifically to construction, manufacturing and most market services (except for ICT services and transportation, which witnessed a notably stronger activity). The said deceleration primarily mirrored the effect of the July 2015 rise in the minimum wage dropping out of the calculation of the annual growth rate. Net average wage earnings in the budgetary sector continued to increase (by 21.0 percent), as in August 2016 low-wage earners in public institutions (and mainly in the health sector) benefited from wage hikes estimated at around 5 percent on average. A further acceleration in the annual dynamics of the average wage is expected in 2017 Q1, following pay rises in the budgetary sector[13] and the increase in the gross minimum wage economy-wide to lei 1,450 (+16 percent) in February 2017.

2. Import prices and producer prices

The consolidating upward path in most international commodity prices in 2016 H2, along with the appreciation trend of the US dollar, was mirrored by import prices and producer prices on the domestic market falling at a significantly slower pace. Hence, although commodity prices have so far acted as a cushion for the pressures built up via the wage costs channel, the recent trend reversal in prices on international markets makes it unlikely for this room for manoeuvre to persist in the future.

2.1. Import prices

Chart 2.9. International commodity prices



Source: IMF, FAO, NBR calculations

Main commodity prices increased further in 2016 Q3, at a faster pace towards end-year, their annual dynamics reverting strongly to positive territory (the change in the aggregate index stood at around 27 percent in December), after two years of successive large contractions. Prices rose across the board, with growth rates ranging between 12 percent for food[14] and 39 percent for energy (Chart 2.9). The upward trend in commodity prices is associated with signs of recovery in global demand (including expectations regarding the implementation of some infrastructure projects in the US), as well as with the narrowing supply following the closure of some metal production facilities (in China and Australia, among others) and with the agreement between oil-producing countries to cut their output.

Against this backdrop, the disinflationary pressures exerted by the external environment on domestic developments faded markedly July through

[13] Namely up 15 percent in health in December 2016, up 15 percent in education in January 2017, up 20 percent in local government and up 50 percent for actors in February 2017.

[14] Behind this category of price dynamics running at the lower bound stood, to a large extent, the cereal price movements, amid the 2016 output exceeding the last 5-year average and the already large global stocks further underpinning the downtrend.

September 2016, the unit value index of imports[15] (UVI) advancing by 3.5 percentage points compared to the previous quarter, to stand at 98.9 percent in annual terms. This trend owed also to the slower pace of appreciation of the euro against the US dollar.

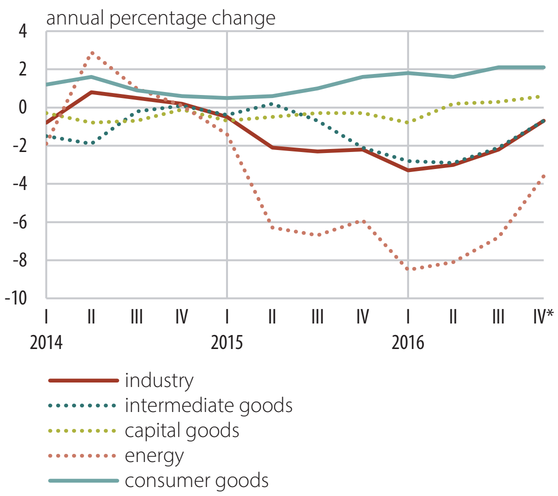
In line with crude oil and metal price movements, mineral products, chemicals and base metals saw significantly slower rates of decline, further making, however, the main contribution to the UVI remaining below one.

As regards goods holding a relevant share in the CPI basket, food items reported increasing indices, most of them rising above one amid the recovery in international agri-food prices (meat, dairy products, and edible oils); the only exceptions were vegetal products, which posted a sharper drop in UVI as a result of the decline in grain prices worldwide. Looking at some non-food items (footwear and accessories, as well as transport means), their UVIs remained above one, albeit falling at lower levels.

2.2. Producer prices on the domestic market

In 2016 Q3, industrial producer prices on the domestic market reported a slowdown in their negative annual dynamics compared to the previous period (+0.9 percentage points, to -2.2 percent), with all groups of goods posting higher rates of change. This owed mainly to developments in energy (+1.3 percentage points, to -6.8 percent) and intermediate goods (+0.9 percentage points, to -2.0 percent), correlated, in both cases, with movements in main commodity prices on international markets (Chart 2.10).

Chart 2.10. Industrial producer prices on the domestic market



*) Oct.-Nov.

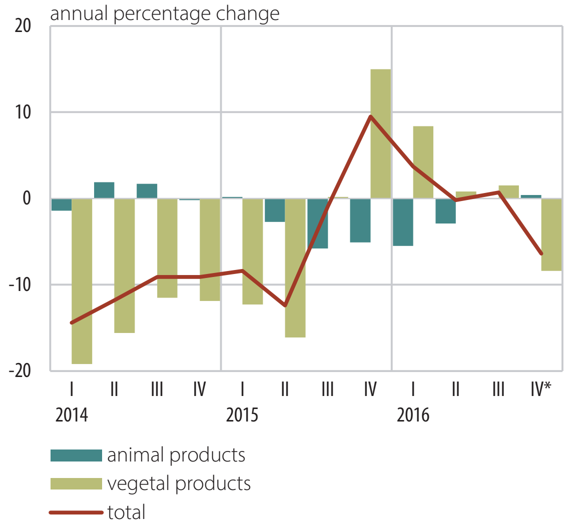
Source: NIS

The annual growth rate of consumer goods prices picked up 0.5 percentage points versus 2016 Q2, to 2.1 percent, mirroring increasing production costs amid a less favourable external influence, concurrently with persistently high wage dynamics in related industries (over 10 percent). The rapid advance in consumption over the past year has created an environment that allows the pass-through to prices of the above-mentioned pressures. However, this is also increasingly conditional on the price strategy of foreign competitors, which have constantly expanded their share on the domestic market (to almost half in 2016).

In 2016 Q3, the annual rate of change of agricultural producer prices re-entered positive territory, albeit recording low levels (0.7 percent). Looking at the vegetal produce segment, prices reported positive annual growth rates in 2016 Q3 as a whole

[15] Calculated based on EUR-denominated data.

Chart 2.11. Agricultural producer prices



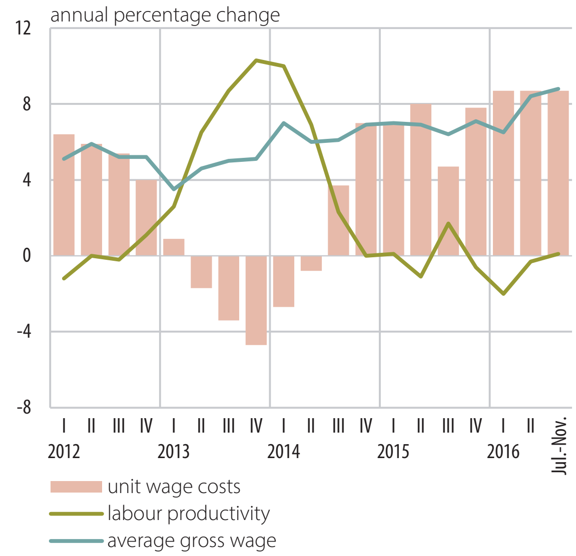
*) Oct.-Nov.

Source: NIS

(1.5 percent), yet they witnessed a trend reversal towards end-quarter – i.e. starting September 2016, their dynamics turned negative (-2.4 percent), once information of an agricultural output above the long-term average had emerged (excluding the corn crop). The negative rate of change of animal product prices slowed to zero, turning slightly positive in October, mainly on account of the narrowing oversupply on the European front (Chart 2.11).

At aggregate level, the available data for October-November 2016 point to an even more pronounced slowdown of the annual rate of decline of industrial producer prices on the domestic market. This owed, yet again, mainly to energy and intermediate goods, amid crude oil and metal prices reverting to substantial annual growth rates. However, in light of the administrative decision to cut electricity distribution tariffs starting January 2017, the rate of change of producer prices on the domestic market may remain in negative territory in the near run as well. Nonetheless, it is likely to return to positive values over the longer term, due to the persistence of the current trend in production costs (materials and labour costs).

Chart 2.12. Unit wage costs in industry



Source: NIS, NBR calculations

Unit wage costs

In July-November as a whole, unit wage costs in industry continued to report a robust annual growth rate, i.e. 8.7 percent (Chart 2.12). The steadiness of the pace was however the result of mixed developments by sub-sector. On the one hand, the decline in energy production amid lower energy consumption was mirrored by faster dynamics of unit wage costs. On the other hand, the growth rate of this indicator slowed down by 1.1 percentage points in manufacturing, yet further standing at a markedly positive level (10.2 percent). The automotive industry, the manufacture of computers and the manufacture of wood witnessed lower pressures via this channel due to more favourable production developments. By contrast, food industry, light industry and manufacture of rubber and plastic products saw faster annual dynamics of unit wage costs owing once again to production developments.

3. Monetary policy and financial developments

1. Monetary policy

In November 2016 and January 2017, the NBR kept the monetary policy rate unchanged at 1.75 percent and maintained the characteristics of the corridor of interest rates on the central bank's standing facilities. Moreover, the NBR further pursued adequate liquidity management in the banking system and preserved the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions (at 8 percent and 10 percent respectively). 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.

In its meeting of 4 November 2016, the Board of the National Bank of Romania decided to keep unchanged the monetary policy rate at 1.75 percent per annum, given that the new medium-term forecast of macroeconomic developments broadly reconfirmed the coordinates of the previous inflation projection[16] – after the latter had witnessed significant downward revisions over two rounds –, while the associated uncertainty heightened. In particular, the same as in the previous forecast, the annual inflation rate trajectory was expected to stay in negative territory until end-2016[17] (at -0.4 percent[18]) and then below the variation band of the target in the early months of 2017, although entering a visibly upward trend at the beginning of 2017. The upward path was even slightly steeper than previously anticipated, with the annual inflation rate seen returning inside the variation band of the target earlier (i.e. at mid-2017[19]) and posting marginally higher readings in the upper half of the band in 2018, to reach 3.1 percent at the end of the projection interval (against the previously-forecasted reading of 3.0 percent)[20]. Looking beyond the base effects associated with the standard VAT rate cuts[21], the projected increase in inflation was primarily driven by inflationary pressures anticipated to be exerted over the projection horizon by the cyclical position of the economy, by unit wage costs

[16] August 2016 *Inflation Report*.

[17] The annual inflation rate declined again in September, after having picked up to -0.2 percent in August (from -0.78 percent in July). However, it stood higher (-0.57 percent) than at end-Q2 (-0.7 percent). Excluding the transitory effects of the standard VAT rate cut, the annual inflation rate would have stood at 0.82 percent in September 2016, up from 0.68 percent in June.

[18] Recalculated net of the one-off impact of the standard VAT rate cut at the beginning of 2016, the annual inflation rate was forecasted at 1.0 percent in December.

[19] Coming in at 2.1 percent in December 2017 (2.0 percent in the earlier projection).

[20] According to the updated forecast, the average annual inflation rate was expected to stay put at -1.5 percent in 2016 and inch up to 1.5 percent (from 1.4 percent) in 2017.

[21] The Tax Code in force foresaw the lowering of the standard VAT rate to 19 percent and the removal of the special excise duty on fuels starting 1 January 2017.

– inter alia amid the labour market tightening trend –, as well as by inflation expectations trending upwards. The opening of the positive output gap was forecasted to be wider than in the previous projection round, given the faster-than-expected pick-up in economic growth in 2016 H1, implying the early reversal of the cyclical position of the economy, and the upward revision of the projected GDP dynamics for 2016 H2, as well as for 2017 and 2018. The assumptions underlying the latter were: (i) the further easing of the fiscal and income policy stance, mainly via indirect tax adjustments and public sector pay rises; (ii) the preservation of stimulative real monetary conditions; and (iii) the gradual recovery of the euro area economy.

Nevertheless, fiscal and income policy prospects, and hence economic growth outlook, were surrounded by significant uncertainties amid the still pending 2017 budget construction. Their relevance was increased, on the one hand, by the characteristics of budget execution January through September 2016 and, on the other hand, by the multitude and nature of fiscal measures initiated in the legislative area – referring to tax cuts, pay rises in the budgetary sector, and higher income in the form of social security benefits –, whose materialisation was, however, uncertain.

Subsequently-released statistical data showed that the annual inflation rate had slipped in November to -0.67 percent[22], slightly below the forecasted level, after having picked up to -0.43 percent in the previous month (from -0.57 percent in September), in line with projections. This was primarily attributable to the slower annual dynamics of tobacco product prices[23] and to the price cuts for compulsory motor third-party liability insurance policies. Data also pointed to a stronger-than-anticipated slowdown in third-quarter economic growth[24] – exclusively on account of the slacker domestic demand –, entailing a highly likely halt in the uptrend of excess aggregate demand during that period, contrary to expectations. At the same time, most economic sectors posted reductions in productivity gains in annual terms, whereas the annual dynamics of net average wage remained at two-digit levels.

Credit to the private sector grew at a slightly faster pace[25] October through November (2.1 percent versus 1.7 percent in 2016 Q3), mainly due to the relative advance in the dynamics of loans to non-financial corporations (-3.4 percent against -4.6 percent in the previous three months), following the rise seen in new business in domestic currency. By contrast, the growth rate of household credit decelerated slightly to 6.3 percent (from 6.6 percent in Q3), with the impact of the slower pace of increase of housing loans (chiefly reflecting the characteristics of carrying out the "First Home" programme) being only partly offset by the relative rebound in the annual dynamics of consumer credit and other loans. Developments across the major customer types confirmed only in part the results of the November 2016 Bank Lending Survey conducted by the NBR, which pointed to expectations of (i) stronger demand for credit October through December 2016 and (ii) the easing in the same period of credit

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22 The annual inflation rate remained in negative territory due solely to the transitory impact of lowering the standard VAT rate from 24 percent to 20 percent as of 1 January 2016, in the absence of which inflation rate would have stood at 0.72 percent.

23 Reflecting, inter alia, a base effect.

24 Based on real-time data, real annual GDP dynamics decelerated to 4.4 percent from 6.0 percent in Q2, while the quarterly growth rate stood at 0.6 percent (1.5 percent in the previous quarter).

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

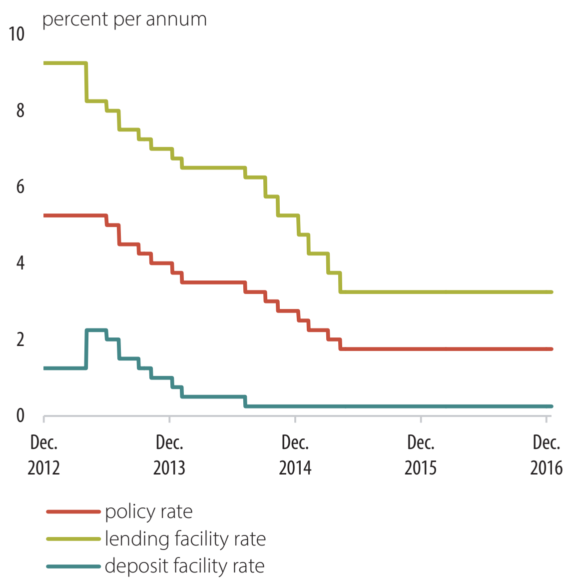
standards for housing loans. Looking at the breakdown by currency, the period under review saw a relative slowdown in the annual pace of decline of foreign currency credit (-12.0 percent, based on readings expressed in euro) and further high dynamics of leu-denominated loans (13.8 percent) – albeit decelerating versus the previous three months –, so that the share of the domestic currency component in total private sector credit continued to widen to a post-1996 high of 56.9 percent in November.

Nevertheless, liquidity in the economy rose at a slower pace October through November 2016 (12.5 percent from 13.3 percent in the previous three months), primarily as a result of the relative reduction in disbursements related to EU funds. M3 components witnessed opposite movements: the rate of change of M1 picked up marginally (largely on the back of households' overnight deposits in domestic currency) – and therefore this component's share in M3 peaked at a post-1995 high in November –, whereas the annual dynamics of time deposits with a maturity of up to two years re-entered negative territory (-1.6 percent against 0.5 percent in Q3). The sole driver of this decline was the marked loss of momentum in the dynamics of leu- and foreign currency-denominated corporate time deposits, while the rate of change of similar household deposits stepped up somewhat in the same period, prompted by the domestic currency component.

The assessments conducted in this context reconfirmed the outlook for the annual inflation rate to re-enter positive territory in 2017 Q1, along with resuming an upward course, owing to the fading out of the transitory effect of the standard VAT rate cut to 20 percent and to inflationary pressures exerted by aggregate demand and unit wage costs. However, the annual inflation rate was expected to stand lower than the level projected in the latest medium-term forecast, published in the November 2016 *Inflation Report*, which saw annual inflation returning inside the variation band of the flat target at mid-2017. Moreover, the new short-term forecast pinpointed a slight step-up in GDP quarterly growth in 2016 Q4, followed by a relative loss of momentum, implying – amid a faster-than-anticipated deceleration in economic growth during 2016 Q3 – a relative slowdown in the widening of the positive output gap and in the strengthening of the ensuing inflationary pressures over the short term. Even though, given the post-election developments at the time, upside risks to the short-term forecast appeared to prevail, fiscal and income policy prospects remained, however, uncertain until the 2016 budget execution features were released and, more importantly, the 2017 budget construction became available.

Against this background, in its meeting of 6 January 2017, the NBR Board decided to keep the monetary policy rate at 1.75 percent, to maintain the characteristics of the corridor of interest rates on the central bank's standing facilities, as well as to leave unchanged the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions (Chart 3.1).

Chart 3.1. NBR rates



During 2016 Q4 as a whole, real monetary conditions remained stimulative. Lending and time deposit rates on new business continued to fall October through November, while the EUR/RON exchange rate stood higher than in July-September[26], owing to external developments, as well as to swings in investor risk perception vis-à-vis the local economy and financial market. The average levels of interbank money market rates and of the relevant ROBOR rates stood slightly higher than at the end of the previous quarter, with their developments – amid the NBR further pursuing adequate liquidity management in the banking system – reflecting primarily the larger-than-expected drop in liquidity surplus in November and its lower-than-anticipated rise towards year-end respectively, both ascribable to Treasury operations.

2. Financial markets and monetary developments

The average interbank money market rate remained virtually unchanged in Q4, while the EUR/RON exchange rate stood higher. Credit to the private sector advanced at a faster pace September through November, whereas broad money dynamics decelerated, owing chiefly to the relative decline in disbursements from EU funds.

2.1. Interest rates

The daily average interbank money market rate stood at the lower bound of the corridor defined by interest rates on the central bank's standing facilities around the policy rate for most of 2016 Q4, posting slightly higher readings at the middle and towards the end of the quarter. The average interbank deposit rate came in at 0.36 percent in the period under review, similarly to the level recorded July through September.

At the onset of the reported quarter, overnight rates remained in the vicinity of the deposit facility rate, given the persistence of the high net liquidity surplus in the banking system. Subsequently, they inched up to around 0.5 percent at the start of the 24 October – 23 November 2016 reserve maintenance period, amid the significant pick-up in the Treasury's liquidity absorptions[27]. The rise was corrected in November, but the adjustment was gradual and was followed by a temporary return to higher readings in the closing week of December, against the backdrop of the relatively slow-in-coming pick-up in the MPF's liquidity injections.

Longer-term (3M-12M) ROBOR rates stuck in the first part of the reported quarter close to their historical lows hit at end-Q3, before trending upwards (Chart 3.2). However, the uptrend was not uneven, with somewhat larger increases seen in mid-November and in the closing part of December. The former episode occurred amid the larger-than-expected drop in banks' excess liquidity, along with heightened volatility on international financial markets following the US presidential elections.

[26] The USD/RON witnessed an even more sizeable increase in Q4.

[27] Prompted by the increase in budget receipts at end-October.

The latter was associated with the lower-than-anticipated rise in the net liquidity surplus across the banking system and with a possible revision of credit institutions' expectations on the future developments in very short-term interest rates on the interbank money market. Against this background, average ROBOR rates edged up in December by around 0.1 percentage points versus their September readings, with the 3M rate standing at 0.83 percent and the 6M and 12M rates at 1.08 percent and 1.20 percent respectively.

Chart 3.2. Policy rate and ROBOR rates

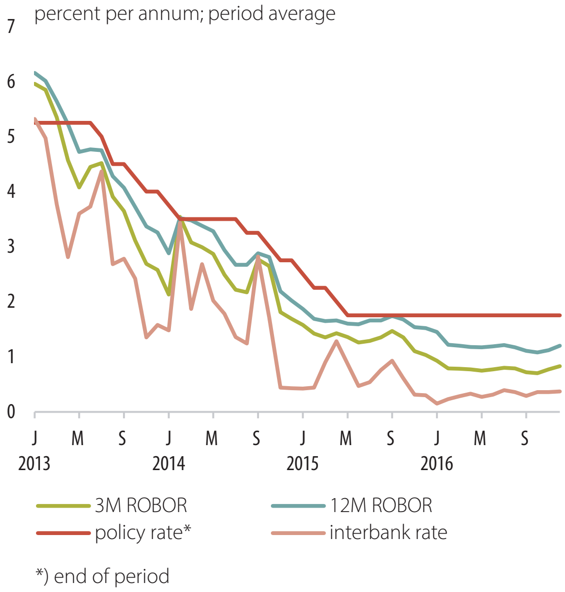
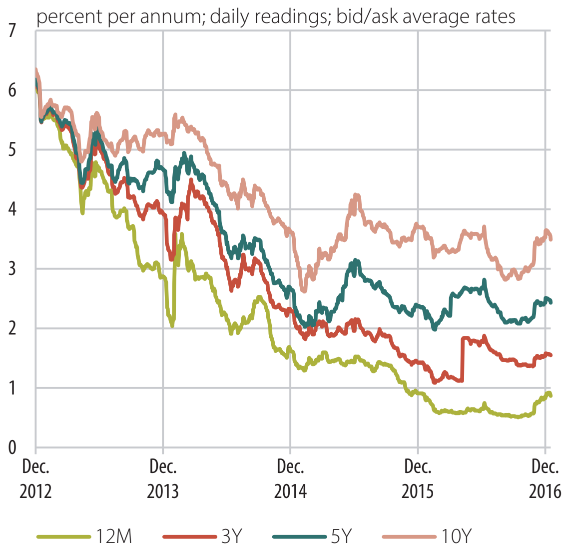


Chart 3.3. Reference rates on the secondary market for government securities



Yields on short-term government securities followed a similar path. Yields at longer maturities (5 to 10 years) – capturing to a larger extent the influence of global factors – tended to increase slightly as early as the onset of the quarter, then witnessed a more sizeable hike in mid-November and remained on an upward path until towards the end of the period under review (Chart 3.3). Their developments were largely correlated with the performance of similar yields in the US and the euro area, reflecting in turn the upward revision of expectations on inflation, as well as on the pace of monetary policy tightening by the Fed[28], following the US presidential elections[29], amid the anticipated fiscal policy easing by the incoming administration. Another potential driver were the concerns about the legislative initiatives regarding the banking sector (in particular, the law on the conversion into lei of CHF-denominated loans) and about the fiscal and wage measures adopted/discussed during that period.

Under the circumstances, the average accepted rates at the last auctions in December rose versus end-Q3 across the entire maturity spectrum by values ranging between 0.34 percentage points (to 0.76 percent) for the 5-month maturity[30] and

[28] Expectations on the future stance of monetary policy were reinforced in the context of the Fed policy meeting of 13-14 December, where it was decided – as anticipated – on an interest rate hike, while the federal funds rate path forecasted by FOMC members was revised upwards.

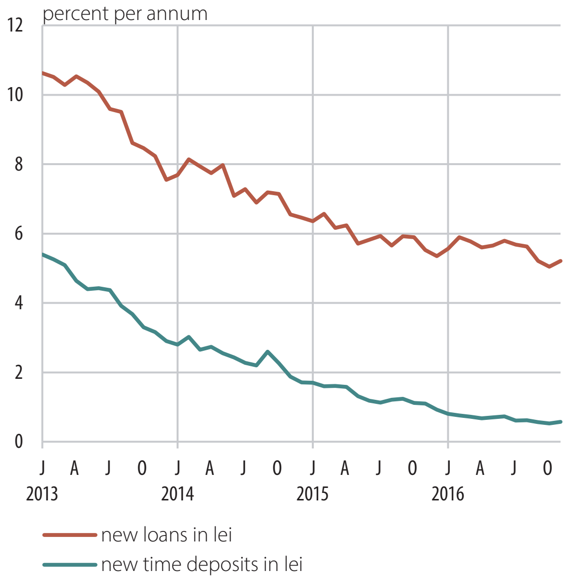
[29] The rise in inflation expectations was also prompted by the oil price hike following the decision taken on 30 November by the OPEC and some non-OPEC members to cut production in 2017 H1.

[30] Taking into account the yield on 6-month bills at the September auction.

0.62 percentage points (to 3.15 percent) for 6-year bonds. In turn, average benchmark rates on the secondary market increased during the same period by values ranging between 0.29 percentage points in the case of the 6-month maturity and 0.64 percentage points for the 10-year maturity, so that the yield curve shifted higher and its upward slope steepened against end-Q3.

Looking at the primary market, investor interest in government securities stood overall below that seen in the previous quarter. The average demand-to-supply ratio followed a downward path during the period under review[31], given that the bid volume shrank both in November and December close to the announced volume. Moreover, the volume of securities issued (lei 7.4 billion) accounted for only 67 percent of the indicative one, with the MPF fully or partly rejecting the bids submitted at 11 of the 20 auctions held October through December; against this background, the average maturity of issued securities contracted slightly when compared to Q3.

Chart 3.4. Bank rates



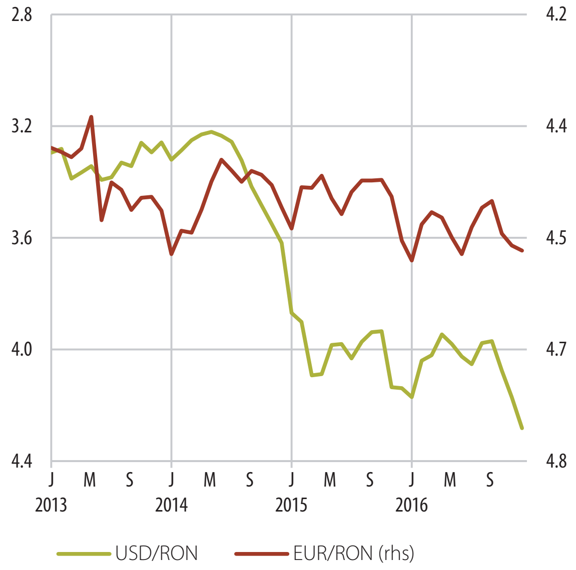
September through November 2016, credit institutions' average interest rates on new time deposits and new loans of non-bank clients continued to decline, shedding 0.04 percentage points (to 0.58 percent) and 0.42 percentage points (to 5.21 percent) respectively (Chart 3.4). The average remuneration of new time deposits decreased slightly (by 0.05 percentage points) for both non-financial corporations and households, to stand at 0.37 percent and 0.90 percent respectively. In turn, the average lending rate on new business diminished across both sectors, despite some monthly fluctuations, associated inter alia with changes in the composition of credit flows. During the reported period overall, the average interest rate on new loans to non-financial corporations edged down 0.07 percentage points (to 3.66 percent), mainly due to the reduction in the average interest rate on lower-value loans (below EUR 1 million equivalent). At the same time, the average lending rate on new business to households witnessed a more sizeable drop, i.e. by 0.32 percentage points (to 6.89 percent), also as a result of the reduction in the average interest rate on new consumer loans.

2.2. Exchange rate and capital flows

In 2016 Q4, the EUR/RON exchange rate posted higher readings, witnessing increased volatility, after having fallen and having remained quasi-stable around the 2016 lows in the previous three months. Its behaviour, only partially correlated with that of the

31 Hitting a historical low in December.

Chart 3.5. Nominal exchange rate



exchange rates of the other currencies in the region, reflected both the changes in global financial market sentiment and the shifts in investors' risk perception vis-à-vis the local economy and financial market, brought about by domestic events/developments in this quarter (Chart 3.5).

At the beginning of the quarter, the EUR/RON rose abruptly, peaking at a three-month high at the end of the first 10-day period of October. This evolution, which diverged from the exchange rate trajectories of the other currencies in the region, was driven by concerns about the legislative initiatives on the domestic agenda in that period with regard to the banking sector[32], as well as about the recently put forward fiscal and wage measures[33], perceived by investors as generating risks to domestic fundamentals. The exchange rate of the domestic currency saw its increase come to a halt amid the relatively quick alleviation of concerns following the actions taken to cushion the effects of some of these measures[34]. However, the EUR/RON remained at its already high level, given the increased likelihood attached by international markets to the Fed conducting a further rate hike in December 2016[35] – in which context the dollar significantly strengthened against the euro and the other currencies in the region embarked on a depreciation path in relation to the single currency.

The fluctuations of the EUR/RON then widened, due to mixed influences from the external environment, marked during this period by: (i) heightened global risk aversion following the US presidential elections – associated with revised expectations on the Fed's pace of tightening monetary policy, amid the potential fiscal stimulus to the US economy implemented by the new Administration –, likely to entail a reversal in some capital flows to emerging economies; (ii) the subsequent relative improvement in global financial market sentiment, also bolstered by expectations of further monetary policy easing by the ECB and by their confirmation in the meeting on 8 December; and (iii) the ensuing steeper appreciation trend of the US dollar versus the euro.

Towards end-December, the temporary heightening of domestic political uncertainties in the post-election environment brought about a new, short-lived increase in the EUR/RON exchange rate. The last month of the year also saw a sizeable

32 In the first part of October, the relevant committees of the Romanian Parliament discussed the draft law on converting CHF-denominated loans into leu-denominated loans at the historical exchange rate, which they adopted on 10 October, eliminating the requirement regarding an indebtedness level of at least 50 percent. On 17 October, the requirement on the maximum value of loans subject to the draft law (CHF 250,000) was also eliminated. The draft law was passed by the Chamber of Deputies on 18 October.

33 Concerning tax and fee cuts, as well as pay rises in the public sector and higher household income in the form of social benefits.

34 The Law on converting CHF-denominated loans into leu-denominated loans was challenged in the Constitutional Court.

35 Given the favourable US economic data, as well as the comments made by Fed officials.

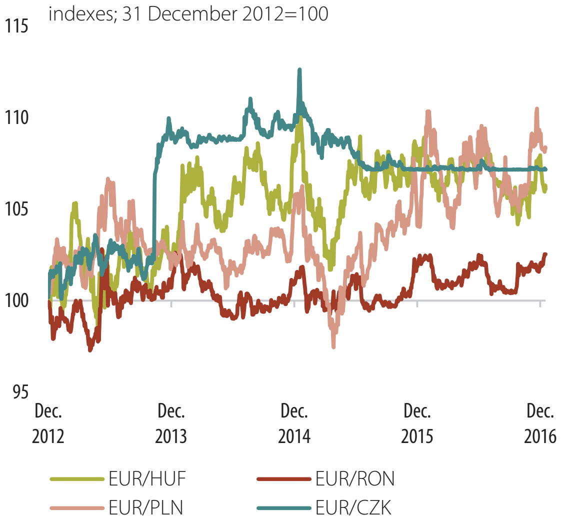
Table 3.1. Key financial account items

EUR million

	11 mos. 2015			11 mos. 2016		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	2,263	-1,838	4,101	6,442	3,823	2,618
Direct investment	885	3,626	-2,741	889	4,582	-3,692
Portfolio investments	330	-232	562	311	1 122	-810
Financial derivatives	-25	0	-25	42	0	42
Other investment	2,053	-5,232	7,285	2,850	-1,880	4,730
– currency and deposits	1,663	-1,854	3,517	643	-2,166	2,809
– loans	260	-3,586	3,845	1,163	-1,022	2,186
– other	130	208	-77	1,044	1,308	-265
NBR's reserve assets, net	-980	0	-980	2,349	0	2,349

*) "+" increase/"-" decrease

Chart 3.6. Exchange rate developments on emerging markets in the region



Source: ECB, NBR

rise in the USD/RON, which hit a historical high on 20 December, as the EUR/USD continued to decline rapidly on international markets[36].

In this context, the interbank forex market turnover picked up considerably in November and December. The negative balance on non-residents' forex transactions was partially covered by the increase in residents' excess supply of foreign currency – also as a result of these economic agents using part of the forex deposits to make budget payments – and therefore the overall market deficit remained virtually unchanged for the period as a whole (Table 3.1).

During the final quarter of 2016, the domestic currency weakened against the euro by 1.5 percent in nominal terms[37] and 0.7 percent in real terms. In relation to the US dollar, the leu depreciated by 7.3 percent in nominal terms and 6.6 percent in real terms (Chart 3.6). Looking at the average annual exchange rate dynamics in 2016 Q4, the domestic currency saw its nominal depreciation widen against both the euro and especially the US dollar.

2.3. Money and credit

Money

September through November 2016, the growth rate[38] of broad money (M3) continued to decelerate, to 12.6 percent from 13.6 percent June through August 2016 (Table 3.2), mainly due to the relatively lower disbursements to recipients of EU structural funds[39], as well as to partial shifts away from money holdings towards other financial assets (government securities and bonds). The increase in payments for agricultural subsidies[40] had an opposite, albeit weaker, impact.

36 On 20 December, the EUR/USD rate posted the lowest reading since December 2002.

37 In the same period, the Hungarian forint weakened by 1.1 percent and the Polish zloty by 2.6 percent.

38 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2016.

39 According to data on EC reimbursements posted on the Ministry of European Funds' website.

40 The MPF granted the Ministry of Agriculture and Rural Development a lei 1,434 million loan for stimulating the absorption of funds allocated through direct payment schemes financed from the European Agricultural Guarantee Fund (Government Decision No. 766/2016), and according to press releases from the Agency for Payments and Interventions in Agriculture, during this period, farmers received payments for the 2015 Campaign and payment schemes in the livestock sector.

Table 3.2. Annual growth rates of M3 and its components

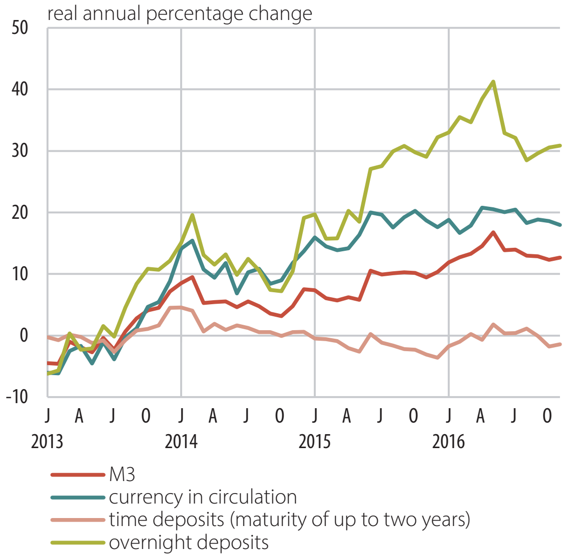
real percentage change

	2015	2016				
	IV	I	II	III	Oct.	Nov.
	quarterly average growth					
M3	10.0	12.6	15.1	13.3	12.3	12.7
M1	26.4	28.6	31.6	26.4	26.6	26.5
Currency in circulation	18.9	17.8	20.5	19.2	18.6	18.0
Overnight deposits	30.4	34.4	37.5	30.1	30.6	30.8
Time deposits (maturity of up to two years)	-3.0	-0.8	0.5	0.5	-1.8	-1.4

Source: NIS, NBR

Both key components of broad money contributed to this development. In the case of M1, the loss of momentum was reflected by currency in circulation – correlated with the slower growth rate of retail trade[41] –, as well as by corporate overnight deposits (in lei, but especially in foreign currency). However, narrow money continued to record elevated dynamics for the post-crisis period and thus saw its share in M3 consolidate at a post-1995 high of 56.6 percent in November. The decline in the rate of change of time deposits with a maturity of up to two years, which entered negative territory, was also attributable to the corporate segment (Chart 3.7).

Chart 3.7. Main broad money components



Source: NIS, NBR

The broad money breakdown by holder reveals a rebound in the pace of increase of household deposits, due to the continued swift hike in this sector's income, both from wages[42] and especially from other sources, including remittances and amounts allocated for farmers' subsidies. By contrast, the dynamics of total M3 deposits of non-financial corporations witnessed a renewed decline, owing, on the one hand, to the relatively smaller amounts received from structural funds and from the government budget for current goods and services and for investments respectively, and, on the other hand, to the larger payments made by these economic agents to the government budget (corporate income tax in particular[43]). An even steeper drop saw the rate of change of non-monetary financial institutions' bank deposits[44], given shifts away from money holdings towards other financial instruments[45] and the reclassification of the Bank Deposit Guarantee Fund from the financial auxiliaries sub-sector to the central government sub-sector[46].

[41] September through November 2016, the average annual growth rate of retail trade turnover (except motor vehicles and motorcycles) decelerated further.

[42] The average net wage increased in real terms by 14 percent September through November versus the same year-earlier period (compared with an annual growth of 14.4 percent in the previous three months).

[43] The real annual dynamics of corporate income tax averaged out at 29.1 percent September through November (23.9 percent in the prior three months).

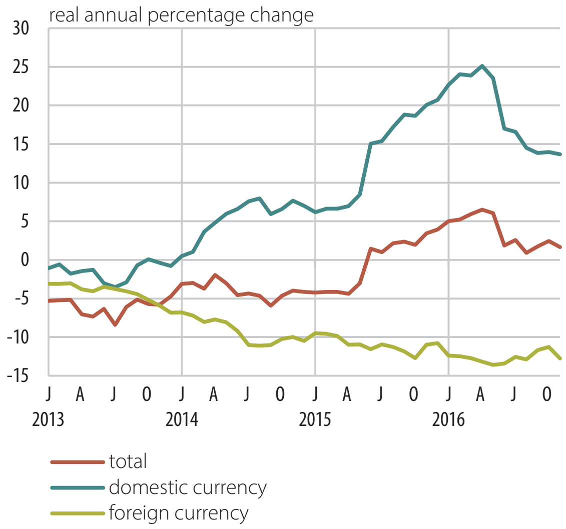
[44] The share of these deposits in M3 contracted from 5.8 percent to 5.0 percent.

[45] The International Investment Bank issued bonds on the local capital market (lei 300 million), while RCS&RDS's parent company issued bonds on the international capital market (EUR 350 million) and there are indications that among the investors were Romanian entities as well.

[46] The Bank Deposit Guarantee Fund was reclassified by the NIS.

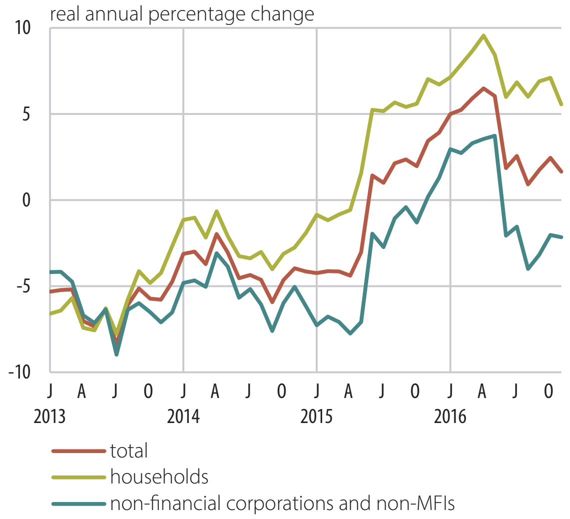
From the perspective of M3 counterparts, the evolution of broad money reflected the swifter growth rate of central government deposits and the slacker rate of change of banks' net foreign assets. Their impact was partially offset by the expansionary influence of the pick-up in the pace of increase of private sector credit and of credit to the public sector, as well as the persistent decline in the dynamics of long-term financial liabilities[47].

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

Credit to the private sector

September through November 2016, the dynamics of credit to the private sector[48] slightly regained momentum (2.0 percent versus 1.8 percent in the previous three months; Chart 3.8), prompted not only by statistical and one-off influences from the weaker leu and the significant contraction in the volume of operations to remove non-performing loans from banks' balance sheets, but also by the stepped-up growth in new leu-denominated loans to non-financial corporations.

In terms of currency composition of private sector credit, the leu-denominated component posted further high growth rates in the period under review, albeit lower than in the previous three months (13.8 percent on average versus 16 percent in the preceding interval), while the foreign currency component declined at a slightly slower pace (-11.9 percent versus -13.0 percent). The share of leu-denominated loans in total credit widened again, reaching a 20-year peak of 56.9 percent in November.

The increase in non-financial corporations' loan demand[49] – supported by improved confidence and historically-low lending rates on new business – entailed a relative recovery in the annual dynamics of loans to these entities (Chart 3.9). The entire maturity spectrum contributed to this evolution, with medium-term loans playing a somewhat more notable part.

The annual growth rate of loans to households also picked up slightly (6.5 percent against 6.3 percent June through August), even if the dynamics of housing loans edged down further

[47] Capital accounts included.

[48] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2016.

[49] This was in line with the results of the November 2016 Bank Lending Survey conducted by the NBR.

– due, inter alia, to the disruptions in the implementation of the "First Home" programme[50] –, given the slower annual decline in consumer credit and other loans, contrary to the previous three months' developments, driven mainly by the swifter dynamics of the leu-denominated component. Nevertheless, housing loans further consolidated their prevailing share in total household credit. At the same time, the share of the domestic currency component in total loans to households widened to 57.9 percent in November (from 56.4 percent in August).

[50] The guarantee ceiling under the "First Home" programme was raised in September 2016 (Government Decision No. 703/2016), whereas the distribution to the banks was made in October (according to an MPF press release).

4. Inflation outlook

The annual CPI inflation rate is seen on the rise throughout the forecast interval, from -0.5 percent at end-2016 to 1.7 percent at the end of 2017 and 3.4 percent at the end of 2018. Inflation rate is expected to near the upper bound of the variation band of the target as a result of the gradual build-up of underlying inflationary pressures reflected in adjusted CORE2 index, along with the fading-out, at the beginning of 2018, of the direct impact of indirect tax cuts introduced in January 2017. Behind the pick-up in the annual core inflation rate stands the envisaged rise in excess demand, given the transmission of fiscal and wage-related stimulus announced by the authorities after the release of the November 2016 *Inflation Report* and of the hike in private sector income. To this adds the return of import prices for consumer goods to faster growth rates, amid a gradual rebound in external inflation. Against this backdrop, economic agents' inflation expectations will converge towards levels close to 2.5 percent in the medium term, from the negative readings seen at end-2016. The balance of risks to the annual inflation projection is further seen to be in equilibrium compared to the path in the baseline scenario, with risks stemming from both domestic and external sources.

1. Baseline scenario

1.1. External assumptions

Over the projection interval, external demand, assessed on the basis of the effective EU GDP (EU-28 excluding Romania), will increase at rates close to 2 percent, posting relatively sluggish developments. In 2017, the growth rate of this indicator (Table 4.1) is slightly higher than that projected in the November 2016 *Inflation Report*, mainly on the back of recent more favourable developments. The major driver of economic recovery across the euro area will be domestic demand, further underpinned by the ECB's persistently accommodative monetary policy stance[51], deleveraging across all sectors, and improvements in labour market conditions. Nevertheless, euro area economic growth is still fragile, amid lingering difficulties in the Italian banking system and uncertainties related to the effects of the new US Administration's

[51] The main non-standard monetary policy measure that the ECB's Governing Council adopted on 8 December (reconfirmed on 19 January 2017) refers to the ECB continuing to make purchases under the asset purchase programme at a monthly pace of EUR 80 billion until the end of March 2017 and thereafter at a monthly pace of EUR 60 billion until the end of December 2017. In case that the economic prospects become less favourable or financial conditions turn out to be inconsistent with the projected path of inflation, the Governing Council confirmed its readiness to recalibrate the duration and/or volume of purchases.

Table 4.1. Expectations on the developments in external variables

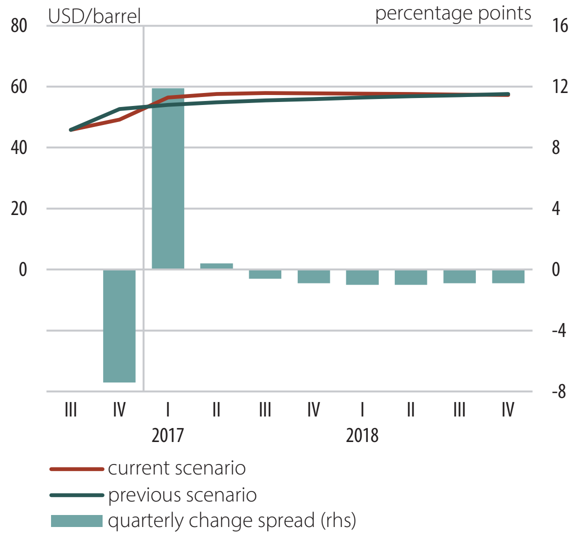
	annual averages	
	2017	2018
Effective EU economic growth (%)	1.81	1.86
Annual inflation rate in the euro area (%)	1.25	1.49
Annual CPI inflation rate in the USA (%)	2.33	2.35
3M EURIBOR interest rate (% per annum)	-0.29	-0.18
USD/EUR exchange rate	1.05	1.06
Brent Oil price (USD/barrel)	57.4	57.5

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

economic policies and to the Brexit implications[52]. External demand gap is expected to stay in negative territory until the end of next year, having a restrictive, albeit gradually lower, impact on domestic economic activity.

The average annual HICP inflation rate in the euro area is projected to stay on an upward path, benefiting, especially in the upcoming period, from the rebound in the global oil price[53], after the sharp declines seen over the past two years. Subsequently, the leading role in external price dynamics will be played by inflationary pressures stemming from labour market improvements, as reflected by the further increase in employment and faster-growing wage earnings, impacting unit wage costs. These expected rises notwithstanding, annual HICP inflation rate in the euro area is projected to continue to run below the 2 percent benchmark throughout the forecast interval. Under the influence of a similar set of determinants, annual inflation in the USA is forecasted on the rise, posting further higher levels than those expected for the euro area, also in the context of brighter growth prospects for the US economy over the medium term.

Chart 4.1. Brent oil price scenario



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

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, running in the vicinity of the previously projected ones.

The EUR/USD exchange rate is expected to follow a quasi-stable path over the projection interval after the depreciation seen late last year. Potential deviations of the ECB's and Fed's monetary policies from the trajectories currently expected by financial markets may cause this variable to depart from the values foreseen in the baseline scenario.

The scenario for the Brent oil price is based on futures prices and foresees a quasi-stable path, reaching USD 57.3 per barrel at the projection horizon (Chart 4.1). The outlook for the oil price is further uncertainty-ridden, as mirrored by the revised trajectories of futures prices in the successive projection rounds.

52 Compared to the previous *Report*, the recent statements by the British Prime Minister hint at a hard Brexit, i.e. the UK is to leave the EU's single market and customs union and, subsequently, retake full control of its borders. Following these statements, the Supreme Court decided on 24 January 2017 that Parliament approval is needed for the British Government to start the process of exiting the EU.

53 In this vein, a large part played the agreement reached among OPEC members at end-November 2016 to cap oil production and between OPEC and non-OPEC member countries in early December.

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 1.7 percent at end-2017 and at 3.4 percent at end-2018. These levels are in the lower half and the upper half of the ±1 percentage point variation band of the 2.5 percent flat target respectively (Table 4.2; Chart 4.2).

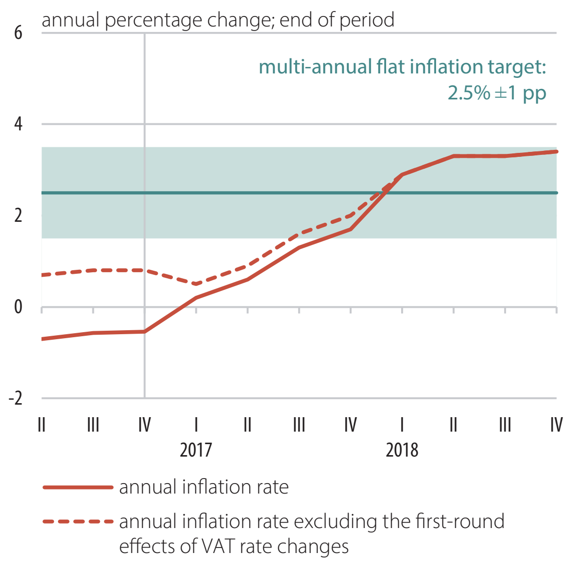
Table 4.2. The annual inflation rate in the baseline scenario

annual percentage change; end of period

	2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	0.2	0.6	1.3	1.7	2.9	3.3	3.3	3.4
CPI projection*	0.5	0.9	1.6	2.0	2.9	3.3	3.3	3.4

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

Chart 4.2. Inflation forecast



Source: NIS, NBR projection

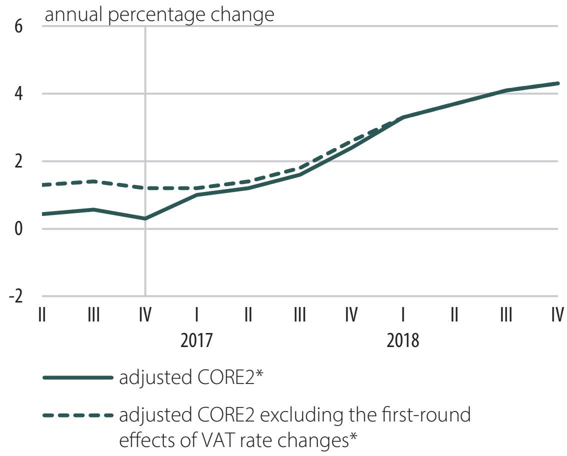
Compared to the previous *Report*, the projected annual CPI inflation rate is revised downwards in the course of this year, as the projection foresees a slower build-up of underlying inflationary pressures reflected in the adjusted CORE2 index and lower hikes in administered prices. Accordingly, the annual CPI inflation rate is projected to return into the variation band of the target in 2017 Q4, two quarters later than in the previous *Report*'s assessment. However, the increasingly pronounced build-up of inflationary pressures coming from the real sector, as shown by the adjusted CORE2 index, will entail higher-than-previously-projected headline inflation rates starting 2018 Q1.

The path of the annual core inflation rate will be similar to that in the previous *Report*, i.e. the adjusted CORE2 inflation will follow an uptrend from the beginning of 2017 and then gather momentum, amid the build-up of underlying inflationary pressures. They are expected to derive from the increase in excess demand, amid the expansionary fiscal policy stance and higher disposable income[54], from the developments in import prices for consumer goods, on the back of the foreseen dynamics of external prices and, under the impact of these factors, from the upward path in inflation expectations.

In the same direction will work the successive fading-out, in January 2017 and January 2018, of first-round statistical effects of the standard VAT rate cuts. Therefore, the annual adjusted CORE2 inflation rate is forecasted to reach 2.4 percent at the end of 2017 and 4.3 percent at the end of 2018, the latter level being above the upper bound of the variation band of the target (Chart 4.3). Core inflation net of the effects

[54] Also amid the income policy envisaging pay rises across the budgetary sector at the end of 2016 and the beginning of 2017 (up by 15 percent in the healthcare sector in December 2016, 15 percent in education in January 2017, 20 percent in local public administration and 50 percent for actors in February 2017), adding to those implemented at end-2015 and those enacted in August 2016, and the successive increases in the gross minimum wage economy-wide, including the hike from lei 1,250 to lei 1,450 as from 1 February 2017. Some of these measures also translate into pay rises across the private sector, adding to those envisaged as a result of improvements in productivity in the economy.

Chart 4.3. Annual adjusted CORE2 inflation and adjusted CORE2 excluding the first-round effects of VAT rate changes



*) end of period

Source: NIS, NBR projection

Table 4.3. Annual adjusted CORE2 inflation rate in the baseline scenario

annual percentage change; end of period

	2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Adjusted CORE2	1.0	1.2	1.6	2.4	3.3	3.7	4.1	4.3
Adjusted CORE2*	1.2	1.4	1.8	2.6	3.3	3.7	4.1	4.3

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

Table 4.4. Components' contribution to annual inflation rate*

percentage points

	2017	2018
Administered prices	0.0	0.4
Fuels	0.0	0.1
VFE prices	0.3	0.3
Adjusted CORE2	1.4	2.6
Tobacco and alcohol	0.0	0.1

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

of the standard VAT rate cut is seen standing at 2.6 percent at end-2017 and the two indices will overlap starting January 2018 (Table 4.3).

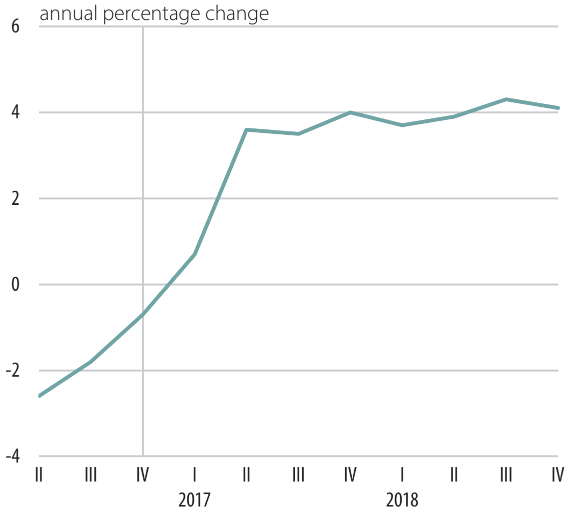
Compared to the previous *Report*, the downward revision in the annual adjusted CORE2 inflation rate in 2017 H1 is based mainly on the slower-than-previously-projected build-up of inflationary pressures fuelled by excess demand. At the same time, the significant cut in the prices of compulsory motor third-party liability insurance policies towards the end of 2016 will have a bearing on the annual adjusted CORE2 inflation rate until October 2017. These factors are anticipated to exert same-direction effects also via the impact on the path of inflation expectations during 2017. For the remaining period, the annual core inflation rate was revised upwards, especially amid the build-up of higher excess demand and, hence, faster-growing inflation expectations.

The cumulative contribution of inflation components exogenous to the monetary policy influence, namely administered prices, volatile food (VFE) prices, fuel prices, and tobacco product and alcohol beverage prices, to the annual CPI inflation rate is 0.3 percentage points at the end of 2017 (being revised downwards by 0.1 percentage points against the previous projection) and 0.8 percentage points at the end of 2018 (Table 4.4).

Volatile food (VFE) prices are projected to go up at an annual pace of 4 percent at the end of 2017, being revised upwards amid a base effect triggered by slow dynamics at the end of 2016 – as a result of agricultural production above the long-term average –, and of 4.1 percent at the end of 2018 (Chart 4.4). Their growth path over the forecast interval is based on the assumption regarding normal agricultural years in 2017 and 2018.

The projection envisages the annual dynamics of administered prices to come in at 0.1 percent at end-2017 and 2.2 percent at end-2018 (Chart 4.5). For this year, the downward revision of 1.9 percentage points is largely based on the scrapping of a number of non-tax fees and charges starting February 2017 (the subscription for national radio-TV services in particular), whereas the assumption on energy prices was left virtually unchanged.

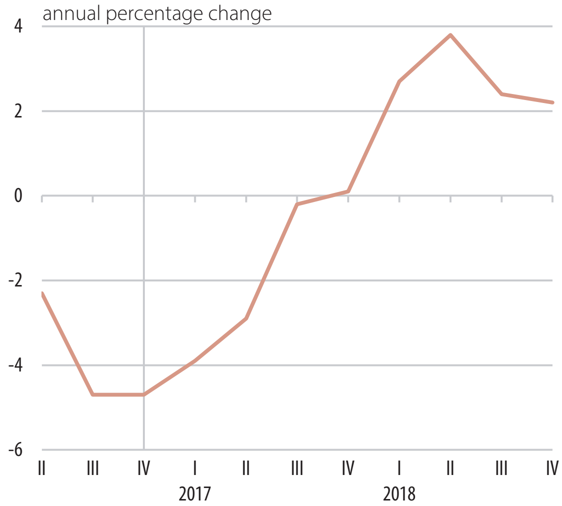
Chart 4.4. VFE prices annual inflation*



*) end of period

Source: NIS, NBR projection

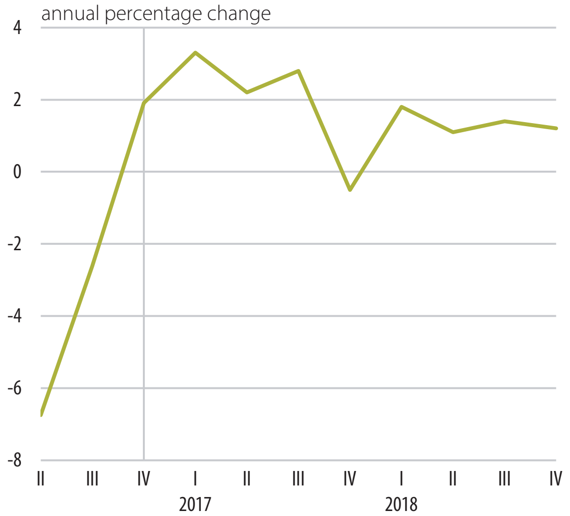
Chart 4.5. Administered prices annual inflation*



*) end of period

Source: NIS, NBR projection

Chart 4.6. Fuel prices annual inflation*



*) end of period

Source: NIS, NBR projection

The annual dynamics of fuel prices are forecasted at -0.5 percent at the end of 2017, being revised upwards by 2.2 percentage points, and 1.2 percent at the end of 2018 (Chart 4.6). In 2017, their annual rate of change is higher than that projected in the previous *Report*, on the back of faster growth in (USD-denominated) oil prices and the recent depreciation of the leu against the US dollar, while opposite influences come from lower inflation expectations. The path of this price category is also shaped by the standard VAT rate cut from 20 percent to 19 percent and the removal of the special excise duty on fuels[55].

The path of the annual inflation rate projected for tobacco products and alcoholic beverages is shaped by the pieces of legislation setting the levels of excise duties on such goods, being affected by the standard VAT rate cut and the hike in specific excise duties in January 2017. Compared to the previous *Report*, the level projected for the end of 2017 is merely 0.1 percentage points lower.

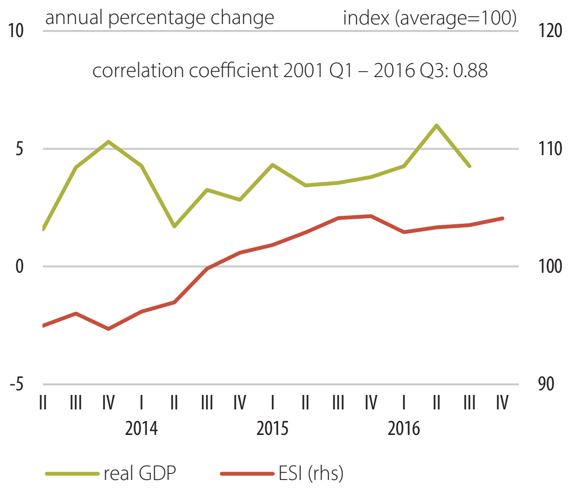
[55] On 1 January 2017, being estimated to have an impact of -0.3 percentage points to the annual CPI inflation rate at the end of this year.

1.3. Demand pressures in the current period and over the projection interval[56]

Output gap

In 2016 Q3, seasonally-adjusted real GDP saw a new quarterly increase (0.6 percent[57]), while both annual and quarterly growth rates slowed down compared to the previous period. Over the next two quarters, real GDP is anticipated to record faster positive quarterly dynamics, albeit its annual percentage change will decelerate further[58]. Near-term forecasts are based on favourable signals coming from indicators such as the economic sentiment (up 0.6 points in 2016 Q4 – Chart 4.7, mainly on account of the consumer confidence indicator) or the volume of retail trade, excluding motor vehicles and motorcycles (+1.6 percent October through November 2016 compared with the Q3 average), to which adds, in 2017 Q1, the joint impact of some fiscal and income policy measures[59]. In this context, the contribution of domestic demand to the quarterly GDP dynamics is projected to be positive, while that of net exports is seen as slightly negative.

Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally-adjusted data

Source: NIS, EC-DG ECFIN

Over the projection interval, potential GDP growth is anticipated to pick up moderately, reflecting the gradually lower negative contribution of labour (amid favourable forecasts of activity rate and unemployment rate), whereas capital stock dynamics are seen to be adversely impacted by recent developments (namely those of 2016 Q3), as well as by the projected performance in investments, estimated to be lower than that recorded until mid-2016. The dynamics of total factor productivity mirror the assumption of economic agents making further efforts to reap the benefits of lending conditions and of the European structural and cohesion funds in their activity streamlining programmes. Acting in the opposite direction are the prospects for integrating innovation elements[60] in production processes or the persisting structural rigidities of some domestic markets, which can be addressed only through the consistent implementation of structural reforms.

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

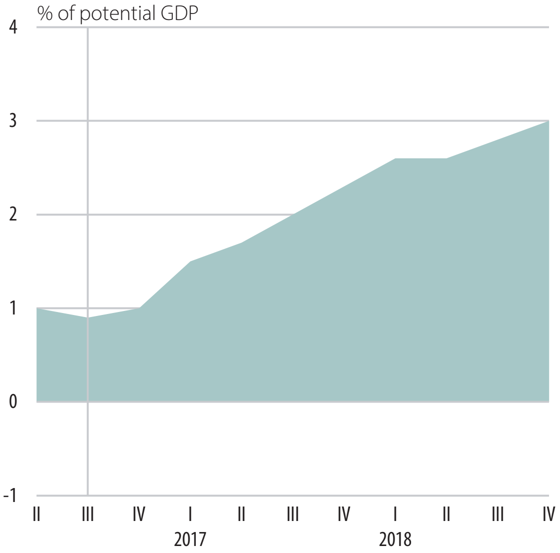
[57] NIS Press Release No. 19 of 13 January 2017. In 2016 Q3, GDP growth came in at 4.3 percent in annual terms.

[58] Given that at end-2015 and in the first half of 2016, amid fiscal and wage incentives, quarterly GDP dynamics were significantly faster.

[59] Such measures refer to the standard VAT rate cut, the reduction in the excise duty on fuels, pay rises for some categories of public sector employees, the increase in the minimum wage, as well as to the removal of non-tax fees and charges.

[60] According to EC assessments under the European Innovation Scoreboard (2016), Romania is classified as a modest innovator, the steady downtrend seen in 2011-2015 being reflected by the widening gap versus the EU average. The innovation index summarizes the performance based on 25 indicators covering human resources, the education system, the R&D expenditure, patent application or organisational processes at company level.

Chart 4.8. Output gap



Source: NIS, NBR projection

Excess demand (assessed to have been manifest since the beginning of 2016) is projected to widen gradually over the forecast interval (Chart 4.8), acting towards strengthening inflationary pressures. This mirrors the dynamics of the real disposable income economy-wide (bolstered inter alia by the impact of fiscal easing and income policy measures), the stimulative set of real broad monetary conditions, as well as the progressive closing of the external demand deficit. The above-mentioned influences could be dampened by the restrictive effects of the US Administration's economic policies and of those related to Brexit, via the trade channel. Compared to the previous *Report*, the output gap leads to a build-up of stronger inflationary pressures almost throughout the projection interval[61], under the influence of fiscal easing and wage policy measures, in particular during the current year. At the same time, the set of real broad monetary conditions, albeit slightly more stimulative (due almost entirely to the contribution of the real effective exchange rate via the net export channel), is further calibrated close to the previously forecasted levels. From the perspective of aggregate demand components, the output gap is forecasted to widen mainly on account of consumption gap, whereas in the case of GFCF, its deviation from the medium-term trend is expected to remain negative. In turn, the gaps of exports and imports are assessed at positive values, yet having a negative net contribution to the output gap.

The baseline scenario further envisages an above-potential GDP growth rate for 2017-2018. However, the GDP dynamics are anticipated to decelerate, mirroring a decrease in the estimated value of the discretionary component of fiscal policy (i.e. the fiscal impulse) compared with the size of the 2016 fiscal incentives. Against this backdrop, the positive contribution of domestic demand to GDP growth is forecasted to decrease, owing to the actual individual consumption of households and to investments. The developments in domestic demand components will reflect the impact of determinants such as the real disposable income of households, the lending conditions and, in the case of investments, the absorption of European structural and cohesion funds[62]. Given the advance in domestic demand, imports of goods and services are expected to further rise faster than exports, thus contributing to the widening of trade deficit in goods and services. Hence, the contribution of net exports to GDP growth is projected to be negative. Its remaining at low values is, however, conditional upon the strengthening of the economic activity of Romania's trading partners, and, implicitly, of the external demand for Romanian products.

61 Compared with the previous *Inflation Report*, output gap assessments for recent periods were revised at slightly lower levels, mainly on account of the lower-than-expected GDP dynamics in 2016 Q3.

62 2016 was the last year when multi-annual financial absorption cycles (2007-2013 and 2014-2020 respectively) overlapped, as a result of derogations given by the EC to beneficiary states.

Aggregate demand components

In 2016 Q3, the actual individual consumption of households dropped 1.4 percent from the previous quarter, yet its annual growth rate remained relatively high. The quarterly dynamics of this component are expected to return to positive territory in 2016 Q4, based on the favourable developments seen in the period from October to November 2016 as compared with the Q3 average, i.e. real increase of 2 percent in the average net wage economy-wide and 1.6 percent rise in the volume of retail trade, excluding motor vehicles and motorcycles. In addition, the consumer confidence indicator gained 3 points in the final quarter of 2016[63]. For 2017 Q1, prospects for a strong consumption rebound take shape, favoured by the evolution of real disposable income, in the context of fiscal policy measures and wage hikes implemented at the beginning of the year.

Over the forecast interval, the actual individual consumption of households is anticipated to expand at swift rates, which are seen, however, to decelerate as compared with 2016. The forecast captures, on the one hand, the diminishing impact exerted on the dynamics of real disposable income by: (i) fiscal and income policy measures, (ii) pay rises in the private sector, which are seen to be lower than a year ago, and (iii) the projected increase in the annual CPI inflation rate. On the other hand, the evolution of this component is expected to be also supported by the low real interest rates, as they boost consumption (via attractive financing sources) to the detriment of saving.

In 2016 Q4, the actual collective consumption of general government is foreseen to remain at a level similar to that recorded in Q3, its growth remaining consistent with keeping the budget deficit in 2016[64] below 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 decelerating positive average annual dynamics.

Gross fixed capital formation decreased by 8 percent in 2016 Q3 versus Q2, on the back of the unfavourable evolution of both civil engineering works and equipment purchases. The GFCF dynamics are forecasted to be modest in the short term amid incoming evidence indicating that the aforementioned developments, particularly those related to investments in the public sector, will carry on in 2016 Q4 as well. The anticipated GFCF growth is underpinned by the industrial output of capital goods, which picked up 0.8 percent in October-November 2016 as compared with the Q3 average, and by the confidence indicator in construction, which saw a slight improvement, i.e. up 0.4 points in 2016 Q4 from the previous quarter[65]. The assessment of this component's dynamics is surrounded by uncertainty, due also to the heightened volatility and the numerous revisions of seasonally adjusted historical series.

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63 A look at the breakdown shows that all components, i.e. employment, saving, general economic context and financial situation, underpinned this development.

64 According to the MPF, the budget execution as at 31 December 2016 indicates a budget deficit of 2.41 percent in nominal GDP.

65 The improvement in this indicator is solely due to employment prospects.

The projection foresees the GFCF posting favourable, yet fluctuating developments over the forecast interval. As compared to the average annual increase estimated for 2016, the GFCF growth will decelerate slightly in 2017 and pick up in 2018. This forecast relies on: (i) the continued absorption of EU structural and cohesion funds, albeit at a slower pace[66] projected for the current year, with a spurring effect on investment, (ii) favourable lending conditions and (iii) the recent adoption of some fiscal measures[67] which carry the potential to release resources that can be channelled to investment programmes.

In 2016 Q3, exports of goods and services rose marginally quarter on quarter, being expected to pick up in 2016 Q4 and 2017 Q1. These dynamics are supported, over both short and medium term, by the prospects[68] for the gradual economic recovery of Romania's trading partners, under the influence of the ECB's quantitative easing measures and the rise in disposable income of households, amid the improving labour market conditions. Exports of goods and services are anticipated to further witness positive changes over the forecast interval, reflecting the persistence of improvements in their composition seen in recent years[69]. The real effective exchange rate will have an additional stimulative effect, albeit gradually diminishing towards the end of the projection horizon, on the forecasted growth rate of exports. In contrast, the swift dynamics of unit labour costs economy-wide are anticipated to have an impact on the price competitiveness of the Romanian products for external markets.

In 2016 Q3, imports of goods and services decreased by 2.5 percent quarter on quarter, in the context of contractions in consumption and GFCF. For end-2016 and over the forecast interval, the dynamics of imports are expected to return to positive territory and record relatively high values, amid the increase in domestic demand and the spurring effect of exports (through their import content). Against this background, net exports are anticipated to make a negative contribution to GDP growth over the projection interval.

Starting with 2015, the balance-of-payments current account deficit reversed its post-crisis closing trend, amid the wider deficits on primary income and trade in goods, with the step-up in domestic demand contributing to the latter development. In parallel, the balance on primary income saw rising deficits, which were indicative of higher outflows of direct investment income, in the form of equity (dividends and reinvested earnings[70]). Over the forecast interval, the current account deficit is expected to further widen gradually before stabilising close to 3 percent of GDP.

[66] 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.

[67] The implemented measures include the cut in dividend tax from 16 percent to 5 percent, the change in the tax regime applicable to micro-enterprises and the removal of the tax on special constructions.

[68] Although marked by a certain degree of uncertainty, also on the back of the changing relationship between the United Kingdom and the European Union and the diverging monetary policy stances of the Fed and the ECB.

[69] For instance, in the services sector or the group of machinery, apparatus, equipment and transport means. Looking ahead, the favourable dynamics of the latter are conditional on factors such as the expansion of productive capacities and the improvement in the related infrastructure.

[70] At the same time, however, they have a direct contribution to current account deficit financing, as they are a subcomponent of equity in direct investment enterprises.

The main determinant of this evolution is the dynamics of imports of goods and services, amid the increase in domestic demand.

The anticipated sources of financing the current account deficit are deemed to remain adequate and favourably distributed in terms of non-debt-creating flows (particularly foreign direct investment and capital transfers[71]). Nevertheless, the reopening of the current account deficit due to the speed-up in consumption and a wider fiscal deficit carries the potential to jeopardise Romania's macroeconomic equilibria, in the event of rising volatility of capital flows to the emerging economies, fostered also by the decisions of central banks of major developed economies.

Broad monetary conditions

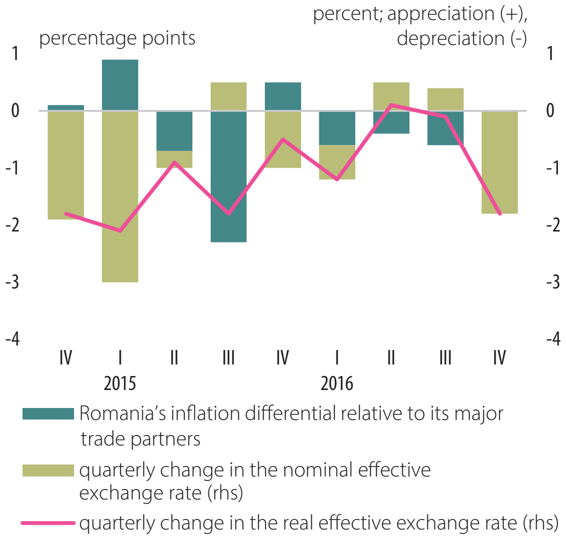
Broad monetary conditions capture the impact exerted on future developments in aggregate demand by the real interest rates applied by credit institutions on leu-denominated loans and deposits of non-bank clients and by the real effective exchange rate of the leu[72]. The exchange rate exerts its influence via the net export channel, as well as via the effects on wealth and balance sheets of economic agents[73].

In 2016 Q4 versus the previous quarter, the average nominal interest rates applied by credit institutions to leu-denominated business in relation to non-bank clients are anticipated to decrease for new loans and remain relatively unchanged – close to historical lows – in the case of new time deposits. For 2017 Q1, the nominal interest rates for both loans and deposits are expected to see marginal quarterly increases. The deviations of real interest rates from their trends are projected to have a cumulated stimulative impact on economic activity in the periods ahead.

In 2016 Q4 against Q3, the domestic currency depreciated in nominal terms, particularly versus the US dollar, but also versus the euro. The leu also depreciated in real effective terms, given an almost nil 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.

The wealth and balance sheet effect in 2016 Q4 and 2017 Q1 exerts stimulative influences on the future aggregate demand, mostly on account of the real foreign interest rate standing below the equilibrium level (strongly negative gap). The sovereign risk premium is assessed to stand

Chart 4.9. Quarterly change in the effective exchange rate



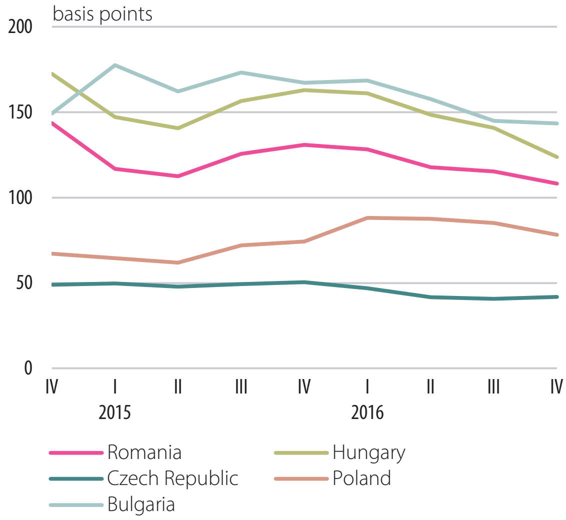
Source: Eurostat, U.S. Bureau of Labor Statistics, NBR, NBR calculations

71 Related to the absorption of EU structural and cohesion funds.

72 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.

73 The relevance of this channel declined gradually in recent periods, given the drop in the share of foreign currency-denominated loans in total credit to the private sector.

Chart 4.10. 5-year CDS spreads for Romania and other countries in the region



Source: NBR calculations based on Reuters data

close to the medium-term trend, thus having a neutral effect. The CDS (Credit Default Swap) quotes for Romania decreased in 2016 Q4 versus Q3 (Chart 4.10). Nevertheless, they were on a rise over the past two months of Q4, particularly on account of the US elections and domestic events. The medium-term prospects for the risk premium are influenced by domestic factors, associated with the construction of the budget and its subsequent execution, as well as by global economic developments, especially the changing relationship between the UK and the EU and the divergence between the Fed's and the ECB's monetary policy stances.

Overall, in 2016 Q4 and 2017 Q1, real broad monetary conditions are assessed to exert a stimulative impact on the aggregate demand in the following quarters. By component, the stimulative impact stemming from the real effective exchange rate (via the export price competitiveness channel) is prevalent.

Real broad monetary conditions are forecasted to continue having a stimulative effect on economic activity over 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 make the wealth and balance sheet effect, fostered by the low real foreign interest rate levels amid the persistence of the quantitative easing programme implemented by the ECB. The projected path of the monetary policy rate aims to ensure and safeguard price stability over the medium term, in a manner conducive to sustainable economic growth.

Assessment of forecast errors for the December 2016 annual CPI inflation

Given the essentially prospective nature of monetary policy decisions, warranted by the inherent time lags in central bank's decisions working their way through the economy, macroeconomic forecasts play a pivotal part in the inflation targeting strategy. With a view to improving the forecasting framework, the assessment of forecast errors is a common practice among central banks with such a monetary policy regime in place[74]. In this context, during 2016, the NBR staff further assessed the accuracy of forecasts the central bank had made in successive rounds relative to the annual CPI inflation rate for end-2016[75]. The analysis showed both the prevalent contribution to the forecast error made by inflation components exogenous to the monetary policy scope, and the importance of the global disinflationary factor in the repeated revisions of inflation projections.

[74] Assessments are made either regularly, namely on an annual basis (e.g. Magyar Nemzeti Bank, Sveriges Riksbank) or occasionally, covering a longer period of time (e.g. Česká národní banka, Bank of England).

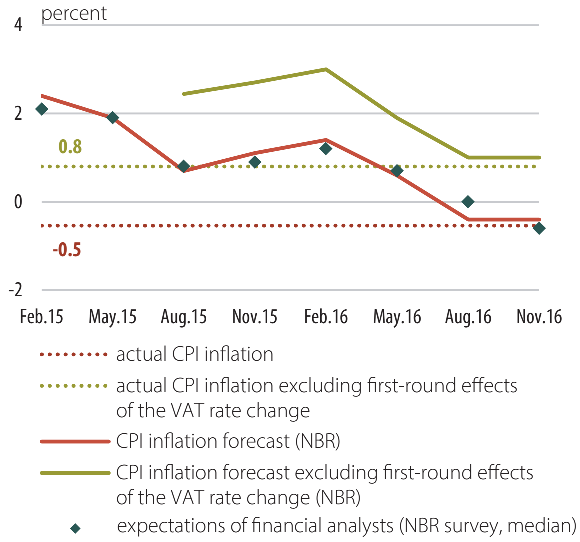
[75] Based on this criterion, the considered forecasting rounds correspond to the *Inflation Reports* published February 2015 through November 2016.

The annual CPI inflation rate for December 2016 (-0.5 percent, according to NIS Press Release No. 20 of 13 January 2017) was overestimated[76] in all eight rounds under review, with forecast errors ranging between a +0.2 percentage point low (in the November 2016 *Inflation Report*) and a +2.9 percentage point high (in the February 2015 *Inflation Report*). In terms of accuracy, the size of these errors is similar to the median of those arising from financial analysts' forecasts (taken from the NBR survey on inflation expectations). In order to ensure comparability, the forecasts considered for analysis were those released by financial analysts in the months when *Inflation Reports* were published (Chart A).

The 2016 actual average annual inflation rate stood at the lower bound of the range defined by the successively projected values of the indicator (Chart B). This owed to a number of favourable supply-side shocks having occurred in the region and/or worldwide (significant falls in the international commodity prices, the persistent oversupply in the EU agri-food market following Russia's ban), along with a slow recovery of effective external demand in the post-crisis period. At the same time, the fiscal measures implemented over the last two years referring to indirect tax cuts, especially the value added tax (VAT)[77], acted also towards lowering the average inflation rate both in Romania and in the other countries under review.

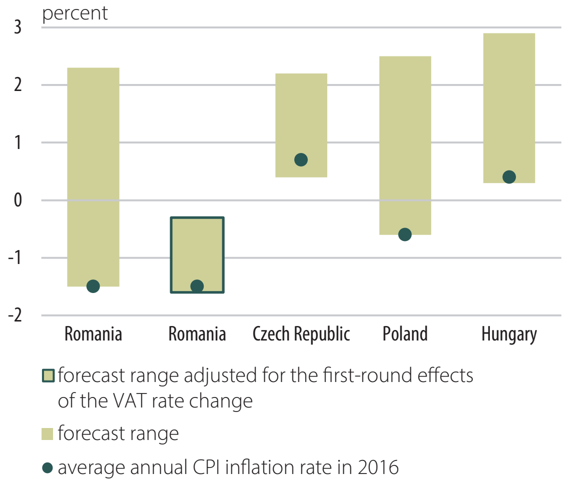
For Romania, the breakdown of forecast errors for end-2016 (Chart C) reveals the important contribution of the CPI basket sub-components directly hit by the mentioned exogenous shocks (volatile food prices[78], adjusted CORE2 index[79]). The prevalent contribution is, however, associated with the dynamics of administered prices. Their current path incorporates the most recent legislative changes in the field targeting

Chart A. Successive forecasts of annual CPI inflation rate for December 2016



Source: NIS, NBR projections, NBR survey

Chart B. Revisions of the forecasts on 2016 average annual CPI inflation made by some central banks in Central and Eastern Europe



Source: NBR, CNB, NBP, MNB

[76] The forecast errors are calculated as the difference between the successively forecasted values and the actual one. A negative difference implies that the projection underestimated the actual CPI inflation rate, whereas a positive difference reveals its overestimation.

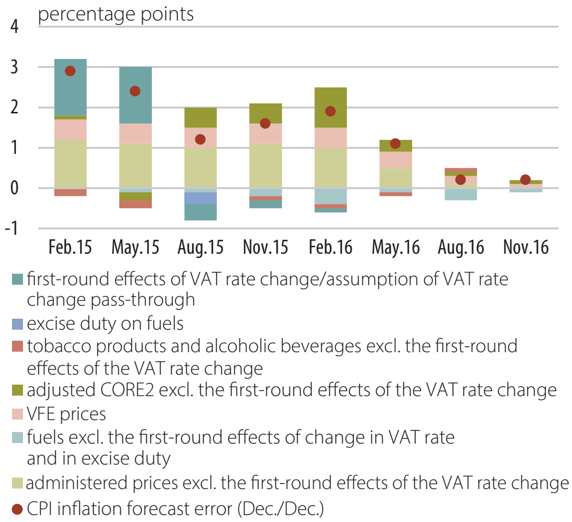
[77] In Romania, the standard VAT rate was cut from 24 percent to 20 percent starting 1 January 2016. Moreover, all four countries subject to the analysis adopted measures for broadening the scope of the reduced VAT rate to a series of product categories in the period under review.

[78] The slow dynamics of volatile food prices at the end of the previous year owed also to an agricultural production that exceeded the long-term average (except for the maize harvest). The standard assumption underlying the forecast refers to normal agricultural years domestically (as compared to the multi-annual average output).

[79] For instance, this component was affected by significant drops in the prices of agri-food commodities, which had an impact on production costs incurred by local companies.

especially prices of electricity and natural gas (revisions of regulated electricity tariffs and of competitive market component prices, deviations from the calendar on the deregulation of the end-user price for domestically-produced natural gas, mirroring inter alia international developments[80]).

Chart C. Forecast errors in successive rounds, by contribution of CPI components



Source: NBR calculations

In spite of the successive downward revisions of the Brent oil price, the annual dynamics of fuel prices were, contrary to apparent expectations, underestimated over the forecasting rounds, following specific developments at the end of the previous year (crude oil prices resuming notable annual growth rates amid the agreement among OPEC and non-OPEC member countries to contain production; the depreciation of the leu against the US dollar).

In the February 2015 and May 2015 projection rounds, an important source of the forecast errors for both CPI inflation and core inflation was the effect – that could not be anticipated back then – of the measure to cut, starting January 2016, the standard VAT rate from 24 percent to 20 percent, also with an impact on the paths of inflation expectations through which the second-round effects of the measure are passed on.

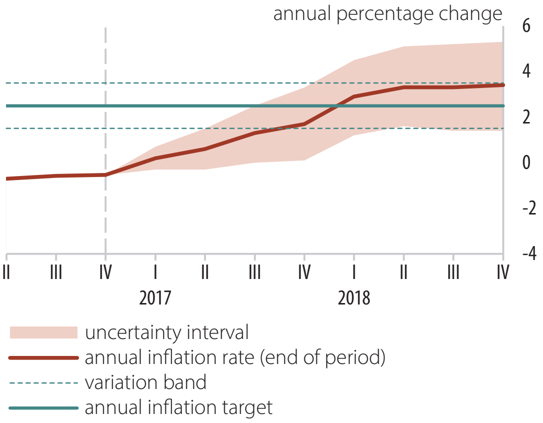
Compared to the provisions of the Tax Code version used for mapping out the August 2015 projection (referring mainly to the standard VAT rate cut from 24 percent to 19 percent and to the lowering of the excise duties on fuels as of January 2016), the subsequent changes thereof (producing a more notable impact on the CPI inflation rate forecast), incorporated in the projection starting with the November 2015 forecasting round, envisaged a one-year delay (from 1 January 2016 to 1 January 2017) in implementing the 1 percentage point reduction in the standard VAT rate and in scrapping the special excise duty on fuels.

1.4. Risks associated with the projection

The balance of risks to the annual inflation rate projection is assessed to be relatively in equilibrium. At the current juncture, relevant uncertainties are associated with possibly slower administered price dynamics in the future, on the one hand, and with opposite influences stemming from the fiscal and income policy conduct, as well as from possible changes in the external environment, on the other hand (Chart 4.11).

[80] For further details see the Romanian Energy Regulatory Authority press releases of 30 March 2016, 23 June 2016 and 30 June 2016, respectively, available at http://www.anre.ro/ro/presa/comunicate (Romanian only).

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 2005-2016. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

On the domestic front, any deviation from the set of fiscal measures in the 2017 draft budget[81] on either revenue or expenditure side would have implications on public finance sustainability and, implicitly, on the configuration of the baseline scenario underlying the macroeconomic projection.

Thus, the financing of the fiscal deficit for 2017 and the effectiveness of compensatory measures to be taken with a view to keeping the deficit below the 3 percent-of-GDP reference level become relevant. Moreover, a budget spending composition where capital expenditures would be cut in favour of current expenditures could translate into a less sustainable structure of domestic demand over the medium term. Under these circumstances, a concomitant worsening of the country's external position could prompt foreign investors to reassess the risk associated with the domestic economy. Adding to these are also the unknowns surrounding the EU funds absorption, given the early stage of the 2014-2020 financial cycle-related absorption, with effects that would eventually feed through into the potential growth and the Romanian economy competitiveness.

Global developments continue to be a sizeable source of risks to the inflation path in the baseline scenario. One of the risks that has partly materialised since the previous *Inflation Report* refers to the divergence between Fed's and ECB's monetary policy stances, as the Fed increased the federal funds target rate in its December meeting and announced likely additional rises therein in the course of 2017, whereas the ECB decided to keep further in place the loose monetary policy stance, at least until the end of the current year. Persistent uncertainties about an increasing divergence between monetary policy stances relate to the future configuration of the economic policies to be pursued by the US Administration, not disclosed until the completion of the current projection. These could imply rolling out a considerable fiscal stimulus stemming from tax cuts, as well as higher infrastructure and defence spending, stricter immigration policies and increased trade protectionism. Portfolio shifts that might occur regionally and/or globally due to more attractive yields in the USA could entail unpredictable swings in the exchange rates of emerging economies, including that of the leu, with an impact on the inflation path projected in the baseline scenario.

Additional uncertainties are associated with the implementation of the Brexit procedure in the context of recent statements by the British prime-minister suggesting steering negotiations towards a "hard Brexit". These risks, fuelled by the

[81] These refer to the recently approved measures: the rise in public sector wages, the lei 200 hike in the minimum wage, the scrapping of non-tax fees and charges, the removal of the cap on health contribution base and of the health contributions for pensions and the elimination of the income tax on pensions under lei 2,000, as well as to the measures envisaged to come into force during the current year: the increase in the minimum pension to lei 520 as of March and the raise in the pension point to lei 1,000 as of July.

economic prospects of other major emerging economies[82], as well as by the problems facing the Italian banking system, have the potential to dampen global external demand and therefore the demand for Romanian products.

The potentially simultaneous materialisation of these risks may lead to a reconfiguration of the inflation path in the baseline scenario via both the import price channel and the medium-term contractionary effects on the Romanian economy's cyclical position. For these reasons, it is necessary to maintain and strengthen the progress achieved over the recent years in rooting out major macroeconomic disequilibria and improving the domestic economy's resilience to adverse shocks by adequately implementing consistent macroeconomic policies. Moreover, the faster implementation of structural reforms is a sine qua non condition in ensuring sustainable economic growth.

Downside risks to the inflation outlook are further attributed to the CPI basket components beyond the scope of monetary policy, administered prices in particular. In this respect, the uncertainties about the timing of future adjustments in the natural gas and electricity prices remain relevant, with developments in the international energy prices being one of the factors that might cause deviations from the assumptions in the baseline scenario. Moreover, the contextual evolution of domestic prices, coupled with the competent authorities' decisions on end-user price components subject to their regulation, could also generate departures from the working assumptions in the baseline scenario of the projection[83].

The risks to the domestic food prices refer to weather conditions which have the potential to influence the agricultural produce supply in both ways.

As for the risks to the inflation outlook coming from developments in energy commodity prices, the uncertainties surrounding the anticipated evolution of the oil price are lower than in the previous forecasting round. Thus, the recent agreements between OPEC and non-OPEC members to cut the world oil production[84] in 2017 contain the likelihood of future downward adjustments in the oil price. 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 leu-denominated price of oil.

82 For China, the latest IMF forecasts (World Economic Outlook, January 2017) indicate improved development prospects in the medium run, yet a notable deviation from these coordinates, also in light of future trade relationships with the USA, could trigger a reconfiguration of the baseline scenario.

83 For further details on the contribution of this component to the downward revision of inflation rate in successive forecasting rounds, see the Box entitled "Assessment of forecast errors for the December 2016 annual CPI inflation".

84 At the meeting held in Vienna on 22 January 2017, 11 out of the 13 OPEC member countries, alongside other 11 non-OPEC countries, reiterated the agreement on cutting the oil production in the first half of the current year.

Abbreviations

CNB	Česká národní banka
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
MLSJ	Ministry of Labour and Social Justice
MNB	Magyar Nemzeti Bank
MPF	Ministry of Public Finance
NBP	Narodowy Bank Polski
NBR	National Bank of Romania
NEER	nominal effective exchange rate
NIS	National Institute of Statistics
OPEC	Organisation of the Petroleum Exporting Countries
REER	real effective exchange rate
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