NATIONAL BANK OF ROMANIA

Inflation Report

May 2017

Year XIII, No. 48

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NOTE

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

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

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Foreword

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

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

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

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

The *Inflation Report* was approved by the NBR Board in its meeting of 5 May 2017 and the cut-off date for the data underlying the macroeconomic projection was 28 April 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

The annual CPI inflation rate returned to positive territory at the beginning of 2017, reaching 0.18 percent in March and posting a relative pick-up versus December 2016 (+0.72 percentage points). The upward trend was mostly induced by the fading-out of the statistical effect of the standard VAT rate cut in January 2016 (from 24 percent to 20 percent), to which added unfavourable supply-side shocks, associated with external developments, with rapid knock-on effects on the dynamics of fuel prices and volatile food prices. Opposite influences have stemmed from the removal of some fees and from cuts in indirect taxes (non-tax fees and charges, VAT, excise duties) further implemented in Q1. In March, the annual inflation rate was similar to the projection in the February 2017 *Inflation Report*. At the same time, the average annual HICP inflation rate continued to see less negative values, coming in at -0.5 percent at end-Q1, which caused the differential versus the EU-wide average to narrow to 1.2 percentage points.

In 2017 Q1, the developments in the annual CPI inflation rate continued to reflect the changes in some indirect taxes and fees; when calculated at constant tax rates, the indicator rose from 0.7 percent in December 2016 to 1.2 percent in March, running further below the lower bound of the variation band of the target (2.5 percent ±1 percentage point). The new cut in the standard VAT rate (from 20 percent to 19 percent) impacted more than half of the CPI basket, except for the items subject to a reduced VAT rate (mainly the food segment). Furthermore, scrapping a number of non-tax fees and charges caused the annual dynamics of administered prices to remain stuck at the sharply negative value seen at end-2016 (-4.78 percent). In addition, the lower excise duty as of 1 January 2017 offset the impact of crude oil price uptrend on fuel prices, the latter reporting a slightly slower annual pace of increase in March than at end-2016 (1.8 percent).

At end-2017 Q1, the annual adjusted CORE2 inflation rate came in at 1.0 percent, against 0.35 percent in December. The dynamics of this indicator net of the direct effect of the VAT rate cut remained around 1.2 percent in the mentioned period, as the ongoing increase in the positive output gap, also visible in Q1, continued to pass through to a limited extent into price developments, in the context of a weaker relationship between inflation and domestic economic activity. This assessment is based on the evidence collected over the past years that saw persistent disinflation worldwide, alongside an increase in the importance of consumer goods imports in accommodating domestic consumer demand.

Labour productivity across the economy continued to rise at a relatively robust pace in 2016 Q4, mostly on account of cyclical developments, whereas structural factors, associated with labour market or the dynamics of investment in the economy, were slow in showing progress. Across industry, labour productivity returned to positive territory, which helped to slightly slow down the annual pace of increase of unit wage costs. Looking ahead, wage hikes already implemented in early 2017 (public sector wages, the whole-economy gross minimum wage), as well as pay rises envisaged in the private sector, are expected to keep the annual dynamics of unit wage costs at high levels, carrying the potential to generate rising inflationary pressures in the medium run amid a relatively elevated share of wage costs in total production costs.

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

In its meeting of 7 February 2017, 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 the first part of 2017 and anticipated its return inside the variation band of the target towards the end of 2017, to stand in the upper half thereof at the end of the projection horizon. This path reflected the fading-out of the transitory effects of the standard VAT rate cuts, the expected gradual dissipation of influences generated by global disinflationary shocks, 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, they were mainly posed by the fiscal and income policy conduct for 2017. The risks coming from the external environment were primarily generated by the persistent uncertainties about economic growth in the euro area induced by the political developments in the context of the 2017 elections and of the Brexit negotiations, by the diverging monetary policy stances of the world's major central banks, as well as by the problems facing the EU banking system.

Subsequently, the statistical data confirmed the return of the annual inflation rate to positive territory in January 2017 (to 0.05 percent, from -0.54 percent in December 2016) and its advance to 0.2 percent in February, in line with the forecasted level. In its turn, the annual adjusted CORE2 inflation rate went up, as forecasted, to 0.9 percent in February, from 0.3 percent at end-2016. In 2016 Q4, the economy rose above expectations, with the annual dynamics of real GDP reaching 4.8 percent (from 4.3 percent in Q3).

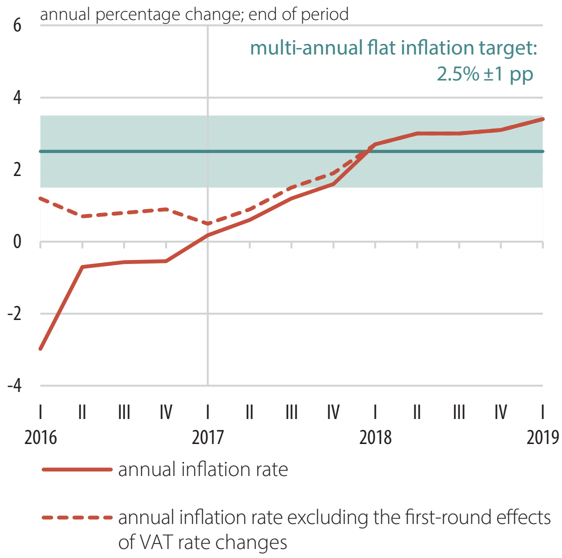
In the Board meeting of 5 April 2017, the latest assessments reconfirmed the prospects for the annual inflation rate to continue to pick up slightly in the coming months, while remaining significantly below the lower bound of the variation band of the flat target. The uncertainties and risks associated with such prospects arose from both the domestic and the external environment. On the domestic front, these continued to be generated mainly by the developments in the fiscal and income policies for 2017, as well as by the uncertainties surrounding the future adjustments in administered prices. On the external front, previously identified risk sources persisted, alongside the risk concerning the international oil price developments.

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, reaching 1.6 percent at end-2017, 3.1 percent at end-2018 and 3.4 percent at the projection horizon, i.e. 2019 Q1. Compared with the previous *Inflation Report*, the projected rates of the annual CPI inflation and core inflation were revised downwards for both 2017 and 2018, due mainly to the decline – based not only on factual evidence, but also on statistical evidence – in the pass-through of domestic demand driven inflationary pressures to core inflation. Considering the stimulative fiscal and income measures affecting the projection interval, core inflation, amid the expected developments in excess aggregate demand, is seen becoming the key determinant of the annual inflation path.

Inflation forecast



Source: NIS, NBR projection

The transitory first-round effects of the standard VAT rate cut effective as of 1 January 2017 are expected to persist until the end of this year, when the annual inflation rate net of this influence is forecasted to stand at 1.9 percent.

Subsequent to the pick-up witnessed in 2016, economic growth is projected to remain in 2017 above potential GDP dynamics, yet below last year's reading. On the one hand, the fiscal and wage-related stimuli already implemented or to be implemented shape a positive fiscal impulse, which is, however, lower than that assessed for 2016. On the other hand, economic growth in Romania's trading partners is expected to strengthen at around 2 percent. Given the nature of stimuli, consumption will remain the major driver of growth, fuelled by developments in real disposable income, amid the fiscal easing and public-sector income policy measures, as well as the anticipated pay rises in the private sector. At the same time, gross fixed capital formation is projected to firm only gradually during the reference interval, given the early stage of implementing the programmes under the EU's Multiannual Financial Framework 2014-2020. Favourable lending conditions are expected to boost developments in both aggregate demand components over the entire forecast period.

With domestic demand projected to increase significantly, imports of goods and services are seen expanding faster than exports, thereby consolidating the reopening tendency of the current account deficit visible since 2015 and causing its share in nominal GDP to post values around 3.2 percent over the medium term. The reopening of the current account deficit, on the back of swifter consumption and a wider fiscal deficit, carries the potential to jeopardise macroeconomic equilibria, with a direct impact on capital inflows to Romania. In the baseline scenario, current account deficit financing is envisaged to further be covered largely by non-debt-creating flows, the share of which will decrease however from that of 2016.

Given the stronger-than-expected GDP growth in 2016 Q4, the positive output gap has been revised to higher values than in the previous forecasting round. To this contribute, starting in the first part of 2017, the wage and tax-related measures, the faster-growing private sector income, the expected rise in excess foreign demand after this indicator reverses its cyclical position in 2018 Q2, and the stimulative real broad monetary conditions. In this context, the output gap will widen until the projection horizon.

The annual adjusted CORE2 inflation rate is projected to reach 2.1 percent at the end of 2017 and 3.9 percent at the end of next year. Both projected levels are lower than those released in the previous *Inflation Report* (amid the evidence of recent decline in the intensity of the relationship between domestic economic activity and inflation – see Box 2). At the same time, for December 2018, the projected level exceeds the upper bound of the variation band of the 2.5 percent ±1 percentage point 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 certain, still soft, inflationary pressures coming from import prices for consumer goods. The anticipated evolution of the annual adjusted CORE2 inflation rate will further be affected by the transitory impact of the standard VAT rate cuts only until the end of this year, when the annual rate of core inflation net of this influence is projected at 2.3 percent.

The cumulative contribution of inflation components beyond the scope of monetary policy to the annual CPI inflation rate is seen at 0.3 percentage points for the end of 2017 and 0.8 percentage points for the end of 2018. While similar to those in the February 2017 *Inflation Report*, these figures reflect diverging influences of the components. Thus, the dynamics of volatile food prices were revised significantly upwards for this year, amid a decline in output of fruit and vegetables at EU level, while the path of fuel prices was revised downwards, for 2017 in particular, considering the slower annual rate of change of the international oil price. The contribution of administered price dynamics to the annual inflation rate is similar to that in the previous *Inflation Report*.

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.

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside relative to the inflation path in the baseline scenario. At the current juncture, the relevance of uncertainties is largely attached to the domestic environment, i.e. the fiscal and income policy stance.

Thus, one of the relevant sources of risk to inflation could be the enactment, in the periods ahead, of the Framework Law on wages for staff paid from public funds. The draft law is in an early stage of the legislative process, under parliamentary debate at the date of completing this *Report*. The potential effects of widening the positive output gap and, hence, of exerting higher inflationary pressures than in the baseline scenario will chiefly depend on the final version of the legal text, the timing of pay rises, and the related conditionality criteria. In addition, as the baseline scenario foresees still slow EU fund absorption and a gradual rebound in local investment, the additional wage stimulus provided by this law could imply further domestic demand accommodation by resorting to consumer goods imports, thereby contributing to a worsening of the current account, with currently difficult-to-assess consequences on its financing costs.

As for the external environment, still relevant are the implications that Brexit, on the one hand, and the diverging policy stances of the Fed and the ECB, on the other, will have on the global macroeconomic coordinates. Thus, the details on the precise institutional arrangements that will prevail in the EU-UK relationship are yet to be known, while the divergence between the monetary policy stances of the Fed and the ECB is also conditional on the economic policies pursued by the US Administration. Furthermore, political developments associated with parliamentary elections to be held later this year in two of the EU powerhouses, i.e. France and Germany, should be closely monitored. Other risk sources that have remained relevant also in the current round refer to the future evolution of global economic activity, fuelled by the uncertainties about the traction coming from emerging economies, especially China.

In what regards the risks induced by international commodity prices, there are still uncertainties surrounding the anticipated evolution of the oil price in particular. Despite the agreement reached between OPEC and some non-OPEC members to cut the world oil production in order to stem falling prices, US unconventional hydrocarbon production kept rising, proving its resilience to weak oil prices. Against this backdrop, a build-up of excess oil reserves at world level is possible over the medium term, causing longer episodes of low oil prices.

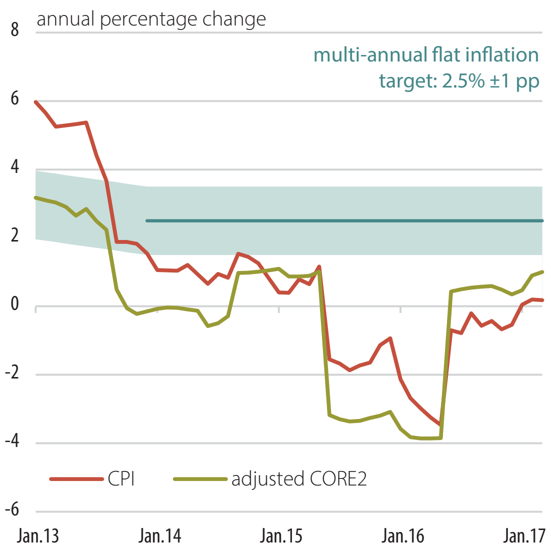
Monetary policy decision

Considering the prospects for a progressive rise in the annual inflation rate throughout the projection horizon, yet on a lower-than-previously-foreseen path, together with the risks to the inflation outlook stemming from the fiscal and income policy stance, and the uncertainty surrounding euro area and global economic growth, the NBR Board decided, in its meeting of 5 May 2017, to keep unchanged the monetary policy rate at 1.75 percent per annum. At the same time, the Board decided to leave unchanged at ±1.50 percentage points the symmetrical corridor defined by the interest rates on the standing facilities around the policy rate, to further pursue adequate liquidity management in the banking system, and to maintain the existing level of the minimum reserve requirement ratio on leu-denominated liabilities of credit institutions. Moreover, given the contraction in foreign currency credit, the consolidation of forex reserves above the adequate level and their improved composition, the Board decided to cut the minimum reserve requirement ratio on foreign exchange-denominated liabilities of credit institutions to 8 percent from 10 percent starting with the 24 May – 23 June 2017 maintenance period. The measure aims to continue the harmonisation of the minimum reserve requirements mechanism with the relevant standards and practices of the ECB and the major central banks across the EU.

1. Inflation developments

At the beginning of 2017, the annual CPI inflation rate returned to positive territory (0.18 percent in March, up 0.72 percentage points from end-2016), remaining however below the lower bound of the ±1 percentage point variation band of the 2.5 percent target. The trajectory of the annual dynamics of consumer prices was further impacted by the changes in indirect taxation and in a number of non-tax fees and charges. Calculated at constant tax rates, CPI inflation stood at approximately 1.2 percent at end-Q1, 0.5 percentage points higher than in December 2016. The uptrend was driven by adverse supply-side shocks associated with external developments (bad weather conditions, the OPEC agreement on crude oil output cuts), which were quickly and strongly reflected by the volatile price component of the CPI basket. On the domestic front, the gradual opening of the positive output gap has further exerted pressure, but the pass-through to consumer prices is still limited, suggesting a lower sensitivity of core inflation to the output gap. In this context, in early 2017 adjusted CORE2 inflation witnessed benign developments, as the level posted in March was similar to that reported in December 2016 (1.2 percent, net of the effect of the VAT rate cut in January 2017; Chart 1.1).

Chart 1.1. Inflation developments

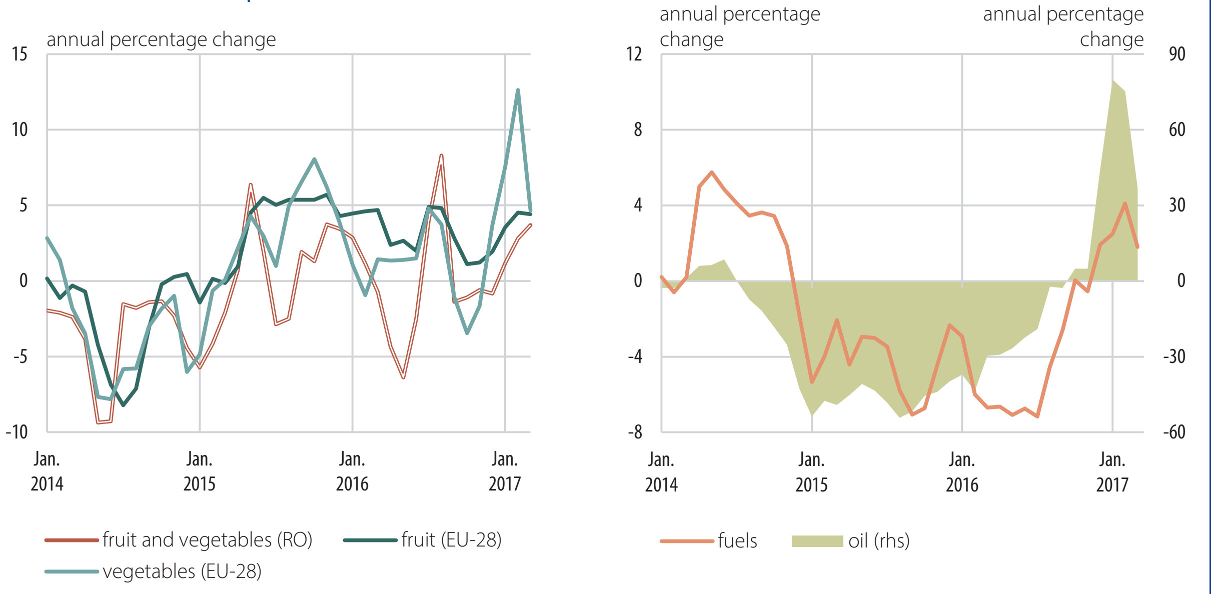


Source: NIS, NBR

The path of the annual CPI inflation rate continued to be marked by the changes in indirect taxation, the base effect associated with the standard VAT rate cut from 24 percent to 20 percent in January 2016 being almost entirely offset by further reductions in the VAT rate and excise duties, as well as by the scrapping of some non-tax fees and charges, with a cumulative impact of about -1 percentage point. Specifically, January 2017 saw a new standard VAT rate cut (to 19 percent), a measure that affected more than half of the CPI basket, its impact on the annual inflation rate being assessed at around -0.3 percentage points. The pass-through to prices was relatively high (approximately 70 percent, close to that in the 2016 episode), given the small size of the cut, the frequency of such measures over the past two years and the current upturn of the business cycle, a possible explanation lying in the increased competitive pressure in the market. Other changes in taxes and fees that were relevant to CPI inflation, cumulating a 0.7 percentage point negative contribution, referred to the removal of the special excise duty of 7 euro cents per litre on motor fuels in January and the scrapping of the subscription for national radio-TV services and the passport issuance fee respectively in February 2017. The latter is in fact the main reason for the annual rate of change of administered prices staying at the strongly negative level seen in December 2016, i.e. -4.8 percent.

Looking at components, the volatile prices in the CPI basket saw swifter hikes in 2017 Q1. In particular, the lower fruit and vegetable production at EU level, on the back of the adverse weather conditions in early 2017, led to the gradually faster annual dynamics of VFE prices, the value posted at end-Q1 (4.1 percent) being almost 5 percentage points higher than that seen in December 2016. The domestic prices of fuels followed a similar trend, as the increase in international oil prices, following the agreement on output cuts reached by OPEC at end-2016 and also joined by other non-OPEC producers, kept the former's annual growth rate in positive territory even after the removal of the special excise duty and the reduction in the VAT rate (1.8 percent in March and 6.7 percent when calculated at constant tax rates respectively; Chart 1.2).

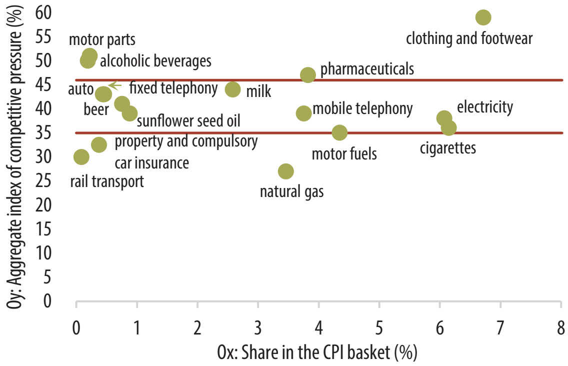
Chart 1.2. Volatile prices in the CPI basket



Source: Eurostat, IMF, NIS

The increasing trend in excess aggregate demand was manifest in 2017 Q1 as well, adjusted CORE2 inflation (net of the first-round effect of the VAT rate cut) remaining however somewhat stable at 1.1-1.2 percent. The muted behaviour of core inflation, even amid the reversal of the cyclical position of the economy and the gradual widening of the positive output gap, marked in fact 2016 as a whole, indicating a weaker relationship between inflation and the positive/negative output gap in the economy (Box 2). This phenomenon may be largely associated with the higher relative importance of imports in accommodating domestic consumer demand (which were facilitated by the favourable price differential – Box 1) and, consequently, with the greater relevance of the external factors to the developments in domestic inflation. At the same time, the domestic FMCG market seems to be highly competitive, a first indication of this fact being the aggressive expansion of large store chains, with

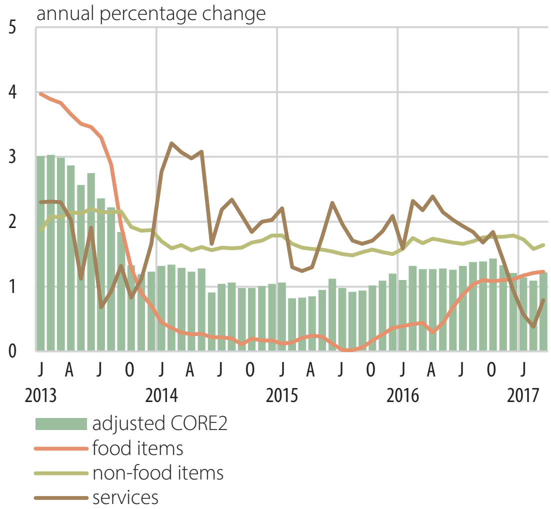
Chart 1.3. Competitive pressure in sectors relevant to the CPI basket



Note: The sectors in which the AICP value is above Q3 = 46% are deemed to be the most open to free competition, whereas the sectors in which the AICP value is below Q1 = 35% are considered the most prone to anti-competitive behaviour.

Source: *Competition developments in key sectors*, 2016, Competition Council, NIS, NBR calculations

Chart 1.4. Adjusted CORE2 inflation



Note: Annual percentage changes are calculated net of the direct effect of the VAT rate cuts.

Source: NIS, NBR estimates

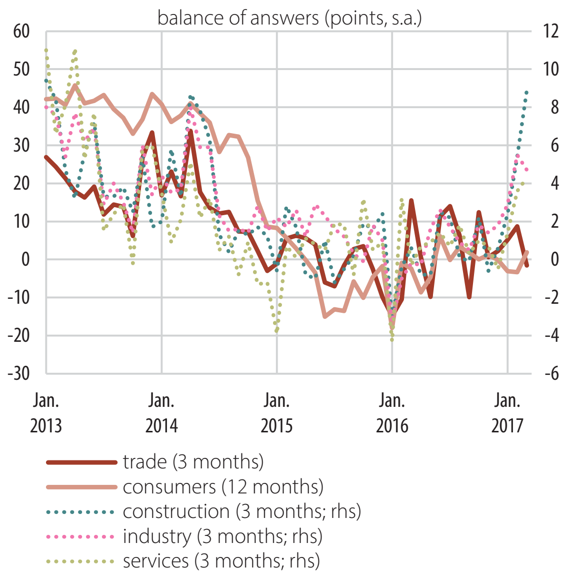
modern trade coming to hold the dominant market position in 2016 (almost 60 percent of the value of sales, according to GfK). The intense competition in various market segments that are representative for the CPI basket is also shown by the aggregate index of competitive pressure (AICP) calculated by the Competition Council[1]. Cases in point are the sale of clothing and footwear, the processing and sale of milk, and telecommunication services, with a cumulative share of over 30 percent of the core inflation basket and with AICP values well above or close to the third quartile (Chart 1.3).

The breakdown of adjusted CORE2 inflation by subgroup shows that only processed food prices witnessed a somewhat faster growth rate than at end-2016 (up 0.1 percentage points, to 1.2 percent in March 2017), this being mainly the case of dairy and meat products. This development was underpinned by the continued narrowing of oversupply in the European market. Specifically, according to European Commission data, in 2016 the EU market reported a drop in supply, following particularly the implementation of a scheme for the voluntary reduction in production, along with rising demand, also from non-EU countries. Nevertheless, the relatively higher food price inflation was fully offset by the slower annual dynamics of prices of non-food items (to 1.6 percent in March) and of market services prices respectively (to 0.8 percent). In the latter case, a decisive contribution was made by the further cut in prices of compulsory motor third-party liability insurance policies following the introduction of a cap on insurance premiums in November 2016, concurrently with the freeze of premiums below the said level in November 2016 – May 2017 (Chart 1.4).

Inflation expectations of financial analysts broadly remained on an upward path in early 2017, standing slightly above the 2.5 percent inflation target one to two years ahead. According to economic agents' answers to the DG ECFIN survey, a relative increase in prices over the short term (a three-month horizon) seems to emerge also in industry, construction, and services. As for trade, however, the opinions of retailers

[1] *Competition developments in key sectors*, 2016.

Chart 1.5. Expectations on price developments



Source: NIS/EC-DG ECFIN survey

and consumers alike are rather indicative of prices stagnating at the three-month and one-year horizons respectively (Chart 1.5).

The average annual HICP inflation rate remained on the uptrend it had followed as early as mid-2016 (when the annual changes affected by the first VAT rate cut in June 2015 started to gradually drop out of the former's calculation), posting less negative values, i.e. -0.5 percent in March 2017. At the same time, the said advance resulted in a decline in the differential versus the EU-wide average, to 1.2 percentage points in March.

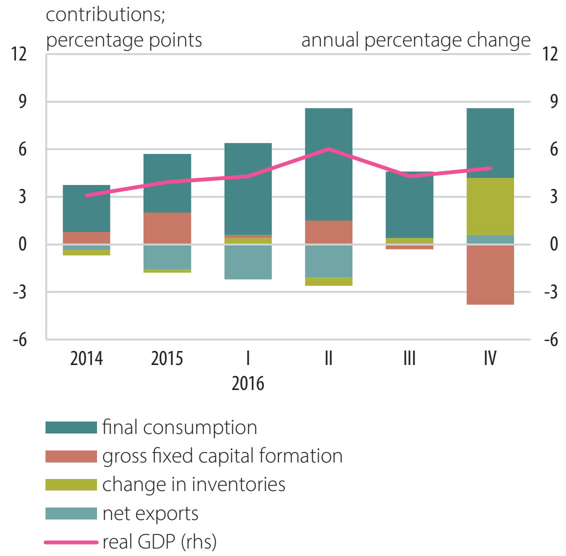
At end-Q1, the annual rate of change of consumer prices was in line with the forecasted level in the February 2017 *Inflation Report*.

2. Economic developments

1. Demand and supply

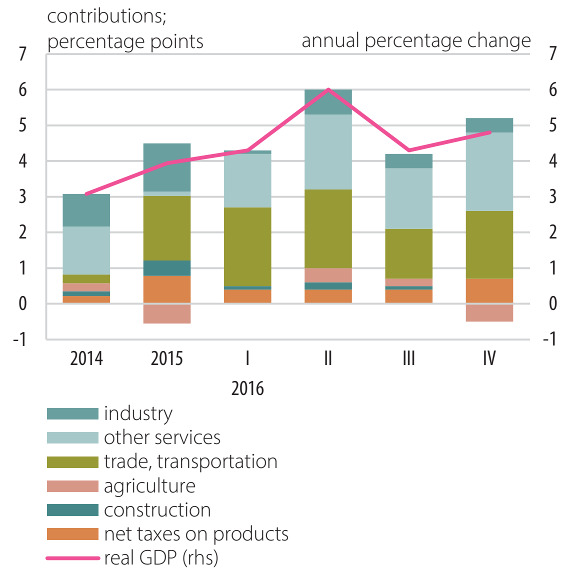
In 2016 Q4, economic activity continued to expand at a brisk pace (4.8 percent), so that the real GDP dynamics reached a post-crisis high in 2016 as a whole. Similarly to the previous quarters, consumer demand was the main driver, but at the same time an improvement was noticed in the contribution of external sector, the recovery of EU economies leading to faster export growth and the reversal of the unfavourable gap between the dynamics of this component and those of imports (Chart 2.1).

Chart 2.1. Demand



Source: NIS, NBR calculations

Chart 2.2. Supply

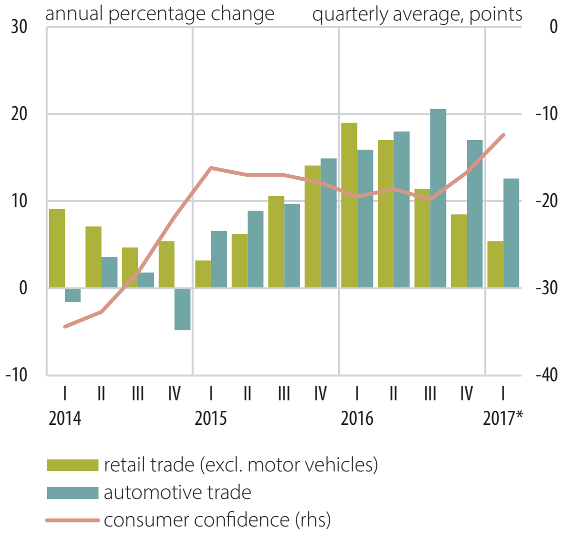


Source: NIS, NBR calculations

Throughout the year, consumer demand followed an upward trend, supported by the easing of fiscal and income policy stances, as well as by improved labour market conditions, in terms of both wages and employment. However, the annual growth rate slowed down in 2016 H2, largely due to the fading-out of the effect associated with the VAT rate change for food items in June 2015, to which added in Q4 a slower increase in motor fuel sales, partly as a response of demand to higher prices (Chart 2.2). Consequently, the advance in final household consumption in October-December 2016, i.e. 6.3 percent year on year (similar to the previous quarter's reading), stood about 2 percentage points lower than the Q1-Q2 average. Yet, this rise has remained relatively swift-paced and it will probably continue to be so over the following months, as suggested by the improvement in consumer confidence up to pre-crisis levels, in correlation with the pay rises implemented at the beginning of the year, as well as with the ongoing increase in employment.

Additionally, in January-February 2017, the volume of new consumer credit and other loans grew further, confirming the favourable prospects of demand for consumer loans in Q1, as shown by the results of the latest Bank Lending Survey conducted by the NBR.

Chart 2.3. Consumer confidence and trade



*) Jan.-Feb. for trade turnover

Source: NIS, EC-DG ECFIN

Although the turnover volume of trade saw its annual growth rate further decelerate in the first two months of 2017, the evolution was rather incidental, being associated with adverse weather conditions that dampened consumer appetite, also on the back of higher utility bills (Chart 2.3). A trend reversal is likely to occur in the period ahead, as signs in this direction are visible for the most important groups of goods. Cases in point are furnishings, the outlook for which is linked to the advance in the residential market, and automotive trade (according to market information[2], new car purchases hit an 8-year record high for February, while the removal of the environmental stamp duty as of February 2017 has been a strong stimulus to demand for used motor vehicles). Expectations appear optimistic also for sales of non-durables – motor fuel sales will be stimulated by the robust growth of the vehicle fleet, whereas in what concerns the sales of foodstuffs and other fast-moving goods, the higher purchasing power of households will prompt the further expansion of modern retailers, amid their keener interest in penetrating the rural market, which is considered increasingly attractive.

In the fourth quarter of 2016, the general government budget balance returned to negative territory (lei -14.6 billion, accounting for a deficit of 1.9 percent of GDP), after posting a modest surplus, i.e. lei 0.2 billion, in the previous three months, the budget execution thus keeping its strongly asymmetric annual pattern[3,4]. This occurred in a context in which budget revenues were quasi-stable as compared with the prior quarter[5] (the decline in non-tax revenues and receipts from property taxes, excise duties and VAT being offset by the increase in receipts from corporate and personal income taxes as well as from social security contributions), whereas

2 Automotive Manufacturers and Importers Association.

3 This asymmetry was somewhat less ample than in the previous year, given that in the final quarter of 2015 the budget balance had posted a lei 15.8 billion deficit (accounting for 2.2 percent of GDP) as compared with a surplus of roughly lei 2 billion (0.3 percent of GDP) in the previous quarter (final data released by the MPF were used for 2015).

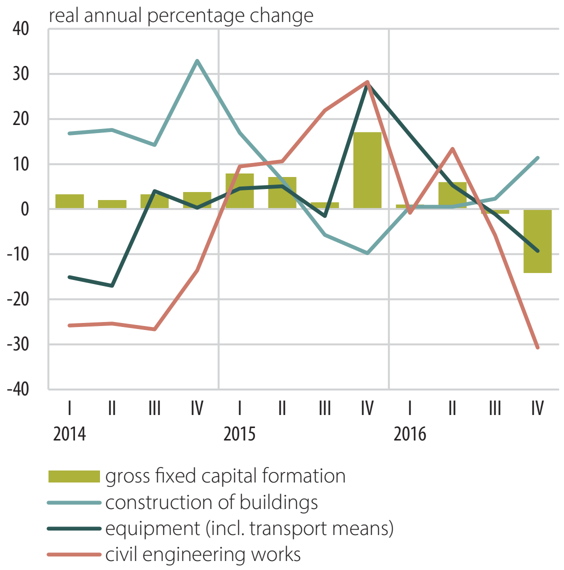
4 In 2016 as a whole, budget deficit totalled lei 18.3 billion (2.4 percent of GDP), standing substantially larger than that recorded in 2015, i.e. lei 9.6 billion or 1.4 percent of GDP.

5 Budget revenues stood 10.0 percent lower in 2016 Q4 from the same year-ago period (as compared with a change of -1.3 percent in Q3), owing particularly to the decline in relative terms in disbursements from the EU.

public expenditure rose markedly versus the preceding quarter[6]. This came largely from higher government spending on goods and services, as well as from capital expenditure, in particular expenditure financed by EU funds.

Gross fixed capital formation had a negative contribution to real GDP growth in 2016, i.e. -0.8 percentage points, as the upward trend it had followed in the first half-year reverted afterwards, the poorest outcome, i.e. -14.2 percent in annual terms, being recorded in Q4 (Chart 2.4). The decline in the last part of the year was largely accounted for by infrastructure construction works, to this adding the sharper contraction in purchases of equipment. None of these segments are seen to show signs of revival in the following months. These developments were partly offset by the fast increase in the construction of dwellings and the favourable outlook for this component is likely to significantly soften the fall in construction investment as a whole.

Chart 2.4. Investment



Source: NIS, NBR calculations

Specifically, the volume of civil engineering works narrowed by 30.7 percent as compared with 2015 Q4, with the budget execution data showing unsatisfactory developments also in the case of EU funded projects, and the downtrend continued in the first two months of 2017, i.e. -19.8 percent in annual terms. Turning to equipment purchases (including motor vehicles bought by companies and public institutions), the weakening trend witnessed throughout 2016 (culminating with a real 9.3 percent contraction in annual terms in the fourth quarter) reflected developments in both domestic financing sources. Thus, the self-financing ratio (capacity) of non-financial corporations[7] in 2016 stood below the past years' average, whereas the real dynamics of equipment loans gradually lost momentum, getting close to zero over the October-December period. No changes were reported by the latter indicator in early 2017 and the standstill in corporate loan demand may be visible throughout the first quarter of the year, as pinpointed by the results of the NBR Bank Lending Survey. Yet at the same time, it is worth noting the stronger support of foreign capital to the Romanian economy, given that net flows of direct investment picked up EUR 1 billion to EUR 3.9 billion (a record high for the post-crisis period).

Conversely, the construction of buildings consolidated its uptrend, the significantly faster annual dynamics (up to 11.4 percent, i.e. 5 times quicker than in Q3) being attributed to residential construction works.The volume of non-residential construction works further

[6] However, in annual terms, public expenditure went down 9.4 percent, largely as a result of the sizeable contraction in EU-funded expenditure, which also reflected the strong increase in such expenditure in 2015 Q4, given that the year-end had been the cut-off date for the eligibility of the expenses incurred by recipients of EU funds under the Multiannual Financial Framework 2007-2013.

[7] Indicator calculated based on national accounts data as a ratio of gross saving to gross fixed capital formation for non-financial corporations.

posted subdued developments, as seen since the beginning of the year under review. In 2016 as a whole, the volume of home construction expanded by over 12 percent; its brisker pace of growth in the first two months of 2017 and the swift increase, at the beginning of this year as well, in the construction area stipulated in residential building permits suggest that this trend will continue in the period ahead. A favourable signal is also sent out by the results of the NIS/DG ECFIN survey, which indicate the rise, throughout 2016 and in 2017 Q1, in household expectations of investment in house purchase/construction or home improvement in the following 12 months.

Although the external sector had a negative contribution to economic growth in 2016 as a whole, the differential between the annual rate of increase of exports and that of imports returned to positive territory in Q4, after the high growth rates of domestic demand had fuelled the prevalence of imports in the first half of the year and Q3 had seen a virtually nil differential.

The year-end witnessed exports of goods gain traction, their annual growth rate picking up to 11.7 percent, also under the influence of one-off factors, associated with scheduling the overhauls in the crude oil processing sub-sector for different time periods in 2015 and 2016.

Among the sub-sectors that saw robust developments over a longer time period, furniture and particularly rubber and plastics recorded faster annual dynamics of export receipts, i.e. up to 13.9 percent and 17.5 percent respectively, the latter industry being supported throughout the year by the expansion of the EU car market[8]. Exports of electrical equipment, as well as of transport means and accessories posted slacker, albeit further two-digit, growth rates. In the latter case, a major contribution had the motor parts sub-sector, with market signals pointing to the continued interest of foreign investors in this field.

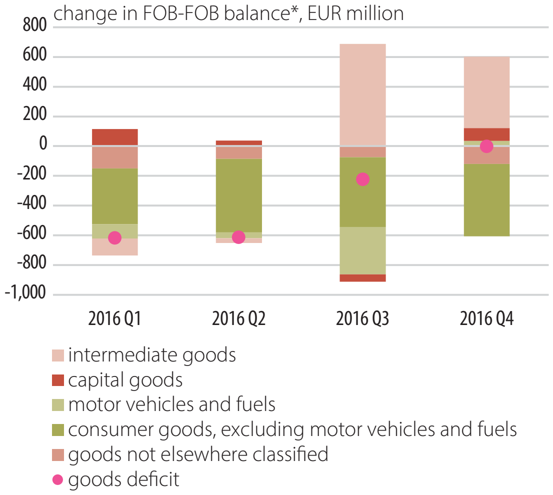
Exports of agri-food commodities, in particular cereals and oleaginous plants, further recorded a notable performance, their volume increasing by 30 percent and 19 percent respectively in 2016 Q4, against the background of a favourable agricultural year.

Over the short term, prospects for external demand are bright, the main signals in this respect coming from the ongoing economic growth in the euro area, according to the EC forecast for the first two quarters of 2017, as well as from the higher confidence indicator in EU-28. As regards local producers' expectations on sales abroad, the results of the NIS/DG ECFIN survey show improvements in most industries relevant in terms of exports (transport means, electrical equipment, machinery and equipment, furniture, metallurgy).

The swifter increase in exports gave a spur to purchases of goods on the international markets, the annual dynamics of which added 1.6 percentage points to 8.9 percent (real change). This evolution may be largely attributed to the faster growth in crude

[8] According to data provided by the European Automobile Manufacturers' Association, in 2016, passenger car registrations rose by 6.8 percent and commercial vehicle registrations by 11.9 percent.

Chart 2.5. Change in goods balance versus the same year-ago period



*) excluding goods under OPT arrangements

Source: Eurostat, NBR calculations

oil imports, which picked up by almost 40 percent, after the contraction reported in Q3, in correlation with the resumption of activity in the refinery sub-sector under improved conditions. Imports of natural gas also rose markedly, owing particularly to market distortions generated by the special tax on the additional income of gas producers, given that market prices dropped below the minimum regulated level used to calculate that tax.

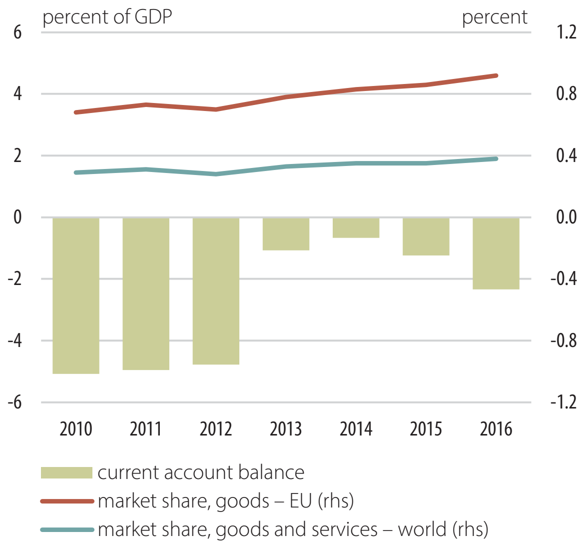
An additional stimulative effect on imports had the positive dynamics of consumer demand, whose slowdown affected however purchases from abroad. Specifically, in Q4 the real dynamics of imports of consumer goods decelerated to about 10 percent, a trend shared by most groups. Amid the still high growth rate of imports, the balance on trade in consumer goods continued to worsen in year-on-year comparison, further exerting a negative impact on trade deficit (Chart 2.5, Box 1). The adverse impact of this evolution on external balance was yet again offset by the buoyant net receipts from services, ICT services and other business services making a significant contribution thereto.

Box 1. Price competitiveness of main industrial groupings and sub-sectors

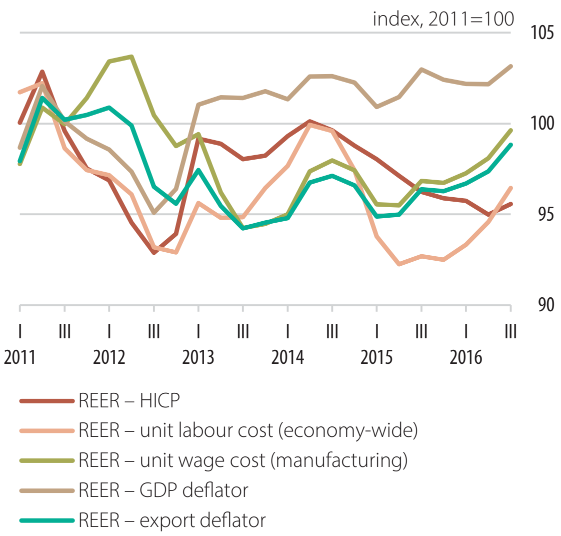
The real effective exchange rate (REER), which is the standard tool for the analysis of price competitiveness, captures the relative position in terms of prices or costs of a country's economic agents vis-à-vis their foreign competitors in various markets. It is common practice in the macroeconomic field to use the aggregate REER, which has the advantage of painting a synthetic picture, but – besides the methodological challenges associated with its calculation – may mask diverging trends of its components, as many of the shocks that affect economic sectors are industry-specific. A deterioration in price competitiveness is expected, in theory at least, to be mirrored in the erosion of the current account balance and/or of the export market share.

Nevertheless, the recent performance of these indicators in Romania has given mixed signals about the competitive position of the economy, the modest dynamics of traditional REER providing scant information in this respect, regardless of the price measure used (Chart A). The most relevant case concerns the CPI/HICP-based REER, as developments in the aforementioned price measures were marked, over the past years, by frequent and extensive changes in indirect taxation that distort the interpretation in terms of competitiveness. This box complements the framework for the analysis of price competitiveness by substantiating and describing several real effective exchange rate measures by main industrial groupings and sub-sectors, which allow for a better assessment of the competitive position of each sector, while also being able to signal potential vulnerabilities.

Chart A. Indicators of the competitive position



Source: European Commission, Eurostat, NBR



Note: Increase/decrease – appreciation/depreciation.

Methodology

Sectoral REER, which is conceptually similar to the macroeconomic indicator, is an aggregate of bilateral real exchange rates between the economy under analysis (Romania's economy) and its competitors:

$$REER_i = \prod_{j=1, i \neq j}^{J} \left(\frac{S_i}{S_j} \frac{P_i}{P_j} \right)^{W_{i,j}},$$

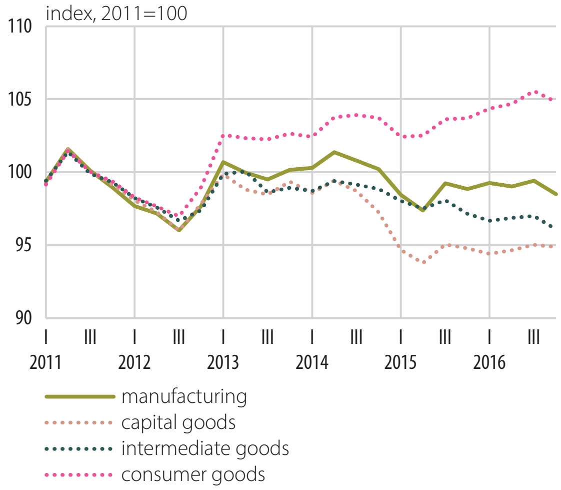
where: S_i and S_j are the nominal exchange rates of economies i and j expressed in EUR, P_i and P_j are the price indices, and $W_{i,j}$ is the weight of economy j used in the calculation of REER for country i. Except for the nominal exchange rates, all the variables in the above-mentioned equation, and hence the resulting real exchange rate, are industry-specific (for simplification purposes, this fact has been omitted from the symbols used in the equation). Consequently, the weight of each trading partner depends on the characteristics of each industry, in some cases certain competitors or certain markets having a higher relevance. The larger the number of trading partners included, the better the signal sent by the indicator, which is however constrained by data availability and/or quality[9]. An illustrative example is China, which is highly relevant in terms of competitiveness to sub-sectors such as metallurgy and the light industry, but in whose case the exhaustive data set necessary to compute sectoral REER is difficult to obtain.
As far as the distinction between the assessment of the competitive profile in the domestic market and that in the international market is concerned, there are alternative weighting schemes (Klau and Fung, 2006): (i) the pressure in the domestic market may be captured by the import weight of each trading

[9] In this analysis, REER for the main industrial groupings, as well as for each NACE division is calculated based on a cluster of competitors including the EU countries except Luxembourg, Malta and Cyprus, to which added the following non-EU economies: Japan, Norway, Switzerland, Turkey and the US. As for REER across manufacturing as a whole, the set of competitors was complemented by Russia and China.

partner in total imports, whereas (ii) double export weights reflect the sum of pressures generated by each competitor in every common market[10].

Although several price or cost indicators may be employed to calculate macroeconomic REER, the sectoral approach works with a narrower set of options, among which the industrial producer price index (IPPI). The reasons for the choice of this deflator mainly referred to data quality and availability: high frequency, shorter release period, limited revisions, and broadly lower volatility. In addition, even at aggregate level, the IPPI has the advantage of providing a better reflection of companies' costs (than ULC) and of the prices of tradable goods on world markets (than CPI) respectively. With a view to avoiding the distortions caused by the possible differentiated price-setting policies in various markets (and also a potential recourse to unfair practices), use was made of total IPPI, which is virtually an average of prices on the external and the domestic market respectively. Nevertheless, an important limitation of the use of the IPPI is that it confines the analysis of price competitiveness to the industrial activity, thus overlooking the tradable services, whose role in Romania's economy has increased notably over the past years in terms of external flows and value added.

Chart B. REER by main industrial groupings – competition on the foreign market



Note: Increase/decrease – appreciation/depreciation.

Source: Eurostat, WIOD, national statistics offices, NBR calculations

Results

The analysis of the evolution of REER broken down by main industrial grouping points to diverging trends, especially beginning with 2014 (Chart B). Specifically, the consumer goods industry has steadily lost price competitiveness, yet its influence is not visible at aggregate level, being offset by the competitiveness gains coming from capital goods up to 2015 and subsequently from intermediate goods respectively.

The picture becomes even more heterogeneous at the next level of disaggregation, namely NACE divisions. Thus, competitiveness gains from intermediate goods are generated by the chemical industry, metallurgy and the manufacture of electrical equipment. The rebound in the competitiveness of the two major energy-intensive industries is probably associated with deep business restructuring and investments to increase efficiency, especially in terms of energy consumption, amid the advancing market deregulation in the energy sector. Moreover, starting with 2015, the positive impact on specialised producers' energy costs made by their partial exemption (up to 85 percent) from the payment of green certificates cannot be ignored either. Looking at the chemical industry, the performance (on the domestic and external markets) of one of the main chemical fertiliser producers is noteworthy,

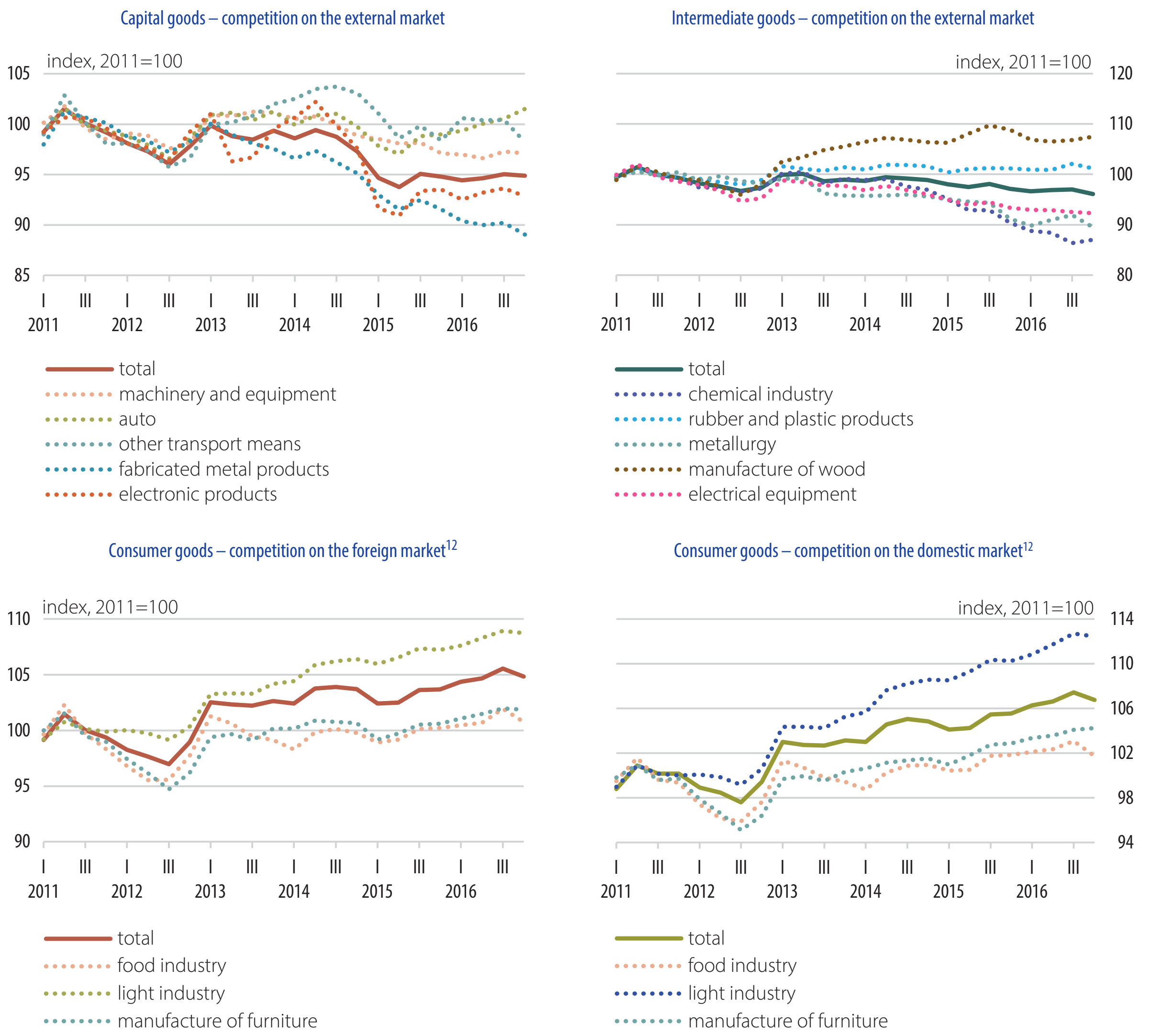
[10] The data series on industrial output at the level of disaggregation required to recompose the main industrial groupings (MIG) were approximated based on the breakdown of exports for each NACE division (using information at the level of NACE groups).

while the stiff competition from China led to strong responses from metallurgy operators in order to keep their place in the market. As for the manufacture of electrical equipment, the advantage of cost competitiveness has spurred higher foreign direct investment inflows in recent years, which had a positive impact on the labour market as well – the annual dynamics of the number of employees in industry in 2016 and early 2017 remaining in positive territory has been partly supported by this sub-sector. Turning to capital goods, it can be observed that the appreciation or depreciation trend is driven by the road transport means industry. In this case, the loss of competitiveness in the past two years can be attributed to the gradual tightening of the labour market, as the recruitment of suitably-skilled personnel has become extremely difficult, especially given that the ability to expand to other regions in the country (currently, the activity is concentrated in the Centre and the West) is limited by the lack of progress in developing road infrastructure (Chart C).

It should also be mentioned that the activity of certain important industrial sub-sectors (specifically, the automotive industry and the related sub-sectors), which are included in the two main industrial groupings presented above, is deeply integrated in global value chains, for which the REER is less relevant for at least two reasons: (i) the import content causes a real depreciation via the nominal channel to have a double effect, namely lower prices for final goods, as well as higher prices for inputs; (ii) the way in which the indicator is defined does not allow for a distinction between the network partners and the actual competitors. In fact, under the impact of broader global value chains, the diminishing relevance of traditional REER to explaining market share developments is not characteristic of the domestic economy only (EFIGE, 2012; CompNet, 2015). Although harder to capture via the REER, which is constructed as an indicator of dynamics and not of level, the cost competitiveness of the local economy was one of the main factors to attract investment in the field, which largely accounted for the increase in the export market share.

However, the evolution which draws particular attention is the steady appreciation of REER for the consumer goods industry starting with 2014. This trend cannot be separated from the swift increase in the gross minimum wage economy-wide, as these are labour-intensive sub-sectors that rely especially on low-skilled workers. While price competitiveness is less relevant in the furniture industry, as manufacturers have gained a competitive advantage by making high-quality products (particularly for the external markets), this is probably one of the key elements of sales in the light and food industries. The latter's limited competitiveness became apparent in 2016, once with the strong boost of consumer demand, local producers increasingly losing ground to cheaper imports (Chart C). The problem however goes beyond price competitiveness, being widely attributable to non-price factors as well, among which: (i) the limited ability of domestic producers to enter the value chain comprising modern trade networks; (ii) small product variety, considering the ongoing diversification of consumer needs; (iii) insufficient or inadequately-trained personnel, in a context of highly competitive markets. It is worth pointing out that in 2016 the aforementioned trends were the major channel of erosion of the current account deficit and hence of the competitive position of the economy, a development that aggregate REER can only partially explain.

Chart C. REER by main industrial groupings – in-depth[11]



Note: Increase/decrease – appreciation/depreciation.

Source: Eurostat, WIOD, national statistics offices, NBR calculations

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[11] For each main industrial grouping, the industries shown in the chart are not the result of its precise disaggregation. A case in point is the manufacture of chemical products, which includes the manufacture of intermediate goods, as well as of consumer goods (e.g. personal care products).

[12] The different REER trajectories for consumer goods on the two markets are essentially due to the larger shares held by Poland and Hungary in Romania's imports, as opposed to exports.

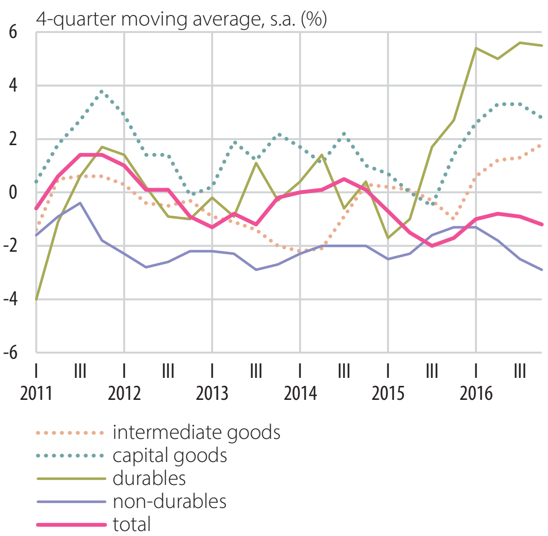
Labour productivity

Labour productivity economy-wide kept increasing at a relatively robust pace in 2016 Q4, yet solely on account of cyclical factors: no signs of support from structural factors are visible on the labour market or in terms of capital endowment. Specifically, NAIRU, i.e. an indicator of structural unemployment in the economy, witnessed only a marginal drop throughout 2016, which suggests the persistence of deficiencies in internal mobility and in matching the skills of labour force with those required by employers (Chart 2.6). The evolution of gross fixed capital formation was not encouraging either, the sharp decline in Q4 and the stagnation seen in 2016 as a whole being caused by the very components that carry the potential to generate long-term productivity gains, i.e. technology and infrastructure.

Chart 2.6. Labour productivity and NAIRU

Source: NIS, NBR estimates

Chart 2.7. Capacity utilisation rate in industry*



*) difference against the long-term average (2005-2015)

Source: EC-DG ECFIN, NBR calculations

By sector, the favourable performance of productivity was largely ascribable to trade, an industry inherently characterised by contained productivity and, thus, having a low capacity to positively influence the growth potential of the economy. Potential structural gains could be associated with the higher efficiency arising from the expansion of large retailers in most country areas, with the stimulative effect that this development may have on investment in consumer goods industries and with a possible spur to discouraged workers to get back into the workforce.

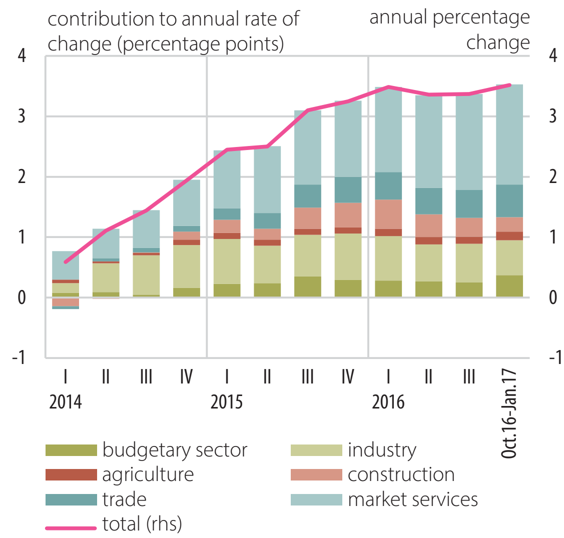
In industry, the annual dynamics of labour productivity re-entered positive territory in the fourth quarter of 2016, also on the back of cyclical factors. The favourable performance of the volume of new orders, particularly from the external market, helped capacity utilisation rate near the long-term average. This indicator still lies below the average solely in non-durables industry, the strong competition from imports containing the reception of the positive impulse from the advance in domestic consumer demand (Chart 2.7). Signals on the full absorption of slack in industry are provided by labour indicators as well, the total hours worked also standing close to the trend. However, the absence of a downward trend in job vacancy rate hints at the persistence of difficulties faced by companies in finding suitably-skilled labour.

Looking at manufacturing, the hydrocarbon processing industry had the largest contribution to labour productivity recovery across the sector, which was triggered by the expansion of activity on the external market, concurrently with additional staff cuts made by main producers. Additionally, positive signs are also manifest in the food industry, rubber industry and the automotive industry, where foreign direct investment was made in the latter half of the preceding year.

Labour market developments[13]

During the period from October 2016 to January 2017, the number of employees in the economy kept rising at the relatively robust pace it had posted since the beginning of 2016 (+3.5 percent in annual terms). The advance was further ascribable to hiring in market services in particular, with trade, administrative and support service activities, and transport making significant contributions, bolstered by the brisk pace of increase of consumption (Chart 2.8). Moreover, hires were also made in the budgetary sector, being more sizeable in the public healthcare sector (after a rise in the number of jobs was decided in the latter half of 2016), whereas payrolls contracted further in education. Conversely, the annual dynamics of workers were stuck at around 2 percent in industry, whereas the growth in the number of employees in construction kept decelerating, amid the failure to launch the large-scale infrastructure projects expected in this sector.

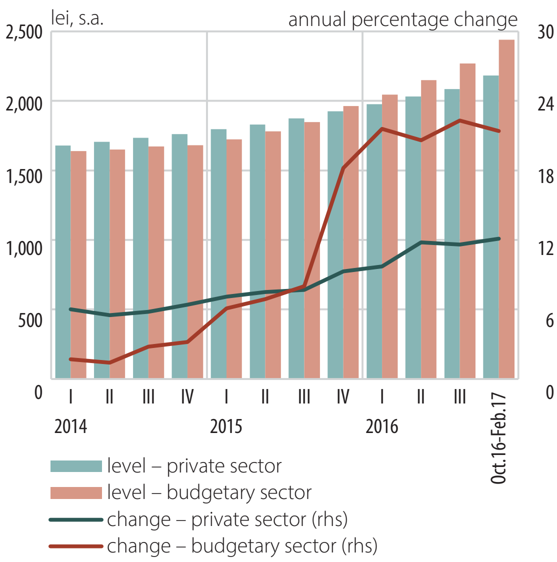
Chart 2.8. Number of employees in the economy



Source: NIS, NBR calculations

The higher capacity of the economy to absorb workforce was also accompanied by a decline in excess supply, so that both unemployment rates lost nearly 0.2 percentage points in the period under review as compared with 2016 Q3, i.e. the registered unemployment rate went down to 4.6 percent and the ILO unemployment rate to 5.5 percent, the latter hitting an all-time low of 5.4 percent in January. In this context, labour market conditions have further tightened, the skill mismatch still persisting, also reflected by the progressive rise in the number of unemployed not receiving unemployment benefits. Their share in total unemployed registered with the NEA exceeded 80 percent in 2016, which hints at the difficulty of absorbing them into the workforce, probably on account of their inadequate skills.

Chart 2.9. Average net wage



Source: NIS, NBR calculations

Prospects for employment appear to be mixed for the first half of 2017. On the one hand, the results of the Manpower survey show robust employment

13 The analysis is based on seasonally adjusted data.

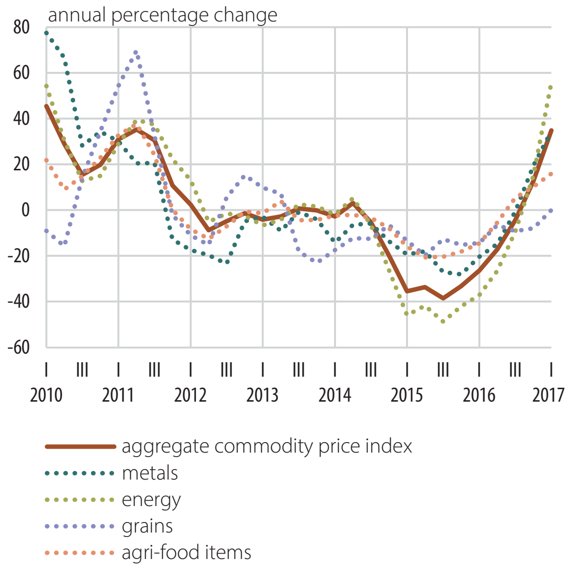
intentions, pointing to job opportunities across all regions and business sectors for the first time since 2008. By contrast, the DG ECFIN survey indicates a stable hiring pace in industry and services and a relative worsening in construction.

In the period from October 2016 to February 2017, average net wage earnings kept increasing at a fast pace, which added 0.4 percentage points from 2016 Q3 to 14.1 percent (Chart 2.9). The evolution mirrors a pick-up in the dynamics of wage earnings in the private sector, stemming from the increase in the gross minimum wage economy-wide to lei 1,450 (+16 percent) in February 2017 and the payment of occasional bonuses (particularly in tobacco industry and trade – the fast employee turnover rate in the latter sector strengthening companies' efforts towards building staff loyalty. Conversely, wage growth slowed down in the budgetary sector, solely as a result of a base effect, additional pay rises being granted to employees in healthcare (December 2016), education (January 2017), public administration and to actors (February 2017).

2. Import prices and producer prices

The end of 2016 was marked by the steeper uptrend in international commodity prices, which persisted into early 2017 as well. This development, along with the depreciation of the domestic currency versus the US dollar, led to a gradual decline in imported deflation and to the annual rate of change of industrial producer prices on the domestic market re-entering positive territory. The trend in the latter is expected to strengthen in the coming months, amid rising pressures from production costs (materials and wage costs) and the further robust dynamics of consumer demand.

Chart 2.10. International commodity prices



Source: IMF, FAO, NBR calculations

2.1. Import prices

The upward trend that the main international commodity prices followed in 2016 continued in the latter part of the said year and the early months of 2017, when double-digit annual growth rates were reported almost across the board[14] (Chart 2.10). Specifically, against the backdrop of the OPEC agreement on output cuts, which was also joined by some non-OPEC producers, in 2017 Q1 the Brent oil price averaged at approximately USD 54 per barrel, up 57.5 percent from the same year-ago period. Nevertheless, according to the latest estimates, the Brent oil price is to range between USD 50 and 55 per barrel by end-2017, as unconventional oil production seems to be resilient even at these price levels. Following closely oil

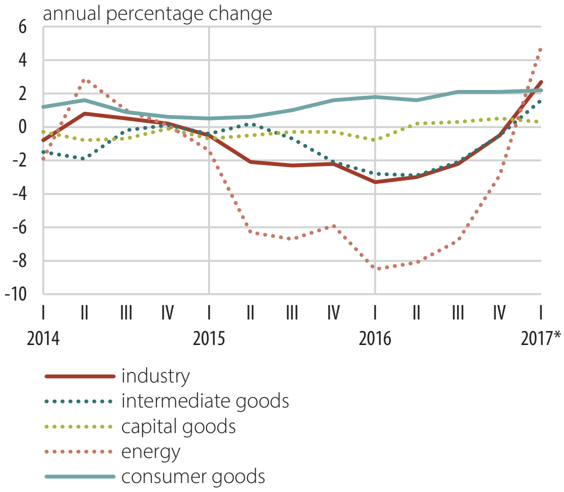
[14] Up to 56.0 percent in the case of energy prices, 35.0 percent in that of metal prices and 16.0 percent in that of agri-food prices. The data refer to 2017 Q1.

market developments, the annual rate of change of natural gas prices witnessed a robust return to positive territory in early 2017 (21 percent in Q1). However, adverse weather conditions in Europe, which boosted energy consumption, also played a role. A similar trend to that of energy prices, albeit of a lower magnitude, was further manifest for main metal prices too, amid the fall in supply and expectations on relatively strong demand (the implementation of infrastructure projects in the US and the resilient growth momentum in China). Agri-food prices also rose, yet at a rather more moderate rate, as a result of mixed developments by component. Specifically, the annual pace of decline of cereal prices slowed down to almost zero, the annual dynamics of the price of sunflower seeds moved deeper into negative territory and most processed food prices further posted swifter growth rates, amid the reduction in global oversupply, following increased demand, especially from China.

Given the aforementioned developments, in 2016 Q4 the unit value index of imports (UVI) reflected a slower fall, going up 0.5 percentage points from the previous quarter to 99.3 percent. Thus, the disinflationary pressures exerted by external prices on the domestic market continued to fade, the effect being compounded by the depreciation trend of the domestic currency versus the euro and particularly versus the US dollar.

The major contributors were mineral products and base metals, the UVI of which saw some of the largest increases, with the index even reaching 100 percent in the former case. Turning to food items, the UVI for vegetal products showed a slowdown in the negative annual rate of change, whereas those for processed food items (meat, fats, sugar) further posted robust annual dynamics. By contrast, the UVI for transport equipment saw a deceleration in growth in the latter half of 2016, possibly owing to the rise in imports of used motorcars, boosted by prospects of a removal of the environmental stamp duty in early 2017[15].

Chart 2.11. Industrial producer prices on the domestic market



*) Jan.-Feb.

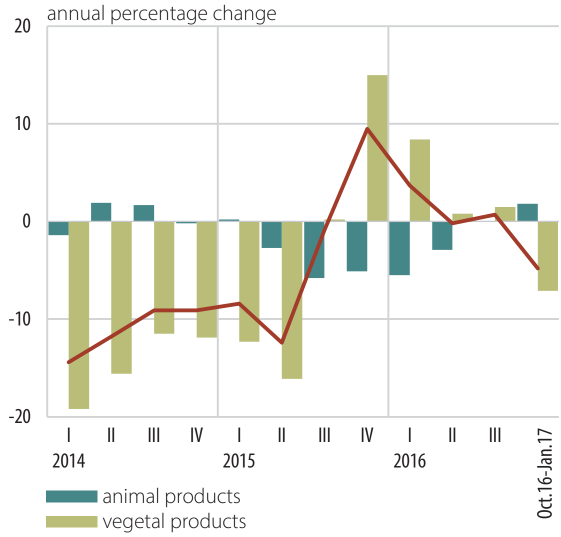
Source: NIS, Eurostat

2.2. Producer prices on the domestic market

After the substantial declines reported in 2016, the annual rate of change of producer prices on the domestic market witnessed a robust return to positive territory in January-February 2017, recording the largest advance over the past three and a half years (2.7 percent annual dynamics, 3.2 percentage points higher than the 2016 Q4 average; Chart 2.11).

[15] Law No. 1/2017 repealing Government Emergency Ordinance No. 9/2013 on the environmental stamp duty for motor vehicles became effective as of 1 February 2017.

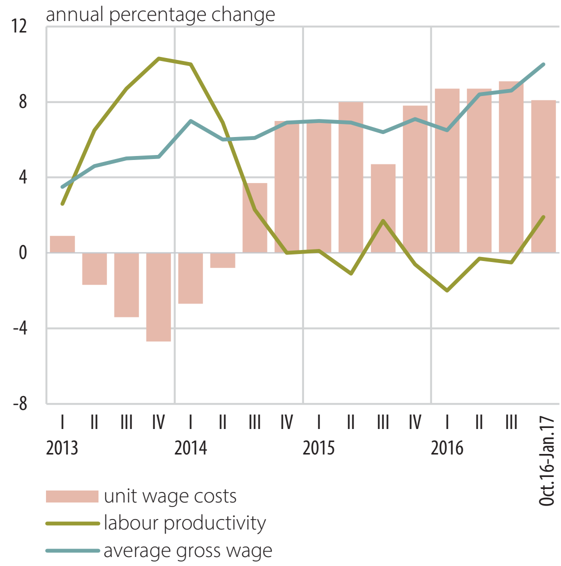
Chart 2.12. Agricultural producer prices



Source: NIS

Upward pressures came from energy and intermediate goods, associated with movements in crude oil and metal prices on international markets. As for energy prices, an additional contributor to the 7.7 percentage point jump in their annual growth rate, to 4.8 percent, was the marked, yet short-lived, hike in electricity prices on the deregulated market, which is at an early stage of development and has given a strong response to some statements regarding the potential occurrence of an energy crisis. Turning to producer prices for capital goods, their annual dynamics decelerated by 0.2 percentage points, to 0.3 percent, amid the slower year-on-year depreciation of the domestic currency against the euro, whereas the growth rate of producer prices for consumer goods picked up slightly to 2.2 percent.

Chart 2.13. Unit wage costs in industry



Source: NIS, NBR calculations

October 2016 through January 2017, the annual rate of change of agricultural producer prices saw a steep return to negative territory, i.e. -4.8 percent, down 5.5 percentage points (Chart 2.12). Behind this development stood solely the declines in prices of vegetal products, driven by a good harvest. Animal product prices posted gradual rises in the latter part of 2016, the trend being more pronounced for pork products and milk, following the narrowing oversupply at EU level (also on the back of the measures taken by the European Commission such as easier access to new markets and financial aid for capping output).

Unit wage costs

October 2016 through January 2017, unit wage costs in industry reported a slacker annual growth rate, i.e. 8.1 percent, down 1 percentage point from 2016 Q3, owing solely to the recovery in labour productivity (Chart 2.13). Nevertheless, over the past two and a half years, the annual dynamics of wages have outpaced those of labour productivity markedly, thus posing a risk of build-up of upward price pressures, as the costs associated with this production factor account for around a quarter of the total costs of industrial companies. Looking at manufacturing, unit wage costs in crude oil processing, the automotive industry and the chemical industry posted slower paces of increase, against the background of increasing production. By contrast, the light industry and the manufacture of plastic products further experienced labour cost pressures, the slacker activity likely reflecting competitiveness losses.

3. Monetary policy and financial developments

1. Monetary policy

In its meetings of February and April 2017, the Board of the National Bank of Romania kept the monetary policy rate at 1.75 percent per annum and maintained at ±1.50 percentage points the symmetrical corridor of interest rates on the NBR's standing facilities around the policy rate; moreover, the NBR Board decided to further pursue adequate liquidity management in the banking system, as well as to leave unchanged the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. The measures continued to be aimed at bringing the annual inflation rate back into line with the flat target of 2.5 percent ±1 percentage point and keeping it there over the medium term, in a manner conducive to achieving sustainable economic growth.

The NBR Board's decision of February 2017 to extend the status quo of the policy rate was taken given that the annual inflation rate had risen more slowly than expected towards the end of 2016[16] and the projected inflation path had been revised downwards in the short term, but upwards over the longer term. Thus, the baseline scenario of the updated forecast reconfirmed the prospects for the annual inflation rate to return to positive territory in 2017 Q1[17], albeit at lower levels, and its subsequent increase was relatively slower[18], due largely to the new disinflationary supply-side shocks that had occurred from November 2016 to February 2017; they consisted of the cut in the prices of compulsory motor third-party liability insurance policies and the scrapping of non-tax fees and charges, the effects of which added to those coming from the lowering of the standard VAT rate to 19 percent and the removal of the special excise duty on fuels as of 1 January 2017, so that the monthly inflation rate was seen posting negative levels in the first two months of the year.

At the same time however, over the longer horizon, the forecasted annual inflation path rose to higher-than-previously projected values in the upper half of the variation band, nearing its upper bound in December 2018. The drivers behind this were significant factors on the supply side[19] and especially the faster-than-previously-projected widening of the positive output gap, given the upward revision of the economic growth

[16] The 12-month inflation rate came in at -0.54 percent in December 2016.

[17] Amid the fading out of the impact of the standard VAT rate cut to 20 percent.

[18] According to the new projection, the 12-month inflation rate was expected to return into the variation band of the target no earlier than 2017 Q4, with a relative time lag compared to the previous forecast (2017 Q2 in the projection included in the November 2016 *Inflation Report*).

[19] Particularly the base effects associated with cuts in/scrapping of indirect taxes/fees and charges, fuel price hikes, higher prices of vegetables, fruit and eggs, as well as the administered price dynamics returning to positive territory.

outlook over the projection horizon[20]; to this added the stronger inflationary pressures expected to derive from the developments in unit wage costs, in import prices of goods and services, and in inflation expectations. The prospects for a relative firming in economic growth had as premises and assumptions (i) the protracted pro-cyclical nature of the fiscal policy and the ongoing easing of the income policy[21]; (ii) the relatively more stimulative real monetary conditions over the projection horizon; and (iii) the consolidation of euro area growth and of the global economic recovery.

The medium-term inflation forecast was still marked by two-way uncertainties and risks related mostly to the fiscal and income policy stance, as the budget execution might depart from this year's programme coordinates, as well as to the global economic growth outlook and euro area recovery.

Subsequently-released statistical data confirmed expectations on the annual inflation rate re-entering positive territory in January 2017 and picking up slightly in February[22], prompted by the fading out of the direct effect of the January 2016 VAT rate cut and by the faster dynamics of prices for vegetables, fruit and eggs[23]; opposite, albeit weaker, effects had the lowering of the standard VAT rate to 19 percent and the removal of the special excise duty on fuels (January), as well as the scrapping of non-tax fees and charges (February). The annual adjusted CORE2 inflation rate also rose in line with the forecast, even amid the faster-than-expected pick-up in economic growth in 2016 Q4[24] (4.7 percent, from 4.3 percent in Q3), implying a likely wider-than-anticipated reopening of the positive output gap. Moreover, the annual rate of increase of the average net wage earnings economy-wide regained momentum in January 2017, the same as that of unit wage costs industry-wide, the faster labour productivity dynamics notwithstanding.

Credit to the private sector[25] grew at a slower annual pace January through February 2017 (1.4 percent versus 2.0 percent in 2016 Q4), given that the impact of the renewed pick-up in the dynamics of new loans[26] was more than offset by that of NPL sales, as well as by the statistical effect of the annual inflation rate[27]. The larger flow of loans was chiefly accounted for by non-financial corporations, as reflected by the ongoing rebound in corporate credit dynamics (-2.7 percent against an average of -3.1 percent in the closing three months of 2016). By contrast, the growth rate of household credit decelerated (from 6.0 percent in 2016 Q4 to 4.8 percent), owing primarily to housing loans, influenced by the characteristics of carrying out the "First Home" programme[28], as well as by the possible postponement of the decision to buy a home in anticipation of the easing of the applicable tax treatment. Developments

20 The annual pace of GDP growth was seen slowing, however, in 2017 and 2018 compared with that likely to have been recorded in 2016.

21 Primarily amid the cuts in/scrapping of taxes/non-tax fees and charges, as well as the new hikes in wages (including the minimum gross wage economy-wide) and in other household income.

22 To 0.2 percent, marginally above the forecasted level.

23 On account of bad weather across Europe at the beginning of this year.

24 This time, behind the strengthening in GDP dynamics stood mainly net exports, while domestic demand contributed to a lower extent.

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

26 Based on data adjusted for renegotiated loans.

27 To which added, in January, a highly likely increase in the volume of household loan repayments.

28 The ceiling for 2017 was set no sooner than at end-February.

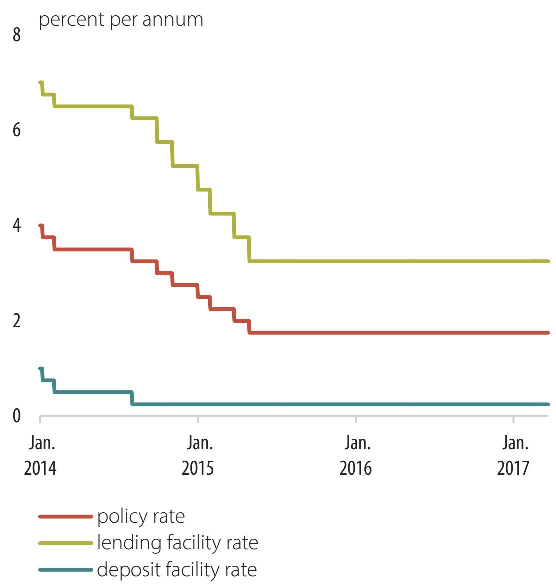
were only partly correlated with the results of the February 2017 Bank Lending Survey conducted by the NBR, which pointed to expectations of a standstill in non-financial corporations' demand for credit and in demand for housing loans in the first quarter of the year; however, demand for consumer credit was seen further on the rise, despite the potential renewed tightening of applicable credit standards. Looking at the breakdown by currency, domestic currency credit continued to grow at double-digit rates, outpacing markedly the dynamics of the foreign currency component; against this background, the share of the leu-denominated component in total private sector credit widened to a post-1996 high of 57.7 percent in February.

In turn, liquidity in the economy continued to witness a slower rise January through February 2017 (9.4 percent from 11.8 percent in 2016 Q4[29]), given the reduction in the dynamics of disbursements related to EU funds and of the amounts allocated from the budget for goods and services, as well as for capital expenditures. These influences fed through primarily to narrow money, which rose at a slacker annual pace (19.9 percent versus 24.7 percent in 2016 Q4), on the back of the deceleration in the dynamics of corporate overnight deposits. The rate of change of time deposits with a maturity of up to two years softened as well; however, it remained unchanged when expressed in nominal terms, amid a quasi-standstill in the dynamics of both household and corporate deposits.

The assessments conducted in this context reconfirmed the outlook for the annual inflation rate to further pick up slightly in the following months, while remaining significantly below the lower bound of the variation band of the target – in line with the projected path shown by the NBR's latest medium-term inflation forecast[30]. The near-term outlook for adjusted CORE2 inflation was also reconfirmed, as were the prospects on quarterly GDP increases, implying a swifter widening of the positive output gap over the short time horizon[31] – mirroring a decline in core inflation sensitivity to the output gap. Also against this backdrop, the uncertainties and risks associated with the inflation forecast heightened, stemming both from the domestic environment (fiscal and income policy developments in 2017, as well as future adjustments in administered prices) and from the external context.

Under the circumstances, in its meeting of 5 April 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



29 The slowdown is partly explained by the statistical effect of the higher annual inflation rate.

30 Published in the February 2017 *Inflation Report*.

31 Amid the faster-than-expected pick-up in economic growth in 2016 Q4.

Real monetary conditions remained stimulative in 2017 Q1. The leu continued to depreciate against the major currencies, while overnight rates on the interbank money market stood in the vicinity of the central bank's deposit facility rate, amid the widening of the net liquidity surplus in the banking system and the NBR pursuing adequate liquidity management. 3M ROBOR rates diminished slightly in the first days of the year, before sticking to levels similar to those seen in the latter half of November 2016, given the consolidation of credit institutions' expectations on the prospective rise in short-term interest rates. The average remuneration of new time deposits from non-bank, non-government clients remained almost unchanged January through February 2017, whereas the average lending rate on new business stood higher than in the period from October to December 2016.

2. Financial markets and monetary developments

The average interbank money market rate contracted marginally in the first quarter of the year, while the EUR/RON exchange rate continued to rise, albeit at a slower pace. The advance in credit to the private sector moderated slightly December 2016 through February 2017, due *inter alia* to the relative expansion in NPL sales; against this background, but especially as a result of the relative decline in disbursements from EU funds, broad money dynamics decelerated further.

2.1. Interest rates

In 2017 Q1, 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. Hence, its quarterly average inched down from the previous three months' reading (-0.04 percentage points to 0.32 percent).

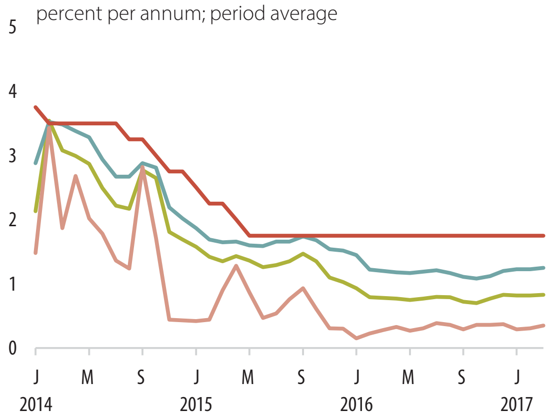
Overnight rates on the interbank money market returned in the immediate vicinity of the NBR's deposit facility rate at the onset of January and remained there for the rest of the quarter under review. Behind this stood the substantial widening of banks' net liquidity surplus in the first month of the year, given the Treasury's sizeable injections, and the subsequent quasi-stabilisation of excess liquidity at high readings, the reversal in the net influence of autonomous liquidity factors notwithstanding.

In turn, longer-term (3M-12M) ROBOR rates saw their late December rise reversed in early January[32], returning and sticking to levels similar to those recorded in the latter half of November. The evolution was somehow opposed to that witnessed by excess liquidity in the banking system, most likely reflecting the consolidation of credit institutions' expectations on the adjustment – in a not too distant future – of short-term interest rates to higher readings. Against this backdrop, average ROBOR rates stood close to their December 2016 levels in the case of 3M and 6M

[32] Fully in the case of 3M and 6M maturities and only marginally for the 12M rates.

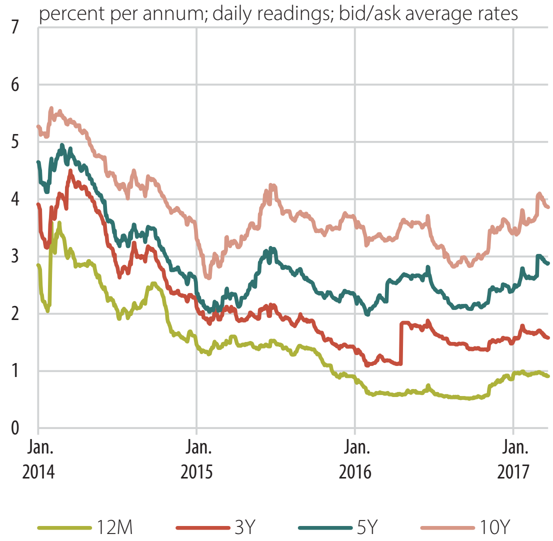
maturities (coming in at 0.83 percent and 1.07 percent respectively in March), whereas the average rate for the 12M maturity edged up 0.05 percentage points to 1.25 percent (Chart 3.2).

Chart 3.2. Policy rate and ROBOR rates



*) end of period

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



Yields on the government securities market posted mixed developments across the maturity spectrum. In particular, yields at the shorter end broadly replicated the developments in relevant ROBOR rates, while longer maturities saw a marked increase in the closing part of January and at the onset of February, under the influence of expectations on the future evolution of very short-term interest rates, as well as because of the higher term premium (Chart 3.3). The latter was driven both by domestic factors – the temporary spike in political tensions and the heightened uncertainty surrounding the fiscal and income policy stance – and by the rise in the similar premium on US government bonds. The increase in yields was partly corrected thereafter and was followed by a relative stabilisation in the case of medium-term notes. Conversely, 10-year bond yields re-embarked on an upward path, which persisted until close to the Fed's monetary policy decision, before witnessing a downward adjustment, in tandem with the yields of similar securities on international markets.

Under the circumstances, the average yield of 6-month securities issued at the last auction in 2017 Q1 stood below the end-December 2016 reading (down 0.05 percentage points[33] to 0.71 percent), whereas those of similar bonds with a 3-year and 6-year maturity exceeded their end-2016 levels by 0.22 percentage points (to stand at 2.2 percent) and 0.15 percentage points[34] (3.3 percent) respectively. In turn, average benchmark rates on the secondary market decreased during the same

[33] Taking into account the average accepted rate for 5-month securities at the December auction.

[34] Since in March 2017 the MPF did not issue bonds with maturities comparable to those of December 2016, differences were calculated based on the last auctions in February.

period by 0.10 percentage points in the case of the 6-month maturity, but increased for the other maturities by up to around 0.4-0.5 percentage points[35], so that the slope of the yield curve steepened against end-December 2016.

Chart 3.4. Bank rates

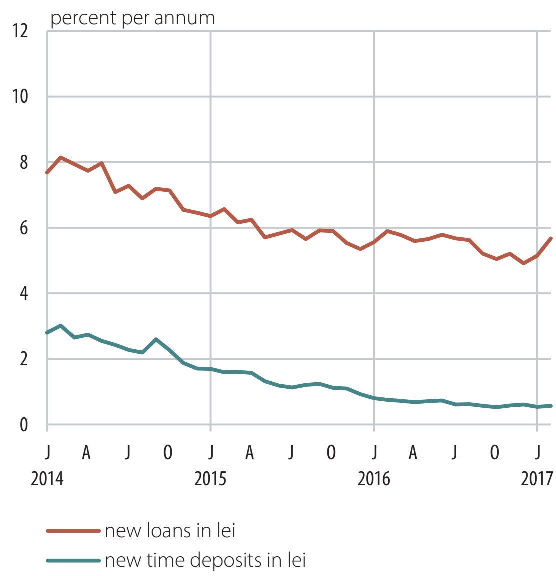
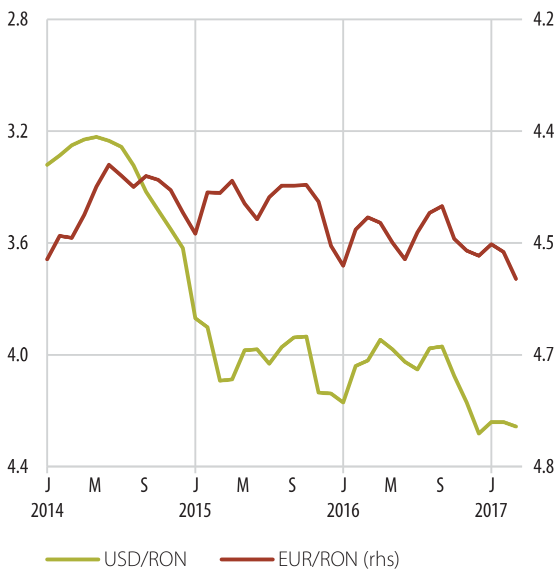


Chart 3.5. Nominal exchange rate



Looking at the primary market, investor interest in government securities saw a modest rise compared with the previous quarter. The average demand-to-supply ratio stood slightly higher, witnessing a recovery January through February, before diminishing in March. Moreover, the volume of securities issued (lei 9.9 billion) accounted for 85 percent of the indicative one (against 67 percent in 2016 Q4), with the MPF fully or partly rejecting the bids submitted at six of the 21 auctions held in the period from January to March. Against this background, the average maturity of issued securities contracted slightly when compared to 2016 Q4[36].

December 2016 through February 2017, the average remuneration of new time deposits witnessed a quasi-standstill (0.57 percent; Chart 3.4), with a similar behaviour visible across both households (0.89 percent) and non-financial corporations (0.37 percent). Conversely, the average lending rate on new business added 0.48 percentage points (to 5.68 percent), driven by the wider share of household loans in total new credit, as well as by the approximately 0.25 percentage point hike in the average interest rate on loans to households (to stand at 7.14 percent) and non-financial corporations (3.91 percent)[37].

2.2. Exchange rate and capital flows

The EUR/RON exchange rate witnessed stronger fluctuations in the first half of 2017 Q1, before embarking on an almost constant uptrend. Its behaviour, only partly correlated with that of the exchange rates of the main currencies in the region,

[35] However, the rise in interest rates at the 5-year and 10-year maturities is partly ascribable to replacing the benchmark series, whose residual maturity had become significantly shorter than the reference one, with bonds having an adequate residual maturity.

[36] In March, the MPF reopened the books on a EUR-denominated bond issue on the domestic market maturing in 2021, thus putting into circulation securities worth EUR 240 million at a 0.42 percent rate.

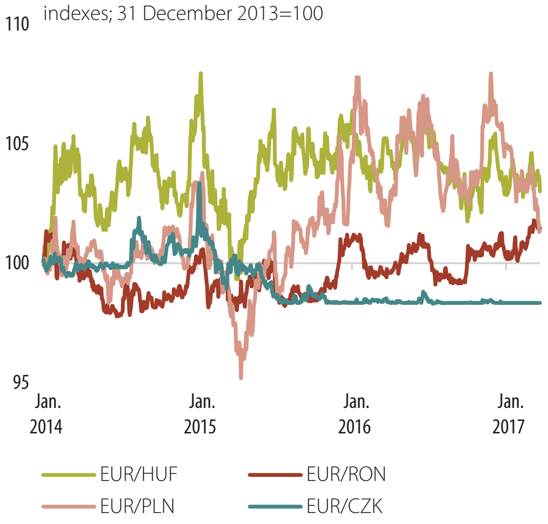
[37] The move was visible across all major types of loans (consumer credit and housing loans, as well as loans below and above EUR 1 million equivalent respectively).

reflected this time primarily the changes in investor sentiment vis-à-vis the local economy and financial market, brought about by domestic events/developments, and, to a smaller extent, the external influences (Chart 3.5).

The EUR/RON dropped sharply in the first ten-day period of January, in a move slightly exceeding the increase seen in the previous month. The fall can be ascribed to the fading away of the uncertainty about the incoming cabinet, being also underpinned by the temporary improvement in global risk appetite, amid favourable signals on macroeconomic developments across the euro area and the US[38]. External influences were subsequently dampened by growing investor fears stemming from the 2017 budget construction, also given the tensions that emerged on the social and political scene towards end-January. On this backdrop, the exchange rate saw its fall come to a halt and near-stabilised at relatively high levels.

The EUR/RON exchange rate swung again widely in early February and embarked on an upward trend thereafter. The move – largely different from those prevailing across the region – most likely reflected investor concerns over the protracted domestic political strains, but notably over the clearer risk of fiscal policy easing to a higher extent than forecasted in the newly-passed 2017 budget[39]. The ensuing effects more than offset those stemming from: (i) higher-than-expected rise in fourth-quarter GDP and a relative slowdown in the widening of current account deficit, as shown by the statistical data released in that period, and from (ii) the ruling of unconstitutionality for the law on converting CHF-denominated loans into leu-denominated loans at the historical exchange rate.

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



Source: ECB, NBR

The EUR/RON rate tended to rise even after the domestic political environment had calmed down, albeit at a slower pace, coming – alongside the exchange rates of the other currencies in the region – under the impact of gradually stronger expectations on the Fed conducting a further rate hike in its meeting of 14-15 March[40]. After making public this decision, the exchange rates of the Polish zloty and the Hungarian forint saw a decline (Chart 3.6) – given that, contrary to some

[38] Germany's economic growth (reaching a five-year peak in 2016), euro area industrial production (robust advance in November 2016), euro area PMI (the manufacturing index reaching a six-year high in January), euro area annual inflation rate (up to 1.1 percent in December 2016); at the same time, developments in the US labour market slightly exceeded expectations.

[39] This risk was also mentioned in the assessments made by the European Commission (in the Winter 2017 *European Economic Forecast* and *Country Report Romania 2017*, both released in February) and by the IMF (as part of the regular consultations under Article IV).

[40] Given the comments made by Fed officials (Chair Yellen, presenting the semiannual *Monetary Policy Report* to the US Congress, and Vice Chair Fischer, in an interview for Bloomberg).

investor expectations, the interest rate path anticipated by FOMC members had remained unchanged[41]. The EUR/RON reflected this influence with a certain lag, as it continued to rise for a short while, only to embark in its turn on a downtrend in the closing 10-day period of March.

Table 3.1. Key financial account items

EUR million

	2 mos. 2016			2 mos. 2017		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	1,145	1,291	-146	924	409	515
Direct investment	432	1,076	-644	141	795	-654
Portfolio investments	71	-260	331	140	-336	476
Financial derivatives	x	x	10	x	x	-11
Other investment	1,975	475	1,499	443	-50	494
– currency and deposits	1,156	-904	2,060	234	-310	544
– loans	-12	22	-35	31	31	0
– other	831	1,357	-526	178	229	-50
NBR's reserve assets, net	-1,343	0	-1,343	211	0	211

*) "+" increase/"-" decrease

In the interbank forex market, these relatively frequent changes in context led to a step-up in non-residents' activity. The balance of non-residents' transactions turned positive in January – largely offsetting the short-lived rise in residents' net demand for foreign currency –, before returning and falling deeper into negative territory thereafter. However, for the period as a whole, the overall market deficit slightly contracted compared with the previous quarter (Table 3.1).

In 2017 Q1, the domestic currency depreciated against the euro by 0.7 percent in nominal terms[42] and 0.9 percent in real terms. In relation to the US dollar, the leu strengthened by 0.6 percent in nominal terms and 0.4 percent in real terms, given the former's weakening against the euro[43]. Looking at the average annual exchange rate dynamics in 2017 Q1, the leu saw its nominal depreciation diminish against the euro and widen versus the US dollar.

2.3. Money and credit

Money

December 2016 through February 2017, the growth rate[44] of broad money (M3) continued to decline, to 9.8 percent from 12.6 percent September through November 2016 (Table 3.2), mainly due to the relatively lower disbursements from EU funds[45] and, to a smaller extent, to portfolio shifts from money holdings into alternative financial assets (government securities, investment fund shares). An opposite, albeit weaker, impact had the increased amounts from the government budget for wages and other types of household income[46].

41 Implying two additional hikes of 0.25 percentage points each in 2017 and three rate increases of a similar size in 2018.

42 In the same period, the Hungarian forint strengthened by 0.8 percent and the Polish zloty by 3.5 percent.

43 By contrast, gold price per ounce gained 7 percent in the period under review.

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

45 According to data from the Ministry of European Funds and the Agency for Funding Rural Investment.

46 This period saw pay rises in healthcare, social work, public administration, and education (Law No. 250/2016, Government Decision No. 38/2017, Government Emergency Ordinance Nos. 9/2017, 2/2017, 17/2017), a hike in the gross minimum wage economy-wide (Government Decision No. 1/2017), an increase in the value of the pension point (Government Emergency Ordinance No. 99/2016) and higher allowances for the disabled, war veterans and war widows (Government Emergency Ordinance No. 92/2016). At the same time, the pension tax ceiling was raised and the health contribution base for pension income was eliminated (Law No. 2/2017).

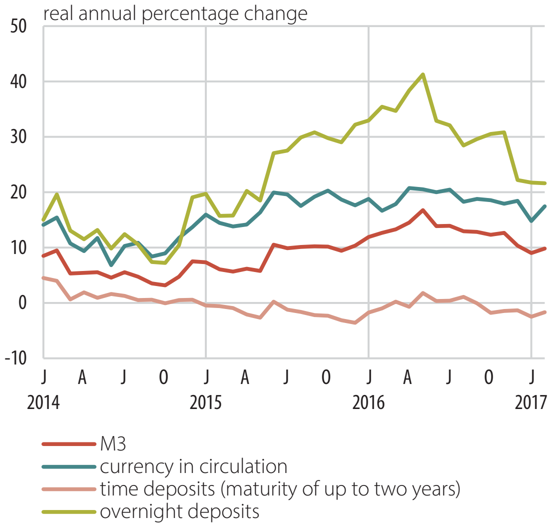
Table 3.2. Annual growth rates of M3 and its components

real percentage change

	2016				2017	
	I	II	III	IV	Jan.	Feb.
	quarterly average growth					
M3	12.6	15.1	13.3	11.8	9.0	9.8
M1	28.6	31.6	26.4	24.7	19.5	20.3
Currency in circulation	17.8	20.5	19.2	18.3	14.8	17.5
Overnight deposits	34.4	37.5	30.1	27.9	21.7	21.6
Time deposits (maturity of up to two years)	-0.8	0.5	0.5	-1.5	-2.5	-1.7

Source: NIS, NBR

Chart 3.7. Main broad money components



Source: NIS, NBR

Similarly to the previous period, the decline in the M3 growth rate was attributed to both its components. In the case of M1, the slower dynamics reflected again the developments in currency in circulation – whose performance continued to be correlated with that of retail trade[47] – and in corporate overnight deposits in lei and foreign currency. However, the more liquid component of broad money further recorded elevated dynamics for the post-crisis period, and thus M1 saw its share in M3 consolidate at a post-1994 high of 57.4 percent in February. The loss of momentum of time deposits with a maturity of up to two years was also attributable to non-financial corporations' investments (Chart 3.7).

In turn, the broad money breakdown by holder reveals a further downtrend in the dynamics of corporate deposits, mainly stemming from lower disbursements from EU funds, a reduction in capital expenditure in relative terms[48], as well as from this sector's partial portfolio shifts of money holdings toward other financial instruments. Conversely, the pace of increase of household deposits continued to gain momentum, amid the rise in income from wages, social benefits and possibly from other sources[49].

From the perspective of M3 counterparts, the evolution of broad money mirrored the decelerating growth rates of loans to the private and public sector respectively, the weaker dynamics of banks' net foreign assets[50], and especially the faster growth of central government deposits.

Credit to the private sector

December 2016 through February 2017, the pace of increase of credit to the private sector[51] slowed down slightly, reaching 1.5 percent from 2.0 percent during the previous three months (Chart 3.8). Considering the faster rise in the flow of loans in the reported period[52], this development reflected the relatively larger influences of non-performing loan sales from banks' balance sheets, as well as the statistical effects of the annual inflation rate and exchange rate[53]. The divergence between the trajectories of the

47 The average growth rate of retail trade turnover (with the exception of motor vehicles and motorcycles) continued to fall.

48 According to general government budget execution data.

49 According to press releases from the Agency for Payments and Interventions in Agriculture, this period saw the payment of subsidies for the diesel fuel used in agriculture in 2016 Q3. The breakdown of these amounts by institutional sector is not possible.

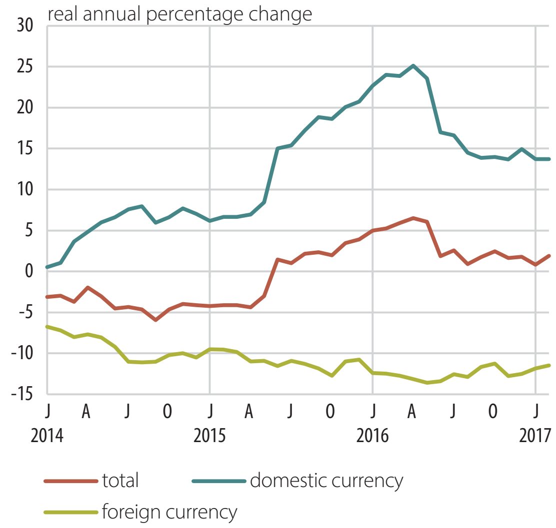
50 An opposite, albeit weaker, impact had the sharper decline in long-term financial liabilities (including capital accounts).

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

52 Based on data adjusted for renegotiated loans.

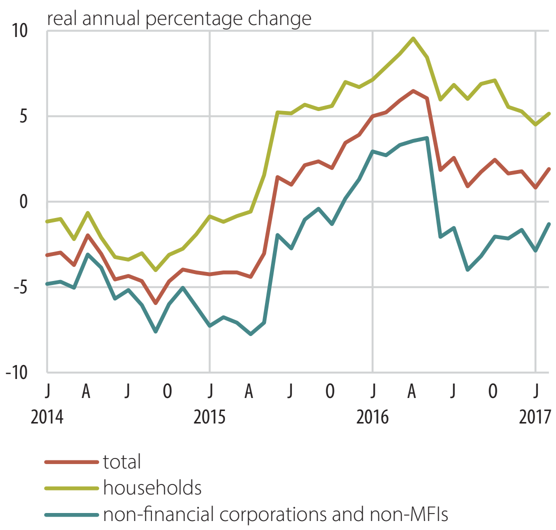
53 The growth rate of credit to the private sector remained unchanged in nominal terms; when corrected for the statistical effect of changes in the EUR/RON exchange rate, it was on the rise compared with the previous three months.

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

dynamics of leu-denominated credit and of the foreign currency component resumed its widening, with the former rising slightly and the latter falling marginally deeper into negative territory. Against this backdrop, the share of the leu-denominated component in credit to the private sector continued to grow, up to a new post-1996 high of 57.7 percent in February.

The breakdown by institutional sector points to opposing developments. Household credit saw slower growth, its stock being affected by credit institutions' balance sheet clean-up operations and, to a lesser extent, by the highly likely temporary step-up in household debt repayments (Chart 3.9). Both housing loans and consumer credit witnessed a loss of momentum, as the rising dynamics of new loans were stymied by the disruptions in the implementation of the "First Home" programme[54] and by the possible tightening of credit standards applicable to consumer loans[55]. The share of the lei component in total credit to households consolidated further (59.4 percent in February, from 57.9 percent in November 2016). In turn, the share of housing loans rose by 0.9 percentage points, to 52.2 percent, in the same period.

However, credit to non-financial corporations continued to recover in the period under review, as the consolidation of economic growth and improved confidence[56], as well as historically low interest rates, contributed to a protracted sharp uptrend in the dynamics of new loans. This was mainly due to the lei component, which saw its growth rate pick up, owing to the relatively faster rate of change of short- and medium-term loans (including overdrafts and revolving credit). In turn, the foreign currency-denominated component posted a slower pace of decline, attributed to medium-term loans.

[54] The unused amounts up to the 2016 ceiling, as well as those allocated for 2017 under the "First Home" programme were distributed to credit institutions after the period under review.

[55] According to the February 2017 Bank Lending Survey conducted by the NBR, consumer credit standards were tightened moderately in 2016 Q4 and respondents expected this to continue in 2017 Q1 as well, considering that the provisions of NBR Regulation No. 5/2016 amending and supplementing NBR Regulation No. 17/2012 on certain lending conditions have become applicable starting this year.

[56] According to the DG ECFIN survey, the average economic sentiment indicator continued to pick up slightly, reaching a post-2008 high.

4. Inflation outlook

The annual CPI inflation rate is foreseen on the rise from the currently low levels, reaching 1.6 percent at end-2017, 3.1 percent at end-2018 and 3.4 percent at the projection horizon, i.e. 2019 Q1. CPI inflation is expected to gain momentum largely amid the build-up of underlying inflationary pressures from domestic fundamental factors, impacting core inflation. To these add some base effects manifest at the beginning of 2018 – albeit lower than those seen early this year –, associated with the indirect tax cuts in January 2017 and the scrapping of a number of non-tax fees and charges one month later. The upward path is more pronounced in case of the adjusted CORE2 index, owing mainly to the gradual build-up of inflationary pressures fuelled by the anticipated rise in excess aggregate demand, amid the expansionary fiscal policy stance and the higher disposable income and, hence, a rebound in inflation expectations of economic agents. This evolution is foreseen to occur despite recent growing evidence of a decline in the pass-through of domestic demand-driven inflationary pressures to core inflation. The balance of risks is assessed as being tilted to the upside against the inflation path projected in the baseline scenario, with risks stemming from domestic sources in particular.

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 post slightly higher annual dynamics than those envisaged in the previous *Inflation Report*[57] (Table 4.1) and is expected to consolidate around 2 percent. The ECB's persistently accommodative monetary policy stance, the progress in deleveraging across all sectors and improvements in labour market conditions will further underpin domestic demand, the key driver of economic recovery in the euro area. External demand gap is expected to remain negative until the end of this year, having thus a restrictive, albeit progressively lower, impact on domestic economic activity. Subsequently, the positive gap of the variable will gradually open until the projection horizon.

Table 4.1. Expectations on the developments in external variables

annual averages

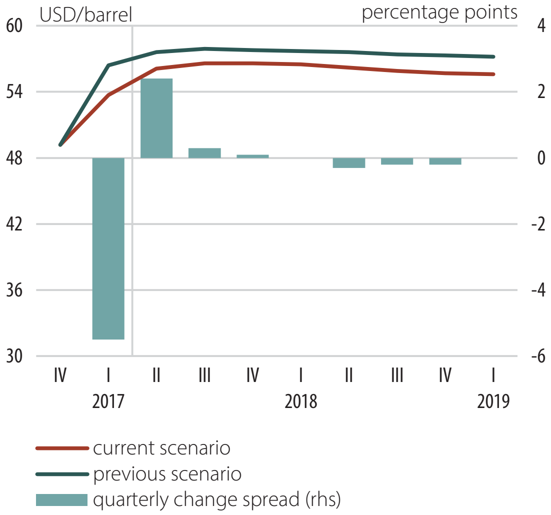
	2017	2018
Effective EU economic growth (%)	2.0	2.0
Annual inflation rate in the euro area (%)	1.6	1.4
Annual CPI inflation rate in the USA (%)	2.5	2.3
3M EURIBOR interest rate (% per annum)	-0.3	-0.2
USD/EUR exchange rate	1.06	1.07
Brent Oil price (USD/barrel)	55.7	56.1

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

57 For 2017, the upward revision in the average annual growth is ascribable to recent more favourable developments in the EU's major economies.

The average annual HICP inflation rate in the euro area is projected at higher levels than those seen in the previous years, i.e. 1.6 percent in 2017 and 1.4 percent in 2018, still running below the 2 percent benchmark. Having picked up in 2017 Q1 against the background of a significant rise in the annual growth of oil prices, starting 2017 Q2 the annual HICP inflation rate is anticipated to slightly moderate, as the former cools down. Another factor seen to exert inflationary pressures throughout the forecast interval is the nominal unit labour cost, amid strengthening economic growth that is expected to entail *inter alia* a rebound in the dynamics of compensation per employee. Under the influence of a similar set of determinants[58] and given the more elevated historical readings, annual inflation in the USA is forecasted to run at higher levels than those foreseen for the euro area and slightly above the 2 percent benchmark.

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 by the end of next year.

The EUR/USD exchange rate is expected to range between USD 1.06 and 1.09 to the euro. Potential divergences of the ECB's and the Fed's monetary policies from the trajectories currently expected[59] by financial markets may cause this variable to deviate 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 55.6 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 successive projection rounds. Despite the price increases seen late last year after the agreement reached between the OPEC members and some non-OPEC countries to cut production, prices are expected to be below the levels in the previous *Inflation Report*, as unconventional hydrocarbon production proves resilient to still weak oil prices, causing excess supply to persist.

[58] In the USA, faster-growing unit labour costs emerge amid a tightening of the labour market.

[59] On the one hand, the Fed raised the interest rate in its December 2016 and March 2017 meetings and announced that "additional gradual rate hikes are likely" in the course of 2017, while the ECB decided to extend its accommodative policy stance at least until this year's end.

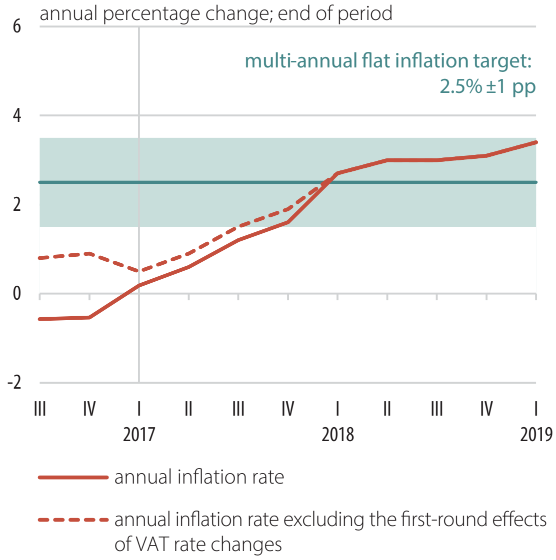
Table 4.2. The annual inflation rate in the baseline scenario

annual percentage change; end of period

	2017			2018				2019
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	0.6	1.2	1.6	2.7	3.0	3.0	3.1	3.4
CPI projection*	0.9	1.5	1.9	2.7	3.0	3.0	3.1	3.4

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

Chart 4.2. Inflation forecast



Source: NIS, NBR projection

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 1.6 percent at end-2017 and at 3.1 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. At the projection horizon, i.e. 2019 Q1, the forecasted rate will reach 3.4 percent (Table 4.2; Chart 4.2). The upward path in the annual inflation rate is largely shaped by the gradual build-up of underlying inflationary pressures coming from domestic fundamental factors (positive output gap), impacting core inflation, and the fading-out, at the beginning of 2018, of the first-round statistical effects related to the indirect tax cuts in January 2017 and the scrapping of a number of non-tax fees and charges starting February 2017.

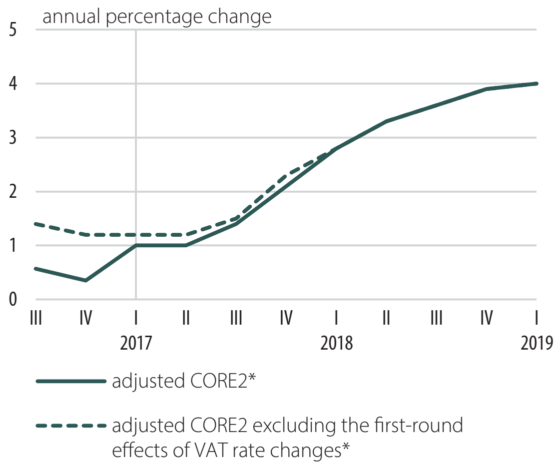
Compared with the previous *Report*, the annual CPI inflation was revised downwards by 0.1 percentage points for the end of this year and by 0.3 percentage points for the end of next year, amid the assessment of a less pronounced pass-through of the impact of domestic aggregate demand on core inflation (Box 2), as well as a lower annual fuel price inflation. For this year, these influences were partly countered by the upward revision of the annual VFE price dynamics. The new CPI basket weights[60] have had no effect on the projected annual growth rate of consumer prices.

The annual adjusted CORE2 inflation rate will gather momentum over the projection interval, rising above the upper bound of the variation band of the target starting 2018 H2, amid stronger underlying inflationary pressures from domestic fundamental factors (Chart 4.3). Even in the context of recent evidence on the weakening intensity of the relationship between inflation and the output gap, the expansionary fiscal policy stance and increasing disposable income[61] are

[60] Starting with the current projection round, the CPI basket weights (released by the NIS in February 2017, after the previous Inflation Report was launched) are calculated based on average monthly expenditure per household, as reflected by the 2015 Household Budget Survey. Compared with the weights used in the preceding four issues of the Inflation Report, the current weights point to a slightly higher influence of fuel, administered and tobacco and alcohol prices, together with a somewhat lower importance of food items with volatile prices and of goods and services included in the adjusted CORE2 index.

[61] Mainly amid the income policy setting forth pay rises in the budgetary sector at the end of 2016 and the beginning of 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 lei 200 hike to lei 1,450 as from 1 February 2017. These rises are to also be reflected by higher earnings in the private sector, as a result of demonstration effects, adding to those specific to inter-sectoral labour mobility, those envisaged to become manifest following the temporary increase in productivity economy-wide, as well as those related to considering a higher inflation rate in wage indexation.

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				2019
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Adjusted CORE2	1.0	1.4	2.1	2.8	3.3	3.6	3.9	4.0
Adjusted CORE2*	1.2	1.5	2.3	2.8	3.3	3.6	3.9	4.0

*) 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	-0.2	0.1
VFE prices	0.4	0.3
Adjusted CORE2	1.3	2.3
Tobacco and alcohol beverages	0.0	0.1

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

foreseen to have a significant contribution to shaping the upward path in core inflation, via the advance in excess demand and, consequently, rising economic agents' inflation expectations. Relatively smaller contributions are attributed to the import prices for consumer goods, reflecting developments in external prices, and the fading-out, in January 2018, of favourable first-round statistical effects of the standard VAT rate cut in January 2017. Core inflation net of these statistical effects is seen standing at 2.3 percent at end-2017 and the two inflation measures will overlap starting January 2018 (Table 4.3).

Compared to the previous *Report*, the downward revision of the annual adjusted CORE2 inflation rate followed the assessed weakening intensity of the relationship between domestic economic activity and inflation.

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 have 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, similarly to the previously forecasted levels. However, the breakdown shows that the aggregate contributions derive from different dynamics of the subcomponents (Table 4.4).

Volatile food prices are projected to go up at an annual pace of 7.1 percent at the end of 2017 – being revised upwards versus the prior forecasting round amid a decline in output of fruit and vegetables at EU level as a result of bad weather conditions early this year – and of 4.1 percent at the end of 2018, a level similar to that projected in the previous *Report* (Chart 4.4). Their growth path over the forecast interval rests on the assumption of normal agricultural years in both 2017 and 2018.

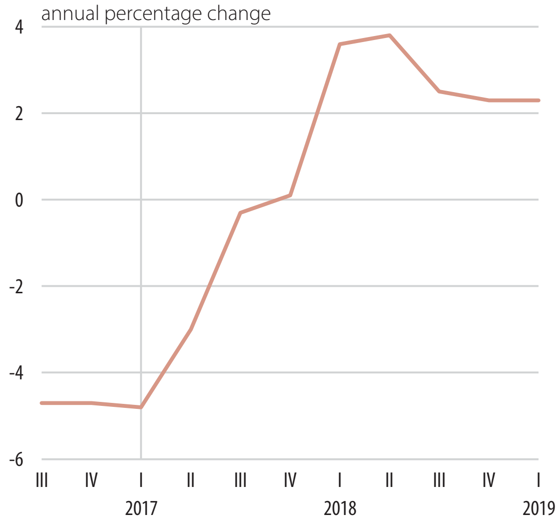
The projection envisages the growth rate of administered prices to come in at 0.1 percent at end-2017, the same level as in the previous *Report*, and 2.3 percent at end-2018, a value that was revised marginally upwards by 0.1 percentage points after the CPI weights of these group items had been updated (Chart 4.5).

Chart 4.4. VFE prices annual inflation*

*) end of period

Source: NIS, NBR projection

Chart 4.5. Administered prices annual inflation*

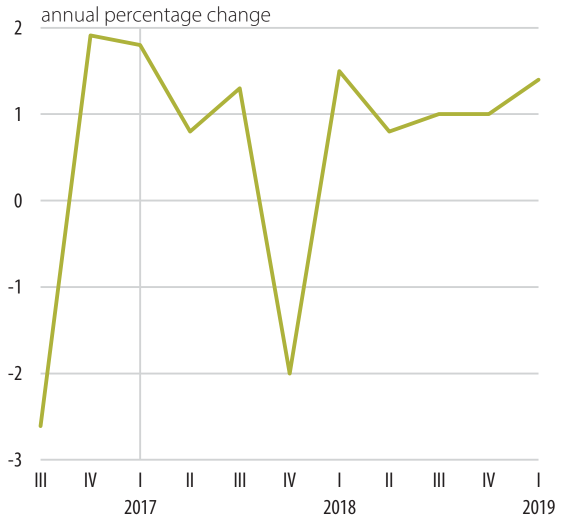


*) end of period

Source: NIS, NBR projection

The annual dynamics of fuel prices are anticipated at -2.0 percent for the end of this year and at 1.0 percent for the end of next year (Chart 4.6). The path of this price category is shaped by the transitory effects of the standard VAT rate cut from 20 percent to 19 percent and the scrapping of the special excise duty on fuels at the beginning of this year. The group's dynamics were revised downwards, especially as the annual change in the international oil price is seen running at lower levels over most of the projection interval. Moreover, the euro is projected at more appreciated values against the US dollar, impacting the USD/RON exchange rate and, in turn, the leu-denominated fuel prices.

Chart 4.6. Fuel prices annual inflation*



*) end of period

Source: NIS, NBR projection

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 in January 2017 and the hike in specific excise duties in January 2017 and April 2018. This inflation measure is seen reaching 0.2 percent and 0.8 percent at end-2017 and end-2018, respectively, similarly to the previously forecasted levels.

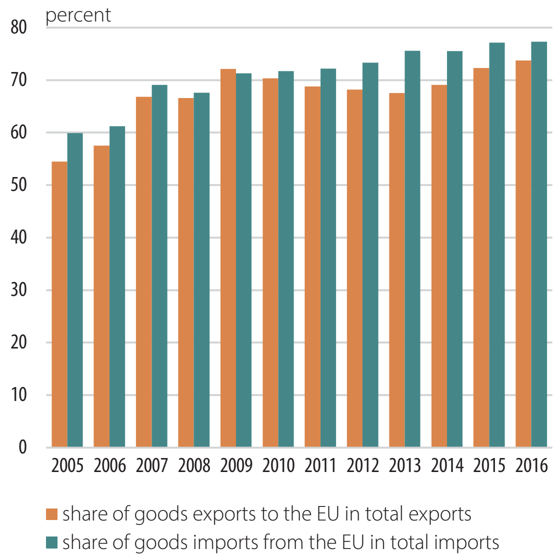
Box 2. The relationship between economic activity and inflation

In view of the central bank's primary objective to ensure and maintain price stability, understanding the determinants of the inflation rate and the inflation developments and outlook is highly relevant. The relationship between economic activity (or the degree of resource utilisation) and inflation is described by the Phillips curve, which is a standard essential tool in international macroeconomic modelling.

This relationship is, however, marked by uncertainty both theoretically and empirically. Thus, inflation rate can be analysed by means of various Phillips curve specifications, which depend, for instance, on the theoretical assumptions concerning the nature of inflation expectations or on the set of other considered determinants. Furthermore, alternative statistical measures can be used to quantify both inflation rate and economic activity, in the latter case some of the measures not being directly observable, such as the output gap or the unemployment gap (i.e. deviation of unemployment from NAIRU).

Another type of uncertainty refers to the stability in time of this relationship, which has been analysed over the past years in the context of a decoupling between economic growth and price dynamics that could be noticed worldwide after the outbreak of the international economic crisis[62]. Specifically, Ciccarelli and Osbat (2017) obtain mixed evidence of the stability in time of the relationship between economic activity and inflation for EU countries. IMF (2016) shows the stability of this relationship starting with mid-1990s for advanced economies. For countries in the region, Szafranek (2016) documents a decline in the Phillips curve slope for Poland over the last years, whereas the Magyar Nemzeti Bank (2015) identifies evidence of a weakening relationship between inflation and unit wage growth in the post-crisis period.

Chart A. The share of trade with the EU

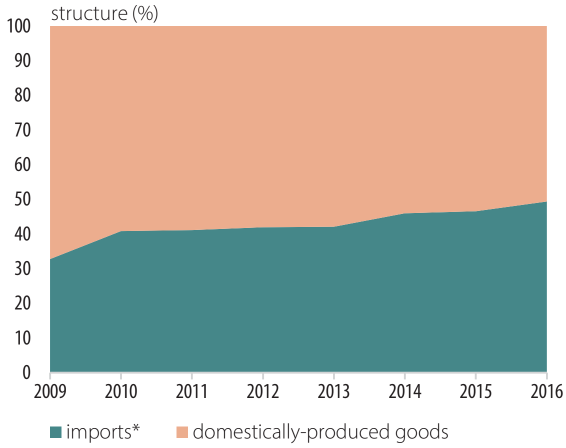


Source: NIS, Eurostat, NBR calculations

For Romania, the analysis of the relationship between inflation and economic activity is faced with additional challenges, given the relatively shorter statistical sample than that available for the mentioned countries, possibly also affected by structural breaks. However, the evidence points to a weakening relationship between core inflation and output gap in the last years. The phenomenon can be linked to an increase in the relative importance of external factors, given also the global (dis)inflationary environment, in explaining the dynamics of domestic prices, to the detriment of domestic factors. This observation builds on evidence of a higher trade integration with the EU (Chart A) and of the increase in consumption being accommodated to a larger extent via imports of goods than via domestically-produced goods (Chart B), also due to the expansion of large

62 See, for instance, Constâncio (2015).

Chart B. Purchases of consumer goods: domestic production versus imports



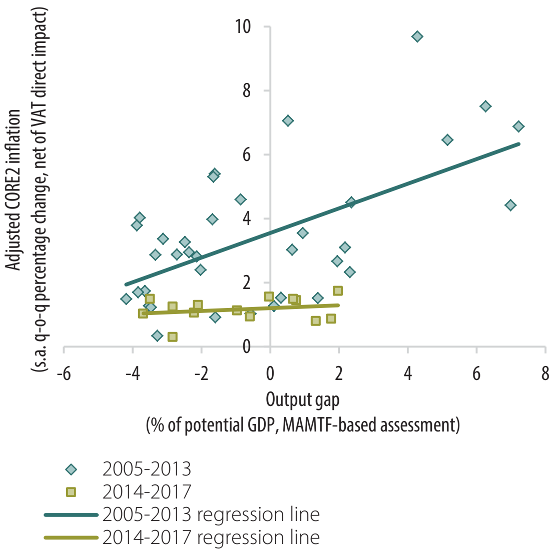
*) at market value[63]; excluding imports used for manufacturing products under OPT arrangements, recorded under the services account (BPM6)

Source: NIS, Eurostat, NBR calculations

foreign retailers integrated with global distribution networks. The high competition in this area diminishes the pass-through of domestic pressures (arising for instance from demand or wage costs) into prices.

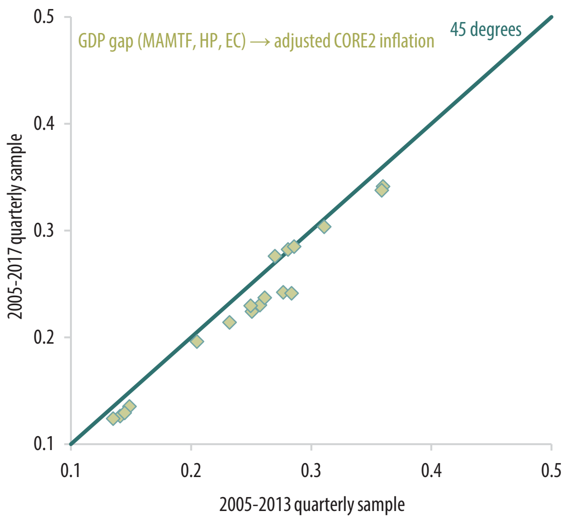
The relevance of the global disinflationary environment to the evolution of domestic inflation over the last years was also underlined in the context of assessing the forecast errors for the December 2016 annual CPI inflation (see Box in the February 2017 *Inflation Report*). According to this assessment, part of the recent tendency to overestimate the projected annual CPI inflation rate is accounted for by core inflation, also most likely as the output gap was estimated to have recorded positive values since the beginning of 2016. In-house analyses revealed that a decrease in the sensitivity of adjusted CORE2 index dynamics to the output gap in the NBR model for analysis and medium-term forecasting (MAMTF) is likely to improve inflation forecast accuracy.

Chart C. Core inflation and output gap (Phillips curve, quarterly values)



Source: NIS, NBR calculations

Chart D. Estimated values of core inflation sensitivity to output gap



Source: NIS, European Commission, NBR calculations

[63] Actual data on trade and transport margin, customs duties and taxes on products, necessary to calculate imports at market value, refer to the period until 2014 only. For 2015-2016, the first two items were approximated based on their rates (applied to base prices) in 2012-2014, whereas for the third item, different VAT rates in the reference years were used.

The flattening of the Phillips curve is shown by the lower slope of the regression line for recent observations, when measuring the economic activity level by the MAMTF-estimated output gap (Chart C). The same applies when using alternative indicators, such as the capacity utilisation rate across industry.

The econometric estimations of the Phillips curve indicate a declining trend in core inflation sensitivity to output gap when the sample is extended to incorporate the observations for the last 3 years (the light-green dots below the 45 degree line[64], in Chart D). For robustness checks, several Phillips curve specifications were estimated, based on alternative measures for the output gap (evaluated using MAMTF, applying a univariate Hodrick-Prescott filter, or European Commission estimated values), as well as for the external sector-related explanatory variables.

One of the notable implications of the Phillips curve flattening is that the output gap has a lower impact on the inflation rate, the variability of which goes down *ceteris paribus*.

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1.3. Demand pressures in the current period and over the projection interval[65]

Output gap

In 2016 Q4, real GDP rose by 1.4 percent[66] versus the previous quarter, while in 2016 as a whole, the GDP dynamics stood at 4.8 percent, the highest level recorded in the post-crisis period. In 2017 H1, real GDP is anticipated to record only slightly lower quarterly growth rates. The near-term forecast is based on broadly favourable signals from real variables (i.e. the turnover volume of retail trade, excluding motor vehicles and motorcycles, the industrial production, and the economic sentiment

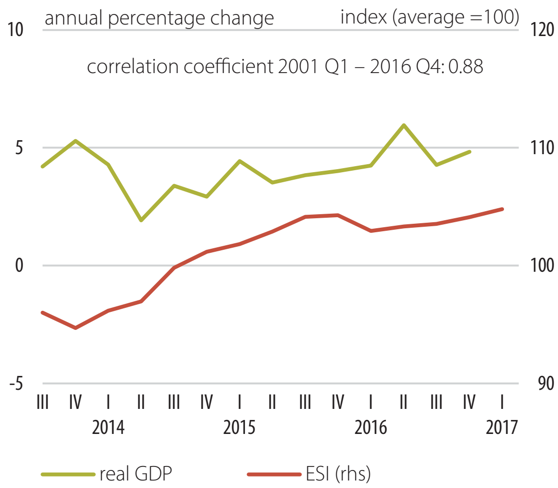
64 The dots on this line show similar values for the coefficient in both samples under review.

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

66 NIS Press Release No. 83 of 7 April 2017.

indicator – Chart 4.7)[67], on the recovery of external demand, and on the impact of some fiscal and income policy measures[68]. In this context, the contribution of domestic demand to the quarterly GDP dynamics is projected to remain positive, while that of net exports is seen as more negative, on account of imports rising at a higher pace, bolstered by the other GDP components.

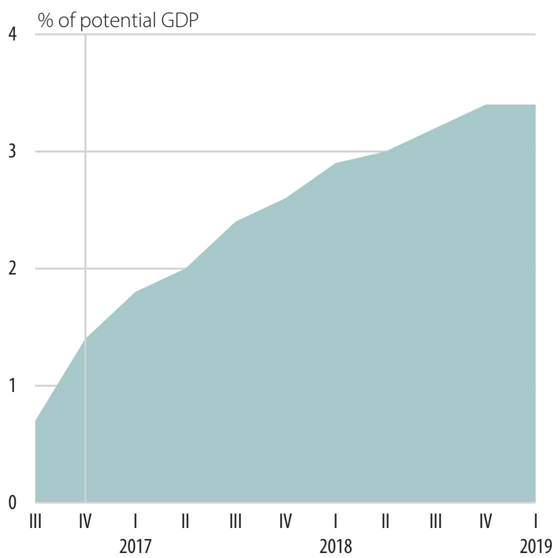
Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

Chart 4.8. Output gap



Source: NBR calculations based on NIS data

Over the projection interval, potential GDP growth is anticipated to pick up moderately. Labour (measured as total hours worked economy-wide) is seen to have a lower negative contribution, amid the expected rise in employed persons, whereas capital stock is projected to reflect the anticipated rebound in investment following a short-lived slowdown in its dynamics on account of the GFCF decrease in 2016. At the same time, behind the improvements in productivity stand companies' plans to extend their operations to other geographical areas (e.g. large retailers, with many positive stimulative effects on production factors) and to make technological investments in existing facilities. Project financing is expected to benefit mainly from favourable lending terms, while the absorption of structural and cohesion funds will mirror the early stage of programme implementation for the new Multiannual Financial Framework 2014-2020.

The output gap, which has turned positive in the first part of 2016, is projected to widen gradually over the forecast interval (Chart 4.8), with implications on inflationary pressures. The projection mirrors the dynamics of the real disposable income (underpinned by the impact of fiscal easing and income policy measures), the stimulative set of real broad monetary conditions (their impact tending to lower as of end-2017), as well as the closing and turning to positive values of the external demand gap. Compared to the previous *Inflation Report*, the output gap is larger throughout the projection interval. The differences reflect mainly the higher-than-expected GDP growth in 2016 Q4, coupled with the more stimulative revision

[67] Compared to the 2016 Q4 average, in January-February 2017 the first two above-mentioned indicators increased by 1.7 percent and 1.4 percent, respectively. The economic sentiment indicator went up 0.7 points in 2017 Q1, mainly on account of the consumer confidence indicator.

[68] 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 economy-wide, higher social transfers, as well as to the removal of non-tax fees and charges.

of the impact of fiscal easing and income policy measures, as well as of that of the external demand gap. These factors are forecasted to be partly offset by the less stimulative set of real broad monetary conditions (over most of the forecast interval), on account of the reassessed effect of the real effective exchange rate (via the net export channel). From the perspective of aggregate demand components, the output gap is projected to widen mainly owing to the consumption gap, whereas the GFCF gap is expected to enter positive territory only in the latter half of 2017. In turn, the gaps of exports and imports are already assessed at positive values, yet having a negative net contribution to the output gap. The assessment of output gap and of the gaps of GDP components is surrounded by a degree of uncertainty which rises in line with the frequency and extent of historical data series revisions, and also with their volatility (in this respect, the GFCF seasonally-adjusted historical series deserves mention).

According to the baseline scenario, the annual real GDP growth is anticipated to decelerate in 2017 and 2018, mirroring a decrease in the discretionary component of fiscal policy (i.e. the fiscal impulse) compared to the previous year. The high positive contribution of domestic demand is due to final consumption and, to a lesser extent, to GFCF. The advance in domestic demand is projected to fuel imports of goods and services to rise faster than exports and thus the contribution of net exports to GDP growth is expected to be negative.

Aggregate demand components

The actual final consumption went up by 6.9 percent in 2016[69]. For 2017 Q1, the forecast points to the quarterly dynamics of this aggregate demand component remaining at a level close to that recorded in the previous quarter, due to the higher real disposable income of households under the impact of recent pay rises (real increase of 6.2 percent in the average net wage economy-wide in January-February 2017 versus 2016 Q4) and of the cut by one percentage point in the standard VAT rate as of 1 January 2017. This development is also underpinned by high-frequency indicators, particularly the turnover volume of retail trade, excluding motor vehicles and motorcycles, and consumer confidence[70] (with a 4.3 point improvement in 2017 Q1 versus the previous quarter). In 2017 Q2, once the impact of pay rises and of the standard VAT rate cut has faded out, the quarterly dynamics of the actual final consumption are anticipated to slow down slightly.

For the remainder of the projection interval, the actual final consumption is forecasted to expand at swift rates, albeit lower than that in 2016. The foreseen trajectory of this component mirrors the anticipated dynamics of households' real disposable income (given the projected step-up in the annual CPI inflation rate throughout the forecast interval), amid wage hikes in the private sector, as well as in the public sector in particular.

[69] For details on the drivers of developments in GDP components in 2016, see Chapter 2, Section 1. Demand and supply.

[70] In 2017 Q1, the consumer confidence indicator ran at levels comparable with those recorded in the pre-crisis period, and the breakdown shows that all components, i.e. employment, saving, general economic context and financial situation, bolstered this development.

Gross fixed capital formation decreased by 3.3 percent in 2016. For the first quarters of 2017, GFCF is forecasted to witness slightly positive growth, also based on favourable signals from construction and industrial output of capital goods (up by 0.2 percent and 3.6 percent respectively in January-February 2017 as compared with the 2016 Q4 average). By contrast, the confidence indicator in construction worsened (-2.5 points in 2017 Q1 versus the previous quarter), on account of prospects on both sales and employment over the next three months.

According to the baseline scenario, the GFCF dynamics are seen to revert to positive territory in 2017 and increase at a faster pace in 2018. The projection is based on assumptions regarding the favourable impact of lending conditions, of some recently implemented fiscal measures[71] and of a further adequate direct investment flow, which may generate additional resources for supporting investment programmes, while the absorption of EU structural and cohesion funds, with a spurring effect on investment, is anticipated to be affected by the early stage of the new financial framework[72]. The forecast for this component remains surrounded by uncertainty, given the negative effects of some structural characteristics, such as infrastructure quality and legal framework stability.

In 2016, exports of goods and services saw their average annual growth rate speed up to 8.3 percent. The near-term forecast shows this component to record positive quarterly growth rates in the first two quarters of 2017, owing to the faster economic recovery of Romania's major trading partners[73].

Over the remainder of the forecast interval, exports of goods and services are anticipated to further witness positive dynamics, mirroring the improvement in external demand and the stimulative influence of the real effective exchange rate, albeit gradually diminishing towards the end of the projection horizon. An opposite effect is anticipated to come from the swift dynamics of domestic unit labour costs, with an impact on the price competitiveness of the Romanian products for external markets.

In 2016, imports of goods and services increased by 9.8 percent, bolstered by the rise in the actual final consumption and exports. In the first two quarters of 2017 and over the rest of the projection interval, imports of goods and services are seen further expanding at a faster pace than exports, against the background of an increase in domestic demand. In this context, net exports are anticipated to make a negative contribution to GDP growth over the entire forecast interval.

In 2016, the balance-of-payments current account deficit continued its widening trend[74], on account of the larger deficits on primary income and trade in goods, with the step-up in domestic demand growth contributing to the latter development. In parallel, the higher deficit on primary income stemmed from outflows of direct

71 For example, the removal of tax on special constructions.

72 2017 is anticipated to witness a slower absorption of structural and cohesion funds, given the early stage of programme implementation of the new Multiannual Financial Framework 2014-2020. However, in this new framework, economic agents will benefit from the furthering of projects started in the 2007-2013 Financial Framework.

73 For details, see Chapter 4, Section 1.1. External assumptions.

74 In 2016, the balance-of-payments current account deficit-to-GDP ratio stood at 2.3 percent, compared to 1.2 percent in 2015.

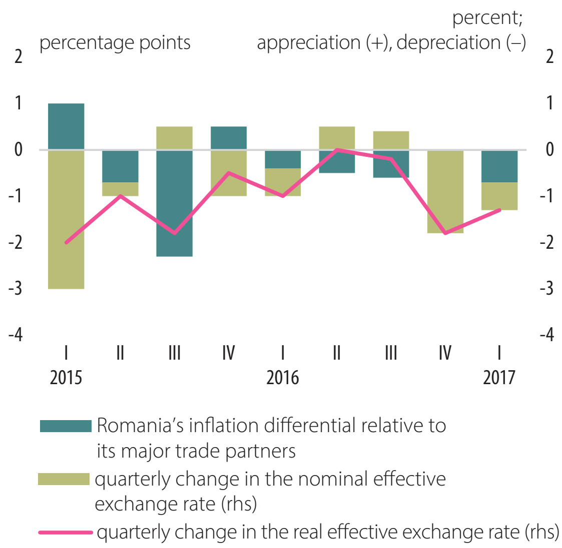
investment income, in the form of equity (dividends and reinvested earnings[75]). Over the projection interval, the current account deficit is expected to widen further before nearing 3.2 percent of GDP. The main determinant of this evolution remains the dynamics of imports of goods and services, supported by the advance in domestic demand. The current account deficit financing is anticipated to come mainly from non-debt-creating capital flows (foreign direct investment and capital transfers[76]), but their share is foreseen to narrow in 2017 and, subsequently, to stay unchanged in 2018. Nevertheless, the widening of the current account deficit due to the larger fiscal deficit and the speed-up in consumption carries the potential to jeopardise macroeconomic equilibria.

Broad monetary conditions

Broad monetary conditions capture the impact exerted on future developments in aggregate demand by the real interest rates applied by credit institutions on leu-denominated loans and deposits of non-bank clients and by the real effective exchange rate[77] of the leu. The exchange rate exerts its influence via the net export channel, as well as via the effects on wealth and balance sheets of economic agents[78].

In 2017 Q1, the average nominal interest rate applied by credit institutions to leu-denominated new time deposits in relation to non-bank clients is anticipated to remain close to its 2016 Q4 reading, while for new loans it is foreseen to rise on account of January-February 2017 developments. For 2017 Q2, the nominal interest rates are expected to remain unchanged from the previous quarter. For the first two quarters of 2017, the adjusted real interest rates are projected to continue to exert a stronger cumulated stimulative impact on the economic activity in the periods ahead.

Chart 4.9. Quarterly change in the effective exchange rate



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

In 2017 Q1, the domestic currency depreciated in nominal terms against both the euro and the US dollar. Behind the dynamics of the leu versus the US dollar stood primarily the latter's strengthening against the euro. To these developments added the quarterly inflation differential between Romania and its trading partners, leading to a depreciation of the domestic currency in real effective terms as well (Chart 4.9).

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

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

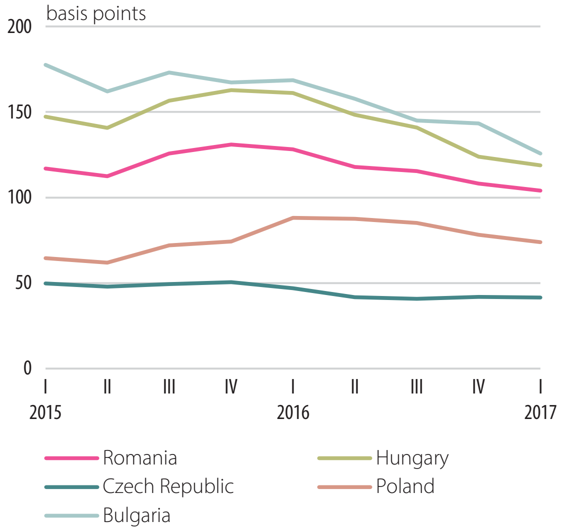
[77] The relevant exchange rate for the NBR's quarterly projection model implies EUR/RON and USD/RON exchange rates, according to the weights of the two currencies in Romania's foreign trade.

[78] 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.

Overall, the real effective exchange rate is anticipated to have a stronger stimulative impact on the economic activity in the periods ahead.

The wealth and balance sheet effect in the first two quarters of 2017 exerts stimulative influences on the output gap in the future periods, mostly on account of the real foreign interest rate standing below the medium-term trend (strongly negative gap). The CDS (Credit Default Swap) quotes for Romania decreased in 2017 Q1 versus 2016 Q4 (Chart 4.10). The medium-term prospects for the risk premium are influenced by domestic factors, associated with the fiscal and income policy stance[79], as well as by global factors, such as the unfolding of the Brexit talks[80] or the potential deviations of the ECB's and Fed's monetary policies from the trajectories currently expected by financial markets.

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



Source: NBR calculations based on Reuters data

Overall, in 2017 Q1 and Q2, real broad monetary conditions are assessed to exert a stimulative impact on aggregate demand in the following quarters, mainly due to the real effective exchange rate (via the export price competitiveness channel), and also to the other aggregate demand components.

Over the forecast interval, broad monetary conditions are projected to have a stimulative impact on economic activity, albeit on the wane as of end-2017. The real effective exchange rate will further exert a prevailing favourable impact via the export price competitiveness channel. An additional contribution in the same direction will have the wealth and balance sheet effect, given the low real foreign interest rate levels amid the persistence of the quantitative easing programme implemented by the ECB. NBR's 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.

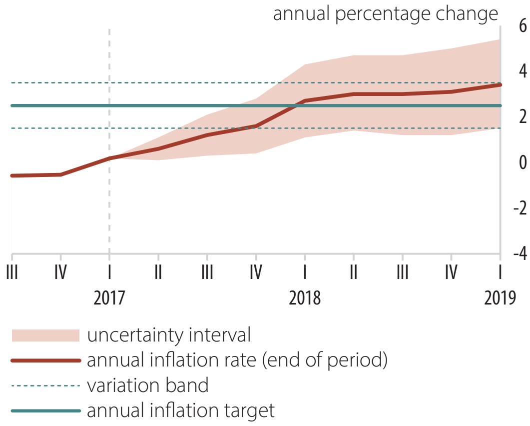
1.4. Risks associated with the projection

The balance of risks is assessed as being tilted to the upside against the inflation path projected in the baseline scenario. The risks specific to the current round relate primarily to the domestic environment, stemming from the future fiscal and income policy stances (Chart 4.11).

[79] On 21 April 2017, Moody's rating agency changed the outlook on Romania's rating to "stable" from "positive". The key drivers for the above-mentioned change, as cited by Moody's, were Romania's expansionary fiscal policy and, respectively, the pro-cyclicality of fiscal policy, as well as the rapid wage growth, leading to a deterioration of the country's external competitiveness.

[80] The proceedings governing the UK's exit from the EU were launched on 29 March 2017, and the negotiating and withdrawal process will have to be completed by April 2019. Subsequently, on 18 April 2017, Britain's prime minister announced an early general election to be held on 8 June 2017.

Chart 4.11. Uncertainty interval associated with inflation projection in the baseline scenario



Notă: 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

Specifically, one of the risk sources could be the implementation in the coming periods of the Framework Law on wages for staff paid from public funds, which was submitted to Parliament for debate. The potential widening of the positive output gap and implicitly the emergence of higher inflationary pressures than in the baseline scenario will essentially depend on the final version of the law, the timing of wage rises and the related conditionality criteria. The possible curtailment in public investments with a view to keeping the general government deficit within the targets agreed by the authorities, alongside an increase in the wage-productivity mismatch, would eventually impact the growth potential and competitiveness of the Romanian economy. Under these circumstances, the deterioration of macroeconomic equilibria would adversely affect foreign investors' risk perception, with a bearing on the stable capital flows made available to the Romanian economy, on the current account deficit financing and, therefore, on the future evolution of the domestic currency.

Turning to the external environment, some of the risks pointed out in the previous forecasting round have partly materialised, in the context of the UK starting the process of exiting the EU, as well as amid the ongoing divergence between the Fed's and the ECB's monetary policy stances. The impact that the two events will exert on global macroeconomic coordinates remains, however, relevant, given that no details have been disclosed concerning the actual institutional arrangements which will prevail in the EU-UK relationship and that the divergence between the Fed's and the ECB's monetary policy stances is expected to strengthen, *inter alia*, in the context of the future configuration of the economic policies pursued by the US Administration. The latter could imply, on the one hand, a significant fiscal stimulus package including tax cuts as well as higher infrastructure and defence spending and, on the other hand, stricter immigration policies and increased trade protectionism. Furthermore, the outcomes of parliamentary elections to be held this year in two of the EU powerhouses, i.e. France and Germany[81], are also relevant, having potential implications on the EU economic prospects and the euro area inflation and implicitly on the ECB's monetary policy. Other risk sources associated with the external environment that continue to be relevant refer to the future evolution of global economic activity, fuelled by the uncertainties about the traction coming from emerging economies, especially China.

The potentially simultaneous materialisation of some of these external risks would have spill-over effects on the domestic economy mainly through indirect channels, depending on the impact that such developments might exert on the

[81] The Parliamentary elections in France are scheduled for 11 and 18 June 2017, while the German federal parliamentary elections will take place on 24 September 2017.

economic activity of the EU, Romania's main trading partner. At the same time, some developments could increase global risk aversion and hence trigger portfolio shifts regionally and/or globally, with consequences on the future path of the leu exchange rate and implicitly on the inflation rate. These implications could be heightened should domestic macroeconomic fundamentals deteriorate. For this reason domestic macroeconomic policies should be adequately consistent so as to ensure the consolidation of progress made in the post-crisis period in removing imbalances.

Relative to the CPI basket components beyond the scope of monetary policy, the uncertainties about the future adjustments in administered prices remain relevant – especially those stemming from the energy market deregulation process – in the absence of any clear information from the relevant authorities concerning future price changes. Moreover, inherent risks are associated with weather conditions, which carry the potential to influence the agricultural produce supply in both ways and implicitly domestic food prices.

As for the risks induced by the evolution of international commodity prices, uncertainties persist about the oil price dynamics. In spite of the agreement between OPEC members and some non-OPEC countries to cut the world oil supply with a view to containing the oil price decline, the current projection round sees a renewed risk of future downward adjustments amid an increasing US output, also in the context of potential future measures across the petroleum sector to be taken by the US Administration in order to raise unconventional production.

Abbreviations

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
FOMC	Federal Open Market Committee
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
ILO	International Labour Office
IMF	International Monetary Fund
MPF	Ministry of Public Finance
NBP	Narodowy Bank Polski
NBR	National Bank of Romania
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
WIOD	World Input-Output Database

Tables

Charts