National Bank of Romania

Inflation Report

August 2017

Year XIII, No. 49

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N O T E

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

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

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Foreword

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

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

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

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

The *Inflation Report* was approved by the NBR Board in its meeting of 4 August 2017 and the cut-off date for the data underlying the macroeconomic projection was 28 July 2017.

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

Contents

Summary

Developments in inflation and its determinants

The annual CPI inflation rate consolidated in positive territory, reaching 0.85 percent in June, after having posted a notable increase in Q2 (+0.67 percentage points versus end-Q1). Its path reflected upward domestic pressures, arising from the pick-up in companies' production costs, whose pass-through into end-user prices for consumer goods is favoured by the opening of the positive output gap. Adding to these were the pressures associated with some exogenous factors, with an impact on the energy market (natural gas and electricity prices) and on volatile food prices. Under the circumstances, in June, the annual CPI inflation rate stood 0.2 percentage points higher than the value forecasted in the May *Inflation Report*. At the same time, the average annual HICP inflation rate returned to positive territory (0.2 percent at end-Q2), reflecting, apart from the developments in consumer prices, the dropping out from the index of some changes associated with VAT rate cuts.

The annual CPI inflation rate calculated at constant tax rates[1] saw, in its turn, a step-up in Q2 from 1.2 percent in March to 1.9 percent in June, which pushed it inside the variation band of the target (2.5 percent ±1 percentage point). Except for fuel prices, which reflected the steep deceleration in the positive annual dynamics of the oil price, the upward movement in the annual CPI inflation rate at constant tax rates stemmed, to different extents, from all components. Specifically, while the annual rate of change of administered prices turned less negative, the annual dynamics of adjusted CORE2 index, volatile food and tobacco and alcoholic beverages prices accelerated during the quarter.

At end-June 2017, the annual adjusted CORE2 inflation rate rose by 0.4 percentage points versus March, coming in at 1.4 percent (1.6 percent net of the VAT rate effect). The indicator saw a similar difference of +0.4 percentage points versus the projection in the May *Inflation Report*. The trend owed especially to food items, amid the faster growth rate of firms' production costs under the influence of strong wage pressures, alongside the fading out of the disinflationary impact of global commodity prices. The pass-through of higher production costs into end-user prices was facilitated by the rise in excess demand in the economy, with competitive pressure among both retailers and producers acting in the opposite direction.

The advance seen by labour productivity in the first three months of 2017 was surpassed by the faster increase in the compensation of employees; under the circumstances, the annual dynamics of unit labour costs economy-wide rose from an average 5.2 percent in the previous year to 8.3 percent, with trade and public services reporting the largest hikes. In industry, the annual growth rate of unit wage costs

[1] Excluding the first-round impact of the changes in the VAT rate, excise duties and some non-tax fees and charges.

slowed down (to 4.5 percent in April-May), mainly as a result of productivity gains, largely associated with the investment flows recently benefiting the sector, with an impact on the technological intensity of the production process. Consumer goods industries continue, however, to see particularly fast annual rates of increase of unit wage costs (around 20 percent). The effects, which are already visible in producer prices, are expected to gradually feed through into consumer prices too, as the disinflationary influence exerted by the external environment fades away and the domestic absorption expands swiftly.

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

In its meeting of 5 May 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 throughout the projection interval, albeit on a slightly lower path than in the previous *Inflation Report*. Thus, the annual CPI inflation rate was anticipated to return inside the variation band of the target towards the end of 2017 and position itself in the upper half of the band at the end of the projection horizon. This path reflected both the fading out of the transitory effects of the standard VAT rate cuts and the foreseen gradual dissipation of global disinflationary influences, as well as the inflationary pressures caused by the progressive opening of the positive output gap and by the upward dynamics of unit wage costs. Moreover, the forecast incorporated the assumption of a lower pass-through of inflationary pressures associated with aggregate domestic demand into core inflation.

The uncertainties and 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, also in the context of recent wage and fiscal legislative initiatives. The risks induced by the external environment were chiefly generated by the persistent uncertainties surrounding economic growth in the euro area and worldwide arising from political developments associated with elections in the European countries, Brexit negotiations and the economic policies pursued by the US Administration.

At the same time, in the context of the contraction in foreign currency lending, the consolidation of forex reserves above the adequate level (EUR 35.96 billion on 30 April 2017), as well as their improved composition, the NBR Board decided, during that meeting, 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 aimed to continue the harmonisation of the reserve requirement mechanism with the relevant standards and practices of the European Central Bank and of the major central banks across the European Union.

Subsequently, statistical data showed a 0.6 percent annual inflation rate in May 2017, slightly above the forecasted level, mainly on account of a step-up in core inflation. Thus, the annual adjusted CORE2 inflation rate rose slightly above the forecasted level to 1.3 percent in May, owing to developments in the prices of processed food items.

In 2017 Q1, economic growth posted a significant, faster-than-expected pick-up, the annual dynamics of real GDP reaching 5.7 percent from 4.8 percent in the previous quarter.

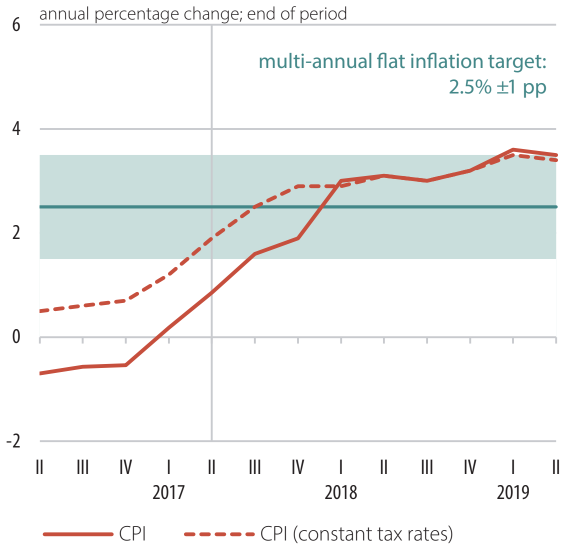
In the Board meeting of 3 July 2017, the latest assessments reconfirmed the prospects for the annual inflation rate to continue to increase in the near future, while following a slightly higher path than in the medium-term forecast released in the May 2017 *Inflation Report*, including as concerns the annual core inflation. 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 mainly generated by the fiscal and income policy conduct, also in the context of recent legislative initiatives in the field. On the external front, previously identified risk sources persisted.

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 rising throughout the forecast interval to 1.9 percent at end-2017, 3.2 percent at the end of 2018 and 3.5 percent at the projection horizon, i.e. 2019 Q2. Compared to the May 2017 *Inflation Report*, the annual CPI inflation rate forecast was revised upwards in both years, more in 2017 (by 0.3 percentage points) than in 2018 (by 0.1 percentage points). The revision is largely attributed to domestic inflationary pressures, which are associated with the build-up of a stronger-than-previously expected excess demand throughout the forecast horizon. Calculated at constant tax rates, annual CPI inflation is seen exceeding the 2.5 percent central target as early as the end of this year, reaching 2.9 percent at this horizon, 3.2 percent at end-2018 and 3.4 percent at mid-2019.

Inflation forecast



Source: NIS, NBR projection

Relative to the 2016 figure, economic growth in 2017 will accelerate, being projected to exceed the 5 percent level and, thus, to run well above the potential GDP dynamics. On the one hand, amid the revision of the output gap to higher levels for the entire forecast interval[2], the structural deficit, i.e. the discretionary component of fiscal policy, was revised upwards, yet its stimulative impact in 2017 is lower than

[2] Nevertheless, recent evidence points to a weaker pass-through of inflationary pressures associated with domestic aggregate demand on core inflation. For further details, see Box 2 in the May 2017 *Inflation Report*.

that assessed for the previous year. On the other hand, economic growth in Romania's trading partners looks set to strengthen at around 2 percent, which implies that the negative external output gap is foreseen to close by the end of this year. Given the nature of stimuli in the economy, private 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 and the pay rises anticipated to occur against the backdrop of ongoing labour market tightening. At the same time, the average annual dynamics of gross fixed capital formation are foreseen to return to positive territory this year, but its evolution will further be saddled with delays in EU funds absorption. 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 anticipated to expand faster than exports and, thus, contribute to the further widening of the current account deficit which, as a share in nominal GDP, is seen posting values around 3.4 percent over the medium term. According to the baseline scenario, current account deficit financing is envisaged to further be covered largely by stable, non-debt-creating flows, the share of which will decrease, however, against 2016, particularly due to an expected lower contribution from structural and investment EU funds (at the same time, net inflows of foreign direct investment are envisaged to rise gradually). Even under these circumstances, 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.

The reassessed path of the output gap will still be influenced by developments in real disposable income of households, amid the fiscal easing and income policy measures, by the stimulative real broad monetary conditions and the return of external demand gap to positive territory in the course of 2018.

The annual adjusted CORE2 inflation rate is foreseen to reach 2.4 percent at end-2017 and 4.0 percent at end-2018. For both years, the projected levels are higher than in the previous *Report*. Leaving aside the impact of VAT rate cuts, the projected levels for both year-ends exceed the inflation target (by 0.1 percentage points and 1.5 percentage points in 2017 and 2018 respectively). 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. An additional inflationary impact on this component is foreseen to also come from the rise in domestic producer prices, on which unit wage costs are anticipated to put further strong pressure.

The cumulative contribution of inflation components beyond the scope of monetary policy to the annual CPI inflation rate is seen at 0.5 percentage points for the end of 2017 and 0.9 percentage points for the end of 2018. The breakdown shows that developments in volatile food prices incorporated the impact that adverse weather conditions in Europe had on import prices for seasonal fruit, while the path of fuel prices was revised downwards, for 2017 in particular, mirroring the dynamics of the international oil price. The contribution of administered price dynamics to the annual inflation rate was revised only for 2017, chiefly on the back of the hike in the electricity price as from 1 July 2017.

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

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside against its 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.

Although one of the risk sources mentioned in the previous *Report* saw a relative alleviation, after the President promulgated Framework Law No. 153/2017 on wages for staff paid from public funds on 28 June 2017, uncertainties still remain as to the manner of implementation and timing of its provisions, as well as over the potential compensation measures aimed, subsequent to its enactment, at keeping the budget deficit within the authorities' targets. Furthermore, by the time the baseline scenario of the projection was completed, a number of unknowns persisted in regard to the broader package of taxation measures to be implemented following the cabinet reshuffle. In addition, given the still weak EU funds absorption foreseen in the baseline scenario and gradual recovery of domestic investment, any additional stimuli that would boost aggregate demand could jeopardise external macroeconomic equilibria by fuelling consumer goods imports. Detrimental effects could be fed by an increased recourse to domestic and external deficit financing from the international markets, which might be hit by specific volatility.

Moreover, given the increasingly significant presence of global value chains, especially large retailers, and the higher contribution from imported goods to covering domestic consumption, which is seen to rise amid, *inter alia*, fiscal and wage stimuli, the relatively low price increases worldwide, in general, and in the EU, in particular, are a relevant source of risks to the projected inflation rate in the baseline scenario, carrying the potential to generate downward deviations from the forecasted path.

As for the external environment, despite the recent abatement of global tensions and political risks associated with the euro area election schedule, heightened uncertainties persist with regard to the implications that Brexit, the economic policies pursued by the US Administration and the monetary policy stances of the Fed and the ECB will have on the global macroeconomic coordinates. Other risk sources that have remained relevant also in the current round refer to the future evolution of global economic activity, fuelled by the uncertainty about the traction coming from major emerging economies, especially China.

The balance of risks posed by international commodity prices (energy prices in particular) appears to be in equilibrium. Uncertainties still linger over the impact that large oil inventories worldwide will have on future crude oil prices, which are likely to counter the effects of the agreement to extend the oil-supply cuts, in which both OPEC and some non-OPEC countries take part.

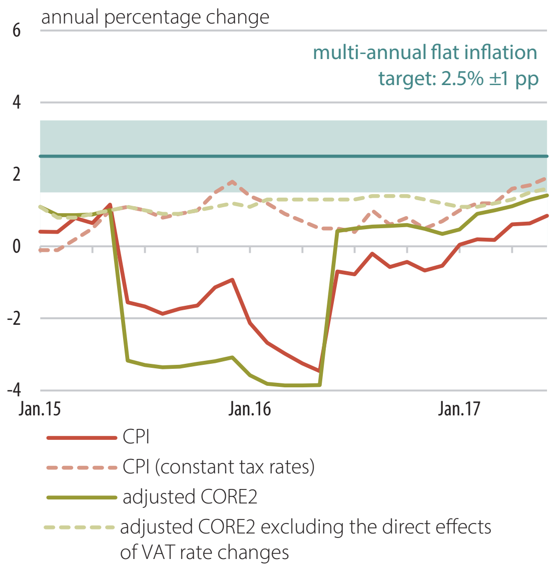
Monetary policy decision

Considering the still notably lower annual inflation rate than those prevailing in European countries and the risks to the medium-term inflation outlook stemming from the fiscal and income policy stance and the uncertainty surrounding economic growth and inflation developments in the euro area and worldwide, the NBR Board decided, in its meeting of 4 August 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 levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

1. Inflation developments

The annual inflation rate rose notably during 2017 Q2, up 0.67 percentage points to reach 0.85 percent in June. The indicator's running below the lower bound of the ±1 percentage point variation band of the 2.5 percent target was solely due to the direct impact of the fiscal measures implemented at the beginning of 2017. Calculated at constant tax rates, CPI inflation stood comfortably within the variation band, nearing 2 percent. Apart from the influence of several exogenous factors, which are essentially linked to the energy market, the uptrend reflects the pressures generated by the steady increase in production costs, whose pass-through into consumer prices is facilitated by the opening of the positive output gap. The effects are visible in the adjusted CORE2 inflation rate, which, after relatively benign developments in the past two years, picked up in 2017 Q2 to 1.6 percent (up 0.4 percentage points versus March, net of the VAT effect; Chart 1.1).

Chart 1.1. Inflation developments



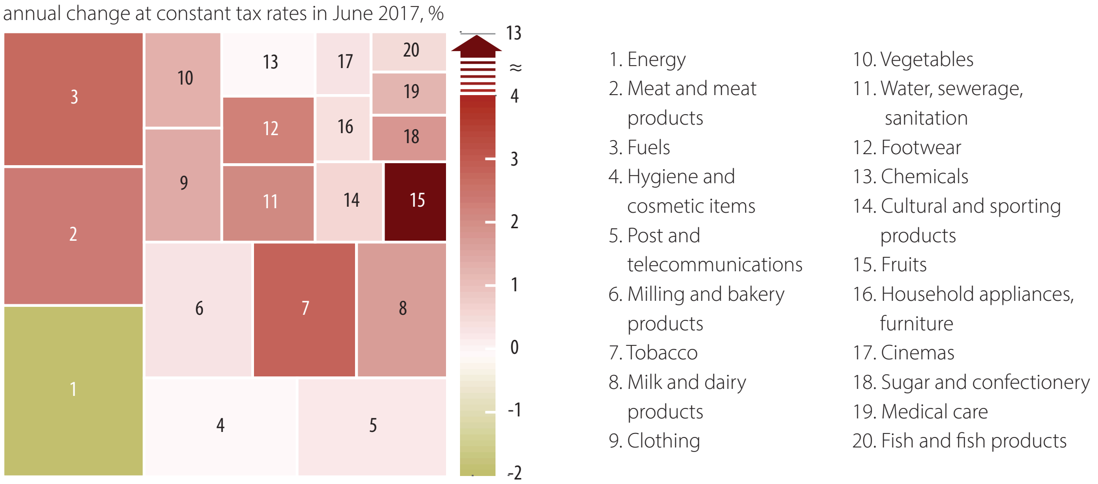
Source: NIS, NBR calculations and estimates

Consumer prices witnessed a swifter growth rate in 2017 Q2, the annual change in CPI index adjusted for the impact of the fiscal changes which took place in the first two months of this year (standard VAT rate cut, removal of the special excise duty on fuels and the scrapping of non-tax fees and charges) nearing 2 percent in June. This evolution was determined, to a great extent, by exogenous factors, namely the latest liberalisation stage of the domestic producer price for natural gas and the augmentation of the support scheme for producers of electricity from renewable sources, which substantially mitigated the negative annual dynamics of administered prices (a contribution of +0.36 percentage points to the step-up in annual inflation rate in the reference period). At the same time, inflationary pressures exerted by higher production costs and a wider output gap in the economy have begun to emerge into consumer prices. Around 65 percent of CPI basket items posted price increases larger than in the first part of the year and 11 percent saw a slower annual contraction (Chart 1.2).

This trend was more apparent for the "food" component and primarily determined by supply-side factors. Turning to volatile prices, the bad weather conditions that prevailed at the beginning of the year in the EU affected the production of citrus and other Southern fruit, contributing significantly to VFE prices increasing by over 7 percent in June. Looking at processed food prices, the uptrend that had emerged during the previous year in the case of several items (meat, milk and products thereof) characterised the entire group in the reviewed period, the annual growth rate picking up to approximately 2 percent, exceeding expectations from the previous forecasting round by almost 0.7 percentage points. These developments point to a visibly upward trajectory of producer prices on the domestic market starting with 2017, whose pace of increase accelerated from almost 1 percent at end-2016 to over 5 percent in May 2017, due to the fading of the disinflationary influence generated by the decrease in commodity prices and to the persistence of strong pressures from unit wage costs (annual rates have fluctuated around 20 percent since the second part of 2016). The rapid rise in consumption has created favourable conditions for passing through these pressures into final prices, companies in the food industry expecting the trend to continue in the following months as well. An opposite impact comes further from competitive pressures among both retailers and producers. In the former case, stiffer competition is associated with the rapid expansion of large retail chains, which aim at reaping the benefits of a growing market. As for production, intense competition, specific to an atomised market, is further fuelled by the pressure exerted by the greater contribution of imports to covering domestic consumption. In fact, this phenomenon explains why the capacity utilisation rate in the food industry has remained below the long-term average, despite the sharp increase in demand over the past two years (Chart 1.3).

Chart 1.2. Developments in the prices of key CPI basket items

annual change at constant tax rates in June 2017, %

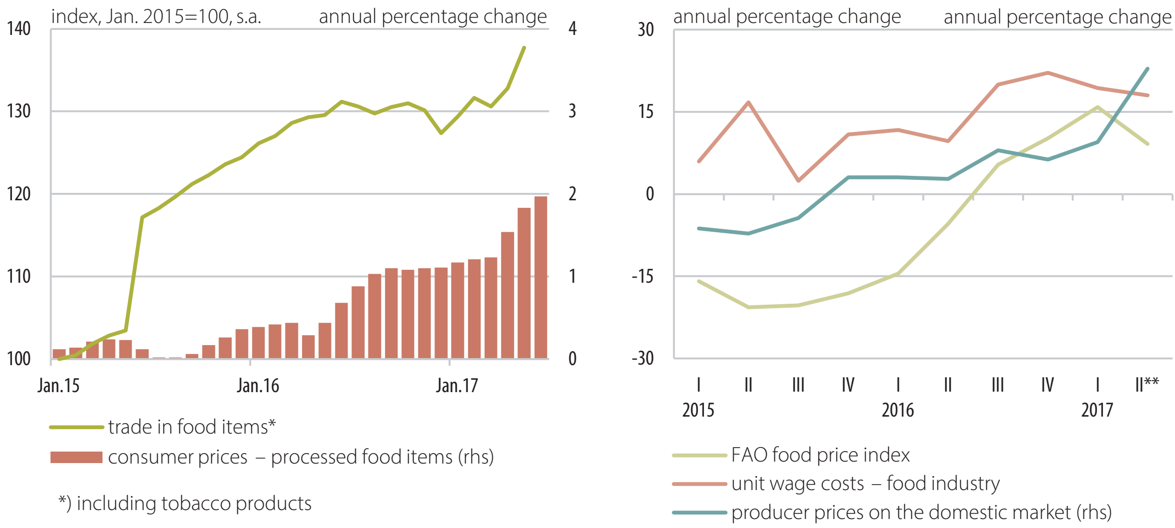


Note: The chart shows products holding about 86 percent of households' CPI basket in 2017. A rectangular area is proportional to the product's share in the CPI basket.

Source: NIS, NBR calculations and estimates

The disinflationary effect of the external environment diminished in 2017 H1, most commodity prices having followed a strong upward path in 2016 Q4 and the first months of 2017. Subsequent corrections, especially to energy prices, considerably slowed down the annual dynamics, which however remained moderately positive in 2017 Q2 as well. These developments do not point to a new trend reversal, market sentiment being favourable to a relative stability or slight increase in prices, supported by the comfortable stock level, concurrently with the gradual recovery of global demand.

Chart 1.3. Production costs and consumer prices for food items

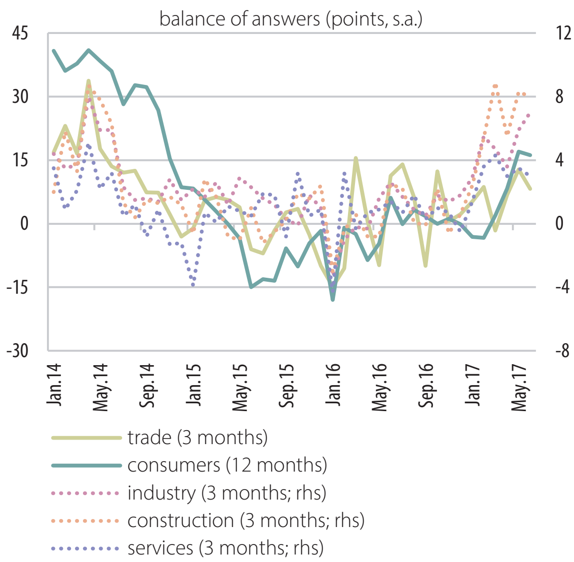


*) including tobacco products

**) Apr.-May

Source: NIS, FAO, NBR calculations

Chart 1.4. Expectations on price developments



Source: NIS/EC-DG ECFIN Survey

The creation of an inflationary environment is also suggested by the upward path of economic agents' expectations on price developments starting with 2016 H2, retailers and consumers recording the highest levels and strongest pick-ups compared with the previous quarter (Chart 1.4). Financial analysts' expectations on inflation are also in line with a rising annual inflation rate, which is seen running in the upper half of the variation band of the target over both the 1-year and 2-year horizon.

With consumer prices recently rising faster and further changes affected by the VAT rate cuts dropping out of the calculation of the average annual HICP rate, the latter re-entered positive territory, standing at 0.2 percent at the end of 2017 Q2. In the same period, the average inflation rate in the EU increased up to 1.1 percent, following the fading out of certain base effects related to the fall in energy prices in 2016, so that the differential between the two indicators shrank to -0.9 percentage points.

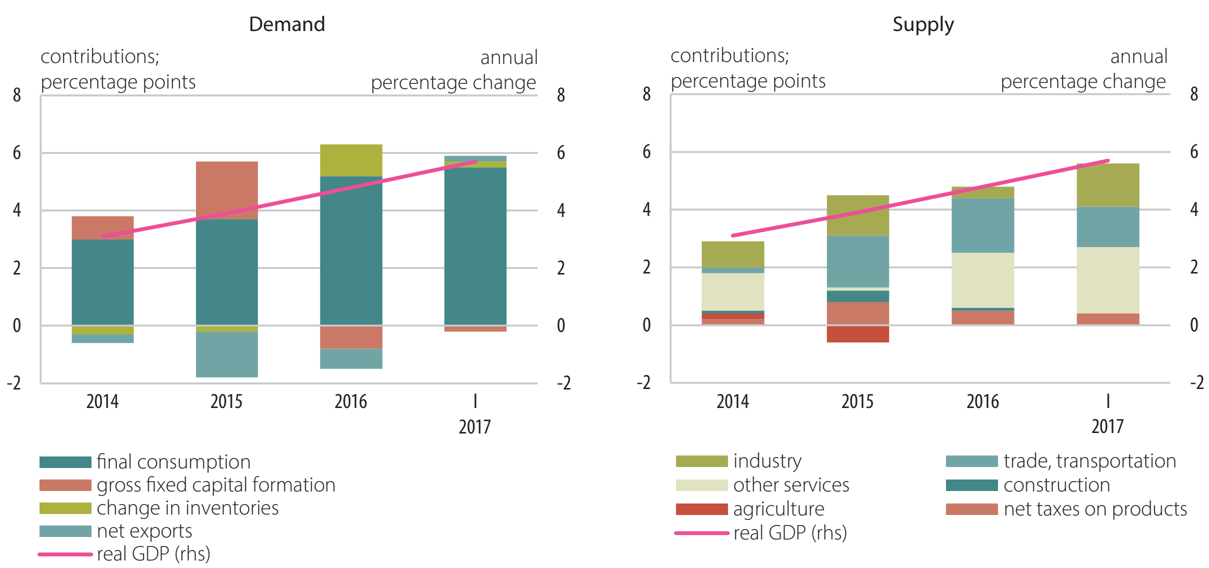
The annual inflation rate at mid-2017 stood 0.2 percentage points above the level projected in the May 2017 *Inflation Report*. This difference was mainly due to higher-than-expected processed food prices, to which added a rise in tobacco product prices between May and June far above the one justified by the projected increase in the specific excise duty (effective as of 1 July). The impact exerted by these two influences was alleviated by the unexpected drop in the crude oil price.

2. Economic developments

1. Demand and supply

In 2017 Q1, economic activity continued to surprise on the upside (annual dynamics of 5.7 percent), driven by the rapid expansion of consumption, which received additional boosts from income and some new tax cuts. The increase in households' purchasing power contributed to the rise in housing demand, with favourable effects on gross fixed capital formation, the annual decline of which slowed down markedly in the period under review. A prolongation of the downtrend in investment in infrastructure and purchases of equipment diminishes however the probability that the current economic growth path will remain sustainable over the medium term. A significant part of domestic demand is further accommodated via imports, the negative contribution to economic growth being yet offset by the swift advance in exports of goods and services, against the backdrop of the economic expansion of EU countries (Chart 2.1).

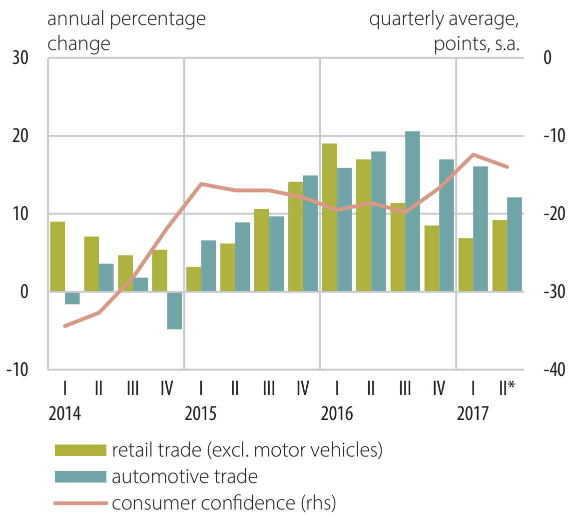
Chart 2.1. Contributions to economic growth



Source: NIS, NBR calculations

The increases in households' purchasing power recorded over the past years have also continued at the beginning of 2017, amid the adoption of new fiscal and income policy easing measures. This trend is seen to persist in the medium run. The new stimuli add to the already favourable labour market conditions in terms of wages and employment. The whole context was mirrored by the strengthening of consumers' confidence, their risk aversion having already declined somewhat. An indication in this respect is the swift growth rate of new consumer loans (despite the tightening of standards applied by commercial banks ever since 2016).

Chart 2.2. Trade and household confidence



*) Apr.-May 2017 for trade turnover

Source: NIS, EC-DG ECFIN

Under the circumstances, consumer demand stepped up its quarterly rate of increase to a level similar to those recorded in the boom period, gaining 7.3 percent in 2017 Q1 versus the same year-ago period. The robust pace of growth of consumer demand is expected to continue in the period ahead. This is also shown by signs coming from the trade sector – the confidence indicator of retailers reached 10 percent in April-June, while the turnover of trade and services was significantly higher in April-May 2017 for both non-durables and durables, i.e. up about 6 percent and 16 percent respectively. In the latter case, a notable advance was posted by purchases of motor vehicles, as consumers' increasing appetite countered the postponement effect induced in the previous years by the launch of the car fleet renewal programme (an additional stimulus was the removal of the environmental stamp duty as of February 2017, with an impact on sales of used motor vehicles). Another particularly dynamic segment is that of sales of furnishings (furniture and household appliances), whose brisk rise is linked to the recent expansion of real estate market and construction of residential buildings (Chart 2.2).

In the first quarter of 2017, the general government budget posted a surplus of lei 1.5 billion, i.e. 0.2 percent of GDP[3]. This occurred after the budget had recorded a deficit of lei 14.6 billion (1.9 percent of GDP) in 2016 Q4 and a surplus of lei 3.0 billion in the period from January to March 2016 respectively and points to an asymmetric pattern of budget execution this year as well, albeit less pronounced than in 2016. The general government budget balance returned to positive territory in a context in which quarterly public expenditure saw a sharp contraction[4], largely on the back of decreases in government spending on goods and services and in capital expenditure, which were counterbalanced only to a small extent by the growth of staff costs[5] and social security spending[6]. Moreover, budget revenues were higher than in the previous quarter[7], given the increase in quarterly receipts from property taxes[8], social

[3] The analysis relied on the operational data related to budget executions, as published by the MPF on a monthly basis.

[4] When compared to the same year-ago period, budget expenditure picked up 10.2 percent in real terms (versus a 9.4 percent decline in the preceding quarter), the step-up owing to the expenditure for projects financed from non-repayable external loans, as well as to staff costs, social security spending and subsidies.

[5] Given the pay rises in January (up 15 percent in the healthcare sector and education) and in February 2017 (up 20 percent in local public administration and 50 percent for public institutions for performing arts or concerts) as well as the hike in the gross minimum wage economy-wide from lei 1,250 to lei 1,450 as of 1 February 2017.

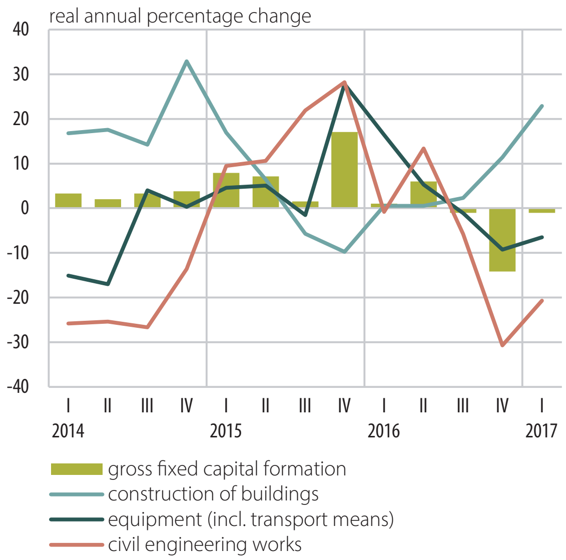
[6] Mainly as a result of increases by 5.25 percent in the pension point (starting 1 January 2017) and by 30 percent in the social indemnity for pensioners (as of 1 March 2017).

[7] Revenues went up 7.0 percent year on year, after dropping by 10 percent in 2016 Q4.

[8] Specific to the beginning of the year.

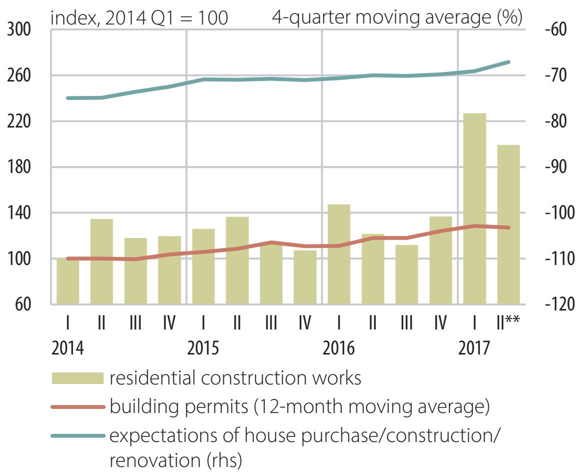
security contributions, VAT and other taxes. Conversely, excise duty and corporate income tax revenues, as well as the disbursements from the EU[9] saw relatively less favourable developments.

Chart 2.3. Investment



Source: NIS, NBR calculations

Chart 2.4. Construction of dwellings*



*) seasonally adjusted data

**) Apr.-May 2017 for residential construction works and building permits

Source: NIS, EC-DG ECFIN, NBR calculations

Gross fixed capital formation declined at a substantially slower pace than in 2016 Q4 (-1 percent, annual change). However, this was almost entirely due to the advance in residential construction works, whereas investment in infrastructure and purchases of equipment decreased further, thus eroding the economy's growth potential (Chart 2.3).

Apart from the strengthening of households' purchasing power, behind the accelerating increase in residential construction works (up to about 80 percent) has largely stood the financing scheme under the "First Home" programme (which covered nearly two thirds of new housing loans in 2016), with households further showing a strong interest in it in 2017 as well. The prospects remain optimistic, given the signals sent out by property developers with regard to the volume of dwellings that are to be completed this year, as well as the rise by more than 10 percent in the construction area stipulated in building permits (average annual change for the past 12 months, calculated for May 2017; Chart 2.4).

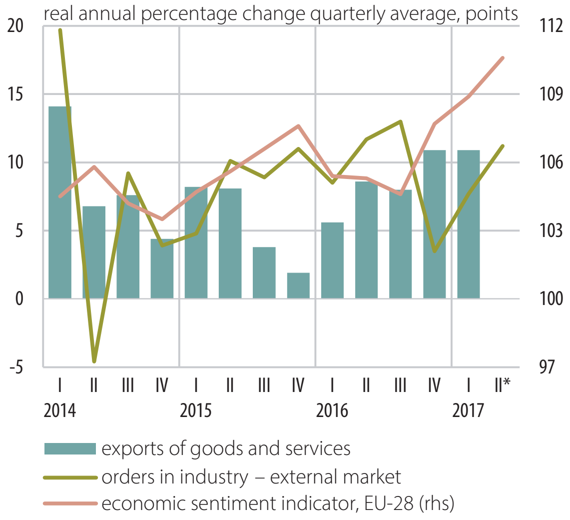
Equipment purchases saw their volume decreasing further in 2017 Q1, yet their negative dynamics slowed down to -6.5 percent (annual change). Although the latest NIS/EC-DG ECFIN survey does not show an improvement in investment flows for this purpose in the period ahead, in certain industrial sub-sectors there is an increasingly visible interest in projects to expand production capacities and manufacture higher value added products, also on the back of automating technological lines. In this regard, mention should be made of investments in sub-sectors producing automotive parts and the related industries (electrical equipment, rubber) – due also to the larger order portfolio of companies from abroad following the enlargement of auto industry capacities in the region – as well as in food industry, manufacture of machinery and equipment and building materials, in the latter case under the influence of higher demand for residential buildings. In fact, these developments contributed to the

[9] However, they rose substantially in year-on-year comparison.

considerable step-up in the dynamics of industrial output volume in the first 5 months of the year (up to 7.8 percent). In terms of funding sources, capital investment benefits, in general, from the increasingly strong support of foreign investors, given that reinvested earnings in the Romanian economy[10] increased in 2016 and in the period from January to May 2017.

Public investment continued to make a strong negative contribution to the annual dynamics of gross fixed capital formation, the volume of civil engineering works in 2017 Q1 standing well below that recorded in the same year-ago period, i.e. -20.7 percent, also on account of delays in the absorption of EU funds under the 2014-2020 financial framework.

Chart 2.5. Exports of goods and services



*) Apr.-May 2017 for orders

Source: NIS, EC-DG ECFIN

In the first part of 2017, exports of goods and services posted a significant annual growth rate of 10.9 percent, similar to that recorded in the preceding quarter. Prospects for external demand remain favourable, as shown by the latest forecasts on euro area economic growth in 2017 Q2-Q3[11], the strengthening of the confidence indicator in EU-28 and the faster increase in export orders to local industrial companies (Chart 2.5).

Exports of goods grew by 10.1 percent, with the robust sales of sub-sectors integrated in the global value chains, such as manufacture of transport equipment and the related industries, further deserving special mention. In the former sub-sector, the growth rate of turnover volume in the external market even exceeded 20 percent, while the opening of new auto production facilities in countries in the region is envisaged to further ensure strong demand for local suppliers. The positive prospects extend beyond the parts and accessories industry, as a new Ford car model is expected to enter production at the Craiova factory this autumn.

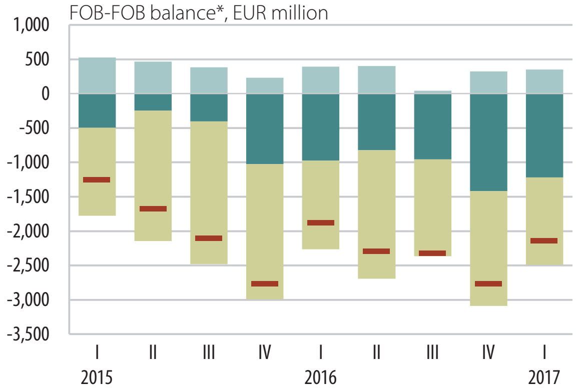
Notable increases were also seen by exports of metal products, whose turnover volume in the external market went up by about 14 percent, also under the influence of measures taken at EU level in order to reduce unfair competition from some Asian producers, as well as by exports of oleaginous raw materials (up by around 38 percent, change in volume, given the previous year's large harvest). Lower export volumes were reported by wearing apparel and petroleum products, in the latter case owing to the volatility generated by the overhaul schedule, despite the overall favourable developments in this sub-sector and the ongoing investment of specialised companies.

10 Expressed as a moving sum over the past 12 months.

11 *Spring Economic Forecast* of the European Commission (May 2017) and *Consensus Forecast Survey* (July 2017).

Imports kept increasing at a swift pace in 2017 Q1 (up 10.6 percent in real terms, with imports of goods gaining 8.8 percent), which reflected the persistence of relatively high levels of domestic absorption and exports, on the one hand, and the influence of some seasonal factors, on the other hand, i.e. the adverse weather conditions in the January-February 2017 period, which caused the over 4-time rise in purchases of natural gas. Faster dynamics were noticeable for some groups of intermediate and capital goods, given the integration of some industrial sub-sectors in the global value chains (as is the case with imports of motor vehicle parts) and the positive signals on investment in the industrial sector.

Chart 2.6. Balance on trade in goods



*) excluding goods produced under processing arrangements

Source: Eurostat, NBR calculations

Consumer demand continued to foster goods purchases from abroad, yet the slowdown in retail sales translated into decelerating dynamics of related imports (from 10 percent in 2016 Q4 to 6.4 percent in January-March 2017, real changes), which were registered by most groups of goods, except for light industry products and motor vehicles. However, the visibly slower growth rate of imports of consumer goods did not help improve the balance on trade in these goods. This remained the major cause of trade balance erosion, given that firm support from exports of consumer goods is still slow in coming. The adverse impact of this evolution on the external balance was further dampened by the persistence of substantial net receipts from services rendered internationally (EUR 1.9 billion, covering 88 percent of the trade in goods deficit in 2017 Q1). Nevertheless, the downtrend followed by the services surplus in the first 5 months of 2017, which is largely associated with households' increasing resort to foreign tourism and transport services, indicates a potential decline in its capacity to counterbalance trade deficit (Chart 2.6).

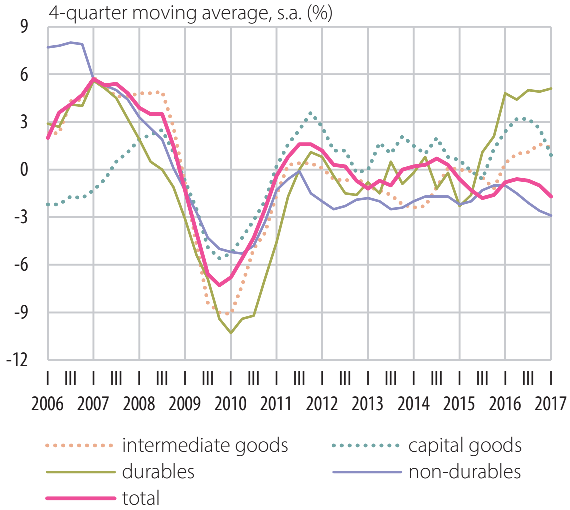
Chart 2.7. Labour productivity and NAIRU

Source: NIS, NBR estimates

Labour productivity

In 2017 Q1, labour productivity economy-wide consolidated its uptrend, witnessing increases in annual terms in almost all economic sectors (Chart 2.7). Productivity gains may be further attributed to cyclical developments, given the increasing number of signs showing above-potential growth. In the labour market, the ILO unemployment rate saw the widening of its negative differential against structural unemployment (NAIRU), whereas the number of employees seems to have flattened out its growth curve, the annual rate of increase remaining virtually unchanged in the past 6 quarters. As for production capacities, a recent EIB survey[12] shows that nearly two thirds of Romanian firms operated in 2016 at or above full production capacity under normal conditions, which is higher than the EU average of about 50 percent. Additionally, over 70 percent of firms consider that investment over the last three years was the right amount, half of investment flows being earmarked for replacing existing equipment. This behaviour practically explains the lack of dynamism of gross fixed capital formation economy-wide.

Chart 2.8. Capacity utilisation rate in industry*



*) difference against the long-term average (2005 Q1 – 2017 Q1)

Source: NIS/EC-DG ECFIN survey, NBR calculations

In industry, labour productivity rose markedly in the period from January to May 2017, this trend being manifest in a large number of sub-sectors. Specifically, in addition to the industries integrated in value chains, significant productivity increases were recorded in metallurgy, food and furniture industries. Apart from the influence of the cyclical factor, reflected by the capacity utilisation rate staying above the long-term average in most industrial groupings, there is an ever growing number of signs pointing to structural gains (Chart 2.8). In the latter case, it is worth noting companies' increasing concern with automating the production process, which is visible particularly in the automotive and electrical equipment industries, where some prominent producers invest in installing robots and are currently recruiting staff with robot control skills.

The automation trend that has recently been noticed in the local economy is a global phenomenon which, apart from the advantages in terms of productivity gains, also has material social implications, due to the pressure exerted on labour force composition and size. Thus, the training requirements for human capital will be increasingly high – a field where Romania has a lot of catching-up to do, as the share of high-skilled personnel in total employees stands well below the EU average –, concurrently with a gradual downsizing in personnel numbers in the future (see the Box).

Labour market in Romania in the digitisation era

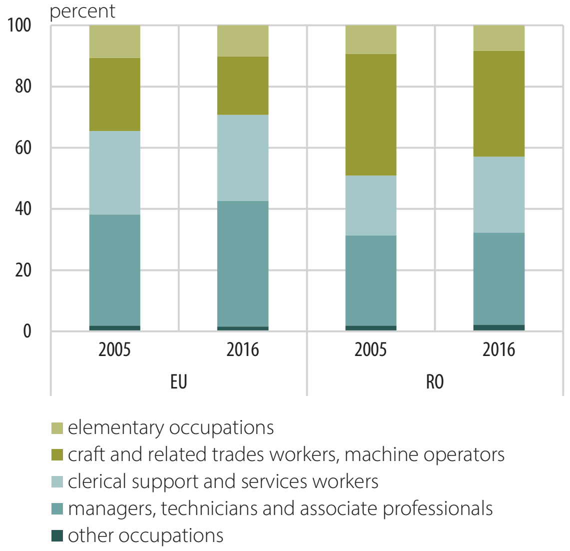
Over the long term, human capital – the knowledge and the skills of individuals that enable them to bring added value to the economy – is deemed to be the most valuable resource of any country. In the context of an increasingly dynamic global economic environment, once with the take-up of the solutions brought by the new generation of technologies[13], machines start to gradually take over the tasks of the labour factor and requirements in terms of staff training and skills become ever more demanding. It is therefore of the essence for investment in human resources to be effective and to address the needs of an ever-changing economy, considering

[12] *Group Survey on Investment and Investment Finance* 2016.

[13] In areas such as robotics, artificial intelligence, 3D printing, cloud computing, big data and data analytics.

the increasingly high likelihood that the types of competences that are currently searched for in the labour market will disappear at the end of the traditional education cycle. This box aims at assessing the current stage of development of human capital in Romania, given that the constraints imposed by labour shortage may press local companies to decide faster on the automation of certain activities.

Chart A. Employees by occupation



Source: Eurostat

Empirical evidence supports the importance of upskilling the labour force in Romania's case as well, as the firms recruiting mostly such staff boast markedly greater productivity than the companies that basically hire low-skilled workers[14]. Similarly to the global trend, the domestic economy has witnessed a larger demand for high-skilled personnel, around two thirds of the job vacancies that were opened in 2016 requiring such competences. At the same time, however, an overwhelming share of companies point to the shortage of suitably-skilled staff as one of the most important deterrents to developing their businesses[15]. This assessment is in no way surprising, given that 80 percent of excess labour supply is accounted for by unemployed not receiving unemployment benefits, a category with generally poor skills, due to their relatively low education level (graduates from primary, secondary or vocational education) and the extended duration of their unemployment (at least one year), with a negative impact on their competences. In addition, the breakdown of employees by occupation shows a marginal change in the share of managers, technicians and associate professionals (occupations that require more sophisticated skills), which fluctuated around 30 percent in the past ten years, in stark contrast to the trend in Europe, where the aforementioned share strengthened from one year to the next, standing at 41 percent in 2016 (Chart A).

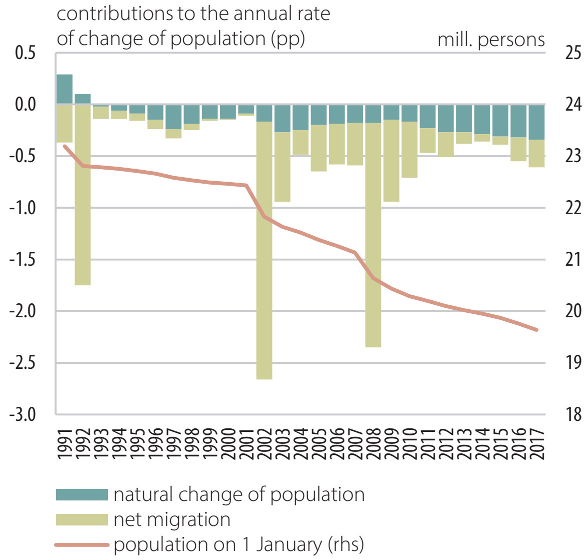
An essential contributor to the emergence of an acute shortage of qualified labour is the massive emigration of the working age population. Specifically, at end-2016 almost 3 million Romanians lived in EU Member States (Chart B), with the largest losses, in relative terms, being visible among highly educated people. This phenomenon, which is common to several Central and Eastern European countries, left its imprint on economic growth in the region, having an estimated negative influence on labour productivity of approximately 5 percentage points, while also adversely affecting the pace of convergence to the living standards in the advanced economies (IMF, 2016). There are consequences in demographic terms as well, as emigration contributes, together with the negative natural change of population, to the stronger ageing trend, with the 15-34 age group posting the

[14] See the Box titled "Total factor productivity (TFP) from a macro- and a microeconomic perspective" in the May 2016 *Inflation Report*.

[15] According to the *Manpower Employment Outlook Survey*, in 2016 as a whole over 70 percent of employers reported difficulties in finding qualified personnel, thus making Romania rank third at international level.

steepest contraction versus 2000 (Chart C). Nonetheless, the rise in the number of 55-64 year olds becomes worrisome, given their lower adaptability to new requirements, particularly as most of them have a medium and low education level (80.2 percent in 2016). Educational programmes ensuring lifelong learning could mitigate the adverse effects of ageing, yet Romania ranks last in the EU in this respect – merely 1.2 percent of the population in the 25-64 age group participated in such training during 2016 compared with an average of 11 percent in the European Union.

Chart B. Developments in Romania's population



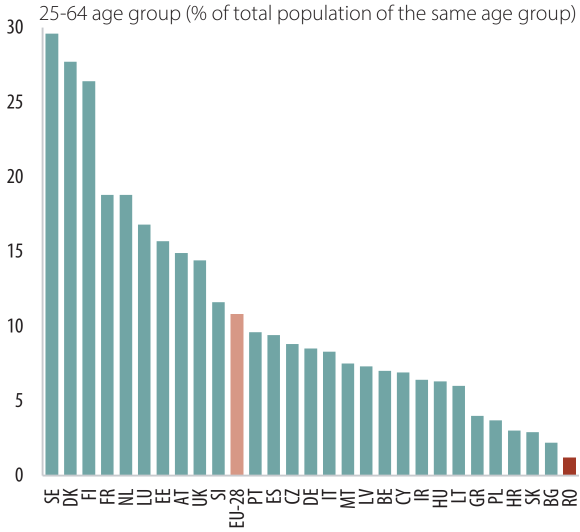
Source: Eurostat, NBR calculations

Chart C. Age pyramid

Source: Eurostat

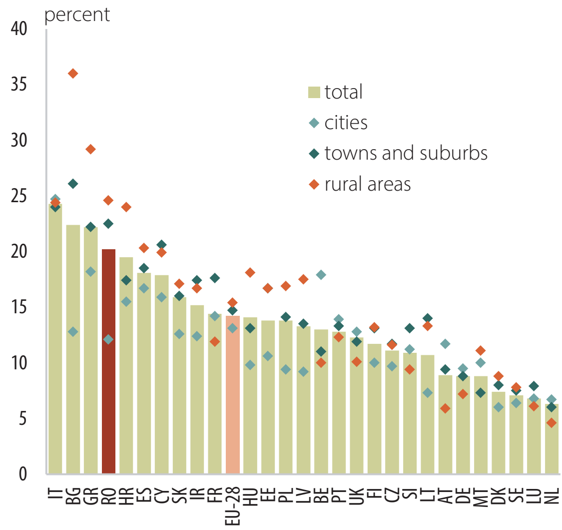
The need for investment in human capital to become an ongoing process has turned into a global priority, given that technological progress exerts strong pressure on the current labour market structure and the capacity of the present-day education systems around the world to timely adapt to the new requirements (not only by swiftly and efficiently changing the curriculum, but also by disseminating the new knowledge to all generations) is debatable (ILO, 2010; WEF, 2014). Thus, shifts in labour force composition are seen carrying the potential to fuel the polarisation of jobs in terms of the education level and, implicitly, of wage earnings. Literature highlights the fact that technological progress is complementary to a high degree of workforce specialisation and a relative substitute in the other cases. Hence, technological advancement is likely to affect low-skill and even middle-skill jobs and, in the first instance, those tending to be repetitive jobs – for example, the introduction of industrial robots into the production process or of self-service machines into trade (Autor *et al*., 2006, Goos and Manning, 2007; Eurofound, 2014). Recent studies have estimated rather significant percentages of occupations at risk of extinction over the medium and long term due to automation (Frey and Osborne, 2013); at European level, the share exceeds 50 percent, the highest risk (over 60 percent) being identified in Romania.

Chart D. Participation rate in education and training, 2016



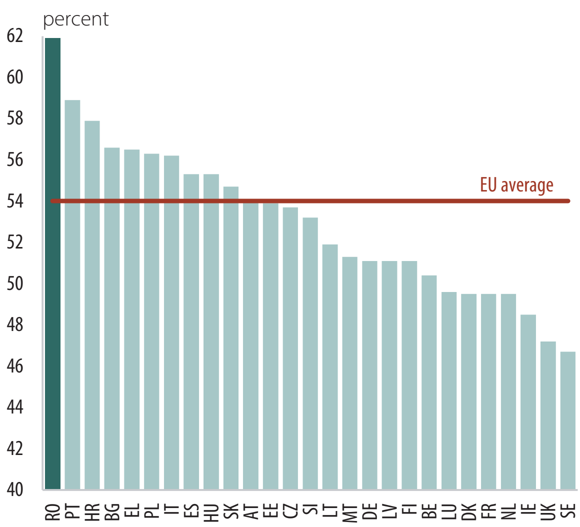
Source: Eurostat

Chart E. Young people neither in employment nor in education or training, 2016



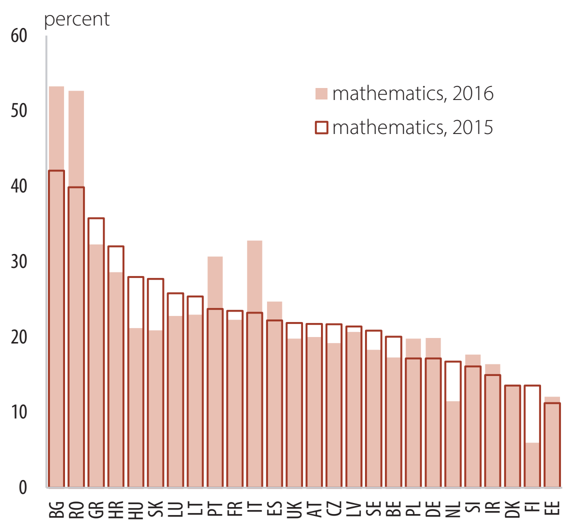
Source: Eurostat

Chart F. Jobs in danger of extinction due to technological advances



Source: Bruegel

Chart G. Students lacking basic skills in using scientific knowledge



Source: OECD

The present economic environment requires basic digital literacy in most types of jobs (WEF, 2016), while in Romania – at odds with the fast-growing ICT sub-sector – more than half of the labour force (54 percent) does not have at least basic digital skills, compared with about 30 percent in the European Union (European Commission, 2016). The worsening issue of adequate workforce skilling is inextricably linked to the adaptability of the education system to the new market needs. Illustrative in this regard are the scorings of Romanian students in PISA tests, which – despite a relative improvement between 2006 and 2015 – continue to be well below the OECD average, as well as the fact that around 40 percent of these students lack basic skills in creatively using scientific knowledge[16], this being one of the highest percentages across the EU. Furthermore, a very high proportion of young people (21 percent of 15-29 year olds), especially those in rural areas and towns, were not involved in any activity (be it education or employment) in 2016 (Charts D-G).

The influence of technological progress on the labour market in Romania has so far translated particularly into a larger demand for highly-skilled workforce, with the expansion of the ICT sub-sector being a case in point. The risk of certain occupations to disappear because of automation is counterbalanced, for the time being, by the fact that wages are still at a level where it is profitable to hire low- or medium-skilled personnel. Nonetheless, the compensation effect is anticipated to weaken in the coming period, given the swift hike in wages in the past years and the likelihood of this trend persisting over the short-term horizon. At the same time, the sectors with the largest labour absorption rates are exactly those facing the highest risk of automation, namely trade and support service activities. As for Romania, the above-mentioned category can also include a great share of the automotive industry (and the related sub-sectors), which involves the performance of low complexity tasks mainly by individuals – probably on the back of the cost advantage of the human factor. However, there are signals about the erosion of this advantage, with manufacturers of road transport means[17] already taking steps for relocating production and increasing automation of production lines.

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Labour market developments[18]

The increase in the number of employees in the economy appears to have reached a ceiling at the beginning of 2016, while the January-May 2017 period is supportive

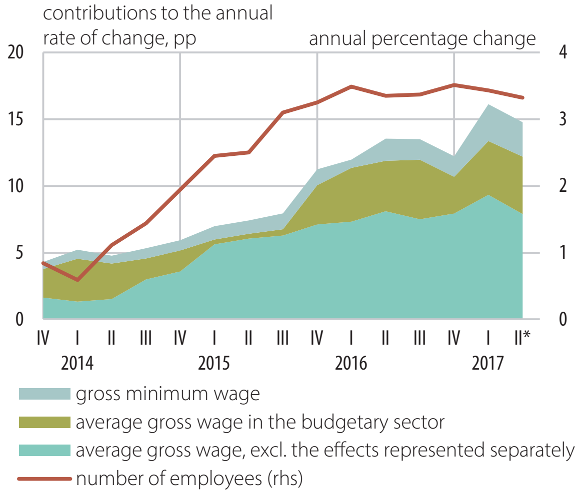
[16] Mathematics and other sciences.

[17] See the Box titled "Price competitiveness of main industrial groupings and sub-sectors" in the May 2017 *Inflation Report*.

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

of this assessment, the annual change levelling off at 3.4 percent (Chart 2.9). This time as well, hires in market services had a prevailing contribution, despite the loss of momentum in their growth rate. Moreover, workers' dynamics in industry further tended to stabilise at below-average levels, i.e. 2.1 percent year on year. However, the growth rate of payrolls in the automotive industry (including the related sub-sectors) picked up. Conversely, the dynamics of the number of employees in the budgetary sector followed an upward course, amid the hires in healthcare.

Chart. 2.9. Number of employees in the economy and average gross wage earnings

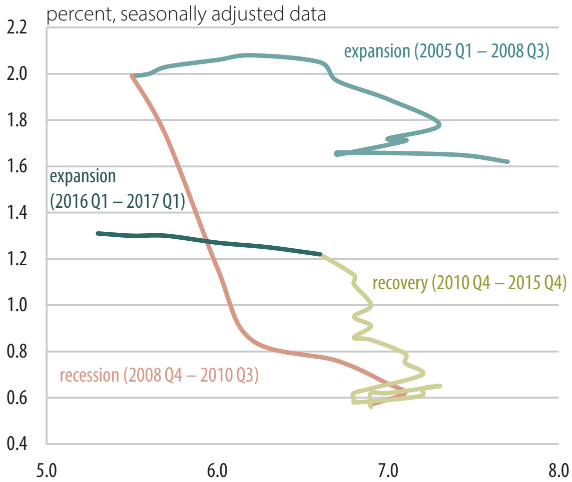


*) Apr.-May

Source: NIS, Ministry of Labor, Family and Social Protection, NBR estimates

The capacity of the economy to absorb workforce, as illustrated by the higher job vacancy rate, was also mirrored by excess supply, with the two unemployment indicators dropping 0.2 percentage points each, i.e. the ILO unemployment rate went down to 5.3 percent (hitting an all-time low) and the registered unemployment rate to 4.5 percent. The evolution is similar to that recorded during the boom of the previous business cycle (2006-2008), yet the job vacancy rate is lower, showing that the structure of the economy has been changing in favour of capital- or knowledge-intensive sub-sectors such as the automotive industry and ICT services (Chart 2.10).

Chart 2.10. The Beveridge curve



Ox: ILO unemployment rate
Oy: Job vacancy rate

Source: Eurostat, NBR calculations

The reduction in the number of potential candidates contributes to the ongoing labour market tightening, so that companies find it more difficult to attract/retain staff. The most important job categories causing difficulties for employers in finding candidates include engineers and qualified workers[19], which indicates that further efforts are necessary to develop the education system, including vocational education. In the latter case, a recovery has been noticed starting 2013, yet the number of graduates accounts for only a quarter of the level registered in the 2000-2005 period.

For the June-September 2017 period, mixed signals are expected with regard to developments in the number of employees. Specifically, the EC-DG ECFIN survey indicates a stable hiring pace in industry, market services and construction, as well as a significant improvement in employment expectations in trade. By contrast, according to the Manpower survey, employment prospects remain positive, albeit less strong than those formulated for 2017 Q2 in most sub-sectors, except construction and transportation.

[19] According to *Manpower's 2016-2017 Talent Shortage Survey*.

The annual dynamics of average gross wage earnings picked up further in the period from January to May 2017 (+3.4 percentage points to 15.6 percent), reflecting pay rises in the budgetary sector[20] and the increase in the minimum wage to lei 1,450 (up 16 percent), on the one hand, and the gradual labour market tightening, on the other hand, the lack of material progress in solving structural deficiencies enhancing the cyclical influence.

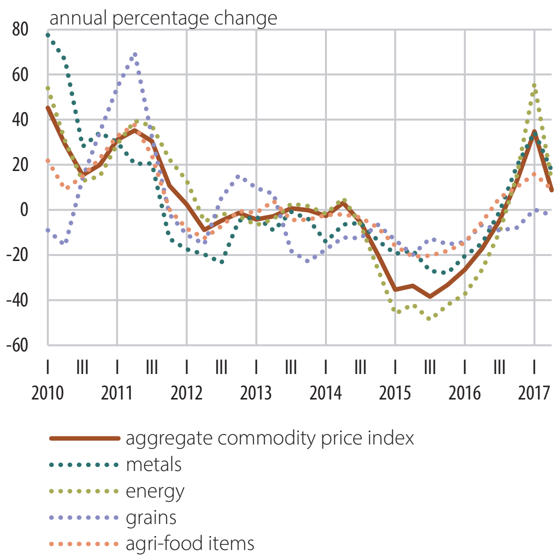
2. Import prices and producer prices on the domestic market

The beginning of 2017 was marked by sharp rises in international commodity prices, whose dynamics, however, slowed down substantially by mid-2017, amid the comfortable global stock levels of most traded goods. Both import prices and producer prices on the domestic market closely followed the said trend, given the latter's relatively high sensitivity to external developments. At the same time, domestic inflationary pressures continued to build up, the rate of change in unit labour costs remaining strongly positive, particularly in consumer goods industries.

2.1. Import prices

After the significant increase in early 2017, the main international commodity prices reported a substantially slower pace of growth in Q2, the annual dynamics of the aggregate index falling to approximately 9.0 percent (-26.0 percentage points from 2017 Q1; Chart 2.11). This trend was visible in most prices, being more pronounced in the case of energy prices, whose rate of change dropped 43 percentage points to 12.7 percent. The oil price fluctuated within a range of USD 50-55 per barrel and even fell below the lower bound of this range in June. Overall, the crude oil supply was further relatively robust – despite the OPEC agreement to cut production, which has been recently extended until March 2018 –, being underpinned by the rising output in the US. In fact, for these reasons, recent estimates[21] point to the oil price remaining close to USD 50 per barrel until end-2017.

Chart 2.11. International commodity prices



Source: IMF, FAO, NBR calculations

As far as metal prices are concerned, their annual rate of change decelerated to 17.3 percent in 2017 Q2, on account of fears about the sustainability of economic growth in China, caused by the worrisome level of indebtedness. In correlation with the favourable expectations regarding global supply, the main

[20] February 2017 saw pay rises for non-teaching staff, public administration employees and for actors.

[21] The latest EIA forecasts and the oil futures released by Bloomberg.

agri-food commodity prices posted a slower annual pace of increase, i.e. 9.2 percent. This time too, prices of meat, milk and dairy products were an exception to the trend, following the rising world demand.

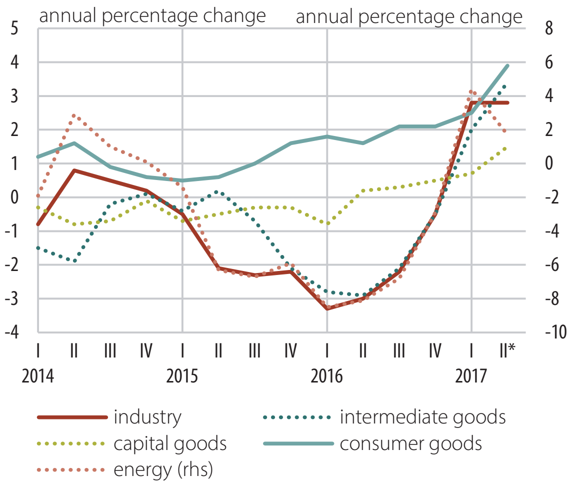
The strong jump in commodity prices in the first months of 2017 was also mirrored by the unit value index of imports, which consolidated its uptrend (up 4.4 percentage points from 2016 Q4, to 103.7 percent). Thus, the upward pressures stemming from import prices intensified, also as a result of the appreciation of the US dollar against the euro.

A look at the breakdown shows that important contributions were made by mineral products, whose UVI rose to 150 percent (up 50 percentage points), and by base metals and chemical products, although in the latter cases the increases were lower. As regards the goods holding a relevant share in the CPI basket, faster UVI annual dynamics were generally reported, for both food items (animal products, vegetal products, oils and fats) and non-food items (wearing apparel and footwear). An exception were transport means, whose UVI remained unchanged at 100.7 percent, on the back of the larger imports of used cars, as the removal of the environmental stamp duty boosted purchases of vehicles with high pollutant emissions at lower costs.

2.2. Producer prices on the domestic market

In April-May 2017, the annual growth rate of producer prices on the domestic market stagnated at the level recorded in 2017 Q1 (2.8 percent), the downward impact of the slower dynamics of most commodity prices being dampened by the pass-through, with a lag, of their strong rise in 2017 Q1 along the production chain, as well as by the built-up pressures from labour costs (Chart 2.12).

Chart 2.12. Industrial producer prices on the domestic market



*) Apr.-May

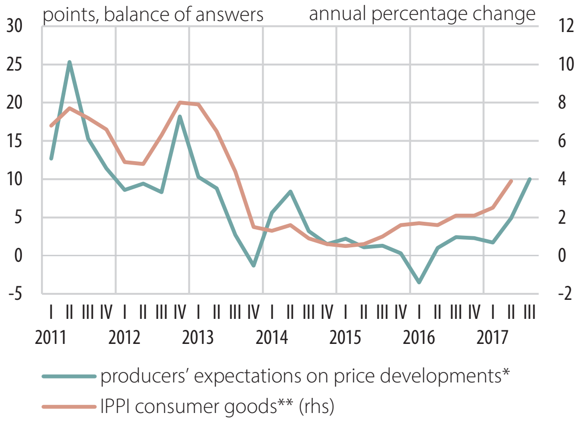
Source: NIS, Eurostat

Only energy prices witnessed a deceleration in their pace of increase (down 2.7 percentage points, to 1.7 percent), the main explanation lying in the slacker annual dynamics of the international oil price. Nevertheless, in the same direction acted the strong correction in electricity prices in the domestic deregulated market, the large jump at the beginning of 2017 being basically artificial, with no correspondent in fundamentals.

Producer prices for intermediate goods and capital goods were less sensitive to the external influence, possibly owing to the pass-through, with a lag, of the rise in commodity prices in the first part of the year, as well as to the softening of the leu versus the main currencies.

In addition, the annual dynamics of producer prices for consumer goods consolidated its upward trend it had followed since 2015 H2, accelerating to 3.9 percent in April-May 2017, up 1.4 percentage points from Q1. The findings of the DG ECFIN survey

Chart 2.13. Producer prices for consumer goods and the expectations of consumer goods producers



*) June-Aug. 2017

**) Apr.-May 2017

Source: Eurostat, NIS/EC-DG ECFIN survey

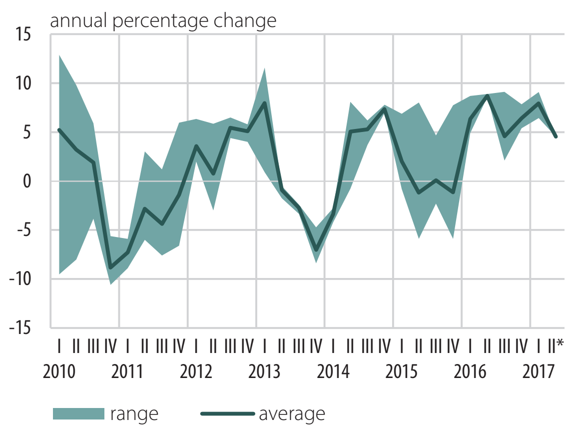
show that the said trend will persist in the upcoming period as well, as the balance of answers for June-August 2017 reached 10.4 points, the highest reading in the past four years (Chart 2.13). This development was more pronounced in the case of food prices, given the annual growth rates close to 20 percent of unit wage costs starting in 2016 H2 and the price rises in certain commodity groups.

January through April 2017, the negative annual rate of change of agricultural producer prices decelerated significantly to -1.1 percent (+4.5 percentage points). The prices of vegetal products witnessed slacker annual declines, on the back of signals about a slightly lower global output than in 2016, yet the trend is unlikely to steepen, given the high stock level. At the same time, the annual growth rate of animal product prices picked up to 4.9 percent, with pork products recording the largest advance, i.e. up 13.4 percentage points, to 20.5 percent, in correlation with the trends observed at the EU level.

Unit labour costs

Labour productivity growth in the first three months of 2017 was outpaced by the step-up in the compensation of employees, causing the annual dynamics of unit labour costs economy-wide to accelerate from a 5.2 percent average in 2016 to 8.3 percent, the greatest rises occurring in trade and public services.

Chart 2.14. Measures of unit labour costs



*) Apr.-May; data available only for unit wage costs in industry

Note: The measures include unit labour costs economy-wide (calculated based on the number of both employees and hours worked) and unit wage costs in industry.

Source: Eurostat, NIS, NBR calculations

In industry, the annual pace of increase of unit wage costs decelerated during 2017 (to 4.5 percent in April-May 2017) due to both substantial productivity gains in certain sub-sectors and the base effect generated at the end of the interval by the minimum wage hike in May 2016. A look at the breakdown shows that the automotive industry and the manufacture of electrical equipment witnessed corrections, as these industries absorb significant investment inflows that influence labour productivity through technological advance. By contrast, consumer goods industries continue to report considerable wage-productivity differentials, with the annual dynamics of unit wage costs further posting two-digit levels (around 20 percent). The effects of pressures that have built up along this channel are already visible in producer prices in the said industries, being expected to gradually impact consumer prices too, given that domestic absorption rises fast and the offsetting influence of the external environment wanes (Chart 2.14).

3. Monetary policy and financial developments

1. Monetary policy

May through July 2017, the NBR kept the monetary policy rate unchanged at 1.75 percent per annum and maintained the characteristics of the corridor of interest rates on the central bank's standing facilities around the policy rate, while also extending the status-quo of banking system liquidity management and of the minimum reserve requirement ratio on leu-denominated liabilities of credit institutions; at the same time, the minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions was lowered from 10 percent to 8 percent. 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.

In its May meeting, the NBR Board decided to keep the monetary policy rate at 1.75 percent per annum, amid the annual inflation rate having re-entered positive territory in 2017 Q1 at very low levels[22], whereas its forecasted path was again revised downwards over the entire projection horizon, given the relative weakening of the relationship between core inflation and output gap. Nevertheless, the rise in excess aggregate demand was seen to be relatively higher than anticipated before, considering the swifter-than-forecasted pick-up in economic growth in 2016 Q4 and the upward revision of its dynamics foreseen in 2017 and 2018. At the same time, inflationary pressures on the rise or at least comparable to the previously projected ones were anticipated to derive from unit wage costs, import prices[23], but also from the uptrend in short-term inflation expectations. The main assumption underlying the outlook for the faster dynamics of economic activity was the relative strengthening of the pro-cyclical stance of the fiscal and income policies across the projection horizon[24]; furthermore, the outlook implied an accommodative nature of real monetary conditions comparable to that in the earlier forecast and sturdier economic growth in the euro area/EU and globally. Under the circumstances, the forecasted trajectory of the annual inflation rate retained its strongly upward profile, with inflation seen climbing into the upper half of the variation band of target at mid-2018 H1 and then standing at 3.1 percent in December 2018[25]. At the end of the

[22] As the base effect associated with the VAT rate cut to 20 percent was partly countered by the impact of a renewed cut, to 19 percent, and of the removal of the special excise duty on fuels starting January 2017, as well as by the influence of scrapping non-tax fees and charges in February. In March, annual inflation rate came to 0.18 percent.

[23] Amid the likely increase in the volume of imports.

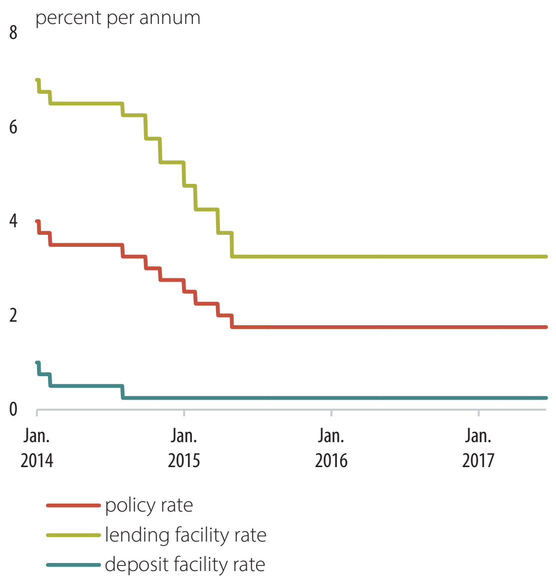
[24] Driven *inter alia* by the cuts in indirect taxes and non-tax fees and charges, by public sector pay rises, by the increase in the gross minimum wage economy-wide, as well as by the rise in pensions and other income in the form of social benefits.

[25] Compared with 3.4 percent in the February 2017 medium-term forecast.

projection horizon (March 2019), the annual inflation rate was expected to come in at 3.4 percent, a similar level to that indicated in the previous medium-term forecast.

The inflation outlook was still marked by uncertainties and two-way risks. They stemmed primarily from the future fiscal and income policy stance, particularly in the context of the uncertainty regarding the new unified wage law and the possible corrective fiscal measures, as well as from the risks to euro area and global economic growth, arising from the elections scheduled in the euro area, the Brexit talks, and the economic policies of the US Administration.

Chart 3.1. NBR rates



Given the ongoing contraction in foreign currency credit, the strengthening of international reserves above the adequate level and their improving composition, the NBR Board decided, however, in its May meeting to cut by another 2 percentage points the minimum reserve requirement ratio on foreign exchange-denominated liabilities of credit institutions[26] (Chart 3.1), thus continuing the harmonisation of the reserve requirement mechanism with the relevant standards and practices of the European Central Bank and the major central banks across the European Union.

Subsequently-released statistical data confirmed expectations on the annual inflation rate picking up in Q2; it climbed in May to 0.64 percent, slightly above the forecasted level, driven chiefly by core inflation[27] and administered prices[28], whose impact was only partly offset by developments in fuel prices, reflecting the decline in the international oil price. Data also pointed to a significant step-up in economic growth[29] in 2017 Q1 (5.8 percent versus 4.7 percent), also against the latest medium-term forecast, implying a likely wider opening of the positive output gap; this time, behind the strengthening in GDP dynamics stood solely domestic demand – whose faster increase was driven both by household consumption and by gross fixed capital formation –, whereas the contribution of net exports to GDP growth slipped marginally back into negative territory[30]. Moreover, the annual dynamics of average gross wage earnings stuck to a two-digit level in April, the slight deceleration versus Q1 notwithstanding, while the annual pace of increase of unit wage costs industry-wide regained momentum, amid the – possibly one-off – decline in the annual rate of change of labour productivity.

26 From 10 percent to 8 percent, effective starting with the 24 May – 23 June 2017 maintenance period.

27 The annual adjusted CORE2 inflation rate reached 1.29 percent in May, from 1.03 percent in March. In the absence of the cut in the standard VAT rate, it would have climbed to 1.47 percent.

28 Way ahead of prices for vegetables, fruit and eggs.

29 Statistical data on economic growth are the provisional ones available at the time of the assessment underlying the monetary policy decision.

30 The step-up to a three-year high in the dynamics of exports of goods and services was exceeded by the pick-up in the pace of increase of imports; in this context, the current account deficit witnessed a steeper widening trend compared with the same year-earlier period.

Credit to the private sector grew at a slightly faster annual pace April through May 2017[31] (2.5 percent on average versus 1.9 percent in Q1). These developments were underpinned in April by credit to non-financial corporations[32] – primarily on account of the long-term component in lei and of short-term forex loans – and in May by loans to households. The renewed pick-up in the annual pace of increase of household loans was attributable to the rebound in the dynamics of leu-denominated consumer credit and other loans[33], amid the rise in income and the relative consolidation of households' favourable expectations on their future financial standing; however, loans for house purchase grew at a slower pace in annual terms, owing to the specifics of the "First Home" programme and the manner in which it unfolded. Developments were partly correlated with the results of the May 2017 *Bank Lending Survey* conducted by the NBR, which pointed to expectations of keener demand for credit in 2017 Q2, as well as of a relative tightening of credit standards on consumer and housing loans[34], whereas those applicable to corporate credit were expected to remain unchanged. The growth rate of domestic currency credit decelerated slightly during the period under review (12.7 percent on average from 13.8 percent January through March), while the annual dynamics of the foreign currency component posted less negative readings (-9.8 percent versus -11.3 percent, based on values expressed in euro); however, the share of the leu-denominated component in total private sector credit continued to widen and reached a post-1996 high of 59.3 percent in May.

Nevertheless, the annual pace of increase of broad money slowed in the first two months of Q2 – to 11.1 percent and 9.8 percent respectively –, after having picked up to 12.0 percent in March. This owed primarily to the relative reduction in disbursements related to EU funds (including in agriculture), to which probably added portfolio shifts away from M3 and into other financial assets; opposite influences came from the faster rise in budget expenditures in May. Against this background, narrow money grew at a slacker pace (20.9 percent versus 21.2 percent), mainly on the back of developments in household overnight deposits. The annual rate of change of time deposits with a maturity of up to two years softened as well, due largely to the steeper decline in deposits from non-monetary financial institutions.

The assessments conducted in this context reconfirmed the outlook for the annual inflation rate to further pick up in the following months, while following a trajectory slightly above that projected in the NBR's medium-term forecast of May 2017, including in the case of the annual core inflation rate. Moreover, the new short-term projection revealed a significant upward revision of the quarterly GDP dynamics forecast for Q2[35] and only a marginal downward revision of the forecast for Q3, entailing a considerably wider positive output gap in the near term, given, *inter alia*, the acceleration way above expectations in the economic growth in Q1. At the same time, however, assessments hinted at a significant increase in the uncertainties

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

[32] The annual dynamics of corporate credit in nominal terms thus re-entered positive territory for the first time in four years.

[33] The nominal annual rate of change of consumer credit and other loans returned to positive readings in May after having stayed in negative territory for the past five years.

[34] In the context of changes to the requirements for assessing debtor creditworthiness, following the coming into force of NBR Regulation No. 5/2016 amending and supplementing NBR Regulation No. 17/2012 on certain lending conditions.

[35] Developments in high-frequency indicators pointed to private consumption as the projected driver of economic growth.

about the short- and medium-term outlook for the fiscal and income policy stance, likely to generate enhanced uncertainties and two-way risks to the latest medium-term inflation forecast; they stemmed from the new unified wage law and its implementation, and from the new measures and legislative initiatives announced in respect of taxation, of wages and pensions, as well as of the operating framework for firms[36]. To these added downside risks to economic growth in the euro area/EU and worldwide induced by the uncertainties arising from Brexit talks and the economic policies pursued by the US Administration.

Under the circumstances, in its meeting of 3 July 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.

Real monetary conditions remained stimulative in 2017 Q2, in a context in which the average EUR/RON exchange rate rose slightly compared with the first three months of the year and the average interbank money market rate advanced marginally, the same as the average 3M ROBOR rate, amid a temporary decline in excess reserves and the NBR further pursuing adequate liquidity management in the banking system. At the same time, the average lending rate on new business stood somewhat higher April through May than in Q1, the annual inflation rate was higher, whereas the average remuneration of new time deposits from non-bank clients continued to shrink.

2. Financial markets and monetary developments

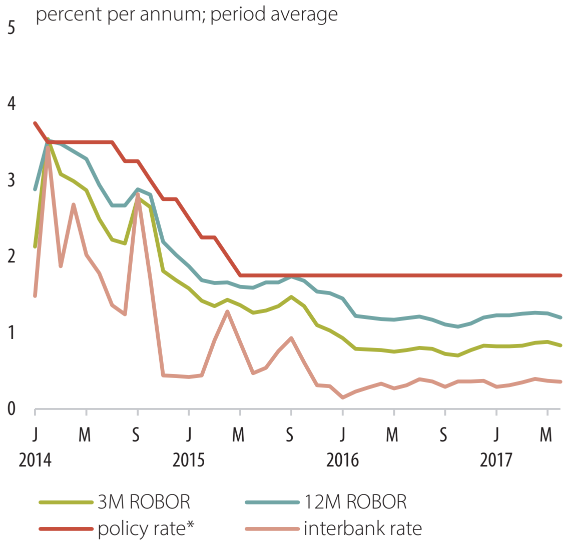
> The daily interbank deposit rate remained in the vicinity of the NBR's deposit facility rate during 2017 Q2, while the EUR/RON exchange rate trended upwards. The dynamics of both credit to the private sector and broad money varied March through May 2017, also influenced in the latter case by fluctuations in disbursements from EU funds.

2.1. Interest rates

The daily average interbank money market rate stood at the lower bound of the corridor defined by interest rates on the central bank's standing facilities for most of the quarter under review, witnessing only brief episodes of relatively higher readings.

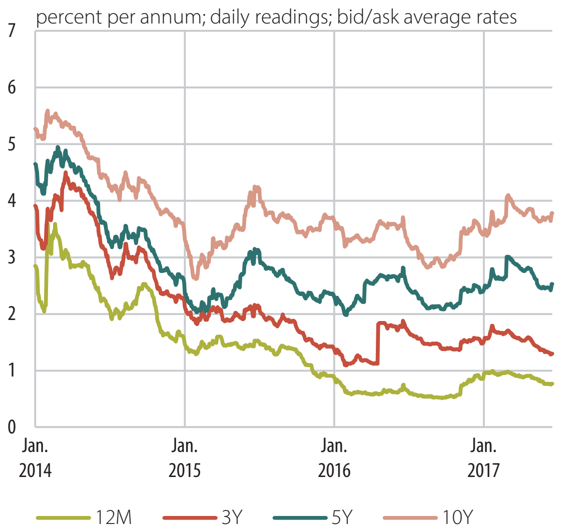
[36] With the appointment of the new Cabinet, the following potential measures were announced (some of them similar, at least in part, to those envisaged earlier): raising the gross minimum wage economy-wide, lowering the standard VAT rate from 19 percent to 18 percent starting 1 January 2019, broadening the scope of the 5 percent VAT rate to the sale of lodgings up to 120 sqm and to inputs in agriculture, as of 1 January 2018, increasing the value of the pension point, minimum guaranteed pension and child allowance, diminishing social contributions by 4.25 percentage points and transferring them exclusively to the employee (payable by the employer), introducing a solidarity tax and a surcharge on unhealthy foods and beverages, lowering income tax from 16 percent to 10 percent, exempting doctors' wage income from taxation, introducing the turnover tax, additional taxation of profits obtained from the extraction of natural resources that are not processed in Romania, scrapping the dividend tax and the tax on agricultural land, reintroducing the global income tax, amending legislation for the purpose of capital replenishment by companies with negative capital, and amending insolvency provisions.

Chart 3.2. Policy rate and ROBOR rates



*) end of period

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



Its quarterly average inched up from the previous three months' level (0.05 percentage points to 0.37 percent).

Overnight rates on the interbank money market remained in the immediate vicinity of the NBR's deposit facility rate until the end of the reserve maintenance period concluded in April, given the further large – albeit narrowing – net liquidity surplus in the banking system. Afterwards, these rates posted a temporary rise at the end of April/ beginning of May – due to the more visible reduction in excess reserves, prompted mainly by the increase in the balance of the Treasury's leu-denominated account[37] –, before reverting close to the deposit facility rate[38] once the MPF had resumed its liquidity injections[39].

In turn, longer-term (3M-12M) ROBOR rates remained relatively unchanged during the first two 10-day periods in April, before rising slightly (Chart 3.2). However, the increase was short-lived, being followed by a downward move – reflecting the revision of credit institutions' expectations on the future path of short-term interest rates – which persisted until mid-June and brought ROBOR rates to 6-month lows; towards the end of the period under review, these rates witnessed a renewed marginal advance. Consequently, the average 3M ROBOR rate stood in June close to its March reading, i.e. 0.84 percent, while the average 6M and 12M rates shed 0.05 percentage points each, to 1.02 percent and 1.20 percent respectively.

Under the influence of the same factors, short-term government security yields (6 to 12 months) posted similar developments (Chart 3.3). At the same time, those on the medium/long term stuck until towards end-May to the downward path they had embarked on in the latter half of March[40]; the move was correlated with the decline in US yields and keener investor interest

[37] Associated with higher budget collections at end-April, overlapping a relatively large volume of net issues of government securities during that month.

[38] A temporary rise in these rates was recorded at end-June as well, *inter alia* amid balance sheet adjustments by some credit institutions in that period.

[39] Also as a result of a series of government securities worth lei 7.8 billion maturing on 11 June.

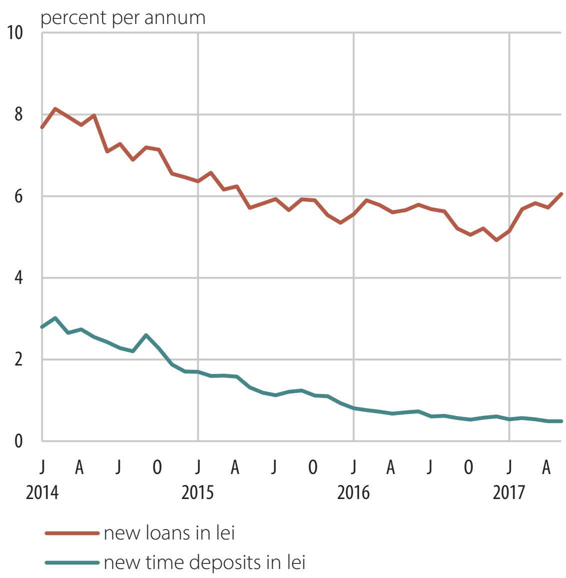
[40] The decline was only temporarily interrupted at end-April and the beginning of May, when these yields were influenced to a certain extent – the same as those on other markets in the region – by the rise in euro area rates after the first round of the French presidential elections, most likely due to the shift in investor expectations on the future conduct of the ECB's monetary policy.

in bonds issued by emerging economies[41] (a context in which yields at regional level shrank as well during that period), and was possibly also influenced by the NBR's revision of the medium-term inflation forecast in May, as well as by the central bank's forward guidance.

Yields on 5-year bonds remained thereafter in the vicinity of their 6-month lows seen since end-May. By contrast, 10-year bond yields trended slightly upwards – whereas interest rates on similar securities in the US, euro area and in the region declined during that period – probably mirroring heightened uncertainties/risks associated with the outlook for the fiscal and income policies, also amid temporary tensions on the domestic political stage. In the closing days of June, the entire medium- to long-term segment of the yield curve witnessed a steeper upward adjustment, brought about – the same as in the case of regional yields – by the change in financial market expectations on the future conduct of the ECB's monetary policy. Reflecting all these developments, average monthly reference rates on the secondary market decreased in June versus March by 0.09 percentage points for the 6-month maturity, and by 0.42 percentage points and 0.22 percentage points for the 5-year and 10-year maturities respectively, so that the slope of the yield curve flattened slightly.

Looking at the primary market, the average accepted rates at the last auctions conducted in June fell below the end-Q1 levels across the entire maturity spectrum by values ranging between 0.17 percentage points for the 1-year maturity (to 0.80 percent) and 0.55 percentage points for the 5-year one (to 2.45 percent). The further rise in investor interest in government securities was also illustrated by the increase in the average demand-to-supply ratio against the previous three months – with this ratio standing higher in April and May and diminishing slightly in June –, as well as by the volume of securities issued accounting for 102 percent (up from 85 percent in 2017 Q1) of the pre-announced volume[42].

Chart 3.4. Bank rates



March through May 2017, the average remuneration of new time deposits from non-bank customers remained on a downward path, shedding 0.08 percentage points to 0.49 percent, the decline being manifest across both households (-0.09 percentage points to a new post-1990 low of 0.80 percent) and non-financial corporations (-0.04 percentage points to 0.33 percent). Conversely, the average lending rate on new business added another 0.36 percentage points (to 6.05 percent), although the advance reflected primarily the effect of changes in the composition of the credit flow (Chart 3.4). Specifically, looking

41 Temporarily dented in the first part of the month by the rise in geopolitical tensions.

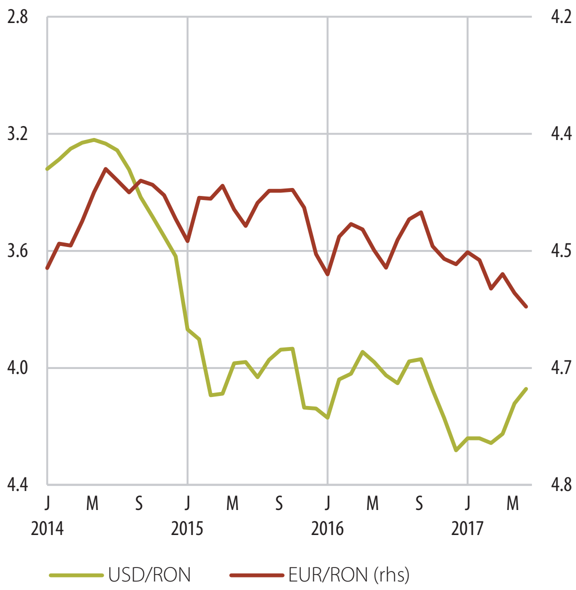
42 Moreover, at end-June, the MPF reopened the books on a EUR-denominated bond issue on the domestic market maturing in 2021, putting into circulation securities worth EUR 100 million at a 0.36 percent average rate (0.06 percentage points lower than the rate on the March 2017 issue for the same bond series).

at households, the wider share of new consumer loans was the sole driver of the rise in the average interest rate (+0.09 percentage points, to 7.23 percent in May 2017), considering that the interest rates on new consumer and housing loans decreased slightly. In turn, the average lending rate on new business to non-financial corporations went up 0.11 percentage points (to 4.02 percent), due to the marginal increase in the interest rate on new low-value loans (below EUR 1 million equivalent) and especially to their larger share in total corporate credit[43].

2.2. Exchange rate and capital flows

During 2017 Q2, the EUR/RON exchange rate followed an overall upward path, in relative contrast to the trajectory of the exchange rates of the other currencies in the region[44], mainly influenced by domestic developments/events, likely to have affected investor sentiment vis-à-vis the local economy and financial market (Chart 3.5).

Chart 3.5. Nominal exchange rate



Specifically, after fully reversing at the start of the quarter the rise seen in March, the EUR/RON re-embarked on an uptrend at the end of the first ten-day period in April, amid a new increase in global risk aversion[45]. Subsequently, the upward path persisted and occasionally even steepened, prompted by investor fears regarding the fiscal and income policy outlook – which resurfaced during this period also due to warnings from rating agencies[46] in April and from the EC and IMF[47] in May – as well as by the further widening of the trade deficit. Under these circumstances, local forex market developments were much less sensitive to the favourable influences on the international financial market following the results of the French presidential elections and the consolidation of the euro area economic recovery[48, 49],

[43] At the same time, the share of loans to non-financial corporations in the total credit flow narrowed.

[44] Including the Czech koruna, considering that the Czech National Bank decided on 6 April to discontinue the use of the exchange rate as a monetary policy instrument and, consequently, to exit from the commitment to maintain the exchange rate above EUR/CZK 27.

[45] Triggered by rising geopolitical tensions, amid the US attacks on Syria and escalating tensions between the US and North Korea.

[46] On 21 April, Moody's revised downwards the outlook for the sovereign rating (from positive to stable), signalling increasing risks associated with the fiscal and income policy outlook. Prior to this, in its assessment on 8 April, Standard & Poor's had confirmed Romania's rating with a stable outlook, signalling the high degree of uncertainty surrounding its fiscal projection.

[47] The EC highlighted in its spring forecast (11 May 2017) the significant risks to the fiscal projection induced by the draft unified wage law for the public sector, showing that it might lead to an increase in the budget deficit of up to 2 percent of GDP in 2018. At the same time, the IMF drew attention to the fiscal outlook in the staff report (published on 25 May 2017) that concluded the Article IV consultation with Romania.

[48] Economic growth in the euro area in 2017 Q1 confirmed expectations (0.5 percent quarterly rate, subsequently revised to 0.6 percent), and the PMI composite index remained at the 6-year high posted in the previous month, contrary to investor expectations of a slight decrease.

[49] Opposite influences came from the short-lived rise in financial market volatility in mid-May, amid political uncertainties in the US.

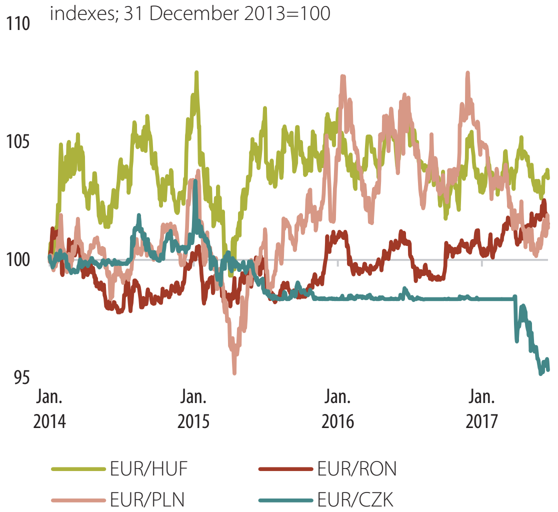
Table 3.1. Key financial account items

EUR million

	5 mos. 2016			5 mos. 2017		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	1,749	716	1,033	3,916	3,397	519
Direct investment	23	1,634	-1,611	137	1,569	-1,433
Portfolio investments	152	645	-493	351	2,219	-1,868
Financial derivatives	x	x	20	x	x	-42
Other investment	900	-1,563	2,463	1,785	-391	2,176
– currency and deposits	290	-1,673	1,963	1,247	-302	1,549
– loans	52	-18	69	72	-793	865
– other	557	128	430	465	704	-239
NBR's reserve assets, net	654	0	654	1,686	0	1,686

*) "+" increase/"-" decrease

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



Source: ECB, NBR

as well as to the new statistical data published in May, showing a significantly higher-than-expected GDP growth in 2017 Q1[50] and a quick rise in industrial output in March.

The increase in the EUR/RON exchange rate picked up in the second 10-day period of June[51], due to emerging financial markets – regional ones included – becoming less attractive following the Fed's meeting of 13-14 June, which invalidated investor expectations on the probable pace of monetary policy normalisation by the central bank of the United States, given that it kept the projected interest rate trajectory unchanged[52]; to this added domestic political tensions in mid-June, likely to have affected investors' risk perception of the local economy and financial market. However, the relatively fast easing of political tensions stopped the rise in the EUR/RON, also bringing about its downward adjustment towards the end of the quarter[53].

Against this background, the interbank forex market turnover picked up considerably in the last month of the quarter, especially due to non-residents' transactions (Table 3.1). At the same time, the quarterly balance of the market fell substantially deeper into negative territory, owing solely to non-residents' net demand for foreign currency, whose sizeable rise was offset only to a small extent by the return to positive territory of residents' net supply of foreign currency.

In 2017 Q2 as a whole, the leu weakened against the euro by 0.5 percent in nominal terms[54], yet it strengthened by 0.1 percent in real terms (Chart 3.6). However, the domestic currency appreciated versus the US dollar by 4.5 percent in nominal terms and 5.1 percent in real terms, given the relatively abrupt

50 5.7 percent in annual terms.

51 In this context, the EUR/RON reached a new 5-year high of 4.5987 on 21 June.

52 This implied a rise of 0.25 percentage points in the interest rate by the end of this year and three increases of similar magnitude in 2018.

53 Slightly opposite influences came from investors' expectations, shaped in this period, regarding an early start of monetary policy normalisation by the ECB, conducive to a relative reduction in the attractiveness of investments on financial markets in the region.

54 In the reported period, the Hungarian forint, the Polish zloty and the Czech koruna appreciated by 0.5 percent, 1.8 percent and 2.9 percent respectively versus the previous three months.

increase in the EUR/USD in this period, due to the decreased likelihood attached by investors to the prospective implementation of a substantial fiscal stimulus to the US economy, but also due to diminishing political uncertainties and an improved macroeconomic environment in the euro area. Looking at the average annual exchange rate dynamics, in 2017 Q2, the domestic currency saw its nominal depreciation increase versus the euro, but decrease slightly against the US dollar.

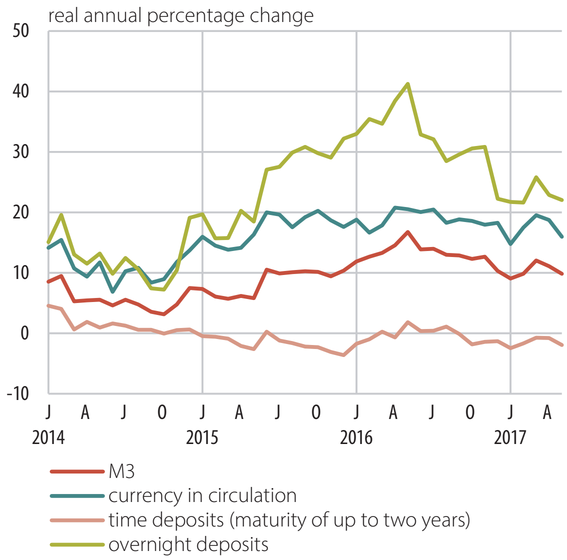
Table 3.2. Annual growth rates of M3 and its components

real percentage change

	2016			2017		
	II	III	IV	I	Apr.	May
	quarterly average growth					
M3	15.1	13.3	11.8	10.3	11.1	9.8
M1	31.6	26.4	24.7	21.2	21.6	20.1
Currency in circulation	20.5	19.2	18.3	17.3	18.8	16.0
Overnight deposits	37.5	30.1	27.9	23.1	22.9	22.1
Time deposits (maturity of up to two years)	0.5	0.5	-1.5	-1.6	-0.8	-2.0

Source: NIS, NBR

Chart 3.7. Main broad money components



Source: NIS, NBR

2.3. Money and credit

Money

The average growth rate[55] of broad money (M3) regained momentum March through May 2017 (11.0 percent versus 9.7 percent December 2016 through February 2017; Table 3.2), yet exclusively due to the significant rise witnessed in March, given the higher disbursements from EU funds[56].

From the perspective of M3 components, the main determinant of the level and pattern of the dynamics of M3 was narrow money, which, in its turn, grew at a significantly quicker pace in the first month of the period under review (23.8 percent, from an average of 20.3 percent in the previous three months) – owing to the faster dynamics of currency in circulation and especially of corporate overnight deposits –, followed, however, by slowdowns in the next months. The annual dynamics of time deposits with a maturity of up to two years also witnessed a slight rebound March through May 2017, yet remained in negative territory. Therefore, the share of narrow money in M3 continued to widen, reaching a new post-1994 high of 58.4 percent in May (Chart 3.7).

The M3 breakdown by holder reveals a renewed pick-up in the growth rate of corporate deposits in the first two months of the period – amid higher disbursements from EU funds and the launch of an initial public offering on the Romanian stock market[57] –, followed by a relative deceleration. The latter was solely determined

[55] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms March through May 2017.

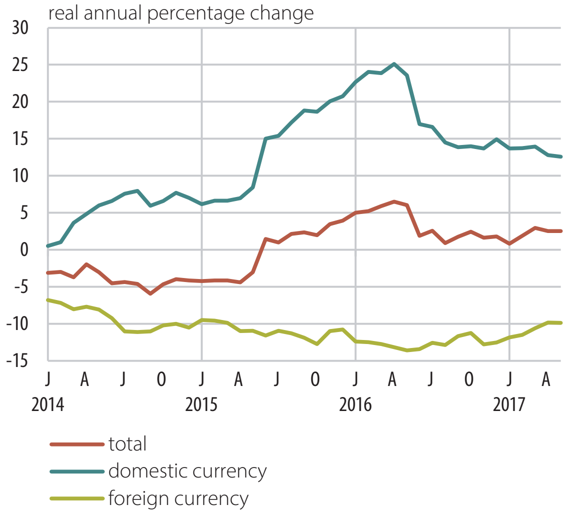
[56] Data on the portal of the Agency for Funding Rural Investment indicate increased disbursements to recipients of EU funds for agriculture. At the same time, according to budget execution data, the real annual growth rate of expenditure for projects financed from non-repayable external loans picked up considerably in March. However, the breakdown of these amounts by group of recipients is not possible.

[57] Digi Communications NV launched between 28 April and 10 May an initial public offering for shares from existing shareholders, in which resident and non-resident investors participated.

by non-monetary financial institutions, whereas the dynamics of non-financial corporations' deposits witnessed a steeper upward path in May, prompted by the faster increase in the amounts received from the government budget as subsidies, VAT returns and payments for goods and services[58]. In turn, the pace of increase of household M3 deposits stepped up in March, correlated with the larger amounts distributed to recipients of EU funds, but then lost momentum, most likely due to shifts away from money holdings towards other financial instruments (shares). However, the magnitude of this increase remained substantial for the post-2009 period, in line with the relatively high growth rates of income from wages and social benefits, as well as of remittances from abroad[59].

From the perspective of M3 counterparts, the faster dynamics of broad money primarily reflected the expansionary influences exerted, during the period as a whole, by developments in private sector credit and, in March, by the reduction in the rate of change of central government deposits[60]. An opposite impact came from banks' net foreign assets, which tended to grow more slowly in annual terms, and from long-term financial liabilities[61], whose annual decline tended to decelerate.

Chart 3.8. Credit to the private sector by currency



Source: NIS, NBR

Credit to the private sector

Loans to the private sector grew at a faster pace in annual terms[62] in the period from March to May 2017 (2.7 percent versus 1.5 percent in the previous three months; Chart 3.8), in this case as well owing to the swifter increase in March, as a result of the pick-up – to a record high for the past 2 years – in the dynamics of funding in the form of credit lines[63]. The rate of change of leu-denominated credit went slightly up in the first month of the period under review – prompted by the step-up in the growth rate of new loans, only partly offset by the relative rise in the volume of loans removed from banks' balance sheets –, before posting successive declines (13.1 percent on average in this period, as opposed to 14.1 percent in the previous three months). At the same time, the negative dynamics of foreign currency-denominated loans (expressed in euro) decelerated in March and April, reaching one-digit levels for the first time in three years. Given the difference between

58 In May, the budget execution generated a deficit of lei 3.5 billion, so that the general government budget ended the first five months of the year on a deficit of lei 2.2 billion (as opposed to lei 0.8 billion in the same year-ago period).

59 According to the provisional balance of payments data on workers' monthly remittances.

60 Banks' government security holdings also contributed to the higher M3 dynamics in the last two months of the period under review.

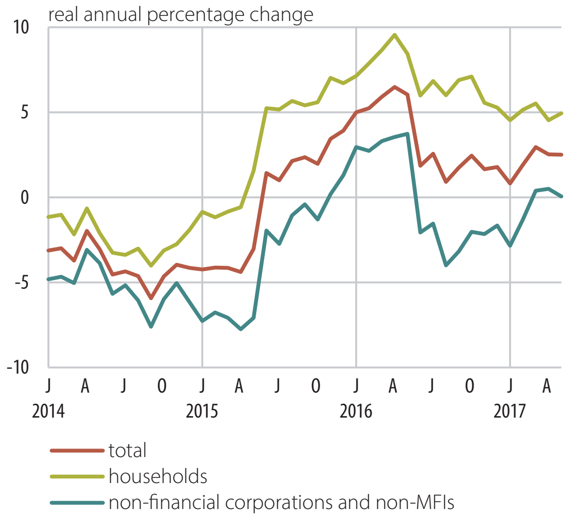
61 Capital accounts included.

62 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms March through May 2017.

63 This category includes overdraft loans, revolving loans, and credit card loans.

the dynamics of the two components, the share of leu-denominated loans in total credit continued to widen, ending the period at a post-1996 high of 59.3 percent.

Chart 3.9. Credit to the private sector by institutional sector



Source: NIS, NBR

Looking at the main types of recipients, the swifter average pace of increase was again ascribable to non-financial corporations. The main driver was the further step-up in the annual growth rate of the lei component, in a context where the very likely increase in loan demand, which occurred also due to ongoing low interest rates, was accompanied by credit terms and standards remaining broadly unchanged[64]. In turn, foreign currency-denominated credit (expressed in euro) to non-financial corporations posted a slower decline, amid developments in short-term loans.

By contrast, the average annual growth rate of household credit saw no change, with the pick-up in March being followed by a slowdown and then by a modest recovery (Chart 3.9). The annual dynamics of the lei component continued to decline in March and April, before rising slightly in May, amid the relative increase in new housing loans (on account of the "First Home" programme), but especially in consumer credit and other loans, as well as in credit card and overdraft loans[65]. In its turn, foreign currency-denominated credit (expressed in euro) to households posted less negative dynamics, mostly due to consumer credit and other loans.

64 See the NBR's May 2017 *Bank Lending Survey*.

65 According to the same survey, demand for consumer and housing loans was expected to continue to rise in 2017 Q2, accompanied however by a renewed tightening of related credit standards.

4. Inflation outlook

The annual CPI inflation rate is seen on the rise throughout the forecast interval, to 1.9 percent at end-2017, 3.2 percent at end-2018 and 3.5 percent at the projection horizon, i.e. mid-2019. Behind the upward path in the annual inflation rate stand the build-up of domestic inflationary pressures affecting mainly core inflation, as well as the fading-out, at the beginning of 2018, of first-round statistical effects exerted by indirect tax cuts in January 2017 and the scrapping of a number of non-tax fees and charges in February 2017. Calculated at constant tax rates, annual CPI inflation is seen reaching 2.9 percent at the end of this year, a level in the upper half of the variation band of the target. For the end of next year and the forecast horizon, tax changes are no longer seen contributing significantly to consumer price dynamics. Core inflation is expected to climb at a fast pace mainly due to the build-up of inflationary pressures exerted by the envisaged rise in aggregate excess demand, amid the expansionary fiscal stance, higher disposable income and the stimulative nature of real broad monetary conditions and, against this backdrop, due to stronger inflation expectations of economic agents. The balance of risks to the annual inflation rate projection is assessed to be tilted to the upside compared to the path in the baseline scenario, with risk sources being linked chiefly to the domestic landscape.

1. Baseline scenario

1.1. External assumptions

Over the projection interval, external demand, assessed on the basis of the effective EU GDP (EU-28 excluding Romania), will increase at annual rates close to 2 percent, posting slightly higher-than-previously-expected levels (Table 4.1). Global economic growth, fuelled mostly by strengthening economic activity in major emerging economies, is seen boosting exports, while the persistently accommodative monetary policy pursued by the ECB and improvements in labour market conditions will further underpin domestic demand in the euro area, the key driver of recovery in economic activity. Nevertheless, the effective EU GDP is not seen rising at a faster pace next year, amid the incomplete implementation of structural reforms. External demand gap is expected to remain negative until the end of the current year, before turning positive and opening gradually until the forecast horizon, thus contributing to the pick-up in economic activity domestically.

Table 4.1. Expectations on the developments in external variables

annual averages

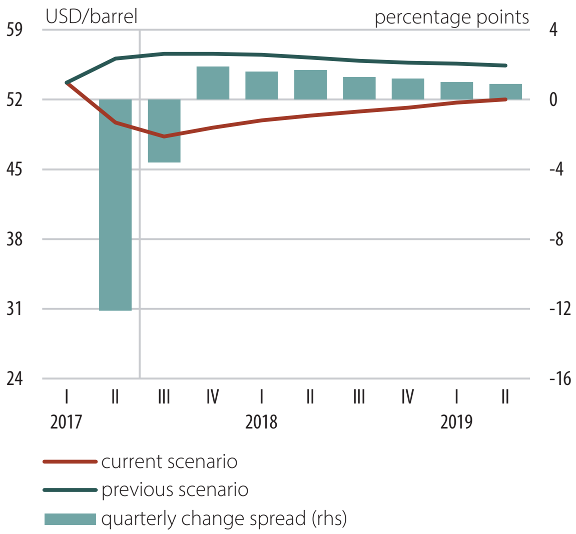
	2017	2018
Effective EU economic growth (%)	2.1	2.0
Annual inflation rate in the euro area (%)	1.6	1.4
Annual CPI inflation rate in the USA (%)	2.3	2.2
3M EURIBOR (% per annum)	-0.3	-0.2
USD/EUR exchange rate	1.10	1.12
Brent Oil price (USD/barrel)	50.2	50.6

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

The average annual HICP inflation rate in the euro area is forecasted to stand at 1.6 percent in 2017 and 1.4 percent in 2018, relatively similar to the values in the previous *Report*, and therefore remain below the ECB's 2 percent benchmark. For this year, behind these developments stand chiefly the dynamics of energy prices, reflecting the recent slower growth rates of oil prices, but subsequently wage costs, underpinned by improvements in labour market conditions, are seen becoming the major determinant. Annual inflation rate in the USA is foreseen to run higher than in the euro area and slightly above the 2 percent level.

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

Chart 4.1. Brent oil price scenario



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

The EUR/USD exchange rate is envisaged to remain stable during the first half of the projection interval, before the euro strengthens marginally until the forecast horizon.

The scenario for the international Brent oil price is based on futures prices and foresees an uptrend throughout the projection interval, hitting USD 52 per barrel at the forecast horizon. Projected values run below those in the previous *Report*, as a result of persistently high inventories and despite recent decisions on cutting production[66] (Chart 4.1). The outlook for the oil price is further uncertainty-ridden, as mirrored by the revised trajectories implied by futures prices in the successive projection rounds. The future dynamics of oil prices are conditional on both supply-side factors (conventional production practices in OPEC members and some non-OPEC countries and unconventional production methods in the USA) and demand-side factors (consumption at global level, particularly in China, India and Germany).

Table 4.2. The annual inflation rate in the baseline scenario

annual percentage change; end of period

	2017		2018				2019	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	1.6	1.9	3.0	3.1	3.0	3.2	3.6	3.5
CPI projection*	2.5	2.9	2.9	3.1	3.0	3.2	3.5	3.4

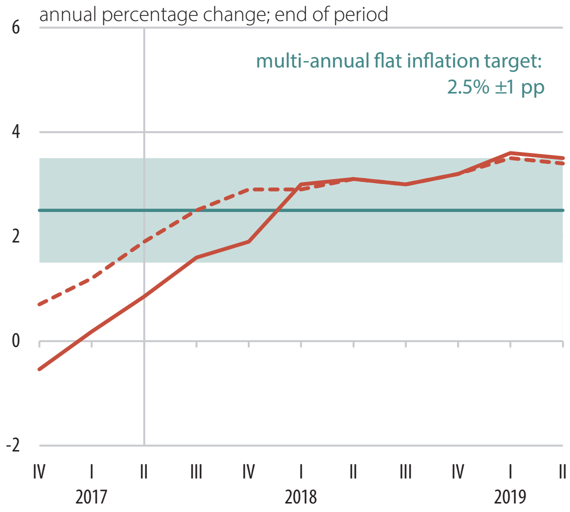
*) calculated at constant tax rates

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 1.9 percent at end-2017 and 3.2 percent at end-2018, these values being inside the ±1 percentage point variation band of the 2.5 percent flat target. At the projection horizon, i.e. 2019 Q2, the forecasted rate will reach the upper bound of the

[66] Since the release of the May 2017 *Inflation Report*, a number of meetings took place between OPEC members and other non-OPEC oil-producing countries (on 25 May 2017 and 24 July 2017), which ended with decisions on enhanced monitoring of compliance with the OPEC agreement on oil output reduction and its extension until end-March 2018.

Chart 4.2. Inflation forecast

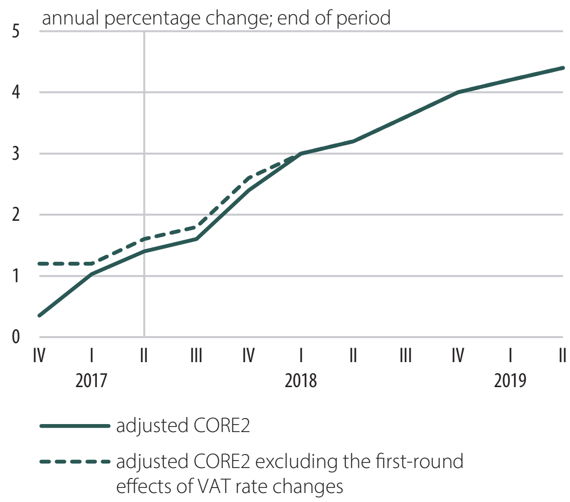


Source: NIS, NBR projection

above-mentioned band, i.e. 3.5 percent (Table 4.2; Chart 4.2). The upward trend in this indicator is largely attributed to the build-up of domestic inflationary pressures affecting mainly core inflation and the fading-out, at the beginning of 2018, of first-round statistical effects exerted by indirect tax cuts in January 2017 and the scrapping of a number of non-tax fees and charges in February 2017. Annual CPI inflation rate recalculated at constant tax rates is foreseen standing at 2.9 percent at the end of this year, 3.2 percent at the end of next year and 3.4 percent in 2019 Q2, all levels being in the upper half of the band.

Relative to the previous *Inflation Report*, the projected annual CPI inflation rate was revised upwards by 0.3 percentage points for end-2017, on the back of contributions from all CPI basket components, except fuels, which exert an opposite effect, and by 0.1 percentage points for end-2018, amid the expected swifter annual dynamics of the adjusted CORE2 index and fuel prices.

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



Source: NIS, NBR projection

The annual adjusted CORE2 inflation rate will follow an uptrend during the 8-quarter projection interval to reach levels above the upper bound of the variation band of the target starting 2018 H2, owing chiefly to the build-up of inflationary pressures stemming from domestic fundamentals (Chart 4.3). Specifically, the rise in excess demand in the economy, amid the expansionary fiscal stance and higher disposable income[67], as well as stimulative real monetary conditions and, in this context, the increase in inflation expectations of economic agents, is set to have a significant contribution to the faster pace of core inflation. An additional inflationary impact is envisaged to come from the rise in domestic producer prices, given the projected persistence of strong pressures from unit wage costs. Driven by external price dynamics, the expected developments in imported goods prices will have significantly lower, and diminishing over the forecast interval, contributions to inflation. The fading-out, in January 2018, of the first-round statistical effect exerted by the standard VAT rate cut on 1 January 2017 is seen to add approximately 0.2 percentage points to core inflation (Table 4.3).

[67] Following the repeated hikes in public-sector wage, its average level advanced by roughly 54 percent over the past two years, running significantly higher than the private sector wage. Since these rises occurred mostly in the non-tradable sector, they are expected to put pressure on domestic prices also via the Balassa-Samuelson effect.

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

annual percentage change; end of period

	2017		2018				2019	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Adjusted CORE2	1.6	2.4	3.0	3.2	3.6	4.0	4.2	4.4
Adjusted CORE2*	1.8	2.6	3.0	3.2	3.6	4.0	4.2	4.4

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

Table 4.4. Components' contribution to annual inflation rate*

percentage points

	2017	2018
Administered prices	0.2	0.4
Fuels	-0.4	0.2
VFE prices	0.5	0.2
Adjusted CORE2	1.4	2.3
Tobacco and alcoholic beverages	0.2	0.1

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

Compared to the previous *Inflation Report*, the projected annual adjusted CORE2 inflation rate was revised upwards by 0.3 percentage points and 0.1 percentage points at end-2017 and end-2018 respectively, especially in the context of faster-than-previously-anticipated increases in production costs, whose pass-through into consumer prices is expected to also be fostered by stronger excess demand over the entire projection interval. Furthermore, larger contributions from inflation expectations are also envisaged, especially via their backward-looking component.

The cumulative contribution of components exogenous to the monetary policy influence, namely administered prices, prices of volatile food items (VFE), fuel prices and tobacco product and alcohol prices, to the annual CPI inflation rate is 0.5 percentage points at the end of 2017 and 0.9 percentage points at the end of 2018, being revised upwards by 0.2 percentage points and 0.1 percentage points respectively versus the previous *Report* (Table 4.4).

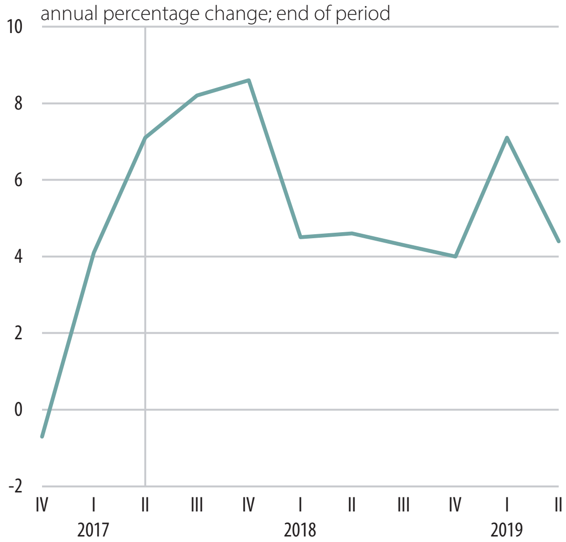
The annual dynamics of volatile food (VFE) prices are projected to stand at 8.6 percent at the end of 2017, being revised upwards by 1.5 percentage points amid adverse weather conditions that hit citrus and other Southern fruit crops in Europe early this year, and at 4.0 percent at the end of 2018, a level revised marginally downwards by 0.1 percentage points (Chart 4.4). The growth path of these prices over the forecast interval is based on the assumption of normal agricultural years in 2017 and 2018, although a more abundant harvest is not excluded, given the recently available information.

According to the exogenous scenario for administered prices, their growth rate is anticipated at 0.8 percent at end-2017 and 2.3 percent at end-2018 (Chart 4.5). The projected path is shaped under the assumption of furthering and completing the electricity price liberalisation by the end of this year, being influenced by the measure of scrapping a number of non-tax fees and charges starting February 2017, which is embedded in the annual rate for as long as one year. Compared to the previous forecasting round, only the value for 2017 was adjusted upwards by 0.7 percentage points, following the reassessment of assumptions on electricity price dynamics, particularly in view of developments seen in July[68].

[68] A decrease of 5.16 percent in regulated prices applied to households and an increase of 8.53 percent in competitive market component prices. For further details, see the Romanian Energy Regulatory Authority press release of 23 June 2017 available at: http://www.anre.ro/ro/presa/comunicate/comunicat-23-06-2017-privind-sedinta-comitetului-de-reglementare-al-anre-din-22-06-2017.

Chart 4.4. VFE prices annual inflation

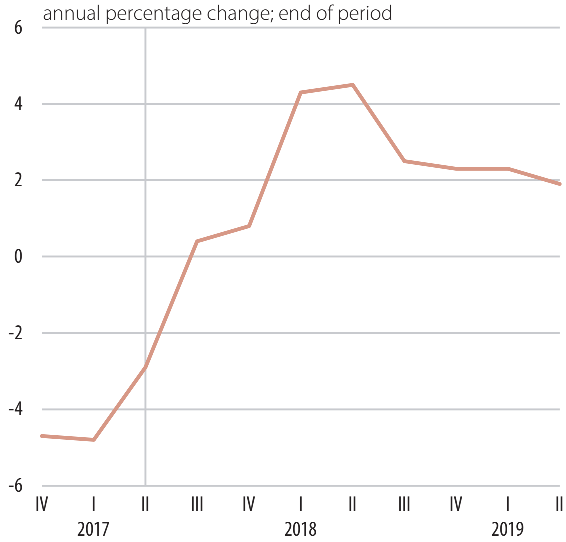
annual percentage change; end of period



Source: NIS, NBR projection

Chart 4.5. Administered prices annual inflation

annual percentage change; end of period

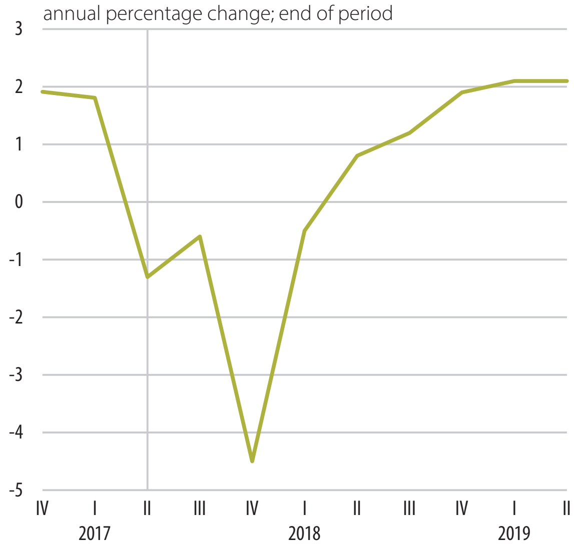


Source: NIS, NBR projection

The annual inflation rate of fuel prices is projected to reach -4.5 percent in December 2017 and 1.9 percent in December 2018, values revised against the previous projection downwards by 2.5 percentage points and upwards by 0.9 percentage points respectively (Chart 4.6). Similarly to the previous forecast, this year's path is marked by the standard VAT rate cut to 19 percent, from 20 percent, and the scrapping of the special excise duty on fuels, both measures being implemented in January 2017 and having a transitory, one-year effect. Compared to the previous forecasting round, the downward revision for this year-end occurs amid slower annual dynamics of the oil price and a projection of the euro at more appreciated values against the US dollar, impacting the leu-denominated oil price via the USD/RON exchange rate. For the end of 2018, the reassessment is associated with a brisker annual pace of increase of crude oil prices anticipated at this horizon.

Chart 4.6. Fuel prices annual inflation

annual percentage change; end of period



Source: NIS, NBR projection

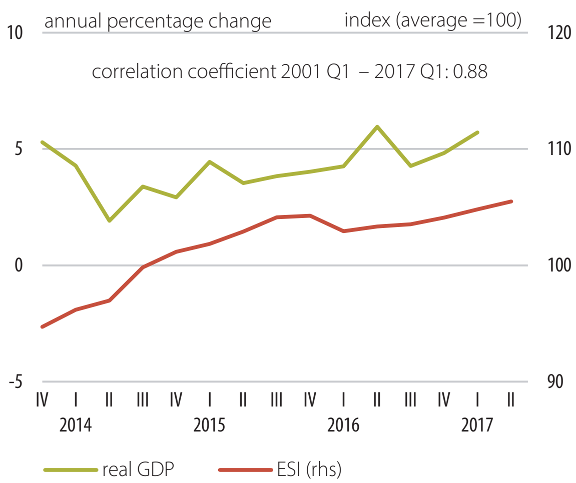
Annual dynamics projected for tobacco products and alcoholic beverages is shaped by the pieces of legislation setting the levels of excise duties on such goods, being affected by the standard VAT rate cut in January 2017, the hike in specific excise duties in January and July 2017, and the increase envisaged for April 2018. For this year, the projected level of 2.4 percent is 2.2 percentage points higher than that in the previous *Report*, amid the uplift in the excise duty levied on tobacco products in July 2017 (the total excise per 1,000 cigarettes was raised from lei 435.58 to lei 439.94). For next year, their dynamics were revised only marginally upwards, by 0.1 percentage points to 0.9 percent.

1.3. Demand pressures in the current period and over the projection interval[69]

Output gap

In 2017 Q1, real GDP rose by 1.7 percent[70] versus the previous quarter, and by 5.7 percent compared with the same year-ago period. For 2017 Q2 and Q3, 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 (for instance, the turnover volume of retail trade, excluding motor vehicles and motorcycles, the industrial production, and the economic sentiment indicator – Chart 4.7)[71]. To these add the prospects for favourable developments in external demand, and also the stimulative impact of the fiscal and income policy stance. In this context, the quarterly GDP growth is anticipated to be further driven by domestic demand, while the contribution of net exports is expected to remain negative on account of imports, fuelled by developments in domestic absorption, as well as in exports.

Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

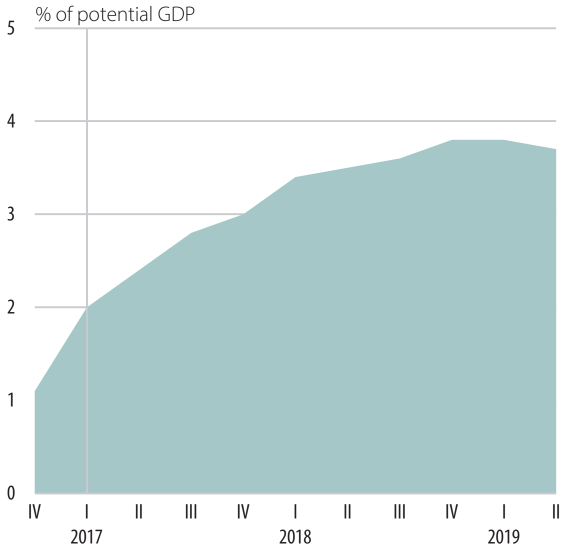
Over the forecast interval, potential GDP growth is projected to pick up slightly. Labour is seen to have an improved contribution, mainly on account of an expected favourable trend in the activity rate of working-age population (despite its multi-annual decline), as a result of the rising number of employed persons economy-wide in the context of the positive economic outlook. Capital stock accumulation mirrors the strongly negative dynamics of gross fixed capital formation (GFCF) in 2016, but also the latter's rebound as of 2017 Q1. The upward trend in total factor productivity is associated with the persistent effects of the stepped-up activity in some high value-added sectors (services, as well as ICT) or in sectors investing in automated product lines (for example, trade or automotive industry) in response to the rise in domestic consumption and also in export orders. Adverse influences on the trend in total productivity factors stem from the still modest allocation of resources that meet the need for technological investments and training, also amid low absorption of EU structural and cohesion funds compared to the previous years.

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

[70] NIS Press Release No. 171 of 7 July 2017.

[71] Compared to the 2017 Q1 average, the first two above-mentioned indicators increased by 3.8 percent and 4.6 percent respectively in April-May 2017. The economic sentiment indicator went up 0.7 points in 2017 Q2, on the back of services and trade.

Chart 4.8. Output gap



Source: NBR calculations based on NIS data

The positive output gap is projected to widen over the forecast interval (Chart 4.8), indicating stronger inflationary pressures from aggregate demand[72]. Excess demand dynamics mirror: (i) developments in the real disposable income, underpinned by the impact of fiscal easing and income policy measures; (ii) the stimulative set of real broad monetary conditions (on the wane over the projection interval), as well as (iii) the closing and shifting to positive territory (during 2018) of the external demand gap. Compared to the May 2017 *Inflation Report*, the output gap is wider throughout the forecast interval, resulting in the revision of the discretionary component of the fiscal and income policy stance (structural deficit) to more stimulative values. The revision of the output gap reflects mainly the higher-than-expected GDP growth in 2017 Q1. From the perspective of aggregate demand components, the output gap is projected to widen on account of the larger consumption gap and of the GFCF gap entering positive territory in the latter half of 2017. In turn, the gaps of exports and imports of goods and services are assessed at positive values, yet having a negative net contribution to the output gap. The assessment of the output gap and of the gaps of GDP components is surrounded by a degree of uncertainty depending on the frequency and size of the revisions of historical series, and also on their volatility (in this respect, the GFCF seasonally adjusted historical series deserves mention).

Compared to the 2016 reading, in 2017 economic growth is projected to record a faster pace and exceed 5 percent, before witnessing a slowdown in 2018, due to a less strong impact of the discretionary component of fiscal policy (i.e. the fiscal impulse). Domestic demand is seen to remain the driver of economic growth, owing primarily to private consumption and, to a lesser extent, to GFCF. The advance in domestic demand is anticipated to fuel imports of goods and services to rise faster than exports and, although the latter's dynamics are expected to be extremely favourable in 2017 as a whole, the contribution of net exports to GDP growth is forecasted to be negative.

Aggregate demand components

In 2017 Q1, the actual final consumption increased at a rapid pace (+4.1 percent versus the previous quarter), pushing its annual growth rate further up to 6.7 percent[73]. For 2017 Q2 and Q3, the forecast points to the quarterly dynamics of this aggregate demand component remaining in positive territory, albeit at lower levels. The step-up in this component is driven by the real disposable income of households, despite mixed signals regarding the latter's financing sources. Specifically, the

[72] Recent evidence points to a weaker pass-through of inflationary pressures associated with domestic aggregate demand into core inflation – for more details, see Box 2 in the May 2017 *Inflation Report*.

[73] For details on drivers of GDP components in 2017 Q1, see Chapter 2, Section 1. Demand and supply.

average net wage economy-wide went up in real terms by merely 0.7 percent April through May; by contrast, the stock of consumer credit to households expanded by 1.2 percent in 2017 Q2, in line with expectations[74]. In parallel, during the same interval, most subcomponents of the consumer confidence indicator (employment, general economic context and financial situation) ran at lower levels compared to the previous quarter readings.

In 2017 as a whole, the actual final consumption is forecasted to further step up its pace of increase, before witnessing a relative slowdown over the next year. The projected trajectory mirrors the anticipated dynamics of households' real disposable income, given the fiscal easing and public wage policy measures, as well as the pay rises expected to be awarded amid ongoing labour market tightening, but against the background of the projected increase in the annual CPI inflation rate throughout the forecast interval.

The quarterly dynamics of gross fixed capital formation (GFCF) returned to positive values (+3.0 percent) in 2017 Q1 and are expected to remain in positive territory, but to witness a slowdown over the next two quarters. The forecast is based on the dynamics of industrial output of capital goods, which are partly offset, however, by developments in construction volume, for instance (compared to the 2017 Q1 average, the rates of change of the said indicators stood at 2.7 percent and -5.0 percent respectively in April-May). The confidence indicator in industry worsened (-0.8 points in 2017 Q2 versus the previous quarter), on account of both the level of orders and the prospects of output over the next three months.

GFCF is expected to increase in both 2017 and 2018, with a number of factors further weighing, however, on its dynamics. The projection mirrors capital investments that accompanied the remarkable developments in industrial output witnessed in 2017 H1 (for example, in sub-sectors such as the manufacture of motor parts and related products), as well as prospects of higher direct investment flows (in the context of favourable forecasts of economic activity domestically and in the main countries of origin[75]), which support investment programmes. Nevertheless, the dynamics of these flows could be affected by one-off factors, such as the poor absorption of EU funds for investment, reflecting delays in the absorption of funds for the 2014-2020 financial framework, or by structural factors, e.g. the quality of infrastructure or the skilled labour shortage.

In 2017 Q1, exports of goods and services increased by 4.4 percent quarter on quarter. The forecast for the next two quarters shows this component to record positive quarterly growth rates, given the prospects on the continuing recovery of external demand[76].

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[74] The May 2017 NBR *Bank Lending Survey* anticipated a higher demand for consumer credit to households, despite tightening credit standards on these loans.

[75] The main countries of origin of foreign direct investment flows are euro area developed economies (i.e. the Netherlands, Austria, Germany, Cyprus, France and Italy), where capital yields are generally less attractive than in emerging economies, Romania included.

[76] For further details, see Chapter 4, Section 1.1. External assumptions.

Over the remainder of the forecast interval, exports of goods and services are anticipated to rise further, mirroring, on the one hand, the expected improvement in external demand and in sales reported by sectors integrated in global value added chains (such as the manufacture of transport equipment and related sub-sectors), as well as the stimulative influence of the real exchange rate (albeit gradually diminishing towards the end of the projection interval), and, on the other hand, the swift dynamics of domestic unit labour costs, with an unfavourable impact on price competitiveness of the Romanian products for external markets.

Rises in domestic absorption and exports led imports of goods and services to increase significantly in 2017 Q1 (+4.8 percent versus 2016 Q4). Over the projection interval, imports of goods and services are seen further expanding at a faster pace than exports, against the background of the advance in domestic demand. In this context, net exports are anticipated to make a negative contribution to GDP growth over the entire projection interval.

In 2017 Q1, the balance-of-payments current account deficit continued its widening trend[77], on account of the larger deficit on trade in goods, as well as of the shift to negative territory of the balance on secondary income associated with the "General government" component (primarily as a result of contributions to the EU budget exceeding EU funds raised). The current account deficit is expected to widen further, largely reflecting the dynamics of imports of goods and services, underpinned by the advance in domestic demand, before posting values around 3.4 percent of GDP over the medium term. At the same time, the current account deficit financing is anticipated to come mainly from stable and non-debt-creating capital flows – foreign direct investment and capital transfers associated with EU structural and investment funds –, but their share is foreseen to narrow in 2017 and 2018, given the expected decline in EU funds absorption rate. Nevertheless, the widening of the current account deficit due to the speed-up in consumption and the larger budget deficit carries the potential to jeopardise macroeconomic equilibria, with a direct impact on capital flows channelled towards the Romanian economy.

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[78] 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[79].

In 2017 Q2, the average nominal interest rate applied by credit institutions on new time deposits in relation to non-bank clients is forecasted to remain close to its previous quarter reading before witnessing an increase in 2017 Q3. During the same

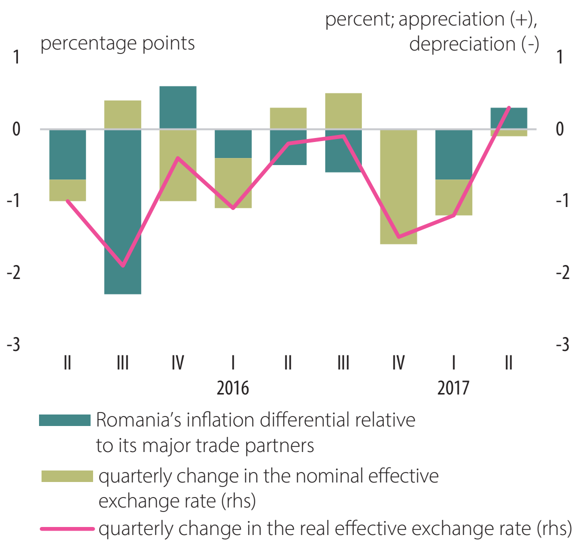
77 In 2017 Q1, the current account deficit-to-GDP ratio stood at 2.6 percent (4-quarter cumulative data), compared with 2.3 percent in 2016 and 1.2 percent in 2015 respectively.

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

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

interval, the average nominal interest rate on new loans is projected to rise, mainly on account of historical developments witnessed in May 2017, whereas for Q3 it is anticipated to remain near the previous quarter readings. For 2017 Q2 and Q3, the adjusted real interest rates 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 Q2, the domestic currency witnessed a marginal depreciation in nominal effective terms versus the previous quarter, its weakening versus the euro being almost entirely offset by its strengthening against the US dollar. However, the leu appreciated in real effective terms, owing to a higher quarterly domestic inflation than that reported by Romania's trading partners (Chart 4.9). Overall, the real effective exchange rate is estimated to have a softer stimulative impact on the economic activity in the periods ahead.

The wealth and balance sheet effect in 2017 Q2 and Q3 continues to exert 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). Romania's risk premium, approximated based on the option adjusted spread (OAS), declined marginally in 2017 Q2. The medium-term prospects for the risk premium are influenced by domestic factors, related to the fiscal and income policy stance, as well as by global factors, stemming from the unfolding of the Brexit talks or from the potential deviations of the ECB's and Fed's monetary policies from the trajectories currently expected by financial markets.

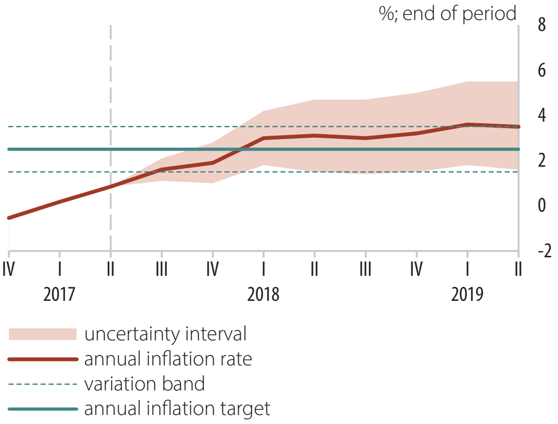
Overall, in 2017 Q2 and Q3, real broad monetary conditions are assessed to exert a stimulative impact on aggregate demand in the following quarters, mainly due to the real effective exchange rate (via the export price competitiveness channel), and also, to a lesser extent, to the other components.

Over the forecast interval, real broad monetary conditions are anticipated to further exert a stimulative impact on economic activity (albeit on the wane almost throughout the projection). A significant contribution is associated with an undervalued real effective exchange rate, especially in the first part of the interval, but also with the wealth and balance sheet effect, given the ECB's stimulative monetary policy. 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

Although one of the risk sources mentioned in the previous *Inflation Report* saw a relative alleviation after the President of Romania promulgated Framework Law No. 153/2017 on wages for staff paid from public funds[80] on 28 June 2017, the balance of risks to the annual inflation rate outlook continues to be assessed as being tilted to the upside compared to its path in the baseline scenario. The fiscal and income policy stances pose the main risks likely to lead to higher-than-forecasted inflation rates (Chart 4.10).

Chart 4.10. Uncertainty interval associated with inflation projection in the baseline scenario



Note: The uncertainty interval was calculated based on the annual CPI inflation forecast errors in the NBR projections during 2005-2016. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

Thus, uncertainties persist around the manner of implementing the mentioned law as concerns the timing of wage rises and the related conditionality criteria, as well as around the possible set of compensation measures aimed, according to the authorities, at keeping the budget deficit within the 3 percent-of-GDP reference value. Moreover, the new legislative initiatives specified in the Government Programme or publicly referred to concerning taxation, new hikes in wages and social payments, as well as the likely adoption of corrective fiscal measures for keeping the budget deficit within the envisaged targets, carry the potential to generate heightened uncertainties and pose two-way risks to the medium-term inflation forecast. These are enhanced by the absence, at the projection cut-off date, of any clear information on the final form of these measures and the related implementation calendar. The relevance of these risks is even higher in the context of sluggish public investment, with an impact on the economic growth potential – given *inter alia* the delays in the absorption of EU structural and investment funds – and on the competitiveness of the Romanian economy, also negatively affected by the prospects of a growing mismatch between wage hikes and labour productivity dynamics. In the event of a deterioration in macroeconomic equilibria, foreign investors' risk perception is expected to be adversely impacted, with implications on stable capital flows channelled to the Romanian economy, and therefore on the financing of the current account deficit and the evolution of the domestic currency.

For the reference period, despite the recent abatement of global tensions and political risks associated with the euro area election schedule, heightened uncertainties persist with regard to external environment. They relate particularly to the effects that Brexit negotiations, the economic policies pursued by the US Administration and the monetary policy stances of the Fed and the ECB will have on the global macroeconomic coordinates. At the same time, the future evolution of economic activity in China and other major emerging economies is also relevant, in light of its

[80] The version promulgated by the President is the one adopted by the Chamber of Deputies on 7 June 2017.

impact on economic growth. The materialisation of some of these risks could have unfavourable effects, which would pass through primarily via indirect channels into Romania's economy, namely via trade partners' external demand. At the same time, through the unfavourable consequences on investors' confidence and the rise in global risk aversion, some developments could trigger portfolio shifts regionally and/or globally and thus affect the future path of the leu exchange rate and implicitly the projected inflation rate. For these reasons, it is necessary to maintain a balanced domestic policy mix that would ensure the resilience of the economy when confronted with possible turbulences.

Moreover, given the increasingly significant presence of global value chains, especially large retailers, and the higher contribution from imported goods to covering domestic consumption, which is foreseen to rise amid, *inter alia*, fiscal and wage stimuli, the relatively low price increases worldwide, in general, and in the EU, in particular, are a relevant source of risks to the projected inflation rate in the baseline scenario, carrying the potential to generate downward deviations from the forecasted path.

Upside risks to the inflation outlook are associated with administered prices, both in the context of recent developments in the electricity market and the persistence, in the absence of any clear information from the relevant authorities, of uncertainties about the size and timing of future adjustments in natural gas and electricity prices. Volatile food prices are marked by inherent uncertainties associated with the impact of weather conditions on the supply of agricultural produce, both domestically and internationally.

The balance of risks posed by international commodity prices (energy prices in particular) is assessed to be in equilibrium. Uncertainties still linger, however, over the impact on future crude oil prices of the large oil inventories worldwide, which have the potential to counter the effects of the agreement to extend oil supply cuts, in which both OPEC and some non-OPEC countries take part.

Abbreviations

CPI	consumer price index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
EU	European Union
Eurostat	Statistical Office of the European Union
FAO	Food and Agricultural Organization of the United Nations
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	industrial producer price index
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NIS	National Institute of Statistics
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of the Petroleum Exporting Countries
ROBOR	Romanian Interbank Offer Rate
UVI	unit value index
VAT	value added tax
VFE	vegetables, fruit, eggs

Tables

Charts