NATIONAL BANK OF ROMANIA

Inflation Report

November 2018

Year XIV, No. 54

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NOTES

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 6 November 2018 and the cut-off date for the data underlying the macroeconomic projection was 31 October 2018.

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

After having reached a 5-year high in 2018 Q2, the annual inflation rate saw, as expected, a halt in its upward trend, falling to 5 percent in September, i.e. 0.15 percentage points above the benchmark forecast in the August 2018 *Inflation Report* and 1.5 percentage points above the upper bound of the ±1 percentage point variation band of the 2.5 percent flat target. The deceleration in the annual inflation rate during 2018 Q3 owed to both the exogenous components and the adjusted CORE2 inflation, mainly as a result of a strong base effect, as 2017 Q3 had witnessed an array of inflationary shocks. The only notable upward influences on the annual inflation rate in 2018 Q3 were exerted by the prices of vegetables, affected by weather conditions, and those of natural gas, under the impact of prices on the domestic competitive market. At the same time, the average annual CPI inflation rate continued to rise to 4.5 percent in September, up 0.9 percentage points versus June. The average annual HICP inflation rate followed a similar path, adding 0.9 percentage points from 2.9 percent in June to 3.8 percent in September. The differential versus the EU average expanded to a 5-year high of 2 percentage points.

The annual adjusted CORE2 inflation rate continued on a downward trajectory to 2.7 percent in September from 2.9 percent in June. Processed food made once again a decisive contribution, as inflationary shocks associated with supply issues in 2017 dropped out of the annual comparison and no significant pressures occurred on this segment in the current period. Moreover, part of the fundamental factors stood behind the favourable dynamics of core inflation during this quarter. Thus, the domestic currency appreciated slightly against the euro, while wage earnings posted a slower increase in annual terms. At the same time, excess demand continued to grow, albeit at a slower pace, while inflation expectations of both analysts and economic agents remained elevated, with the latter undergoing, however, a slight correction. Under the circumstances, despite the slowdown seen during the quarter under review, latent inflationary pressures associated with the adjusted CORE2 index continue to persist.

In 2018 Q2, unit labour costs economy-wide posted an annual growth rate similar to that in Q1 (15.6 percent), with the faster dynamics of the compensation of employees being offset by productivity gains. By contrast, in industry, the developments in unit wage costs saw fluctuations, with the acceleration to 6.5 percent in Q2 being followed by a wider correction to 4.6 percent in July-August amid the advance in production. Further highly relevant to the dynamics of the two indicators is the persistence of structural constraints, especially those relative to the quantitative and qualitative labour market mismatches, the annual growth rate of the number of employees nearing zero in industry. Thus, even without accelerating any further, the persistence of a significant growth rate of unit labour costs is indicative of an ongoing build-up of adverse pressures on the competitive position of the economy.

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

In its meeting of 6 August 2018, the NBR Board decided to keep the monetary policy rate at 2.5 percent per annum and leave unchanged the deposit facility rate and the lending facility rate at 1.5 percent and 3.5 percent per annum respectively. The annual CPI inflation rate stopped increasing in June, when it stalled at 5.4 percent, above the variation band of the inflation target. The stagnation occurred as the faster increase, in annual terms, in fuel prices and the prices of vegetables and fruits was offset by the slower dynamics of tobacco product prices. In turn, the annual adjusted CORE2 inflation rate continued to decline marginally to 2.9 percent in June from 2.99 percent in the previous month and 3.05 percent in March. This was driven by the processed food and services segments, under the influence of movements in international prices of some agri-food items and in the EUR/RON exchange rate. The latest forecast reconfirmed the outlook for the annual inflation rate to return, at the end of 2018, to the vicinity of the upper bound of the variation band of the target.

The uncertainties and risks associated with the inflation outlook stemmed mainly from the developments in administered prices (gas and electricity) and the prices of food items, as well as from labour market conditions and the fiscal policy stance. Further relevant were also the future developments in the international oil price, the economic growth rate and the dynamics of inflation in the euro area and the EU, and implicitly, the monetary policy stance of the ECB and the central banks in the region.

Subsequently, statistical data confirmed the evolution of the annual CPI inflation rate for the first two months of Q3 overall as being in line with expectations. Thus, the indicator fell to 4.56 percent in July 2018 and then reached 5.06 percent in August. Once again the drivers behind this were the influence of supply-side factors and some base effects with an impact on the slowdown of the growth rates of administered prices and fuel prices. The annual adjusted CORE2 inflation rate dropped slightly to 2.8 percent in August, after having reached 2.9 percent in July, amid the developments in the prices of processed food items and services. Provisional data indicated a slight re-acceleration, in annual terms, of economic growth in 2018 Q2 to 4.1 percent from 4.0 percent in the previous quarter, with household consumption remaining the main growth engine. The contribution of net exports to GDP growth, although further unfavourable, improved slightly compared to the previous quarter amid a more visible deceleration in the growth rate of imports than in that of exports.

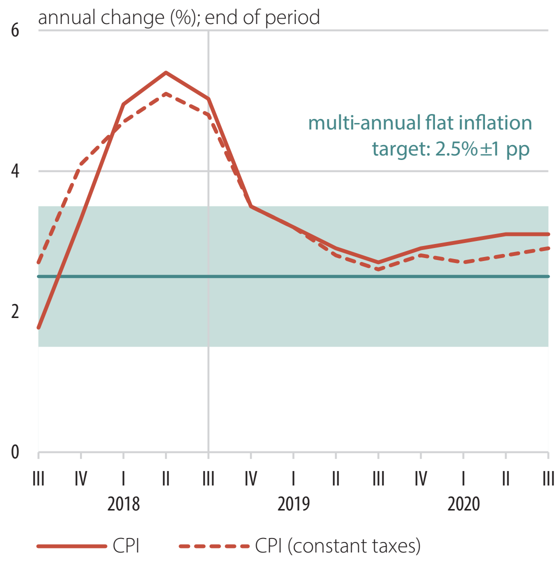
In the NBR Board meeting of 3 October 2018, the latest assessments reconfirmed the medium-term forecast in the previous *Inflation Report*. The assessment was further surrounded by significant risks and uncertainties related to developments in some food prices and the prices of energy (gas, electricity and fuels), to which added labour market conditions and the fiscal policy stance. The risks associated with euro area and global economic growth prospects, as well as with the danger of escalating trade protectionism remained further relevant.

Based on the data available at that time and in the context of the identified risks and uncertainties, the NBR Board decided to keep the monetary policy rate at 2.5 percent per annum. Furthermore, the Board reiterated the importance of an adequate dosage and pace of adjustment of the monetary policy stance, from the standpoint of anchoring inflation expectations and keeping the annual inflation rate on the path shown by the NBR's medium-term forecast, while safeguarding financial stability.

Inflation outlook

According to the baseline scenario, the annual CPI inflation rate is foreseen to reach 3.5 percent at end-2018, 2.9 percent at end-2019 and 3.1 percent at the projection horizon, i.e. 2020 Q3. Compared to the previous *Inflation Report*, the updated scenario reconfirms the forecast for end-2018 and revises upwards by 0.2 percentage points that for December 2019. Exogenous components' contribution to headline inflation was revised upwards by approximately 0.1 percentage points and 0.2 percentage points for end-2018 and end-2019 respectively, while the forecasted annual adjusted CORE2 inflation rate was updated at lower values only for the end of this year. Against this backdrop, the cumulated contribution of exogenous components to the annual CPI inflation rate amounts to 2 percentage points and 0.9 percentage points at end-2018 and end-2019 respectively.

Inflation forecast



Source: NIS, NBR projection

For this year, a more sizeable revision of exogenous components came from fuel prices (whose contribution was revised by 0.2 percentage points against the previous projection), whereas for 2019 the revision was almost entirely accounted for by the developments in administered prices (with a 0.2 percentage point larger contribution). The 12-month CPI inflation rate at constant taxes is set to display a pattern similar to that of the headline inflation forecast, the two indicators showing differences for end-2019 (2.8 percent versus 2.9 percent), amid the further hike in excise duties levied on motor fuels as well as tobacco products and alcoholic beverages.

The baseline scenario of the projection reconfirms economic growth slowing down markedly in the course of 2018, before its regaining some momentum next year. Compared to 2017, the forecasted pattern of GDP dynamics reflects weaker traction from domestic demand, on the back of the projected slower increase in consumption, dampened by the significant reduction in real disposable income growth. At the same time, gross fixed capital formation is anticipated to deteriorate, after having witnessed quarterly contractions in the first half of 2018; yet, this component is expected to fare better over the years ahead, conditional also on the pace of absorption of EU funds targeting this expenditure class and, implicitly, the performance of public investment. The contribution from net exports is projected to stay in negative territory, posting a more negative value this year and less negative thereafter.

The baseline scenario sees this year's current account deficit further on the upward path that started in 2015, before flattening out and remaining below 4 percent of GDP over the medium term. In regional terms, however, there is a lingering divergence between the values of this indicator, hinting at a faster build-up of macroeconomic imbalances in Romania. External deficit financing is envisaged to be covered by stable, non-debt-creating capital inflows in the medium term, yet this year it is affected by the smaller volume of EU structural and investment funds attracted by Romania under the 2014-2020 Multiannual Financial Framework.

Compared to the previous *Inflation Report*, the output gap was subject to an upward reassessment throughout the projection interval, owing mainly to the stronger-than-expected developments in economic activity in 2018 Q2, also with a persistent effect on the projected level of this variable. Subsequent to this quarter, the output gap will follow a moderate uptrend, before flattening out in the latter half of 2019 and contracting gradually thereafter, amid the reconfiguration of real broad monetary conditions to close-to-neutral levels and the moderating discretionary fiscal policy stance, i.e. the fiscal impulse. Therefore, the annual average of excess demand in 2018 is estimated to roughly match that of 2017, but increase in 2019, the component thus making a marginal contribution to economic growth this year and a positive one next year.

According to the baseline scenario, the annual adjusted CORE2 inflation rate is forecasted to come in at 2.5 percent at end-2018, 3.2 percent at end-2019 and 3.3 percent at the projection horizon, i.e. 2020 Q3. The value for end-2018 was revised downwards from the previous *Inflation Report*, by 0.2 percentage points, while for end-2019 it remained unchanged. In terms of economic fundamentals, the end-2018 revision occurred against the backdrop of lower inflation expectations and more favourable movements foreseen for the prices of imported consumer goods at this horizon. Looking at the dynamics, inflationary pressures on the annual core inflation rate continue to stem from the output gap and from the anticipated developments in prices of imported consumer goods, given the projected trajectory of external prices.

The monetary policy stance is configured to ensure and preserve price stability over the medium term in a manner conducive to achieving sustainable economic growth and safeguarding a stable macroeconomic framework.

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to its path in the baseline scenario. Relevant risks to the current projection stem further from both domestic and external sources.

Domestically, extremely relevant appear to be the possible reconfigurations of the dynamics of exogenous components of the consumer basket. Specifically, in the case of administered prices, uncertainties surround the developments in electricity and natural gas prices, arising from either the competent authority's regulations (e.g. the yearly mandatory acquisition quotas for green certificates) or the developments in market prices (e.g. how natural gas prices on international markets impact domestic prices). As for food items, the possible effects of African swine fever outbreak are further a matter of concern, although a material impact on the developments in domestic prices from this source cannot be detected yet.

A risk factor whose relevance was reconfirmed refers to developments in the labour market, due to the still elevated level of tightness associated with the lingering structural drawbacks, on the one hand, and to the uncertainties about the scheduling and magnitude of pay rises provided by law to public sector employees, as well as the final version of the pensions law, on the other hand. Considering their impact on households' real disposable income growth, deviations from the assumptions in the baseline scenario would influence the projected trajectories of inflation and economic growth rates.

On the external front, increasingly relevant has become the faster loss of momentum in global economic activity, which might be fuelled by a potential escalation of trade protectionism and the exhaustion of traction from the cyclical component of economic activity in some advanced economies, as well as by a possible worsening of prospects in certain emerging economies, Turkey in particular. Should these sources of risk materialise either individually or simultaneously, Romania's economy would be hit via both the trade channel and the financial channel, and the latter effects could be enhanced by an increased divergence in monetary policy stances pursued by the major central banks. International commodity prices, assuming they follow an upward trend, might reinforce these developments.

In view of this broad range of risks and uncertainties, the consistent implementation of a balanced macroeconomic policy mix domestically is called for, along with the furthering and deepening of structural reforms in order to ensure sustainable economic growth, without prejudice to the objective of price stability.

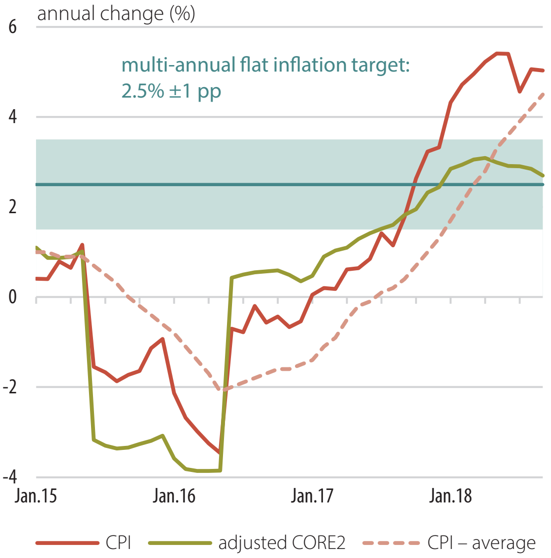
Monetary policy decision

In view of the prospects for the annual inflation rate to decline further towards the upper bound of the variation band of the target in December 2018, before dropping and remaining in the upper half of the band until the end of the current forecast horizon, the Board of the National Bank of Romania decided in its meeting of 6 November 2018 to keep unchanged the monetary policy rate at 2.50 percent. Moreover, the Board decided to leave unchanged the deposit facility rate at 1.50 percent and the lending (Lombard) facility rate at 3.50 percent. In addition, the NBR Board decided to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

1. Inflation developments

After peaking at a five-year high in 2018 Q2, the annual inflation rate subsequently halted its upward trend, falling to 5 percent in September (down by 0.4 percentage points from June), still markedly above the upper bound of the ±1 percentage point variation band around the 2.5 percent flat target (Chart 1.1). The slowdown in the annual inflation rate stemmed from both the exogenous components and the adjusted CORE2 inflation, mainly as a result of a strong base effect, as 2017 Q3 had witnessed an array of inflationary shocks. Apart from these statistical influences, behind the favourable course of the CPI stood the marginal appreciation of the domestic currency against the euro, the abatement of the annual dynamics of wage earnings, the levelling-off of inflation expectations, amid a slightly wider excess demand in the economy.

Chart 1.1. Inflation developments

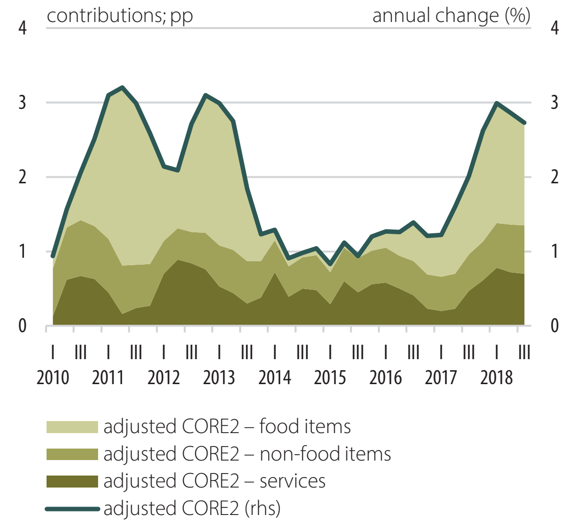


Source: NIS, NBR

Energy prices were the main contributor to the lower annual inflation rate in 2018 Q3. Specifically, looking at administered prices, this deceleration was ascribable to a base effect associated with a sharp increase in the electricity price in July 2017 as a result of a hike in competitive market prices. In addition, electricity prices fell slightly in the reviewed period, given the drop in the prices approved for the purchase of electricity under the universal service, as well as in the contribution for efficient cogeneration starting with 1 July. The mitigating effect on CPI inflation was partly offset by the rise in the mandatory quota for green certificates in August.

As for fuel prices, the disinflationary trajectory was largely determined by the first stage of increasing the excise duty on motor fuels (implemented on 15 September 2017) dropping out of the calculation. In the same direction acted the downtrend in the Brent oil price in the first half of the quarter, following the OPEC+ agreement to boost supply. However, that favourable performance on the international markets proved to be temporary, as crude oil prices resumed a steep upward path in mid-August, up to USD 85 per barrel at the end of the period, close to a four-year high. This uptrend occurred amid lower production in countries such as Venezuela and Libya, as well as on the back of expectations, given the entry into force of sanctions against Iran in November, likely to exert additional pressure on global supply.

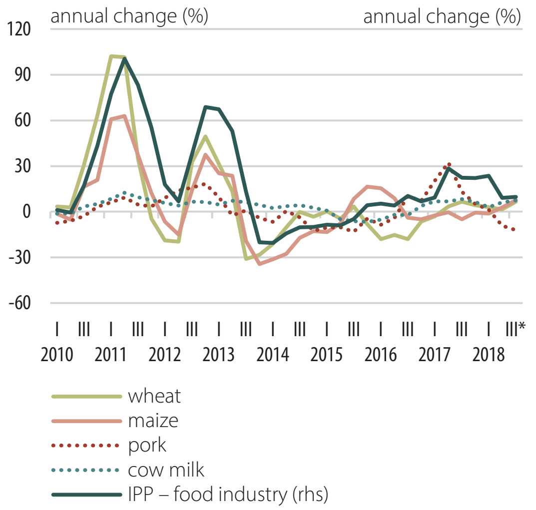
Chart 1.2. Core inflation components*



*) excluding the direct effects of VAT rate changes

Source: NIS, NBR calculations

Chart 1.3. Agricultural commodity prices and producer prices in the food industry



*) Jul.-Aug. 2018

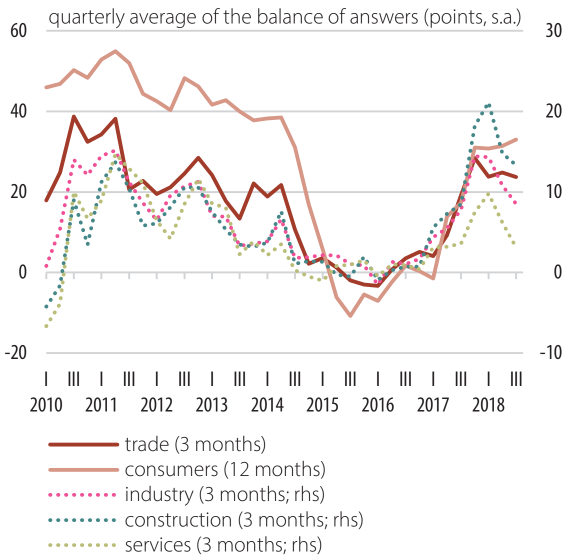
Source: NIS

In line with the path of the aggregate index, the annual dynamics of adjusted CORE2 inflation eased to 2.7 percent in September, down 0.2 percentage points from end-2018 Q2. This time too, processed food prices made a decisive contribution, as inflationary shocks related to the supply issues in 2017 for pork and some dairy products dropped out of the annual comparison (Chart 1.2). Consumer prices of food items exerted no significant pressures July through September 2018. Whereas cereal production in Romania proved plentiful, the aggregate harvest at EU level fell below the last five-year average, due to adverse weather conditions, and thus external prices for wheat and maize rose by more than 10 percent from the same period of 2017. These developments are expected to pass through to local consumer prices over time, considering the strong relationship between external and domestic commodity prices (correlation of more than 85 percent) and their influence on local consumer prices[1]. The pork segment is also governed by uncertainty, amid the outbreak of African swine fever, as the slaughters carried out are likely to significantly reduce the local supply in the longer run. However, due to the initial oversupply generated by the desire to capitalise on the still healthy animals, there were no discernible upward pressures on consumer or producer prices throughout 2018 Q3 (Chart 1.3).

In addition to these factors, signals from fundamental factors also suggest a slightly downward path of the annual core inflation rate. Specifically, wage earnings saw a slacker advance in annual terms (yet further posting elevated values of over 10 percent), which was also reflected by trade developments. In addition, economic agents' short-term inflation expectations recorded corrections, albeit remaining high, whereas inflationary pressures from excess demand seem to have levelled off. Against this backdrop, the coordinates of the local economy can be further deemed specific to an inflationary environment, with some signs of abatement.

[1] For example, there is a long-term equilibrium relationship between the external price of wheat and the price of milling and bakery products on the domestic market – a 1 percent increase in the price of the commodity adds nearly 0.4 percentage points to the rise in the price paid by consumers. Moreover, while the consumer price for this category of goods generally absorbs increases, it rarely responds to declines in commodity prices.

Chart 1.4. Expectations on price developments



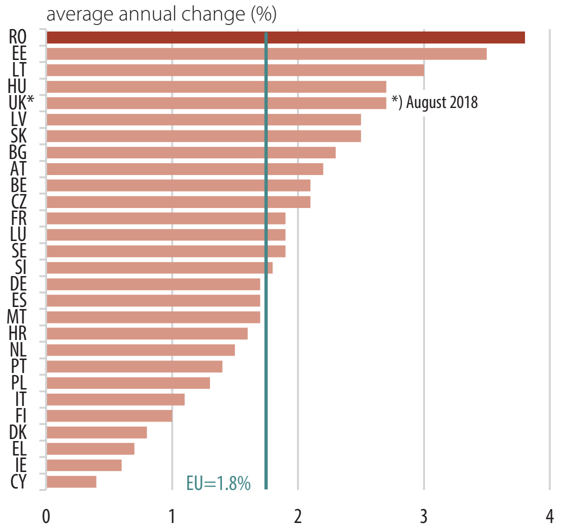
Source: NIS/EC-DG ECFIN Survey

The only notable influences towards a faster annual inflation rate came from vegetable prices, mainly due to poor crops of potatoes – an item that holds a significant share in the CPI basket –, and from natural gas prices respectively. The latter saw their annual dynamics pick up considerably following the upward adjustment made by the Romanian Energy Regulatory Authority on 1 August, in line with the price movements of domestically-produced gas recorded on the competitive market.

All economic agents (trade, services, industry and construction) corrected slightly their short-term (3M) expectations on price developments, July through September 2018, while financial analysts maintained their inflation projection for end-2018 marginally above the variation band of the flat target. However, analysts' expectations remained anchored around 3 percent in the longer run, i.e. one year ahead, at end-2019, and two years ahead respectively. By contrast, it was only consumers' expectations over the 12-month horizon which stood higher than in the previous quarter (Chart 1.4).

The average annual inflation rate stayed on a fast uptrend, as the rates mechanically reduced by the fiscal measures adopted in early 2017 were dropping out of the calculation, and this will continue until the end of this year. Specifically, based on the national methodology, the average annual inflation rate reached 4.5 percent in September, while the value calculated in accordance with the harmonised structure rose to 3.8 percent – the highest among EU Member States (Chart 1.5). Under the circumstances, the difference against the EU average widened to a five-year high of 2 percentage points.

Chart 1.5. Average annual HICP in the EU – Sep. 2018



Source: Eurostat

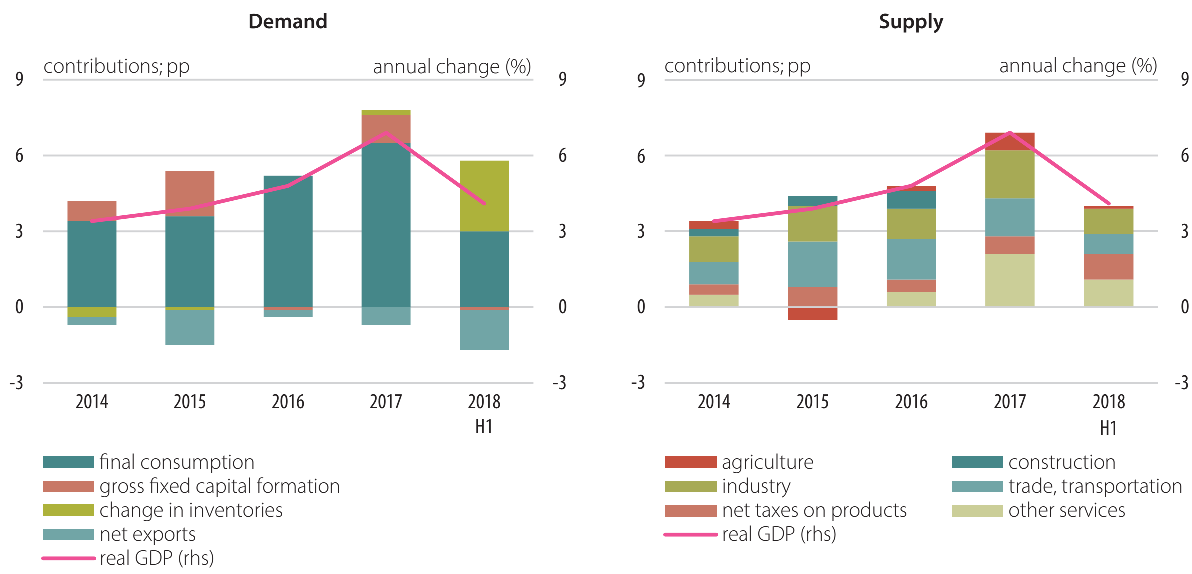
The annual CPI inflation rate at end-2018 Q3 stood marginally higher than the level projected in the August 2018 *Inflation Report* (5 percent versus a 4.9 percent forecast). This difference was due mainly to the much higher prices of vegetables in September, but also to the unexpected increase in the mandatory quota for green certificates in August.

2. Economic developments

1. Demand and supply

The annual growth rate of real GDP in Q2 was similar to that recorded in the first three months of 2018, i.e. 4.1 percent, with consumer demand remaining the key driver. Conversely, investment failed to deliver the same performance as in the previous three quarters, the erosion effect on economic growth arising from its contraction overlapping the further negative contribution of net external demand. However, it is worth mentioning that, according to the current version of national accounts data, the said components did not manage to account for more than 0.4 percentage points of GDP growth, the remaining 3.7 percentage points corresponding to the contribution of the change in inventories, a position which, despite its name, has low economic content[2] (Chart 2.1).

Chart 2.1. Contributions to economic growth



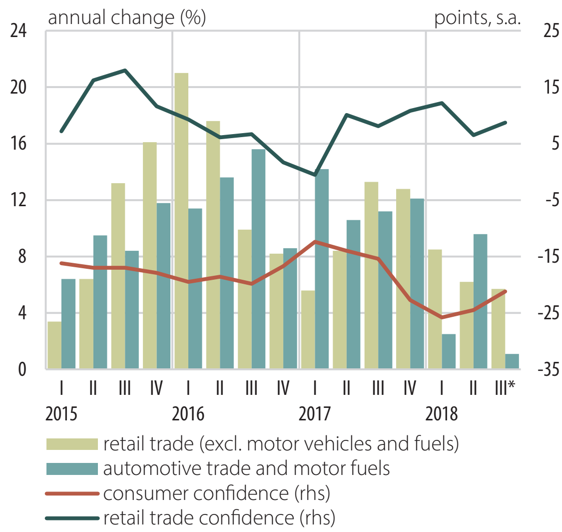
Source: NIS, NBR calculations

Household final consumption rose by 3.6 percent year on year, underpinned by the swift increase in real income. Its dynamics were slacker than in Q1, i.e. down 0.5 percentage points, and the signs for the period ahead hint at the persistence of a positive annual growth rate of consumer demand, albeit probably slower than in the first half-year. Specifically, in terms of households' financial resources, the period from July to August saw a further robust advance in income from wages and pensions

[2] Looking from a historical perspective, this component may undergo significant changes when the national accounts series are revised.

(a trend also mirrored by the improved consumer confidence), in parallel, however, with an easing of the annual pace of increase of new loans, which is likely to persist given that commercial banks envisage tighter credit standards in Q3 (according to the NBR's August 2018 *Bank Lending Survey*). Moderately optimistic signals also come from economic agents' confidence indicators, which are slightly improving in trade and on a wane in services (as revealed by the DG ECFIN Survey).

Chart 2.2. Trade and confidence indicators



*) Jul.-Aug. 2018 for trade turnover

Source: NIS, EC-DG ECFIN, NBR calculations

In fact, the easing of consumer demand is also suggested by the evolution of trade and market services to households, as their turnover slowed its annual growth pace to around 4 percent in the period from July to August. However, it is worth noting that this development occurred primarily on two segments, i.e. motor vehicles and fuels, whereas the volume of sales of the other components kept expanding at a swift clip (Chart 2.2). As for the automotive trade, the slacker annual dynamics may be associated with the fading-out of the upsurge in demand ahead of the change in the emissions measurement procedure for new motor vehicles, effective in the EU as of 1 September 2018. In this context, auto dealers offered significant price discounts for cars in stock which could no longer be registered after that date. Turning to motor fuel trade, sales saw a trend reversal on account of a base effect (the spike in purchases in the period preceding the excise duty hike in the autumn of 2017), but also as a result of the steady advance in fuel prices over the past months.

In 2018 Q2, the general government budget posted a deficit of lei 10.5 billion (or 1.1 percent of GDP). The wider deficit than that recorded in the previous quarter[3] – implying however a slower pace of budget execution easing versus that seen a year ago[4] – was predominantly the result of the rise in total budget spending[5], following the increase in certain current expenditure components (particularly, compensation of employees[6], as well as interest expenses, spending on goods and services and social security expenses[7]), with the reduction in capital expenditure[8], EU-funded expenditure and subsidies expenses acting in the opposite direction. In turn, total

3 Lei 4.5 billion (i.e. 0.5 percent of GDP).

4 In 2017 Q2, the budget execution had generated a deficit of lei 7.8 billion, i.e. 0.9 percent of GDP, as compared with a surplus of lei 1.5 billion, i.e. 0.2 percent of GDP, posted in the previous quarter.

5 However, its real annual dynamics decelerated slightly in Q2 to 10.4 percent, from 16.7 percent in the first quarter of 2018.

6 Due to pay rises in healthcare and education as of March 2018, in compliance with Framework Law No. 153/2017 on wages for staff paid from public funds.

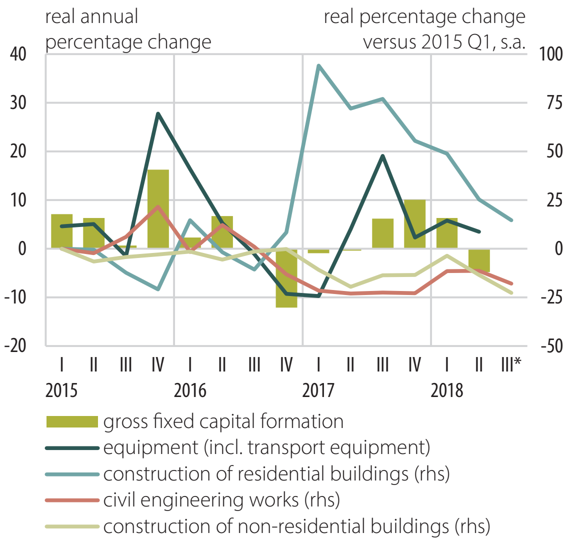
7 Also on account of the earlier payment in June of amounts representing part of July pension expenses, pensions which are distributed via the Romanian Post National Company.

8 Their decline also mirrored a base effect associated with defence expenditure in Q1.

budget revenues decreased slightly[9], mainly on account of base effects[10], as well as of the decline in disbursements from the EU, their impact being only partly offset by the rise in receipts from social security contributions, excise duties[11] and non-tax revenues.

The annual dynamics of gross fixed capital formation saw a reversal, i.e. -4.8 percent in Q2 versus +6.3 percent in Q1, given the two quarterly contractions reported in 2018. Both equipment purchases and construction posted weaker results than in the first quarter (Chart 2.3). In 2018 H2, technological investments may remain on a slightly upward trend, whereas construction is expected to see mixed developments, as the lower appetite for residential buildings can be partly offset by the step-up in the supply of non-residential spaces, as well as by the long-awaited recovery of investment in infrastructure, which is conditional on the improved absorption of EU funds.

Chart 2.3. Investment



*) Jul.-Aug. 2018

Source: NIS, NBR calculations

Corporate equipment purchases expanded further, but their annual pace lost momentum as compared with 2018 Q1, i.e. down to 3.5 percent, from 5.8 percent. They may continue to record moderately positive dynamics in the following months as well, amid the recently emerging divergent signals – on the one hand, the portfolio of orders from local companies placed with capital goods producers posted robust growth in the period from April to July and equipment loans followed a slightly steeper upward trend (up to 8 percent in July and August, annual change); on the other hand, inflows in the form of equity and earnings reinvested by foreign companies[12] embarked on a downward path April through August. Interest in capital investments was more visible in sub-sectors such as the manufacture of building materials and equipment, the manufacture of motor parts, food industry. Thus, investment projects underway concerned technological investments and the expansion of current capacities, as well as the opening of new facilities (also by attracting foreign investors), with increasing attention being paid to automation improvement, environmental protection and higher product quality. Nevertheless, capital investments are far from having reached their potential, owing, inter alia, to the shortage of public infrastructure projects, the correction of which would likely bolster the overall economic activity.

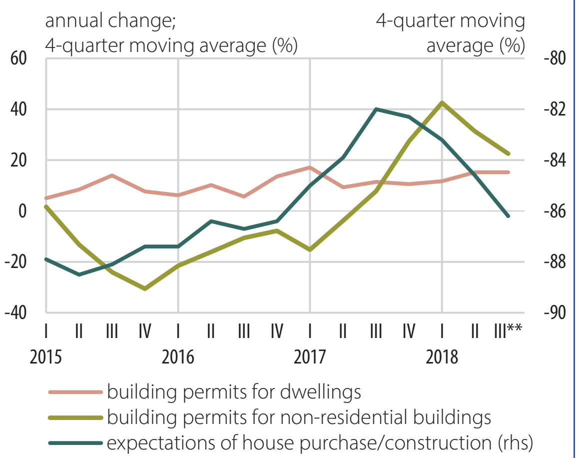
9 In annual terms, however, they posted a slightly faster real growth rate than in the previous quarter, i.e. 8.1 percent versus 6.5 percent.

10 Associated with higher receipts from property taxes in Q1 (as the end of the quarter coincides with the first deadline for payment), as well as from personal income tax (given that the effect of the cut to 10 percent in the tax rate became visible starting with the February receipts).

11 Also as a result of the hike in the excise duty on tobacco products starting with April.

12 12-month cumulative value.

Chart 2.4. Outlook for the construction of buildings*

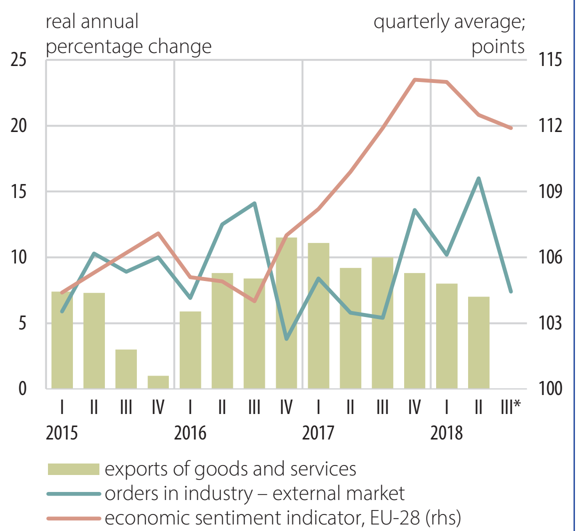


*) seasonally adjusted data

**) Jul.-Aug. 2018 for building permits

Source: NIS, EC-DG ECFIN, NBR calculations

Chart 2.5. Exports of goods and services



*) Jul.-Aug. 2018 for orders

Source: NIS, EC-DG ECFIN, NBR calculations

Investment in construction, i.e. new construction works and capital repair works, saw its volume decreasing further by 2.3 percent year on year, on the back of the persistent decline in public investment (real contraction by about 14 percent[13]) and the loss of steam in residential construction works. Looking ahead, while public works may witness a certain rebound in 2018 H2 (to the extent that the absorption of non-repayable EU funds for infrastructure projects sees a recovery), the construction of dwellings is less likely to experience a step-up, signals in this respect being given by new housing loans embarking on a downward path and the households' intention to purchase/build a home in the next 12 months remaining at a very low level (according to the DG ECFIN Survey). In what concerns the non-residential construction works, the moderately positive evolution of the supply of new spaces seen in the first half-year (due to the twofold increase in logistic property as compared with the same period in 2017) will probably be followed by faster growth that analysts anticipate to occur on all segments, i.e. office, commercial and logistic spaces and to be more pronounced outside Bucharest (Chart 2.4).

Exports of goods and services rose at a slightly slower tempo as compared with Q1, i.e. by 1 percentage point to 7 percent (annual change), on account of temporary influences that led to the quarterly contraction in exports in the April-June period. However, exports may witness a certain rebound in the period ahead, as indicated by foreign orders placed with local industrial companies, the volume of which kept increasing at a fast annual pace of about 10 percent in the period from May to August (Chart 2.5).

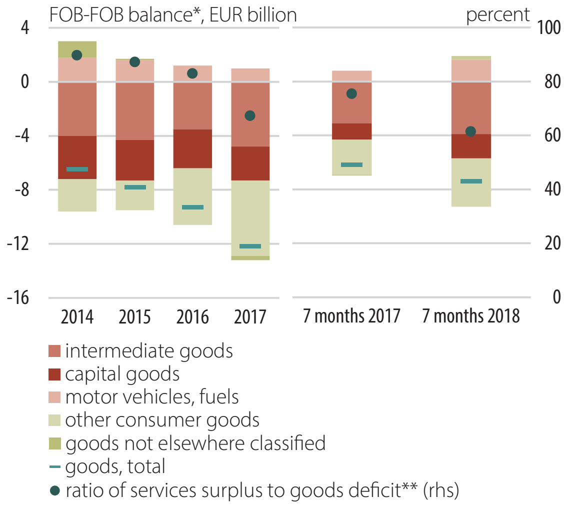
External partners' weaker demand for motor parts made a significant contribution to the slowdown in export dynamics, amid the volatility that emissions testing changes induced to the European automotive production. In the same direction acted developments in metallurgy (possibly in association with the lower demand in the external automotive industry, as well as with the uncertainties stemming from the international trade tensions) and oil processing (a sub-sector which is generally

13 Calculations based on the data on general government budget execution, using the cost index for civil engineering works as a deflator.

subject to major fluctuations, due to the periodic technical overhauls). Conversely, the sales of motorcars maintained their real advance at around 30 percent, after the new car models (Dacia Duster, Ford EcoSport) were launched on the external markets at the beginning of this year. Moreover, swifter annual changes (up to two-digit levels) were mainly reported by exports of machinery and equipment, fabricated metal products, telecommunications equipment, chemical products, vessels and cereals.

The decelerating pace of domestic absorption (attributed mainly to investment demand) and of the production for external markets was also visible for imports (real annual growth of 9.5 percent versus 11.5 percent in Q1). This was mainly accounted for by intermediate goods, whose imports saw their annual dynamics decreasing to less than half, i.e. down to 3.2 percent, but decelerations were also recorded by capital goods and consumer goods (down to 7.1 percent and 5.7 percent respectively). Contrarily, automotive imports saw a significantly brisker annual pace of increase in Q2 (up to around 16 percent in real terms), due to the frontloaded purchases in the above-mentioned context.

Chart 2.6. Balance on trade in goods



*) excluding goods produced under processing arrangements

**) 8 months 2017, 8 months 2018 for the last two periods

Source: Eurostat, NBR, NBR calculations

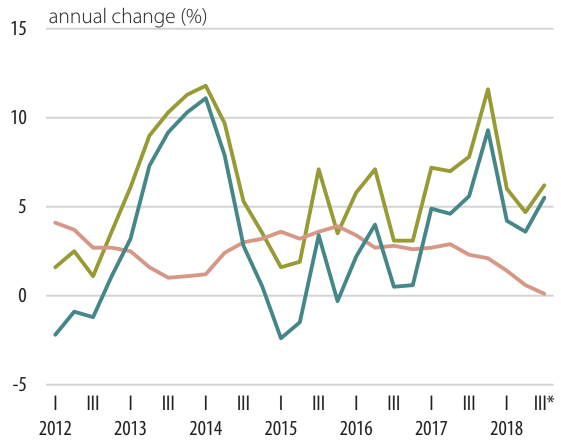
Under the circumstances, the balance on trade in goods worsened further, the cumulative deficit in the period from January to August 2018 standing EUR 1.5 billion wider than in the same year-ago period (Chart 2.6). In addition, net receipts from international services decreased slightly (chiefly on account of households' increasing preference for foreign travel and transportation services), so that their counterweight to the external imbalance of trade on goods declined to 61.4 percent, from 75.4 percent in January-August 2017. The deterioration witnessed by both main current account components caused the widening by 37.8 percent of the current account deficit to EUR 5.8 billion.

Labour productivity

In 2018 Q2, labour productivity economy-wide saw a recovery in annual terms (up to 5.6 percent), largely reflecting, however, the entry into negative territory of the growth rate of employment, which was visible mostly in agriculture and construction. In fact, the unfavourable developments in investment economy-wide, the labour market trends, as well as the weakening positive influences from the economic performance of the euro area provide a moderate outlook for productivity gains in the period ahead.

Even though the dynamics of labour productivity in industry remained unchanged in the period from April to August 2018 (3.6 percent in annual terms, a pace similar to that seen in Q1), several developments in the structural determinants on this segment also deserve mention. Specifically, the slacker annual dynamics of investment in machinery and equipment, possibly influenced by the low level of

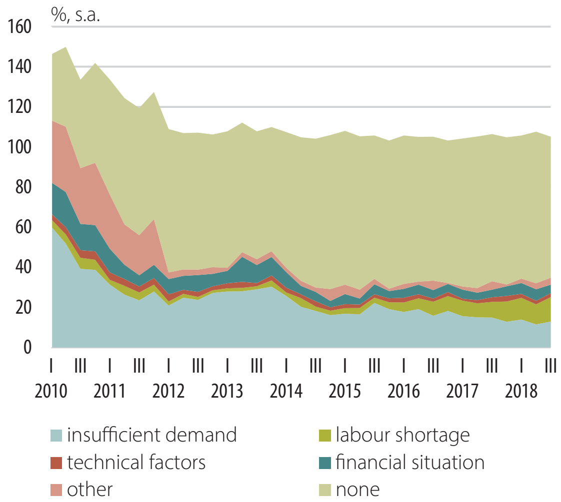
Chart 2.7. Labour productivity in manufacturing



*) Jul.-Aug. 2018

Source: NIS

Chart 2.8. Factors limiting the advance in industrial production



Note: The respondents may choose multiple choice answers.

Source: EC-DG ECFIN

subscribed capital of foreign-owned companies in 2018 H1[14] (particularly in manufacturing), and the further weak support from public investment weighed on productivity gains. At the same time, after the increases in the past seven years (of 2.5 percent, on average), the annual growth rate of the number of employees in manufacturing slipped slightly into negative territory in August 2018 (this trend being also visible in the automotive industry, the main driver of the post-crisis rebound in manufacturing), which hints at the deterioration in the quality of remaining human capital (Chart 2.7).

As for cyclical factors, the second quarter painted a mixed picture. On the one hand, new foreign orders in industry saw stronger growth, bringing the share of economic agents with activity hampered by insufficient demand down to a new all-time low, according to the DG ECFIN Survey (Chart 2.8). On the other hand, the only sub-sector reporting an improved capacity utilisation rate was that of non-durables, while the slower economic growth pace in the euro area since the beginning of 2018 was accompanied by the continued deterioration in confidence in manufacturing across the EU.

Looking ahead, there are several signals pointing to investment that has the potential to generate productivity gains in manufacturing sub-sectors, such as food industry, in the context of signs indicating the emergence and development of larger agricultural cooperatives; building materials and fabricated metal products, which further benefit from the expansion and opening of production facilities; and even the automotive industry, amid investment targeting the automation of production processes.

Labour market developments[15]

In 2018 Q2, the advance in the number of employees economy-wide continued to follow the downtrend seen since the beginning of 2017, the annual dynamics going down below 2 percent for the first time in the past three years, the same picture being also shown in July and August 2018. This time, the main contributor was the

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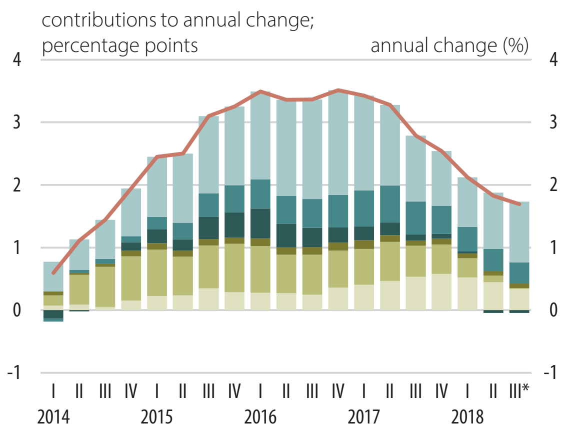
[14] According to the Trade Register data, the subscribed share capital of foreign companies totalled lei 2.23 billion in 2018 H1, down by 30 percent as compared with 2017 H1, thus recording the second lowest level in the past decade (based on a publicly available analysis). Out of the 10 most important capital inflows, only one was channelled to manufacturing.

[15] The analysis is based on seasonally adjusted data; the main sources are NIS, Eurostat and NEA.

Chart 2.9. Number of employees economy-wide



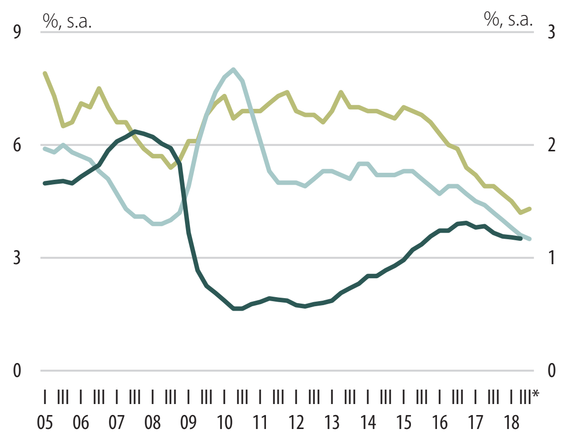
*) Jul.-Aug. 2018

Source: NIS, NBR calculations

relatively broad-based deceleration in the pace of hiring in industry (which was sharper in the manufacture of motor vehicles), possibly connected to the unfolding automation process, to which added the contraction in the number of employees in construction, given the lack of investment in infrastructure and the setback in residential construction works (Chart 2.9).

The downward course in the growth pace of payrolls economy-wide is also the result of the cumbersome recruitment process, given that excess labour supply fell sharply. Unemployment indicators stood at or close to post-2000 lows, as both the ILO unemployment rate and the registered unemployment rate continued to decline compared to 2018 Q1, reaching 4.3 percent in July-August and 3.5 percent respectively in 2018 Q3 (Chart 2.10). Similarly, the long-term unemployment rate hit a historical low of 1.8 percent, whereas the number of persons available to work but not seeking reverted to pre-crisis lows. The labour shortage is also ascribable to the massive emigration of the working age population, especially young people; in 2017, approximately half of the number of emigrants were people aged 15-34, according to NIS data. Therefore, labour market conditions have further tightened, with labour market tightness resuming an upward path, amid the stalling job vacancy rate. In fact, in the period from 2000 to 2016, job creation was governed, on average, by young, small-sized companies that are also the most volatile, making a prevailing contribution to job destruction economy-wide. In order to reduce those fluctuations, it is essential to create a stable business environment by implementing a legal and regulatory framework that stimulates the entrepreneurial culture, as well as by improving the quality of infrastructure and human capital (see Box – Evidence on job creation and destruction in Romania).

Chart 2.10. Unemployment and vacancies

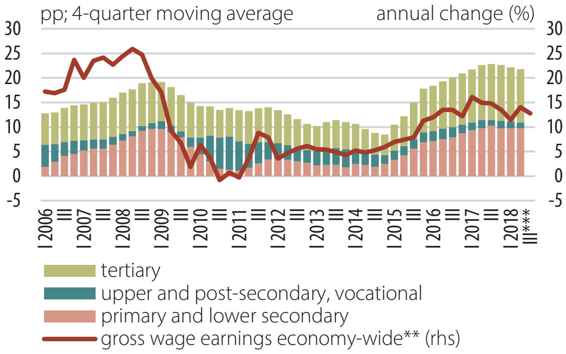


*) Jul.-Aug. for the ILO unemployment rate

Source: NEA, Eurostat, NBR calculations

For the end of 2018, mixed prospects are emerging with regard to the evolution of the number of employees economy-wide. On the one hand, the DG ECFIN Survey indicates stable employment intentions in industry, market services and construction, while expectations on new hirings in trade improved. On the other hand, the Manpower survey shows the most favourable hiring climate in the past ten years, with a considerable improvement in employment prospects in both construction and trade, while the outlook for industry is set to remain stable.

Chart 2.11. Skill mismatch index on the labour market* and gross nominal wage earnings



*) calculated as the sum of differences in absolute value across each skill group between labour supply (approximated based on the share of the unemployed with a certain level of education in total unemployed) and labour demand (approximated based on the share of the employed with the same level of education in total employment)

**) excluding the effect of the transfer of social security contributions starting 2018

***) Jul.-Aug. 2018

Source: Eurostat, NIS, NBR calculations and estimates

In 2018 Q2, the annual dynamics of average gross wage earnings stepped up to 36.8 percent[16] (up 3 percentage points versus Q1), remaining unchanged July through August. The advance was particularly ascribable to the budgetary sector (up 10.6 percentage points to 47.4 percent), given the pay rises granted in March 2018 to employees in education and public healthcare. A brisk pace of increase of average gross wage earnings is further visible in the private sector as well, on the back of difficulties facing companies in staff recruitment. Specifically, the skill mismatch index, albeit slightly decelerating starting with 2017 Q4, has remained high, pointing to an economic environment where employers are discouraged to seek skilled labour[17] (unlike periods of recessions when workers are discouraged) and, as a result, pay increased attention to retaining current employees. (Chart 2.11).

Evidence on job creation and destruction in Romania

Literature provides conclusive empirical evidence on the importance of young and small businesses, especially start-ups, in the job-creation process[18]. The replacement of mature companies by newly-established ones, which are more productive and have a higher technological content ("creative destruction"), is the engine of economic advance and employment growth[19]. Thus, assessing the importance of two company-specific features, i.e. size (measured by the number of employees) and age – is pivotal, also from the perspective of adopting possible public policies that target this segment.

This Box aims at measuring and decomposing the flow of jobs created and destroyed by Romania-based companies by firm size and age. The database used includes annual balance sheet information on firms with majority private capital in the economy during 2000-2016[20]. By definition, in the establishment year, firms participate in job creation only. Similarly, firms exiting the market contribute to job destruction alone (in the year following the last year for which balance sheet information is available). For each existing company, the number of jobs created/destroyed during a certain year is defined as equal to the positive/negative change in the number of employees in the respective year versus the year before.

16 The high dynamics reflect the transfer of social security contributions payable by employers to the charge of employees as of January 2018.

17 This conclusion is also supported by the business sentiment index calculated by the Foreign Investors Council, with half of respondents complaining about the lack of skilled workforce as compared with only a quarter of respondents who were of the same opinion two years ago.

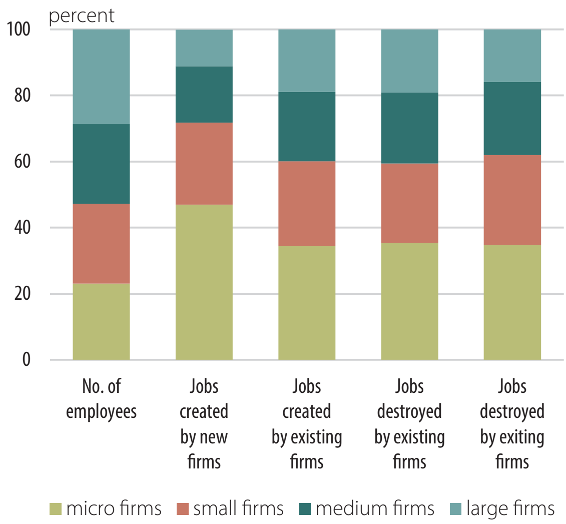
18 See Haltiwanger *et al.* (2013) and Fort *et al.* (2013) for the US economy.

19 See Gourio *et al.* (2014).

20 Source: Ministry of Public Finance. Data do not cover the financial sector (Section K of the NACE Nomenclature). In the case of firms that have missing or erroneous data for certain years, the average number of employees was interpolated based on the adjacent observations.

Firms are grouped by size according to the EC recommendations[21]: (i) micro-enterprises (under 10 employees), (ii) small enterprises (between 10 and 49 employees), (iii) medium-sized enterprises (between 50 and 249 employees), and (iv) large enterprises (250 employees and more). The categorisation of companies depends on the average of the number of employees in the current year and that in the previous year (the reference year)[22].

Chart A. The distributions of the number and dynamics of jobs by firm size



Source: MPF, NBR calculations

Chart A shows the distributions of five indicators on the number and dynamics of jobs by firm size: the total number of employees; the total number of jobs created by newly-established firms (that start to submit fiscal statements in the respective year); the total number of jobs created by continuing firms (by raising the number of employees versus the previous year); the total number of jobs destroyed by existing firms (by reducing the number of employees versus the previous year); jobs destroyed by firms exiting the market (that cease to submit fiscal statements in the respective year). The available data indicate an approximately uniform distribution of the total number of employees by employer size. However, micro firms (under 10 employees) make a disproportionately larger contribution to job creation by both the entry into the market of new firms (about 47 percent of total), and the expansion of existing firms (34 percent of total). At the same time, micro-enterprises also account for a larger share of jobs destroyed (as compared to their share in the total number of employees in the economy), with continuing firms and firms exiting the market holding 35 percent each. Unlike micro firms, large companies (with at least 250 employees) are more stable in terms of job flows, taking lower shares of both job creation and job destruction compared to their share in the number of employees in the economy.

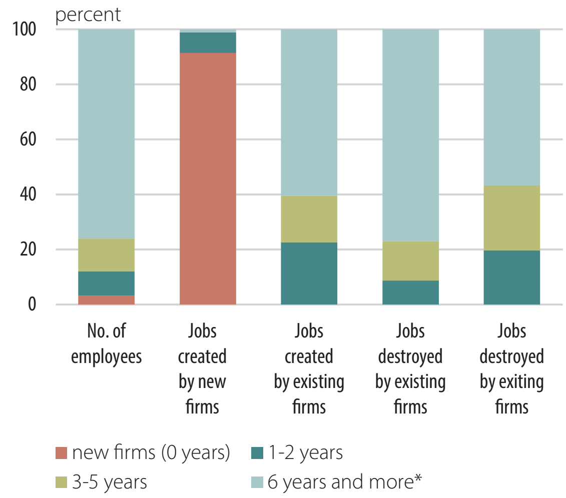
Chart B shows similar distributions by firm age. The distribution of the total number of employees in the economy reveals the elevated share of long-established firms, aged at least 6 years old[23]. However, such enterprises make a disproportionately lower contribution to job creation, as well as to job destruction by firms exiting the market. Newly-established firms and young businesses (aged at most two years old) account for only 12 percent of the total number of employees, but create

21 See *User Guide to the SME Definition* available at http://ec.europa.eu/regional_policy/sources/conferences/state-aid/sme/smedefinitionguide_en.pdf

22 The use of a conventional method, namely the categorisation based on the number of employees in the previous year (the reference year), would have generated effects likely leading to an overestimation of both the role of small firms in the job creation process and that of large firms in the job destruction process. For further details, see Davidsson *et al.* (1998).

23 The share of such companies is overestimated as firms established before 2001 have been included into this age group, owing to the lack of information on the establishment year for the firms existing in the first year of the sample (2000). The qualitative results are however similar when analysing only the enterprises established over the period corresponding to the available sample (i.e. excluding companies existing in 2000).

Chart B. The distributions of the number and dynamics of jobs by firm age



*) including firms established before 2001

Source: MPF, NBR calculations

Table A. The average annual net number of jobs created (2001-2016)

thousands

	Micro firms	Small firms	Medium firms	Large firms	Total
New firms (0 years)	58.2	24.3	17.3	12.7	112.5
1 year	20.5	12.2	7.5	1.9	42.1
2 years	0.8	4.4	3.8	3.0	12.0
3 years	-3.0	1.0	0.8	2.0	0.9
4 years	-4.0	-0.4	-0.1	1.3	-3.2
5 years	-4.1	-0.9	-0.5	1.1	-4.4
6 years	-3.9	-1.2	-0.6	0.0	-5.7
7 years and more*	-36.7	-22.1	-25.6	-20.7	-105.0
Total	**28.0**	**17.3**	**2.6**	**1.3**	**49.1**

*) including firms established before 2001

Note: Figures may not add up because of rounding.

Source: MPF, NBR calculations

almost all new jobs by their entry into the market[24], as well as about 23 percent of the jobs created by the expansion of continuing firms.

Table A depicts the intersection of information in the two charts, showing the average annual net flow of jobs (i.e. jobs created minus jobs destroyed) broken down by categories of firms based on size (on columns), and age (on rows). During 2001-2016, the private sector created, on average, a net number of 49.1 thousand jobs on an annual basis. In this respect, young and small businesses made a decisive contribution, especially newly-established micro firms (which created annually more than 58 thousand new jobs). The average net flow of jobs becomes negative starting with the fourth year since the establishment, but there is heterogeneity depending on the size. Thus, micro firms show a more pronounced dynamism and a negative net flow of personnel (they create, on average, less jobs than they destroy) from the age of three years, while large firms raise their number of employees over a period of up to six years, on average, since establishment.

The results summarised in this box certify a high degree of heterogeneity as concerns the dynamics of jobs across the companies categorised into groups by size and age. In particular, the analysis underlines the importance of young and small businesses that contribute to a disproportionately higher extent to both job creation and job destruction (as compared to their share of employees in the economy). Other features with a potential impact on the performance of the business sector, subject to additional research, refer to firms' business sector and access to financing via bank loans.

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Davidsson, P., Lindmark, L., and Olofsson, C. – "The Extent of Overestimation of Small Firm Job Creation: An Empirical Examination of the Regression Bias", *Small Business Economics*, Vol. 11(1), August 1998, pp. 87-100

24 By construction, jobs created by the entry of new businesses into the market should be entirely attributed to firms aged 0 years old. Not-null shares taken by firms of different ages in Chart B (the second column) occur in the case when a company is created with zero employees, but hires personnel in the years following its establishment.

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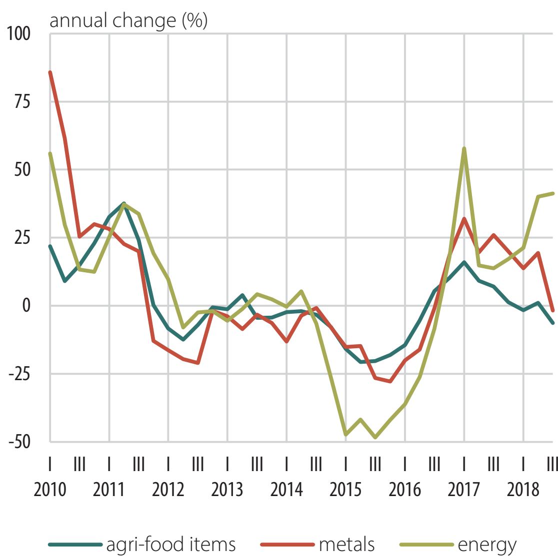
2. Import prices and producer prices on the domestic market

The substantial rise in the Brent oil price, which exceeded the USD 80 per barrel mark towards the end of 2018 Q3, reflected in the faster annual rates of increase of import prices and producer prices on the domestic market. As for producer prices of consumer goods, their annual dynamics stayed below those recorded throughout 2017, in the absence of significant upward pressures on food producer prices, given the developments in international commodity prices.

2.1. Import prices

Commodity prices embarked on divergent trends in 2018 Q3 (Chart 2.12). Energy prices remained on an upward path, reaching annual rates of approximately 40 percent. Apart from the contribution of the contraction in oil production in Venezuela and Libya, the oil supply was strongly affected by the gradual decline in purchases of crude oil from Iran, amid the information regarding the sanctions imposed by the US, which are scheduled to become effective starting November 2018. The effect of these influences was only partly offset by the decision of OPEC+[25] to boost the crude output by about 1 million barrels per day, which was agreed in a new deal signed in June. Specifically, the Brent oil price rose above the USD 80 per barrel mark towards the end of September (a four-year high). Conversely, the annual change in metal prices turned negative in the period from July to September, i.e. -1.8 percent versus 19 percent in Q2), the main determinant being the deterioration of investor sentiment as a result of the economic policies pursued by

Chart 2.12. International commodity prices



Source: World Bank, FAO, NBR calculations

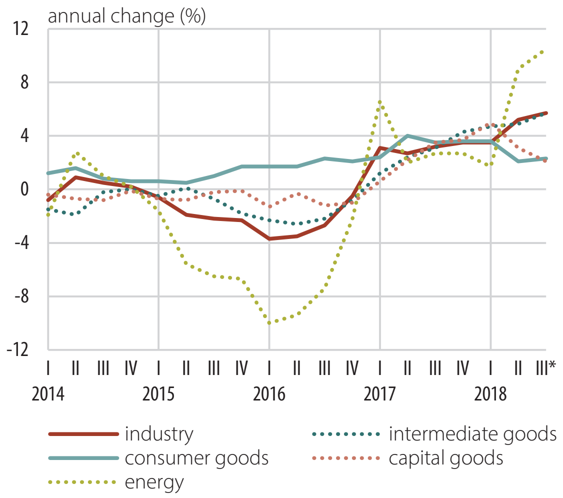
[25] OPEC+ is the name of the association between OPEC members and other 10 petro-nations, such as Russia, Mexico and Kazakhstan, which holds a cumulative share of 55 percent of global oil supplies.

the US Administration[26]. No upward pressures were visible overall in the case of agri-food commodity prices either, as they were confined to the grains market – the latest FAO estimates indicate weaker crops than in the year before, largely on account of Europe's lower harvest. Broad-based annual declines were recorded by prices of processed foods (meat, dairy products, vegetable oils, sugar) as a result of excess supply. However, on the pork meat segment, price increases are not excluded over the longer term, due to global supply decreases associated with preserving food safety.

The annual unit value index of imports[27] remained above one in 2018 Q2 (101.8 percent), accelerating slightly versus the previous quarter. Fuels and petroleum products remained the major contributors hereto, amid the hike in international oil price, the effect being enhanced by the appreciation trend of the US dollar versus the euro. The UVI of base metals was further high, albeit decelerating (105.5 percent), and this downward course is expected to be more pronounced in the period ahead, given the recent dynamics of world base metal prices.

In line with the trend of international agri-food prices, the declines in the UVIs of food items (meat and dairy products, sugar, animal fats and vegetable oils) were relatively broad-based, with the only exceptions of grains and fruit and vegetables, the UVIs of which were above one. As for non-food consumer goods, developments were mixed: decelerations or declines in the UVIs of semi-durables and acceleration in the UVI of transport equipment.

Chart 2.13. Industrial producer prices on the domestic market



*) Jul.-Aug. 2018

Source: Eurostat

2.2. Producer prices on the domestic market

In July-August 2018, the annual dynamics of industrial producer prices on the domestic market gained momentum to 5.7 percent (up 0.5 percentage points as compared with Q2), mainly on account of the hikes in prices of energy and intermediate goods[28] (up to 10.5 percent and 5.7 percent respectively), which were triggered by the uptrend in world energy prices during the past months. Contrarily, the annual rate of change of producer prices for capital goods decelerated (down 1 percentage point to 2.1 percent), in correlation with the strengthening of the domestic currency versus the euro in the period under review (Chart 2.13).

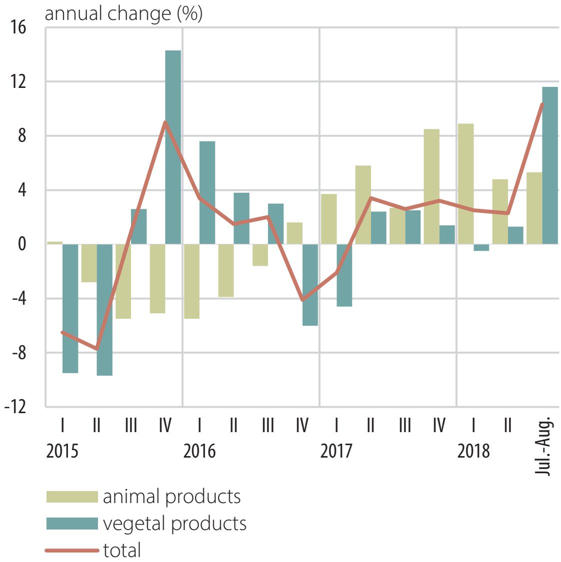
26 For instance, a more restrictive monetary policy of the US brings about higher financing costs, but also the reduction in emerging countries' liquidity, which may have indirect effects on the demand for metals. Additional influences in this respect came from the uncertainty induced in the market by the protectionist measures adopted by the US, particularly with regard to its relation with China.

27 Expressed in EUR.

28 Intermediate goods sub-sectors are energy intensive industries.

The annual pace of increase of producer prices for consumer goods stepped up marginally to 2.3 percent (up 0.2 percentage points versus Q2). Nevertheless, it stays further below the average of over 3.5 percent recorded in the period from 2017 Q2 to 2018 Q1, amid a more moderate growth pace of prices in food industry, which followed the trend in international agri-food commodity prices. In fact, upward pressures on prices stem only from grains, as although the local agricultural harvest is estimated to be plentiful, there is an increased likelihood that domestic prices align with external developments (the adverse weather conditions in the EU pushed up the prices of wheat and maize, which posted annual changes of 21 percent and 12 percent respectively in 2018 Q3).

Chart 2.14. Agricultural producer prices



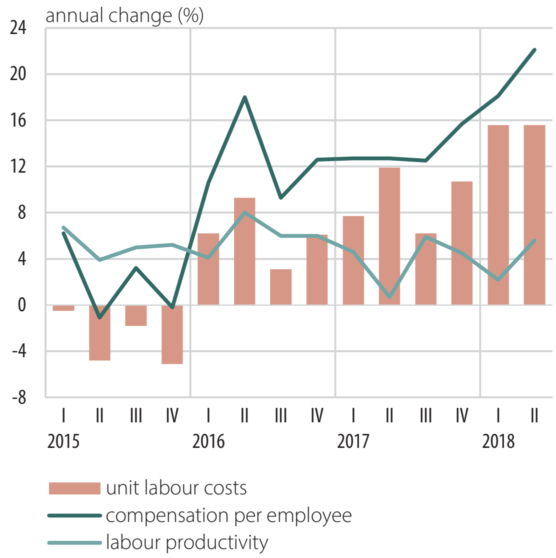
Source: NIS

Specifically, the annual dynamics of agricultural producer prices on the domestic market accelerated strongly in July and August 2018 to reach 10.3 percent (up 8 percentage points as against Q2; Chart 2.14). Behind this stood largely the prices of vegetal products, whose annual rate of change went up 10.3 percentage points, from 1.3 percent, as most components recorded swifter rises, in line with external market trends. The only exception was the price of sunflower seeds, which saw a sharper drop in annual terms. The annual growth of prices for animal products picked up marginally from the preceding quarter (up 0.5 percentage points to 5.3 percent), against the background of mixed developments by sub-group: while pork prices saw larger declines, prices of milk, beef and poultry steepened their upward path.

Unit labour costs

In 2018 Q2, the annual rate of increase of unit labour costs economy-wide remained unchanged at 15.6 percent, the faster growth pace of compensation of employees being offset by labour productivity gains (Chart 2.15). The further high growth rate of unit labour costs (over 10 percent for the third quarter in a row) reflects the persistence of pressures put by this component on the competitive position.

Chart 2.15. Unit labour costs



Source: NIS

By contrast, the annual rate of change of unit wage costs in industry rose slightly to 6.5 percent in Q2, on the back of the slowdown in productivity, being followed, however, by an adjustment in July-August (down to 4.6 percent), due to the rise in production. However, manufacturing was the only sub-sector that saw an adjustment in the period from April to August, with the annual change in the ULC declining by 1.6 percentage points to 5 percent, largely as a result of the slower pace of increase in wage earnings. Downward pressures via the ULC channel were seen in construction-related industries, such as non-metallic mineral products (also due to the higher production capacity as a result of investment made) and fabricated metal products, and particularly in the automotive industry and the related electrical equipment sub-sector, where the annual dynamics of unit wage costs fell into negative territory mainly on account of the advance in labour productivity. Conversely, in other manufacturing sub-sectors, such as hydrocarbon processing, machinery and equipment or other transport equipment, the pressure of unit wage costs was higher, on the back of incidental influences or base effects.

3. Monetary policy and financial developments

1. Monetary policy

In August and October 2018, the NBR kept the monetary policy rate at 2.5 percent and left unchanged the deposit facility rate at 1.5 percent and the lending facility rate at 3.5 percent. Moreover, the central bank maintained the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions at 8 percent. The measures aimed to ensure adequate monetary conditions from the perspective of bringing the annual inflation rate back into line with the flat target of 2.5 percent ±1 percentage point in a lasting manner, inter alia via the solid anchoring of inflation expectations over the longer time horizon, while safeguarding financial stability.

The NBR Board decision to keep the monetary policy rate at 2.5 percent at the August meeting was taken in a context in which the annual inflation rate had stopped increasing in June[29] and the outlook for its following a downward trend in 2018 H2 had been reconfirmed, alongside the stronger-than-anticipated deceleration of economic growth seen in Q1[30], implying – contrary to forecasts – a contraction in excess aggregate demand during that period. A levelling-off, at least temporarily, of demand-side inflationary pressures, consumer demand pressure in particular, was also indicated by the slight deceleration in adjusted CORE2 inflation[31] during Q2. At the same time, monetary conditions were more visibly less accommodative in July, given that the relevant interbank money market rates rose markedly, climbing and consolidating significantly above the policy rate, while the EUR/RON exchange rate trended downwards, amid the relative improvement in global risk appetite and the larger differential between interest rates on the local market and those prevailing in Europe and regionally.

Moreover, the medium-term forecast updated in this context pointed to slightly improved prospects for inflation, whose annual rate was expected to decline to 3.5 percent in December 2018 and then to 2.7 percent at end-2019[32], due mainly to the significant disinflationary base effects associated with the previous increases in all CPI exogenous components[33]. The path of the annual core inflation rate was

29 Remaining at 5.4 percent, relatively similar to the May reading (5.41 percent).

30 To 4.0 percent in annual terms, from 6.7 percent in 2017 Q4.

31 Whose annual rate fell from 3.05 percent in March to 2.91 percent in June.

32 Versus 3.6 percent and 3.0 percent respectively in the previous forecast.

33 Administered prices, fuel prices, tobacco product prices and VFE prices.

also revised downwards, especially over the short term, although it was further seen going down until end-2018, but gradually rising afterwards[34], amid increasingly manifest inflationary pressures starting 2019 Q2 anticipated to stem from aggregate demand and unit wage costs, as well as from short-term inflation expectations and import prices.

Pressures from excess aggregate demand were, nevertheless, expected to be less intense than forecasted earlier, given the likely stronger-than-previously-projected moderation of economic growth in 2018, followed however by a return of its annual rate in line with the potential. The outlook implied a marked abatement, also in relation to the previous forecast, of the expansionary nature of the fiscal policy in 2018, which was then seen becoming neutral in 2019, as well as the deceleration – albeit more moderate than previously anticipated – in the dynamics of households' real disposable income. The outlook also assumed a somewhat slower reduction in the degree of accommodation of monetary conditions over the projection horizon and a relative improvement in EU funds absorption, based inter alia on the hypothesis of stronger economic growth in the euro area/EU and globally than in the previous forecast.

The outlook for the European economy was, however, further surrounded by uncertainties, given the risks stemming – also via affecting investor confidence – from protectionist trade policies, but also from Brexit talks and implementation, as well as from global financial market volatility. On the domestic front, major sources of uncertainties and risks were household confidence and the pace of EU funds absorption, but also labour market conditions and the fiscal policy stance. Particularly relevant in this context was the monetary policy stance of the ECB and of central banks in the region.

The subsequent developments in the annual inflation rate were in line with expectations, as it saw a significant downward correction in July to 4.56 percent, before reaching 5.06 percent in August, slightly below the forecast, mainly against the backdrop of base effects associated with the evolution of administered prices and fuel prices. Core inflation as well further contributed to the inflation slowdown, with the annual adjusted CORE2 inflation rate remaining flat at 2.9 percent in July and then declining to 2.8 percent in August, i.e. slightly below the forecast, due to some base effects manifest on the processed food segment, to the relative appreciation of the leu against the euro, but also to the influences likely stemming from the unexpectedly sudden loss of momentum of consumer demand in 2018 Q1, associated with the moderation of the cyclical position of the economy.

However, economic growth saw a slight re-acceleration in annual terms in Q2[35], given the step-up in its quarterly dynamics, which was indicative of a larger-than-expected

[34] The annual adjusted CORE2 inflation rate was anticipated to fall to 2.7 percent in December 2018 (3.2 percent in the earlier projection), before advancing and sticking to 3.2 percent until the end of the forecast horizon (compared with a previously-forecasted level of 3.4 percent).

[35] To 4.1 percent from 4.0 percent in Q1.

re-widening of excess aggregate demand April through June. Moreover, labour market tensions regained momentum and the annual dynamics of the average gross nominal wage picked up again. At the same time, unit labour costs increased at a faster rate in industry and continued to record double-digit annual dynamics economy-wide, albeit slightly slower versus the previous quarter.

Key interbank money market rates remained high, although they saw their positive spread vis-à-vis the monetary policy rate narrow gradually after the resumption of repos by the central bank on 6 August, given the reoccurrence of a net reserve shortfall on the money market in that period. In turn, the EUR/RON exchange rate was further relatively stable during Q3 as a whole, most likely attributable to the considerable differential of interest rates on the local market versus those prevailing in Europe and regionally.

The annual growth rate of credit to the private sector remained robust July through August[36], with the dynamics of the leu-denominated component sticking to double-digit levels, yet following a somewhat steeper downtrend, primarily on the back of housing loans and credit to non-financial corporations. However, the share of the domestic currency component in total private sector credit further widened in July, before remaining unchanged at 65.3 percent in August. At the same time, the annual growth of liquidity in the economy moderated, owing to the relative slowdown in money creation on account of the budget execution and of EU funds, despite further posting two-digit levels[37].

The short-term projection updated in this context reconfirmed the outlook for the annual inflation rate to decline further in the near run, in line with the medium-term forecast published in the August 2018 *Inflation Report*. The significant downward correction in inflation developments expected for 2018 Q4 was mainly ascribable to the base effects associated with the previous year's increases in all CPI exogenous components. Their disinflationary contribution was, however, seen to be more modest than in the latest medium-term forecast[38], a more visible input being likely in the case of core inflation. The new assessments also reconfirmed the prospects for a marked deceleration in economic growth in Q3 – largely on the back of negative base effects –, followed by a more moderate re-acceleration in 2018 Q4, implying a slightly slower widening of the positive output gap during the second half of the year than in the August forecast, yet at somewhat higher values than previously anticipated, as a result of its reopening above expectations in Q2.

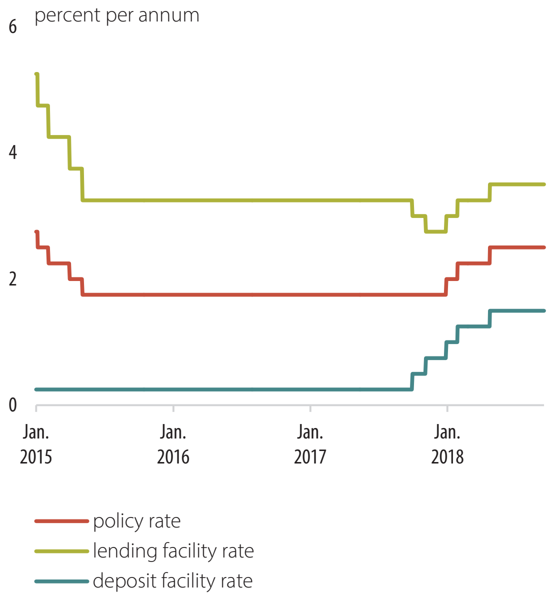
Also relevant, however, were the risks to the August medium-term forecast stemming from the volatility of consumer confidence, as well as from the lower-than-planned EU funds absorption and public investment spending. To these added the risks to

36 An annual pace of 6.6 percent in each month, only marginally below the Q2 average and slightly above the Q1 reading.

37 Namely 11.1 percent in July and 10.8 percent in August (in annual terms).

38 Given the unexpected hike in the electricity price in August, as well as the relative increase in oil prices.

Chart 3.1. NBR rates



euro area's economic performance induced by trade protectionism, the Brexit uncertainties, the situation in Italy and the global financial market volatility, with possible implications for the ECB's monetary policy stance, also relevant in terms of the decisions taken by central banks in the region.

Against this background, ensuring adequate monetary conditions with a view to anchoring medium-term inflation expectations and keeping the annual inflation rate in line with the current medium-term forecast, while safeguarding financial stability, warranted the status quo of the monetary policy rate. Therefore, in its meeting of 3 October 2018, the NBR Board kept unchanged the monetary policy rate at 2.5 percent, the deposit facility rate at 1.5 percent and the lending facility rate at 3.5 percent (Chart 3.1).

2. Financial markets and monetary developments

In 2018 Q3, longer-term interbank money market rates continued to rise, albeit more moderately than in the previous three months, while the EUR/RON exchange rate fluctuated around relatively lower levels than in Q2. The credit to the private sector extended its robust annual growth into July and August 2018, whereas the dynamics of liquidity across the economy declined further, amid the relative slowdown in money creation owing to the budget execution and to EU funds.

2.1. Interest rates

The daily average interbank money market rate stuck to a generally upward trend in the first part of Q3 and, posting larger fluctuations, reached the upper bound of the interest rate corridor, before witnessing a downward adjustment and returning to the vicinity of the monetary policy rate. Under the circumstances, its quarterly average recorded a renewed increase, although more modest than in the previous three months (i.e. 0.19 percentage points, to 2.59 percent).

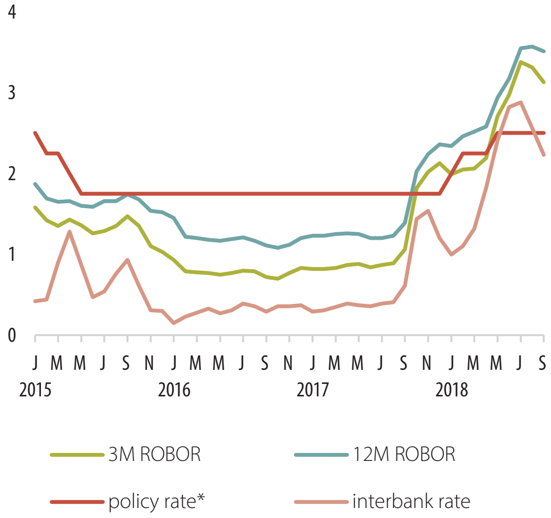
The further rise in daily ON rates, which resulted in their nearing the lending facility rate and standing slightly above the end-Q2 readings towards the end of July and in the early days of August, reflected the increased restrictiveness of liquidity conditions under the influence of autonomous factors[39]. Nonetheless, this restrictiveness was alleviated once the NBR resumed the supply of liquidity on 6 August in the form

[39] With a view to covering their reserve shortfall, some credit institutions resorted during this period to the central bank's lending facility.

of 1W repos conducted via fixed-rate tenders with full allotment[40], given the reoccurrence of a net reserve shortfall on the money market[41]. Very short-term yields on the interbank money market therefore witnessed a downward adjustment, returning to the vicinity of the monetary policy rate[42].

In turn, 3M-12M ROBOR rates increased at a faster pace during the first month of the quarter under review[43], hence widening their positive spread vis-à-vis the monetary policy rate, also as a result of credit institutions' expectations on the future developments in the NBR's key rate. With the resumption of repos by the central bank, as well as in the context of the monetary policy rate status quo, these rates re-embarked on a downward path which extended into mid-September, before quasi-stabilising or posting marginal increases towards the end of the period. Against this background, average ROBOR rates in the closing month of the quarter continued to rise versus those recorded at the end of the previous three months, albeit more moderately than in Q2, with the 3M rate adding 0.16 percentage points, to 3.13 percent, and the 6M and 12M rates advancing 0.31 percentage points, to 3.38 percent, and 0.34 percentage points, to 3.51 percent, respectively (Chart 3.2).

Chart 3.2. Policy rate and ROBOR rates



*) end of period

On the government securities market, the NBR's decisions and actions, associated with investors' rekindled appetite for leu-denominated investments, counterbalanced the influences from the external environment[44]. Thus, reference rates on the secondary market saw their uptrend recorded since mid-April come to a halt as early as the onset of the quarter and followed afterwards a downward path – which was initially visible only for the medium and long maturities, but which became broad-based and steepened in August –, before remaining somewhat stable in September at the lower levels thus reached (Chart 3.3). During the quarter overall, yields[45] on the 6-month and 12-month maturities continued nonetheless to rise, albeit more slowly than in the previous three months, their September averages adding approximately 0.2 percentage points against June, to 3.15 percent and

40 Thus, after having continued to hold weekly auctions in July for taking 1W time deposits (the volume of credit institutions' bids being nil or insignificant, except for the 16 July auction, when it amounted to lei 11 billion), the NBR conducted three repos in each of August and September, the daily average balance of these operations amounting to lei 5.3 billion and lei 4.8 billion respectively.

41 For the first time this year.

42 Temporary declines in the lower half of the interest rate corridor were seen towards the end of reserve maintenance periods, amid episodes of excess liquidity, mopped up via the deposit facility.

43 Peaking at end-July and remaining in the early days of August at the highest readings in almost four years and a half.

44 Marked in July and August by a relative stability of long-term government security yields, manifest in the US and in the euro area, but also across the region, followed by an upward trend in September.

45 Bid/ask average rates.

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

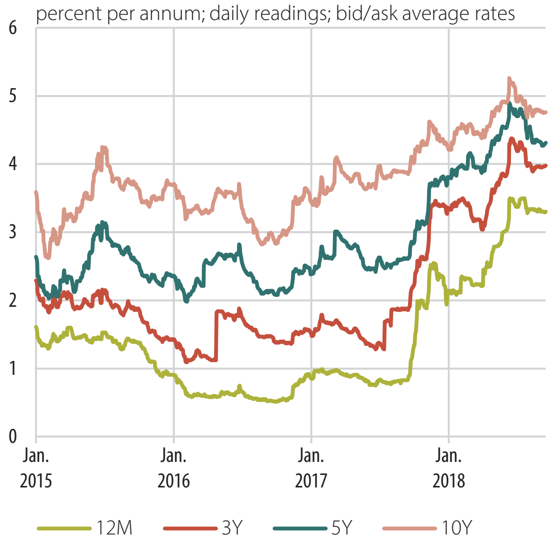
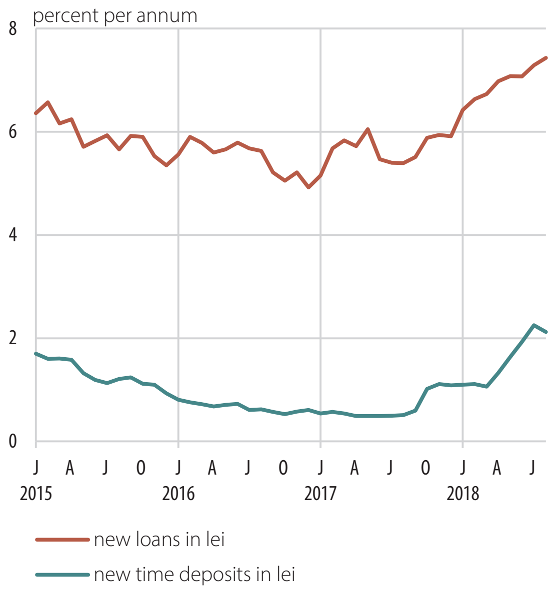


Chart 3.4. Bank rates



3.31 percent respectively. However, the rates for 5-year and 10-year maturities shed up to 0.3 percentage points, to 4.31 percent and 4.77 percent respectively; in this context, the yield curve remained on a flattening trend.

On the primary market, the average bid rates at the last auctions conducted in September increased versus end-Q2 readings in the case of 12-month Treasury certificates (by 0.29 percentage points), while diminishing for medium and long maturities (by 0.4 to 0.5 percentage points for 3- to 7-year residual maturities and by 0.1 percentage point for the 15-year residual maturity). Also illustrative of the rebound in investor appetite for government securities was the rise versus the previous three months both in the average demand-to-supply ratio – whose progressive and sizeable increase in July and August was followed by only a slight reduction in September[46] – and in the ratio of the volume of issues to the announced value (105 percent from 68 percent in 2018 Q2); in turn, the average maturity of securities issued advanced marginally, after shrinking for two consecutive quarters.

June through August 2018, credit institutions' average interest rates on non-bank clients' new loans and new time deposits went up further, at a slightly slacker pace than in the earlier three months (+0.36 percentage points, to 7.43 percent, and +0.48 percentage points, to 2.12 percent respectively). The advance was almost broad-based, both from the perspective of the two customer sectors and across the types of new loans and new time deposits (Chart 3.4). Specifically, the average lending rate on new business to non-financial corporations climbed by another 0.63 percentage points, to 6.02 percent, on account of both categories of loans (below and above EUR 1 million equivalent respectively). In turn, the average lending rate on new business to households added 0.30 percentage points, to 8.51 percent, driven exclusively by the rise in the average interest rate on new housing loans. At the same time, that on new consumer loans continued to display the relative immobility posted since the prior quarter, due primarily to the behaviour of the average interest rate on fixed-rate loans, which saw their large share in this category consolidate. The average remuneration of new time deposits grew slightly faster for households compared with the relatively sluggish pace

46 Inter alia amid the upturn in the scheduled volume of issues.

Chart 3.5. Nominal exchange rate

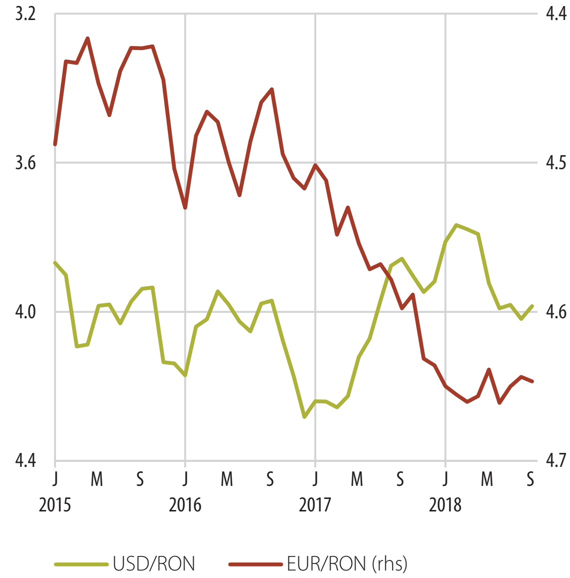


Table 3.1. Key financial account items

EUR million

	8 mos. 2017			8 mos. 2018		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	4,155	6,242	-2,087	1,889	4,960	-3,070
Direct investment	-91	2,916	-3,007	900	3,718	-2,818
Portfolio investments	382	2,300	-1,918	160	1,487	-1,327
Financial derivatives	x	x	-35	x	x	66
Other investment	2,212	1,026	1,186	3,400	-246	3,646
– currency and deposits	1,580	-962	2,542	2,098	-837	2,934
– loans	52	328	-275	-64	-1,072	1,008
– other	580	1,660	-1,081	1,366	1,663	-296
NBR's reserve assets, net	1,687	0	1,687	-2,637	0	-2,637

*) "+" increase/"-" decrease

recorded previously (+0.37 percentage points, to 1.47 percent) and continued its relatively sturdy advance in the case of non-financial corporations (up 0.54 percentage points, to 2.40 percent).

2.2. Exchange rate and capital flows

In 2018 Q3, the EUR/RON exchange rate continued to fluctuate, albeit around relatively lower levels than in the previous quarter, reflecting the prevalence of domestic influences in this quarter as well (Chart 3.5).

At the beginning of 2018 Q3, the EUR/RON remained on the slight downtrend it had embarked on towards end-June, and then fell at a faster pace, thus fully correcting the significant increase recorded in the latter part of 2018 Q2, which had led to a new historical high[47]. Behind this adjustment stood the relative recovery of the global risk appetite, being spurred by the larger differential between interest rates on the local financial market and those prevailing in Europe and regionally and probably by expectations of a hike in the monetary policy rate in August. The improvement in global financial market sentiment became more pronounced towards the end of July[48], which triggered even more visible declines in the exchange rates of the other relevant currencies in the region, in correlation with the magnitude of increases witnessed during the sell-off on emerging markets in the prior quarter.

After having reached a new low this year at the beginning of August[49], the EUR/RON saw a new episodic increase. The latter started after the monetary policy decision taken by the NBR Board on 6 August and then steepened amid financial market turmoil in some emerging economies – particularly Turkey[50] and Argentina – and the escalating trade row between the US and China, conducive to rekindled global risk aversion and worsening investor sentiment towards

47 EUR/RON 4.6695 on 21 June.

48 Amid signals on defusing tensions in the trade relations between the US and the European Union and on the back of the ECB reconfirming the prospects for key interest rates to remain unchanged at least through the summer of 2019.

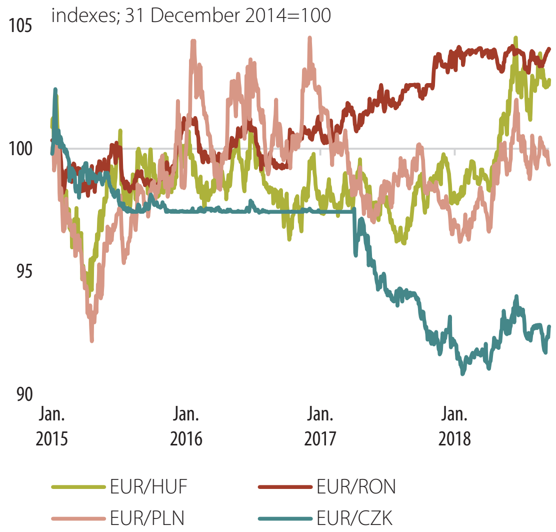
49 EUR/RON 4.6206 on 3 August. Another close value was reached on 22 May, i.e. EUR/RON 4.6225.

50 With domestic economic developments deteriorating, the tensions surrounding political relations with the US, followed by the trade sanctions and tariffs adopted by the latter at the beginning of August, led to the sharp depreciation of the Turkish lira.

emerging markets[51] (Table 3.1). However, in the latter half of the month, the leu largely made up for the lost ground, given the relative calming of the Turkish financial market[52] and the increase in capital inflows in the form of portfolio investment, amid higher interest rates in the domestic market and Moody's confirmation of Romania's sovereign rating on 24 August[53].

At the end of the first 10-day period in September, the EUR/RON resumed, however, a slight upward trend, with the exchange rates of the main currencies in the region following suit later on, most likely in anticipation of the Fed conducting a rate hike in its meeting of 25-26 September. Subsequently, exchange rates in the region witnessed heterogeneous developments, probably reflecting the rising influence of some local factors.

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



Source: ECB, NBR

In this context, the interbank forex market saw a new increase in turnover compared with the previous quarter, as well as a substantial improvement in the balance of transactions, primarily on account of non-residents. During 2018 Q3 as a whole, the leu strengthened slightly against both the euro (0.3 percent in nominal terms[54] and 0.6 percent in real terms) and the US dollar (0.2 percent in nominal terms and 0.4 percent in real terms). Looking at the average annual exchange rate dynamics in Q3, the domestic currency saw its nominal depreciation versus the euro slow down in this period as well, and posted the first nominal depreciation against the US dollar in the past five quarters (Chart 3.6).

2.3. Money and credit

Money

July through August 2018, broad money (M3) dynamics[55] continued to decrease, owing to the relative slowdown in money creation on account of budget execution and EU funds, yet stuck to a two-digit level (10.9 percent versus 11.8 percent in 2018 Q2; Table 3.2)[56].

51 Against this background, but also as a result of favourable developments in the US economy, implying stronger expectations on the Fed continuing to increase the policy rate, the US dollar appreciated fast against the euro.

52 Also in the context of the Turkish central bank adopting measures to increase liquidity in the financial market on 13 August. Against the backdrop of the decline in global risk aversion and the start of trade talks between the US and China, the US dollar largely corrected its strengthening versus the euro seen in the first half of the month.

53 On 31 August, S&P confirmed, in its turn, Romania's sovereign rating.

54 In 2018 Q3, the Polish zloty and the Czech koruna also strengthened against the single currency, by 0.1 percent and 0.6 percent respectively, whereas the Hungarian forint depreciated by 0.7 percent.

55 Unless otherwise indicated, percentage changes in this section refer to the average of annual growth rates in nominal terms.

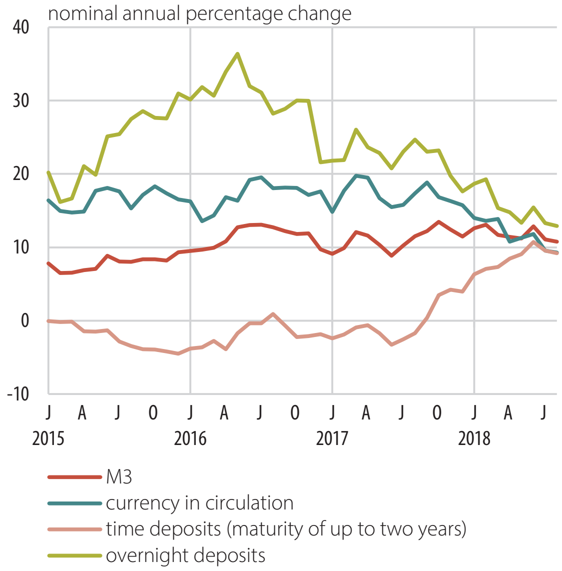
56 In real terms, the slowdown in the average annual dynamics of M3 was more modest (from 6.2 percent in 2018 Q2 to 5.8 percent July through August).

Table 3.2. Annual growth rates of M3 and its components

nominal percentage change

	2017		2018			
	III	IV	I	II	Jul.	Aug.
	quarterly average growth					
M3	11.3	12.4	12.4	11.8	11.1	10.8
M1	21.6	19.0	16.6	13.5	12.1	11.8
Currency in circulation	17.3	16.3	13.8	11.3	9.5	9.3
Overnight deposits	23.6	20.2	17.8	14.5	13.3	12.9
Time deposits (maturity of up to two years)	-1.3	3.9	6.9	9.4	9.5	9.2

Chart 3.7. Main broad money components



The loss of momentum was again induced by the softer growth of narrow money (M1), attributable to the performance of both currency in circulation and overnight deposits of the two main customer categories. By contrast, the advance of time deposits with a maturity of up to two years remained steadily high when looking at the past five years, given that household deposits saw a new pick-up in growth (up to a five-year high, mainly owing to the foreign currency component), while corporate deposits witnessed relatively slower dynamics (visible for both leu and foreign currency components), albeit still very high by the standards of the past almost ten years. However, the share of M1 in broad money widened again in July, after the more significant leap at end-2018 Q2, reaching 60.8 percent (record high since December 1994), and then narrowed only marginally in August (Chart 3.7).

In the case of total M3 deposits as well, developments were heterogeneous across main customers. Specifically, household deposits rose at a slightly faster pace, amid the increase in some income categories[57] and probable portfolio shifts from other financial instruments (cash, investment fund shares), whose cumulated effects more than offset the impact of the somewhat slacker pace of increase of net wage earnings. Conversely, non-financial corporations' deposits further witnessed slower dynamics, amid the decrease in the annual rate of change of disbursements from EU funds[58] and of government spending on goods and services respectively. An additional contribution thereto came from the rise in payments to the general government budget on account of certain taxes[59] and of dividends in the case of entities where the state is a shareholder[60].

From the perspective of broad money counterparts, behind the deceleration in M3 dynamics stood, in the reported period as a whole, the slower decline of central government deposits; an opposite, albeit weaker, impact had the re-acceleration

57 The raise in the pension point and the social indemnity for pensioners in July.

58 According to the monthly data on public spending for projects financed from non-repayable external funds (from the general government budget execution), along with the data regarding disbursements from EU funds for agriculture (source: the website of the Agency for Rural Investment Financing).

59 According to the monthly data on general government budget execution, the annual dynamics of payments for the corporate income tax and other taxes on income, profits and capital gains increased slightly July through August compared with those in 2018 Q2.

60 Reflected by the considerably faster annual dynamics of non-tax budget revenues in July.

Chart 3.8. Credit to the private sector by currency

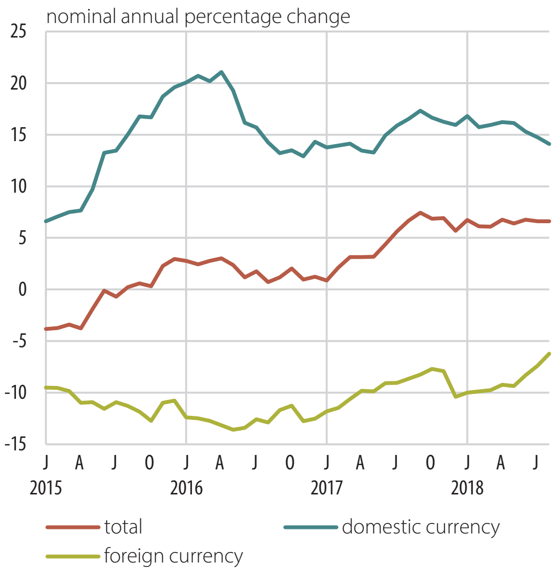
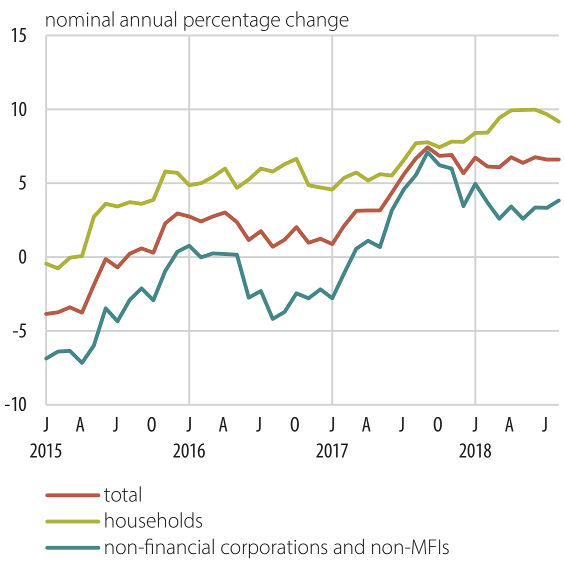


Chart 3.9. Credit to the private sector by institutional sector



in the advance of banks' government security holdings and the renewed drop in credit institutions' long-term financial liabilities[61].

Credit to the private sector

July through August 2018, the growth of credit to the private sector remained robust, at a high value as compared to the past five years (6.6 percent, similar to the 2018 Q2 average)[62], benefiting from the further sizeable contribution of new loans, whose annual rate of change tended, however, to decrease[63], as well as from the rise in credit line financing[64]. The annual growth rate of the leu component witnessed a slightly steeper downtrend, yet remained in the two-digit range, and the foreign currency component (expressed in euro) saw a less negative rate of change (Chart 3.8). However, the share of domestic currency loans in total private sector credit widened further, reaching a post-September 1996 record high in July (65.3 percent), before holding steady in August.

The breakdown by institutional sector points to diverging developments in this quarter as well (Chart 3.9). Specifically, the increase in loans to non-financial corporations regained traction, amid the slower annual decline in the foreign currency component, which benefited from a new rise in the volume of new business. The dynamics of leu-denominated loans stuck to a downward path – given that the slowdown in the pace of increase of new business had a larger impact than the faster growth rate of overdraft loans and revolving credit –, yet remained high by comparison to the past five and a half years. By contrast, the advance of household credit decelerated, after reaching a near nine-year high in the previous quarter. The slacker pace was induced by leu-denominated loans, whose growth rate, albeit still high, declined under the influence of the new loss of momentum in the dynamics of housing loans – attributable to loans granted under the "First Home" programme[65] – and, to a lesser extent, as a result of the somewhat slower growth of consumer credit and other loans.

61 Capital accounts included.

62 In real terms, the average annual dynamics of credit to the private sector picked up (1.7 percent, from 1.2 percent in 2018 Q2).

63 Also possibly on account of the likely tightening of banks' credit standards in 2018 Q3, according to the expectations reflected in the NBR's August 2018 *Bank Lending Survey.*

64 Overdraft loans, revolving loans, and credit card loans.

65 Based on CCR data.

4. Inflation outlook

The annual CPI inflation rate is foreseen to reach 3.5 percent at end-2018, 2.9 percent at end-2019 and 3.1 percent at the projection horizon, i.e. 2020 Q3. The downturn in the annual inflation rate, which started in 2018 Q3, is expected to gather pace in the fourth quarter and to continue in the first part of the projection horizon, amid the lower contribution to inflation from the exogenous components of the consumer basket. The indicator is thereafter anticipated to re-embark on an uptrend, posting levels marginally higher than 3 percent at the projection horizon. The annual core inflation is expected to resume an upward path starting 2019 Q1 and to stabilise in the latter half of the projection interval at values slightly above those anticipated for the annual CPI inflation rate. The evolution is ascribed largely to the foreseen dynamics of prices of imported goods, under the impact of gradual convergence of external inflation towards the 2 percent benchmark, partly countered by the slow correction of inflation expectations to levels close to 3 percent. Inflationary pressures from excess demand in the economy persist, but are projected to abate in the latter half of the projection interval, amid a reconfiguration of real broad monetary conditions and the discretionary fiscal policy stance to close-to-neutral levels. Even though some of the risk sources identified in the previous *Inflation Report* have already materialised, the balance of risks to the annual inflation rate projection is assessed as being further tilted to the upside compared to its path in the baseline scenario, with risks stemming from both domestic and external sources.

1. Baseline scenario

1.1. External assumptions

Over the projection interval, external demand, assessed based on the effective EU GDP (EU-28 excluding Romania), is expected to increase at annual rates of around 2 percent, albeit losing some momentum. The projected levels are below the previously foreseen ones (Table 4.1), amid more modest global economic growth, with a negative impact on the EU's export performance, yet they further exceed the bloc's potential growth levels. Hence, the cyclical advance of economic activity in Romania's major trading partners, as reflected by the effective EU GDP gap, will gain ground over the projection interval, albeit at a somewhat slower pace towards its end, having a stimulative impact on the local economy. Private consumption will continue to be the major driver of economic growth, further benefiting from the ECB's

Table 4.1. Expectations on the developments in external variables

annual averages

	2018	2019
Effective EU economic growth (%)	2.3	2.0
Annual inflation rate in the euro area (%)	1.7	1.7
Annual inflation rate in the euro area, excluding energy (%)	1.3	1.6
Annual CPI inflation rate in the USA (%)	2.5	2.2
3M EURIBOR (% per annum)	-0.3	-0.2
USD/EUR exchange rate	1.18	1.18
Brent oil price (USD/barrel)	73.8	76.3

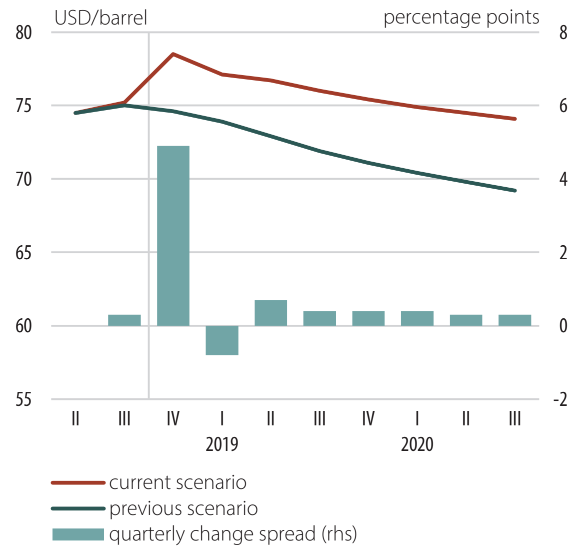
Source: NBR assumptions based on data provided by the ECB, European Commission, Consensus Economics and futures prices

accommodative monetary policy[66], the still elevated levels of consumer confidence (as also reflected by the ESI still outperforming its historical average) and from the improvements in labour market conditions (in terms of both employment and wage earnings).

The average annual HICP inflation rate in the euro area is forecasted to remain below the ECB's 2 percent price stability benchmark, namely 1.7 percent in both 2018 and 2019, as only next year's level was marginally revised upwards by 0.1 percentage points. The average annual HICP inflation rate excluding energy in the euro area is projected to stay on an upward path over the projection interval, from 1.3 percent in 2018 to 1.6 percent in 2019. This comes in the context of further labour market tightening, with a bearing on the expected pay rises, and of indirect effects from the recent spike in the oil price. For 2019, the level of this indicator was revised marginally downwards against the previous *Inflation Report*, in line with the outlook for a less brisk pace of growth. Annual inflation rate in the US is foreseen to run higher than 2 percent.

Against the background of the ECB's persistently accommodative monetary policy, the nominal 3M EURIBOR rate is anticipated to further register negative values, yet their magnitude is set to decline in the latter half of the projection interval.

Chart 4.1. Brent oil price scenario



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

The US dollar is projected to soften versus the euro starting in the first months of 2019. The exchange rate is foreseen at EUR/USD 1.22 at the projection horizon, amid expectations of a stronger pro-cyclicality of fiscal policy in the US, negatively impacting the country's current account deficit and, hence, being likely to fuel protectionist trade policies.

Starting from the recent substantial increases in the Brent oil price (which exceeded the USD 80 per barrel threshold in 2018 Q3, nearing a four-year high), the scenario for its evolution based on futures prices envisages an uptrend in 2018 Q4 as well. The oil price is seen embarking on a downward course beginning with the first part of 2019 and

66 In its meeting of 25 October 2018, the ECB's Governing Council decided to continue making net purchases under the asset purchase programme at the monthly pace of EUR 15 billion in the final three-month period of 2018. At the same time, subject to incoming data confirming the medium-term inflation outlook, the decision was maintained to end these purchases starting next year and to keep unchanged the key ECB interest rates for as long as necessary to ensure that the performance of inflation stays in line with its currently-expected sustainable path, at least through summer 2019.

reaching USD 74.1 per barrel at the projection horizon (Chart 4.1). Its expected dynamics are further characterised by high uncertainty[67], as also mirrored in the revised trajectories of futures prices in the successive projection rounds.

1.2. Inflation outlook

The baseline scenario of the macroeconomic projection places the annual CPI inflation rate at 3.5 percent at end-2018 and at 2.9 percent at end-2019. These levels stand at the upper bound of and inside the ±1 percentage point variation band of the 2.5 percent flat target, respectively. At the projection horizon, i.e. 2020 Q3, this rate is projected at 3.1 percent (Table 4.2; Chart 4.2). The forecasted end-2018 level incorporates a 1.5 percentage point contribution of core inflation, while the 2 percentage point difference reflects the contribution to inflation of the consumer basket components beyond the scope of monetary policy. These exogenous components are seen making a significantly smaller contribution in 2019, in parallel with the annual core inflation rate being foreseen to follow an upward path starting 2019 Q1.

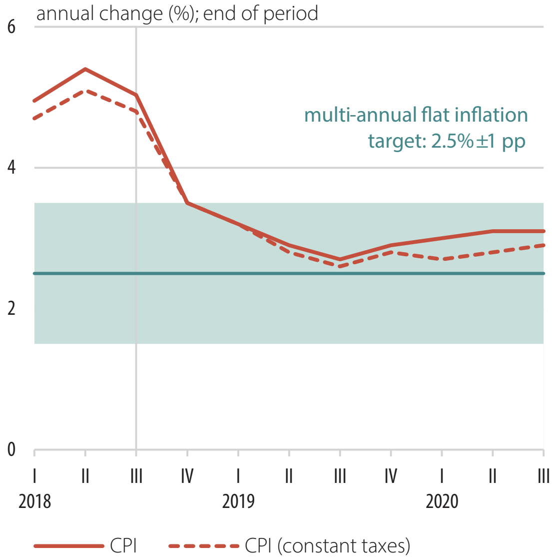
Table 4.2. The annual inflation rate in the baseline scenario

annual change(%); end of period

	2018	2019				2020		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	3.5	3.2	2.9	2.7	2.9	3.0	3.1	3.1
CPI projection*	3.5	3.2	2.8	2.6	2.8	2.7	2.8	2.9

*) calculated at constant taxes

Chart 4.2. Inflation forecast



Source: NIS, NBR projection

From 5.0 percent at the end of Q3, the annual CPI inflation rate is expected to post a noticeable 1.5 percentage point slowdown in 2018 Q4. The evolution is anticipated to stem from a deceleration in both the contribution of exogenous components and the adjusted CORE2 inflation, especially amid significant base effects, as 2017 Q4 saw multiple supply-side inflationary shocks[68]. From the beginning of 2019 until the forecast horizon, the annual CPI inflation rate is expected to return into and remain in the upper half of the variation band of the target. The repositioning of inflation inside the band starting 2019 Q1 is foreseen to be driven mostly by the exogenous components of the consumer basket, the contribution of which will narrow sizeably by 2019 Q3 assuming no new supply-side shocks occur. At the same time, the annual core inflation rate is projected to stay inside the variation band of the target until the projection horizon.

67 For further details, see Chapter 4, Section 1.4. Risks associated with the projection.

68 The hikes in electricity prices and the excise duty on fuels in October 2017, the upswing in the oil price at the end of the previous year and an atypical increase in processed food prices.

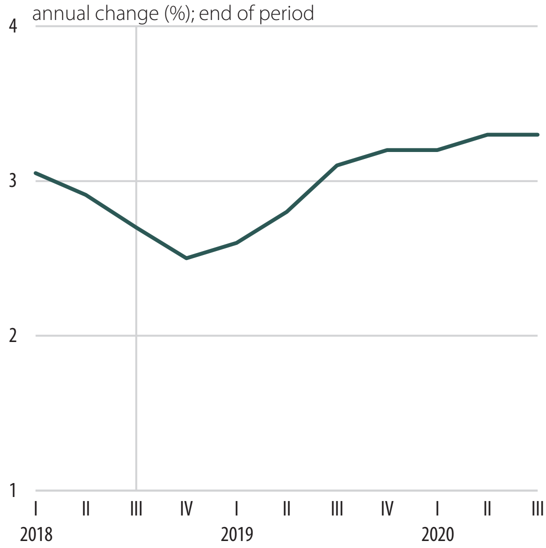
For the end of 2018, the annual CPI inflation rate is forecasted at a level relatively similar to that in the previous *Inflation Report*, given that the higher contributions of administered and fuel prices are offset by the downward revision in those of the adjusted CORE2 index and volatile food prices. For next year, the indicator was revised upwards by 0.2 percentage points, particularly on the back of a larger contribution from administered prices.

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

annual change (%); end of period

	2018	2019				2020		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Adjusted CORE2	2.5	2.6	2.8	3.1	3.2	3.2	3.3	3.3

Chart 4.3. Annual adjusted CORE2 inflation



Source: NIS, NBR projection

The annual adjusted CORE2 inflation rate is forecasted to decline further in the course of 2018 Q4 to 2.5 percent in December, down 0.2 percentage points against September (Table 4.3; Chart 4.3). This will occur particularly amid the fading-out of unfavourable pressures stemming from some agri-food commodity prices on processed food prices[69] in the final months of 2017, before even reversing its trend in early 2018. Furthermore, inflation expectations will flatten out towards the end of 2018, albeit at a level marginally higher than the upper bound of the variation band of the target, yet lower than that foreseen in the previous round. From the end of 2018 Q4, the annual adjusted CORE2 inflation rate is projected to follow a slightly upward trend, reaching 3.2 percent in December, and it is anticipated to stabilise near that value until the projection horizon. The evolution is widely ascribed to the foreseen dynamics of prices of imported consumer goods, under the impact of gradual convergence of external inflation towards the 2 percent benchmark, partly countered by the slow correction of inflation expectations to levels close to 3 percent. Inflationary pressures from excess demand economy-wide persist, but they are projected to abate in the latter half of the projection interval, amid a reconfiguration of real broad monetary conditions and the discretionary fiscal policy stance to close-to-neutral levels.

Compared to the August 2018 *Inflation Report*, the path of the annual adjusted CORE2 inflation rate was marginally revised downwards only for the end of 2018 (by 0.2 percentage points) amid the recent slower-than-previously-anticipated dynamics of some agri-food commodity prices impacting processed food prices, lower inflation expectations and the more favourable evolution of imported consumer goods at this horizon[70]. The influence of the above-mentioned factors is partly countered by stronger inflationary pressures from excess demand.

[69] Core inflation subcomponent.

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

The cumulative contribution of inflation 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 2 percentage points at the end of 2018 and 0.9 percentage points at the end of 2019, being revised upwards by 0.1 percentage points and 0.2 percentage points respectively against the previous *Report* (Table 4.4).

Table 4.4. Components' contribution to annual inflation rate*

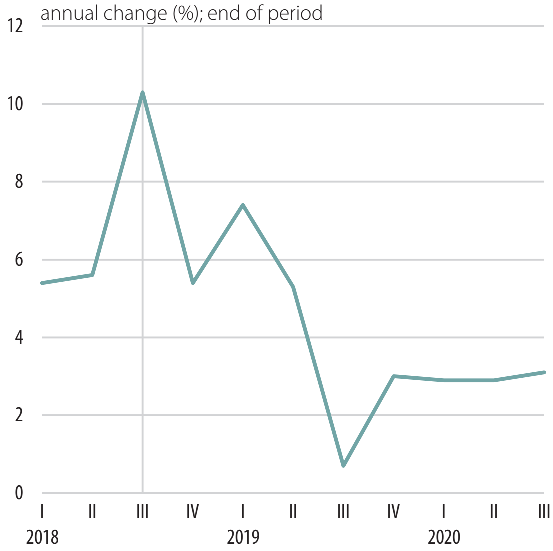
percentage points

	2018	2019
Administered prices	0.7	0.4
Fuels	0.7	0.2
VFE prices	0.3	0.2
Adjusted CORE2	1.5	2.0
Tobacco and alcoholic beverages	0.3	0.2

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

Volatile food (VFE) prices are projected to rise at an annual pace of 5.4 percent at the end of this year, 3 percent at the end of next year, with both values being revised downwards by 1 percentage point[71] and 0.2 percentage points respectively, and 3.1 percent at the projection horizon (Chart 4.4). Their growth path over the forecast interval rests on the assumption of normal agricultural years domestically in 2019 and 2020.

Chart 4.4. VFE prices annual inflation



Source: NIS, NBR projection

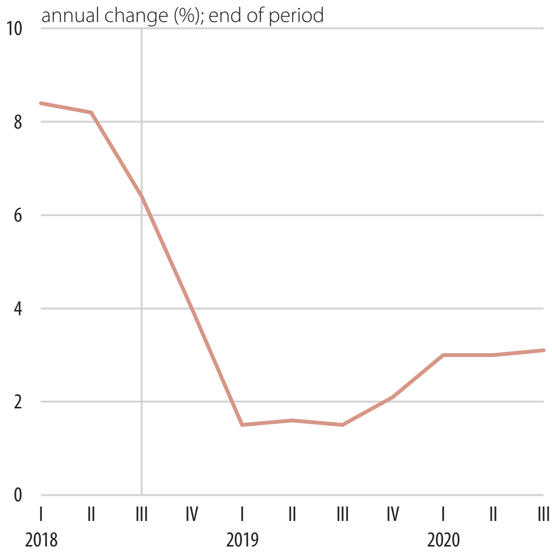
The exogenous scenario of administered prices anticipates rises by 4.0 percent at end-2018, 2.1 percent at end-2019, and 3.1 percent at the projection horizon (Chart 4.5). Compared to the previous *Report*, the levels were revised upwards by 0.1 percentage points for end-2018, following an unforeseen hike in electricity prices in August, and by 1 percentage point for end-2019, amid the projected increase in the average annual impact of green certificate acquisition on households' bills[72].

The annual dynamics of fuel prices are anticipated to reach 8.8 percent at end-2018, being revised upwards by 2.0 percentage points, 1.9 percent at end-2019, also following an upward revision of 0.4 percentage points, and 1.8 percent at the projection horizon (Chart 4.6). The significant revision for end-2018 occurs amid the annual dynamics of the international oil price running above those projected in the previous *Report* for this horizon as a result of supply-side factors. Moreover, the euro is forecasted to witness a stronger depreciation against the US dollar, impacting the USD/RON exchange rate and, in turn, the leu-denominated fuel prices.

71 Against the backdrop of more favourable developments on the vegetables-fruit segment in July and August than those anticipated in the previous *Report*.

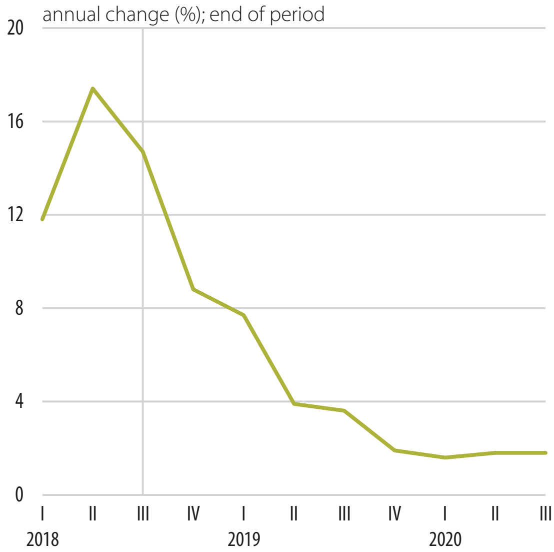
72 The values of the yearly mandatory acquisition quota for green certificates are set forth by Law No. 184/2018 governing the regulation of the system for the promotion of energy produced from renewable sources. The path in administered prices incorporates the estimated impact of enforcing this law on electricity prices, which are, however, surrounded by elevated uncertainty in terms of the size of their expected hikes and their implementation timeline.

Chart 4.5. Administered prices annual inflation



Source: NIS, NBR projection

Chart 4.6. Fuel prices annual inflation



Source: NIS, NBR projection

The scenario for tobacco product and alcoholic beverage prices envisages relatively similar annual dynamics to those in the previous *Report*, i.e. 3.3 percent and 3.2 percent at end-2018 and end-2019 respectively. Their growth rate is estimated to reach 3.1 percent at the projection horizon. The projected annual inflation path for these prices is shaped based on the applicable legislation concerning excise duties levied on these products and is surrounded by elevated uncertainty.

1.3. Demand pressures in the current period and over the projection interval[73]

Output gap

In 2018 Q2, real GDP saw a 1.4 percent advance in quarterly terms, growing significantly faster than in Q1 and also compared to the benchmark forecast; the annual dynamics stood at 4.1 percent[74], similar to those registered in the first quarter of the year. The quarterly GDP growth mirrored a rise in domestic demand, based exclusively on the consumption component, given the further GFCF decrease. Concurrently, the negative contribution of net exports to GDP growth widened, reflecting the divergent developments in exports (slight decline) and imports (faster pick-up), respectively.

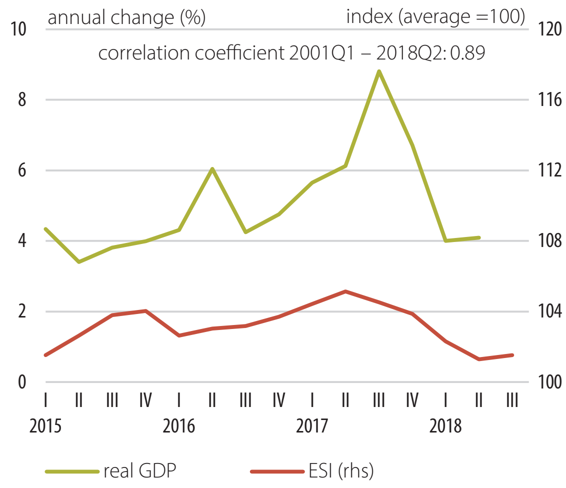
For the latter part of the current year, the signals coming from monthly indicators point mostly to slower quarterly GDP dynamics. Specifically, a slight weakening in industrial output and in the volume of retail trade was noticed compared to Q2, impacting domestic demand, however in parallel with an increase, albeit more

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

[74] NIS Press Release No. 172 of 6 July 2018. The annual dynamics are calculated based on gross data series.

moderate than in Q2, of real net wage earnings, and with an improvement in the economic sentiment indicator, mainly due to industry and consumer components (Chart 4.7). Quarterly GDP growth is foreseen to continue to be driven by domestic demand (consumption, in particular), but the dynamics are expected to be considerably slower than those in the previous year. At the same time, net exports of goods and services are projected to further make a slightly negative contribution, yet significantly lower compared to Q2.

Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

The baseline scenario of the projection foresees a notable slowdown in economic growth in 2018, under the influence of the developments recorded at the end of last year and during the first quarter, amid the drop in economic agents' confidence. For 2019, GDP growth is anticipated to pick up slightly and post values close to the potential one. By comparison with 2017, the forecasted GDP dynamics reflect the lower traction of domestic demand, mainly due to a deceleration in consumption growth, dampened by the sharply slower increase in real disposable income; at the same time, the GFCF contribution is expected to worsen, as this component is visibly affected by the contractions recorded in the first two quarters. Given the slightly stronger growth rate of imports of goods and services compared to that of exports thereof, the contribution of net exports is anticipated to stay in negative territory, posting a more negative value this year and less negative thereafter. For 2018, mention should be made of the substantial contribution of the change in inventories, accumulated almost exclusively on the back of developments in the first half of the year, which does not have an explicit economic interpretation.

The assessment of potential GDP indicates a slowdown in its dynamics throughout the current year, followed by an upturn in the next two years. The deceleration in 2018 reflects the smaller contribution of the TFP trend, in parallel with an unfavourable evolution of GFCF and with a slower labour productivity growth rate in the economy. Subsequently, the stronger potential GDP dynamics are due to the TFP trend. Its rebound is anticipated in the context of a relatively stable forecasted capital accumulation, alongside the prospects for new investments in the economy (technological ones, in particular) and a forecasted increase in employment (the Box in Chapter 2, Section 1 shows evidence on job creation and destruction in Romania), especially in high-tech industries or services. Efficiency gains are expected to be amplified assuming an improvement in the absorption of EU structural and investment funds in the following periods, including in the context of a potential accomplishment of recently postponed projects. However, the TFP trend contribution is projected to relatively level off, amid persistent adverse influences that can be attributed to a modest allocation of resources for innovation, to the poor quality of infrastructure[75], but also to some lingering deficiencies in the management of projects for EU funds absorption[76]. Compared to the previous *Inflation Report*, potential GDP dynamics were reassessed slightly upwards for the current year (incorporating the higher-than-expected GDP growth recorded in Q2), and downwards for the following years, respectively, in the context of capital accumulation being marked by a worsening investment path.

Chart 4.8. Output gap

Source: NBR assessments based on data provided by the NIS

The output gap (Chart 4.8) is anticipated to embark on a moderately upward path in the latter half of 2018 and the first part of 2019, on the back of the external demand gap advancing into positive territory. After a levelling-off of excess demand in the second half of 2019, the latter will gradually decrease under the impact of the accommodative nature of real broad monetary conditions abating to close-to-neutral values at the projection horizon (2020 Q3), the fading of fiscal stimuli associated with the discretionary component of fiscal policy and an expected deceleration of stimuli coming from the economic activity of foreign trading partners, respectively. From the perspective of aggregate demand components, the output gap path is projected to be shaped by the developments in the gap of actual individual consumption of households, while the GFCF gap is forecasted to be placed in negative territory. In turn, the gaps of exports and imports of goods and services are assessed at positive values, yet further 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 mirroring, inter alia, the frequency and size of the revisions of historical series and also their relatively high volatility.

As compared to the previous *Inflation Report*, the output gap was reassessed upward due to: (i) the higher-than-expected developments in economic activity in 2018 Q2, with a lingering impact on the future path of the variable, and to (ii) the updating of information comprised in the set of determinants, out of which mention should be made about the revision of fiscal stimuli associated with the discretionary component of fiscal policy[77] to higher levels for the next two years, and the abatement of the stimulative nature of real broad monetary conditions more gradually than in the previous assessment.

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75 Additional evidence regarding the TFP trend slowdown is brought by the *European Innovation Scoreboard* analysis of the EC, the *Ease of Doing Business* ranking of the World Bank or the *Global Competitiveness Index* report of World Economic Forum.

76 See, for example, the ECB's *Convergence Report*, May 2018, which highlights the need for significant efforts to improve the low EU funds absorption rate. According to EC data (as at end-October 2018), the total absorption rate of EU funds (reimbursements and advances) is of approximately 20 percent for Romania, slightly below the European average (23 percent) and also below the other countries in the region. This gap is mainly due to the modest developments in structural and cohesion funds.

77 Approximated based on the fiscal impulse.

Aggregate demand components

Following the near standstill of 2018 Q1, amid, inter alia, the worsening in consumer confidence, actual final consumption posted a 1.4 percent increase in Q2 versus the previous period[78]. For the next quarters, actual final consumption is expected to remain on an upward trend, although easing somewhat. Signals in this respect stem from an anticipated slower increase in real net wage and from an expected improvement in consumer confidence.

The actual final consumption is projected to remain the key driver of economic growth throughout the following year, but with a smaller contribution than in 2017. The developments in this component are in line with the dynamics of real disposable income, which are seen decelerating. Its path is attributable to its main component – the wage bill –, affected by the slowdown in net wage increase in nominal terms, while the inflation rate outlook has a favourable impact. A positive influence comes also from labour market tightness, which is anticipated to remain at a relatively high degree. Throughout the entire forecast interval, consumer resources benefit from the stimulative, albeit declining, impact of real interest rates.

Following the notable worsening in GFCF in the first two quarters of the current year, the quarterly dynamics of this component are projected to rebound during the second half. However, this path is marked by uncertainty, given the persistent adverse influences exerted by the containment of public investment and by structural factors. The signals stemming from high-frequency indicators are mixed. Specifically, the absorption of European structural and investment funds, which could finance equipment purchase and further implementation of infrastructure projects, has been modest during the first three quarters of the year, while the improvement in the confidence indicator in construction is expected to have stimulative effects in this sector.

Although the GFCF quarterly growth rate is foreseen to recover over the forecast interval, its average annual rate is expected to be negative in 2018 (being marked by the contractions registered during the first part of the year), and subsequently to revert to positive, albeit moderate, values. The structural factors impacting the forecast of the component are the following: the limited predictability of the legislative framework, the authorities' discretionary investment stance, but also the poor quality of infrastructure and the difficulty to identify available skilled workforce, which delays the start of investment projects. However, the GFCF is forecasted to benefit from the continuing gradual rise in foreign direct investment inflows – underpinned by the prospects for economic growth in Romania and in the main countries of origin – to which may add stimulative influences from further assuming an improved absorption of structural and investment funds[79], as well as the resources mobilised through the European Fund for Strategic Investments (EFSI).

[78] For details on drivers of GDP components in 2018 Q2, see Chapter 2, Section 1. Demand and supply.

[79] Taking into consideration the frequent legislative changes aimed at enabling a smoother implementation of projects included in operational programmes, the framework agreement worth EUR 1 billion, signed between Romania and the European Investment Bank for co-financing priority transport projects, as well as the completion by March 2019 of phased projects under the current financial allocation (not completed during the previous financial framework and cumulating approximately EUR 4 billion).

Against the backdrop of robust external demand, the quarterly developments in exports of goods and services are expected to recover (following the -0.5 percent decline in Q2), the annual dynamics remaining thus in positive territory throughout the entire forecast interval. This component is, nevertheless, foreseen to decelerate compared to previous years. On the one hand, exports will be supported by expected favourable developments in the economies of major trading partners, especially in the sectors integrated in global value chains (such as manufacture of transport equipment and related sub-sectors). On the other hand, the following are taken into account: (i) a worsening trend in price competitiveness of local products, amid a further increase in unit labour costs (albeit at significantly slower rates), also reflected in production cost developments, and (ii) a series of dragging structural features of the economy, such as the lack or poor quality of infrastructure or the structure of value added created by production processes, amid the still low level of innovation.

Even though domestic absorption reported modest developments during the first half of the current year, imports of goods and services continued to rise at a sustained quarterly pace, driven by exports' stimulative effects, albeit softer in Q2. Over the projection interval, the growth rate of imports of goods and services is forecasted to gradually slow down, in line with the developments in domestic absorption. At the same time, imports are anticipated to rise faster than exports. The gap is expected to be substantial in 2018 and significantly narrower in the following year, bringing a negative proportional contribution to GDP growth.

In 2018 Q2, the current account deficit remained at levels similar to Q1[80], mirroring the increase in the deficit on trade in goods and services, in contrast to the marginal fall in income deficit (4-quarter cumulative data). Throughout 2018, the current account deficit is seen further following the uptrend it embarked upon in 2015, and then flattening, amid a deceleration in domestic absorption, standing at values below 4 percent of GDP. The current account deficit financing for the current year is anticipated to be largely covered by stable, non-debt-creating capital flows, against the background of further low absorption of European structural and investment funds (ESIF)[81]. Over the remaining part of the forecast interval, their share in nominal GDP is however assessed to progressively increase, assuming a gradual rebound of foreign direct investment inflows and an improved absorption of ESIF, as a result of the emerging conditions favouring an accelerated implementation of the projects financed from these sources. Nevertheless, the widening of the current account deficit due to swifter consumption carries the potential to act towards worsening the macroeconomic equilibria, with a direct impact on capital flows to the local economy, given that the position of Romania's current account balance is opposite to that recorded by the other emerging economies in the region.

[80] As a share in GDP, its value stood at 3.2 percent (4-quarter cumulative data) as compared to 3.3 percent in Q1 2018 and 3.2 percent at end-2017.

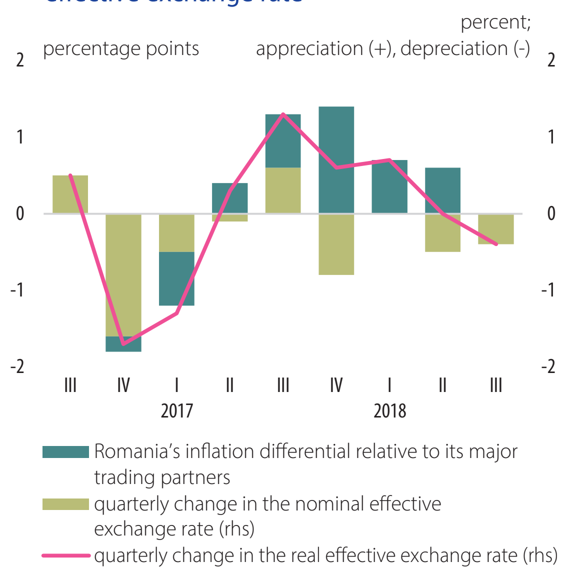
[81] The same as in the previous year, the ESIF share in GDP is expected to remain in 2018 well below that of 2016 (1.2 percent), registered amid the overlapping of two multiannual financial frameworks.

Broad monetary conditions

Broad monetary conditions capture the cumulated impact exerted on future developments in aggregate demand by the real interest rates applied by credit institutions on leu- and foreign currency-denominated loans and deposits of non-bank clients and by the real effective exchange rate[82] 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[83].

Both the average nominal interest rate on new loans in lei and that on new time deposits in lei are expected to pick up in 2018 Q3 and Q4. Moreover, in real terms, interest rates are anticipated to post an upward path in the aforementioned quarters, reflecting mostly their developments in nominal terms, as inflation expectations are on the rise only in Q3 and then remain unchanged during the last quarter. For Q3 and Q4 2018, the real interest rates continue to exert a cumulated stimulative impact, albeit on a decline, 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 the second half of the current year, amid a depreciation in nominal effective terms (due to the prevailing effect of a weaker leu in US dollar terms), the real effective exchange rate is assessed to temporarily halt its appreciation trend, which was initiated in the previous year and was shaped by the systematically higher domestic inflation rates compared to those of Romania's trading partners (Chart 4.9). In this context, the deterioration of price competitiveness of the national economy is provisionally slowing down, in the past two quarters the real effective exchange rate having a relatively neutral impact on the economic activity in the periods ahead via the net export channel.

In 2018 Q3 and Q4 on the whole, the wealth and balance sheet effect is assessed to exert stimulative influences on the output gap in future periods, mostly on account of the real foreign interest rate (3M EURIBOR) standing below the equilibrium level (significant negative gap), given the still accommodative ECB monetary policy stance. In addition, in the period under review, a slightly stimulative contribution comes from the change in the real effective exchange rate gap. By contrast, the sovereign risk premium, approximated based on the option adjusted spread (OAS), is assessed to have a slightly restrictive effect.

[82] The relevant exchange rate for the NBR's macroeconomic model for analysis and medium-term forecasting relies on the EUR/RON and USD/RON exchange rates, with the weighting system mirroring the weights of the two currencies in Romania's foreign trade.

[83] The relevance of this channel has declined gradually in recent periods, given the narrowing of the share of foreign currency-denominated loans in total credit to the private sector, amid the faster rise in leu-denominated flows versus those in foreign currency.

Overall, in 2018 Q3 and Q4, real broad monetary conditions are assessed to maintain almost unchanged their stimulative impact on the aggregate demand in the following quarters, the diminishing stimulative effect of adjusted real interest rates being offset by a slightly higher contribution from the wealth and balance sheet effect.

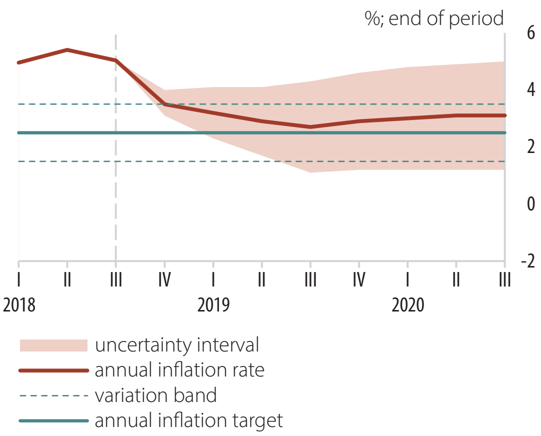
Real broad monetary conditions are anticipated to diminish their stimulative influence over the projection interval, recording close-to-neutral levels at the projection horizon. The path is mainly shaped by the real effective exchange rate developments, via the net export channel, reflecting the worsening in price competitiveness of local products given that the inflation rate in Romania is anticipated to stay above those of external trading partners. In turn, the stimulative influence of real interest rates will continue declining over the following quarters. The NBR's monetary policy stance is shaped with a view to ensure an adequate dosage and pace of adjustment from the perspective of anchoring inflation expectations and maintaining the annual inflation rate on the trajectory corresponding to the NBR's latest medium-term forecast, while safeguarding financial stability.

1.4. Risks associated with the projection

The balance of risks to the annual CPI inflation rate projection is assessed as being tilted to the upside compared to the path in the baseline scenario (Chart 4.10), with risks stemming from both the domestic and external environment. The risks specific to the current round relate primarily to developments in the exogenous components of the consumer basket. At the same time, even if some of the risks mentioned in the previous *Report* partly materialised, the risks associated with the external environment coordinates remain relevant from the perspective of the evolution of energy commodity prices, a possible escalation of trade protectionism, as well as of a potentially faster deceleration of the economic activity of Romania's main trading partners than in the baseline scenario, in the context of deteriorating global economic prospects.

Domestically, risks are primarily associated with developments in the exogenous components of the consumer basket. The uncertainties surrounding the administered price dynamics increased their relevance in the current round. They are associated with the final effect on the electricity price caused by the raise in the annual mandatory quota for the acquisition of green certificates and the reduction in the regulated rate of return of electricity providers[84]. At the same time, possible additional inflationary pressures are associated with the

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 2005-2017. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

84 For further details, see the Romanian Energy Regulatory Authority press release of 17 September 2018, available at: https://www.anre.ro/ro/presa/comunicate/comunicat-17-09-2018-aprobarea-ratei-reglementate-a-rentabilitatii (Romanian only).

natural gas component, in the context of the high correlation between the prices of domestically-produced natural gas on the national stock exchange and international prices, with the latter carrying the potential to continue their recent upward trend in the periods ahead[85].

Another source of risks refers to potentially higher rises in food prices than forecasted in the baseline scenario, in the context of the international developments in some grain prices[86], as well as of the African swine fever epidemic. Moreover, there are inherent uncertainties about the impact of weather conditions on the agricultural product supply domestically, as well as across the region and even worldwide.

Turning to prices of tobacco products and alcoholic beverages, any deviation from the regulated levels of excise duties applicable to these goods, possibly in the form of higher increases than those set forth in the Tax Code, can lead to upward deviations of the inflation path from the values in the baseline scenario.

In the assumption of any shock materialising, or worse, of a series of shocks concurring, the risk of de-anchoring inflation expectations would become more relevant amid the relatively large share of exogenous components in the consumer basket (i.e. approximately 39 percent).

Another risk factor specific to the domestic environment refers to the evolution of the household real disposable income during the projection interval. Behind this stand a further relatively high degree of labour market tightness, against the background of persistent structural deficiencies (pronounced skill mismatch, high inactivity rate, low internal mobility, intense emigration, etc.), and uncertainties about the timing and magnitude of pay rises in the public sector that are expected to persist in the periods ahead.

From the perspective of the fiscal and income policy stance, heightened uncertainties are associated with the measures specified in the Government Programme that could be adopted by law, as well with the final version of the pensions law[87]. At the same time, further relevant is the risk of potential reconfigurations of the public budget coordinates during the forecasting interval, inter alia amid compensation measures that might become necessary in order to maintain the budget deficit within the authorities' targets. In this context, not meeting the envisaged levels of public investment spending may have unfavourable implications for the future dynamics of gross fixed capital formation and, implicitly, for the potential GDP growth rate. Under the circumstances, a durable and sustainable economic growth, without prejudice to the price stability objective, is strictly conditional on the implementation of a balanced mix of macroeconomic policies, as well as on the acceleration of structural reforms.

85 Behind this trend are the extreme weather conditions in North America and Western Europe, alongside excess demand.

86 The EU crops overall stood below the 5-year average under the impact of unfavourable weather conditions, leading to recent significant increases in the external prices for wheat and maize.

87 The draft law on reforming the pension scheme, included in the Government Programme, has recently been adopted by the Government and submitted to Parliament for discussion and approval.

On the external front, a possibly faster deceleration in global economic activity is becoming increasingly relevant, with risks to economic performance arising also from a potential escalation of trade protectionism, deteriorating prospects for some emerging markets, especially Turkey, as well as from the fading out of the traction from the cyclical component of economic activity in some advanced countries. Under the circumstances, the Romanian economy could be hit via the trade channel, with direct and indirect effects. Further relevant are the uncertainties about Brexit, the recent developments in Italy and their potential spill-over effects on euro area and EU developments, as well as the monetary policy stance of the main central banks. Other factors that remained relevant in the current round refer to mounting geopolitical tensions, likely to increase volatility on the international financial markets.

The developments in international commodity prices, especially energy prices, continue to be significant sources of risk to the annual inflation rate projection. Elevated uncertainties surround particularly the future dynamics of oil prices, which are conditional upon both supply-side factors – the outlook for the US crude oil supply produced by unconventional methods, a possible decline in Iran's oil exports in the context of the US sanctions, and the geopolitical developments in Venezuela and Libya, as well as the extent to which these likely effects are to be offset by an increased production from OPEC and the aligned producers –, and demand-side factors, given the global economic prospects.

Abbreviations

CCR	Central Credit Register
CPI	consumer price index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
ESI	Economic Sentiment Indicator
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
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NIS	National Institute of Statistics
OPEC	Organisation of the Petroleum Exporting Countries
ROBOR	Romanian Interbank Offer Rate
TFP	total factor productivity
VAT	value added tax
VFE	vegetables, fruit, eggs

Tables

Charts