National Bank of Romania

Inflation Report

May 2019

Year XV, No. 56

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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 15 May 2019 and the cut-off date for the data underlying the macroeconomic projection was 6 May 2019.

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

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Summary

Developments in inflation and its determinants

The annual CPI inflation rate saw its downward path come to a halt in early 2019, reaching 3.83 percent in February, i.e. above the variation band of the flat target of 2.5 percent ±1 percentage point, and 4.03 percent in March, i.e. 0.76 percentage points above the end-2018 level. Except for administered prices, all major groups of goods and services in the CPI basket triggered this change in the inflation trajectory under the joint impact of unfavourable shocks such as the significant hike in the prices of vegetables, the rise in the international crude oil price, the moderate depreciation of the domestic currency and the surge in the excise duty on cigarettes. The annual adjusted CORE2 inflation rate also posted an upward trend, adding 0.3 percentage points in the first three months of 2019 versus end-2018 to 2.7 percent. As a result, in March 2019, the annual CPI inflation rate stood 1 percentage point higher than the forecast in the February 2019 *Inflation Report*. Conversely, the average annual CPI inflation rate calculated based on national methodology entered a downward trajectory in the first three months of 2019, reaching 4.4 percent in March. At the same time, the average annual HICP inflation rate stood further at 4.1 percent, with the differential versus the EU-wide average remaining elevated (above 2 percentage points).

In contrast to 2018, the annual adjusted CORE2 inflation rate followed an upward path in 2019 Q1, due to non-food items and services. The drivers behind developments in market services prices were the faster depreciation of the domestic currency in early 2019 and the higher prices of some telecommunications services, following the legislative changes in place as of end-2018 that were aimed at levying additional taxes on companies in this sector. At the same time, core inflation continued to persistently reflect pressures via both companies' labour costs (fuelled by the further high degree of labour market tightness) and excess consumer demand. The latter continued to exert both a direct effect, via the impact of the positive output gap on core inflation, and an indirect effect, facilitating the pass-through into consumer prices of various inflationary shocks in the economy. Hence, 2019 Q1 saw a broad-based increase in the inflation expectations of economic agents – companies in trade, industry, construction and services, as well as consumers –, confirming the latent inflationary pressures in the economy.

In 2018 Q4, the annual growth rate of unit labour costs economy-wide fell to 10.6 percent (down 3.9 percentage points from Q3), but remained high for the 12th quarter in a row. In addition, pressures stemming from unit wage costs continued to be high in industry (the 5.8 percent annual change in 2018 Q4 was similar to that in the previous quarter[1]). Moreover, January-February 2019 saw a jump to 10.6 percent, mainly caused by the swifter wage growth rate. Failing to close the gap between wages and labour

[1] Values excluding the effect of fiscal changes implemented at the beginning of 2018.

productivity (as noticed over the recent months across most manufacturing sub-sectors, except for the auto sector) jeopardises the competitiveness of Romanian exports on international markets, while it can also result in a pick-up in consumer prices on the domestic market.

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

In its meeting of 7 February 2019, 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 continued to decrease in December 2018 to 3.27 percent from 3.43 percent in November, thus moving deeper into the variation band of the flat target. The annual CPI inflation rate dropped mainly as a result of the fall in fuel prices – in view of the dynamics of the international oil price –, partly offset by the rises in the prices of vegetables and fruits and advances in tobacco product prices. The annual core inflation rate went down from 2.6 percent in November 2018 to 2.4 percent in December. The latest forecast reconfirmed the prospects for the annual inflation rate to decline further over the following three quarters to values even slightly lower than those previously anticipated, before rising and remaining slightly below the upper bound of the variation band of the target, until the projection horizon.

The uncertainties and risks associated with the inflation outlook referred to the new set of fiscal and budgetary measures that came into force on 1 January 2019, as well as to the still pending 2019 draft budget, implicitly to the future fiscal and income policy stance. Further relevant were also the uncertainties related to the pace of euro area and global economic growth, the developments in the international oil price, as well as to the monetary policy stances of the ECB and major central banks in the region.

Subsequently, statistical data showed an increase in the annual CPI inflation rate to 3.32 percent in January and to 3.83 percent in February 2019, above the upper bound of the variation band of the target and higher than the forecast. All major CPI components rose above expectations, but the main drivers behind the inflation rate developments were the hike in the prices of vegetables and fruits, the pick-up in the price of tobacco products and the advance in core inflation rate. The annual adjusted CORE2 inflation rate went up to 2.5 percent in January and 2.7 percent in February 2019, amid rising inflationary pressures from demand and wage costs, as well as given the impact of the leu exchange rate and the indirect effects of the recent hike in fuel prices. Data regarding economic growth in 2018 Q4 showed the annual dynamics of real GDP remaining quasi-steady at 4.1 percent. On the demand side, household consumption became again the main driver of economic growth, followed by the change in inventories, whereas gross fixed capital formation made a lower negative contribution thereto. Net exports had a larger negative contribution to GDP dynamics in the context of exports of goods and services rising at a slower pace than imports. In 2018 as a whole, GDP dynamics shrank to 4.1 percent from 7 percent in the previous year amid a drop in investment, a slower private consumption growth, which remained, however, robust, as well as a larger negative contribution of net exports. Alongside the deterioration of the primary income balance, the evolution of net exports caused the substantial widening of the current account deficit to 4.5 percent of GDP in 2018 from 3.2 percent in the previous year.

In the NBR Board meeting of 2 April 2019, the latest assessments indicated the prospects for the annual inflation rate to remain above the upper bound of the variation band of the target on the short time horizon, given its shift onto a higher trajectory compared to the latest medium-term forecast published in the February 2019 *Inflation Report*. The outlook was further surrounded by significant risks and uncertainties, stemming from the fiscal and income policy stance and labour market conditions. At the same time, the evolution of the current account deficit remained a cause for concern. Further relevant were also the previously identified external risks, including the potential effects of Brexit.

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, concurrently with maintaining strict control over money market liquidity. Moreover, the NBR Board underlined that the balanced macroeconomic policy mix and the implementation of structural reforms designed to foster the growth potential over the long term are of the essence in safeguarding a stable macroeconomic framework and strengthening the capacity of the Romanian economy to withstand potential adverse developments.

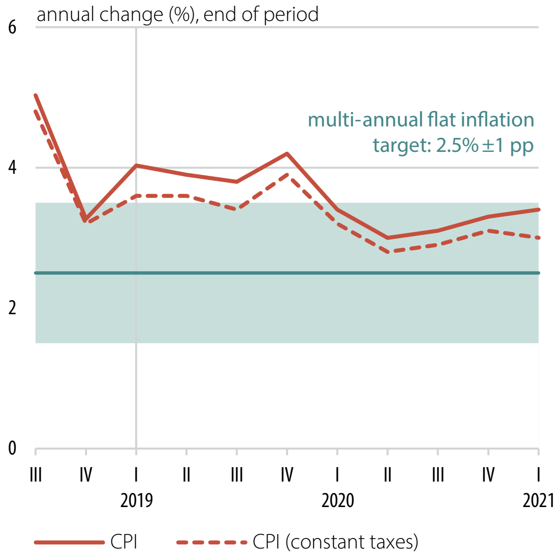
Inflation outlook

According to the baseline scenario, the annual CPI inflation rate will reach 4.2 percent at end-2019 and 3.3 percent at end-2020. Compared to the previous *Inflation Report,* the updated scenario incorporates a significant revision of this end-of-year forecast, by 1.2 percentage points, and a marginal revision of the end-2020 forecast, by 0.2 percentage points. The significant difference from the previous forecast for 2019 is largely due to first-quarter developments in inflation components beyond the scope of monetary policy, especially prices of vegetables, fuels and tobacco products, having a cumulated contribution of 0.9 percentage points at end-2019. The annual adjusted CORE2 inflation rate was assessed to exert an influence in the same direction, having a revised contribution of +0.3 percentage points to the CPI inflation projection in December 2019, whereas the administered price dynamics were revised downwards for the same horizon.

Leaving aside the consumer basket components that are prevailingly hit by supply-side shocks (vegetables, fruit, eggs, and fuels), whole-economy inflationary pressures were significantly shaped by the recently-enacted legal provisions (Government Emergency Ordinance No. 114/2018, as amended by Government Emergency Ordinance No. 19/2019). Specifically, looking at the annual adjusted CORE2 inflation rate, 0.4 percentage points of the increase in this component owes to hikes in telecommunication services prices, already or soon-to-be implemented by the companies targeted by the additional taxes on turnover. The projected dynamics of administered prices reflect the provisions of GEO No. 19/2019, as well as the norms issued by competent authorities (the Romanian Energy Regulatory

Authority), and take into account the decisions to cap the natural gas purchase price and the electricity price for end-users. As for tobacco, the baseline scenario coordinates reflect mainly the same legal provisions concerning the calendar for raising excise duties on these products and the economic agents' past behaviour relative to final price increases in this sector.

Inflation forecast



Source: NIS, NBR projection

Data published subsequently to the release of the February 2019 *Inflation Report* confirmed expectations on a slowdown in economic growth in 2018 (to 4.1 percent year on year against 7 percent a year earlier) and its composition. Specifically, the GDP advance was driven by consumption, amid slightly receding investment and decelerating positive dynamics of exports, combined with sustained import growth. The loss of momentum in economic activity is expected to persist into 2019 and 2020, with the foreseen economic growth nearing its potential rate at the projection horizon. Despite the uncertainty associated with the impact of legislative amendments, growth is further seen to be mainly consumption-led, its path being correlated with that of real disposable income, amid the persistence of pay rises in both private and public sectors, as well as higher budget transfers (following the announced increases in the pension point). At the same time, the baseline scenario envisages an improved evolution of gross fixed capital formation, subsequent to the contraction seen in 2018, yet the annual dynamics appear set to remain below the post-crisis average. The component is directly affected by the recent fiscal measures, which could prompt economic agents to postpone or scale down part of their planned investment, including foreign direct investment flows towards Romania. Against this background, faster dynamics of gross fixed capital formation, which are of the essence for boosting the economy's productive capacity, are strictly conditional on the EU funds absorption rate and public investment expenditure. The contribution from net exports is projected to stay in negative territory, further large during 2019 as well, and on the wane thereafter.

Under the circumstances, starting from the 2018 figure of 4.5 percent, the baseline scenario foresees that the current account deficit-to-GDP ratio will continue to rise over the projection interval. In what regards the 4 percent-of-GDP threshold set by the European Commission as a scoreboard indicator for the EU Member States[2], the projected levels show, aside from a deviation from the scoreboard criteria, a faster build-up of external imbalances in Romania than in its regional peers. Sustainability of current account deficit performance is problematic also in terms of the outlook for this deficit being only partly financed from EU structural and investment funds under

2 Calculated as an average for the past three years. For further details, see the European Commission's website, the Section on Macroeconomic Imbalance Procedure Scoreboard.

the 2014-2020 Multiannual Financial Framework and from foreign direct investment inflows. The latter will be affected by slower economic growth in Romania's main trading partners and multiple legislative changes domestically.

The output gap is anticipated to follow a slightly upward path until the beginning of 2020, before flattening out somewhat for the remainder of the forecast interval. Its path reflects accommodative real broad monetary conditions – expected to persist only until the first part of next year –, a rise in effective external demand – although its dynamics are projected to slow both against 2018 and potential growth assessments –, as well as the stimulative fiscal incentive – largely on the back of provisions concerning the significant increase in the pension point. The new output gap levels trail, however, behind those in the previous *Inflation Report* over the entire forecast interval, mirroring the downward revision of external demand and of the impact of real broad monetary conditions. In this context, the output gap is estimated to make a close-to-zero contribution to economic growth in 2020.

According to the baseline scenario, the annual adjusted CORE2 inflation rate is forecasted to rise further up to 3.8 percent at the end of 2019, before losing some momentum and reaching the upper bound of the variation band of the target (3.5 percent) at the end of 2020. Starting from the end-2018 level of 2.4 percent, inflationary pressures that have been building up within this component are seen augmenting gradually. Heading in this direction are the larger excess aggregate demand in the economy, amid an across-the-board increase in economic agents' inflation expectations on a four-quarter horizon, and the build-up of stronger external inflationary pressures on the leu-expressed prices of imported goods over the medium term.

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

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

Despite the abatement of some risks mentioned in the prior round, as the larger potential adverse effects of GEO No. 114/2018 were partly alleviated by the provisions of GEO No. 19/2019, the fiscal and income policy stance remains a relevant source of risks and, most notably, uncertainty over the forecast interval. Specifically, the multiple election rounds in 2019-2020 could weigh on the configuration of these policies, as possible measures to boost current expenditure to the detriment of investment spending could further reduce the authorities' fiscal room for manoeuvre. These risks might increase if difficulties emerged in ensuring stable deficit-financing and public debt-refinancing sources, and, *ceteris paribus*, might affect the economy's external position.

The new provisions of GEO No. 19/2019 may render unpredictable the investment behaviour of economic agents in the private sector and, at the same time, may hamper monetary transmission via certain specific regulations, with implications for the general framework of monetary policy. The possible effects could consist of a medium- and long-term decrease in potential output dynamics following weaker investment in the economy, on the one hand, and a less balanced dosage of Romania's economic policies necessary for smoothing cyclical fluctuations in economic activity, on the other hand.

A risk factor whose relevance was reconfirmed in the current round refers to developments in the labour market, due to the still elevated level of tightness associated with the lingering structural drawbacks, a feature manifest in the region as well. Considering their potential to influence households' real disposable income growth, on the one hand, and to put pressure on firms' costs, also with an impact on the domestic and external competitiveness of some economic sectors, on the other hand, any deviations from the assumptions in the baseline scenario would produce changes in the projected trajectories of economic growth and inflation rate.

Turning to the external front, risks stem from the global economic slowdown, also amid a potential flare-up in protectionist measures, given the worsening of US-China trade ties. Further relevant are the risks associated with the ECB's monetary policy stance, in spite of the recent change in perspective that reduces the probability of their becoming manifest and, in this context, the risks relating to the likely stance of central banks in the region. The final configuration of Brexit is still a noticeable source of uncertainties, despite their abatement after the deadline was deferred to 31 October 2019. The materialisation of some of these risks could entail portfolio reallocations in the region and/or worldwide, with implications for the future path of the leu exchange rate and, implicitly, for the projected inflation rate.

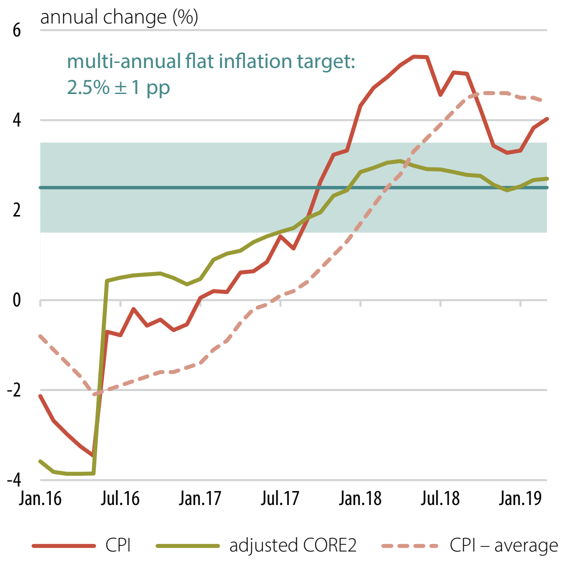
Monetary policy decision

In view of the characteristics of the inflation outlook, the multitude of related uncertainties and risks stemming from both domestic and external sources, together with the relevance of monetary policy stances of the ECB and of the Fed, as well as of central banks in the region, the Board of the National Bank of Romania decided, in its 15 May 2019 meeting, to keep the monetary policy rate at 2.50 percent, while tightening control over money market liquidity. Moreover, the NBR 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

The annual CPI inflation rate saw its downward path come to a halt in early 2019, exceeding the variation band of the flat target of 2.5 percent ±1 percentage point in February and ending the first quarter at 4.03 percent (0.76 percentage points above the end-2018 level). Except for administered prices, all major groups of goods and services in the CPI basket triggered this change in the inflation trajectory by the joint impact of unfavourable shocks, such as the rise in international crude oil price, the moderate depreciation of the domestic currency or the surge in the excise duty on cigarettes, as well of the inflationary pressures from fundamentals – companies' high labour costs and robust consumer demand. Under these circumstances, adjusted CORE2 inflation also saw its annual dynamics pick up slightly, reaching 2.7 percent at end-2019 Q1 versus 2.4 percent in December 2018 (Chart 1.1).

Chart 1.1. Inflation developments

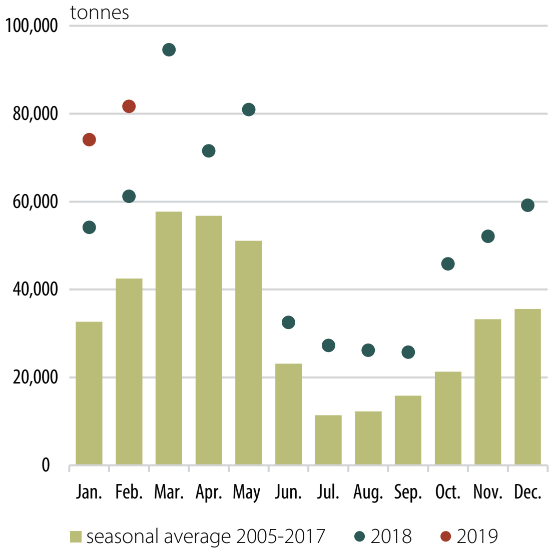


Source: NIS, NBR

The step-up in the annual inflation rate was decisively ascribable to the significantly higher vegetable prices. Domestic crops were affected by the drought in August-October 2018, which generated supply shortages in the case of potatoes and other vegetables and imports that exceeded the seasonal averages of winter months (Chart 1.2). This occurred in a period of depreciation of the national currency against both the euro and the other currencies in the region and of a broad-based increase in the price of vegetables in EU Member States (driven by unfavourable weather conditions), and exerted pressure on the domestic consumer prices for this category of goods, leading, in March, to the fastest annual dynamics of the last seven years, i.e. 35 percent (Chart 1.3).

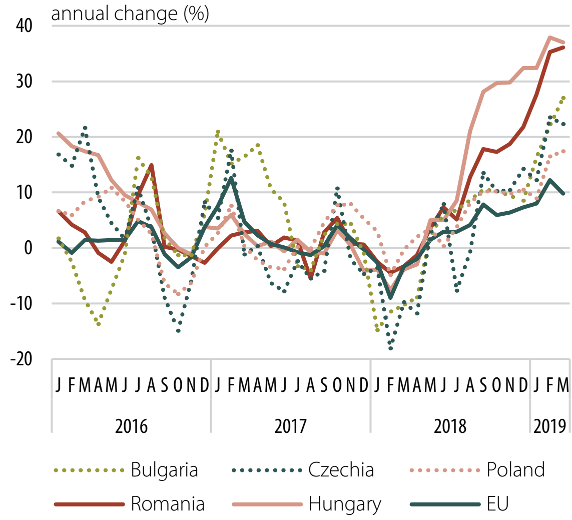
At the same time, tobacco products also contributed to the upward movement of annual CPI dynamics, following the sharp rise in the excise duty at the beginning of 2019. Specifically, the initial calendar for setting the excise duty, which implied its increase by 2 percent on the 1 April of every year, was brought forward by implementing a rise of approximately 8 percent starting with 1 January 2019, as well as by establishing a higher amount in the next years. In this context, producers made two consecutive adjustments of 50 bani each to the price of a packet of cigarettes in 2019 Q1, a little over the level justified by the new value of the excise duty.

Chart 1.2. Vegetable imports



Source: Eurostat

Chart 1.3. Vegetable price inflation in Europe



Note: In accordance with the harmonised price structure.

Source: Eurostat

Fuel prices were another component beyond the scope of monetary policy that saw a slight pick-up in their annual dynamics (up to 6.2 percent in March), amid a cluster of unfavourable shocks: the rise in excise duty starting with 1 January 2019 (determined by the indexing to the inflation rate), the uptrend on which the Brent oil price embarked ever since the first day of the year, as well as the depreciation of the leu versus the US dollar. Although the combined impact of these factors translated into relatively strong hikes in the price of fuels in 2019 Q1 (almost 4 percent cumulatively), the effect on the annual rate was partially offset by the price increases at the beginning of 2018.

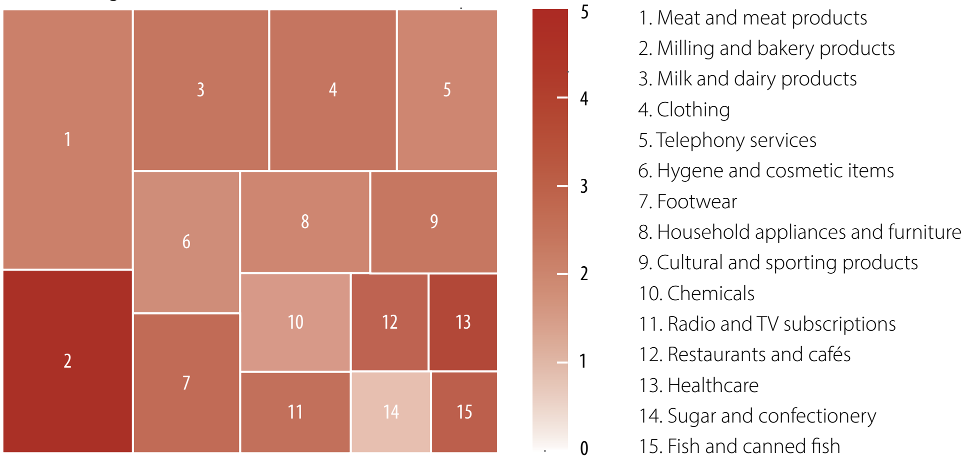
Moreover, annual adjusted CORE2 inflation re-embarked on a slightly upward trend in the first three months of 2019, up to 2.7 percent. This time around, the movement stemmed from non-food and services prices, after a year where the developments in core inflation were driven by food prices. The latter sector no longer saw pressures from agri-food commodities (negative annual dynamics for pork, milk, sugar), with the exception of wheat, which continues to prompt higher-than-average monthly increases in the prices of bakery products (+0.4 percent monthly change, on average, in the last year). The inflationary path of market services in 2019 Q1 was largely determined by the faster domestic currency depreciation, to which added the first effects of the legislative amendments introduced at end-2018, transposed in the higher prices of some television subscriptions.

Furthermore, the fundamental coordinates of the domestic economy continue to generate quarterly dynamics of core inflation above the longer-term averages. Still relevant to the adjusted CORE2 dynamics is the build-up of pressures over the last three years via companies' labour costs and excess consumer demand. The latter has been covered significantly from external sources, which has fuelled the widening of the deficit on trade in consumer goods (in 2018 alone, the trade in non-food consumer goods contributed to the deterioration of the balance of goods by over EUR 1 billion).

Beyond their direct influence, the above-mentioned factors are also likely to act as a catalyst, facilitating the pass-through of pressures from adverse supply-side shocks into consumer prices, as well as of pressures stemming from legislative changes or domestic currency depreciation. In this context, the annual core inflation on the non-food segment reached a post-2011 high of 2.5 percent in February (Chart 1.4).

Chart 1.4. Developments in the prices of the main items in the adjusted CORE2 inflation basket

annual change, March 2019, (%)

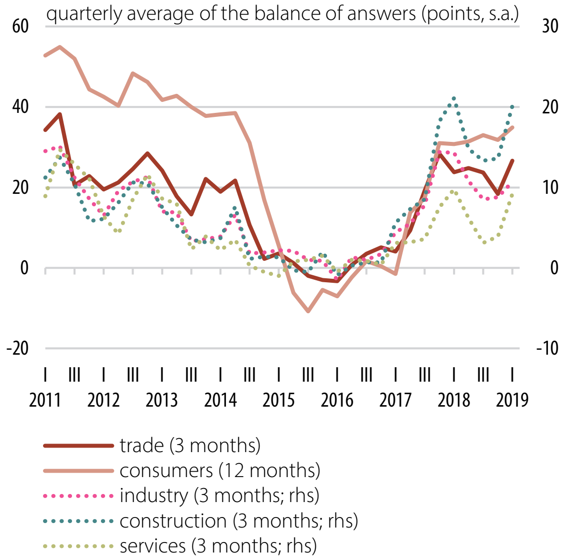


Note: The chart shows items holding about 81 percent of the core infation basket in 2019. A rectangular area is proportional to the item's share in adjusted CORE2, while the colour intensity is proportional to the annual change in the price.

Source: NIS, NBR calculations

Chart 1.5. Expectations on price developments

quarterly average of the balance of answers (points, s.a.)

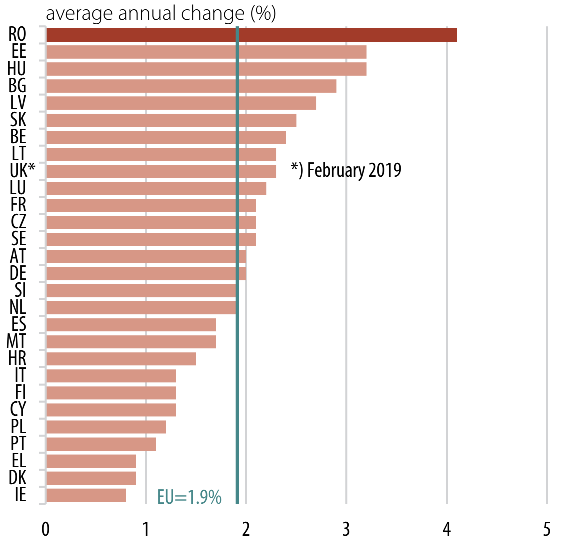


Source: EC-DG ECFIN

The only group that had a disinflationary impact in the first three months of the year was that of administered prices. However, behind this stood a favourable base effect related to utilities price hikes in 2018 Q1, which were replicated only to a small extent this year. In addition, the VAT rate cut to 9 percent for sewerage services starting with 1 January 2019 also contributed to the downtrend.

Looking at expectations, in 2019 Q1, both consumers and economic agents in all sectors adjusted upwards their expectations on price developments (Chart 1.5). The largest increases in the balance of answers were observed in the case of companies in trade and construction, consumers being the only ones for whom the balance exceeded the high value reached at end-2017 (a moment marked by multiple supply-side shocks). The same picture is painted by financial analysts' opinions in January-April 2019, who foresee a higher annual inflation rate at end-2019. By contrast, the expected inflation rates over longer horizons (up to two years) were recalibrated to slightly lower values compared to the prevailing outlook in 2018 Q4, while remaining inside the variation band of the target.

Chart 1.6. Average annual HICP in the EU – Mar. 2019



Source: Eurostat

Although the annual inflation rate resumed its upward path in the first three months of 2019, the average annual rate followed a downward trend, due to the dropping-out from the calculation of the values recorded at the beginning of 2018, when inflation posted some of the highest rates over the recent period. Specifically, based on the national methodology, the average level fell slightly to 4.4 percent at end-2019 Q1, while the average HICP rate remained at 4.1 percent in March, the highest among EU Member States for the eighth consecutive month, with a further significant difference against the European average, exceeding 2 percentage points (Chart 1.6).

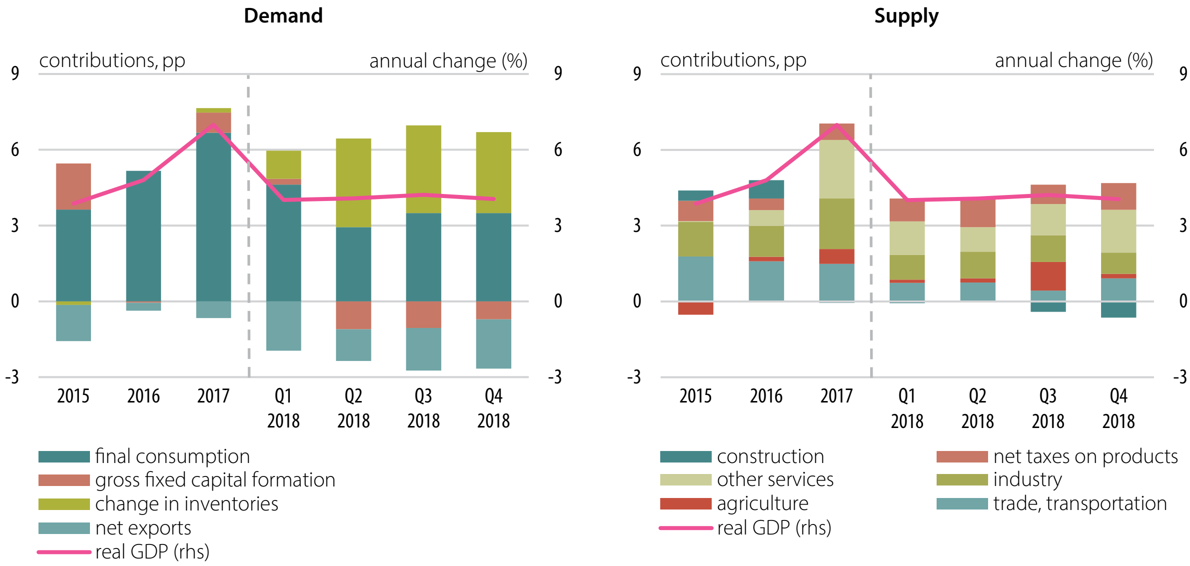
At end-2019 Q1, the annual inflation rate stood one percentage point above the level anticipated in the February 2019 *Inflation Report* (4 percent versus a 3 percent forecast). Although all the components of the consumer basket had a contribution, this difference from the forecast was mainly attributed to the considerable and unexpected rise in the price of vegetables. Adjusted CORE2 inflation at end-2019 Q1 (2.7 percent, annual change) was higher by 0.2 percentage points than the anticipated value.

2. Economic developments

1. Demand and supply

> In 2018 Q4, the advance in real GDP remained unchanged at the value recorded in the first nine months of the year, i.e. 4.1 percent (annual change). The Romanian economy thus ended another year of consumption-led growth, with capital investment being on the wane from 2017 and exports seeing less robust developments, due to the weaker-than-expected performance of European economies, as well as to some temporary influences and competitiveness losses (Chart 2.1).

Chart 2.1. Contributions to economic growth

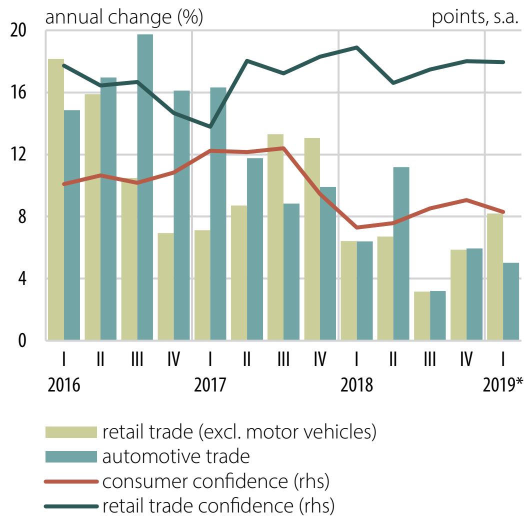


Source: NIS, NBR calculations

In line with its anticipated trajectory, private consumption grew at a faster rate, i.e. up to 4.5 percent in 2018 Q4 (annual change), being boosted by the robust pace of increase of households' real income (for instance, the wage component[3] rose by approximately 11 percent year on year, which is a slightly swifter tempo than that seen in the first three quarters). An additional contribution came from the brisker growth rate of new consumer credit (excluding renegotiated loans), i.e. up to around 25 percent (real annual change). The expansion of household consumption reflected in the turnover volume of trade and market services, whose rate of increase picked up steam to reach about 6.0 percent, as well as in self-consumption and purchases on the agri-food market, given the outstanding agricultural production.

[3] Calculated as the product of the average real net wage economy-wide and the number of employees.

Chart 2.2. Trade and confidence indicators



*) Jan.-Feb. for trade turnover

Source: NIS, EC-DG ECFIN, NBR calculations

Household consumption dynamics will most likely remain high in the period ahead, as shown by the expectations of trade and services companies for 2019 Q1, the confidence indicators recording further high levels, according to the NIS-DG ECFIN Survey. Moreover, consumer confidence improved successively over the first three months of 2019, the new pay rises that were also generated by the minimum wage growth in January hinting at households' improved outlook of their financial standing, also in what concerns their intention to purchase durables. Conversely, borrowed funds will most likely make a smaller contribution, with commercial banks anticipating a standstill in demand for consumer loans in 2019 Q1, also as a result of the significantly tighter credit standards[4] (the evolution has been already confirmed by the real flow of new consumer credit, excluding renegotiated loans, which declined marginally in annual terms January through February). The further robust consumer demand in the first part of 2019 is mirrored by the favourable trend in the turnover volume of trade and services to households in January-February – a step-up in the annual growth rate to about 8 percent, which was visible for non-durables and especially for durables (purchases of furnishings in particular) as well as for market services to households (Chart 2.2).

In 2018 Q4, the general government budget posted a deficit of lei 10.6 billion (equivalent to 1.1 percent of GDP), well above that posted in the prior quarter (lei 1.8 billion or 0.2 percent of GDP), the easing of budget execution being, however, significantly lower than that recorded in the same year-ago period[5]. The deficit widening was the result of the substantial increase in total budget spending[6], chiefly on account of the rise in expenditure on projects financed from non-repayable external funds[7], capital expenditure[8] and spending on goods and services. Budget revenues picked up as well, yet to a lesser extent[9], particularly due to higher disbursements from the EU[10], as well as to the increase in receipts from VAT, corporate and personal income taxes and social security contributions[11].

4 According to the NBR's February 2019 *Bank Lending Survey*.

5 In 2017 Q4, the general government budget execution generated a considerably wider deficit, i.e. lei 17.5 billion or 2.0 percent of GDP, after being relatively balanced in the previous quarter, i.e. lei -0.5 billion.

6 The annual pace of increase of total expenditure decelerated, however, slightly to 9.3 percent in real terms from 11.8 percent in Q3.

7 Their impact on the change in general government budget balance being, however, offset by the increase in disbursements from the EU.

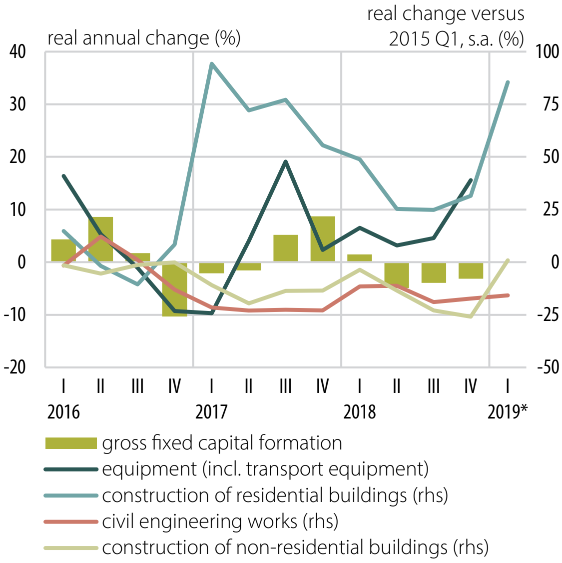
8 Also reflecting the impact of defence expenditure.

9 Their real annual increase was considerably faster than that of spending, reaching 21.8 percent, from 10.0 percent in the preceding quarter.

10 Also mirroring the positive impact of windfalls from the EU.

11 An opposite influence had the contraction in non-tax revenues, which was also due to a base effect associated with the evolution of receipts from dividends from state-owned enterprises.

Chart 2.3. Investment



*) Jan.-Feb.

Source: NIS, NBR calculations

Gross fixed capital formation further contracted in annual terms, i.e. down 3.2 percent in 2018 Q4, the brisk increase in equipment purchases proving insufficient to offset a new decline in construction investment (Chart 2.3). Gross fixed capital formation is expected to decrease at a slower pace in the first part of 2019, amid the recovery in the construction of buildings (the financing sources of technological investment also witnessing an upturn). However, the negative influence of the postponement in relaunching large infrastructure projects and the persistence of uncertainty-ridden environment owing to some recently adopted legislative measures should not be excluded.

In October-December 2018, equipment purchases (including the motor vehicles bought by companies and institutions) stayed on the upward course they had followed in the first three quarters, i.e. +15.6 percent, due to both purchases on the local market and imports. Incoming information pointing to the recent completion or carrying-out of investment projects for technologically upgrading and expanding current capacities, as well as for opening new facilities, is stronger in industries such as the manufacture of motor vehicles and motor parts, the manufacture of household appliances and building materials.

Corporate investment will expand further in the period ahead, but its growth pace is little likely to see a pick-up. Specifically, certain financing sources (in the form of equity and earnings reinvested by foreign companies, as well as of equipment loans[12]) stayed on an upward trend in January-February 2019, which, nevertheless, may lose momentum in the subsequent period. This may occur given the standstill in corporate demand for medium- and long-term loans anticipated for Q1, following the considerable tightening of banks' credit standards[13]. Moreover, the structural limitations further hindering corporate investment, particularly those related to the insufficiency of modern transport infrastructure and the shortage of skilled labour, cannot be overlooked. To these add concerns about the leu exchange rate movements and the instability of the legislative framework.

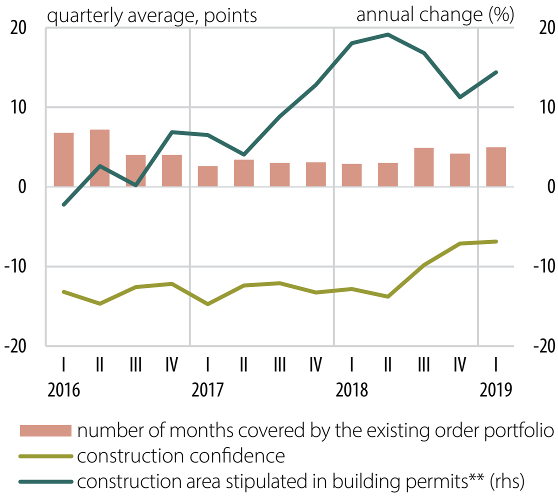
Similarly to the first three quarters of 2018, investment in new construction works and capital repairs followed a diverging trend as compared to that of equipment purchases. However, the decline in the period from October to December 2018, i.e. -7.6 percent in annual terms, was no longer as strong as in the previous quarter, partly on account of the recovery in quarterly terms in the construction of buildings,

12 The first two above-mentioned categories (representing foreign direct investment flows) have continuously increased their value as of July 2018 (calculated as the sum of the past 12-month values); the stock of equipment loans rose by 6.2 percent in real terms in January-February 2019, posting slightly slower annual dynamics than in October-December 2018.

13 According to the NBR's February 2019 *Bank Lending Survey*.

a trend that continued into January-February 2019 as well. Civil engineering works expanded by 7.3 percent (annual change), although in 2018 as a whole, this segment was still far from recovering the severe losses registered in 2016-2017 (-30 percent, cumulative change).

Chart 2.4. Outlook for construction*

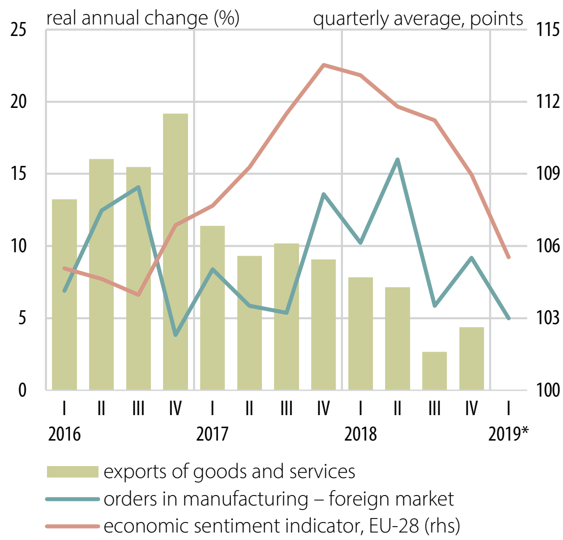


*) seasonally adjusted data

**) 12-month moving average; Jan.-Feb. 2019 for the last period

Source: NIS, EC-DG ECFIN, NBR calculations

Chart 2.5. Exports



*) Jan.-Feb. for orders

Source: NIS, EC-DG ECFIN, NBR calculations

The supply of new buildings may continue to paint a bright picture in the following months, as indicated by the swifter increase in the construction areas stipulated in building permits in the period from March 2018 to February 2019 (especially in the case of dwellings), which was also reflected by the confidence indicator in construction remaining at significantly higher levels in 2019 Q1 versus 2018 (Chart 2.4). At the same time, however, construction seems to be faced with a recent build-up of factors hindering the sector's activity in the period ahead – the tightening of credit standards, the domestic currency depreciation as well as the difficulties created by some legislative changes. In the latter case, it is worth noting the delays in the development of construction projects signalled by some market players, as a result of the ambiguities and expenses arising from the adoption of GEO No. 114/2018. In fact, the provision concerning the wage hike in construction starting January 2019 also affects public investment projects, including the EU-funded projects, and there is a risk that covering the additional costs may lead to an increase in the ineligible value of projects, which would have an impact on the capital expenditure in the government budget.

Net external demand continued to erode economic growth in 2018 Q4 (-1.9 percentage points), yet more strongly than in the first three quarters. Exports of goods rose in real terms by merely 0.4 percent (annual change), in an uncertainty-ridden international environment, to which added temporary influences and competitiveness issues of local products. Exports will go up further in the months ahead, albeit at a moderate pace, given the downward revisions of economic growth forecasts in the EU and globally. As a matter of fact, in January-February 2019, the annual growth rates in terms of both export value[14] and the volume of foreign orders to local industrial companies stood

[14] According to the *Balance of Payments and International Investment Position Manual* (BPM6).

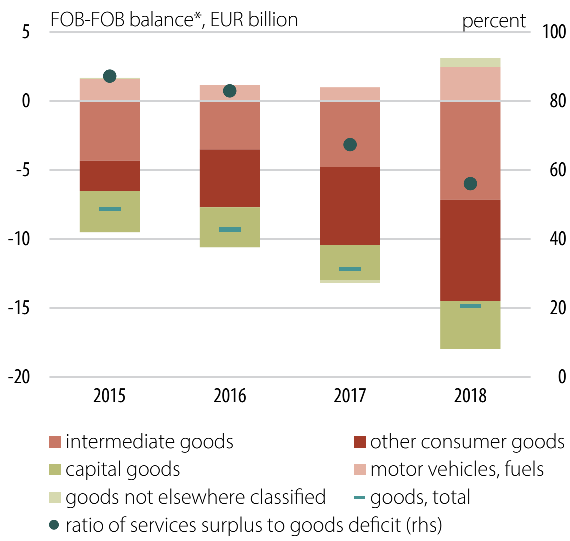
below the 2018 averages. A favourable influence could come, however, from exports of agri-food commodities, on account of the exceptional maize and sunflower crops (Chart 2.5).

The main contribution to the slower pace of increase of exports of goods came from the sales of motor parts which saw a stronger contraction as compared with 2018 Q3 (down to -17.6 percent, annual change), linked with the fluctuation in the automotive production at EU level caused by the changes in the emissions measurement procedure for new motor vehicles as of 1 September 2018. Negative developments were also reported by exports of petroleum products (temporary decline, possibly associated with the overhaul carried out by a major local refinery in November 2018), ships and aircraft equipment (industrial subsectors affected by strong volatility in their activity) as well as by exports of consumer goods (a subsector further affected by competitiveness losses stemming from the swift increase in unit labour costs). Contrarily, sales of motor vehicles, electric motors and transformers posted outstanding results, the same as in 2018 as a whole, thus consolidating their shares on the European market (the main destination for both categories of products).

Import of goods rose by 7.8 percent in real terms, the step-up in consumer demand entailing an advance by around 8 percent in purchases on this segment (especially food products, pharmaceuticals and cosmetics, footwear, furniture). An acceleration was also reported by imports of intermediate goods (2.8 percent), whereas the growth pace of imports of capital goods remained brisk (8.5 percent), driven by the expansion in technological investment, but dropped to half of that recorded in July-September.

The diverging trajectories of exports and imports in 2018 Q4 caused the balance on trade in goods to worsen further, the deficit for 2018 as a whole widening by EUR 2.7 billion from the year before to EUR 14.8 billion (Chart 2.6). In addition, net receipts from international services rose marginally, with households' increased preference for foreign travel and transportation services offsetting almost entirely the more substantial income from freight transport and ICT companies. Under the circumstances, the counterweight of the services surplus to the external imbalance of trade in goods declined to around 56 percent (from 67.4 percent in 2017). The deterioration in the balance on trade in goods and the weaker performance of income accounts caused the widening of the current account deficit for a fourth straight year to EUR 9.2 billion (4.5 percent of GDP). It is also worrisome that this evolution is accompanied by an erosion of the current account deficit financing from stable sources in the form of foreign direct investment and capital account

Chart 2.6. Balance on trade in goods



*) excluding goods produced under processing arrangements

Source: Eurostat, NBR, NBR calculations

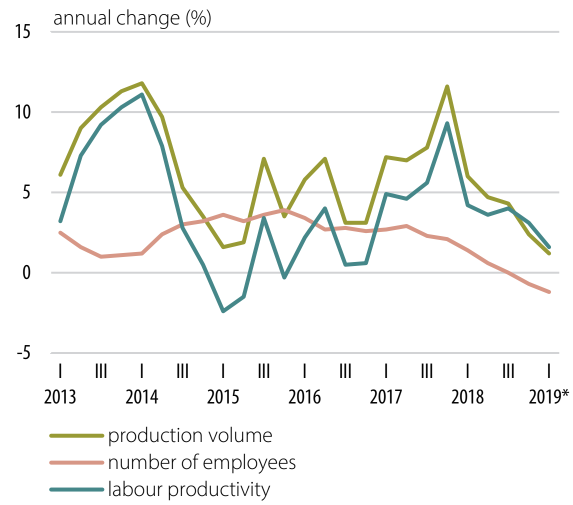
flows; in 2018, the coverage by such funds went below 100 percent (54 percent for FDI and 27 percent for the capital account), as a result of the still modest absorption of non-repayable EU funds for investment projects in the current multi-annual financial framework (2014-2020).

Labour productivity

In 2018 Q4, labour productivity economy-wide saw its annual dynamics decelerate slightly (3.4 percent as against 4.1 percent in the previous quarter), given the weakening of the strong impulse from the remarkable agricultural year in Q2 and Q3. The annual growth rate of labour productivity slowed down somewhat in industry as well. In manufacturing, it moderated to 3.1 percent in 2018 Q4, despite the moderately positive demand conditions, as hinted at by the faster pace of increase of new orders and the higher capacity utilisation rate (Chart 2.7).

Although the slowdown in industry may be partly due to a series of incidental factors, such as the overhauls at some refineries or the substantial hikes in timber prices which acted as a deterrent to the manufacture of furniture, a role was also played by the determinants with long-lasting impact in some manufacturing sub-sectors. Thus, three major investors recently decided to close production in their local plants. In food industry, the shutdown of a major unit counting over 400 employees was ascribed to labour shortage and the change in consumer habits, whereas in the light industry, where productivity declined for the eighth consecutive quarter, the close-down of two enterprises with approximately a total of 1,000 employees was due to the loss of competitiveness, amid the sharp rise in labour costs and the increasingly severe shortage of skilled labour, stemming also from the plummeting interest in vocational education. In addition to the difficulties faced in staff recruitment, caused by the labour shortage in both quantitative terms (indicated by the continued fall in unemployment rate and the widening of the negative unemployment gap) and qualitative terms (inadequately skilled candidates), companies are affected by an uncertain and volatile legislative framework that hampers the investment plans in some key economic sectors, such as energy, telecommunications or the financial sector. As a

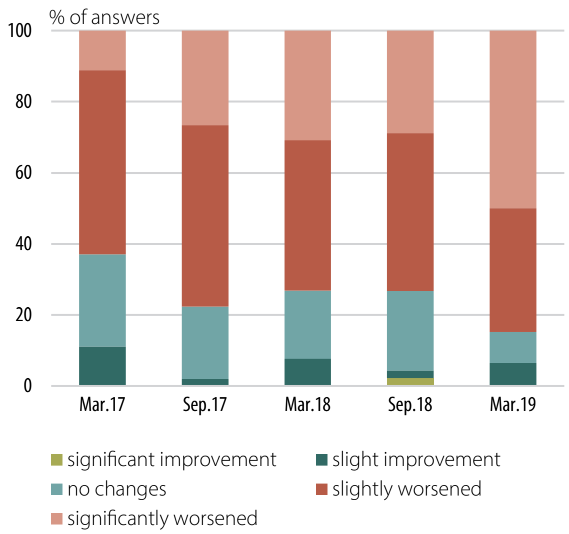
Chart 2.7. Labour productivity in manufacturing



*) Jan.-Feb.

Source: NIS

Chart 2.8. Investors' perception towards recent developments in the business environment



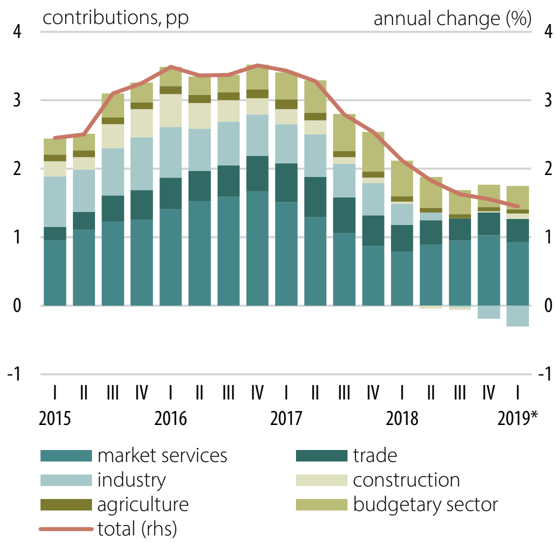
Source: Foreign Investors Council; *Business Sentiment Index* (March 2019) result, the *Business Sentiment Index* (March 2019)[15] shows a worsening of business conditions in Romania, as pointed out by 85 percent of respondents, a record high that stands significantly higher than the 73 percent response rate in the September 2018 survey (Chart 2.8).

At the opposite pole, the best-performing manufacturing sub-sectors over the past years continue to make investments that could transpose into a step-up in industrial productivity in 2019. Specifically, the automotive industry remains on an upward trend, after another quarter of double-digit annual growth in productivity, with the contraction in the number of employees probably signalling investment made in automation and streamlining. Moreover, the expansion of this segment is suggested by new substantial investment in the production facilities of motor parts in the first months of 2019. A bright picture also emerges in electrical equipment industry, due to the opening of new household appliance factories, in the manufacture of building materials, with numerous investments in production capacity expansion, and in the manufacture of pharmaceuticals, after a specialised plant has been reopened.

Labour market developments[16]

In 2018 Q4, the rise in the number of employees economy-wide stabilised at 1.6 percent (annual change), a trend that continued into the first two months of 2019. Specifically, the pick-up in hirings in construction and market services (such as administrative and support services, accommodation and food service activities) was offset by the staff cuts in industry, i.e. to -1.2 percent in February. The latter owed to the contraction in the number of payrolls in the manufacture of motorcars, which was most likely triggered by the gradual increase in the automation of production, given the further robust activity in this sub-sector, as well as in the textiles sub-sector, in line with the trend of relocating the activity of some producers to areas with cheaper labour force (Chart 2.9).

Chart 2.9. Number of employees economy-wide



*) Jan.-Feb.

Source: NIS, NBR calculations

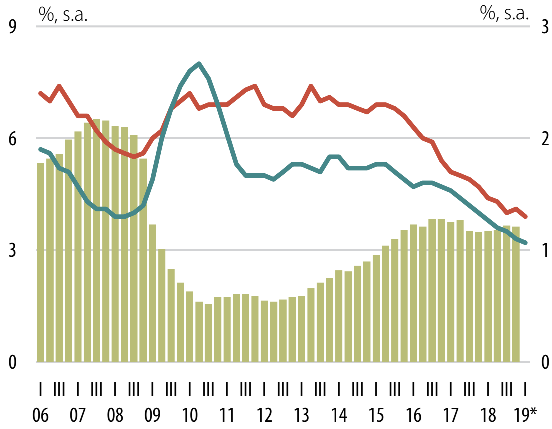
At the same time, the excess labour supply continued to narrow, with both unemployment indicators recording post-2000 lows, i.e. 3.2 percent for the registered unemployment rate and 3.8 percent for the ILO unemployment rate in February 2019. Turning to labour demand, the job creation process subsided – the job vacancy rate adjusted slightly downward, yet further reported high values (Chart 2.10). As a result, labour market conditions remained tight and only cyclical factors could contribute to a potential easing, given the limited capacity in the short run of remedial

15 Published twice a year by the Foreign Investors Council, the survey is conducted among more than 120 companies and shows their expectations on the evolution of activity and the quality of business environment in Romania.

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

measures to solve the persistent structural problems (skilled labour shortage, inadequacy of the education system, low internal mobility, high emigration – the latter feature being specific to Eastern Europe countries).

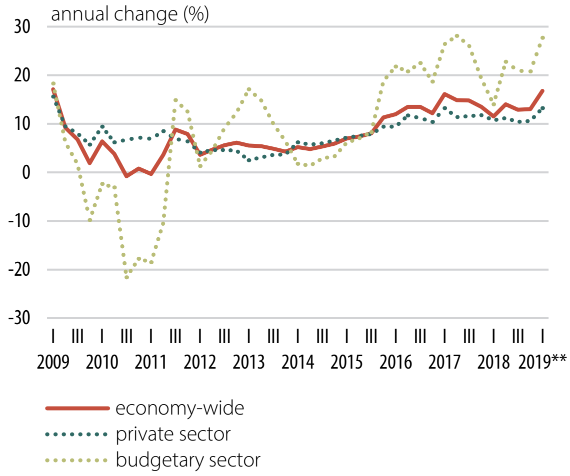
Chart 2.10. Unemployment and job vacancies



*) Jan.-Feb.

Source: NEA, Eurostat, NBR calculations

Chart 2.11. Nominal gross wage earnings*



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

**) Jan.-Feb.

Source: NIS, NBR calculations

For the period ahead, the results of the EC-DG ECFIN Survey further point to a broadly stable picture, expansions of payrolls being expected only in trade, the manufacture of electrical equipment, other transport equipment and machinery and equipment.

Average gross wage earnings continued to grow at a steadily fast pace in 2018 Q4 (35.6 percent in annual terms and 13 percent – net of the effect of fiscal changes as of 1 January 2018). The further brisk pace of increase since the beginning of the year was ascribable to the difficulties reported by employers in finding candidates, to which added the demonstration effects from the budgetary sector (with annual dynamics of over 40 percent and 20 percent respectively, net of the effect of fiscal changes). In 2019, the annual growth rate of the average wage economy-wide accelerated markedly, i.e. up 3.7 percentage points to 16.8 percent in January-February, largely on the back of the rise in the gross minimum wage (by 9 percent to lei 2,080 and the setting of a minimum wage of lei 2,350 for highly-skilled personnel and of lei 3,000 for employees in the construction sector), the hikes set forth by the unified wage law applicable in the public sector, as well as the granting of a 10 percent stress incentive for the teaching staff in education (Chart 2.11). The hike was more substantial for the average net wage, i.e. up 4.9 percentage points to 18.1 percent, as the employees in the construction sector were exempted from paying the personal income tax for a 10-year period and social security contributions were reduced for both employees and employers.

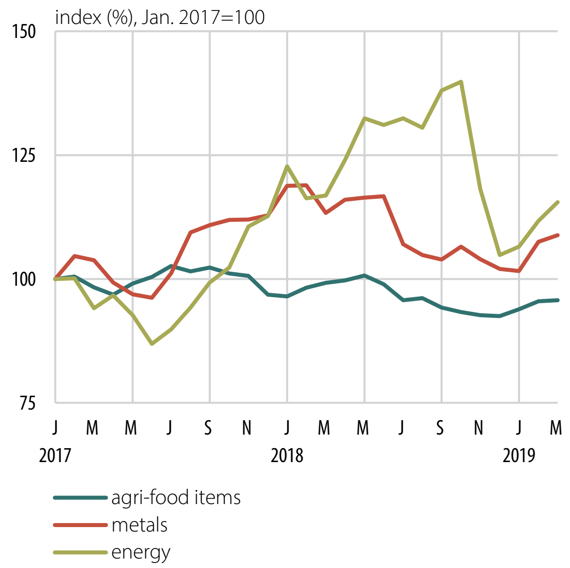
2. Import prices and producer prices on the domestic market

In 2018 Q4, the international prices of main commodities followed a downward course, the sharp decline in Brent oil price (which was reversed only partly in the first months of 2019) making a decisive contribution to the deceleration in the dynamics of import prices and producer prices on the domestic market. The change in producer prices for consumer goods remained relatively stable at 2 percent, amid benign influences from agri-food commodity costs. Conversely, non-food producer prices posted faster growth rates, with specific factors in the pharmaceutical industry adding to the build-up of pressures from unit wage costs, while favourable demand conditions in the economy facilitated the upward movements in prices.

2.1. Import prices

After increasing considerably during most of 2018, energy prices saw a trend reversal in October-December (Chart 2.12). Under the joint impact of the slowdown in global demand and the greater supply of crude oil production from the main producers (the US, Saudi Arabia and Russia), the Brent oil price took a plunge, reaching USD 50/barrel towards end-December 2018 as compared with USD 86/barrel in early October. Subsequently, the beginning of 2019 was marked by supply-side constraints, associated also with the entry into force of the latest output cut agreement among OPEC+ countries, so that the oil price resumed growth (in early April 2019, it tested the USD 70 per barrel mark). Its trajectory was additionally influenced by a slight recovery in market optimism related to the global demand developments, amid signals from the US with regard to the reconfiguration of economic policies[17].

Chart 2.12. International commodity prices



Source: World Bank, FAO, NBR calculations

The international prices of metals followed a downward path in 2018 H2, amid the slowdown in global industrial activity and the concerns about China's economy, so that the annual dynamics of the aggregate index stood at -7 percent in 2018 Q4. Year 2019 started with a sharper annual contraction, followed by a gradual deceleration in February and March (to -4 percent), under the impact of the same demand-side factors behind the oil price recovery.

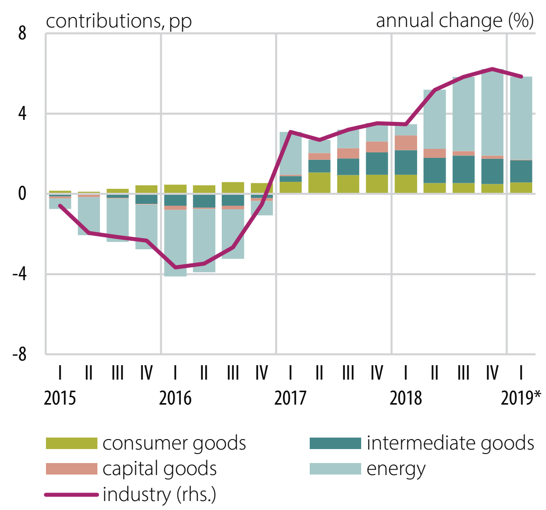
17 Influences in this respect had both the monetary policy, due to the Fed's announcement on the more accommodative monetary policy stance throughout 2019, and the trade policy, in the context of some progress made in the negotiations of relations with China.

Prices on the agri-food market posted relatively small changes during 2018; the annual dynamics of the FAO index has entered negative territory starting June and stayed there in January-March 2019 as well (annual change of -3 percent). Cereals were further among the exceptions, as their prices remained higher than those charged a year before, yet pressures have faded in this case as well, given the favourable outlook for the 2019 harvest and the large global stocks. Prices of dairy products have also seen increases recently, triggered by expectations of a weaker supply worldwide.

Thus, October through December 2018, inflationary pressures from external prices abated, the annual unit value index of imports (UVI)[18] decelerating to 102.5 percent. The pass-through of this influence to domestic prices was partly offset by the depreciation of the leu versus the US dollar, the domestic currency reporting a relatively stable performance against the euro. Behind the loss of momentum in the aggregate UVI were mainly intermediate goods, such as mineral products, chemicals and base metals, in line with the movements in commodity prices on international markets.

As regards the goods holding a relevant share in the CPI basket, pressures were limited for agri-food items – the UVI decreased or stood below 100 percent in the case of meat products, fats and oils, sugar, vegetal products. Conversely, the UVI posted a broad-based increase for non-food items, wider changes being visible in the case of transport equipment (108.6 percent for 2018 as a whole), possibly as a result of the shift in consumers' preference towards new, more expensive products, given the substantial pay rises over the past years.

Chart 2.13. Industrial producer prices on the domestic market



*) Jan.-Feb.

Source: Eurostat, NBR estimates

2.2. Producer prices on the domestic market

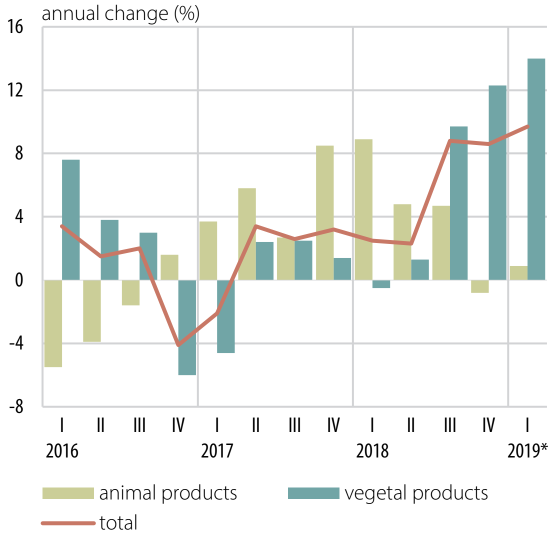
The trend in commodity prices on international markets caused the annual dynamics of industrial producer prices on the domestic market to slow down to 5.8 percent in January-February 2019 (-0.4 percentage points as compared to the 2018 Q4 average), the loss of momentum detected for main industrial groupings being almost across the board (Chart 2.13). Energy prices were sensitive to the sizeable correction in the Brent oil price towards end-2018, yet the effect of this factor was largely offset by the swift growth of prices in the production and supply of electricity, heating and gas, the market producing a strong reaction to the uncertainty generated by the hasty nature of some legislative changes in this field, to which added

18 Expressed in EUR.

supply-side issues of a temporary nature[19]. Slower rates of increase were also visible for prices of intermediate and capital goods, the impact of the downward trend in commodity prices covering the faster depreciation of the leu versus main currencies in the first months of 2019.

As for consumer goods, the annual rate of change of producer prices has been hovering around 2 percent for almost one year, with diverging developments of components emerging in the recent period. In the food industry, pressures from agri-food commodity prices remained contained, the change in prices stabilising at around 1.6 percent. Contrarily, the non-food sub-sectors (light industry, in particular) have been increasingly affected by the pressure stemming from unit wage costs, as they are especially vulnerable to minimum wage hikes, the swifter growth rates of prices being also underpinned by the favourable demand conditions economy-wide. A significantly faster rise in producer prices was visible in the pharmaceutical industry, but in this case it was due particularly to specific factors. The evolution of the clawback tax over the past years, as well as the obligation to charge a price at most equal to the smallest price for the same medicine in 12 EU Member States (a provision introduced in 2015) urged the companies in this market to reconfigure their drug portfolios and put an end to the production of cheap medicines that were no longer profitable.

Chart 2.14. Agricultural producer prices



*) Jan.-Feb.

Source: NIS

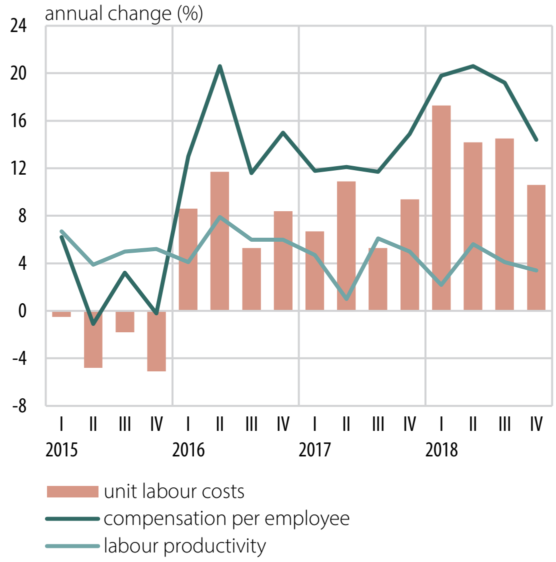
The annual dynamics of agricultural producer prices on the domestic market picked up slightly in January-February 2019 to 9.7 percent, adding 1 percentage point from 2018 Q4 (Chart 2.14). Looking at the vegetal product segment, prices went up 14 percent (as compared with 12 percent in the previous period), yet they are likely to see a slower growth pace in the following months, in line with the recent movements in the external markets. As for animal products, prices exceeded marginally the levels recorded a year ago (annual change of 0.9 percent, from -0.8 percent in 2018 Q4).

Unit labour costs

Unit labour costs economy-wide posted a slower pace of increase in 2018 Q4, i.e. down 3.9 percentage points as compared to the previous period, to 10.6 percent in annual terms, which however has remained high for the 12th quarter in a row. Failing to close the gap between wages and labour productivity jeopardises the competitiveness of Romanian exports on international markets, while it can also result in a pick-up in consumer prices on the domestic market.

19 The supply shortage caused by the lower production of electricity from renewable sources deepened at the beginning of 2019, following the miners' strike at Oltenia Power Plant, Romania turning into a net importer of electricity in December 2018 and January 2019.

Chart 2.15. Unit labour costs



Source: NIS

Moreover, the high pressures induced by unit wage costs persisted in industry in 2018 Q4 (annual change of 5.8 percent, similarly to that recorded in the previous period[20]). However, a surge in dynamics (up to 10.6 percent) was visible in January-February 2019, mainly on account of the faster growth pace of wages. Looking at the manufacturing sub-sectors, the evolution during October 2018 – February 2019 may be ascribed to both incidental influences in crude oil processing and chemical industries (overhauls) and structural factors – competitiveness issues (in food and light industries), higher commodity prices (manufacture of wood and furniture) or the difficulties in construction. Conversely, in the automotive industry, there are conditions for preserving competitiveness, given that the increase in labour productivity outpaced further that in wages for the 11th consecutive month (Chart 2.15).

[20] Values excluding the effect of fiscal changes implemented at the beginning of 2018.

3. Monetary policy and financial developments

1. Monetary policy

February through April 2019, the NBR kept the monetary policy rate at 2.50 percent and left unchanged the deposit facility rate at 1.50 percent and the lending facility rate at 3.50 percent, while tightening control over money market liquidity. Moreover, the central bank maintained the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions at 8.0 percent. The measures aimed to ensure adequate monetary conditions from the perspective of bringing and keeping the annual inflation rate in line with the flat target of 2.5 percent ±1 percentage point, inter alia via the solid anchoring of inflation expectations over the longer time horizon, while safeguarding financial stability.

In its February meeting, the NBR Board decided to leave unchanged the monetary policy rate in a context where the annual inflation rate had declined in December 2018 as well and had thus moved deeper into the variation band of the target, implicitly reaching a slightly lower-than-anticipated level[21], while the new medium-term forecast had reconfirmed the outlook for the annual inflation rate to decline further in the first three quarters of 2019, but also the prospects for its climbing and remaining slightly beneath the upper bound of the target band in the latter part of the forecast horizon[22]. The slowdown envisaged over the short term was mainly driven by supply-side factors, especially the anticipated declines in fuel and VFE price dynamics, but also the likely slight deceleration in the growth rate of administered prices. By contrast, the annual dynamics of core inflation were foreseen to regain momentum in 2019 Q2 and climb thereafter to 3.3 percent in December 2019 and 3.4 percent at the end of the forecast horizon, marginally above the previously anticipated values, amid simultaneous, gradually rising inflationary pressures projected to stem from the cyclical position of the economy, short-term inflation expectations and import prices, reflecting inter alia the likely developments in the leu's exchange rate.

The positive output gap was seen sticking to the slightly upward path until 2020 Q1, given that the pace of economic growth, anticipated to decelerate both in 2019 – in contrast to the previous forecast – and in 2020, was expected to remain above and then in line with the potential rate. A major source of change in the short-term

21 The annual inflation rate fell to 3.27 percent in December from 3.43 percent in November and 5.03 percent in September.

22 It was anticipated to reach 3.0 percent in December 2019 and 3.1 percent at the end of the forecast horizon, i.e. almost identical to the previously forecasted levels.

outlook for economic expansion consisted in the impact presumably stemming from the set of fiscal and budgetary measures implemented in 2019, anticipated to be felt also as a supply-side shock and hence to influence potential GDP. The new outlook for economic growth also implied, however, a quasi-neutral fiscal policy stance in 2019, followed by the return to a pro-cyclical stance in 2020, due mainly to the provisions of the pensions law being enforced as of the autumn of 2019, as well as a slower reduction in the degree of accommodation of monetary conditions, but also a more visible deceleration in economic growth in the euro area/EU and globally.

Even in these circumstances, the uncertainties associated with the medium-term projection remained particularly high. They had as major sources the set of fiscal and budgetary measures effective as of 1 January 2019[23] – given the associated ambiguities and the multitude of transmission channels in the economy, but also the set-up of the tax on credit institutions' financial assets, likely to affect monetary policy –, as well as the still pending 2019 draft budget, with implications for the future fiscal and income policy stance. To these added the heightened uncertainties related to the slowdown in euro area and global economic growth, amid the higher risks due to the trade row and the Brexit, as well as to international financial market volatility. Moreover, further relevant were the ECB's monetary policy stance and the probable stance of central banks in the region.

According to subsequently released statistical data, the annual inflation rate re-embarked on an upward path in January 2019, contrary to forecasts, climbing to 3.32 percent and then to 3.83 percent in February – hence above the variation band of the target and significantly above the forecast –, mainly driven by the increase in the prices of vegetables and fruit and in tobacco product prices. In turn, core inflation resumed growth more strongly than anticipated, its annual rate reaching 2.7 percent in February from 2.4 percent in December 2018. Aside from the influences of a weaker leu against the euro and the indirect effects of the advance in fuel prices, these developments reflected rising demand-pull and wage cost-push inflationary pressures. Thus, economic growth remained little changed in 2018 Q4[24], in the context of a slowdown in the quarterly pace of increase that made it likely for excess aggregate demand to rise slightly in that period, as forecasted. Moreover, household consumption made a stronger contribution to economic expansion, whereas net exports continued to post a larger negative contribution, which was also conducive – alongside a more pronounced worsening of the primary income balance – to a significant widening of the current account deficit in that period. At the same time, labour market tightness remained high, as the ILO unemployment rate hit a new low in the first month of 2019, concurrently with the number of employees in the economy climbing to a new historical high, while the advance in average net real wage earnings picked up further in January 2019 and the dynamics of unit wage costs in industry almost doubled.

23 Laid down in GEO No. 114 of 2018.

24 At 4.1 percent versus 4.2 percent in 2018 Q3.

Key interbank money market rates reverted to higher readings February through March and hence saw their positive spread vis-à-vis the monetary policy rate widen again, amid the tightening of liquidity conditions on the market. The EUR/RON exchange rate remained, however, close to the historical high reached in the second half of January for most of Q1; furthermore, the ongoing deterioration of the external position of the economy was likely to entail an increase in pressures on the exchange rate – with an adverse impact on inflation and on confidence in the domestic currency –, especially in the event of a sudden change in the global financial market sentiment or of a change in the risk perception vis-à-vis the local economy/financial market.

At the same time, the annual growth rate of credit to the private sector continued to pick up in January, but lost some momentum in February, its average for the period as a whole rising markedly against 2018 Q4. The evolution reflected the annual dynamics of leu-denominated loans staying at double-digit levels, albeit slightly on the wane, but especially the considerable slowdown in the decline of the foreign-currency component, amplified as a statistical effect by the increase in the EUR/RON exchange rate. Against this background, the share of the leu-denominated component in total private sector credit narrowed marginally to 65.7 percent. The annual pace of increase of liquidity in the economy stepped up in January 2019, before moderating in February, its average dynamics for the period[25] declining versus 2018 Q4.

The short-term projection updated in this context showed that the annual inflation rate would probably remain above the upper bound of the target band in the near run and on a significantly higher path than in the medium-term forecast published in the February 2019 *Inflation Report*. The revision was only partly ascribable to past performance, clearly also reflecting the likely less disinflationary action of supply-side factors in the future, given the envisaged much quicker dynamics of prices of vegetables, fruit, eggs and of fuels, compared to the February forecast, as well as relatively stronger effects expected from the new taxes levied in telecom and energy sectors. At the same time, it also reflected stronger than previously forecasted inflationary pressures expected over the short time horizon from aggregate demand and wage costs, as well as from the leu's exchange rate movements.

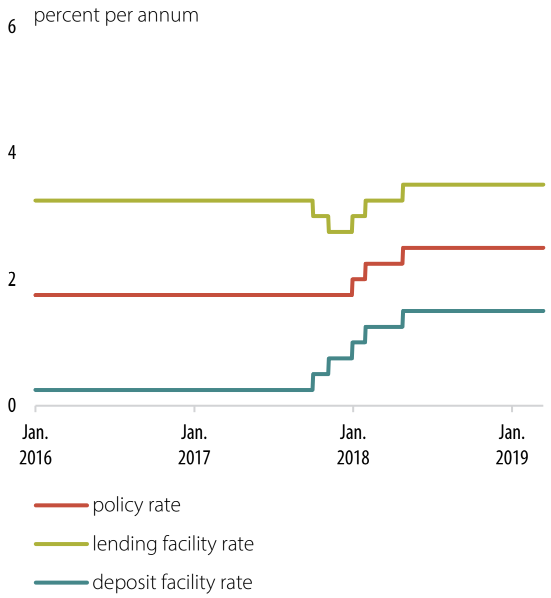
Economic growth was seen to remain robust in 2019 H1, with small changes in annual dynamics during the two quarters and a relatively steady quarterly rate, implying further increases in the positive output gap during that period on a trajectory only marginally lower compared to the February medium-term projection.

Recent economic developments and their near-term outlook were conducive to heightened uncertainties and risks to the most recent medium-term projection. Important uncertainty sources continued to be the future fiscal and income policy stance, as well as the fiscal and budgetary measures implemented this year, but also labour market conditions. To these added the major uncertainties and the elevated risks associated with the external environment, given the economic slowdown at European level and the recent downward revisions of the outlook for

[25] 9.4 percent.

EU and global growth, and hence the euro area inflation forecast, as well as the evolution of Brexit and of trade rows. Particularly relevant was the recent change in perspective of the ECB's monetary policy stance and the probable stance of central banks in the region. At the same time, an important source of uncertainties consisted in the recently approved provisions of some legal acts on the banking sector, which altogether complicate monetary transmission, with implications for the general framework of monetary policy.

Chart 3.1. NBR rates



Against this background, tailoring 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 warranted a tightening of monetary conditions. Therefore, in its meeting of 2 April 2019, the NBR Board kept unchanged the monetary policy rate at 2.50 percent, the deposit facility rate at 1.50 percent and the lending facility rate at 3.50 percent (Chart 3.1), while maintaining strict control over money market liquidity. In addition, the central bank preserved the current levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

2. Financial markets and monetary developments

In 2019 Q1, longer-term interbank money market rates resumed growth and hence saw their positive spread vis-à-vis the monetary policy rate widen again, while the EUR/RON exchange rate moved to and consolidated at higher readings. The annual growth rate of credit to the private sector stepped up January through February 2019, whereas the dynamics of liquidity across the economy continued to decelerate slightly.

2.1. Interest rates

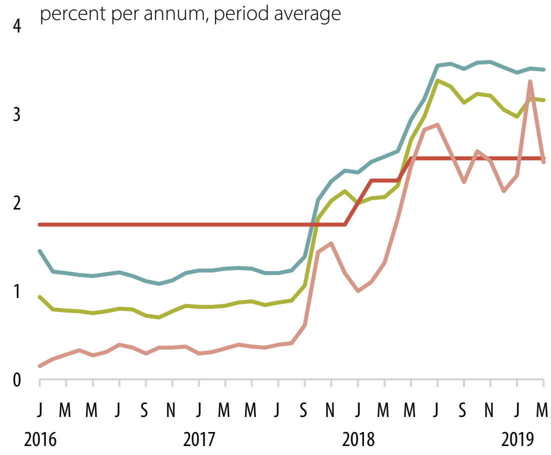
The daily average interbank money market rate fluctuated during Q1, but stood mostly in the vicinity of the upper bound of the corridor defined by interest rates on the central bank's standing facilities around the policy rate. Hence, its average[26] added 0.33 percentage points against the previous three months' value, peaking at a five-and-a-half-year high of 2.71 percent.

26 Weighted by the volume of transactions.

Liquidity conditions on the interbank money market continued to witness heightened volatility induced by the fluctuations of autonomous factors. The periods in which they had a restrictive nature tended to prevail[27], alternating with periods of significant reserve surpluses, which prompted the NBR to resume 1W time deposit-taking operations with full allotment[28]. Against this backdrop, after having run in the lower half of the interest rate corridor at the onset of the quarter, ON rates on the interbank money market climbed during the 24 January–23 February reserve maintenance period – initially abruptly and then more smoothly – to the upper bound of the corridor and remained stuck to it. Afterwards, they declined only temporarily in March, returning towards end-Q1 to the vicinity of the lending facility rate.

Chart 3.2. Policy rate and ROBOR rates

percent per annum, period average

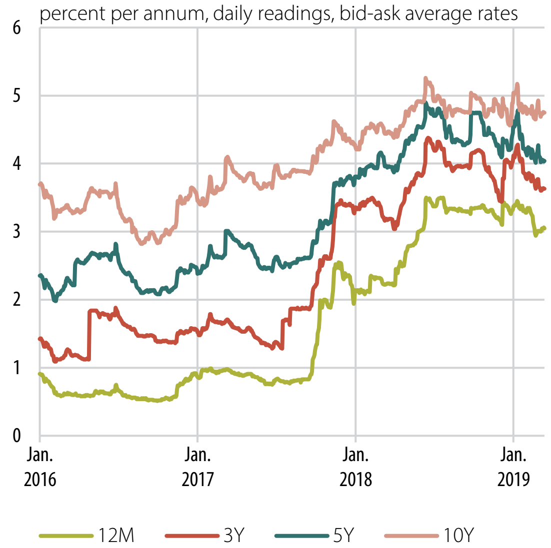


*) end of period

3M-12M ROBOR rates saw the generally downward path they had embarked on in November 2018 come to a halt in mid-January and followed an uptrend until the latter part of February, staying thereafter – amid somewhat more fluctuating developments – close to the higher readings recorded, comparable with those prevailing September through November 2018. Under the circumstances, average ROBOR rates in March rose versus those in the closing month of 2018 Q4 by 0.11 percentage points for the 3-month maturity (to 3.16 percent), but were marginally lower in the case of 6M and 12M rates, i.e. 3.31 percent and 3.50 percent respectively (Chart 3.2).

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

percent per annum, daily readings, bid-ask average rates



On the government securities market, reference rates on the secondary market[29] witnessed a steep advance in the latter half of January – amid the adoption of the new set of fiscal and budgetary measures[30] –, which was however partly corrected towards the end of the month (Chart 3.3). Then they stuck to a downward path until the first 10-day period of March – due to the alleviation of concerns about the set-up of the tax on credit institutions' financial assets and about the new regulations on private pension funds, given the talks on a potential revision thereof – and remained quasi-stable

27 Credit institutions' demand for reserves was accommodated exclusively via the central bank's lending facility.

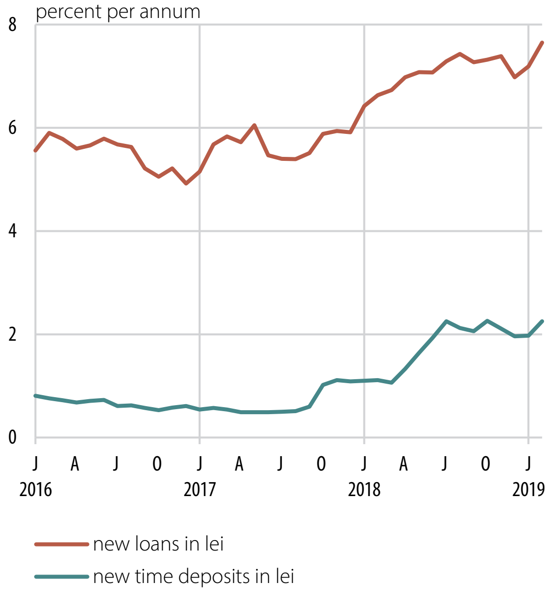
28 The central bank carried out three such operations during Q1, on 14 and 21 January and on 18 March, worth lei 12.9 billion, lei 4.3 billion, and lei 6.1 billion respectively.

29 Bid/ask average rates.

30 Thus nearing the past five years' highs recorded at mid-2018.

thereafter[31]. Their March averages declined against those recorded in December 2018 by up to 0.2 percentage points for the 6- and 12-month maturities (to 2.91 percent and 3.04 percent respectively), as well as for the 5-year maturity (to 4.09 percent), and by 0.07 percentage points (to 4.75 percent) on the 10-year maturity.On the primary market[32], the average accepted rates at the auctions conducted in March decreased versus the December 2018 readings for most of the maturities[33], by around 0.2 percentage points. However, they further posted mixed developments during the quarter, with the January increases (by up to 0.4 percentage points for 10-year securities) being followed by across-the-board declines in February (by up to 0.4 percentage points for the 5-year maturity) and in March (by up to 0.2 percentage points for 3-year securities). Investor interest in government securities dwindled over the quarter as a whole, although the visible drop in January was followed by a relative recovery; at the same time, the MPF resized the supply, the scheduled volume of issues being reduced in February for the third consecutive month and increased only slightly in March. The ratio of the amounts of bids submitted to the announced volume fell during the quarter as a whole to 1.7 (from 1.9 in 2018 Q4), as it dropped markedly in January, but rose in February and stayed at a close level in March. In turn, the ratio of the volume of issues to the announced volume decreased to 0.85[34], after having stood above one for two quarters in a row; nevertheless, the average maturity of securities issued continued to increase (to 5.5 years, from 4.9 years in October-December 2018).

Chart 3.4. Bank rates



Average interest rates on non-bank clients' new loans and new time deposits resumed growth in the period from December 2018 to February 2019 as a whole, adding 0.26 percentage points (to 7.65 percent) and 0.14 percentage points (to 2.25 percent) respectively (Chart 3.4). The advance in the average lending rate on new business to households stood out in terms of magnitude (up 0.26 percentage points, to 8.60 percent), driven mainly by the marked increase in the average interest rate on new consumer loans (up 0.39 percentage points)[35], which thus reached in

31 On foreign markets, long-term government security yields in the US and the euro area tended to go down during 2019 Q1. Regionally, they went up in Czechia and, towards the end of February – beginning of March, in Hungary and Poland as well.

32 On 16 January, the MPF reopened on the domestic market a EUR-denominated bond issue maturing in 2023, accepting bids worth EUR 84 million (out of a total of EUR 132.2 million), at a 0.97 percent average rate (marginally on the rise compared with the December 2018 securities auction at a similar maturity). Moreover, on 27 March, the MPF issued on the external market Eurobonds worth EUR 3 billion, comprising three series of securities with maturities of 7 years (EUR 1.15 billion, 2 percent rate), 15 years (EUR 0.5 billion, 3.5 percent rate), and 30 years respectively (EUR 1.35 billion, 4.625 percent rate). In addition, the MPF continued to conduct during the quarter under review subscriptions for government securities intended exclusively for households, issuing in February and March securities totalling around lei 1.2 billion, with maturities ranging between 1 and 5 years and interest rates between 3.5 percent and 5.0 percent.

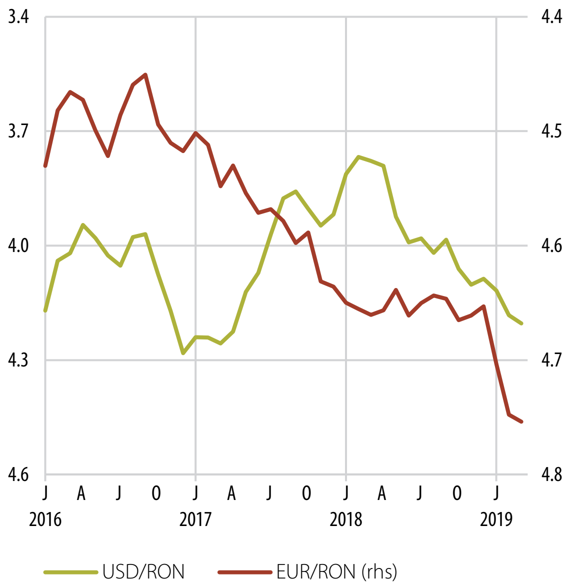
33 Except for the average rates on 3- and 10-year bonds, which were relatively unchanged.

34 It fell markedly in January (to 0.5), but advanced during the following two months (to 1 and 1.2 respectively), as the issued volumes exceeded the announced ones at most of the auctions held in February and March.

35 At the same time, the share of this type of credit in total new loans to households widened.

February its June 2014 peak, after having dropped significantly in the previous three quarters. The remuneration of new time deposits from households also seems to have witnessed a change in behaviour, albeit in the opposite direction, as it saw a reversal of its upward trend, shedding 0.14 percentage points, to 1.62 percent; the evolutions might also hint at possible effects of the new fiscal measures effective 1 January 2019. Looking at non-financial corporations, the average lending rate on new business inched up 0.06 percentage points, to 6.18 percent, ascribable solely to large-value loans (above EUR 1 million equivalent), whereas the average remuneration of new time deposits, more closely correlated with shorter-term rates on the interbank money market, posted a relatively sturdy rise of 0.22 percentage points, to 2.49 percent.

Chart 3.5. Nominal exchange rate



2.2. Exchange rate and capital flows

The EUR/RON exchange rate witnessed a relatively abrupt increase in the latter part of the first month of 2019, before remaining close to January's historical peak, on a relatively fluctuating path (Chart 3.5).

The slight upward path the EUR/RON had embarked on in the closing days of 2018 continued at the beginning of 2019, before posting a relatively sudden steepening in the latter half of January[36], amid concerns over the new fiscal and budgetary measures implemented at the onset of 2019 – especially over the tax on credit institutions' financial assets and the new regulations on private pension funds –, including in the context of the worsening trend in the economy's external position (Table 3.1). The move was at odds with the predominantly downward evolution of the exchange rates of the other currencies in the region, the latter reflecting the relative improvement in global financial market sentiment, driven mainly by some headway in the US-China trade talks and by signals from the Chinese authorities on the adoption of further stimulus to the economy; their influence more than offset that stemming from the uncertainties surrounding the slowdown of the global economy and the unfolding of Brexit.

Table 3.1. Key financial account items

EUR million

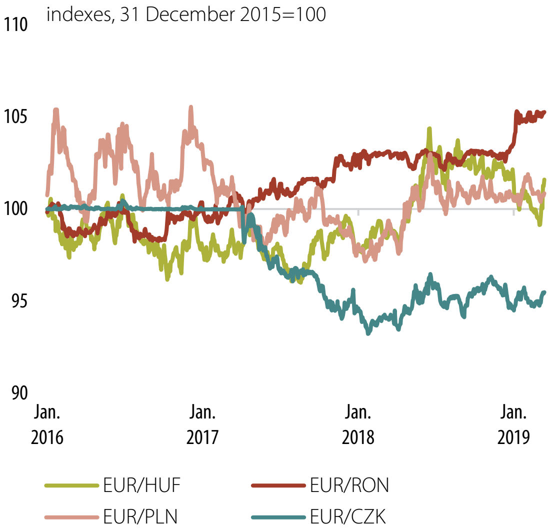
	2 mos. 2018			2 mos. 2019		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	2,728	3,031	-303	773	395	378
Direct investment	388	1,055	-667	131	1,172	-1,040
Portfolio investments	-22	1,709	-1,732	13	-345	359
Financial derivatives	x	x	48	x	x	-23
Other investment	585	267	318	1,317	-431	1,748
– currency and deposits	8	-30	38	1,236	-577	1,813
– loans	-6	50	-56	-29	-80	51
– other	583	247	336	110	226	-116
NBR's reserve assets, net	1,730	0	1,730	-665	0	-665

*) "+" increase/"-" decrease

36 Reaching a historical high of 4.7648 on 25 January.

However, the rise in the EUR/RON exchange rate levelled off relatively quickly and was even slightly corrected afterwards, inter alia amid the tightening of liquidity conditions and the increase in interbank money market rates. Subsequently, given the ongoing worsening of the external position of the economy, but also the persistence of tighter money market conditions and the relative alleviation of concerns about the fiscal measures regarding the financial sector, the exchange rate almost stabilised at levels slightly below the January peak. The evolution of the currency pair was probably also influenced by the more visible improvement in global financial market sentiment, amid the major central banks' signals/decisions on reconsidering the perspective of the monetary policy stance[37], alongside the expectations for settling the trade disputes.

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



Source: ECB, NBR

In mid-March, the EUR/RON posted, however, a renewed steeper rise, after which the currency pair stuck to levels in the immediate vicinity of the January peak. The evolution reflected the probable increase in investor concerns about domestic economic fundamentals[38], but also the relative heightening of global financial market volatility in the closing 10-day period of March. The latter, which occurred amid stronger signals on a global economic slowdown[39], also involved an appreciation of the US dollar versus the euro, which fed through to the exchange rates of the other currencies in the region as well, in the sense that they reversed their primarily downward paths (Chart 3.6).

The overall deficit on the interbank forex market widened further January through March, reaching the highest level for the past three quarters, in a context where residents' net demand for foreign currency shrank considerably.

During 2019 Q1 as a whole, the leu weakened versus the euro by 2.1 percent in nominal terms[40] and by 0.04 percent in real terms. In relation to the US dollar, the domestic currency depreciated 2.8 percent in nominal terms and 0.7 percent in real terms, given that the former strengthened against the euro on international markets.

37 On the occasion of its monetary policy decision at end-January, the Fed signalled a reconsideration of future adjustments in the benchmark interest rate, while in February ECB officials suggested the possibility of another round of long-term liquidity providing operations through targeted longer-term refinancing operations (TLTROs). On 7 March, the ECB extended at least through the end of 2019 (previously the summer of 2019) the horizon over which it expects key interest rates to remain at their present levels and decided to launch a new series of TLTROs starting in September 2019, the package of adopted measures exceeding market expectations.

38 Given inter alia the statistical data published in this period, regarding the evolution of inflation in February and of the trade/current account deficit in January.

39 In its meeting of 19-20 March, the Fed revised downwards the growth outlook for the US economy and the anticipated path of the interest rate (implying its status-quo this year), while also announcing the completion in September 2019 of the balance sheet normalisation process by reducing the volume of financial instruments in its portfolio. In addition, statistical data released in March indicated below-expectations performances by the US and euro area economies, while the uncertainties surrounding the Brexit were on the rise.

40 The Polish zloty depreciated slightly in this period (0.2 percent), whereas the Czech koruna and the Hungarian forint strengthened against the single currency by 0.6 percent and 2.2 percent respectively.

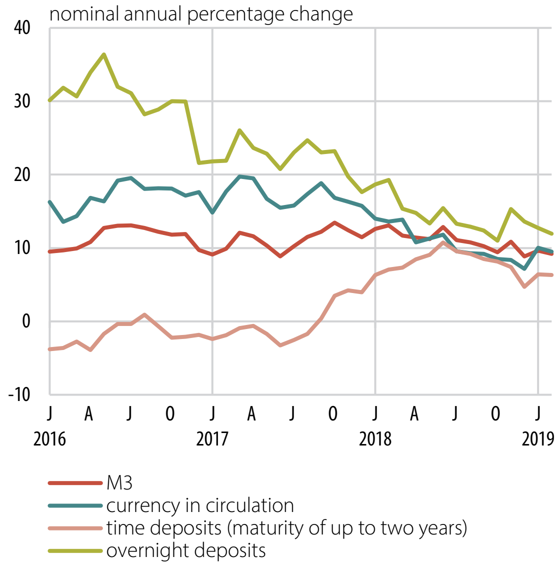
Looking at the average annual exchange rate dynamics in Q1, the leu saw its nominal depreciation accelerate versus both the euro and particularly the US dollar (the largest nominal depreciation in the past 13 quarters).

Table 3.2. Annual growth rates of M3 and its components

nominal percentage change

	2018				2019	
	I	II	III	IV	Jan.	Feb.
	quarterly average growth					
M3	12.4	11.8	10.7	9.7	9.7	9.2
M1	16.6	13.5	11.8	11.7	11.9	11.2
Currency in circulation	13.8	11.3	9.3	8.0	10.0	9.5
Overnight deposits	17.8	14.5	12.9	13.3	12.7	11.9
Time deposits (maturity of up to two years)	6.9	9.4	9.1	6.8	6.4	6.3

Chart 3.7. Main broad money components



2.3. Money and credit

Money

Broad money (M3) annual dynamics[41] continued to decelerate slightly January through February, reaching 9.4 percent from 9.7 percent in the previous three months (Table 3.2). However, this masked uneven developments, with the January step-up – due mainly to the increase in annual terms in the public wage bill, in government spending on goods and services, as well as in spending on social benefits[42] – being followed by a slowdown in February, inter alia amid the money-holders' larger portfolio of alternative financial instruments (leu-denominated government securities[43], foreign currency deposits with a maturity of over two years) compared to last year.

During the period as a whole, the loss of M3 momentum was induced, the same as in the previous quarter, by both its main components (Chart 3.7). In particular, narrow money (M1) growth continued to decelerate marginally, as its slight pick-up in January was followed by a somewhat more pronounced decline in February. Behind the developments for the period as a whole stood primarily the performance of ON deposits from households – also influenced by their being partly converted into time deposits –, whereas corporate ON deposits and currency in circulation grew at a faster annual pace. In turn, the rate of change of time deposits with a maturity of up to two years remained on a downward path, largely on the back of the further steep decline in the dynamics of corporate deposits, driven solely by the leu-denominated component. By contrast, similar household deposits rose at a swifter pace in this period as well (to a new 6-year

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

42 According to monthly data from the general government budget execution.

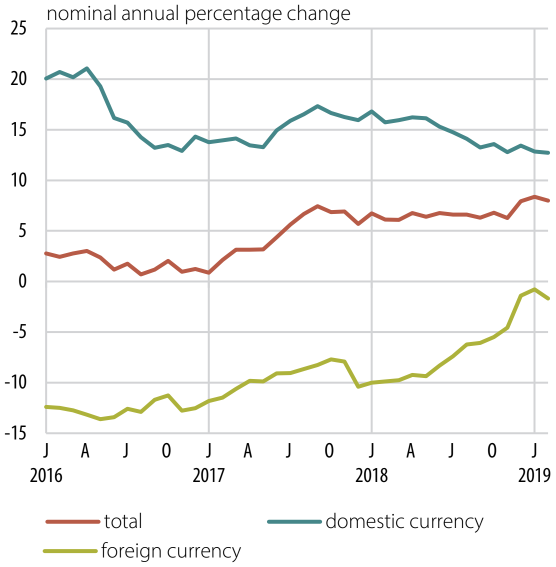
43 In January and February, the annual growth rate of leu-denominated government securities holdings by non-financial corporations and households (including those issued for households via the State Treasury and the Romanian Post National Company) was the highest for the past approximately three years and a half.

high in January), on account of both domestic and foreign currency components. Against this background, the share of M1 in broad money narrowed slightly, but remained high by historical standards, i.e. 60.8 percent in February.

The M3 breakdown by holder shows a slowdown in the dynamics of non-financial corporations' M3 deposits, as the rebound seen in January – ascribable mainly to the significantly faster growth rate of government spending on goods and services – was followed by a more pronounced decline in annual terms, given: (i) the steeper contraction in government spending on subsidies and in relation to recipients of EU funds, (ii) the slower growth rate of public spending on goods and services, as well as (iii) the higher payments by this segment in relation to some categories of taxes and to wages[44]. Conversely, household M3 deposits posted a slightly brisker advance, with the step-up in January – which reflected primarily the influence of the faster income growth[45] – being followed by a slight moderation in February, also amid households' larger holdings of government securities[46].

From the perspective of broad money counterparts, the reduction in M3 growth was mainly due to the slower annual decline of central government deposits, to the deceleration in the dynamics of credit institutions' government security holdings (both induced by the developments recorded in February), as well as to the pick-up in the rate of change of long-term financial liabilities; an opposite, albeit weaker effect had the faster dynamics of credit to the private sector and of banks' net foreign assets.

Chart 3.8. Credit to the private sector by currency



Credit to the private sector

In the first two months of 2019 Q1, the annual growth rate of credit to the private sector stepped up versus the previous quarter (8.2 percent from 7.0 percent), an evolution which masked the fact that the further advance in January (to a post-May 2012 high) was followed by a slight decline (Chart 3.8). During the period as a whole, behind these developments stood the faster dynamics of overdraft and revolving loans, as well as the reduction in the volume of non-performing loans removed from banks' balance sheet compared with the previous year.

From the perspective of the main components, the evolution reflected, to some extent, the further double-digit growth of leu-denominated loans, its ongoing slender decline notwithstanding, amid

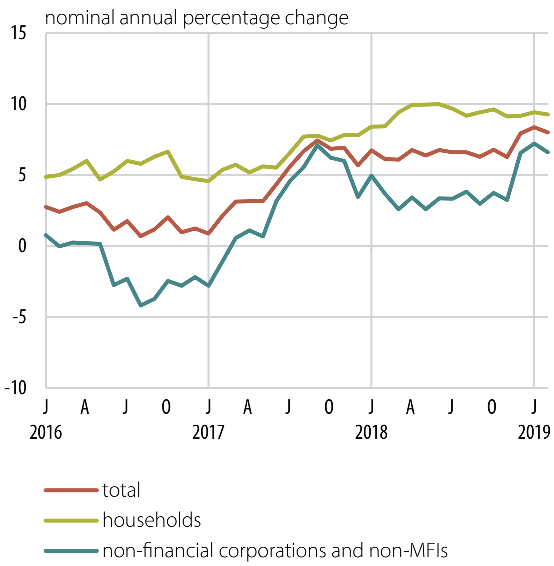
44 Pursuant to Government Decision No. 937/2018, the minimum gross wage economy-wide was raised starting 1 January 2019 from lei 1,900 to lei 2,080 lei (lei 2,350, under certain conditions, for higher education employees). Moreover, employees in the construction sector earn a minimum gross wage of lei 3,000 as of 1 January 2019, according to GEO No. 114/2018.

45 In January 2019, the annual dynamics of the average net wage earnings economy-wide peaked at a 2-year high.

46 The annual growth rate of total government security holdings by households, including those issued through the State Treasury and the Romanian Post National Company, was the fastest since August 2011.

slightly negative annual changes in the volume of new business. However, a stronger influence was exerted by the renewed softening of the contraction in foreign currency credit. This was due to the faster dynamics – during the period overall – of revolving and overdraft loans to non-financial corporations and was amplified by the statistical effect of the increase in the EUR/RON exchange rate[47]. In this context, the share of the leu-denominated component in total private sector credit narrowed marginally to 65.7 percent in February.

Chart 3.9. Credit to the private sector by institutional sector



At a sectoral level, the key driver behind the faster growth of private sector credit was the considerable pick-up in the dynamics of loans to non-financial corporations (Chart 3.9), which continued to gain traction in January and then moderated slightly in February. The pattern was ascribable to the annual rate of change of the foreign currency component (expressed in euro), whose strong acceleration in January (to a record high for the past approximately seven years)[48], but also its subsequent slight deceleration were mainly induced by developments in overdraft and revolving loans.

At the same time, the rate of change of household credit remained constant during the reported period overall. The domestic currency component continued to grow at a very swift pace, despite a slight slowdown, visible both in the case of housing loans – amid the reduction in "First Home" loans[49] – and in that of consumer and other loans, reflecting the weaker dynamics of new business, probably also attributable to the fiscal and macroprudential measures effective since the beginning of the year. Conversely, the foreign currency component declined at a slower rate, but this was solely due to the statistical effect of the increase in the EUR/RON exchange rate.

47 When expressed in lei, the annual rate of change of foreign currency loans to the private sector entered positive territory for the first time in six years.

48 A similar level was also recorded in February 2012.

49 Based on CCR data regarding loans granted with state guarantees, associated to the "First Home" programme.

4. Inflation outlook

The annual CPI inflation rate is projected to reach 4.2 percent at end-2019 and 3.3 percent at end-2020, i.e. above the levels forecasted in the February 2019 *Inflation Report* by 1.2 percentage points and 0.2 percentage points respectively. The CPI inflation rate is foreseen to stay above the upper bound of the variation band of the target until the end of this year, owing to the multiple supply-side shocks in the first part of the year and the inflationary impact of fundamentals that is expected to linger over the medium term. The annual core inflation rate is seen gaining momentum during 2019 amid both the already or soon-to-be implemented rises in some telecom services prices in the first half of the year and the slight upturn in inflationary pressures from excess demand, along with inflation expectations nearing the upper bound of the target band. The annual CPI inflation rate will re-enter the upper half of the variation band around the central target starting in 2020 Q1 due mostly to the fading-away of the inflationary contribution from exogenous components of the consumer basket. Moreover, in the first part of 2020, the fading influences associated with the hikes in telecommunication services prices will also cause the annual core inflation rate to decline slightly. Subsequently, this indicator is set to return to an upward path, given the anticipated stronger increase in import prices under the impact of a gradual rise in external inflation and the persistence of domestic inflationary pressures from excess demand. The significant revision of the annual CPI inflation forecast for this year owes largely to developments in the first quarter, when most exogenous components of the consumer basket were hit by previously unforeseen supply-side shocks. The balance of risks to the annual inflation rate projection is assessed to be tilted to the upside compared to its path in the baseline scenario, with the sources of risks being associated with both the domestic and international environment.

1. Baseline scenario

1.1. External assumptions[50]

External demand, assessed based on the effective EU GDP (EU-28 excluding Romania), is envisaged to experience a sharp deceleration of its annual dynamics, from 2.1 percent in 2018 to 1.6 percent in 2019 and 2020 (Table 4.1). The values

[50] Source: NBR assumptions based on data provided by the European Commission, ECB, Consensus Economics and Bloomberg (futures prices).

projected for the short term are lower than the previously-anticipated ones, given the overlapping of domestic factors (disruptions in automotive production, particularly in Germany, Romania's main trading partner, amid changes to emissions test procedures; social tensions and fiscal uncertainties in some EU Member States) with global factors[51] (escalating protectionist trade measures, tighter lending conditions in China). On the medium term, however, a rebound in economic growth is envisaged, underpinned further by the ECB's persistently accommodative monetary policy[52] – with a positive impact on consumption and investment –, and by the expected improvement in labour market conditions – that will lead to a more substantial rise in real wages, also fuelled by still weak inflationary pressures. The effective EU GDP gap, an indicator reflecting the cyclical component of economic activity in Romania's main trading partners, is seen posting positive values throughout the forecast interval, in line with the economic upswing, yet lower than those mentioned in the previous *Report* and even slightly slowing as from 2020.

Table 4.1. Expectations on the developments in external variables

annual averages

	2019	2020
Effective EU economic growth (%)	1.6	1.6
Annual inflation rate in the euro area (%)	1.3	1.5
Annual inflation rate in the euro area, excluding energy (%)	1.2	1.6
Annual CPI inflation rate in the USA (%)	1.8	2.2
3M EURIBOR (% per annum)	-0.3	-0.2
USD/EUR exchange rate	1.14	1.17
Brent oil price (USD/barrel)	67.8	66.3

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

The average annual HICP inflation rate in the euro area is forecasted to stand at lower values than those in the previous *Report* (still below the ECB's 2 percent benchmark consistent with its definition of price stability). The major driver of this evolution is the sharper-than-previously-projected slowdown in global and euro area economies. The average annual HICP inflation rate excluding energy in the euro area – the relevant measure for shaping the path of prices of imported goods – will follow an upward path over the projection interval, from 1.2 percent in 2019 to 1.6 percent in 2020. Nevertheless, the levels have been revised downwards compared with the previous *Report*, amid a slower advance in the cyclical component of economic activity. Annual inflation rate in the USA is foreseen to run higher than in the euro area in both years, standing above the 2 percent level in 2020.

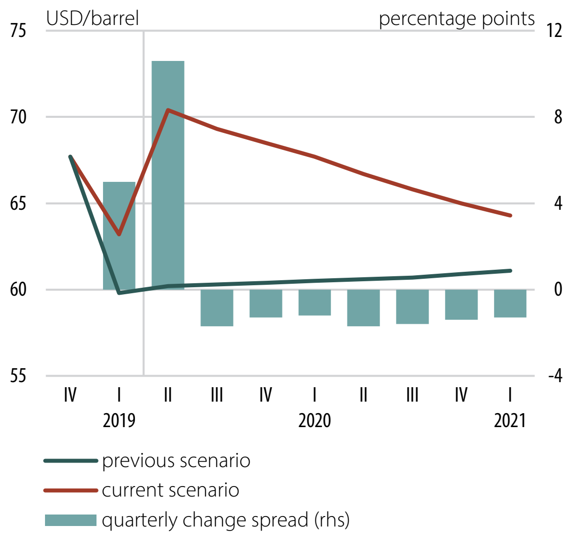
Against the background of the ECB's persistently accommodative monetary policy, which has been strengthened since the release of the previous *Report*, the nominal 3M EURIBOR rate is anticipated to further register negative values throughout the projection interval, yet their magnitude is expected to decline.

According to the projection, the euro will soften slightly against the US dollar in the first part of 2019, before strengthening to EUR/USD 1.19 at the forecast horizon. This path is, however, saddled with high levels of uncertainty, given

51 For further details, see the Box entitled "Recent developments in and the outlook for global economic activity".

52 Following the meeting of 10 April 2019, the ECB's Governing Council decided to leave unchanged the key ECB interest rates at least through the end of 2019, and in any case for as long as necessary to ensure the convergence of inflation to levels that are below, but close to, 2 percent.

Chart 4.1. Brent oil price scenario



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

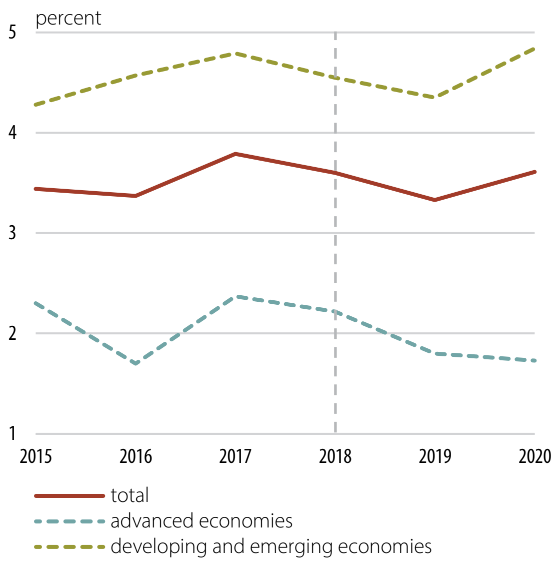
the swings in the exchange rate of the two currencies and the monetary policy stance in these blocs.

The scenario for the developments in the Brent oil price, based on futures prices, foresees a steep rise in 2019 Q2, after the drop recorded late last year to USD 50 per barrel in December and the rebound in 2019 Q1. Subsequently, the Brent oil price will decrease slightly, reaching USD 64 per barrel at the forecast horizon (Chart 4.1). The expected developments are further marked by high uncertainty and are conditional on both supply-side factors (the OPEC+ countries' commitment to keeping oil production at low levels, geopolitical tensions) and demand-side factors (US oil inventories), as well as on structural developments this market has seen over the recent years (steadily rising shale oil market share, with implications for the demand-supply ratio in the oil market).

Recent developments in and the outlook for global economic activity

Global economic growth experienced a slowdown in 2018 against a year earlier, with real GDP dynamics being projected to lose momentum in 2019 as well, before rebounding in 2020 (IMF forecast, *World Economic Outlook*, April 2019; Chart A). The slacker pace of increase in the period 2018-2019 is engendered by the developments in activity in advanced economies, as well as in developing and emerging economies, while the recovery in 2020 is attributed to those in the latter category.

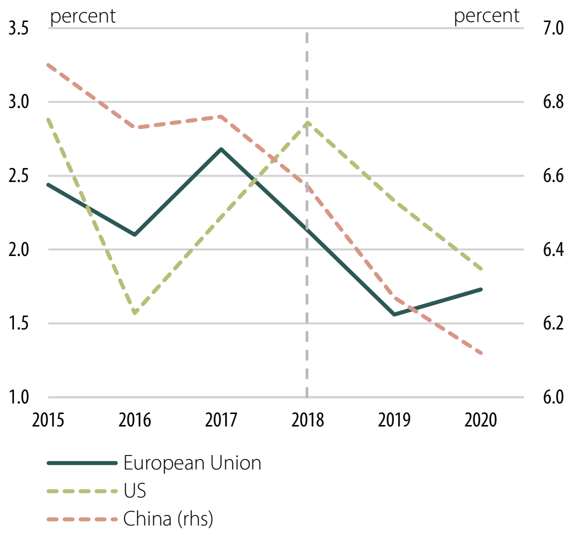
Chart A. Global economic growth



Source: IMF, *World Economic Outlook*, April 2019

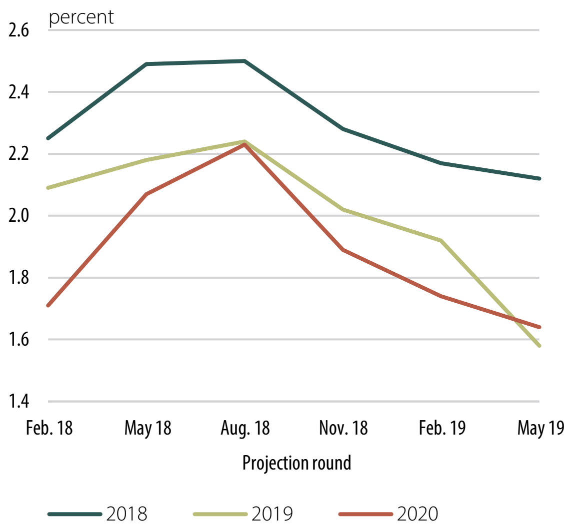
Out of the world's three major economies, the US witnessed a pick-up in economic growth in 2018, amid fiscal loosening and favourable labour market developments (Chart B). As for China, the slowdown in growth in 2018 occurred against the background of escalating trade protectionism and tighter lending conditions. In the EU, consumer and business confidence softened last year owing to weaker external demand (notably from the economies in Asia), disruptions in the automotive sector activity (hit by changes to emissions test procedures) and geopolitical uncertainties (including those related to Brexit). The slowdown in global economic growth is forecasted to persist over the first part of 2019, under the ongoing impact of the above-mentioned factors,

Chart B. Economic growth, the world's major economies



Source: IMF, *World Economic Outlook*, April 2019

Chart C. Revised projections for effective EU GDP growth



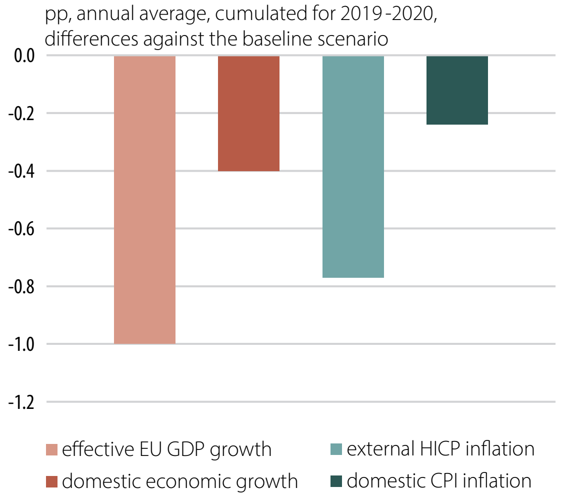
Source: European Commission, *Consensus Forecast*, NBR calculations

a recovery being anticipated starting in the latter part of the year. This will be underpinned by the reconfiguration of policy stance to support economic activity, facilitated by the lack of inflationary pressures, in spite of a widening output gap. Specifically, the Federal Reserve, the ECB and the Bank of Japan announced more accommodative-than-previously-expected policies, whereas China will roll out a fiscal and monetary stimulus to spur the economy. Moreover, the prospects for trade tensions brightened as a result of progress in US-China negotiations. At the same time, labour market developments remained robust and hence created the conditions for keeping in place the virtuous circle between the increase in employment and labour income and that in consumption.

Nevertheless, in most economies around the world, the pace of growth is not foreseen to return to the 2017 level. Global trade dynamics lost significant momentum and economic activity saw a synchronised slowdown. The risks to global recovery remain significant. Possible adverse developments as concerns trade tensions and Brexit remain relevant. There are also vulnerabilities associated with public and private debt levels in some countries, which could depress investor sentiment, leading to portfolio shifts and capital flight away from seemingly riskier investments. The scope for conventional economic policies is limited and the materialisation of risks could significantly weigh on the outlook. Against this background, the advance in economic activity is vulnerable to possible adverse macroeconomic shocks, also in terms of their being transmitted through global value chains.

Turning to Romania's main trading partners, the projected effective EU GDP growth, which proxies the demand dynamics for the country's exports, envisages its deceleration slightly below the potential rates for the period 2019-2020. The previous years' brisker advance caused the output gap to move into positive territory, which was assessed to have occurred in 2017. The effective EU GDP dynamics were subject to downward revisions in the last three forecast rounds, with the 2019 growth rate being 0.6 percentage point lower than in the August 2018 round (from 2.2 percent to 1.6 percent; Chart C). This strengthens the relevance of risks associated with a less bright picture of external economic

Chart D. Assessment of the impact of the scenario on a faster slowdown in external economic activity



Source: NBR calculations

activity than that assumed in the baseline scenario. Quantitative assessments based on the model for analysis and medium-term forecasting (MAMTF) point to pronounced sensitivity of domestic economic activity to changes in the EU's effective economic growth. Specifically, should the latter slow down at a faster pace, i.e. by a cumulative 1 percentage point in the period 2019-2020, and external prices post weaker dynamics by 0.8 percentage points in total, domestic GDP growth would be 0.4 percentage points below that projected in the baseline scenario. Against the background of more subdued domestic inflationary pressures, alongside softer import prices, average annual CPI inflation rate would stand 0.25 percentage points lower (Chart D). Worth noting is that this negative impact may increase significantly if domestic macroeconomic imbalances worsen and the activity of trading partners deteriorates more steeply, which may cause adverse external shocks pass swiftly through the channel of foreign financial flows.

1.2. Inflation outlook

According to the baseline scenario of the macroeconomic projection, the annual CPI inflation rate will reach 4.2 percent at end-2019 and 3.3 percent at end-2020. At the projection horizon, i.e. 2021 Q1, the forecast shows a rate of 3.4 percent (Table 4.2; Chart 4.2). Having posted a significant leap in 2019 Q1, at the end of which it already reached 4.0 percent, the annual inflation rate will be marked by some statistical base effects. Specifically, it is expected to decline slightly until the end of 2019 Q3, amid lower inflationary pressures from the exogenous components of the consumer basket. Subsequently, consumer prices will see faster annual dynamics resulting from the dissipating influence of favourable supply-side shocks manifest in the latter part of 2018, i.e. declines in international oil prices and citrus fruit prices on the markets of origin. Over the current year, these base effects will overlap with heightened domestic inflationary pressures reflected by the path of core inflation and associated partly with excess demand and partly with increases in the prices of telecommunication services[53]. Starting with 2020 Q1, once 2019 Q1 inflationary developments drop out of the calculation and hence the contribution of exogenous components narrows,

Table 4.2. The annual inflation rate in the baseline scenario

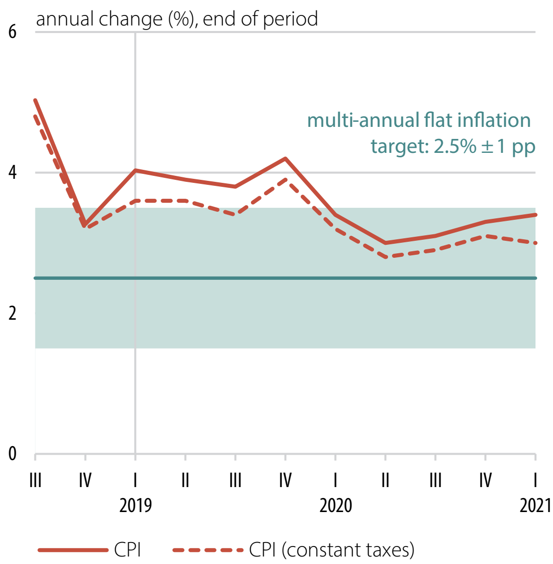
annual change(%); end of period

	2019			2020				2021
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	3.9	3.8	4.2	3.4	3.0	3.1	3.3	3.4
CPI projection*	3.6	3.4	3.9	3.2	2.8	2.9	3.1	3.0

*) calculated at constant taxes

53 Most likely due to the provisions of GEO No. 114/2018 impacting electronic communications.

Chart 4.2. Inflation forecast



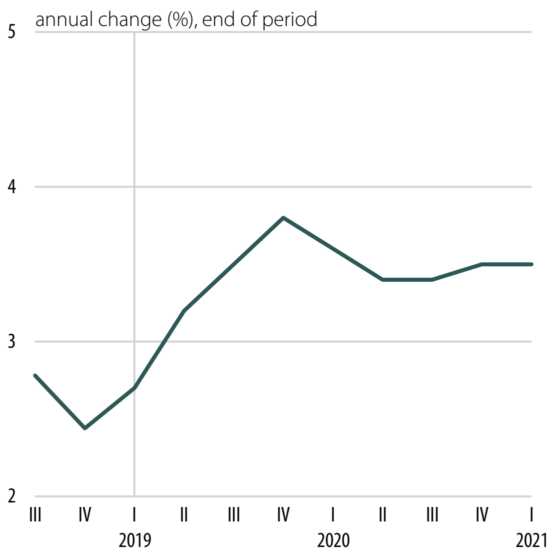
Source: NIS, NBR projection

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

annual change (%); end of period

	2019			2020				2021
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Adjusted CORE2	3.2	3.5	3.8	3.6	3.4	3.4	3.5	3.5

Chart 4.3. Annual adjusted CORE2 inflation



Source: NIS, NBR projection

the headline inflation rate is expected to re-enter and then remain inside the upper half of the band of the flat target of 2.5 percent ±1 percentage point until the forecast horizon, assuming no new supply-side shocks occur.

Compared to the previous *Report*, the forecasted annual CPI inflation rate was revised upwards for the end of both years of the projection, by 1.2 percentage points and 0.2 percentage points respectively. The revision relies mainly on the expected developments of the exogenous components (volatile food prices, primarily on the vegetables segment, and fuel prices for 2019, and tobacco product prices for the next year), as well as on the assessment of higher inflationary pressures associated with the annual dynamics of core inflation.

After the trend reversal at the start of the year, the annual adjusted CORE2 inflation rate is foreseen to continue to rise until the end of 2019, when it will reach 3.8 percent. This can be attributed both to the price hikes of some telecommunication services, already in effect or anticipated for 2019 Q2, and to slightly higher domestic inflationary pressures associated with excess demand. Although the said price hikes are not expected to produce persistent effects on core inflation dynamics, the scale of this shock, estimated to translate into an additional 0.4 percentage point contribution to the annual core inflation rate at the end of the year, is forecasted to generate second-round effects via economic agents' inflation expectations[54]. The latter have already recorded, since mid-2018, and are anticipated to further record values above the upper bound of the variation band around the central target by end-2019, before running in the upper half of the band in the medium term. In the first part of 2020, amid the fading out of the influences associated with the price increases in telecommunication services, the annual core inflation rate will slow down more markedly. It will subsequently re-embark on an upward path, reaching 3.5 percent

[54] Via their backward-looking component.

at end-2020, amid the anticipated swifter pick-up in prices of imported goods, under the impact of a progressive increase in external inflation and of the persistence of domestic inflationary pressures, attributed to excess demand (Table 4.3, Chart 4.3).

Compared to the February 2019 *Inflation Report*, the annual adjusted CORE2 inflation rate was revised upwards by 0.5 percentage points and 0.1 percentage points at the end of 2019 and 2020 respectively. The revision was made given the previously-unforeseen price hikes for telecommunication services, with a bearing particularly on 2019, and, inter alia under their effect, to the higher inflation expectations throughout the projection interval. The influence of these factors is only partly countered by weaker inflationary pressures from excess demand and by the downward reassessment of the annual HICP inflation rate excluding energy in the euro area, with a relatively more favourable impact on import prices.

Table 4.4. Components' contribution to annual inflation rate*

percentage points

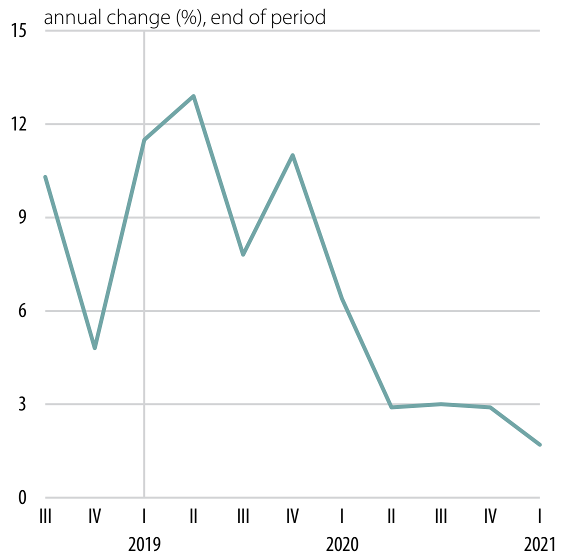
	2019	2020
Administered prices	0.3	0.4
Fuels	0.5	0.1
VFE prices	0.6	0.2
Adjusted CORE2	2.4	2.2
Tobacco and alcoholic beverages	0.3	0.4

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

The cumulative contribution of inflation components exogenous to the scope of monetary policy, namely administered prices, prices of volatile food items, fuel prices and tobacco product and alcoholic beverage prices, to the annual CPI inflation rate is 1.8 percentage points at the end of 2019 and 1.1 percentage points at the end of 2020, being revised upwards by 0.9 percentage points and 0.1 percentage points respectively against the previous *Report* (Table 4.4).

Volatile food prices are projected to go up by 11.0 percent at the end of 2019, a significant upward revision (by 10.3 percentage points) compared to the February 2019 *Inflation Report*. The change in the forecast was mainly driven by the significant rise in prices of vegetables since the beginning of the year, which echoed across all EU Member States. At the same time, the price dynamics of this consumer basket component were also influenced by the low potato production domestically, as well as by the gradual fading-out of the positive supply-side shock in the previous year related to the plentiful crop of citrus fruits on the markets of origin. The growth path of VFE prices over the forecast interval rests on the assumption of normal agricultural years domestically in 2019 and 2020. Against this background, the group's annual dynamics are projected to stand at 2.9 percent at the end of next year, relatively similar to those forecasted in the previous *Report* (Chart 4.4).

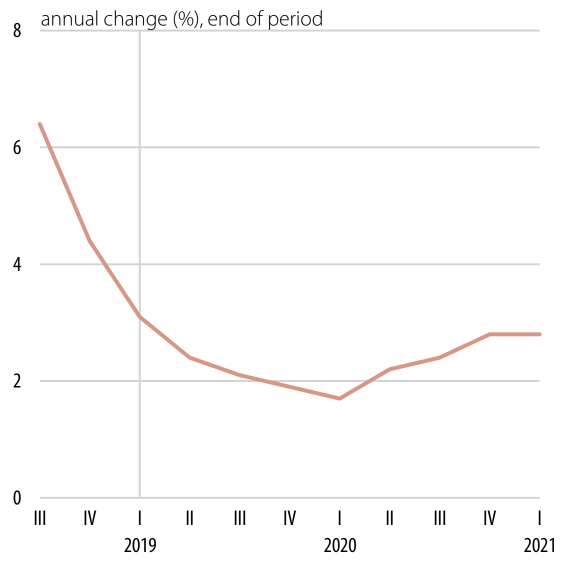
Chart 4.4. VFE prices annual inflation



Source: NIS, NBR projection

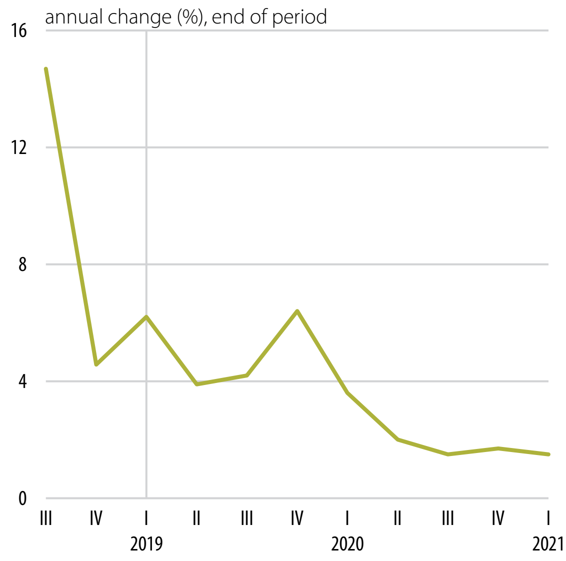
According to the exogenous scenario for administered prices, their growth rate is anticipated at 1.9 percent and 2.8 percent at the end of 2019 and 2020 respectively (Chart 4.5). Compared to the prior *Report*, the projection for the end of this year was revised downwards by 0.1 percentage points[55], due to the downward reassessment of natural gas and electricity prices, partly offset by the hikes already implemented or expected in the prices of water, sewerage and waste disposal, and of medicines. For end-2020, the revision by 0.3 percentage points versus the previous *Report* is attributable to the changed assumption on the annual dynamics of prices of water, sewerage and waste disposal, amid recent developments.

Chart 4.5. Administered prices annual inflation



Source: NIS, NBR projection

Chart 4.6. Fuel prices annual inflation



Source: NIS, NBR projection

The annual rate of increase of fuel prices is anticipated to reach 6.4 percent at end-2019, being revised upwards by 4.4 percentage points, and 1.7 percent at end-2020, following a downward reassessment of 0.3 percentage points (Chart 4.6). The significant revision for 2019 occurs amid the annual dynamics of the international oil price running above those projected in the previous *Report* for this horizon (due to higher quarterly changes in 2019 H1), higher inflationary expectations and a stronger anticipated depreciation of the euro against the US dollar, impacting the leu-denominated fuel prices (the Brent oil price on international markets being expressed in US dollars).

The scenario for tobacco product and alcoholic beverage prices envisages annual dynamics of 4.3 percent at end-2019 (revised slightly downwards from the previous *Report*, by 0.5 percentage points) and of 4.5 percent at the end of the next year. For 2020, the upward reassessment by 1.7 percentage points results from incorporating into the projection the historical behaviour of economic agents in this sector regarding increases in the final price, also amid the persistent excess demand in the economy.

55 In the context of the reduction in the high degree of uncertainty in the previous round, which was associated with the absence of norms of the competent authorities for the transposition of the general provisions of GEO No. 114/2018. However, still relevant are some uncertainties about the transposition into norms and methodologies of some provisions of GEO No. 19/2019 (for further details, see Chapter 4, Section 1.4. Risks associated with the projection).

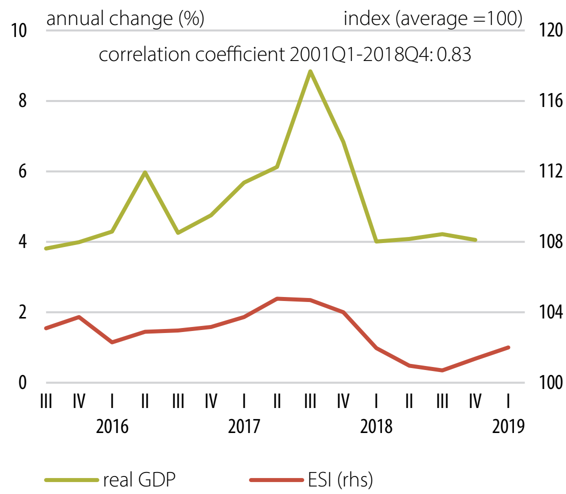
1.3. Demand pressures in the current period and over the projection interval[56]

Output gap

In 2018 Q4, real GDP saw a new advance in quarterly terms (0.9 percent, lower than in Q3[57]) and its annual dynamics stayed at values slightly above 4 percent[58], as in most of last year's quarters. The quarterly GDP growth mirrored a renewed substantial contribution from consumption (which further had stronger dynamics than GDP), while the contribution of GFCF returned to negative values, yet smaller than in the first half of the year. Concurrently, net exports made a negative contribution, on the increase compared to the previous quarter, given the quarterly dynamics of exports re-entering positive territory, yet remaining weaker than those of imports[59].

In the first two quarters of the current year, the quarterly GDP dynamics are foreseen to be moderate. The path of the GDP is assessed to include unfavourable effects in connection to the uncertainty issuing from recent legislative measures, with probable adverse effects on investment projects[60]. The signals stemming from high-frequency indicators are mixed. Unlike the industrial output contraction of 2019 Q1 against the previous quarter, retail trade turnover volume and real net wage earnings (influencing domestic demand) witnessed favourable developments. Business surveys[61] indicate for January-May 2019 a fluctuating trajectory in the construction sector and expected increases in the trade activity, respectively. An improvement in the economic sentiment indicator adds to these signals, chiefly due to the services component (Chart 4.7). On the demand side, consumption is anticipated to remain the key driver of quarterly GDP growth. At the same time, net exports of goods and services are projected to further make a notable negative contribution.

Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

The baseline scenario of the projection reconfirms (following the 2018 slowdown) new losses of momentum in 2019 and 2020, with the foreseen

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

57 2018 Q3 witnessed an outstanding increase in agricultural output, with an impact also on individual household consumption, via the component of self-consumption and purchases on the agri-food market.

58 According to NIS press release No. 83 of 8 April 2019, in 2018 Q4 real GDP rose by 4.1 percent year on year. The annual dynamics are calculated based on gross data series.

59 For further details, see Chapter 2, Section 1. Demand and supply.

60 Short-term GDP forecast mirrors for 2019 Q1 the adverse effects on GFCF resulting from the provisions of GEO No. 114/2018. For the next quarters, the unfavourable impact of GEO No. 114/2018 on investment plans will linger on, given that the changes pursuant to GEO No. 19/2019 targeted only the procedures regarding the tax on bank assets, while those referring to the tax on telecommunications services and electricity and natural gas production remained mostly unchanged. As for the privately managed pension funds, GEO No. 19/2019 only postponed the deadline for the increase in minimum share capital.

61 NIS press releases No. 47 of 28 February 2019 and No. 73 of 28 March 2019, respectively.

economic growth nearing its potential rate at the projection horizon. The same as in the previous *Inflation Report*, the recent legislative changes remain relevant for the forecast, given their effects – yet difficult to quantify – on GFCF and implicitly on GDP and potential GDP growth rates. In this respect, the Box "Recent developments in investment: several coordinates" in the previous *Inflation Report* estimates that uncertainty (measured by the volatility of shares of firms listed on the Bucharest Stock Exchange) and the debt level exert an inhibiting effect on capital accumulation and the decisions to start investment projects. Over the forecast interval, final consumption is expected to remain the key driver of economic growth, with a contribution close to that of 2018. The actual individual consumption of households is foreseen to benefit from the further uptrend in the dynamics of real disposable income, chiefly on account of the increase in wages, to which add the rises in budget transfers, against the backdrop of the provisions to raise the pension point[62]. Following the contraction recorded during 2018 (due to the unfavourable developments in construction), GFCF is projected to witness an improvement, but the contribution of this component will remain affected by the limited predictability of the legislative framework. Given the stronger growth rate of imports of goods and services compared to that of exports thereof, the contribution from net exports is anticipated to stay in negative territory, posting a large value in 2019 as well and lowering thereafter. Mention should be made of the still substantial contribution of the change in inventories expected throughout the current year, mostly due to a statistical carry-over effect from 2018, the size of this component making difficult to clearly identify the composition of economic growth in terms of consumption, investment and net exports.

As anticipated in the previous *Inflation Report*, in parallel with the loss of momentum in economic growth, annual dynamics of potential GDP over the projection interval are assessed to be slightly slower than the year before, as a result of smaller contributions from all production factors. The path of potential GDP – mainly through capital accumulation and the dynamics of total factor productivity – is further affected by the uncertainties stemming from the recently adopted legislative measures. These could delay or diminish the volume of investment projects in the telecommunications, electricity and natural gas sectors. In addition, the TFP trend dynamics will continue to be contained by structural deficiencies of the economy – modest allocation of resources for innovation, poor infrastructure and high skill mismatch[63]. Efficiency gains could be obtained inter alia via an assumed better absorption rate of EU structural and investment funds[64] and a further uptrend in the share of employees involved in the high-tech or services sectors. Despite the fact that demographic trends remain unfavourable (ageing population, negative natural population change,

62 According to GEO No. 114/2018, the pension point will be significantly raised in September 2019. At end-2018, the Chamber of Deputies approved and sent for promulgation the most recent draft of the law on the public pension system, which provides for other significant increases in the pension point in September 2020 and September 2021, respectively.

63 Related evidence 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 Report* of the World Economic Forum.

64 As mentioned in the Fiscal Strategy for 2019-2021, the Government "aims to accelerate the pace of spending European funds to reach 72.5 percent by 31 December 2020 and 100 percent by 31 December 2023". According to the *Net Financial Balance* published by the Ministry of Public Finance, in the first two months of 2019 the inflows of structural and cohesion funds totalled EUR 0.7 bn.

Chart 4.8. Output gap

Source: NBR assessments based on data provided by the NIS

emigration), labour contribution is foreseen to stay slightly positive, mainly due to the anticipated increase in activity rate, alongside economic expansion[65].

The output gap (Chart 4.8) will follow a slightly upward path until the beginning of 2020, before flattening out somewhat for the remainder of the forecast interval. This trajectory reflects: (i) the persistently accommodative nature of real broad monetary conditions until the first part of next year, and its subsequent reversal, respectively; (ii) a growing effective external demand, though at slightly lower than potential rates and lower than those foreseen in the previous *Report*; (iii) the stimuli from the discretionary component of fiscal policy, chiefly due to the provisions to significantly raise the pension point. 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 cyclical component will have a modest contribution. 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 their relatively high volatility, as well as the frequency and size of the historical series revisions.

Although the output gap follows a path similar to that in the previous *Inflation Report*, its level was revised slightly downwards over the entire projection interval. In 2019, the revision mirrors the downward reassessment of external demand (given its worsened prospects) and of the impact of real broad monetary conditions, partially offset by the upward reassessment of fiscal impulse. For next year, the contributions from all fundamentals were revised downwards.

Aggregate demand components

The quarterly dynamics of final consumption slowed down to 1.3 percent in 2018 Q4, reflecting a loss of momentum of the actual individual consumption of households[66]. In the short term, quarterly dynamics are anticipated to stay at similar levels, supported by the upward trend of real disposable income and by the impact of real interest rates, which is assessed to remain stimulative.

Over the projection interval, given the expected modest positive contributions from GFCF and negative ones from net exports, final consumption is projected to remain the key driver of economic growth. It will be mostly fuelled by the robust growth

[65] Thus, at the beginning of 2019, the *Manpower Group Survey* shows a positive net employment outlook, mainly for medium and large-sized companies.

[66] On account of a slowdown in real net wages in 2018 Q4 against the previous period. Contrarily, during the aforementioned quarter, a rise in the consumer confidence indicator was noticed.

rates of the actual individual consumption of households, correlated with the real disposable income, which are forecasted to remain strong. This trajectory is shaped both by the expected increases in real (net) wage, as well as by the envisaged higher budget transfers, against the backdrop of the provisions to raise the pension point. Throughout the current and (to a lesser extent) the following year, the advance in wages will reflect the relatively high degree of labour market tightness, amid the persistent constraints of structural determinants. The increase in the minimum gross wage economy-wide and the pay rises in the public sector are also relevant for the beginning of 2019.

In 2018 Q4, GFCF decreased by 0.7 percent versus the previous quarter, while in 2018 as a whole, it contracted by 3.2 percent. For the future, a quasi-stagnation of GFCF is expected in the short term, the signals stemming from high-frequency indicators being mixed. Thus, on the one hand, the construction sector witnessed favourable developments in all its segments (residential, non-residential and civil engineering) January through February 2019 against the 2018 Q4 average. On the other hand, during these first two months, credit flows to non-financial corporations are assessed to be on a sharp decline compared to both 2018 Q4 and the same year-earlier period.

The annual GFCF dynamics are foreseen to recover over the forecast interval, their trajectory being nonetheless marked by heightened uncertainties. These are also associated with the recent legislative amendments that carry potential adverse effects on the investment plans of companies in major economic sectors, which could also weigh on the foreign direct investment inflows to these sectors. However, compared to the February *Report*, the negative impact on some sectors' profitability – banking's in particular – is assessed to be lower, given the GEO No. 19/2019 amendments to the GEO No. 114/2018 provisions. The authorities' investment stance[67] also remains relevant, after having led to cuts in investment spending over successive rounds. Structural factors specific to the local economy – the limited predictability of the legislative framework, the relatively poor quality of infrastructure, the rising skill mismatch – will hamper the future developments in investments. On the other hand, GFCF is anticipated to be supported by foreign direct investment inflows, yet these are affected by the slowdown in the economic growth in Romania and in the main countries of origin. In addition, stimulative influences arise from further assuming an improved absorption of EU structural and investment funds.

Exports of goods and services are expected to advance further over the forecast interval, yet at a decelerating pace in annual terms. The expected developments in the component take into account: (i) the decrease in price competitiveness, amid the rise in unit labour costs, albeit at slower rates, (ii) the diminishing traction exerted by effective external demand, and (iii) a series of dragging structural features of the economy, such as the slow bridging of gaps regarding infrastructure or the sophistication level of production processes, with a direct impact on the structure of value added of the Romanian products targeting external markets. The annual

67 The preliminary coordinates of the 2019 government budget target the increase in public investment expenditure as a share of GDP by about 1 percentage point (chiefly due to that for projects financed from non-redeemable external funds). Throughout 2018, the indicator climbed by 0.5 percentage points.

dynamics of the component are projected to be slower than in the assessment in the previous *Inflation Report*, amid worsening prospects for effective external demand and price competitiveness of local products.

The imports of goods and services are anticipated to further post a brisk increase during the first part of the projection horizon, followed by a subsequent abatement, reflecting the path of domestic demand[68] and the stimulative effect, albeit softer, of exports. Imports dynamics are assessed to exceed those of exports (with the differential still remaining large this year), causing a negative contribution of net exports to GDP growth and thus increasing the negative contribution of trade balance to the current account deficit.

Throughout 2018, the current account deficit remained on the upward path it had embarked upon in 2015, reaching 4.5 percent of nominal GDP, mainly due to the increase in the deficit on trade in goods and services. This trend is expected to continue over the projection interval, at the end of 2019 and 2020 the current account deficit being envisaged to stay at levels that exceed the 4 percent-of-GDP indicative threshold set by the European Commission as a scoreboard indicator for EU Member States[69]. Regionally, Romanian economy stands out because of the widening of the balance-of-payments current account deficit, prompted by the negative trade balance (primarily that with non-EU countries[70]). The current account deficit financing is anticipated to be only partly covered by stable, non-debt-creating capital flows over the entire projection interval. The main factors influencing the coverage of the current account deficit by these flows are, on the one hand, the possible adverse effects on direct investment against the background of a slowdown in the economic activity of main trading partners, but also amid the frequent legislative changes carrying the potential to affect foreign investors' perception of the domestic business environment predictability. On the other hand, a partly offsetting impact comes from the expected improved absorption of European (mostly structural and cohesion) funds, as progress under the 2014-2020 financial framework is made. The higher current account deficit carries the potential to act towards worsening the macroeconomic imbalances, with a direct impact on capital flows to the local economy, especially since the position and magnitude of Romania's current account balance are markedly different from those recorded by other emerging economies in the region.

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

68 In the context of a slow-moving GFCF, compared to the decrease registered in 2018, and amid the dynamics of household consumption sustained by those of real disposable income, domestic demand is foreseen to witness in 2019 more favourable developments versus the previous year.

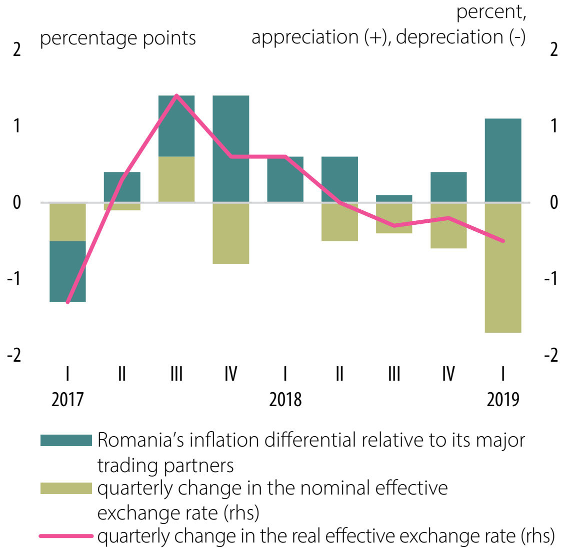
69 Calculated as an average for the past three years. For further details, see the European Commission website, the Section on Macroeconomic Imbalance Procedure Scoreboard.

70 In what Romania is concerned, a significant contribution to the rise in the negative balance on trade in goods comes from mineral fuels, lubricants, as a result of higher international oil prices.

non-bank clients and by the real effective exchange rate[71] of the leu. The exchange rate exerts its influence via the net export channel, as well as via the effects on wealth and balance sheets of economic agents[72].

The nominal interest rates on new time deposits and new loans in lei are estimated to rise in 2019 Q1. Real interest rates follow the path of nominal interest rates, the change of the former being yet slightly steeper, on the background of slightly decreasing inflation expectations following the elevated – close to 4 percent – value posted at end-2018. For the remainder of the projection interval, real interest rates will continue to exert a stimulative, albeit gradually diminishing, impact, amid inflation expectations staying further high throughout 2019 and declining slightly in 2020.

Chart 4.9. Quarterly change in the effective exchange rate



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

In 2019 Q1, the domestic currency depreciated in real effective terms on account of the developments in the leu exchange rate in nominal terms (against the euro and the US dollar), being only partly counterbalanced by an increasing inflation differential (Chart 4.9). After a quasi-stability of the leu in 2019 Q2 (amid its dynamics in nominal terms being offset by the inflation differential), for the remainder of the projection interval the domestic currency is expected to strengthen slightly in real effective terms, chiefly due to the systematically higher domestic inflation rates as compared to those of Romania's trading partners. Thus, in 2019 H1, the real effective exchange rate continues to exert, via the net export channel, a stimulative impact on future economic activity, which subsequently turns restrictive, increasing slightly until the projection horizon.

In 2019 Q1 and Q2 on the whole, the wealth and balance sheet effect is assessed to exert a stimulative influence on the output gap in the future periods, especially on account of the real foreign interest rate (3M EURIBOR) standing below the equilibrium level (significant negative gap), given the still persistently accommodative ECB monetary policy stance. In the period under review, the contribution from the change in the real effective exchange rate gap is close-to-neutral in 2019 Q1 and marginally stimulative in 2019 Q2. The sovereign risk premium, approximated based on the option adjusted spread (OAS), is assessed to have a restrictive effect, its path being potentially influenced by uncertainties associated with the impact of the most recent legislative measures and by their direct and indirect effects inter alia on the configuration of economy's domestic and external equilibria. Throughout

71 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.

72 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.

the projection interval, under the impact of real foreign interest rate, the wealth and balance sheet effect will exert a stimulative, albeit declining, impact on future economic activity.

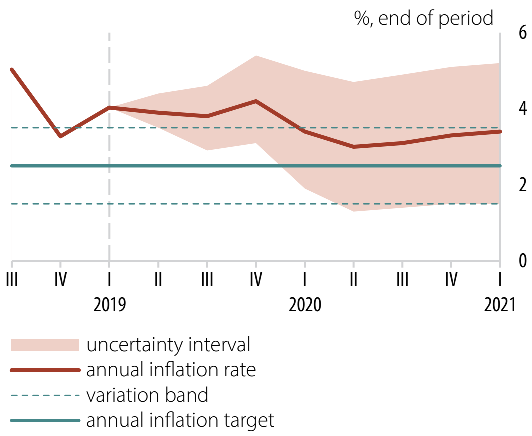
Overall, in 2019 Q1 and Q2, real broad monetary conditions are assessed to maintain their stimulative impact on aggregate demand in the following quarters, with an intensity close to that of 2018 Q4. These will further have a stimulative, yet waning, effect on economic activity by mid-next year, and a slightly restrictive influence afterwards. The projected path is shaped by the downward trend of contributions of all components. The developments in real effective exchange rate are the most prominent as they are seen to exert, starting with the second half of this year, a growing restrictive impact on the price competitiveness of the domestic economy. In addition, the stimulative influence of real interest rates is gradually diminishing over the forecast interval.

The 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, ensuring sustainable economic growth and preserving macroeconomic stability.

1.4. Risks associated with the projection

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to the path in the baseline scenario (Chart 4.10). Risks to the current projection stem from both domestic and external sources. On the domestic front, relevant risk factors are the future fiscal and income policy stance as well as the high degree of labour market tightness, including at a regional level. On the external front, the developments in the international commodity prices are likely to put additional inflationary pressures. Opposite influences are associated with the unfavourable economic growth outlook in Europe and globally.

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 2005-2018. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

High uncertainties continue to stem from the fiscal and income policies, in terms of both their future stance, inter alia in the context of the multiple election rounds in 2019-2020, and the fiscal measures implemented in the current year[73]. All these are likely to significantly impact economic activity and implicitly the economic growth potential via: (i) the discretionary fiscal

[73] On 1 January 2019, a series of fiscal measures came into force, among which: (i) the hike in the minimum wage, (ii) the change in the taxation system in the construction sector, (iii) the introduction of the tax on bank assets (amended, however, by GEO No. 19/2019). New measures are to be implemented (the raise in the pension point).

policy stance[74] and the budget expenditure composition and (ii) the change in the investment and consumer behaviour of private economic agents. Moreover, a potential increase in the fiscal deficit above the reference value of 3 percent of GDP under the Stability and Growth Pact, in the event of emerging difficulties in ensuring stable deficit-financing sources, would also lead, *ceteris paribus*, to a worsening of the economy's external position. In this case, there is a risk that foreign investor sentiment deteriorates, which would affect the risk premium and the exchange rate. The ensuing inflationary effects would be only partly offset by the influences stemming from the still relatively subdued dynamics of import prices. In this light, the developments in the current account deficit remain relevant, also considering the entrenched, structural causes.

Despite the moderation of some risks underlined in the previous round, as the potential adverse effects of GEO No. 114/2018 have been partly alleviated by the provisions of GEO No. 19/2019, new uncertainties surround the monetary policy transmission mechanism in the context of a new index calculated based on interbank transactions (the quarterly benchmark index for consumer loans)[75].

From a broader perspective, it is desirable to preserve a balance between the fiscal and income measures aimed at stimulating aggregate demand and the economic potential, on account of raising the volume of productive investment. Therefore, it is necessary to implement a balanced mix of macroeconomic policies, without jeopardising the price stability objective.

Another domestic risk factor whose relevance was reconfirmed in the current round refers to labour market conditions, due to the further elevated level of tightness, a structural feature manifest in the region as well. Among the contributors to labour market tightness are the increasing skill mismatch, the high inactivity rate and the heavy emigration. These factors are likely to put pressure on firms' costs that may subsequently pass through into consumer goods prices, with an impact also on domestic and external competitiveness of some economic sectors.

Uncertainties about natural gas and electricity prices refer to the transposition of the provisions of GEO No. 19/2019 into detailed norms of the competent authorities[76]. Further relevant are the developments in the natural gas sector, inter alia a possible deterioration of the balance between domestic production and imports. This may occur given the capping of the natural gas purchase price at lei 68/MWh, concurrently with the setting forth of a contribution in the amount of 2 percent of turnover, payable by the licensees operating in this sector.

74 The fiscal impulse, measured as the change in the primary structural deficit.

75 GEO No. 19/2019 respecified the manner of imposing the tax on bank assets, with an impact on its amount (i.e. lower tax receipts), thus contributing to the mitigation of some potential adverse effects. The new provisions on calculating at quarter-end the benchmark index based on the interbank transactions in the previous quarter, carry, however, the potential to complicate monetary transmission.

76 According to GEO No. 19/2019, the amount of the contribution payable by the licensees in the area of coal-fired electricity and the combined heat and power area is to be set by the Romanian Energy Regulatory Authority norms.

Although during the current round volatile food prices underwent significant shocks, uncertainties still persist due to the impact of weather conditions on the supply of agricultural produce both domestically and regionally or even globally.

Turning to the external front, risks stem from the global economic slowdown[77], also amid a potential flare-up in protectionist measures, given the worsening of US – China trade ties. At the same time, the monetary policy stance of the ECB remains further relevant (given the recent change in outlook), alongside the likely stance of central banks in the region. The final configuration of Brexit is still a noticeable source of uncertainties, despite their abatement after the deadline was deferred to 31 October 2019. The Romanian economy could be affected both directly, via the trade channel, and indirectly, amid a potential rise in volatility on the international financial markets. Under the circumstances, portfolio reallocations are possible in the region and/or worldwide, with implications for the future path of the leu exchange rate and, implicitly, for the projected inflation rate.

The balance of risks posed by international commodity prices (energy prices in particular) is assessed to be tilted to the upside from the path in the baseline scenario. High uncertainties persist concerning the dynamics of the oil price, in the context of the conflict in Libya and the sanctions on Iran. At the same time, their future evolution depends on both demand-side factors – the still robust demand, reflected by the drop in the US oil stocks – , and supply-side factors – signals conveyed by OPEC+ relative to keeping the oil production at lower levels.

[77] See the Box entitled "Recent developments in and the outlook for global economic activity".

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