National Bank of Romania

Inflation Report

February 2020

Year XVI, No. 59

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N O T E S

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* provides the National Bank of Romania's quarterly projection on inflation over an eight-quarter horizon, including the associated uncertainties and risks, and an assessment of the recent and future macroeconomic context from the perspective of the monetary policy decision.

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

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

The *Inflation Report* was approved by the NBR Board in its meeting of 7 February 2020 and the cut-off date for the data underlying the macroeconomic projection was 31 January 2020.

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

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Summary

Developments in inflation and its determinants

The annual CPI inflation rate overshot the upper bound of the variation band of the flat target in 2019 Q4, ending the year at 4.04 percent (0.55 percentage points above the September level and 0.2 percentage points above the previous forecast). Apart from a strong base effect from fuel prices, the evolution reflected the impact of supply-side shocks on some agri-food items (fruit, pigmeat) whose pass-through into consumer prices was eased by the persistent excess aggregate demand. The slight depreciation of the leu versus the major currencies added to the inflationary impact. At end-2019, the contribution of indirect tax changes to the annual CPI inflation rate amounted to 0.3 percentage points, being mainly accounted for by hikes in excise duties on tobacco products and fuels. The average annual inflation rate remained at the previous quarter's level, i.e. 3.8 percent for the CPI inflation calculated based on the national methodology and 3.9 percent for the HICP inflation calculated in accordance with the Harmonised Index of Consumer Prices. At the same time, the average annual indicator further recorded the highest level among the EU Member States, with the differential versus the EU average going up to 2.4 percentage points.

In 2019 Q4, the annual adjusted CORE2 inflation rate continued to follow the upward trend seen since the beginning of 2019, coming in at 3.7 percent in December, i.e. 0.3 percentage points above the level recorded in September. A significant driver of the faster increase in core inflation during this quarter was the supply-side shock on the pigmeat segment manifest worldwide. Moreover, core inflation continued to persistently capture pressures from companies' unit labour costs amid further robust wage dynamics alongside modest and declining productivity gains.

In 2019 Q3, the annual dynamics of unit labour costs economy-wide picked up mildly to 3.7 percent (up 0.2 percentage points), while in manufacturing the indicator reported an annual growth rate similar to that in the previous quarter, remaining in the two-digit territory (13.6 percent). The wage-productivity mismatch in manufacturing, with adverse effects in terms of both inflationary pressures and competitiveness, reflects the weak developments in industrial production, in the context of a deteriorating international environment.

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

In its meeting of 6 November 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. In September 2019, the annual CPI inflation rate went down to 3.5 percent from

3.9 percent in August, thus returning to the upper bound of the variation band of the target. The evolution owed primarily to the pronounced slowdown in the annual growth rate of volatile food prices and that of fuel prices. By contrast, the annual adjusted CORE2 inflation rate continued to increase in Q3 from 3.3 percent in June to 3.4 percent in September. The advance reflected opposite influences stemming from the rise in some international agri-food prices and from the cut in the prices of telecommunication services, overlapping significant demand-pull and wage cost-push inflationary pressures. The latest forecast pointed to the outlook for the annual inflation rate to end 2019 slightly above the variation band of the target, before returning and staying in the upper half of the band until the end of the forecast horizon, on a trajectory below that envisaged previously.

The main uncertainties and risks surrounding the inflation outlook stemmed from the future fiscal and income policy stance, especially amid the 2019-2020 election calendar, while the level and trend of the current account deficit remained a matter of concern. Heightened uncertainties continued to be associated with the increasingly obvious weakening of the euro area and global economies, as well as with the growing risks to their outlook, in the context of the trade war and Brexit. Particularly relevant were also considered the ECB's and the Federal Reserve's decisions on monetary policy easing, as well as the stance of central banks in the region.

Subsequently, the statistical data showed the drop in the annual CPI inflation rate in October to 3.4 percent, from 3.5 percent in September, followed by its climb in November to 3.8 percent, i.e. above the variation band of the target, in line with the latest medium-term forecast. The advance against September owed mainly to the hike in fruit and vegetable prices, but also to the pick-up in core inflation. The latter continued to move up in the first two months of Q4, from 3.4 percent in September to 3.5 percent in November, slightly above the forecast. The increase reflected the impact of some higher global agri-food commodity prices and the slightly softer leu versus the euro, overlapping persistent and significant inflationary pressures from demand and unit labour costs. Statistical data on economic growth in 2019 Q3 indicated the deceleration of its annual dynamics to 3 percent from 4.4 percent in the previous quarter. On the demand side, the contribution of household consumption remained significant, yet it shrank visibly (down to 3 percentage points amid the unfavourable agricultural year), falling substantially behind that of gross fixed capital formation (5.9 percentage points). Net exports saw their negative contribution to GDP dynamics rise, given the more pronounced reacceleration in the growth of imports relative to that of exports of goods and services. Under the circumstances, the current account deficit recorded a renewed widening, inter alia on the back of the deterioration of the primary and secondary income balances, while its coverage by foreign direct investment and capital transfers narrowed.

In the NBR Board meeting of 8 January 2020, the latest assessments revealed the outlook for the annual inflation rate to end the year 2019 slightly above the variation band of the target, before returning and staying in the upper half of the band in the near run, at slightly lower values than in the latest medium-term forecast published in the November 2019 *Inflation Report*. The uncertainty factors identified previously remained relevant, with those arising from the external environment configuration becoming relatively stronger amid mounting geopolitical tensions and vulnerabilities faced by some emerging markets and worldwide.

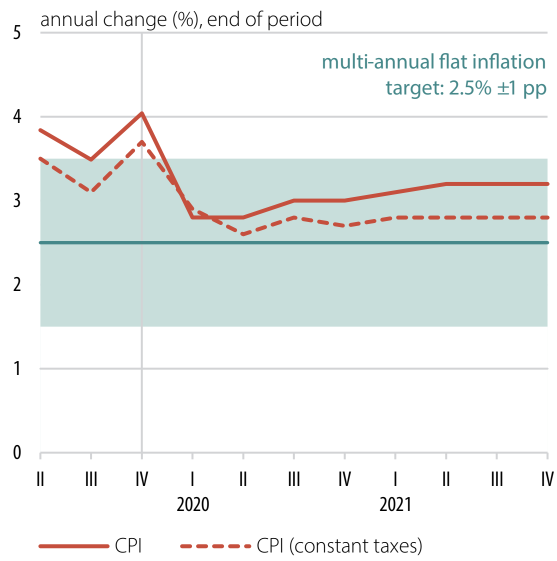
Based on the data available at that time and in the context of the identified risks and uncertainties, the NBR Board decided to keep the monetary policy rate at 2.5 percent per annum, while maintaining strict control over money market liquidity. Moreover, the NBR Board underlined that the balanced macroeconomic policy mix and the implementation of structural reforms designed to foster the long-term potential growth are of the essence in preserving macroeconomic stability and strengthening the capacity of the Romanian economy to withstand potential adverse developments.

Inflation outlook

After having reached 4.04 percent at end-2019, according to the baseline scenario, the annual CPI inflation rate will return into the variation band of the target to reach 3 percent at end-2020 and 3.2 percent at end-2021. At the end of 2019, this measure was 0.2 percentage points higher than the level forecasted in the previous *Inflation Report*, while for the end of 2020 the projection was revised downwards by 0.1 percentage points. At this horizon, except for the annual core inflation rate and the annual inflation rate for tobacco products, all the other components were revised downwards. The annual adjusted CORE2 inflation rate was revised upwards by 0.2 percentage points for the end of this year.

Data published subsequently to the November 2019 *Inflation Report* confirmed the expectations on the slowing annual dynamics of economic activity in 2019 Q3, given that consumer demand softened somewhat and net exports increased their negative contribution. At the same time, investment experienced a substantial advance, associated with more flexible labour market regulations, the fiscal stimuli targeting the construction sector and the hike in public investment spending in the run-up to the election cycle. Turning to gross fixed capital formation, its contribution to economic growth is expected to have been significant in 2019 as a whole, yet its intensity is likely to moderate again over the medium term. This outlook stems, on the one hand, from the persistence of certain structural deficiencies of the economy, and, on the other hand, from the authorities' expressed intention to increase investment project financing from EU funds, amid the uncertainty about the performance of attracting and allocating these funds, augmented by the current multiannual financial framework coming to a close. Against this background, the growth pattern is anticipated to further reflect the prevailing contribution from household consumption over

Inflation forecast



Source: NIS, NBR projection

the medium term, while net exports of goods and services are foreseen to make new negative contributions, in line with the less favourable prospects for economic activity of Romania's trading partners.

Starting from the most recent values, the baseline scenario envisages the trade deficit to widen further over the projection interval, after the current account deficit being expected to have overshot, as of 2019 already, the 4 percent-of-GDP indicative threshold set by the European Commission as a multiannual indicator monitoring the external imbalance in EU Member States[1]. Given the faster build-up of external imbalances in the case of Romania than in its regional peers and, hence, the emergence of a shortage of non-debt-creating flows for current account financing, this evolution is likely to fuel a number of vulnerabilities facing the Romanian economy, with an impact also on the gradualness and macroeconomic consequences of future adjustments needed to redress these imbalances.

After having flattened out at approximately 2.9 percent in the course of 2019, the output gap is forecasted to enter a slightly downward path and reach 2.5 percent at the end of 2021. Its path will reflect the weaker traction, which was revised downwards over the medium term, from effective external demand and – given the revenue and expenditure measures enacted so far – the fiscal impulse projected at positive values, albeit slightly lower in 2021 than in the previous round. At the same time, real broad monetary conditions will continue to be accommodative, yet their intensity is seen declining steadily over the next eight quarters to close-to-neutral values at the projection horizon. Compared to the previous *Inflation Report*, worth noting is the downward revision of the output gap during 2021, amid the reconfiguration of the effective external demand gap and reassessment of the effects of the fiscal and monetary policy stances.

According to the baseline scenario, after having reached 3.7 percent at end-2019, the path of the annual adjusted CORE2 inflation rate will be marked by temporary disinflationary pressures in the first part of 2020, reflecting base effects associated with higher rises of this index seen last year. After having hit a low of 3.2 percent expected for June 2020, the indicator will reverse its path, in step with the still high domestic inflationary pressures, namely from excess aggregate demand and economic agents' inflation expectations. At the same time, foreign inflationary pressures are seen picking up gradually via their impact on the leu-expressed prices of imported goods. These factors will cause the adjusted CORE2 inflation to remain in the upper half of the variation band of the target over the next eight quarters, coming in at 3.4 percent at the end of both 2020 and 2021.

For end-2020 and end-2021, the contribution of indirect tax changes to the annual CPI inflation rate is projected at 0.3 percentage points and 0.4 percentage points respectively, reflecting higher excise duties on tobacco products and fuels.

[1] 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".

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

The balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to its path in the baseline scenario, mainly due to domestic factors. Sizeable risks continue to be associated with the external environment as well, yet such pressures are seen to have a rather disinflationary potential on the aggregate.

Compared to the November 2019 *Inflation Report*, the uncertainties about income and fiscal policies augmented. This assessment is based on both the budget execution profile of late 2019, leading to the significant opening of the government deficit, and a number of measures announced by the authorities, which, albeit enacted, are saddled with uncertainty over the time of their enforcement and the actual magnitude of the entailing adjustments[2]. For this year, fiscal and income policy configuration is also marked by the successive rounds of local and parliamentary elections. Under the circumstances, the risks associated with the fiscal policy stance could become manifest in both directions. However, starting fiscal consolidation is desirable as soon as possible in order to ensure compliance with the reference budget ceilings consistent with the definition of sound public finances and, hence, with a balanced economic policy mix for mitigating the risks of a further rise in external imbalance.

A risk that remains relevant also in the current round refers to future movements in administered prices, particularly in terms of the gradualness and magnitude of liberalisation of the markets for electricity and natural gas delivered to household end-users. Uncertainties refer to the manner in which the provisions of Government Emergency Ordinance No. 1/2020 are to be enforced via specific norms issued by the competent authorities, on the one hand, and to the prices prevailing on the free electricity and natural gas markets at the time of completing the liberalisation stages envisaged by the authorities, with an impact on the baseline scenario coordinates of the macroeconomic projection, on the other hand.

Despite a slight easing of labour market tensions in the recent period, the risks associated with developments in this market remain particularly worrisome, in the current round as well, amid the labour shortage on certain market segments, the relatively elevated share of inactive population and the migration of active population. Under these conditions, stronger pressures on wages have a sizeable potential, as they could reshape the inflation path as against the baseline scenario, the more so as structural reforms directly targeting this market could yield tangible results, most likely, only in the medium term.

Compared to the previous round, the risks of an economic slowdown in the euro area have subsided and signals have emerged of a possible easing of trade and technology tensions between the main economies engaged in the trade row, while the uncertainty

2 For instance, the adoption of Law No. 14/2020 on doubling child benefits.

surrounding Brexit has abated. Nevertheless, although the agreement on the UK's withdrawal from the EU was signed, the outcome of talks over a possible free trade agreement and the extension of the transition period remain uncertain. At the same time, risks are associated with a potential resurgence of geopolitical tensions and trade rows, which would enhance the fundamental vulnerabilities of some emerging markets. Another risk factor that has emerged recently, yet carrying a notable potential of affecting the baseline scenario coordinates, refers to the possible spread of the coronavirus outbreak, entailing both direct and spillover effects on economic growth and prices worldwide. Opposite effects, i.e. of fuelling economic growth, may stem from a possible easing of the monetary policy stance by the ECB and the Fed. The likely actions of other central banks in the region also remain relevant, given the local and the global context.

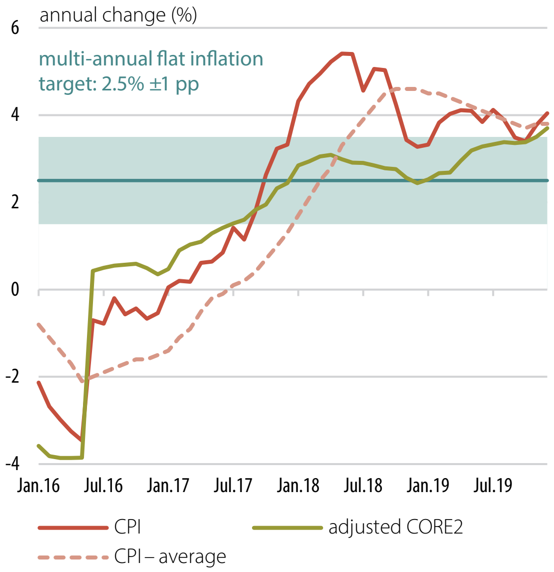
Monetary policy decision

In view of the characteristics of the new medium-term inflation forecast and the multitude of related uncertainties and risks stemming from both domestic and external sources, also in the context of the monetary policy decisions by the ECB and the Federal Reserve, as well as of the probable stance of central banks in the region, the NBR Board decided, in its 7 February 2020 meeting, to keep the monetary policy rate at 2.50 percent, while maintaining strict 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 level of the minimum reserve requirement ratio on leu-denominated liabilities of credit institutions. At the same time, given the developments in foreign currency lending and the adequate level of forex reserves, the NBR Board decided to cut the minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions to 6 percent from 8 percent starting with the 24 February – 23 March 2020 maintenance period. The measure also aims to continue the harmonisation of the minimum reserve requirements mechanism with the relevant standards and practices of the European Central Bank and the major central banks across the European Union.

1. Inflation developments

The annual CPI inflation rate overshot the upper bound of the variation band of the flat target in 2019 Q4, ending the year at 4.04 percent (0.55 percentage points above the September level). Apart from a strong base effect from fuel prices, the evolution reflected the combined impact of supply-side shocks on some agri-food commodities (fruit, pigmeat), whose pass-through into consumer prices was eased by the persistence of pressures from fundamentals. The slight depreciation of the leu versus the major currencies added to the inflationary impact. Against this background, adjusted CORE2 inflation stayed on an upward path, its annual dynamics reaching 3.7 percent in December (Chart 1.1). At the same time, economic agents' short-term expectations were revised downwards.

Chart 1.1. Inflation developments

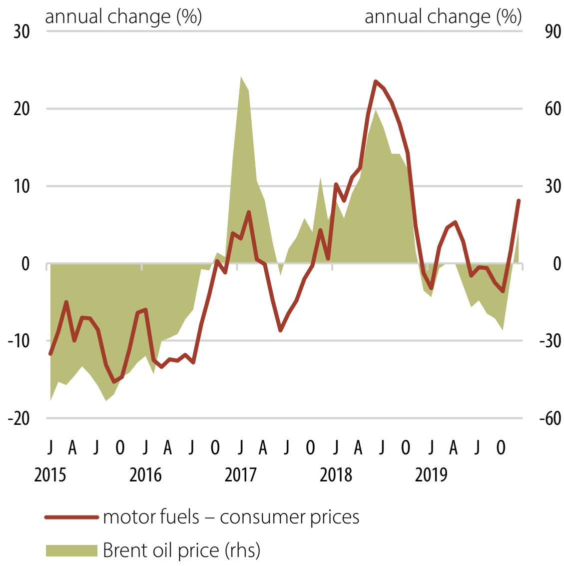


Source: NIS, NBR

Fuel prices accounted for over half of the advance in the annual inflation rate in 2019 Q4. Although the international oil price remained relatively unchanged compared to the average in the previous period, the annual price dynamics of this component were decisively impacted by an unfavourable base effect associated with the fast decrease in motor fuel prices in the last two months of 2018. The USD/RON exchange rate also had a marginal contribution, the domestic currency depreciating slightly against the US dollar in 2019 Q4 (by 1.1 percent on average from July-September). However, in the latter part of December, the oil price per barrel increased in international markets, against the background of the optimism arising from the prospects of a trade deal between the US and China, and of the temporary escalation of the geopolitical conflict in the Middle East (Chart 1.2).

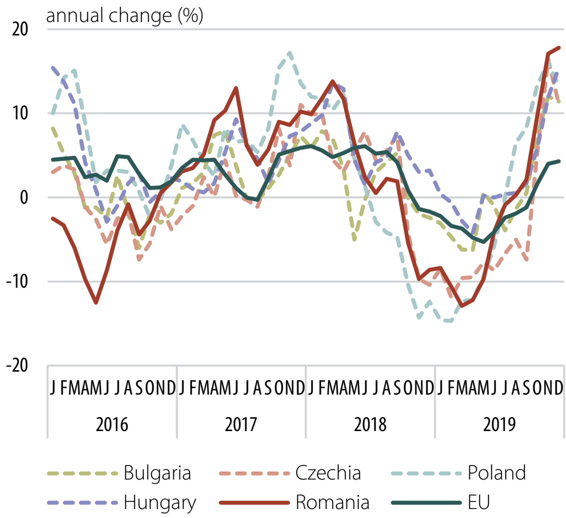
Also pertaining to volatile prices, the fruit group witnessed strong movements in 2019 Q4, its annual growth rate surging to 16.7 percent, up by 14.7 percentage points from end-2019 Q3. The repeated price increases in the fresh fruit sub-group, significantly exceeding the averages common for this time of the year, reflect the adverse weather conditions in the region throughout 2019, i.e. wide temperature fluctuations, periods of frost in late spring or long droughts in the recent period. Specifically, the prices of the said goods trended upwards in the majority of European countries, the annual inflation rate entering the two-digit territory in Poland, Hungary or Bulgaria as well (Chart 1.3).

Chart 1.2. Oil and motor fuel prices



Source: NIS, Bloomberg

Chart 1.3. Fruit prices in Europe



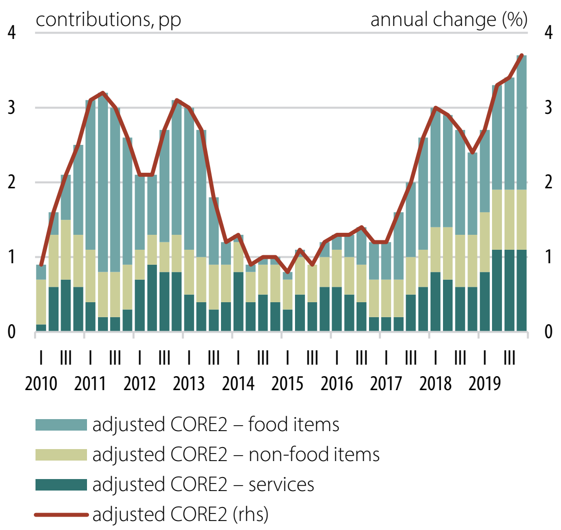
Note: In accordance with the harmonised price structure.

Source: Eurostat

These developments were offset only to a small extent by the exogenous components with a slight disinflationary impact – tobacco products and goods and services with administered prices. In the first case, the trajectory was ascribable to a favourable base effect associated with the earlier-than-expected rise in cigarette prices in December 2018 (i.e. before the entry into effect of the higher duty on 1 January 2019) dropping out from the calculation. In the latter case, the main driver was the cut in heating prices in November, following local measures on subsidies for households. An opposite influence had the decision to increase the contribution for high efficiency cogeneration in December 2019, which impacted the electricity bill for household consumers.

In 2019 Q4, a significant driver of the faster increase in the adjusted CORE2 inflation was the international supply-side shock on the pigmeat segment, still marked by the African swine fever outbreak at global level. The virus affected China in particular, the world's largest consumer of pork, practically halving the number of pigs in the country over a year and a half since the first case was recorded. As a result, China's imports from Europe and South America went up at a fast pace throughout 2019, in an attempt to cover household demand, leading to a surge in international prices. In Europe, Romania was the most affected by the spread of African swine fever, the approximately 550,000 animals slaughtered up to end-2019 accounting for over 10 percent of the existing pig population at the time when the presence of the virus in the country was first reported. In this context, the agricultural price of pigmeat on the local market went through a new steep increase in November, reaching a level around 50 percent higher at end-2019 compared to the previous year. However, the ramifications of the phenomenon extend beyond this segment, an overall uptrend in the prices of other agri-food products already being visible in China, as the population tries to make up for the absence of pigmeat in their diet by turning to other sources of protein, such as eggs, poultry or beef. These developments are expected to leave a mark on the dynamics of international prices for this type of goods, which will continue to exert pressure on domestic prices in the coming period as well.

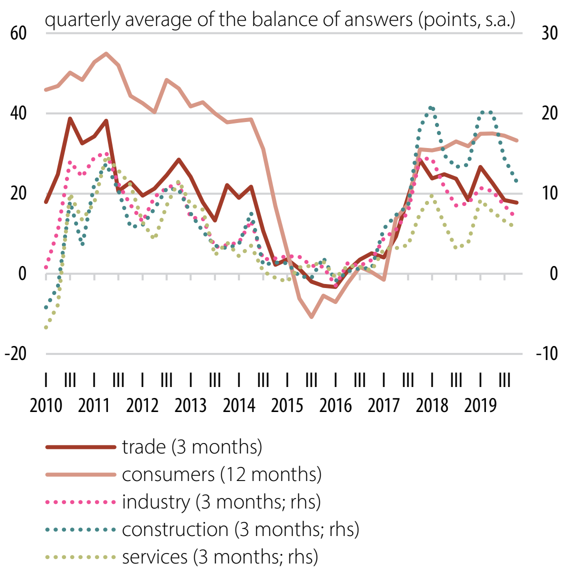
Chart 1.4. Core inflation components*



*) excluding the direct effects of VAT rate changes

Source: NIS, NBR calculations and estimates

Chart 1.5. Expectations on price developments



Source: EC-DG ECFIN

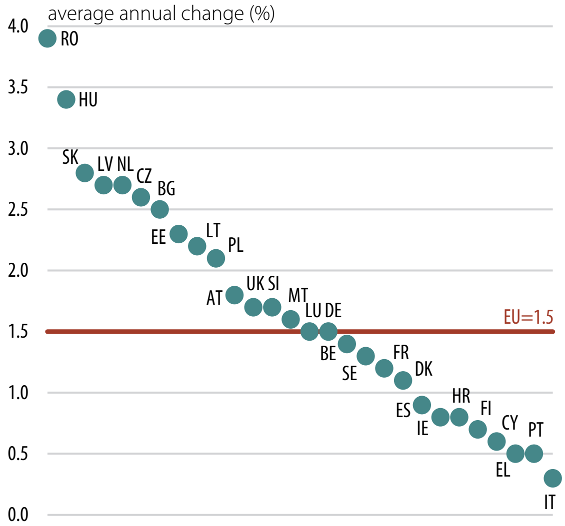
Given the scale of the phenomenon and the excess aggregate demand in the economy easing the pass-through into consumer prices, the annual adjusted CORE2 inflation went up in 2019 Q4 to 3.7 percent (+0.3 percentage points versus September) – a new 10-year high[3]. Moreover, producers continued to be affected by the pressure stemming from unit labour costs (with manufacturing posting two-digit annual rates of increase for most of the year), the further robust wage dynamics being accompanied by a disappointing evolution of labour productivity. Apart from the food group (whose annual inflation rate rose to 4.5 percent), the other adjusted CORE2 components witnessed relatively favourable developments: the annual growth rate of prices of non-food items stayed around 2.4 percent, while that of services went up slightly to 4 percent. The latter reflected the costlier compulsory motor third-party liability insurance policies for vehicles with high cylinder capacity, as well as the marginal depreciation of the domestic currency against the euro (Chart 1.4).

During 2019 Q4, expectations on price developments stuck to a downward trajectory, as the balance of answers to the DG-ECFIN Survey adjusted for both consumers (12-month horizon) and agents from all sectors of the economy (3-month horizon; Chart 1.5). Turning to financial analysts, they forecast growth rates of prices similar to the results of the previous survey, anticipating the annual inflation rate to remain inside the variation band of the flat target, at 3.3 percent for end-2020 and 3.0 percent for the 2-year horizon.

The average annual inflation rate remained unchanged from the end of the previous quarter, i.e. it was 3.8 percent in December 2019 based on the national methodology, while the indicator calculated in accordance with the harmonised structure stood at 3.9 percent. However,

3 After excluding the first-round effects of VAT rate changes.

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



Source: Eurostat

Romania still has the highest average annual HICP inflation rate among EU Member States (for the 17th month in a row), the difference against the EU average widening up to 2.4 percentage points, amid a marginal decrease in the EU average (Chart 1.6).

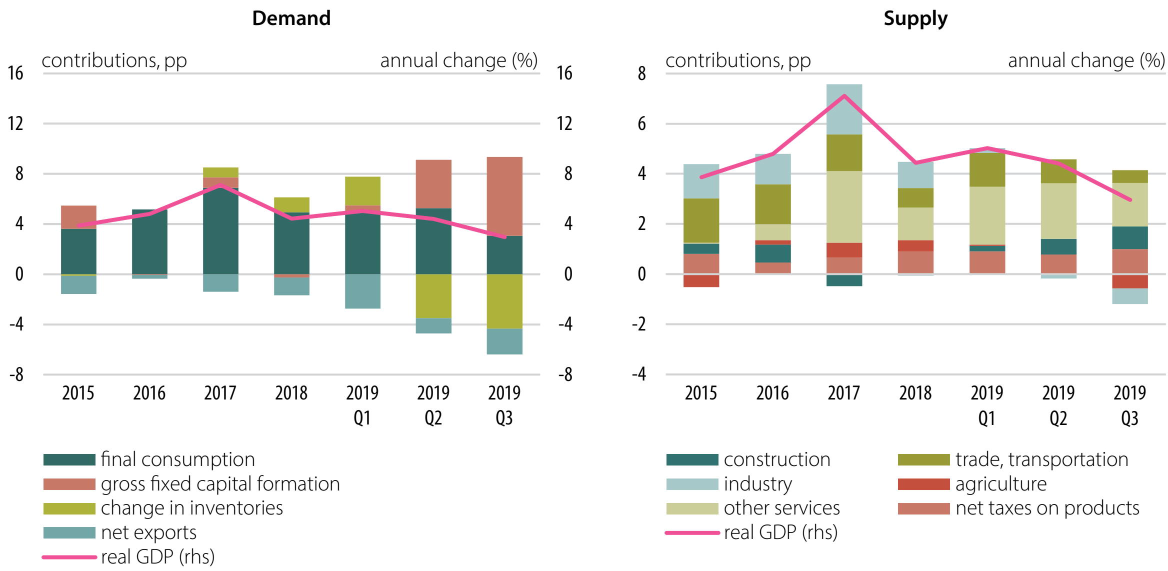
The annual CPI inflation rate at end-2019 stood slightly higher than the level projected in the November 2019 *Inflation Report*, i.e. 0.2 percentage points above the anticipated value. The main contribution came from underestimating the trajectory of adjusted CORE2 inflation (which ended the year 0.3 percentage points above the forecast), as a result of the higher-than-expected prices of pigmeat and meat products. Fuel prices also had an upward influence, albeit less significant, amid the oil price per barrel rising at a pace somewhat faster than anticipated.

2. Economic developments

1. Demand and supply

The annual growth rate of real GDP slowed down to 3 percent in 2019 Q3, as consumer demand eased somewhat and exports of goods showed further weakness. In the first three quarters of 2019, the economy rose by 4 percent, a notable contribution coming from the swift increase in investment, bolstered mainly by the recovery in construction works (Chart 2.1).

Chart 2.1. Contributions to economic growth



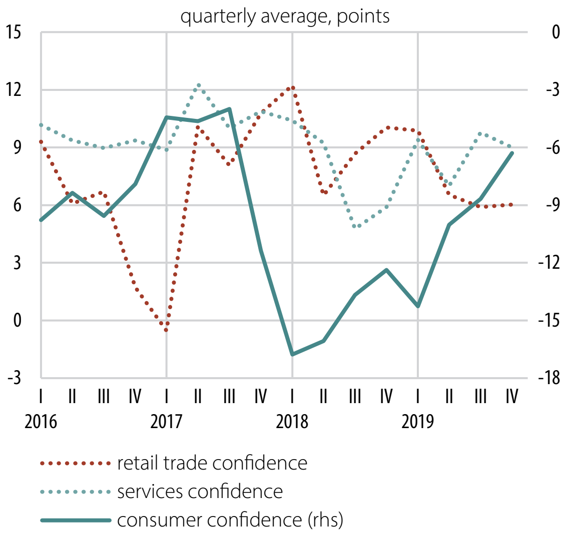
Source: NIS, NBR calculations

The slacker annual dynamics of private consumption in 2019 Q3 (down to 3.8 percent) are attributable to the components[4] sensitive to developments in agricultural output, given that this sector failed to deliver in 2019 the same outstanding performance as in the previous year. By contrast, households' appetite for retail purchases gained momentum, both main financing sources (wage income and new loans) posting real increases by more than 10 percent. These coordinates will most probably remain in place in the period ahead, amid expectations on new hikes in household income and relatively flat consumer credit demand versus Q3[5]. This outlook is mirrored by the consumer confidence indicator, which improved gradually during 2019, hitting a 2-year record high in Q4, according to the DG ECFIN Survey (Chart 2.2).

4 Household self-consumption, purchases on the agri-food market and home industry.

5 According to the NBR's November 2019 *Bank Lending Survey*.

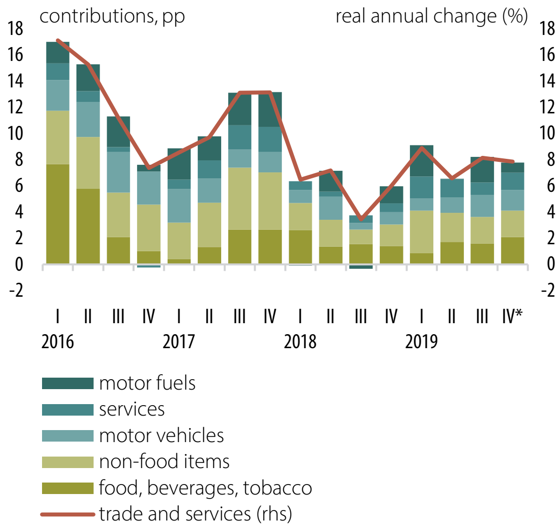
Chart 2.2. Outlook for household consumption*



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

Chart 2.3. Trade



*) Oct.-Nov.

Source: NIS, NBR calculations

The brisk pace of consumer demand in late 2019 is also reflected in the swift dynamics of the turnover volume of trade and services in October-November (over 8 percent; annual change, net of motor fuel sales, a component featuring high volatility). Behind this stood the larger purchases of durables (up around 12 percent), as well as the more substantial growth of household expenditures for market services (particularly for accommodation and food service activities). In the first case, favourable developments saw purchases of furnishings, also boosted by the Black Friday promotions in November, and sales of motor vehicles. The growth rate of motor vehicle trade remained swift in October-November, i.e. 9.9 percent, but decelerated somewhat as compared with the Q3 average. The trend may steepen in the forthcoming period, the information provided by the Automotive Manufacturers and Importers Association already reflecting a slight reduction in automotive sales in November, as a result of the fading impulse from the car fleet renewal programme (the funds available under this programme were exhausted at end-October). Sales of non-durables also posted a relatively high growth rate of over 5 percent, which nonetheless slowed down somewhat versus Q3, driven by non-food trade (Chart 2.3).

In 2019 Q3, the general government budget execution led to a deficit of lei 7.0 billion, i.e. 0.7 percent of GDP, well above that posted in the same year-ago period (lei 1.8 billion or 0.2 percent of GDP). At the same time, the narrowing of the deficit against Q2 (lei 14.5 billion or 1.4 percent of GDP) was relatively lower than in the previous years. It was mainly ascribable to an increase in total budget revenues[6], which was largely due to higher VAT receipts and excise duties[7], as well as to a base effect associated with some tax refunds in the previous quarter. In turn, total budget

6 However, their real annual growth slowed down markedly to 5.7 percent, from 8.3 percent in Q2, even though this occurred broadly on account of the drop in non-tax revenues, due also to a base effect associated with the earlier payment of dividends by state-owned companies in 2019 Q2.

7 Similar (albeit lower) contributions were made by receipts from property taxes and fees (also as a result of the revenues from the tax on credit institutions' financial assets), corporate and personal income taxes, which posted real annual dynamics significantly higher than in Q2.

spending posted a decline[8], albeit only marginal, given that the impact of the rise in capital expenditure, government spending on goods and services and social security spending[9] was offset by that of the decline in interest expenses and staff costs[10].

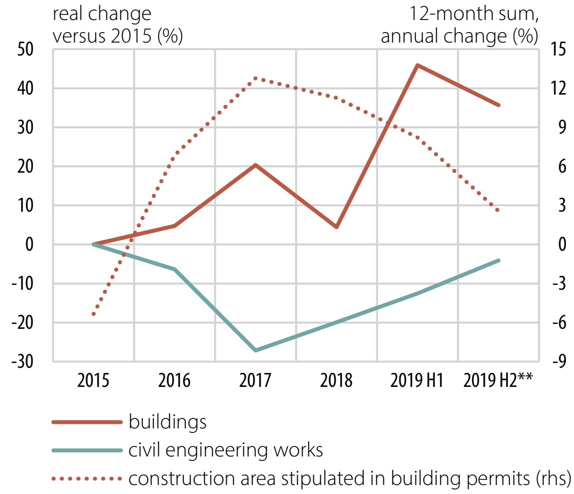
Gross fixed capital formation increased further in annual terms, at a swifter pace of 25.6 percent, due to both its major components. Over the coming months, investment will likely lose momentum, as construction activity seems to cool down, while equipment purchases may post an adjustment after the fast growth rates recorded in Q2 and Q3[11] (Chart 2.4).

Chart 2.4. Investment

*) Oct.-Nov.

Source: NIS, NBR calculations

Chart 2.5. Construction activity*



*) seasonally adjusted data

**) Jul.-Nov.

Source: NIS, NBR calculations

In the construction sector, 2019 is expected to reverse the three consecutive years of decline (totalling about 10 percent), with the improved labour market regulations making a significant contribution through tax incentives and easier conditions for hiring non-EU workers. However, the upward trend seemed to be manifest only in the first half-year (quarterly growth rates of 18 percent and 15 percent, respectively), while it saw a reversal in the period from July to November. The evolution is ascribable to building works (-11.4 percent versus the Q2 average), which are little likely to step up in the period ahead, despite the improved expectations of construction companies during 2019. A hint in this respect comes from the gradual loss of momentum seen by the construction area stipulated in building permits, i.e. from 14 percent in January to less than 3 percent in November (12-month change), which was visible on both residential and non-residential

8 Its real growth even picked up slightly as compared with the same year-ago period, i.e. to 12.2 percent from 11.6 percent in Q2.

9 Also amid the increase in the pension point and the social indemnity for pensioners starting in September 2019.

10 Their real annual dynamics reverted to single-digit levels for the first time in the past three years.

11 This category cannot be characterised by looking at quarterly developments, as only the annual volume indices are available.

segments. Similar signals are also sent by real estate market analysts, who argue that the 2019 remarkable performance of new deliveries on all segments, particularly non-residential spaces, will be hard to match in 2020 (Chart 2.5).

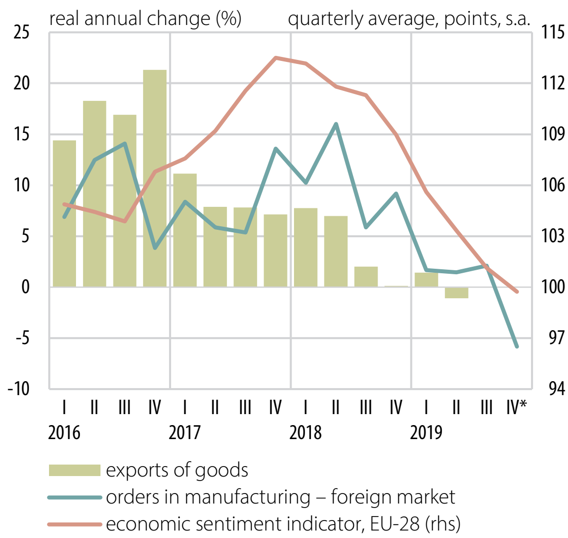
Unlike building construction, civil engineering works confirmed the recovery trend manifest since the beginning of 2019, as they grew by 2.7 percent July through November versus Q2. Their remaining on an upward path in the period ahead will be however conditional upon the improvement in EU funds absorption (visible towards end-2019 and expected to continue in the context of the current multiannual financial framework coming to a close). Moreover, the 2020 election calendar could also support this trend.

Equipment purchases doubled their annual pace of increase in 2019 Q3 (up to 14.6 percent). This was quite unlikely to have been underpinned by the industrial sector, given that its recovery is long in coming. Production declined July through November 2019 and the volume of orders continued to post subdued annual dynamics (0.7 percent), which reflected in a further contraction in the capacity utilisation rate in Q4, while the industrial managers' expectations remain pessimistic. Although less frequent than before, the market information concerning investments made by industrial producers point to some sub-sectors (e.g., the manufacture of building materials, the automotive industry, consumer goods industry) sending stronger signals of the recently completed or ongoing investment projects for the opening/expansion of productive capacities, technological and logistical upgrades and the advance in research and development activities. Outside the industrial sector, other companies that probably increased their investment effort are construction companies (in line with the expansion in activity seen over the past year) and road freight transport companies, as hinted at by the growth in imports of construction equipment and heavy motor vehicles (up by around 27 percent and nearly 6 percent respectively) in the first three quarters of the year.

In the period ahead, whole-economy technological investment will likely lose momentum, as the latter half of 2019 saw an easing of demand for both local and foreign capital goods. Specifically, domestic orders to the capital goods-producing sub-sectors saw notably slower annual dynamics July through November as compared with the H1 average, while the annual growth rate of imports of capital goods entered negative territory in the period from July to October. The same prospects have emerged for certain financing sources – inflows in the form of equity, including the earnings reinvested in the economy by non-resident direct investment enterprises, declined as compared with the cumulative value recorded in July-November 2018, while the stock of equipment loans posted a slight deceleration versus H1.

The sluggishness in euro area activity, amid the persistent uncertainty and tensions worldwide, hurt the domestic tradables sector in 2019 Q3 as well, the industrial output volume standing 2.2 percent lower in January-November 2019 as compared with the same year-ago period. As for the exports of goods, this evolution translated into a further contraction in quarterly terms for the fifth time in the past six quarters. The landscape appears to remain unchanged in the months ahead, as the European managers' sentiment continued to worsen, touching a 5-year low in 2019 Q4. The trend is mirrored in the visibly weaker foreign orders to local industrial companies, their volume narrowing by 1.4 percent in annual terms July through November. External demand may, however, witness a recovery in the longer run, as suggested, inter alia, by the abatement of the trade row between the US and China and the near prospects of the Brexit completion (Chart 2.6).

Chart 2.6. Exports

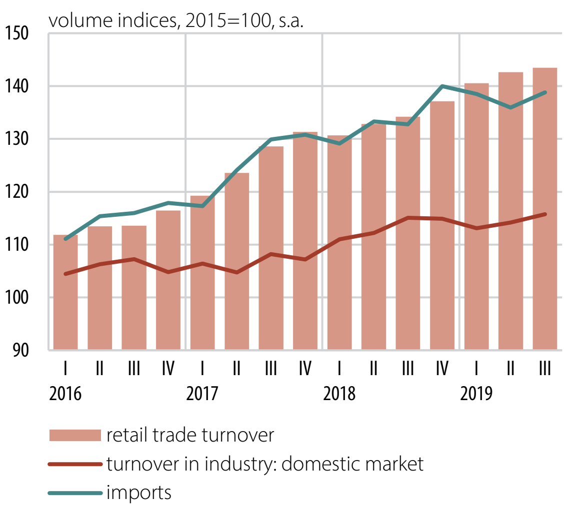


*) Oct.-Nov. for orders

Source: NIS, EC-DG ECFIN, NBR calculations

Even though the downtrend in exports of goods was less visible in annual terms (the national accounts data pointing to a standstill), exporters' situation remained delicate, especially on the motor parts segment. Specifically, the volume of motor parts exports decreased by 6.8 percent (annual change), with domestic producers being affected by the contraction in Germany's car-making sector and recording additional declines in extra-EU exports (lower sales to Iran and Russia). Exports of motor vehicles also contracted their volume (down 6.4 percent), but this is probably short lived, given that both local car manufacturers displayed a more upbeat outlook – Dacia would see in 2020 the completion of the project to increase production capacity, whereas Ford has already launched the new Puma SUV into production. Positive developments in sales recorded the following categories of goods: machinery and equipment, furniture, petroleum products, agri-food commodities (maize) and naval transport means. Exports to extra-EU markets were the main contributor to the performance of the last three groups.

Chart 2.7. Consumer goods: domestic production vs imports*

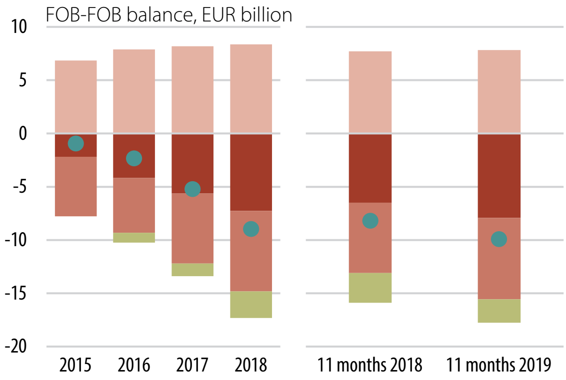


*) excluding motor vehicles and fuels

Source: NIS, Eurostat, NBR calculations

The further robust domestic absorption fuelled the step-up in imports of goods and services (up to 9 percent in annual terms), visible for intermediate goods and especially consumer goods. In the latter case, it is worth noting the pick-up in purchases of furnishings (electrical and electronic products, communication equipment, furniture), possibly in association with the forthcoming Black Friday promotions, which in 2019 enjoyed the increased interest of consumers. Imports of consumer goods rose by 6 percent, thus exceeding in 2019 Q3 as well the annual dynamics of this subsector's turnover on the domestic market (1.2 percent), which reflected the persistence of local producers' incapacity to reap the benefits of the expansion in consumer demand over the past years (Chart 2.7). At the same time, the competitiveness of consumer goods manufacturers eroded further on external markets as well (largely

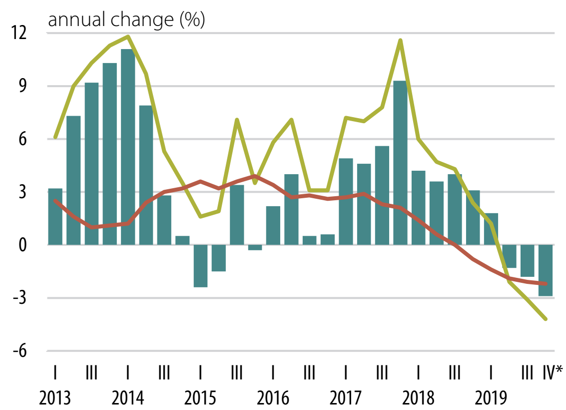
Chart 2.8. Current account



*) approximated for the latest period

Source: Eurostat, NBR, NBR calculations

Chart 2.9. Labour productivity in manufacturing



*) Oct.-Nov.

Source: NIS

on account of the persistent increases in unit labour cost), so that the balance on trade in such goods continued to make a major contribution to the widening of trade imbalance (by EUR 2.5 billion January through November 2019). As a result, the current account deficit rose by 21 percent to EUR 9.9 billion in the same period, its share in GDP being most likely to post the fifth consecutive annual increase in 2019 as a whole (Chart 2.8).

Labour productivity

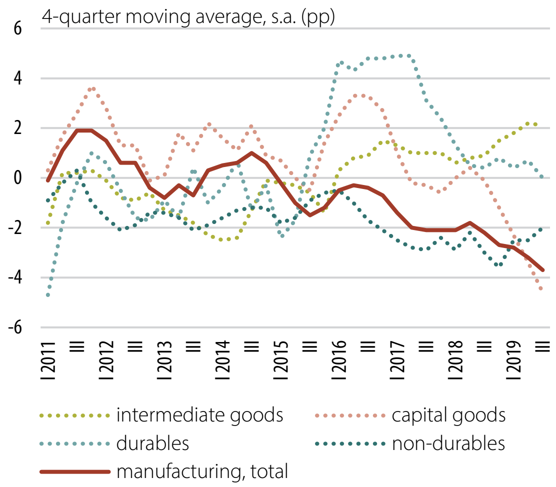
In 2019 Q3, labour productivity economy-wide saw its dynamics decelerate slightly in annual terms versus the previous period, i.e. down 0.6 percentage points to 4 percent, with all major sectors contributing to this slowdown. The sectors still reporting high labour productivity growth rates are construction, which has benefited from stimulative fiscal measures and a favourable cyclical context, and IT, where this indicator posted a two-digit rate of increase for the fourth quarter in a row, reflecting also in a robust export performance.

The fragile international environment had a decisive impact on the evolution of domestic industry in 2019 Q3 as well (Chart 2.9). The automotive industry remains one of the weak spots, producing far-reaching effects on many other manufacturing sub-sectors and even on services, given the high complexity of production chains. According to the IMF forecasts[12], the automobile industry slump in 2018 accounted for over a quarter of the global growth slowdown and for about one third of the decrease in international trade volume, while the preliminary data for 2019 point to a contraction in global car sales over two times larger than in the previous period. In this context, important car manufacturers (some of which are also present at a local level) announced their downsizing plans, invoking the worsening financial results and the high investment costs for adjusting production processes to the new reality of electromobility, while labour productivity in the domestic automotive industry witnessed a very weak quarter, falling by 2.5 percent versus the preceding period. In fact, labour productivity continues to see positive annual dynamics in only five manufacturing sub-sectors, in most of them due, however, to the contraction in the number of employees. The moderate advance in the volume of domestic orders

12 Included in the latest edition of *World Economic Outlook*.

in industry was insufficient to make up for the stagnation of external orders, which resulted in a further reduction in the capacity utilisation rate to a new post-crisis low of 73.1 percent (Chart 2.10). Furthermore, according to the DG ECFIN Survey conducted among industrial producers, the prevalence of unfavourable demand conditions, rather than the constraints of scant labour force, is the main barrier to the development of production capacities.

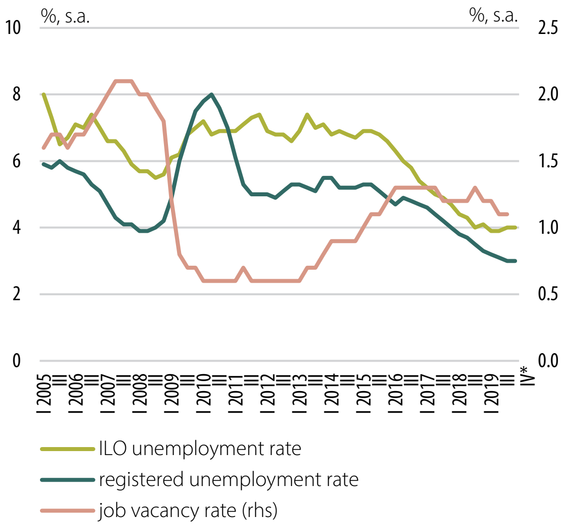
Chart 2.10. Capacity utilisation rate in industry*



*) difference versus the long-term average (2005-2018)

Source: EC-DG ECFIN, NBR calculations

Chart 2.11. Unemployment and vacancies



*) Oct.-Nov.

Source: NEA, Eurostat, NBR calculations

The domestic industrial activity is not expected to revert to a positive trend in the forthcoming period. The industrial confidence indicator moved deeper into negative territory in Germany at year-end, recording levels close to 0 in the domestic industry, while the local signals on productive investment are limited. However, there are signs in this direction in sub-sectors such as building materials, food industry, electrical equipment (once a new important household appliances factory became operational) or the automotive industry (after the necessary investment was made for launching a new SUV model at the Craiova-based factory), but a trend reversal at aggregate level is further little likely to occur in the absence of an improvement in global macroeconomic conditions.

Labour market developments[13]

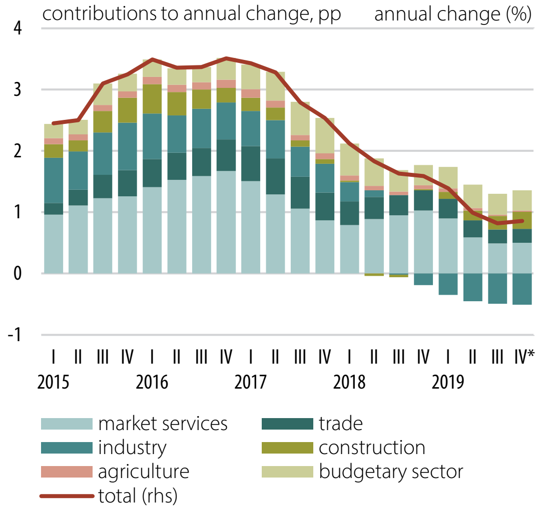
The labour market painted the same picture as in the past year, i.e. scant supply of workforce, the continued downward path of the annual advance in the number of employees and the fast-paced annual growth of wage earnings.

The available labour supply remained very low in the period from July to November 2019 as well, the ILO unemployment rate standing at 4 percent and the NEA rate at 3 percent at the end of the period (Chart 2.11). Moreover, the job vacancy rate stayed on the slightly downward trend that had started in 2018 Q4, mainly on account of the lower number of openings in public administration and accommodation and food service activities. In this context, labour market tightness tended to abate somewhat, yet structural problems still persist, i.e. the inadequacy of the education system to the economy's requirements (in terms

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

of skills and the quality of training[14]), the high emigration rate among the working-age population, as well as the low internal mobility. This situation is also presented in the "Status of the HR function in Romania"[15] survey, according to which the challenges faced by companies include attracting suitable staff (as stated by 28 percent of the respondents), employee retention (24 percent of respondents) and inadequately skilled staff (23 percent of respondents). The research studies in this field also highlight the skill mismatch, one quarter of the companies interviewed by PwC Romania in the "PayWell 2019" Survey contemplating the import of workforce, especially unskilled workers, in order to cover the employee shortage. In this regard, a decision was made to maintain the quota for newly-admitted foreign workers to the Romanian labour market (30,000 persons) in 2020. Labour market difficulties are also mirrored in the high share (over 60 percent) of companies that see the workforce shortage as the main challenge for 2020, according to the results of the "Barometer on the state of economy" conducted by Frames between 1 and 15 December 2019 on a sample of 450 companies.

Chart 2.12. Number of employees economy-wide

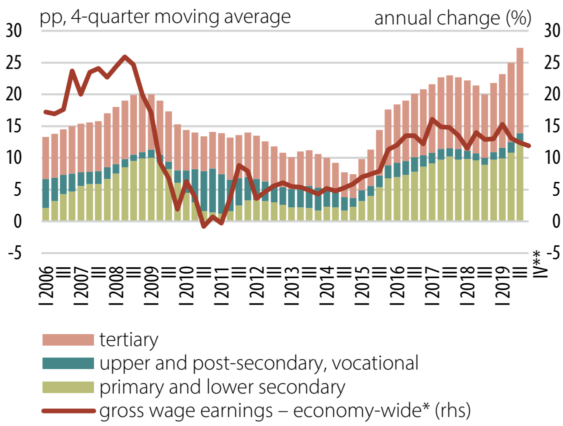


*) Oct.

Source: NIS, NBR calculations

Against this background, the downtrend that the growth rate of the number of employees in the economy had followed for the past two years continued in the period from July to October 2019 (0.8 percent in annual terms). Specifically, the coordinates of the recruitment process are similar to those seen in the previous period, i.e. a slower hiring pace in market services (particularly in trade, administrative and support services) and professional, scientific and technical activities, and a contraction in the number of payrolls in the automotive industry and the related sub-sectors, concurrently with a swifter pace of recruitment in construction, as a result of the tax incentives granted since the beginning of 2019 (Chart 2.12).

Chart 2.13. Skill mismatch index[16] on the labour market and nominal gross wage earnings



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

**) Oct.-Nov.

Source: NIS, Eurostat, NBR calculations

Looking ahead, the Manpower Survey points to increases in payrolls in most sectors in the first

[14] As shown by the poor international test results. A relevant example in this respect is the PISA 2018 test, where the score points for reading, mathematics and science were very modest, standing lower than those previously earned in 2012 and 2015.

[15] The survey was conducted on the occasion of the *HR SmART Conference* (30 October 2019) on a sample of over 100 companies.

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

quarter of 2020, the strongest hiring intentions being expected in construction and finance, insurance and real estate (in the latter case, employment expectations reached a two-year high). In fact, hirings are also anticipated for 2020 as a whole by the PwC HR Barometer survey conducted in October 2019 on 65 companies. Specifically, more than half of these companies are planning to increase headcount by an average of 11 percent in 2020, the highest demand for new employees coming from the ICT sector. Conversely, for December 2019 – February 2020, the EC-DG ECFIN Survey suggests larger payrolls only in trade, while stability is expected in the remaining sectors.

Average gross wage earnings further posted robust annual dynamics July through November 2019 (12.2 percent in annual terms), amid the severe labour shortage[17], the skill mismatch index hitting a new historical high in Q3 (Chart 2.13). High growth rates are also expected in the period ahead, in view of the rise in the minimum wage economy-wide as of 1 January 2020 (up by 7.2 percent to lei 2,230) and the hikes set forth by the unified wage law applicable in the public sector.

2. Import prices and producer prices on the domestic market

> Amid the slow pace of global economic growth in 2019 Q3 and the absence of recovery signs from the industrial sector, the annual dynamics of commodity prices returned to positive territory no sooner than year-end, generally posting rather moderate levels. Inflationary pressures were nonetheless visible at the level of food prices.

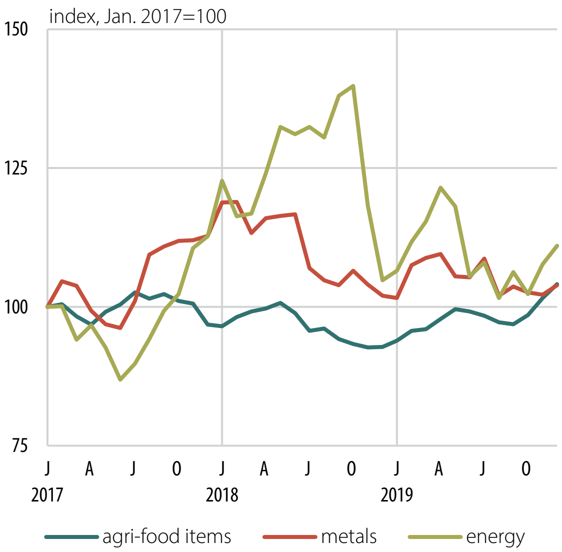
2.1. Import prices

Global economic growth remained moderate in 2019 Q3 as well, i.e. annual increases of 1.6 percent and 3.8 percent respectively for the advanced and the emerging economies (similar values to those recorded in the previous period, according to the World Bank data; seasonally adjusted data), whereas the evolution of industrial sector was further weak. Under these circumstances, the annual change in commodity prices left negative territory no earlier than end-2019, after reporting several steep decreases in the preceding months.

After annual contractions that exceeded 20 percent in the period from July to October 2019, energy prices posted a significantly less sharp annual decline in November, re-entering positive territory at year-end (5.9 percent). This was due to oil price developments, as a result of a statistical effect and a recovery in the recent period, amid accommodative financial conditions, the favourable signals from the negotiations between the US and China, the plans to cut oil supply that were subject

17 This conclusion is also confirmed by the business sentiment index calculated by the Foreign Investors Council, with two thirds of respondents complaining in September 2019 about the lack of skilled workforce (i.e. the highest balance of answers so far).

Chart 2.14. International commodity prices

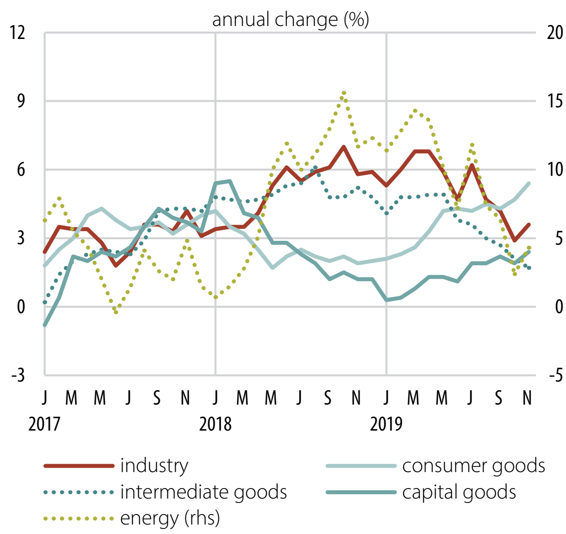


Source: World Bank, FAO, NBR calculations

to OPEC+ agreements and geopolitical tensions. In the case of natural gas, the plentiful supply led to additional, sharp annual decreases in prices. The annual dynamics of metal price index[18] further posted negative values in the period under review, albeit less significant towards the year-end, reflecting the weak global industrial activity as well as the few potential recovery signals that were manifest more recently. The annual growth rate of food commodity prices stepped up to 9.1 percent in 2019 Q4, given that the FAO index hit a 5-year high. This was particularly due to influences from prices of meat products (amid the persistent pork supply shortage in the Asian region, in association with the African swine fever outbreak) and some oleaginous and dairy products (Chart 2.14).

Movements in international commodity prices also affected import prices July through September 2019. Specifically, in 2019 Q3, the annual unit value index of imports (UVI)[19] decelerated notably as against the previous period, going below one (99.2 percent). The major contributors to the decline in the aggregate UVI are pharmaceutical products (99.6 percent, down 16.6 percentage points), petroleum products (89 percent, down 14.4 percentage points) and chemical products (96.8 percent, down 9.4 percentage points).

Chart 2.15. Industrial producer prices on the domestic market



Source: NIS, Eurostat

As regards the goods holding a relevant share in the CPI basket, pressures were further visible on the meat products segment, resulting in an increase of the index by 9.4 percentage points to 118.3 percent. Moreover, the UVI of sugar confectionery reverted to values above one (up to 104.4 percent), while that of vegetal products rose only marginally by 0.6 points to 103 percent.

2.2. Producer prices on the domestic market

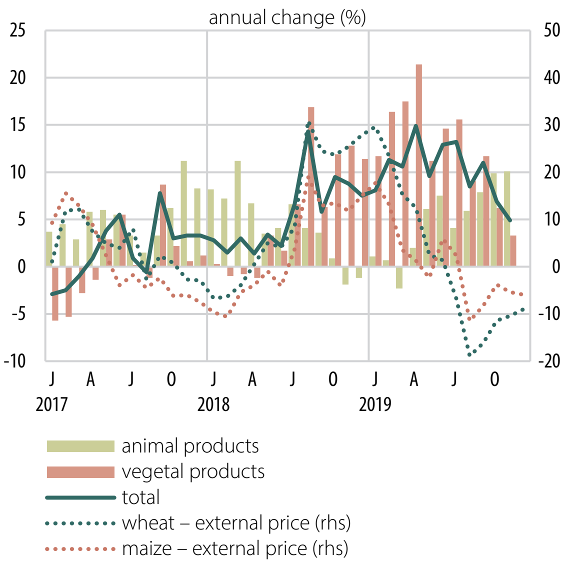
The annual dynamics of industrial producer prices on the domestic market decelerated sharply in October-November 2019, i.e. down 1.7 percentage points as compared to Q3 average to 3.2 percent (Chart 2.15).

18 The index leaves out the price of iron ore.

19 Expressed in EUR.

The annual change of producer prices for energy saw the sharpest slowdown (to 3.4 percent), on the back of the stronger annual decline in the international prices of energy commodities in October (this influence is expected to abate until the end of the fourth quarter). In addition, electricity prices posted a slower growth rate, but their pace is further high (10 percent), amid the 2019 low electricity production, especially that from renewable sources. The growth rate of intermediate goods prices also witnessed losses of momentum, albeit of a lower magnitude (i.e. down to around 2 percent, under the influence of developments in commodity prices), but it is likely to pick up in the period ahead. Conversely, the annual rate of increase of producer prices for consumer goods accelerated significantly to 4.9 percent, mainly on account of movements in international food prices.

Chart 2.16. Agricultural producer prices



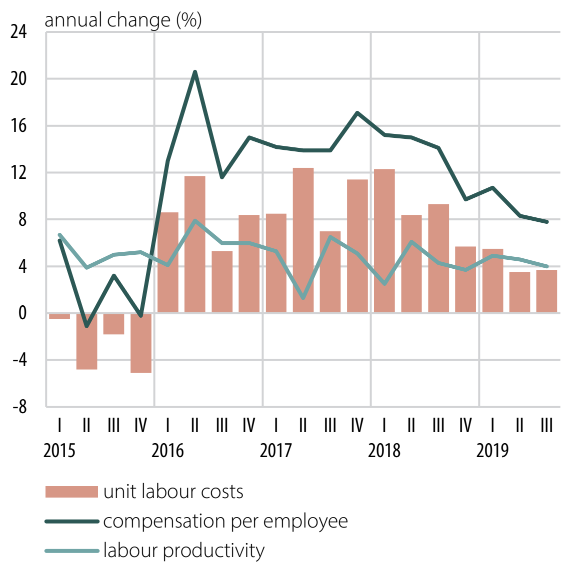
Source: NIS, Bloomberg, NBR calculations

In October-November 2019, the annual dynamics of agricultural producer prices on the domestic market fell sharply to 5.9 percent, from 16.7 percent in Q3. This was attributed to prices of vegetal products, significantly slower growth rates being reported by potatoes prices, while negative annual changes were seen in the case of some cereals (wheat, maize). By contrast, the annual growth rate of prices for animal products stayed on an upward path, reaching the 10 percent ceiling (up 4.7 percentage points as compared with the Q3 average), mainly in association with the upward movements in pork and mutton prices (Chart 2.16).

Unit labour costs

In 2019 Q3, the annual growth rate of unit labour costs economy-wide went up slightly to 3.7 percent (up 0.2 percentage points), under the influence of the slower pace of increase of labour productivity (Chart 2.17). In industry, the annual rate of change of unit wage costs also stayed on an upward course, i.e. up 1.4 percentage points to 14.5 percent in the period from July to November 2019, amid higher productivity losses. This was due to developments in mining and energy, where production was affected by measures to reduce the pollutant segments (additional costs associated with the carbon dioxide emissions certificates). In the latter case, a similar effect had the scant rainfall during the summer and the provisions of the Winter Energy Programme regarding the 25 percent increase in the energy reserve in the large hydropower plants. In manufacturing, the annual growth rate of unit wage costs remained high at 13.6 percent,

Chart 2.17. Unit labour costs



Source: NIS, NBR calculations

the same as in the previous period. In fact, the mismatch between wage and labour productivity continued to be visible in all manufacturing sub-sectors, as the challenging international context mirrored in the frail evolution of industrial output. Thus, most sub-sectors posted two-digit annual growth rates of unit wage costs, ranging between 10.4 percent and 35.9 percent, with few exceptions, such as the automotive industry or the hydrocarbon processing sub-sector, with slower dynamics of 3.8 percent and 3.3 percent respectively.

3. Monetary policy and financial developments

1. Monetary policy

> November 2019 through January 2020, 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 maintaining strict control over money market liquidity. Moreover, the central bank kept the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions at 8.0 percent. The measures aimed to bring the annual inflation rate back into line with the flat target of 2.5 percent ±1 percentage point and keep it there over the medium term, inter alia via the solid anchoring of inflation expectations over the longer time horizon, while safeguarding financial stability.

The November decisions of the NBR Board were taken in a context in which the annual inflation rate had fallen in September to the upper bound of the variation band of the target[20] – thus declining slightly more than expected in Q3 –, while inflationary pressures in the economy were anticipated to abate across the policy-relevant horizon, also compared with the August forecasts, but to remain significant and slightly regain momentum starting 2020 H2. According to the new medium-term forecast, after a likely modest climb above the variation band of the target in December 2019, to 3.8 percent[21], the annual inflation rate would fall comfortably in the upper half of the band in 2020 H1. It would thereafter re-embark on a slowly upward path, to reach 3.1 percent in December 2020 and 3.2 percent at the end of the forecast horizon[22]. Its likely downward correction in the first part of 2020 and its markedly lower-than-previously-anticipated values over the short time horizon were almost entirely attributable to the action of supply-side factors[23]. At the same time, fundamentals were expected to further exert significant and mildly rising inflationary pressures[24], albeit slightly weaker than in the August projection, given

20 To 3.5 percent from 3.8 percent in June.

21 Against 4.2 percent in the forecast published in the August 2019 *Inflation Report*.

22 Versus the previously projected 3.4 percent and 3.3 percent respectively for the same moments in time.

23 Stemming from the larger/incidental declines seen over the past months in vegetable prices and the prices for telecom services respectively, as well as from the base effects associated with previous developments in VFE, tobacco and fuel prices, but also with the tax levied on the telecom sector, whose joint impact was counterbalanced only to a small extent by that anticipated to come from administered price dynamics.

24 At the level of projected core inflation, they were somewhat masked in the first part of 2020 by the disinflationary base effects of the previous year's supply-side shocks, namely the introduction of the telecom sector tax and the increase in prices of some agri-food commodities.

the forecasts on the cyclical position of the economy, wage costs, as well as import price dynamics, reflecting inter alia the foreseen developments in the leu's exchange rate[25].

Thus, excess aggregate demand was expected to rise considerably in 2019, to a new post-crisis high, and afterwards fluctuate slightly around that level, although recording lower values than previously forecasted, amid an anticipated gradual slowdown in economic growth 2019 through 2020 – somewhat steeper in the short run than in the earlier forecast –, followed nevertheless by a renewed step-up in 2021. Furthermore, household consumption was seen becoming again in 2020 and remaining thereafter the main driver of economic growth – against the backdrop of robust, albeit decelerating dynamics of real disposable income and the developments in real interest rates –, whereas net exports were anticipated to have a further negative contribution to GDP dynamics, implying a likely protracted deterioration, also in relative terms, of the current account balance.

Heightened uncertainties and risks to the outlook were, however, associated with the future stance of fiscal and income policies – assumed to further be pro-cyclical, especially in the context of the election calendar –, given the considerable widening of the budget deficit in 2019, as well as the stronger anticipated impact of the new pension law, likely rendering necessary measures to halt the deterioration of the fiscal position, also from the perspective of the Stability and Growth Pact. Significant uncertainties and risks also stemmed from the increasingly obvious weakening of the euro area and global economies, as well as from the adverse implications of the trade war and Brexit. In the context of the higher interest rate differential and the trade balance worsening trend, particularly relevant were the ECB's and the Fed's decisions on monetary policy easing, as well as the stance of central banks in the region.

According to subsequent statistical data, the annual inflation rate fell to 3.4 percent in October, before climbing again in November above the variation band of the target, to 3.8 percent, in line with the forecast. The pick-up versus September was mainly brought about by the rise in vegetable and fruit prices, but also by the advance – slightly above expectations – in the annual adjusted CORE2 inflation rate, to 3.5 percent in November. Apart from the effects of higher global agri-food commodity prices and of the slightly weaker leu against the euro, the step-up in core inflation reflected significant demand-pull and labour cost-push inflationary pressures.

At the same time, the faster-than-anticipated deceleration of economic growth in Q3[26] occurred concurrently with a minor slowdown, markedly below expectations, in its quarterly pace, ascribable to the contraction in agricultural output. This likely implied a continued upward trend of excess aggregate demand, contrary to the expectations of its temporary halt in the first half of 2019 H2. Moreover, the contribution of

[25] Under the circumstances, the annual adjusted CORE2 inflation rate was expected to remain at 3.4 percent in December 2019 – slightly below the previously projected level of 3.9 percent – and to decline in the first part of 2020 to values visibly lower than those forecasted in August, before resuming growth and climbing gradually to 3.2 percent in December 2020 and 3.4 percent at the end of the projection horizon, versus 3.6 percent in the earlier forecast for both moments in time.

[26] To 3.0 percent from 4.4 percent in Q2.

household consumption to the economic advance remained significant, in spite of a notable fall, being considerably exceeded by that of gross fixed capital formation, while net exports increased their negative contribution. The latter was a result of a more pronounced reacceleration in the growth of imports relative to that of exports of goods and services, also visible in the renewed step-up in the annual dynamics of the negative balance on trade. Furthermore, the current account deficit continued to widen in annual terms, albeit at a somewhat slower pace, due to the improvement in the income balance.

In turn, labour market tightness remained at elevated levels, given that the job vacancy rate ceased to decrease in 2019 Q3, while the ILO unemployment rate stayed during the last months near the historical low seen at end-Q2, posting only a marginal rise. Reflecting these developments, the annual growth rate of average gross nominal wage earnings, as well as that of net real wage earnings, stuck to two-digit readings, while the two-digit annual change in the unit wage cost in industry even continued to expand, in the context of a sharper deterioration of labour productivity.

At the onset of Q4, the IRCC level rose marginally versus the previous quarter's reading, to 2.66 percent. At the same time, the main ROBOR rates saw their slow downtrend come to a halt in November 2019, before posting an increase in December, amid the relative temporary tightening of liquidity conditions, as well as the steady mopping up by the NBR of excess liquidity on the money market through deposit-taking operations. Against this background, the interest rates on interbank transactions climbed as well and remained slightly above the policy rate in December, their quarterly average thus widening marginally versus that in Q3. The EUR/RON exchange rate also trended upwards in Q4, primarily half way through the quarter – relatively at odds with the prevailing developments across the region –, stabilising however towards year-end, amid the considerable interest rate differential, the improvement in global financial market sentiment, and the decisions/expectations on the persistence of the accommodative monetary policy stance of the ECB and the Fed, as well as of the conduct of central banks in the region.

The growth witnessed by credit to the private sector remained robust in the first two months of Q4[27], decelerating only slightly, exclusively due to the rate of change of the foreign currency component going down, even into negative territory. However, the advance in the domestic currency component remained constant, amid the quasi-standstill in the dynamics of household loans at two-digit readings – with the prevailing contribution of housing loans –, but also the slight reacceleration in the growth of loans to non-financial corporations. In this context, the share of domestic currency loans in total private sector credit widened to 67.2 percent in November. In turn, broad money saw its dynamics pick up slightly[28], most likely on account of the budget execution and inflows of European funds.

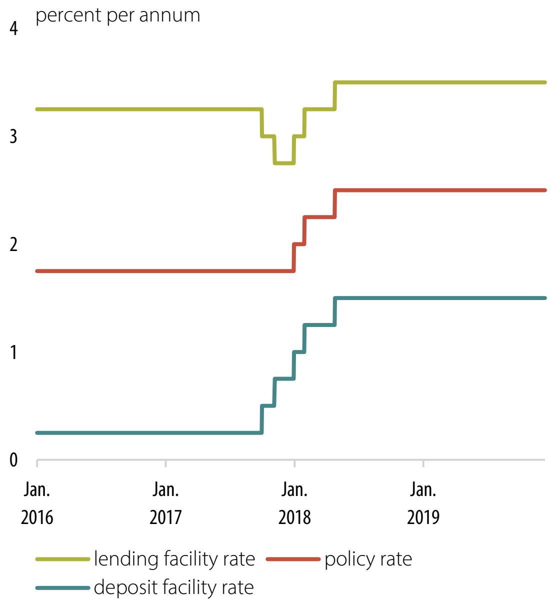
27 Its average dynamics declining to 7.3 percent against 7.9 percent in Q3.

28 October through November 2019, the average annual growth rate stepped up to 9.6 percent from 8.8 percent in Q3.

The assessments conducted in this context reconfirmed the prospects for the annual inflation rate to stand slightly above the variation band of the target at end-2019 and then to fall comfortably in the upper half of the band in the early months of 2020, exclusively under the action of supply-side factors, to slightly lower values than in the November medium-term forecast. The relative steepening of the expected downward correction was primarily ascribable to the foreseeable more pronounced deceleration in the fuel price dynamics, as a result of removing the special excise duty on motor fuels in January 2020. The action of fundamentals was, however, anticipated to be slightly more inflationary over the short-time horizon than previously envisaged, owing mainly to demand-side pressures, given the expected relative pick-up in economic growth during 2019 Q4 and 2020 Q1 overall, implying a quasi-standstill of the positive output gap in that period at the relatively higher value reached in 2019 Q3, i.e. above the levels forecasted in November.

The uncertainties stemming from the fiscal and income policy stance, as well as the risks thus induced to the latest medium-term forecast, were however particularly high, given, on one hand, the probable increase in the 2019 budget deficit significantly above the 3 percent-of-GDP ceiling set under the Stability and Growth Pact and, on the other hand, the difficulty of starting in 2020 – amid the election calendar and the provisions of the new pension law – the fiscal consolidation presumed by the deficit target set for this year. High uncertainties continued to stem from the external environment as well, given the relative halt in the weakening trend of the euro area and global economies, but also the heightened geopolitical tensions and the potential resurgence of risks induced by the trade row and Brexit.

Chart 3.1. NBR rates



Against this background, tailoring monetary conditions with a view to anchoring medium-term inflation expectations and bringing the annual inflation rate back into line with the inflation target and keeping it there, while safeguarding financial stability, warranted the policy rate status-quo and the maintenance of strict control over money market liquidity. Therefore, in its meeting of 8 January 2020, 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, while preserving strict control over money market liquidity (Chart 3.1). In addition, the central bank kept in place the current levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

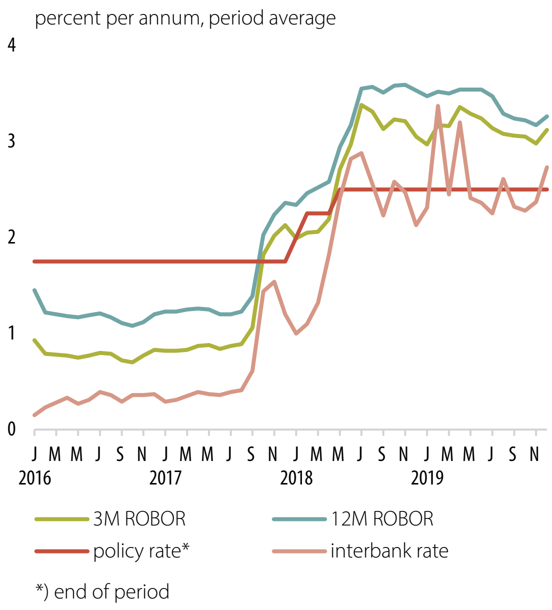
2. Financial markets and monetary developments

At the onset of 2019 Q4, the IRCC level rose marginally, to 2.66 percent. At the same time, longer-term rates on the interbank money market saw their slow downtrend come to a halt in November, before reverting to higher readings in December, although their quarterly average continued to decline, albeit at a slower pace. Conversely, the average interest rate on interbank transactions[29] posted a renewed increase in Q4. The EUR/RON exchange rate followed a steeper upward path in mid-Q4, before tending to stabilise in December 2019 at the higher levels thus reached. The annual growth rate of credit to the private sector decelerated slightly October through November, while the annual dynamics of liquidity across the economy regained momentum for the first time in eight quarters.

2.1. Interest rates

The daily average interbank money market rate saw its volatility subside further in Q4, while its monthly average remained practically unchanged in October and then increased gradually, climbing in December above the monetary policy rate (Chart 3.2). Its quarterly average thus returned onto an upward path, adding 0.12 percentage points to the level recorded in the previous period, to stand at 2.52 percent, without however exceeding the values seen in the first two quarters of 2019.

Chart 3.2. Policy rate and ROBOR rates



The NBR continued to consistently organise 1W deposit-taking operations conducted via weekly fixed-rate tenders with full allotment, in order to mop up the net liquidity surplus in the banking system. The surplus narrowed, however, under the action of autonomous factors, more visibly in the latter part of the quarter[30], with liquidity conditions even becoming slightly restrictive in December[31]. In this context, ON rates on the interbank money market posted weaker fluctuations, staying slightly below the monetary policy rate October through November[32], before climbing and remaining above the policy rate in December, temporarily even increasing their spread vis-à-vis the latter in the closing 10-day period of the month.

29 The average interest rate on transactions in deposits on the interbank money market (excluding the NBR), weighted by the volume of transactions.

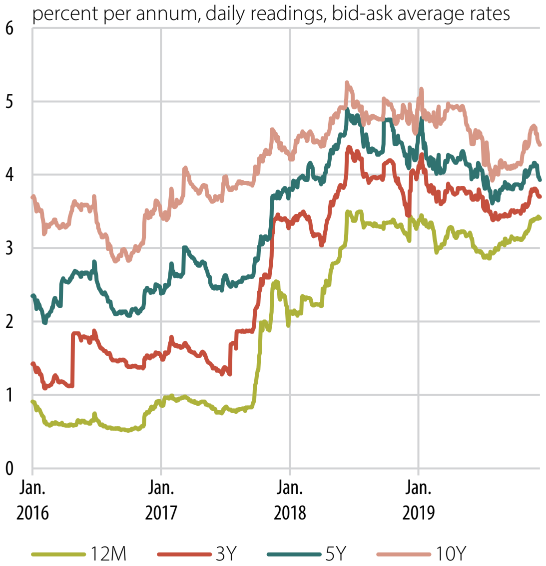
30 The daily average balance of 1W deposits taken shrank to around lei 4.4 billion in October (from an average of lei 6.6 billion in Q3), then to lei 3 billion in November and lei 0.3 billion in December.

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

32 Except for the temporary declines towards the lower bound of the interest rate corridor recorded at the end of reserve maintenance periods.

In turn, 3M-12M ROBOR rates saw their slowly downward trend, which had extended into the first month of Q4, come to a halt in November, before reverting to higher readings in December, amid the change in current liquidity conditions and, probably, the revised expectations on their outlook. The quarterly averages of these rates continued, however, to contract for the second consecutive quarter, albeit more slowly, to 3.05 percent for the 3M rate (down 0.04 percentage points) and to 3.12 percent and 3.22 percent for 6M and 12M rates respectively (down 0.08 percentage points and 0.11 percentage points respectively).

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



The government securities market reflected inter alia the influences stemming from the substantial increase, during the latter part of the quarter under review, in the MPF's borrowing requirements, alongside the repricing of related risk by investors[33], but also from the prevalence of a favourable sentiment on the international financial market. Against this background, reference rates on the secondary market[34] witnessed a quasi-standstill in October and in the early days of November, before posting a relatively steep rise[35], followed – in the latter part of December – by a slight downward correction in the case of longer-maturity rates, given investors' rekindled demand for those securities (Chart 3.3). Hence, the December averages of reference rates increased markedly against those in September across the board, standing at 3.29 percent (up 0.42 percentage points) and 3.39 percent (up 0.34 percentage points) for the 6- and 12-month maturities respectively and at 4.08 percent (up 0.28 percentage points) and 4.56 percent (up 0.45 percentage points) for 5-year and 10-year securities respectively. The slope of the yield curve steepened again, reversing its flattening trend seen in the latter part of 2019.

On the primary market[36] as well, the average accepted rates stood relatively still in the first half of the quarter, but then rose both in the latter part of November (by up to 0.2 percentage points for 12-year securities) and in December (by up to 0.3 percentage points for 15-year securities[37]). The evolutions were associated with the

33 Amid evidence of a more pronounced deterioration of the fiscal position in 2019 and probably in 2020.

34 Bid-ask averages.

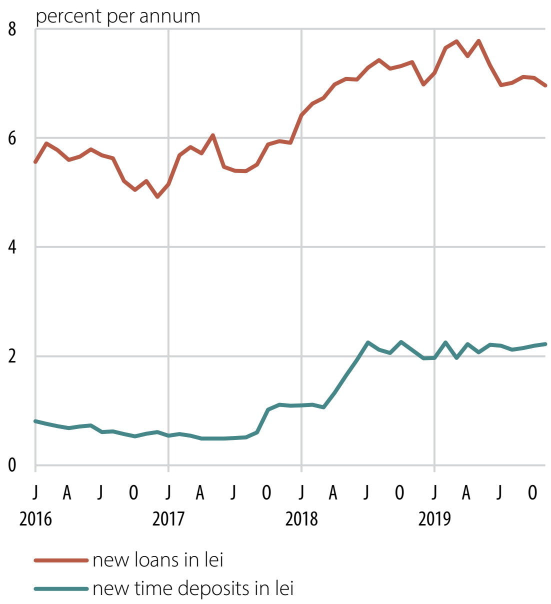
35 To 17-month highs over the short maturities and 7-month highs for longer maturities.

36 The MPF conducted in November and December tenders for EUR-denominated bonds as well. In particular, on 6 and 27 November the MPF issued bonds in the same series maturing in December 2023, worth EUR 338 million and EUR 332.6 million respectively, at average rates of 0.24 percent and 0.31 percent respectively; on 18 December, the MPF issued EUR-denominated bonds worth EUR 416.1 million, maturing in February 2021, at an average rate of 0.13 percent and fully rejected credit institutions' bids in amount of EUR 233.2 million in the case of a new issue maturing in April 2025, with bid rates ranging between 0.65 percent and 0.78 percent.

37 Looking at the auction for 5-year securities, average accepted rates remained, however, practically unchanged versus November.

considerable increase in the MPF's supply of government securities[38], accompanied by a rise in the ratio of the volume of issues to the scheduled volume[39], a context in which the volume of net issues in 2019 Q4 was the highest for the past approximately eight years[40]. The ratio of the amounts of bids submitted to the announced volume also went up during the reported quarter overall, to 2.2 from 2.0 in the previous three months, as it followed a steadily upward path, from 1.3 in September to 2.4 in December; at the same time, the average maturity of the issued securities diminished only slightly, to 5.4 years from 5.7 years July through September 2019.

Chart 3.4. Bank rates



The average interest rate on non-bank clients' new loans declined marginally in October and somewhat more visibly in November (to a 20-month low of 6.96 percent), its average for the two months remaining unchanged versus that in 2019 Q3. By contrast, the interest rate on new time deposits advanced slightly in both months (to 2.22 percent), its average inching up 0.05 percentage points against the previous three months (Chart 3.4). Looking at the two customer sectors, developments were somewhat heterogeneous. Specifically, the average lending rate on new business to households saw its downward trend noticed since 2019 Q2 resume and steepen, coming in at a 22-month low of 7.68 percent in November, and its average for the two months under review shed 0.24 percentage points compared with that in Q3, to 7.83 percent. Behind the decline stood the marked decrease in the average interest rate on consumer credit in November, visible for the fixed-rate component and probably reflecting inter alia the effect of some promotional offers. Conversely, the average interest rate on new housing loans posted minor increases in both months, in correlation with the marginal pick-up in the IRCC level in Q4. The average lending rate on new business to non-financial corporations moderated its upward adjustment, increasing marginally in October and November (to 5.90 percent) and thus staying significantly below the values recorded in 2019 H1. Its average for the two months added 0.18 percentage points versus Q3, to 5.89 percent. The advance was attributable to developments in the average interest rate on large-value loans (above EUR 1 million equivalent), which rose relatively sturdily during both months, whereas the interest rate on loans below EUR 1 million equivalent diminished slightly. The average remuneration of new time deposits from households stuck to the slow uptrend seen since March, increasing somewhat more visibly in October, but marginally in November (to 2.07 percent); its average added 0.15 percentage points against Q3. By contrast, the average interest rate on new time deposits from non-financial corporations witnessed minor both-way fluctuations, so that its average for October-November remained unchanged from Q3.

38 To lei 14.1 billion during Q4 overall (the third post-2009 peak) from lei 12.3 billion in the previous three months, especially due to the upturn in the scheduled volume of issues to lei 5.9 billion in December.

39 To 1.1 during Q4 as a whole (from 0.9 in the previous quarter), the indicator posting values above 1 in October and November (1.1 and 1.2 respectively) and only marginally below 1 in December.

40 It expanded to lei 13.5 billion from lei 10.5 billion in Q3.

Chart 3.5. Nominal exchange rate

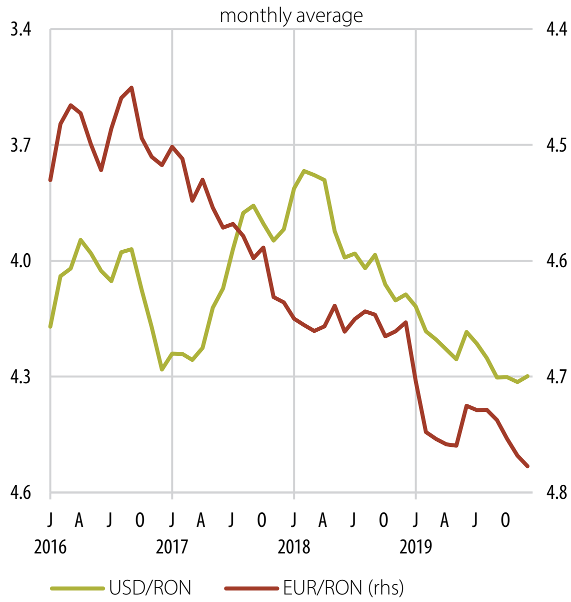


Table 3.1. Key financial account items

EUR million

	11 mos. 2018			11 mos. 2019		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	2,520	7,785	-5,265	2,638	8,381	-5,743
Direct investment	1,126	5,850	-4,725	789	5,900	-5,111
Portfolio investments	393	2,989	-2,596	1,265	3,503	-2,238
Financial derivatives	99	x	99	-32	x	-32
Other investment	2,329	-1,055	3,383	107	-1,022	1,129
– currency and deposits	1,346	-243	1,588	-1,182	-635	-548
– loans	51	-1,919	1,970	-97	-1,229	1,132
– other	932	1,107	-175	1,386	842	545
NBR's reserve assets, net	-1,427	0	-1,427	509	0	509

*) "+" increase/"-" decrease

2.2. Exchange rate and capital flows

In mid-2019 Q4, the EUR/RON exchange rate steepened its upward path seen since September, before tending to stabilise at those higher readings in the last month of 2019 (Chart 3.5).

The EUR/RON further increased in October, albeit at a slower pace than in the previous month, before discontinuing its rise in the last 10-day period of the month, amid the mixed influences stemming, on the one hand, from the uptrend in the trade deficit in association with the widening of the fiscal deficit and, on the other hand, from the improvement in global risk appetite due to the relative easing of trade tensions between the US and China[41] and to higher chances of an orderly Brexit[42] (Table 3.1). The latter influences were more visibly captured by the exchange rates of the main currencies in the region, which embarked and remained in October on a relatively steep downward path, reversing – fully or partially – the increases accumulated during 2019 Q3. The leu saw its depreciation trend against the US dollar come to a halt, given that the latter weakened against the euro, inter alia amid the worsening of a number of US economic indicators and the increased likelihood attached by investors to a further rate cut by the Fed at end-October.

The international financial market sentiment remained favourable in November, amid the positive developments of the trade row between the US and China[43], the lower risk of a no-deal Brexit, and the slightly higher-than-expected readings of relevant indicators for the euro area and US economies. However, the leu exchange rate witnessed considerably stronger pressures in this period, amid evidence/anticipation of a more pronounced deterioration of the fiscal position in 2019-2020 – mainly following the new pension law –, with implications for the external position of the economy as well[44], likely to determine a revision of expectations on the EUR/RON

[41] On 11 October, the US authorities announced a "phase one" trade deal with China, which also entailed the US suspending the rise in tariffs on some Chinese imports, which had been scheduled for 15 October, and China increasing purchases of US agricultural goods.

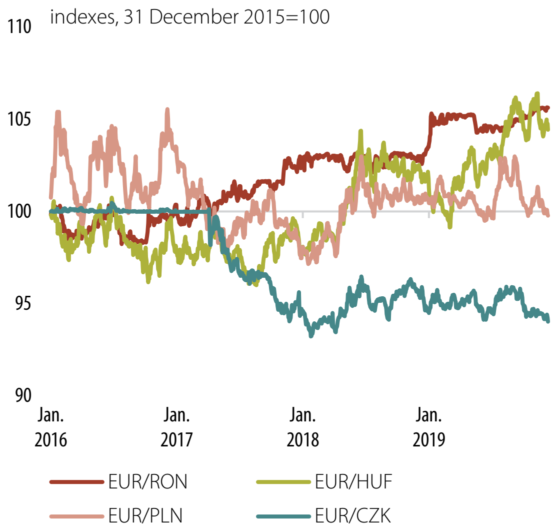
[42] The EU agreed on 25 October the delay of Brexit until 31 January 2020.

[43] The US and China agreed, insofar as progress is made in completing the trade deal, on a phased rollback of mutually imposed tariffs; this prompted expectations on the scrapping of tariffs scheduled for 15 December 2019.

[44] In this context, on 10 December, S&P credit rating agency revised the outlook for Romania's sovereign rating to "negative" from "stable".

exchange rate evolution and a corresponding change in the behaviour of investors on the domestic financial market (Chart 3.6). At the same time, residents' net demand for foreign currency on the interbank forex market increased, possibly in correlation with the worsening trend of the trade/current account balance. Under these circumstances, the EUR/RON resumed and then steepened its upward path[45].

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



Source: ECB, NBR

Nevertheless, in December, the EUR/RON tended to stabilise, amid the relative tightening of conditions on the money market, but also the further improvement in global financial market sentiment, following the announcement of the completion of the first stage of the US-China trade deal and the outcome of the UK's parliamentary elections[46]. However, the pressures associated with residents' transactions on the interbank forex market intensified, especially towards the end of the month. Thus, their balance deteriorated significantly in 2019 Q4 overall, which led to the widening of the interbank forex market deficit to a six-quarter high.

During 2019 Q4 as a whole[47], the domestic currency weakened against the euro by 0.8 percent in nominal terms[48] and strengthened by 0.2 percent in real terms. In relation to the US dollar, the leu appreciated by 0.1 percent in nominal terms and 1.2 percent in real terms, given the former's weakening versus the single currency. Looking at the average annual exchange rate dynamics in 2019 Q4, the leu saw its nominal depreciation widen against the euro and diminish versus the US dollar.

2.3. Money and credit

Money

The annual growth rate[49] of broad money (M3) regained momentum October through November 2019, for the first time in the past eight quarters (to 9.6 percent from 8.8 percent in 2019 Q3[50]; Table 3.2), amid the step-up in money creation owing to the budget execution and to EU funds, whose impact was only partly offset by the faster increase in non-bank entities' government security holdings.

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45 The exchange rates of the Hungarian forint and the Polish zloty also resumed their uptrend in November, primarily under the impact of domestic factors.

46 Against this background, the exchange rates of the main currencies in the region followed a downward path in December, with those of the Polish zloty and the Hungarian forint correcting the previous month's rise.

47 Versus the previous quarter, based on the exchange rate averages in December and September respectively.

48 In the same period, the main currencies in the region strengthened against the euro (the Hungarian forint by 0.5 percent, the Czech koruna by 1.5 percent, and the Polish zloty by 1.9 percent).

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

50 In real terms, the average annual M3 dynamics further increased, reaching 5.8 percent in the first two months of 2019 Q4, from 4.8 percent in July-September.

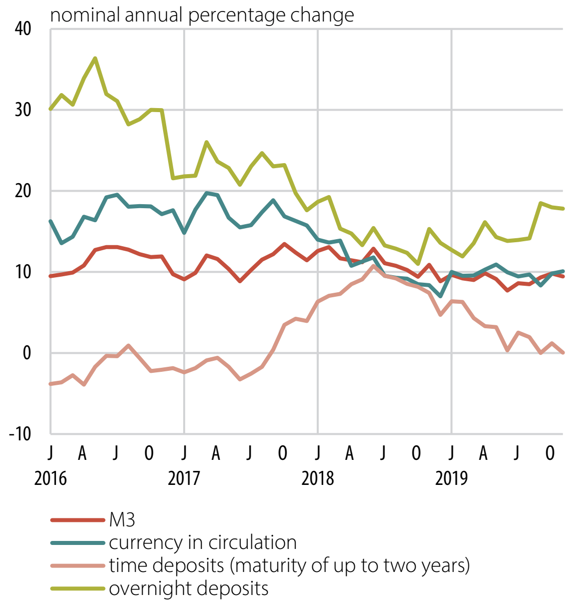
Table 3.2. Annual growth rates of M3 and its components

	2018	2019				
	IV	I	II	III	Oct.	Nov.
	quarterly average growth					
nominal percentage change						
M3	9.7	9.3	8.9	8.8	9.8	9.5
M1	11.7	11.8	13.5	13.6	15.5	15.6
Currency in circulation	8.0	9.7	10.4	9.2	9.8	10.1
Overnight deposits	13.3	12.7	14.8	15.5	18.0	17.8
Time deposits (maturity of up to two years)	6.8	5.7	2.3	1.5	1.2	0.0

The renewed step-up in the advance of M3 was due solely to its most liquid component (M1), whose annual dynamics witnessed a surge (to a seven-quarter high), stemming mainly from developments in corporate overnight deposits and, to a lower extent, from the rebound in the pace of increase of household overnight deposits and currency in circulation (Chart 3.7). By contrast, the growth rate of time deposits with a maturity of up to two years continued to lose traction, to a nine-quarter low. Its behaviour was ascribable to both the ongoing downtrend in the dynamics of household deposits – primarily visible in the case of leu-denominated deposits and probably correlated also with the level of the respective interest rates – and the rate of change of corporate deposits remaining in negative territory. In this context, the share of M1 in M3 continued to widen, reaching 64.4 percent in November – a new post-October 1994 record high[51].

From the perspective of institutional sectors, the step-up in the M3 pace of increase reflected in particular the new acceleration in the dynamics of non-financial corporations' total deposits (up to a six-quarter high), mainly associated with the faster growth in government spending on goods and services, as well as with the larger volume of disbursements to recipients of EU funds[52]. At the same time, the downward course in the annual pace of increase of similar household deposits came to a near halt, amid the higher rate of change of social security spending and increased revenues from EU funds, and despite the higher volume of households' holdings of government securities in domestic currency.

Chart 3.7. Main broad money components



Looking at M3 counterparts, the renewed pick-up in M3 dynamics in October-November was mirrored in the annual contraction in central government deposits and, to a smaller extent, in the slower growth rate of long-term financial liabilities[53]. Opposite influences came from the reduction in the dynamics of credit to the private sector and in those of net foreign assets of the banking system, as well as from the slight decline in the annual dynamics of banks' government security holdings.

51 A similar level was also recorded in November 1994.

52 According to the general government budget execution.

53 Capital accounts included.

Chart 3.8. Credit to the private sector by currency

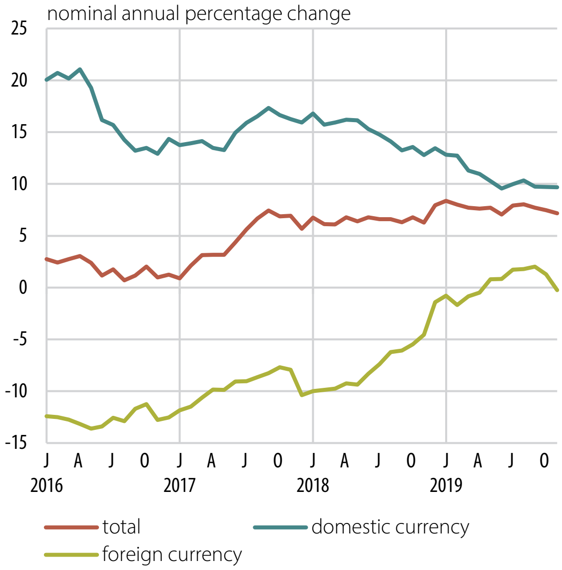
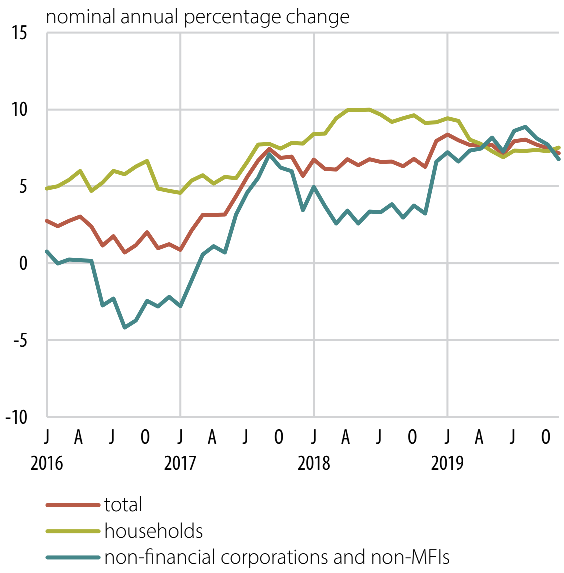


Chart 3.9. Credit to the private sector by institutional sector



Credit to the private sector

The annual growth rate of credit to the private sector slowed down slightly in the first two months of 2019 Q4[54] (an average of 7.3 percent versus 7.9 percent in July-September; Chart 3.8) – in correlation with developments in the annual dynamics of the credit flow[55] and in those of loans granted through lines of credit[56], as well as with the pick-up in sales of non-performing loans. The deceleration was ascribable primarily to the foreign currency component, whose annual rate of change[57] recorded a pullback, even re-entering negative territory in November, after the prolonged upward path seen since March 2019. The lei component had a smaller contribution to the slackening, with a growth rate further around two-digit levels, yet continuing to decline sluggishly, amid the slower dynamics of new loans and of loans granted through lines of credit, and the higher volume of NPL sales. Against this background, the share of leu-denominated loans in total private sector credit widened in November to 67.2 percent – hitting a post-May 1996 high[58], despite an unfavourable statistical effect of the EUR/RON exchange rate.

Looking at institutional sectors, the slower growth rate of credit to the private sector was mainly due to the weaker dynamics of loans to non-financial corporations, albeit still around the relatively high values prevailing since the beginning of 2019. The decline was driven by the loss of momentum witnessed by the foreign currency component (expressed in EUR), while leu-denominated loans posted a slightly faster rate of change, on the back of loans with a maturity of over five years, even amid the rise in NPL sales.

A slowdown effect was also ascribable to the deceleration of the advance of credit to non-monetary financial institutions, especially that of the lei component, which had a visible impact at aggregate level, despite the small share of this sector.

54 In real terms as well, the average rate of change of credit to the private sector slowed down slightly (3.6 percent, from 3.9 percent in 2019 Q3).

55 The data on new loans were taken from the Report on interest rates, net of renegotiations.

56 Revolving loans, overdraft loans, and credit card loans.

57 Determined based on EUR-denominated values.

58 A similar level was also recorded in June 1996.

By contrast, the annual dynamics of household credit remained fairly steady at the somewhat lower level reached in 2019 Q2, given that the rise in leu-denominated loans continued to comfortably record two-digit readings, albeit at a slightly slower pace, while the foreign currency component (expressed in EUR) maintained its annual contraction almost unchanged (Chart 3.9). The evolution of domestic currency-denominated loans reflected a marginal renewed pick-up, for the first time in the past seven quarters, in the pace of increase of housing loans – due to the faster dynamics of new loans granted under the "First Home" programme and to the further swift growth of loans granted without state guarantee[59], yet probably offset to a large extent by the higher volume of repayments –, but also the modest slackening of the dynamics of consumer credit and other loans, amid the decline in the rate of change of new loans and credit card loans, as well as the increase in NPL sales.

59 According to CCR data referring to loans granted with state guarantee associated with the "First Home" programme.

4. Inflation outlook

After having reached 4.04 percent at end-2019, the current projection shows the annual CPI inflation rate returning into and staying in the variation band of the target over the next eight quarters. It is projected to come in at 3.0 percent and 3.2 percent at end-2020 and end-2021 respectively. Compared to the previous *Inflation Report*, the level recorded at the end of 2019 was 0.2 percentage points higher, while for the end of 2020 the projection was revised downwards by 0.1 percentage points. Inflation rate will return inside the variation band of the target in early 2020 due mostly to the slower dynamics of the exogenous components of the consumer basket and, to a lower extent, to the adjusted CORE2 index, chiefly on the back of some base effects following the adverse developments in the first part of 2019. The annual core inflation rate is projected to halt its uptrend in the seen all through 2019 and follow a downward track by mid-2020. Thereafter, it will gather momentum and reach 3.4 percent at end-2020, stabilising at this level until the projection horizon. Core inflation is foreseen to remain in the upper half of the variation band of the target mainly due to the persistence of domestic inflationary pressures associated with excess demand and inflation expectations, whereas stronger pressures from imported inflation are anticipated over the medium term as well. As in the previous round, the balance of risks to the annual inflation projection is assessed to be tilted to the upside compared to its path in the baseline scenario, owing to domestic factors in particular.

Baseline scenario

4.1. External assumptions[60]

The baseline scenario envisages a slowdown in the growth rate of external demand, assessed based on the effective EU GDP (EU-28 excluding Romania), to 1.3 percent in 2020 and a slight rebound in the course of 2021 to 1.5 percent, a level similar to that of 2019 (Table 4.1). Compared to the previous *Inflation Report*, the value for this year was subject to a downward revision of 0.1 percentage points, amid the protracted sluggishness across manufacturing and slower global trade in an international environment saddled with major uncertainties (structural shifts in China's economy, the future relationship between the United Kingdom and the rest of EU Member States following the completion of Brexit, the change in consumer

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

Table 4.1. Expectations on the developments in external variables

annual averages

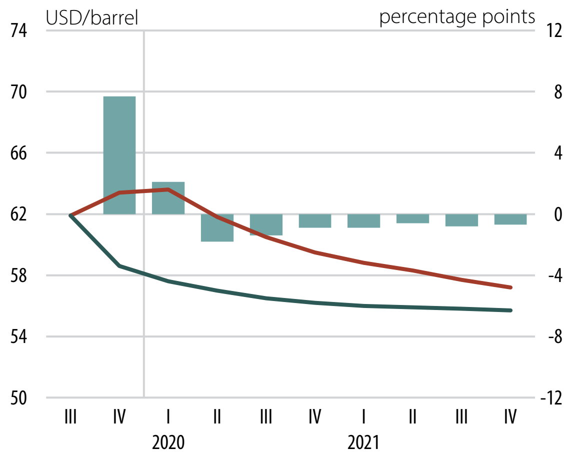
	2020	2021
Effective EU economic growth (%)	1.3	1.5
Annual inflation rate in the euro area (%)	1.1	1.4
Annual inflation rate in the euro area, excluding energy (%)	1.4	1.5
Annual CPI inflation rate in the USA (%)	2.0	2.1
3M EURIBOR (% per annum)	-0.4	-0.4
USD/EUR exchange rate	1.12	1.14
Brent oil price (USD/barrel)	61.3	58.0

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

preferences impacting the car-manufacturing sector[61]). Private consumption is further the key driver of economic growth, benefiting from the persistently accommodative monetary policy pursued by the ECB and central banks in the region, the stimulative fiscal policy in some Member States and the real wage increases, amid a robust labour market and a lower unemployment rate (which fell below pre-crisis levels). The effective EU GDP gap, an indicator reflecting the cyclical component of economic activity of Romania's main trading partners, is seen having a lower stimulative impact on the domestic economy and at the same time weaker than in the previous *Inflation Report*.

The average annual HICP inflation rate in the euro area is projected to post an upward trend over the projection interval, which was, however, revised marginally downwards compared to the prior *Inflation Report* (amid lower expected economic growth), still running below the 2 percent benchmark. 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 a moderately upward path over the projection interval, from 1.4 percent in 2020 to 1.5 percent in 2021, given that the adverse effects of the above-mentioned uncertainties on economic growth are seen abating.

Chart 4.1. Brent oil price scenario



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

Against the background of the ECB's persistently accommodative monetary policy, which was confirmed by the institution's decisions[62], the nominal 3M EURIBOR rate is anticipated to remain in negative territory over the projection interval.

The EUR/USD exchange rate foresees a slight strengthening of the euro throughout the forecast interval, reaching USD 1.14 per euro in 2021 versus USD 1.12 per euro in 2020. Given the past episodes of swings in the currency pair, the projection of the exchange rate path is marked by elevated uncertainty.

The scenario for the developments in the Brent oil price, based on futures prices, foresees a downtrend over the forecast interval to USD 57 per barrel at the projection horizon from USD 64 per barrel

61 According to the European Commission's assessments published in its Autumn 2019 Economic Forecast.

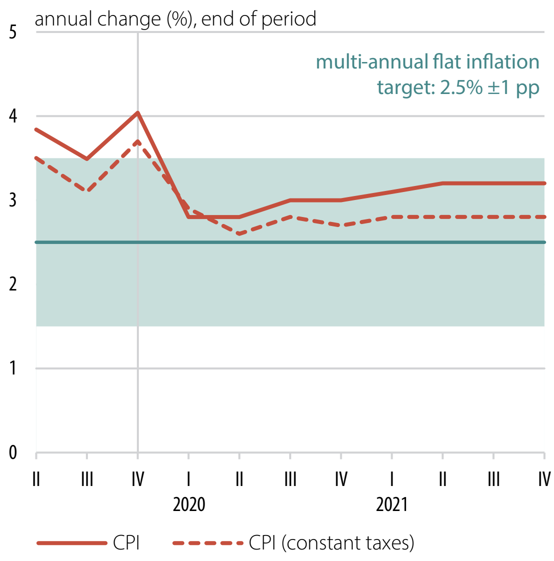
62 In the meeting of 23 January 2020, the ECB's Governing Council decided to reiterate its previously adopted policies, namely to leave unchanged the interest rates on the deposit facility, the main refinancing operations and the lending facility, and to continue its asset purchase programme (APP) at a monthly pace of EUR 20 billion. The Governing Council expects the programme to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates.

projected for 2020 Q1 (Chart 4.1). Nonetheless, this anticipated evolution is surrounded by high uncertainty, as mirrored also in the revised trajectories of futures prices in the successive projection rounds. The future dynamics of oil price are conditional on both supply-side factors (geopolitical tensions in the Middle East, oil production cuts agreed on by OPEC and Russia, and the United States switching to a net oil exporter) and demand-side factors (the concern for a possibly lower energy consumption need worldwide).

4.2. Inflation outlook

After having reached 4.04 percent at end-2019, the annual CPI inflation rate is projected to return into the upper half of the variation band of the target in early 2020. This return will reflect the alleviating inflationary impact coming from the exogenous components of the consumer basket and, to a lower extent, from the adjusted CORE2 index, chiefly on the back of some base effects following the adverse developments in the first part of 2019[63]. Thereafter, inflation rate is projected to rise slightly by mid-2021, remaining inside the variation band of the target (Chart 4.2). The projected values for end-2020 and end-2021 are 3.0 percent and 3.2 percent respectively (Table 4.2).

Chart 4.2. Inflation forecast



Source: NIS, NBR projection

Table 4.2. The annual inflation rate in the baseline scenario

annual change(%); end of period

	2020				2021			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Central target	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	2.8	2.8	3.0	3.0	3.1	3.2	3.2	3.2
CPI projection*	2.9	2.6	2.8	2.7	2.8	2.8	2.8	2.8

*) calculated at constant taxes

The annual inflation rate at constant taxes is assessed at lower levels than headline inflation, with the contribution of indirect tax changes[64] being estimated at 0.3 percentage points at end-2020 and 0.4 percentage points at end-2021. As an annual average, the CPI inflation rate will go down until the beginning of next year, when it is seen running at 2.9 percent, before reversing its trend to reach 3.2 percent at the projection horizon, a level similar to that expected for the annual inflation rate at the end of 2021.

Compared to the previous round, the present baseline scenario envisages a lower annual CPI inflation rate by 0.1 percentage points for the end of 2020. Except the annual core inflation rate and the annual inflation rate for tobacco products, all the other CPI basket components have smaller contributions.

63 Fuel and vegetables price hikes (only partly offset by the favourable performance of late last year) in the case of exogenous components and the sizeable increase in the pigmeat price and higher telecommunication prices in the case of the adjusted CORE2 index.

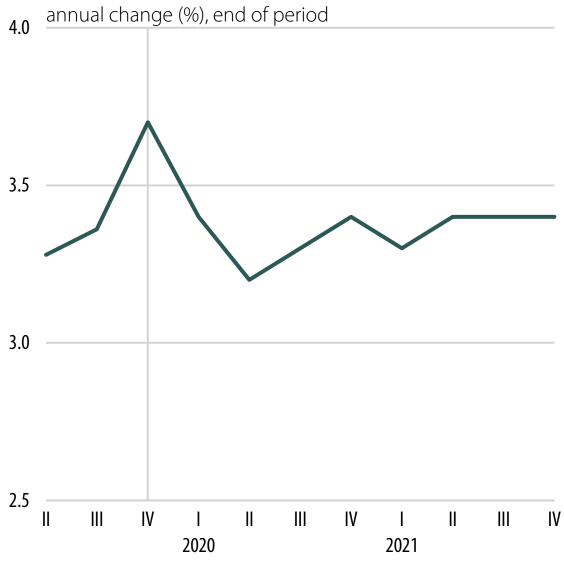
64 The hikes in excise duties on tobacco products and fuels.

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

annual change (%); end of period

	2020				2021			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Adjusted CORE2	3.4	3.2	3.3	3.4	3.3	3.4	3.4	3.4

Chart 4.3. Annual adjusted CORE2 inflation



Source: NIS, NBR projection

Table 4.4. Components' contribution to annual inflation rate*

percentage points

	2020	2021
Administered prices	0.4	0.4
Fuels	-0.1	0.1
VFE prices	0.1	0.2
Adjusted CORE2	2.1	2.1
Tobacco and alcoholic beverages	0.5	0.4

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

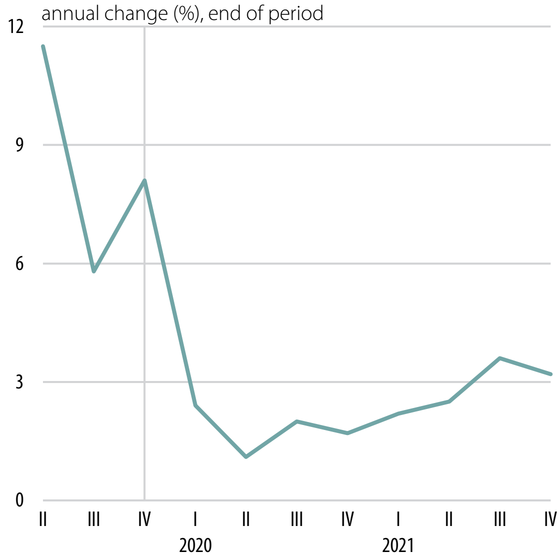
The annual adjusted CORE2 inflation rate is anticipated to see its upward trend recorded during the past year come to a halt. This trend steepened in 2019 Q4 following the supply-side shock on the international pigmeat market. Given the favourable base effects, associated with movements in prices of some telecommunication services and pigmeat in 2019 H1, the indicator is forecasted to fall to 3.2 percent at mid-2020. It will then gather momentum until the end of the year, when it is expected to stand at 3.4 percent, stabilising at this level until the projection horizon (Table 4.3, Chart 4.3). The persistence of core inflation at levels in the upper half of the variation band of the target stems largely from lingering domestic inflationary pressures associated with excess demand and inflation expectations. The latter are foreseen to re-enter the upper half of the variation band of the target in the second part of 2020 and stay there until the end of the forecast interval. Imported goods prices are also projected to exert weaker inflationary pressures over the short term, albeit stronger over the medium term, under the impact of the slow increase in external inflation. However, uncertainties still persist over the near term as concerns the developments in global agri-food prices, especially amid the African swine fever epidemic, carrying a substantial inflationary potential, given the large share of food items in the adjusted CORE2 index.

Compared to the November 2019 *Inflation Report*, the annual adjusted CORE2 inflation rate was revised upwards by 0.2 percentage points for the end of the current year. The revision occurred amid the resurgence of short-term inflationary pressures associated with food items, i.e. a higher-than-expected hike in pigmeat and related product prices. This implicitly affected the values at the starting point of the projection and the related second-round effects.

The cumulative contribution of inflation components beyond the scope of monetary policy, namely administered prices, volatile food prices, fuel prices and tobacco product and alcoholic beverage prices, to the annual CPI inflation rate is seen at 0.9 percentage points at end-2020 (a value revised downwards by 0.2 percentage points) and 1.1 percentage points at the end of 2021 (Table 4.4).

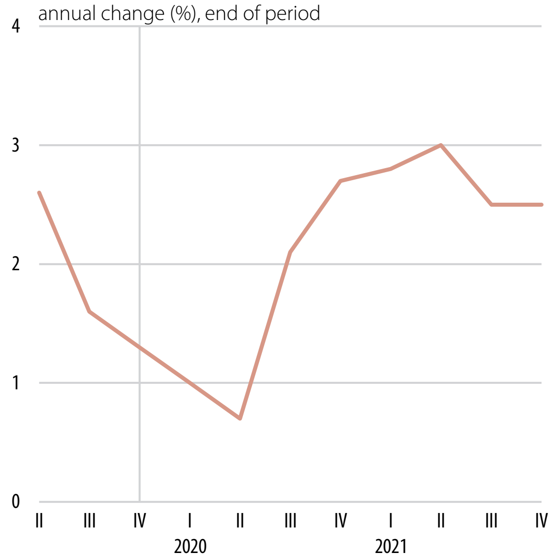
The annual dynamics of volatile food (VFE) prices are projected at 1.7 percent at the end of this year and 3.2 percent at the end of next year (Chart 4.4), assuming a harvest nearing the multi-annual average[65] in 2020 and 2021. Compared to the previous *Inflation Report*, the forecasted value for the annual dynamics of this group at end-2020 was revised downwards by 1.1 percentage points, given the latest developments affecting favourably vegetables prices.

Chart 4.4. VFE prices annual inflation



Source: NIS, NBR projection

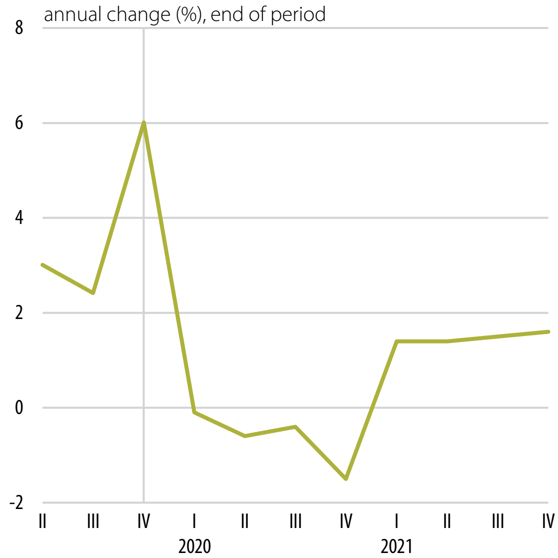
Chart 4.5. Administered prices annual inflation



Source: NIS, NBR projection

Administered prices are foreseen to go up by 2.7 percent and 2.5 percent at the end of 2020 and 2021 respectively (Chart 4.5). Compared to the previous *Inflation Report*, the projection for the end of this year was subject to a marginal downward revision, by 0.1 percentage points, largely due to developments in electricity prices, given the lower-than-previously-anticipated increase in the mandatory quota for green certificates. The uncertainty surrounding the projected values are, however, assessed to be significant, amid the ongoing liberalisation of the electricity and natural gas markets.

Chart 4.6. Fuel prices annual inflation



Source: NIS, NBR projection

The annual dynamics of fuel prices are forecasted at -1.5 percent at the end of 2020 and 1.6 percent at the end of 2021 (Chart 4.6). Compared to the prior *Inflation Report*, the -3.5 percentage point revision for the end of 2020 owes mainly to the cut in the excise duties levied on these goods as of 1 January (assessed as having a -0.2 percentage point contribution to the annual CPI). The path of this component is also influenced by the downtrend, as shown by futures prices, in the oil price throughout the projection interval, except 2020 Q1, and by the

[65] Standard assumption in the absence of other relevant information.

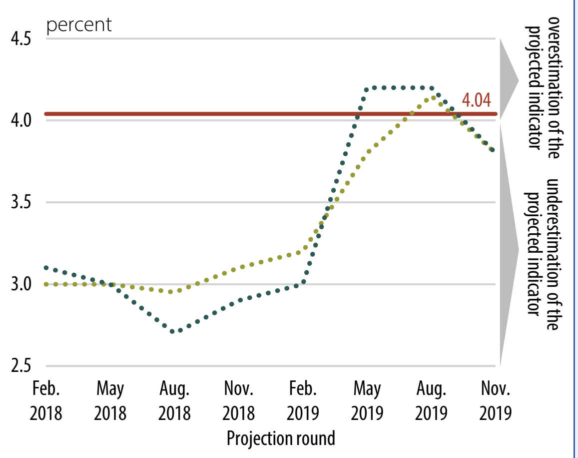
projection of a stronger euro versus the US dollar, with an impact on the USD/RON exchange rate that is relevant for the movements in leu-expressed prices for this category of goods. Adding to these factors is the ongoing downward drift, over the projection interval, of inflation expectations, which are anticipated to re-enter the variation band of the flat target later this year and thereafter stabilise in its upper half.

The annual price dynamics projected for tobacco products and alcoholic beverages are envisaged at 6.5 percent and 4.7 percent at end-2020 and end-2021 respectively. Their path for 2020 is marked by the two-stage increase in the total excise duty on 1,000 cigarettes from lei 483.74 to lei 533.97[66], with an estimated total impact of 0.5 percentage points on the annual CPI inflation rate. Against this backdrop, compared to the November 2019 *Inflation Report*, the end-of-year level is revised upwards by 2.4 percentage points for 2020. Subsequently, the annual dynamics are shaped in light of the current legislation concerning excise duties levied on these goods, also considering the past behaviour of economic agents in this field as regards the final price adjustment following tax changes.

Assessment of forecast errors for the December 2019 annual CPI inflation rate

This box assesses the accuracy of the projections the NBR made in successive rounds concerning the annual CPI inflation rate for end-2019[67] with a view to improving the forecasting framework by understanding the reasons behind the forecast errors. This assessment, initiated in recent years, is common practice among central banks with an inflation targeting monetary policy regime in place, considering the importance of macroeconomic forecasts in influencing economic agents' inflation expectations.

Chart A. Successive forecasts of the annual CPI inflation rate for December 2019



Source: NIS, NBR projections, NBR survey

The annual CPI inflation rate reported in December 2019 (4.04 percent, according to NIS Release No. 15/14 January 2020) fell within the range of values projected by the NBR for this horizon, being however underestimated during most of the rounds. The forecast errors, defined as the difference between the forecasted value and the actual one[68], ranged between -1.3 percentage points (the level related to the August 2018 *Inflation Report*) and +0.2 percentage points (the value corresponding to the *Inflation Reports* published in May and August 2019). Their magnitude is comparable to that of the errors calculated based on the median of financial

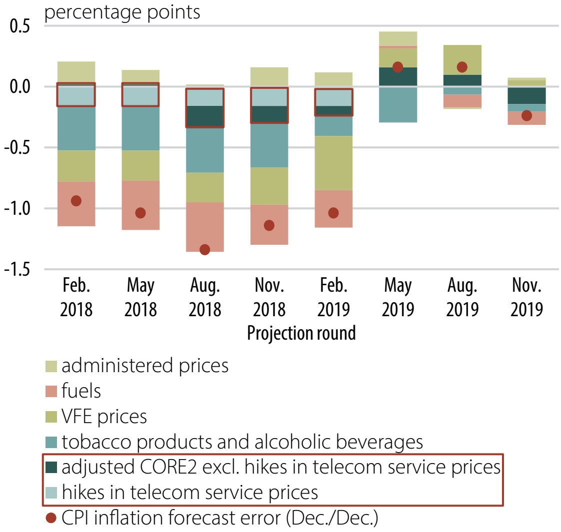
66 The first stage was on 1 January 2020 (from lei 483.74 per 1,000 cigarettes to lei 503.97 per 1,000 cigarettes) and the second is scheduled for 1 April 2020 (from lei 503.97 per 1,000 cigarettes to lei 533.97 per 1,000 cigarettes).

67 Based on this criterion, the assessment focused on the forecasting rounds corresponding to the *Inflation Reports* published February 2018 through November 2019.

68 A positive difference implies that the variable of interest was overestimated, whereas a negative difference shows its underestimation.

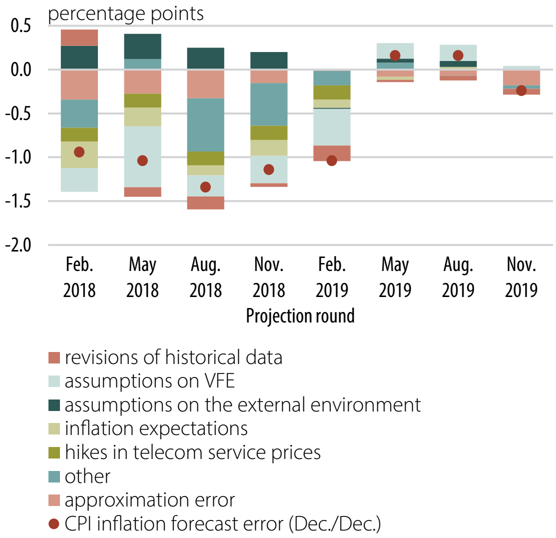
analysts' forecasts retrieved from the inflation expectation surveys conducted by the NBR in the months when *Inflation Reports* were published in order to ensure comparability with the NBR forecasts (Chart A).

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



Source: NBR calculations

Chart C. Forecast errors in successive rounds, distributed by contribution of MAMTF factors



Source: NBR calculations

The breakdown of forecast errors by consumer basket component (Chart B) shows the prevailing contribution of CPI basket components beyond the scope of monetary policy in explaining them. The first five forecasting rounds considered for analysis deserve mentioning, as the largest contributions to the inflation underestimation came from fuel prices, tobacco product and alcohol prices, and volatile food prices. At the same time, administered prices made a marginally opposite contribution. Fuel prices contributed to the annual CPI inflation rate underestimation especially in the rounds conducted February 2018 through February 2019, amid the depreciation of the euro (instead of its anticipated appreciation) against the US dollar, with an impact on the USD/RON exchange rate and implicitly on the leu-denominated fuel prices. Moreover, successive revisions were made to the trajectories of futures prices for the Brent oil, on a market facing stronger crude price volatility[69], in the context of growing uncertainties about both supply- and demand-side factors.

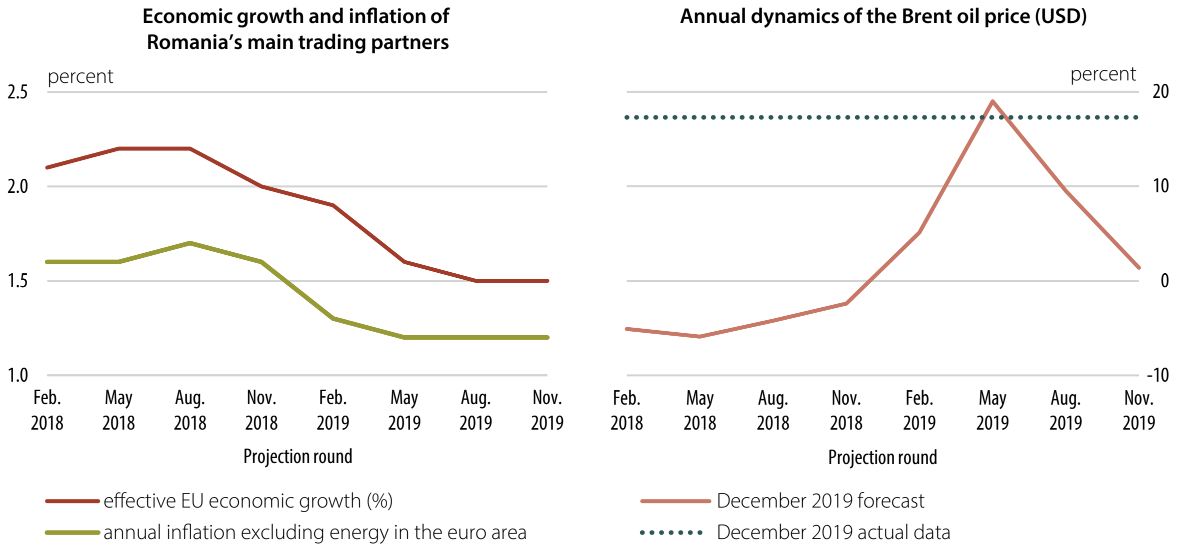
The annual dynamics of volatile food prices for December 2019 were significantly affected by both the low potato production domestically and the marked rise in the vegetables price at European level since early 2019, the information being embedded in the baseline scenario coordinates starting with the May 2019 round.

The underestimation of the annual growth rate of the tobacco product price in the first half of the period under review occurred mainly amid a larger-than-anticipated rise (based on the legislation in force at the time the forecasts were made) in the specific excise duty levied on cigarettes, in the context of adopting GEO No. 114/2018. At the same time, the economic agents in this sector implemented price increases higher than those justified by the fiscal changes, most likely reflecting the inelastic demand for these products.

69 For further details, see Chapter 4, Section 1.1. External assumptions in the *Inflation Reports* published in the period under review.

As regards administered prices, the forecast for their annual dynamics was marked by the uncertainties surrounding the impact of the measures in GEO No. 114/2018, as amended by GEO No. 19/2019, on the electricity and natural gas prices, given the absence, at the time the forecasts were made, of detailed norms of the competent authorities for their transposition. As norms were adopted, the level of uncertainty dropped and the contribution of administered prices to the forecast error diminished[70].

Chart D. Revision of assumptions on the external environment for 2019



Source: Eurostat, US Energy Information Administration, NBR assumptions based on European Commission's data, Consensus Economics, ECB and Bloomberg

The path of the annual adjusted CORE2 inflation rate was influenced by the legislative changes introduced at end-2018 via GEO No. 114/2018, as amended by GEO No. 19/2019, on the taxes applicable to telecommunication companies (translating into price hikes for telephony and television services implemented by all major providers in the market), to which added a more pronounced depreciation of the domestic currency against the euro. Following the incorporation in the projection of the impact exerted by higher prices for the mentioned telecommunication services, the contribution of adjusted CORE2 inflation to the forecast error of headline inflation declined significantly during the rounds in May-November 2019. Furthermore, the annual adjusted CORE2 inflation rate for end-2019 was also influenced by developments in processed food prices, once supply-side shocks on the pigmeat segment passed through into consumer prices, amid the persistent effects of the African swine fever virus which affected the pigmeat supply globally and locally[71].

[70] The approval in July 2019 by the Romanian Energy Regulatory Authority of the cut in the regulated prices of natural gas delivered to households played an important part. For more details, refer to the Romanian Energy Regulatory Authority press releases issued in 2019 available at: http://www.anre.ro/ro/presa/comunicate (Romanian only).

[71] The marginal overestimation of core inflation in the May and August 2019 projection rounds owes primarily to more moderate hikes in meat product prices than those anticipated at the moment the forecasts were made.

The breakdown of the forecast errors based on the specific factors in the NBR's model for macroeconomic analysis and medium-term forecast (MAMTF)[72] shows the significant contribution to underestimating the annual CPI inflation rate of the assumptions on developments in volatile food prices, in the context of the negative supply-side shocks during 2019 previously mentioned (Chart C). At the same time, opposite influences were exerted by the exogenous assumptions on the external environment, as Romania's main trading partners witnessed successive downward revisions of the 2019 growth rate, and therefore of the HICP inflation rate excluding energy in the euro area[73], amid the overlapping action of multiple regional and global factors[74] (Chart D). In Chart C, "other" includes the contribution of forecasting framework-specific factors (such as assumptions on developments in the risk premium, the cyclical component estimates for the main macroeconomic variables etc.). In addition, the decomposition also captures an approximation error, generated by a shift from the average quarterly inflation (modelled in the MAMTF) to end-of-period inflation, used in defining the inflation target.

4.3. Demand pressures in the current period and over the projection interval[75]

Output gap

In 2019 Q3, the quarterly growth of real GDP[76] dropped again (by 0.3 percentage points, down to 0.5 percent, slightly above the forecast in the prior *Inflation Report*[77]), which reflected in a significant slowdown in the annual rate (by 1.4 percentage points, down to 3.0 percent)[78]. The breakdown of aggregate demand shows new positive contributions from final consumption and GFCF. Net exports made a notable negative contribution, amid the much faster rise in imports (fuelled by the substantial domestic demand) than that of exports (affected by the sluggish industrial output in the euro area). The contribution of the change in inventories and of the statistical discrepancy (to which an economic substance can hardly be attributed) became positive.

For the next two quarters (2019 Q4 and 2020 Q1, respectively), real GDP is expected to register relatively robust quarterly growth rates. This forecast is supported by the overall favourable developments in confidence indicators[79] (Chart 4.7) and by the

72 This decomposition assumes counterfactual simulations in which projection input data (specific factors) are supposed to be exactly known (being assigned the actual historical values). The difference between the inflation projections released in the eight *Inflation Reports* and those resulting from the counterfactual simulations allows for determining the contribution made by each of the specific factors to the total forecast error.

73 A relevant measure for shaping the path of prices of imported goods within the MAMTF.

74 For further details, see the Box entitled "Recent developments in and the outlook for global economic activity" in the May 2019 *Inflation Report*.

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

76 For details on recent developments in economic activity, see Chapter 2, Section 1. Demand and supply.

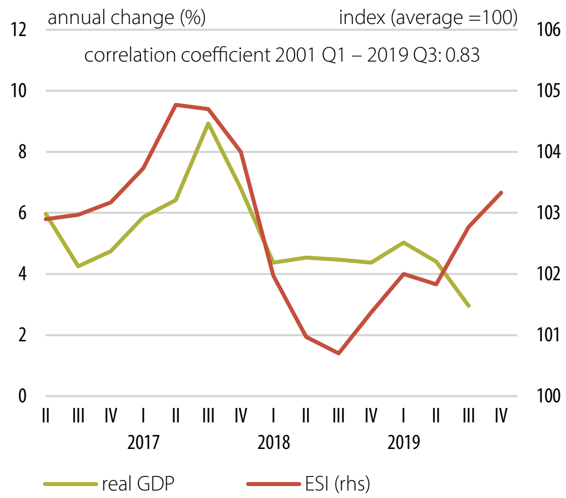
77 In the context of a lower negative contribution of agricultural output to quarterly GDP growth compared to that expected in the previous forecasting round. Mention should be made that agricultural sector performance also influenced the actual individual consumption of households, with an impact on the variable via its self-consumption component.

78 According to NIS Press Release No. 16 of 14 January 2020. The annual dynamics are calculated based on gross data series.

79 Apart from services, all other components making up the ESI indicator improved slightly in 2019 Q4.

signs pointing to a slower pace of decline of industrial output[80]. Specifically, over the projection interval, economic activity continues to benefit from the elevated levels of consumer confidence, inter alia amid the net wage increase in real terms, being also supported by the rise in both retail trade (excluding motor vehicles and motorcycles) and market services to households. These favourable developments are foreseen to act in the opposite direction from that of the difficulties facing the industrial output (which was hit throughout 2019 by the weakness of the external environment). Over the next two quarters, the subdued signals stemming from this sector, to which add those regarding external demand indicators, are assessed to be deterrents of GFCF (forecasted to post quarterly increases significantly lower than the recent ones[81]) and exports, as well (additionally affected by the fading stimulative impact of the real effective exchange rate). Thus, the breakdown shows that quarterly GDP growth is assessed to remain ascribable to domestic demand (with a robust contribution from consumption and a more moderate one from GFCF). Given the steady advance in imports (reflecting the path of domestic demand and the stimulative impact, albeit on the wane, of exports), further negative, but lower, contributions are expected from the net exports of goods and services.

Chart 4.7. Economic sentiment indicator* and economic growth



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

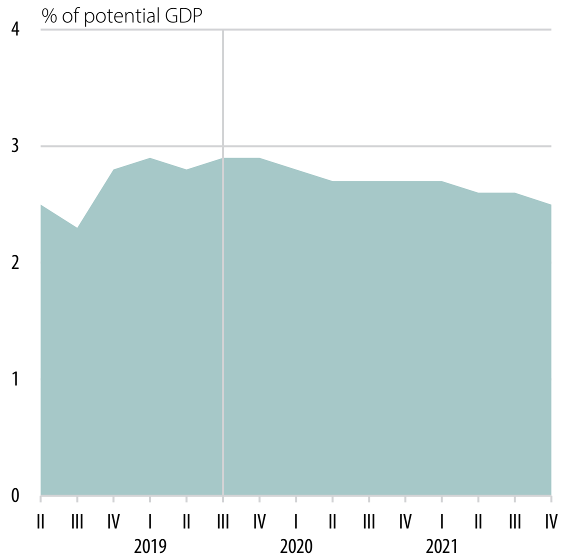
Subsequent to the decelerating GDP dynamics of 2019, the baseline scenario of the projection envisages that 2020 and 2021 will record economic growth rates slightly below the potential GDP rates. The outlook for the Romanian economy is further surrounded by uncertainties stemming from factors such as the fiscal and income policy stance, and the economic slowdown in the euro area and at global level (amid trade rows and technology conflicts). Mention should also be made that the accuracy of the macroeconomic forecast is marked by the high volatility and the magnitude of successive revisions of historical data series. Over the projection interval, the breakdown shows that the GDP path mirrors the prevailing contributions from final consumption (even though smaller compared to the 2016-2018 period), to which add, especially during 2019, the contributions coming from GFCF. Against the background of systematically slower dynamics of exports of goods and services compared to those of imports, the contribution of net exports to real GDP growth remains negative (more pronounced in 2019 and lowering slightly thereafter), thus fuelling the widening of the current account balance.

80 The smaller contraction of October through November versus 2019 Q3 and the relative stabilisation in the confidence of economic agents in this field (both in the euro area and domestically) show a slowdown in the deterioration of industrial output, at least for 2019 Q4.

81 In the first three quarters of 2019, GFCF posted notable quarterly dynamics (5.2 percent, 9.0 percent and 6.4 percent), especially on the back of the advance in construction, while equipment purchases gained momentum mainly during Q3.

Over the projection interval, the dynamics of potential GDP are assessed to pick up moderately, mainly on the back of a higher contribution of capital stock (projected to record a more pronounced rise compared to the previous *Inflation Report*). Its path reflects the GFCF advance (with recent historical readings revised upwards by the NIS), which incorporates the expansion of construction works mainly, but also of equipment purchases[82] (favouring the technological upgrading of production capacities), as well as the expected increases in the volume of investment. The assessment of the contribution coming from the trend of total factor productivity (TFP) points to a slowdown and a relative levelling-off over the projection interval, encompassing a series of persistent adverse influences – modest allocation of resources relative to the needs of innovation and upgrading in technology, shortcomings of the regulatory framework of the business environment, and the poor quality of infrastructure[83] which affects, inter alia, the labour force mobility. In addition, the assessment takes into consideration the uncertainties surrounding the external environment, a main driver of the possible volatility of foreign direct investment inflows. Efficiency gains could be facilitated by a continuously improved absorption rate of European structural and investment funds[84]. Similarly to the previous forecasting round, the contribution of labour to potential growth is assessed to remain low, ascribable to the prospects for a stabilised trend of unemployment rate, along with unfavourable multiannual demographic developments.

Chart 4.8. Output gap



Source: NBR assessments based on data provided by the NIS

After the 2019 levelling-off (to about 2.9 percent), the output gap is foreseen to enter a slightly downward path and reach 2.5 percent at end-2021 (Chart 4.8). The projected output gap path mirrors: (i) the protracted stimulative nature of the discretionary fiscal policy (although of a slightly lower magnitude in 2021 compared to the previous round), given the planned measures regarding the raise in the pension point (Law No. 127/2019)[85], (ii) the weaker traction of effective external demand, revised downwards for the medium-term, (iii) a further stimulative nature of real broad monetary conditions throughout the forecast interval, but diminishing to close-to-neutral values at this horizon. As compared to the previous *Inflation Report*, the output gap will be slightly larger in 2019 and 2020, reflecting the persistent influences coming from the

[82] The annual dynamics of net investment in equipment (transport means included) registered in 2019 Q3 were 14.6 percent, up by about 7 percentage points compared to the previous quarter.

[83] Additional evidence regarding the TFP trend slowdown is brought by the *Ease of Doing Business* ranking of the World Bank, the *Global Competitiveness Index* Report of the World Economic Forum or the *European Innovation Scoreboard* analysis of the EC (ranking Romania among modest innovators).

[84] According to the Net Financial Balance, throughout 2019 structural and cohesion funds inflows totalled EUR 2.6 billion, a significantly higher figure than that of the previous year (EUR 1.5 billion).

[85] The pension point increased by 15 percent as of September 2019, the next raises being scheduled starting September 2020 (by around 40 percent) and September 2021 (by around 6 percent), respectively.

revisions of the historical GDP developments, as well as from the reassessment of the fiscal impulse and from the impact of effective external demand. In 2021 it is worth noting that the output gap will decrease (in comparison to the widening forecasted in the previous round), due to the revision to less stimulative values of the impact from the effective external demand, the discretionary component of fiscal and income policy stance, and the nature of real broad monetary conditions.

From the perspective of aggregate demand components, the output gap path is shaped by the gap of actual individual consumption of households and, to a lesser degree, by the GFCF gap. In turn, the gaps of exports and imports of goods and services are projected at positive values, albeit their net contribution to the output gap remains negative. The assessment of the output gap and of the GDP components' gaps is surrounded by uncertainty, which reflects the high volatility of historical series, as well as the frequency and size of their revisions.

Aggregate demand components

Final consumption is foreseen to post robust developments, although on the wane, in line with the dynamics of economic confidence indicators and real disposable income. The latter is assessed to further benefit from the significant, albeit slower, rise in wages. Starting this year, social transfers will however have a prevailing contribution to the climb of real disposable income, in the context of the announced substantial increase in related expenses[86]. Nevertheless, the uncertainty regarding the magnitude and timing of these raises is significant and expected to be higher as compared to the November 2019 *Inflation Report*, given the limits imposed by the 3 percent-of-GDP threshold for the budget deficit set forth in the Stability and Growth Pact, but also by the 2020 election calendar. At the same time, wage dynamics, though losing momentum, are forecasted to remain robust, especially in the private sector, amid persistent structural problems on the labour market, marked particularly by a severe shortage of labour force, as well as amid incidental factors, such as the hike in the minimum wage[87]. Last but not least, the moderation in final consumption dynamics is also conditional on the developments in real monetary conditions, whose stimulative impact is seen diminishing towards close-to-neutral values at the projection horizon.

The GFCF dynamics are forecasted to decelerate as of 2020, following the outstanding developments of the previous year. The developments in the absorption of EU funds could act in as a positive re-enforcement in the future, given the Multiannual Financial Framework 2014-2020 coming to a close; so could the plans to "reorient public investment expenditures in order to make a gradual transition from investments financed entirely from national sources to co-financed investments from European funds"[88]. A similar impact on the GFCF dynamics stems from the anticipated advance

86 Law No. 127/2019 on the public pension system stipulates significant raises in the pension point in September 2019 (already implemented) and September 2020. Moreover, GEO No. 2/2020 sets forth the postponing of the hike in state child benefits until 1 August 2020.

87 As of 1 January 2020, the gross minimum wage economy-wide was raised from lei 2,080 to lei 2,230 pursuant to Government Decision No. 935/2019.

88 According to the Fiscal Strategy of the Government of Romania for 2020-2022. At the same time, the reliance on institutional and structural factors of the capacity to replace domestic funds by European ones triggers uncertainty about the carrying out of public investment.

of foreign direct investment, in line with the domestic and global developments. By contrast, GFCF could be slowed down by the authorities' discretionary investment stance, amid the need to keep the budget deficit within sustainable targets. An impact in the same direction is envisaged via the restructuring and relocations planned within the global value chains (especially in industry, also given the effect of automation and the recent modest performance of industrial output) and as a result of the existing structural problems related, inter alia, to labour market deficiencies (the mismatch between demand and supply, in particular) or to the access to infrastructure. In addition, the dynamics of the real effective exchange rate, which act towards the erosion of competitiveness reserves, could impact investment decisions, especially those of export-oriented companies.

Exports of goods and services are projected to continue their advance over the forecast interval, at lower annual rates compared to 2016-2018. The anticipated developments in this component take into account: (i) the prospects regarding a lower traction from effective external demand, revised downwards for the medium term (Germany holds the largest share in effective external demand); (ii) a decline in price competitiveness due to the increase, albeit at slower rates, in unit labour costs; 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 effect on the structure of value added of the Romanian products targeting external markets. Compared to the previous forecasting round, the annual dynamics of the component are slightly swifter, reflecting among others the reassessment of the gap of the real effective exchange rate and the alleviation of risks stemming from the further worsening of the euro area and global economies.

The annual growth of imports of goods and services is expected to remain brisk over the projection interval, reflecting the path of domestic demand and the stimulative (albeit reduced) impact of exports. Imports dynamics are forecasted to stay above those of exports, but the differential is seen to narrow. Nominal net exports of goods and services are anticipated to make a rising negative contribution to the balance-of-payments current account balance over the forecast interval.

In 2019 Q3, the current account deficit widened to around 4.7 percent of nominal GDP (4-quarter cumulative data), against the 4.5 percent value of the previous quarter, mirroring the increase in the deficit on trade in goods and services, but also the relative stability of the primary income deficit and of the positive impact of the secondary income balance. The current account deficit is estimated on the rise in 2019 overall, being envisaged to exceed, from a multiannual perspective, the 4 percent-of-GDP indicative threshold set by the European Commission as a scoreboard indicator for EU Member States[89]. The current account deficit as a share of GDP is anticipated to increase in 2020 and 2021 as well, due to the further growth in the negative balance of trade. Regionally, the Romanian economy stands out due to the significant widening of the balance-of-payments current account deficit, driven

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

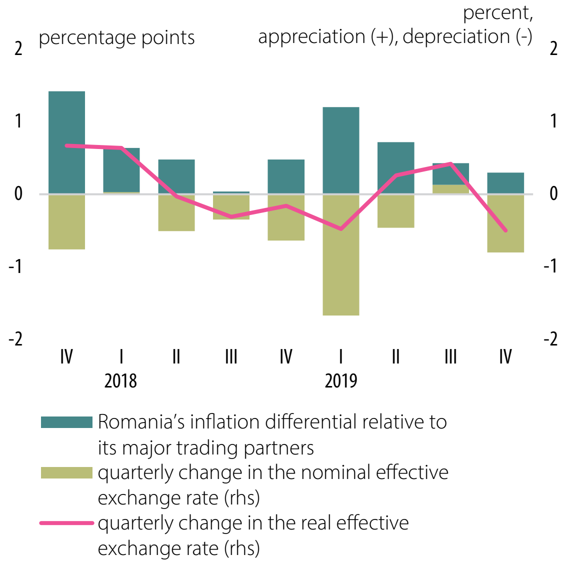
by the negative balance on trade in goods (which is on the increase in terms of both intra-EU and extra-EU countries[90]). Over the entire projection interval, the financing of the current account deficit is expected to continue to be mainly covered by stable, non-debt-creating capital flows, albeit their coverage is seen to decline gradually. The key factors influencing the coverage of the deficit by these flows are the magnitude and dynamics of external imbalances and a possible slowdown in direct investment, taking into consideration the economic growth outlook for the main countries of origin and the investor sentiment. A partly counterbalancing effect stems from an expected improvement in the absorption of EU funds.

Broad monetary conditions

Broad monetary conditions capture the cumulated impact induced on future developments in aggregate demand by the real interest rates applied by credit institutions on leu- and foreign currency-denominated loans and deposits of non-bank clients and by the real effective exchange rate[91] 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[92].

In 2019 Q4 and 2020 Q1, given the relative steady nominal interest rates on new time deposits and new loans in lei, real rates are estimated to follow an upward path almost exclusively on the back of easing inflation expectations. Subsequently, the projection points out the further gradual increase in real interest rates (a trend which diminishes their stimulative impact on economic activity). In the context of the changes regarding the benchmark index used for the indexation of the interest rate on new variable-rate loans to households, which were provided for by GEO No. 19/2019, the near-term forecasts of interest rates on new loans and new time deposits are marked by a high degree of uncertainty. This uncertainty is mainly generated by the fact that the influence of the new index (IRCC) on the interest rates applied by banks on the new loans and new time deposits of their clients is difficult to assess at present, as the evidence accumulated subsequently to the entry into force of the new benchmark index (May 2019) is limited.

Chart 4.9. Quarterly change in the effective exchange rate



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

In 2019 Q4, the domestic currency depreciated in real effective terms, on account of the

90 In the first 11 months of 2019, the negative balance on trade in goods increased by approximately EUR 2.4 billion against the same year-ago period. The groups of goods with the largest contribution to this deterioration are the following: chemical products and related products, and miscellaneous manufactured articles.

91 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.

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

developments in the leu exchange rate in nominal terms, which temporarily offset the impact of systematically higher domestic inflation rates than to those of Romania's trading partners (Chart 4.9). For the remainder of the projection interval, the inflation differential is assessed to prevail again, leading to a strengthening trend of the domestic currency in real terms, with a gradually increasing negative effect on the price competitiveness of Romanian exporters.

In 2019 Q4 and 2020 Q1 on the whole, the wealth and balance sheet effect is assessed to have stimulative influences on future economic activity, on account of the real foreign interest rate (3M EURIBOR) standing below its long-term equilibrium level (given the accommodative ECB monetary policy stance), as well as due to the real effective exchange rate of the leu. The sovereign risk premium, approximated based on the option adjusted spread (OAS), is however estimated to have an increasing restrictive effect, amid growing internal as well as external imbalances in the economy. Over the projection interval, the wealth and balance sheet effect will exert a slightly stimulative influence, albeit on the decline, on future economic activity, chiefly on account of the impact of the real foreign interest rate, but also as a result of the real effective exchange rate gap.

Overall, the baseline scenario of the projection shows a further stimulative nature of real broad monetary conditions, but diminishing throughout the forecast interval to close-to-neutral values at the projection horizon. This trajectory is shaped both by the declining stimulative effect of real interest rates as well as by real effective exchange rate developments. The latter will exert an increasing restrictive effect on economic activity, eroding the price competitiveness of Romanian exporters. Overall, the influence exerted by the real effective exchange rate on economic activity via the net export channel will prevail over that exerted via the wealth and balance sheets of economic agents.

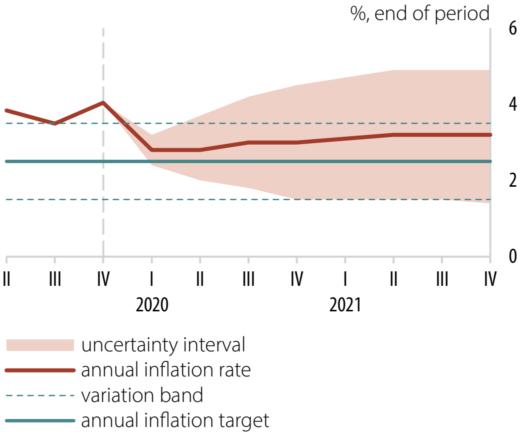
The monetary policy stance is tailored to ensure and maintain price stability over the medium term in a manner conducive to achieving sustainable economic growth and safeguarding a stable macroeconomic framework.

4.4. 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 its path in the baseline scenario, mainly due to domestic factors (Chart 4.10). At the current juncture, the uncertainties associated with the future dynamics of administered prices remain relevant, whereas those related to the fiscal and income policy stance became more pronounced, featuring the possibility of both-way deviations. On the external front, the risk factors saw a partial decline in intensity from the previous round and are seen to hold further a net disinflationary potential.

A source of uncertainty whose relevance increased in the current round refers to the fiscal and income policy stance. At end-2019, the substantial advance in budget spending led to a significant opening of the cash-based budget deficit, which is

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 2005-2019. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

expected to reflect also in the budget execution based on the ESA methodology[93]. The budget deficit, anticipated to remain further elevated[94], might increase in the medium term, especially in view of the provisions of the pension law and of other fiscal measures enacted into law but facing high uncertainties as to their enforcement[95]. From this perspective, the need emerges to start fiscal consolidation. The timing for initiating this process and the potential corrective measures as well as their dosage are saddled with large uncertainties, depending, inter alia, on developments in economic activity. At the same time, the option to reconfigure the already approved fiscal measures is not excluded either, by possible new extensions of the deadlines for their entry into force or by the reassessment of the magnitude of the rises already set forth by law for certain categories of spending.

Apart from leading to a worsening of the current account balance, the deterioration of the general government budget balance also poses problems related to a possible triggering of the excessive deficit procedure. Under such circumstances, this could result in the repricing of the risk associated by investors with the economy and the change in international market sentiment, with an impact on the future path of the exchange rate and, implicitly, on the projected inflation rate. Moreover, if the subsequent macroeconomic rebalancing called for wide corrections in a short period of time, the process could be less orderly, with adverse consequences on the stability parameters in the economy's scoreboard.

Overall, the future fiscal and income policy stance is marked by high uncertainty, with both upside and downside related risks. On the one hand, this stance is influenced by the need for fiscal consolidation, which might also include the reconfiguration of measures already enacted into law. On the other hand, the fiscal and income policy stance is also affected by the busy election calendar. It is necessary to ensure a balanced macroeconomic policy mix and it is desirable to preserve a balance between the fiscal measures aimed at stimulating aggregate demand and the economic growth potential, respectively, without prejudice to the objective of price stability.

Another source of uncertainty refers to the future dynamics of administered prices amid the electricity and natural gas market liberalisation. Risks are associated with the stages of this process and the magnitude of its effects, inter alia in the context of the

93 In 2019, according to the Ministry of Public Finance, the cash-based budget deficit is assessed at 4.6 percent of GDP. The ESA-based budget execution data for the whole year will be released by Eurostat in April 2020.

94 According to the Fiscal Strategy for 2020-2022, the budget deficit (ESA) is anticipated to exceed the 3 percent-of-GDP ceiling set under the Stability and Growth Pact: 3.8 percent of GDP in 2019, 3.6 percent of GDP in 2020 and 3.4 percent of GDP in 2021.

95 For instance, Law No. 14/2020 on child benefits. The initial deadline for coming into force (February 2020) was already extended by GEO No. 2/2020.

transposition of the provisions of GEO No. 1/2020 into norms issued by the competent authorities. At the same time, uncertainties surround the prices prevalent on the open electricity and natural gas markets upon the completion of the liberalisation stages envisaged by authorities.

Notable risks continue to be associated with developments in the labour market amid its tightness remaining at elevated levels. Behind the labour market tightness stand the labour shortage on certain market segments, the difficulties encountered by employers in the recruitment process, and the relatively large share of the inactive population. To these add the ageing of population and the magnitude of emigration. Under the circumstances, additional inflationary pressures from labour costs are not ruled out, the latter also putting pressure on the price competitiveness of Romanian products for external markets.

Volatile food prices continue to be surrounded by inherent uncertainties about the impact of weather conditions on the agricultural product supply. At the same time, risks are associated with the potential spread of the African swine fever and bird flu.

On the external front, the risks of a further worsening trend of euro area and global economies moderated in relative terms. Favourable signals come from the US-China negotiations, especially after the two countries signed a preliminary trade agreement. In addition, the uncertainties about Brexit faded. Although the UK-EU Withdrawal Agreement was signed, the results of the negotiations on a possible free trade agreement, as well as the extension of the transition period remain uncertain. At the same time, risks are associated with the possible escalation of geopolitical tensions likely to fuel the fundamental vulnerabilities facing some emerging markets. Another risk factor that has recently emerged refers to the possible spread of the coronavirus outbreak, with potential effects on the international commodity prices, already partly reflected in oil prices. Its contingent effects could include the weakening of China's economy, with adverse consequences on global growth, given China's high integration in global value chains. Opposite effects, stimulating economic growth, may stem from a possible monetary policy easing by the ECB and the Fed. The actions that some central banks in the region may take continue to be relevant, given both the local and global contexts.

The balance of risks posed by international commodity prices is assessed to be in equilibrium. In this context, the future developments in energy prices, particularly oil prices, are marked by heightened uncertainties. In the short run, inflationary pressures could stem from escalating geopolitical tensions in the Middle East or the measures to cap the oil supply taken within the OPEC+ agreements. In the medium and long term, however, these pressures could be offset by both demand-side factors – a lower energy consumption worldwide, amid a slowing global economy, and supply-side factors – the USA becoming a net oil exporter.

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

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