INFLATION REPORT

August 2020

Summary

Developments in inflation and its determinants

In 2020 Q2, the annual CPI inflation rate followed the downward trend visible since early this year and neared in June the mid-point of the variation band of the flat target, standing at 2.58 percent compared to 3.05 percent in March. The disinflationary trend owed mainly to the large fall in fuel prices given the plummeting international oil prices induced by the strong contraction of aggregate demand amid the health crisis and the uncertainties about the trajectory of the global economic recovery. At the same time, however, the simultaneous occurrence of demand- and supply-side shocks, arising from the measures taken to flatten the epidemic curve, put the annual adjusted CORE2 inflation rate on a relatively stable course, coming in at 3.7 percent at quarter-end. Under the impact of these developments, in June, the annual CPI dynamics stood 0.1 percentage points below the latest macroeconomic projection (in the May 2020 *Inflation Report*). Moreover, in the course of Q2, the average annual HICP inflation rate continued to count among the highest across the EU Member States, closing, however, part of the gap with the EU average.

Contrary to forecasts, the annual adjusted CORE2 inflation rate continued to post fast dynamics in 2020 Q2 too, running only 0.1 percentage points below the March level. On the demand side, the slowing wage growth and households' more cautious behaviour, in view of the uncertainties about the future economic situation, caused the output gap to fall deeply into negative territory in Q2. The influence of demand conditions was counterbalanced by the health crisis-specific supply-side developments: the closure of shopping centres, the contraction of activity (by reducing the number of employees), alongside additional costs generated by the adoption of protective measures. Looking ahead, it is difficult to anticipate how persistent each of the two categories of shocks will be, while in the short run, at end-Q2, the annual core inflation rate exceeded significantly the previously-projected value (+0.3 percentage points) as a result of underestimating the magnitude of the supply shock to economic agents.

In 2020 Q1, the annual growth rate of unit labour costs economy-wide came in at 6.7 percent, running above the previous quarter's 5.8 percent reading. Given that the COVID-19 pandemic effects are seen to fully become manifest in Q2, unit labour costs are estimated to jump significantly during this period, following a much larger decline in economic activity than the adjustment on the labour market – this behaviour was prevalent during the past recession and will probably be a feature of the present crisis as well, considering the broad government support for retaining employees through furlough schemes. The data available for the industrial sector show the annual growth rate of unit wage costs picking up markedly in April and decreasing mildly in May (45.3 percent and 33 percent respectively, against an average of about 13 percent in the last four quarters). Leaving aside the impact of firms' recourse to furlough schemes, the change in unit wage costs is similar in terms of magnitude to that seen during the previous recession.

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

The global economy and its outlook have been strongly affected by the major adverse impact and the unprecedented uncertainty generated by the coronavirus pandemic, alongside the containment measures imposed by the authorities. In turn, the National Bank of Romania's response in this context was prompt. Specifically, the NBR Board convened for an emergency meeting on 20 March 2020 and adopted a package of measures aimed at mitigating the economic impact of the pandemic, but also at consolidating liquidity in the banking system so as to ensure the smooth functioning of the money market and of other financial market segments, as well as the smooth financing of the real economy and the public sector.

Thereafter, statistical data confirmed the severe economic impact of the coronavirus pandemic. Thus, the annual CPI inflation rate remained unchanged in March at 3.05 percent and then fell to 2.68 percent in April (from 4.0 percent in December 2019). The annual adjusted CORE2 inflation rate tended however to increase slightly during the first four months of 2020, contrary to forecasts, reaching 3.73 percent in April from 3.66 percent in December 2019. The evolution owed to changes in the consumption structure brought about by social distancing measures, associated also with probable disruptions and cost increases in production and supply chains, overlapping persistent demand-pull and wage cost-push inflationary pressures. According to preliminary data, economic growth slowed down visibly in 2020 Q1 to 2.4 percent from 4.3 percent in the previous quarter, in spite of remaining particularly robust in the first two months of the year. At the same time, the trade deficit posted a markedly faster widening amid a steeper decline in exports than in imports of goods and services. Consequently, the dynamics of the current account deficit regained momentum[1], the improvement in the primary and secondary income balances notwithstanding.

Financial market conditions improved after the adoption of the monetary policy decisions and after the end-March peak in tensions generated by the COVID-19 crisis. Key interbank money market rates witnessed a significant downward adjustment in the closing 10-day period of March and afterwards continued to decline gradually, while yields on leu-denominated government securities went down progressively, amid the increased volume of liquidity injected by the NBR through bilateral repo operations and through purchases of leu-denominated government securities on the secondary market. At the same time, the EUR/RON exchange rate saw lower

[1] Subsequently, the revisions of balance-of-payments statistics did not confirm the renewed widening of the current account deficit.

fluctuations, moving in a narrow range, *inter alia* amid an improvement in global financial market sentiment.

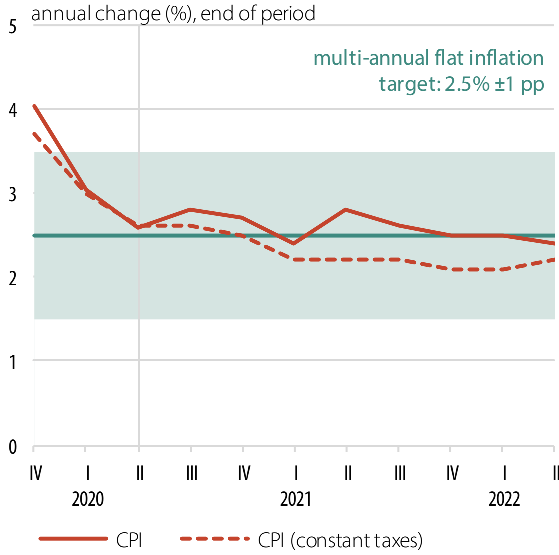
In the meeting of 29 May 2020, based on the available data and assessments, as well as considering the extremely high uncertainty, the NBR Board decided to lower the monetary policy rate to 1.75 percent per annum, from 2.00 percent per annum, as of 2 June 2020. Moreover, the NBR Board decided to cut the deposit facility rate to 1.25 percent per annum from 1.50 percent per annum and the lending (Lombard) facility rate to 2.25 percent per annum from 2.50 percent per annum. Furthermore, the NBR Board decided to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. Given the liquidity shortfall on the money market, the Board decided that the NBR should further conduct repo transactions and continue to purchase leu-denominated government securities on the secondary market, keeping financial market stability. At the same time, the NBR Board stressed that it would seek to maintain international reserves, forex ones included, at an optimal level.

Furthermore, in view of the elevated uncertainty surrounding economic and financial developments, the NBR Board decision to suspend the previously announced calendar of monetary policy meetings was kept in place, with monetary policy meetings to be held whenever necessary. In addition, the NBR Board underlined that the decisions aimed to ensure and preserve price stability over the medium term in a manner conducive to achieving sustainable economic growth and amid safeguarding financial stability.

Inflation outlook

The current baseline scenario is fraught with multiple interlinked sources of risks and especially of uncertainty, stemming primarily from developments in the public health situation. The contraction – unprecedented in recent history – induced by the spread of the novel coronavirus led to large bottlenecks in global value chains and significant spikes in international financial market volatility. Against this background, economic agents' plans have been severely disrupted and, until the situation returns to normalcy, downside risks to economic activity are expected to prevail. Even in the absence of adverse risks materialising, the recovery of the economies, implicitly that of Romania, is anticipated to be slow. Conversely, the worsening of the epidemic, in a scenario whose probability to materialise has increased, would only fuel the challenges to the authorities' set of measures, given the gradual exhaustion of their room for manoeuvre. Therefore, significant future reconfigurations of the baseline scenario coordinates are likely, insofar as the current sources of uncertainty are progressively clarified.

Inflation forecast



Source: NIS, NBR projection

The baseline scenario of the macroeconomic projection is based on the assumption of keeping the epidemic under control nationwide, which would help avoid the reintroduction of broad-based administrative social-distancing measures in the future. Nevertheless, the recent resurgence in the number of SarsCov-2 infections and implicitly the recent extension of the alert state by another month add to the uncertainty about the gradual normalisation of economic activity. Under the circumstances, for 2020 as a whole, the annual GDP growth rate is expected to post a significant negative value, close to those recorded at the height of the 2008-2009 economic crisis, while income losses at aggregate level are anticipated to be fully recovered within at least a year.

Similarly to the previous *Inflation Report*, the record levels of uncertainty reached in the recent period are expected to weigh mainly on investment dynamics, as the implementation of a number of government programmes aimed to support corporate financing, although having in principle a favourable impact, is unable to clarify the duration and outcome of the crisis, two key variables for companies' investment decisions. The contraction in the disposable income of households and their extremely prudent behaviour, reflected in a higher precautionary saving rate, and the low availability of certain categories of goods and services will probably cause a relatively abrupt discontinuation of the favourable trend of consumption seen in recent years. Conditional on how the medical crisis evolves, the persistence of a wary consumption behaviour of households should not be ruled out, despite the financial support from the government-backed labour retention schemes.

The outlook for a broader contraction in trading partners' economic activity compared to that projected for Romania is seen to translate into a slight deterioration of this year's current account deficit, i.e. above 4 percent of GDP for the third year in a row. This is also anticipated amid a budget deficit widening significantly beyond the EU-defined prudential limits, given the increase in government spending to mitigate the effects of the public health crisis, alongside significant government revenue losses occasioned by the sizeable economic downturn. Hence, the analysis of the determinants of budget deficit dynamics also highlights a rise in public spending, under the action of automatic stabilisers triggered by the countercyclical fiscal policy conduct in the current context.

Given the still presumably temporary nature of the pandemic shock, the assumption of the contraction in economic activity this year being reflected mainly in the dynamics of the cyclical component (output gap) is reconfirmed. However, the prospects of a limited and non-persistent impact on potential GDP will become uncertain should the medical crisis linger on. The negative output gap, expected to open widely as early as 2020 Q2, will be relatively persistent, as it is expected to fully close no sooner than the final part of next year. This assessment is strictly conditional on the implementation of the package of stimulative measures recently adopted by the authorities, with the monetary and fiscal policy conduct having a favourable, stronger impact during the current year.

The build-up of significant disinflationary pressures following the contraction in economic activity is likely to put the annual CPI inflation rate on a downtrend and keep it inside the variation band of the flat target, reaching 2.7 percent at the end of this year and 2.5 percent at the end of the next. Compared to the previous *Inflation Report*, the indicator recorded new downward revisions, albeit of a smaller magnitude, by 0.1 percentage points for December 2020, whereas for the end of next year it is expected to post a relatively similar value.

Over the short term, unlike the headline index, the annual core inflation rate continued to be under greater inflationary pressures than in the previous *Inflation Report*, which were associated mainly with the influence of supply-side shocks in the specific context of the medical situation. In the medium term though, the projection reconfirms the start of a more significant downward correction of the annual adjusted CORE2 inflation rate, with broadly-based and persistent disinflationary pressures from aggregate demand – including via the foreseen worsening of labour market conditions – anticipated to gradually regain prevalence. Adding to these influences is the somewhat more marked-than-previously-expected weakening of inflationary pressures associated with import price dynamics, especially those foreseen for next year. Therefore, the annual adjusted CORE2 inflation rate was revised slightly upwards for end-2020, namely by 0.2 percentage points to 3.3 percent, and reconfirmed at 2.2 percent for end-2021.

As a conditioning input for the macroeconomic projection, the monetary policy conduct is configured so as to ensure price stability and macroeconomic stability, as well as the smooth functioning of the banking system and financial markets supportive of households and local companies.

The economic impact of the public health crisis on the configuration of the domestic and external environment will continue to shape notable sources of risks and uncertainty in the coming periods. From this perspective, it is still difficult to assess the speed of this process and the degree of symmetry of economic recovery. Specifically, some economies will likely continue to reverse losses consistently, while in others, depending on the economic imbalances already manifest at the beginning of the crisis or accumulated during the pandemic, upturns will alternate with stagnation or even downturns, with a difficult-to-anticipate impact on the future configuration of these economies. In probabilistic terms, the sources of risk from the domestic and external environment appear to be almost on a par at this juncture, and the balance of risks to the annual inflation rate projection is seen tilted, especially in the medium term, to the upside as against the values forecasted in the baseline scenario.

On the domestic front, fiscal and income policies continue to be relevant sources of uncertainty. Specific risks stem from a larger volume of budget expenditures, triggered by a potential extension of the public health crisis either due to an escalation of the unfavourable medical situation at local level, as seen in recent weeks, or associated with a possible worsening of the global pandemic, linked to the onset of the cold season. Moreover, at the time of preparing the baseline scenario, several alternative assumptions were considered as regards the future configuration of social transfers (pensions), yet lacking predictability, in the absence of clearly outlined legal provisions. The medium-term impact of these permanent expenditure increases on the government deficit would be the opposite of that implied by the need to continue the fiscal adjustments related to the excessive deficit procedure against Romania.

Given also the prospective evolution of the current account deficit in the baseline scenario, the absence of a fiscal correction or its late onset would imply a persistence of twin deficits. This carries the potential to weaken the resilience of Romania's economy in the event of other adverse shocks over the medium term and, in the near run, it may affect the financing of these deficits in adequate volumes and at reasonable costs.

A source of risk specific to the present pandemic context is the potential prevalence of adverse supply-side shocks over a longer period, with an impact mostly on the adjusted CORE2 index, especially if the public health crisis lingers on or intensifies. Their slower fading would lead to additional inflationary pressures that would have an immediate impact on the prices of essential goods and services and, over the medium term, as the health crisis is resolved, could be visible in the majority of sectors hit by closure/restraint of activity. At the same time, the net impact on the annual CPI inflation rate from other types of risk factors is marked by considerable uncertainty: the across-the-board spread of African swine fever, weaker harvests of certain crops, grains in particular, downward pressures on the natural gas price in the context of market decentralisation starting with 1 July 2020 or the medium-term outlook for the oil price following the historical lows recorded earlier this year.

Monetary policy decision

In view of the characteristics of the new macroeconomic forecast and the related extremely high uncertainty, likely to trigger two-way risks to the inflation outlook over the projection horizon, the NBR Board decided in its meeting of 5 August 2020 to cut the monetary policy rate by 0.25 percentage points to 1.50 percent per annum. Moreover, it decided to lower the deposit facility rate and the lending (Lombard) facility rate by 0.25 percentage points each to 1.00 percent and 2.00 percent per annum respectively. Furthermore, the NBR Board decided to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. Given the liquidity shortfall on the money market, the Board decided to further conduct repo transactions and continue to purchase leu-denominated government securities on the secondary market, while safeguarding financial stability.