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N O T E

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

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Foreword

In August 2005, the National Bank of Romania adopted a new monetary policy strategy, i.e. inflation targeting. This regime is based primarily on the anchoring of inflation expectations to the inflation target announced by the central bank and therefore on efficient communication with the public. Inflation Report is the main means of communication.

To this end, the National Bank of Romania revised both the structure and the frequency of Inflation Report which has become a quarterly publication in accordance with the frequency of the forecast cycle. In addition to the information on economic and monetary developments, and on the rationale behind the monetary policy decisions in the reviewed period, the quarterly report includes the NBR projection on inflation rate developments on a six-quarter time horizon and the uncertainties and associated risks, as well as a section dedicated to monetary policy assessment.

Inflation Report was completed on 5 August 2005 and approved by the NBR Board in its meeting of 8 August.

All issues of this publication are available in hard copy as well as on the NBR website (http://www.bnro.ro).

ABBREVIATIONS

AMIGO	Household Labour Force Survey
ANRE	Romanian Electricity and Heating Regulatory Authority
ANRGN	National Authority for Regulation in Natural Gas Sector
CPI	Consumer Price Index
ECB	European Central Bank
EIA	Energy Information Administration (within the U.S. Department of Energy)
EU	European Union
EUROSTAT	Statistical Office of the European Communities
GCF	Gross Capital Formation
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IFS	International Financial Statistics
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
OPEC	Organisation of Petroleum Exporting Countries
ULC	unit labour cost
1W	one week
12M	12 months

Contents

I. SUMMARY

During the first part of 2005, a temporary halt in disinflation became manifest under the impact of primarily supply-side factors, the most significant being the increases in administered prices, excise duties and world oil price. In Q2, the annual inflation rate averaged out at 9.9 percent, 1.1 percentage points higher than in the first 3-month period of 2005.

Persistent excess aggregate demand in 2005 Q1, while lower than in 2004 Q4, also favoured the effects of the supply-side factors being passed onto the growth rate of consumer prices. Excess aggregate demand was driven by the acceleration of domestic demand growth (11.2 percent), as a result of the still high rate of increase in private consumption and of the fast dynamics of investment and government consumption. Behind the developments in domestic demand components stood chiefly the expansion in incomes, due to (i) looser wage policy starting with the latter half of 2004, (ii) higher disposable incomes entailed by the reduction in income tax and profit tax, and (iii) larger public administration payrolls. Apart from these developments, non-government credit, especially foreign exchange-denominated loans, grew at a sustained pace on the background of the economy's still significant euroisation.

Despite the upturn in domestic absorption, the annual GDP growth rate slowed in 2005 Q1 to 5.9 percent, down 3.8 percentage points from the level recorded in 2004 Q4. Nevertheless, the growth rate of consumption outpaced that of gross fixed capital formation, pointing to the need to avoid any additional stimulus to aggregate demand, which would result in higher inflationary pressures, a widening of the current account deficit and would jeopardise the sustainability of economic growth in the longer run.

In Q2, monetary policy implementation continued to be confronted with the risk of higher volatile capital inflows, given the then imminent freeing of non-residents' access to *leu*-denominated time deposits and the still high interest rate differential between domestic and world markets. Apart from inducing a higher liquidity surplus in the banking system, capital inflows imposed constraints on the use of monetary policy instruments. Given the additional constraints on the interest rate policy, the central bank had to specifically tailor the use of its tools, including instruments with direct impact on credit and prudential instruments, while taking into account the current and future effectiveness of monetary policy transmission mechanism.

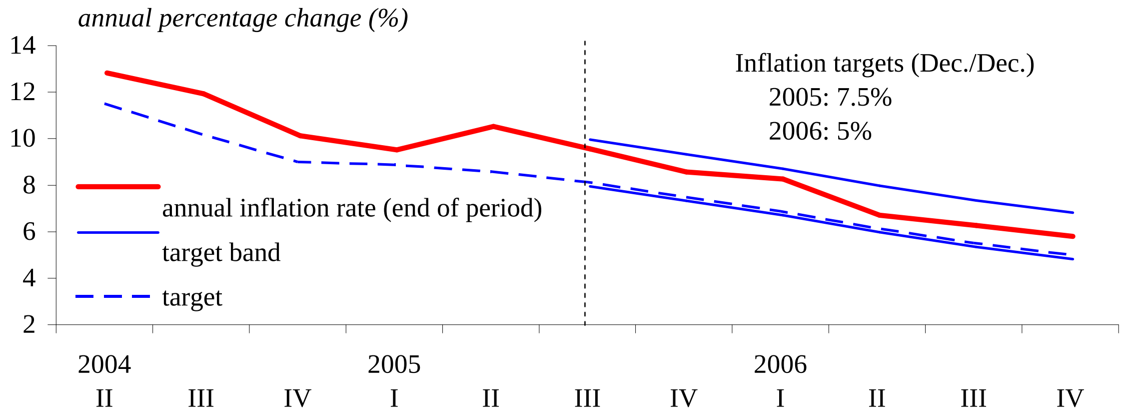
Thus, adequate sterilisation of the liquidity surplus prevented the effects of excess aggregate demand from fully feeding through into the increase in the general price level. As a result of this environment and given the progress in disinflation in the first quarter of 2005, the National Bank of Romania decided in April to reduce the monetary policy rate by two percentage points to 12.5 percent and to keep the effective interest rate on sterilisation operations at 8 percent. The gradual cut in the policy rate, set as the ceiling for interest rates on NBR deposit-taking operations, was aimed at signalling the maintenance of a prudent monetary policy stance, at preserving the expectations of further disinflation, and at containing the quick downtrend in interest rates on bank deposits, while the lower and more variable effective interest rate helped avoid excessive inflows of short-term capital.

The temporary halt in disinflation, together with the confirmation, following the release of statistical data for Q1, of an increase in demand-pull inflationary pressures, as well as the relatively weaker threat of the potentially volatile capital inflows, prompted the central bank to put a halt to policy rate cuts in the second half of Q2; subsequently, the policy rate was prudently left unchanged at 12.5 percent. The steady nominal appreciation of the domestic currency against the euro contributed significantly to maintaining tight monetary conditions during 2005 Q2.

According to the baseline scenario, disinflation will resume in 2005 Q3, with the annual inflation rate being expected to gradually approach the target set for end-2006. Over the forecast horizon, the increase in administered prices is seen as the strongest exogenous source of inflationary pressures; in addition, temporary increases in some food prices are also expected in the short run as a result of floods. Estimates point to a positive output gap, with near-term inflationary pressures still in place. Assuming that fiscal policy, income policy and external demand will not significantly constrain excess aggregate demand, the central bank should adjust the monetary policy stance in order to phase out excess aggregate demand, in a manner consistent with the need to attain the inflation target.

Given current and future economic conditions, the NBR Board's assessment of the risks that could endanger the achievement of the inflation target revealed that, on the one hand, further tightening of monetary policy is needed. On the other hand, it is imperative that the central bank resort to the most effective monetary policy instruments, as the risk of a rise in potentially volatile capital inflows has proved to be persistent. Furthermore, considering the adoption of inflation targeting in August, with the expectations channel of monetary policy becoming more important and complementing the removal of the structural component of excess demand, the Board has reiterated the need to increase the transparency and consistency of monetary policy signals. Against this background, with a view to boosting the signalling role of the policy rate, the NBR Board has decided to eliminate the temporary departure between the policy rate and the effective sterilisation rate by unifying them at a level of 8.5 percent, half of a percentage point higher than the average effective interest rate on sterilisation operations in July. Concurrently, the NBR Board has decided to closely monitor any developments that might affect the path of future disinflation, standing ready to take appropriate and prompt remedial measures.

Inflation Forecast



Note: ±1 percentage point on either side of targeted inflation path

II. INFLATION DEVELOPMENTS

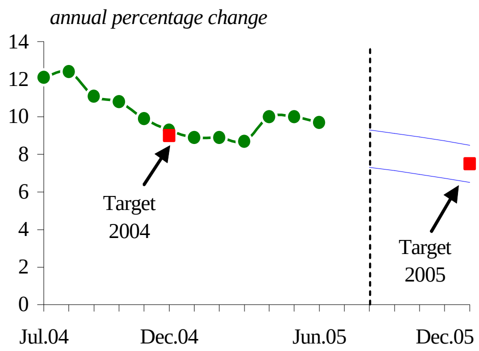
In 2005 Q2, disinflation came to a halt as the average annual growth rate of consumer prices rose to 9.9 percent, 1.1 percentage points above the previous quarter's reading. In the reported period, the developments in inflation were largely influenced by supply-side shocks due to both domestic and external factors. However, robust consumer demand helped the direct effects of such pressures feed through into the other consumer prices.

Supply-side factors that caused the reversal in the downtrend of annual inflation rate were the following: (i) adjustments of administered prices, particularly the prices for natural gas[1] and water, sewerage and refuse collection; (ii) implementation of a new stage of harmonising excise duties with those in the EU, the heaviest impact on consumer price increases having the hike in excises levied on fuels, tobacco, cigarettes; (iii) growing sensitivity of domestic operators to the movements in world oil prices, as mirrored by the weekly revision of fuel prices; (iv) scant supply of fresh fruit and vegetables because of adverse weather conditions (low temperatures, storms, floods).

These influences were unevenly distributed during 2005 Q2. In April, the annual growth rates of administered prices and fuel prices went up in a range from 3 percentage points to 5 percentage points against March. In May and June, the favourable effects of abating pressures detected for these two categories of prices were partly offset by the faster growth of fruit and vegetables prices, whose 12-month rates advanced from 5.2 percent in April to 9.1 percent in June.

The heightening pressures the administered and volatile prices put on the general price level are also highlighted by the wider spread between inflation rate and CORE2[2], from an average of 1.1 percentage points in 2005 Q1 to 2.1 percentage points in 2005 Q2. The spread could reach about 2.6 percentage points by excluding from CORE2 the impact of changes in indirect taxes in April-June 2005, namely the raise in excise duties on tobacco and alcohol combined with the removal of VAT exemption in regard to cable TV operators.

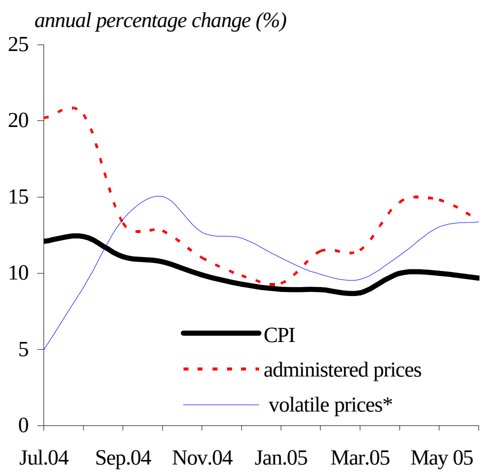
Inflation Developments



Note: ±1 percentage point on either side of targeted inflation path

Source: NIS, NBR calculations

Inflation Rate



*) products with volatile prices: vegetables, fruit, eggs, fuels

Source: NIS, NBR calculations

[1] The effects of the increase in the price of domestically-produced natural gas (applied in order to narrow the gap between domestic and import prices) were heightened by the April change to the billing system whereby a monthly subscription was introduced. Two months later, the authorities decided to revert to the former billing system.

[2] See Box 1.

Administered Prices versus Market Prices

annual percentage change (%)

	2004			2005	
	II	**III**	**IV**	**I**	**II**
Inflation Rate	**12.3**	**11.9**	**10.0**	**8.8**	**9.9**
Administered prices	**18.3**	**17.9**	**11.2**	**10.8**	**14.3**
1. Non-food items:	**18.9**	**17.2**	**12.1**	**12.0**	**16.5**
electricity	28.1	30.7	17.7	12.5	12.5
heating	0.0	0.0	10.4	12.0	12.0
natural gas	51.5	36.1	22.2	21.6	45.2
medicines	-5.3	-6.6	–6.9	1.4	1.0
2. Services, of which:	**17.1**	**18.2**	**9.8**	**8.9**	**11.0**
water, sewerage, refuse collection	22.3	23.2	23.4	22.4	27.8
telephony	14.1	15.4	–0.1	3.1	4.3
passenger railway transport	12.0	17.5	19.2	14.6	12.0
(passenger) city transport	16.8	16.4	17.0	16.3	21.0
Market prices (CORE1)	**10.6**	**10.1**	**9.5**	**8.2**	**8.5**

Source: NIS, NBR calculations

Manufacturing prices were not accountable for the halt in disinflation, as their annual growth rates followed the downward trend manifest in the previous two quarters. This owed mostly to (i) stronger nominal appreciation of the domestic currency versus the major currencies, (ii) larger exposure of the productive sector to external competitive pressures and to stiffer competition in the retail sector and (iii) the favourable influence of costs associated with some non-energy raw materials. Their favourable influence offset the negative impact of larger ULC and costlier energy inputs. Thus, the slower growth of gross average wage notwithstanding, the 12-month rate of increase of ULC stepped up 4.6 percentage points against 2005 Q1 following the drop in productivity gains[3]. Although this was mainly the result of the developments in some sectors having a limited direct impact on consumer prices (except energy and tobacco processing sectors), the tensions attributed to this cost item in food industry and particularly light industry[4] should not be ignored. Moreover, during January-June 2005, world prices of oil and natural gas skyrocketed, the large changes being reflected by above-average annual growth rates of domestic prices in hydrocarbons extraction and oil processing sectors.

Inflationary pressures were dampened by (i) prices of animal products, thanks to increased supply and heightened competition stemming from the fact that some large operators (supplying meat, milk and dairy produce) saw their market shares increasing, and (ii) prices of imported consumer goods, amid the steadily stronger *leu* in nominal terms and relatively flat prices on this market segment.

CPI by Category of Products

annual percentage change (%)

	2004			2005	
	II	**III**	**IV**	**I**	**II**
Food, beverages, tobacco	12.4	11.4	9.8	8.1	8.0
Wearing apparel and footwear	7.8	7.2	6.0	5.5	4.9
Household appliances, furniture	7.3	7.0	6.7	6.5	6.0
Fuels	13.2	15.6	20.1	15.8	18.3
Utility expenses*	24.1	23.2	18.4	16.5	23.0
Healthcare	2.7	1.7	0.9	4.9	4.5
Transport	14.7	15.2	15.8	15.3	19.0
Post and telecoms	15.4	14.2	1.0	-0.7	-0.4
Leisure and culture	11.2	10.9	8.7	8.5	7.5
Other goods and services	6.5	6.3	6.6	6.9	6.3

*rent, water, sewerage, refuse collection, electricity, heating, gas
Source: NIS, NBR calculations

Under the impact of the above-mentioned factors, the average annual growth rate of non-food prices reached 13 percent and that of services prices stood at 10.7 percent, up 2.6 percentage points and 1.3 percentage points respectively from 2005 Q1. Disinflation was manifest only in the case of food prices, their growth rate slowing 0.6 percentage points to 6.4 percent.

On the demand side, the potential inflationary pressure arising from household consumption remained high in 2005 Q2. Behind this development stood the following: (i) further high growth rates of net wages (about 13 percent in real terms) after the tax easing performed earlier in the year, the rise in gross minimum wage, wage bargaining in the private sector, pay increases in the budgetary sector and (ii) larger household resort to funds extended by banks and non-bank financial institutions

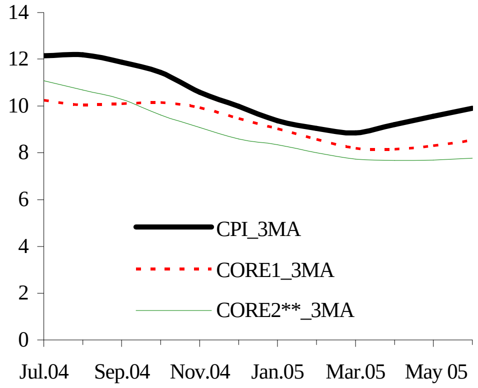
[3] From annual rates upwards of 10 percent during 2004 to 7.1 percent in 2005 Q1 and 3.1 percent for April-May 2005.
[4] Annual growth rates in these sectors are still high (15-35 percent).

such as leasing and consumer credit companies amid further falling interest rates and the strengthening of the domestic currency against the euro. At aggregate level, the output gap forecast[5] for the 3-month period under review points to excess demand, which hints at the risk of overheating.

Although supply-side shocks were mostly accountable for the rise in inflation in 2005 Q2, robust consumer demand helped their feeding through into the other consumer prices, as illustrated by the slower disinflation determined by CORE2 adjusted by the effects of the change in indirect taxes than in Q1. The relative worsening of inflation expectations also played a role – the banks participating in the NBR survey for April-July 2005 expected the pace of decline in the annual rates of inflation to slow down and medium-term interest rates to rise.

Trend* in Inflation Rate

annual percentage change (%)



*) compiled on a 3-month moving-average basis
CORE1 (which strips out administered prices)
CORE2 (which strips out administered and volatile prices)
**) including the effects of indirect tax adjustment

Source: NIS, NBR calculations

In 2005 Q2, the 12-month inflation rate was 0.9 percentage points above the short-term forecast prepared in March. The deviation was attributed to:

(i) larger-than-expected increase in the natural gas price in April (the authorities only announced the magnitude of the price hike, without mentioning the impact of the introduction of a monthly subscription);

(ii) heightened volatility of the oil price on the world market[6], which hampered the assessment of its impact on domestic fuel prices the more so as the swings concurred with the effects of the increase in excise duties and the strengthening of the US dollar by almost 8 percent versus the euro in April-June 2005 (in contrast to the steady evolution envisaged by the forecast).

Even though the spread between the forecasted and the actual ROL/USD exchange rates also affected other categories of market prices, their contribution to the negative gap between the forecasted and the actual inflation rates in the reported period was insignificant, given the small weight of items such as mobile telephony services and cable TV operators in the CPI basket and fierce competition among providers of these services.

The forecasts of the other exogenous variables, i.e. the ROL/EUR exchange rate and net average wages, were close to the actual levels.

[5] Based on quarterly changes.
[6] March saw the highest volatility over the past three years (except December 2004).

Box 1

Core inflation

The shift to inflation targeting requires an adequate framework for decision-makers, which implies having in place and using a measurement of inflation relevant for monetary policy decisions.

It is universally accepted that the consumer price index – an indicator the general public is most familiarised with, which is used by most central banks in defining the inflation target – reflects the impact of some factors that are beyond the control of the monetary authority such as the adjustments in administered prices and in taxes, adverse weather conditions or oil market shocks. Despite their significant impact on inflation rate, such short-lived shocks do not require monetary policy responses, as they are usually reversible and do not affect inflation expectations. In order to separate the effects of such shocks, inflation is decomposed into a transitory component and a permanent component – core inflation – that mirrors the persistent sources of inflationary pressures and, owing to its lower volatility, is more relevant for monetary policy decisions and easier to forecast than headline inflation.

Professional literature features several methods to construct core inflation. In order to single out the most adequate measure, the following criteria must be met: (i) it should be available in a timely manner for decision-making purposes and revisions must not be frequent; (ii) distortions can be removed so that the trend of the time series should not be systematically different from the trend of inflation rate, thus obviating the possibility of sending false signals, and (iii) it should be readily verifiable, which is essential for ensuring credibility.

The National Bank of Romania chose, like most central banks, to determine core inflation by using the exclusion method, i.e. CORE1[*] which strips out administered prices from headline inflation and CORE2[*] which, apart from excluding administered prices, strips out highly-volatile prices, i.e. those of fresh fruit and vegetables, eggs, fuels. The main reason behind this option was that this method is a simple one, which is essential in ensuring good communication with the public, especially when it comes to introducing a new concept. Moreover, the importance of this selection criterion was underscored by the need to avoid potential credibility erosion that could arise from the fact that the institution whose main objective is to attain a certain inflation target is, at least for the time being, the same as the one calculating core inflation.

The most common approaches to deriving measures of core inflation include:

- **moving averages**, by determining the inflation trend; however, this time series is not available in timely manner, as the observation at a specific moment should be based on both past and future information (in the case of centred moving averages);
- **exclusion** of some products from the CPI basket, which are believed to have a substantial contribution to inflation volatility or which are affected by supply-side shocks;
- **trimmed mean** (including **median**); the upshot of this method is an index obtained as a weighted average of an ordered distribution of price changes, by removing in advance a certain percentage of the lowest and the highest price changes;
- **Edgeworth index**, by recalculating the weights in the CPI basket, highly volatile components being associated with lower weights.

*) For lack of fixed base indexes, calculations took into account the monthly growth rates of prices.

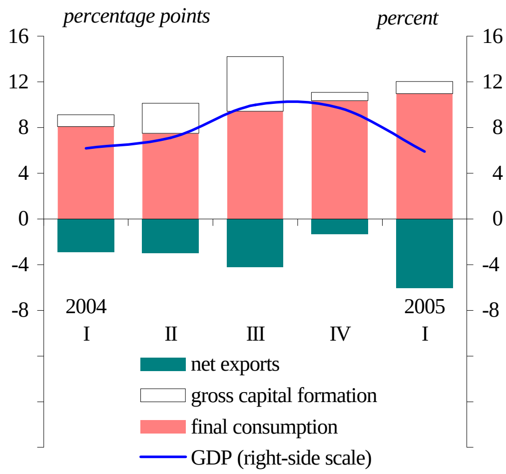
III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2005 Q1, economic growth rate slowed 3.8 percentage points from the previous quarter to 5.9 percent[7]*. However, the output gap remained positive, pointing to further excess aggregate demand.*

On the supply side, although all four sectors of the economy saw lower growth rates than in 2004 Q4, it was mainly agriculture that depressed GDP growth, with a contribution of only 0.1 percentage points (compared to 3.7 percentage points). By excluding the incidental influence of agriculture, the slowdown in economic growth was of only 0.9 percentage points.

Contribution of Main Demand Components to GDP Growth



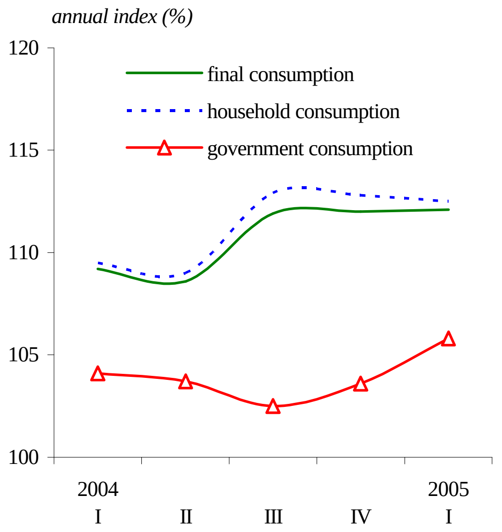
Source: NIS, NBR calculations

1.1. Demand

The change in the pattern of economic growth seen in the previous quarter, when final consumption became the main engine of economic expansion to the detriment of investment, persisted into the period under review. While final consumption continued to witness significant growth rates (12.1 percent), the rate of increase of gross fixed capital formation (5.2 percent), albeit higher than in the previous period, was still below the average recorded in the first three quarters of 2004, i.e. 12.5 percent.

In 2005 Q1, the contribution of net external demand to economic growth worsened by 4.6 percentage points owing to the strong acceleration in the growth rate of imports (amid inadequate domestic supply and the strengthening of domestic currency against the major currencies), with the growth rate of exports remaining unchanged from the previous quarter.

Actual Final Consumption



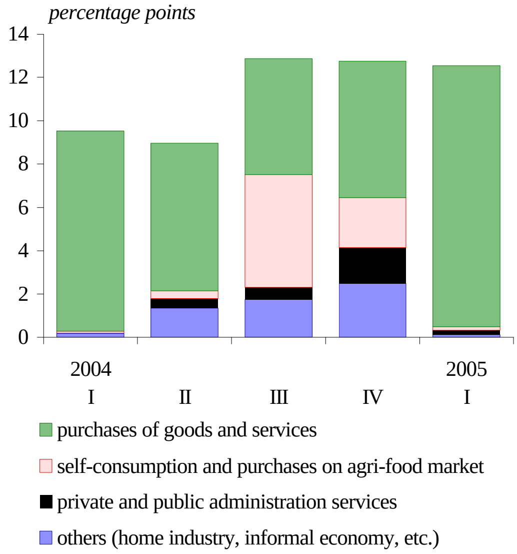
Source: NIS

1.1.1. Consumer demand

Over the period, final consumption grew at a pace similar to that seen in the previous quarter; nevertheless, in terms of structure, household consumption slowed down somewhat, while government consumption recorded an unexpectedly fast post-election increase. However, the significant inflationary potential of household consumption remained high given that its slackening was solely the result of the slower pace of

[7] Unless otherwise indicated, the growth rates in *Section III. Economic developments* are annual percentage changes.

Final Household Consumption Growth



Source: NIS, NBR calculations

increase in self-consumption and consumption of public and private administration services, whereas the growth rate of purchases from the commercial network posted a steep rise.

Household consumer demand

In spite of the slight deceleration in the annual growth rate of household actual consumption (down 0.3 percentage points against the previous quarter to 12.5 percent), in 2005 Q1, inflationary pressures from consumer demand picked up, with the growth rate of purchases of goods and services speeding up, from 11 percent to 15.9 percent. The expansion of the main component of private consumption was propelled by the rise in incomes[8] (as a result of the introduction of flat tax rate, hike in the gross minimum wage, wage bargaining in the private sector and indexations in the public sector) and by still readily-available loans[9] (the downtrend in interest rates, particularly on *leu*-denominated loans, and the appreciation of the domestic currency against the euro). Moreover, new resources were provided by (i) the development of the instalment buying system promoted by big suppliers of household appliances and electronic products including via partnerships concluded with consumer credit companies and (ii) the extension of leasing purchases.

The faster growth rate of purchases of goods concurred with the slower growth rate of sales in the industries producing non-durables and durables for the domestic market[10], so that it may be asserted that the larger consumer demand was met by imported goods rather than by domestically-manufactured goods.

As far as the structure of private consumption is concerned, the impact of the step-up in purchases of goods and services from the commercial network was offset by the fivefold deceleration in the growth rate of self-consumption and purchases from the agri-food market (to 2.5 percent) and by the decline in individual services supplied by public and private administration (to 1.9 percent); this development was not surprising considering that, in 2004 Q4, the growth rates of those indicators were influenced by the bumper agricultural year and the election period.

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[8] The growth rate of net real average wage added 1.6 percentage points to 13.1 percent quarter over quarter.

[9] In 2005 Q1, the annual growth rate of new short- and medium-term loans granted to individuals went up over the previous quarter. The growth rate of *leu*-denominated loans reverted to positive readings (+5.2 percent in real terms, from -20.1 percent), while that of EUR-denominated loans increased almost six times.

[10] Except for road transport means industry

Government consumption demand

The quicker growth rate of actual final government consumption (5.8 percent) was unusual for a post-election period (compared to the 3.5 percent quarterly average in 2004), being attributable particularly to the larger number of the personnel in public administration[11].

Budgetary developments

Contrary to expectations, in 2005 Q1, the faster rate of increase of the actual final government consumption was accompanied by a positive gap between revenues and expenditures of the consolidated general government budget (0.1 percent of GDP), which is indicative of a relative drop in public investment spending.

The consolidated general government budget balance improved versus 2004 Q1[12], while the quarterly primary surplus doubled. The weight of budget revenues in GDP increased by 0.1 percentage points, while that of expenditures declined by 0.1 percentage points.

The introduction of the 16 percent flat rate tax on incomes and profits starting with 2005 produced partial effects in the first three months of the year. Thus, receipts from income tax contracted from 0.7 percent of GDP in 2004 Q1 to 0.6 percent of GDP in 2005 Q1, whereas collections from profit tax picked up year on year, from 0.5 percent to 0.6 percent of GDP, as a result of the base effect[13]. In year-on-year comparison, the receipts from social security contributions and those from other direct taxes saw an increase in their shares in GDP, from 2.1 percent to 2.2 percent (following the hike in wages[14] and the larger payrolls) and from 0.2 percent to 0.3 percent respectively (as a result of the twofold increase in the tax on micro-enterprises turnover). By contrast, revenues from excise duties diminished year over year, from 0.7 percent to 0.6 percent of GDP, particularly owing to exchange rate developments, whilst revenues from VAT posted a level similar to that recorded in 2004 Q1 (1.7 percent of GDP).

General Consolidated Budget

percent of GDP

	2003	2004	2004	2005
	IV	I	IV	I
Revenues	**8.5**	**6.7**	**8.3**	**6.8**
Profit tax	0.7	0.5	0.8	0.6
Income tax	0.8	0.7	0.8	0.6
Social security contributions	2.7	2.1	2.7	2.2
VAT	2.1	1.7	1.9	1.7
Excise duties	1.0	0.7	0.9	0.6
Expenditures	**10.1**	**6.8**	**9.2**	**6.7**
Staff costs	1.4	1.2	1.4	1.3
Materials expenditures	2.8	1.5	2.4	1.4
Interest payments	0.4	0.3	0.3	0.3
Subsidies	0.8	0.6	0.5	0.5
Transfers	3.2	2.7	3.1	2.7
Capital expenditures	1.4	0.5	1.5	0.5
Primary expenditures	9.7	6.5	8.9	6.4
General Consolidated Budget (balance)*	**-1.6**	**-0.1**	**-0.9**	**0.1**
Primary surplus (+)/deficit (-)	-1.2	0.2	-0.6	0.4

*) calculations based on IMF methodology

[11] The number of personnel in public administration rose by 5.8 percent.
[12] When the consolidated general government budget built up a deficit of almost 0.1 percent of GDP
[13] In 2005 Q1, most revenues from profit tax came from receipts for 2004 Q4 (when a 25 percent tax was levied) while, in 2004 Q1, those revenues came from collections for 2003 Q4 (including the 12.5 percent tax on export earnings).
[14] The wages of the personnel in the public sector rose by 6 percent starting January 2005.

The fall in expenditures compared to the same year-ago period was almost solely the result of smaller shares of subsidies and material expenditures in GDP, by 0.1 percentage points each. Capital outlays, transfers and public debt-related interest payments remained unchanged as percentage of GDP compared to 2004 Q1, while staff costs went up following the rise in the wages of public sector employees at the end of the previous year and at the beginning of the current year.

The fiscal deficit target for 2005 was lowered from 1.5 percent to 0.74 percent of GDP as a result of the budget revision in early July. The narrowing of the budget deficit envisaged the much steeper cut in expenditures than in revenues. The share of expenditures declined by 1.6 percentage points of GDP (mainly on the back of transfers, capital outlays and public-debt-related interest payments)[15], whereas that of revenues dropped by 0.9 percentage points of GDP (by decrease in receipts from income tax, excise duties and other direct and indirect taxes).

1.1.2. Investment demand

Investment

annual percentage change (%)

	Year	I	II	III	IV
Total	2004	7.2	12.0	18.1	1.7
	2005	4.8			
- new construction	2004	7.6	9.6	13.3	6.9
works	2005	0.9			
- equipment	2004	14.9	26.4	38.4	5.5
	2005	7.0			
- others*	2004	–30.7	–40.2	–38.8	–37.6
	2005	10.3			

* vineyards, orchards, afforestations, livestock purchases

Source: NIS

In the reviewed period, the annual growth rate of gross fixed capital formation accelerated by 2.5 percentage points quarter over quarter to 5.2 percent, failing however to reach the levels seen in the first nine months of 2004. Behind this development stood the equipment purchase (including transport means) and the upturn of investment in agriculture; the growth in the volume of new construction works slowed down (-6 percentage points) to almost one percent.

Mention should be made that, according to available statistical data, the 7 percent step-up of investment in equipment (up 1.5 percentage points compared to 2004 Q4) appears to be attributed to purchases of transport means rather than to retooling of the economy given that (i) the increase in the annual rate of domestic sales of capital goods was due to road and non-road transport means[16], whilst the volume of domestic sales of "machinery and equipment" and "electrical machinery and apparatus" – including goods for investment – saw a decrease; (ii) statistical data provided by the Automotive Manufacturers and Importers Association show a sharper rise in the number of imported vehicles than in the previous quarter; (iii) the value of imports of capital goods considered as gross fixed capital formation witnessed a slower increase, from

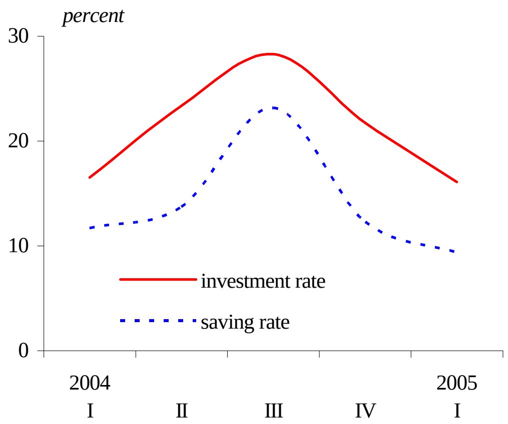
[15] The cut in transfers and capital outlays envisaged primarily external loans granted to ministries, government budget, local budgets and budget of the Roads and Motorway National Company.

[16] From +21.3 percent to +32.5 percent and from -9.5 percent to +7.8 percent respectively. Nevertheless, mention should be made that the first component includes also motor vehicles for individuals (which, according to the national accounts methodology, fall into the category of consumer goods).

36.4 percent to 19 percent, a development ascribable primarily to the volume component, considering the insignificant influence of price movements[17].

After having recorded successive decreases starting 2003 Q4, investment in agriculture saw a turnaround in 2005 Q1, increasing by 10.3 percent. The explanation lies with the approaching EU integration, given that during the reported period livestock purchases surged, with imports contributing markedly; to this also contributed the beginning, on 1 April 2005, of the reference year set by the authorities to measure the milk output of each farm with a view to establishing the annual output quotas.

Investment Rate and Saving Rate



Note: investment rate is the ratio between gross capital formation and GDP; saving rate is the sum between gross capital formation and current account deficit as a share of GDP

Source: NIS, NBR calculations

1.1.3. Net external demand

The eightfold increase in the unfavourable gap between the growth rate of import volumes and that of export volumes compared with 2004 Q4 entailed a surge in the negative contribution of external demand to GDP growth (to 6 percentage points, the highest reading in the past six years). Given that the annual growth rate of exports remained unchanged at 8.8 percent, the development was driven by the considerable step-up in the real growth rate of imports of goods and services to 18.4 percent, against the background of a further relatively low capacity of domestic supply to meet demand and the significant strengthening of the domestic currency against the euro (+9.4 percent against -0.3 percent in 2004 Q4). Balance of payments data suggest that although the pick-up in final demand contributed significantly to the 8.4 percentage point acceleration in the growth rate of imports this development was, to a larger extent, the result of the rise in intermediate consumption (crude oil, natural gas, metals, meat).

Trade Composition According to National Accounts System

percent

	Exports (fob)		Imports (cif)	
	2004 IV	2005 I	2004 IV	2005 I
Total, of which:	100.0	100.0	100.0	100.0
Capital goods	7.9	6.7	17.7	15.2
Intermediate goods	52.9	53.9	60.6	64.2
Consumer goods	35.8	34.4	17.3	16.2

Source: NIS

In 2005 Q1, the flat annual growth rate of exports may be ascribed to:

(i) the decline in the growth rate of EU demand for imports (the annual rate of increase of EU25 imports from non-member states went down to 9.2 percent from 12.4 percent in 2004 Q4);

(ii) the weaker influence than in the previous year of favourable developments on some foreign markets (metals, chemicals);

(iii) the lower competitiveness of most basic products intended for exports (metal products, electrical machinery

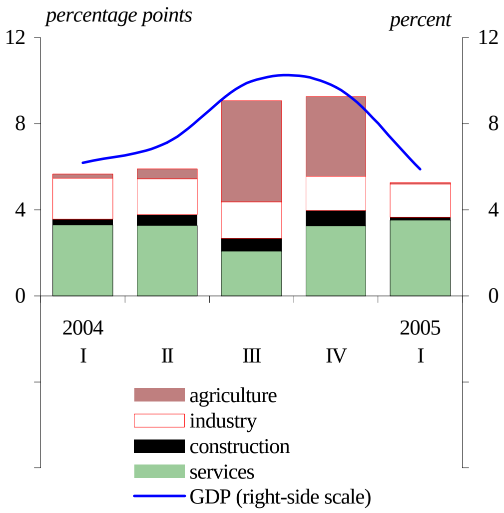
[17] The annual growth rate of prices of capital goods exported by the EU25 reached 0.2 percent, up only 0.4 percentage points compared to the previous quarter.

and apparatus, and especially light industry[18] goods, which faced greater difficulties because of world market liberalisation and removal of export quotas for China[19]).

However, there were products which recorded a faster increase in exports (particularly transport means and some metal products).

1.2. Supply

Contribution of Main Supply Components to GDP Growth



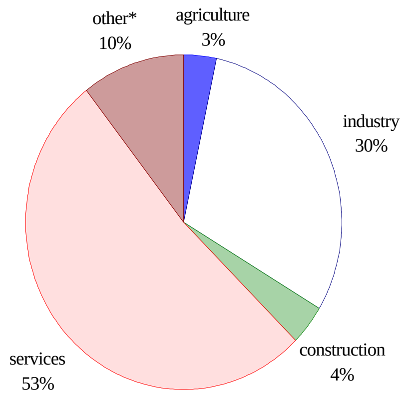
Source: NIS, NBR calculations

The weaker GDP growth in 2005 Q1 was the result of the slowdown in all four sectors of the economy, particularly in agriculture which posted a merely 1.8 percent growth rate compared with 27.6 percent in the previous quarter.

After the positive supply-side shock of agricultural output in the last two quarters of 2004, services resumed their position as main driver of GDP growth (+3.5 percentage points). The 0.3 percentage point decrease versus 2004 Q4 in the growth rate of gross value added of services was associated with the slowdown in industry and construction, and it was probably seen in wholesale trade, transport of goods and services for enterprises. On the contrary, retail trade continued to advance on the background of structural changes brought about by the enhanced market share of hypermarkets and supermarkets.

In industry, behind the decrease in the growth rate of gross value added (from 6.8 percent to 5 percent) stood not only the lower external demand, but also the persisting difficulties in matching supply to domestic (final and intermediate) demand in most industries[20], which caused the annual rate of domestic sales of industrial goods to decelerate 5 percentage points to 0.6 percent.

GDP Formation in 2005 Q1



*) net taxes on product and adjustment of financial intermediation services indirectly measured

Source: NIS, NBR calculations

In construction, the growth rate of gross value added slowed 5.3 percentage points to 3.8 percent due particularly to "residential buildings", which suffered the impact of (i) cessation, in early 2005, of works via the National Housing Agency due to the lack of funds; (ii) blocking of projects, mainly because of ambiguous legal status of some plots; (iii) delay in concluding some contracts caused by the recalculation of selling prices after the considerable strengthening of the domestic currency against the euro and the related renegotiations.

[18] Annual ULC rates (based on the wage expressed in euro) increased in a range from 7 percentage points to 33 percentage points compared with the previous quarter.
[19] Following the expiry on 1 January 2005 of World Trade Organisation Agreement on textiles and wearing apparel.
[20] Except for oil processing and coal coking industry, transport means industry, and light industry which saw increases of up to 17 percentage points in the growth rate of domestic sales.

2. Labour market[21]

Unemployment rate hit a 13-year record low, pointing to further pressures on the labour market[22], despite the weaker demand for additional labour. The introduction of the flat tax rate had different impacts on labour costs and consumer demand: while the annual growth rate of gross wage slowed down (also due to net wage bargaining in some private sectors of the economy), partly offsetting the unfavourable developments in labour productivity in industry, the fast-paced annual growth in net wage spurred private consumption.

2.1. Labour force

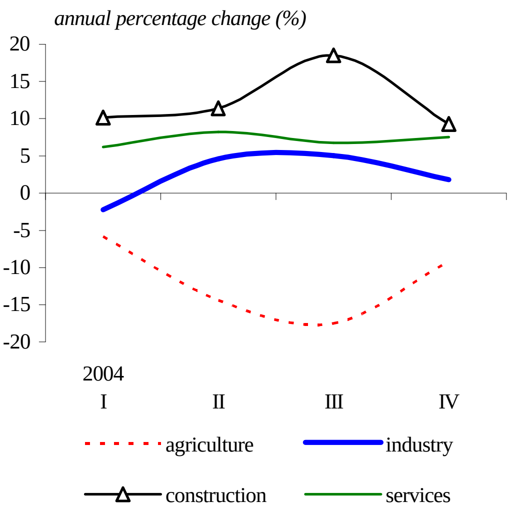
The first indications of the weaker demand for additional labour appeared in 2004 Q4, as illustrated by both the AMIGO survey and the records of the National Employment Agency (NEA). The AMIGO survey pointed out the slowdown in the annual growth rate of employment in the secondary and tertiary sectors (5.4 percent compared to 7 percent in 2004 Q2 and Q3) and the NEA showed that the number of openings it had identified shrank by more than 40 percent from 2004 Q3. Although in 2005 Q1 the number of vacancies identified by the NEA was noticeably higher than the prior period figure, it contracted by roughly 12 percent year on year, a trend that continued into April as well.

The possible reasons behind this development are the following:

(i) slower economic growth, particularly in the secondary sector;

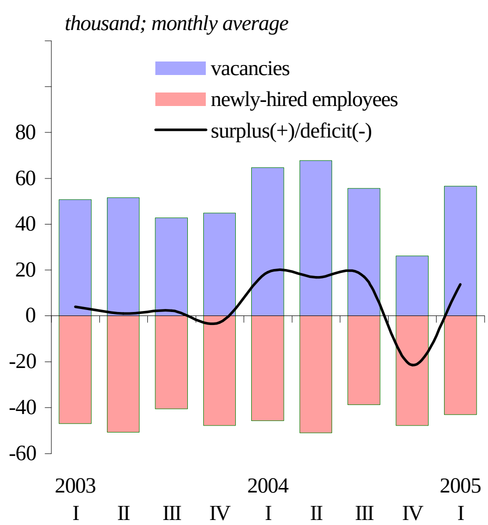
(ii) contraction in the number of hirings with a view to improving efficiency indicators, given that in some sectors, the growth rate of labour productivity[23] was below that of wages for several quarters, and competition in the tradables sector stiffened on both domestic and external markets. The faster rise in the annual growth rate of payrolls economy-wide January through May 2005 cannot be attributed to larger demand for labour alone, but also to the formalisation of some labour contracts following the loosening of the fiscal policy;

Employment by Sector



Source: NIS - AMIGO

Number of Vacancies and Number of Filled Vacancies

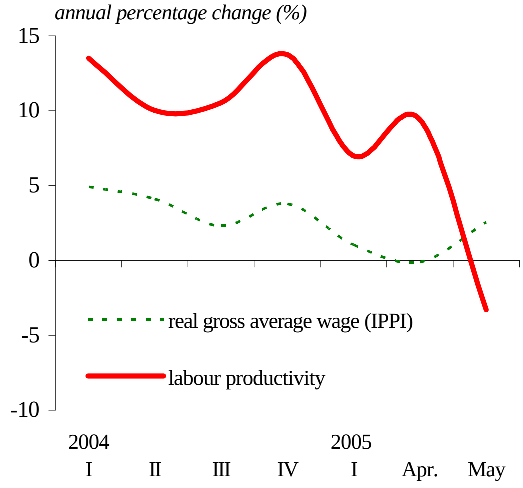


Source: NEA

[21] Unless otherwise indicated, data analysis in terms of dynamics in this section was based on the comparison with the same year-earlier period.
[22] Labour market pressures stem from the employers' difficulties to find staff with the required qualifications and skills, which may entail the rise in the wage subject to bargaining.
[23] Calculated as the ratio of the annual index of GVA in an economic sector to the annual index of the employed in the respective sector.

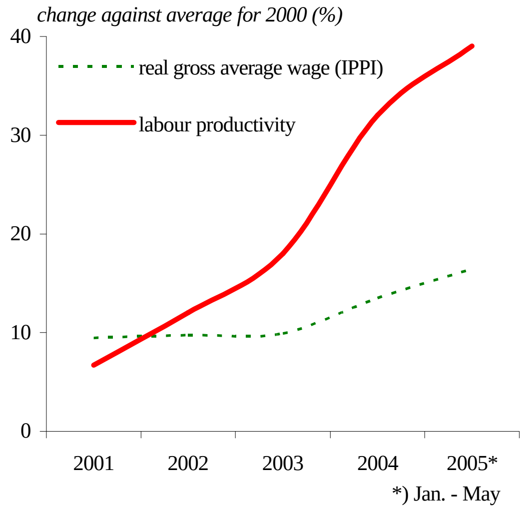
(iii) difficulties encountered by employers in identifying appropriately qualified staff, disclosed by some companies and suggested by the above par ratio[24] (1.32:1), recorded in 2005 Q1, between the number of openings identified by the NEA and the number of the newly employed.

Gross Wage and Labour Productivity in Industry (a)



Source: NIS, NBR calculations

Gross Wage and Labour Productivity in Industry (b)



Source: NIS, NBR calculations

Given the 35.5 percent decline in lay-offs compared to 2004 Q1 and the considerably smaller number of unemployed not entitled to benefits who renewed their applications for a job, as well as of the persons requesting registration with the NEA in order to benefit from the minimum guaranteed income (categories with small chances of finding a job due to their low professional skills), excess labour supply shrank in early 2005, the registered unemployment rate moving down to 6.2 percent and 5.6 percent respectively in 2005 Q1 and Q2 from an average of 7.8 percent in 2004 Q1.

2.2. Incomes

In contrast to the previous quarters, when the real growth rates of gross average wage and net wage economy-wide were similar, in 2005 Q1, the growth rates of the two indicators differed (7.1 percent and 13.1 percent respectively) as a result of the introduction of the flat tax rate.

The rise in gross wage was generated by (i) the increase in minimum gross wage economy-wide to ROL 3.1 million[25] (ROL 3.3 million according to the national collective labour contract signed by labour unions and employers), (ii) the pay rises and annual bonuses in the public sector in January, and (iii) the wage bargaining in the private sector amid still tight labour market conditions. Nevertheless, due to net wage bargaining in some segments of the private sector[26] (where the introduction of the flat tax rate favoured the employers), the annual rate of gross wage slowed down compared to the prior quarters[27], helping alleviate cost-push pressures.

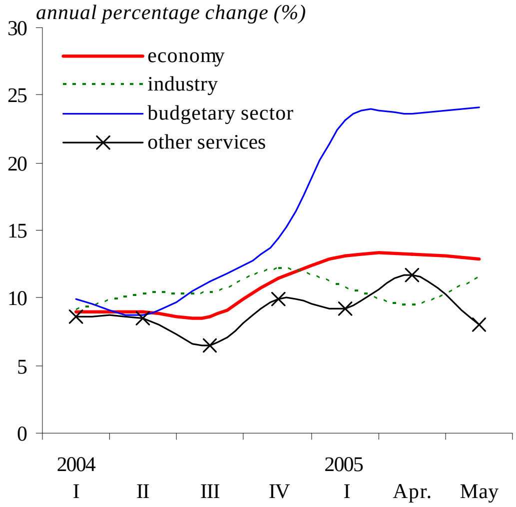
[24] Similar to 2004 Q1-Q3.
[25] Government Decision No. 2346 of 14 December 2004.
[26] This practice was manifest particularly in the private services sector (where the annual growth rate of gross real wage declined to around 1 percent) and in some industrial sectors.
[27] Moreover, even where gross wage was subject to negotiations, the introduction of the flat tax rate may have eased pressures put by employees and reduced employers' readiness to increase wages.

In industry[28], particularly in the export-bound sectors, the favourable impact of the slower growth in gross wage on unit labour costs was however offset by the slower annual growth rate of productivity (to 7 percent from 13.7 percent)[29]. Despite recent developments, the productivity gains achieved in January-May 2005 were still considerably higher than those recorded in 2000 – the year which marked the beginning of the present economic expansion – productivity gains outpacing significantly the growth rate of gross real wage.

On the demand side, the 1.6 percentage point advance in the annual growth rate of net real average wage compared to the prior quarter further boosted household consumption; a similar impact had the annual growth rates in pensions (14.2 percent in real terms) and in inflows of compensations of employees and private transfers[30] (25.9 percent) – despite the fact that they were lower than those recorded in 2004 Q4.

April and May 2005 saw no significant changes from the prior quarter as regards wage developments and their influence on both consumer demand and nominal unit labour costs in industry; the annual growth rate of the nominal unit labour cost stepped up 4.6 percentage points to 12.5 percent as a result of the sharp drop in labour productivity in May. It is noteworthy the persistence or even acceleration in the high growth rate of ULC in the sectors having a significant bearing on consumer prices (food industry, light industry, energy sector) despite the relative improvement achieved in the previous quarter.

Net Real Wage*



*) deflated by CPI

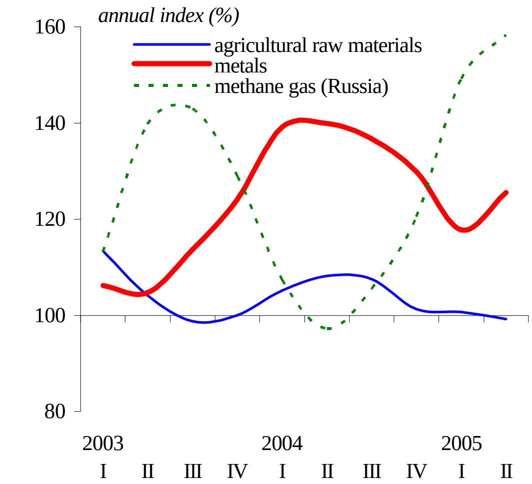
Source: NIS, NBR calculations

[28] The only sector for which data on labour productivity in 2005 Q1 are available.

[29] The positive spread between labour productivity growth in industry and the rise in gross real wage (deflated by IPPI) narrowed by 4 percentage points compared to 2004 Q4.

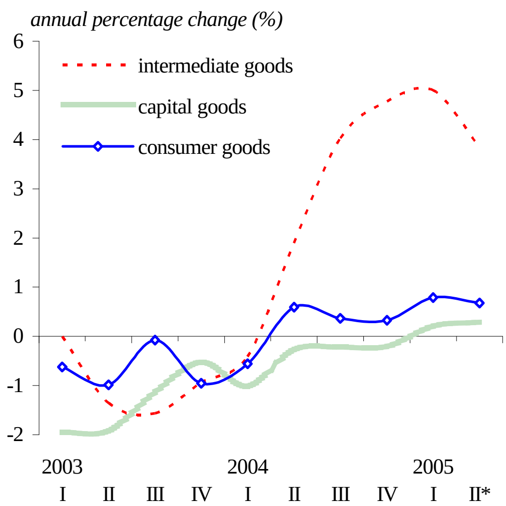
[30] They were however subject to erosion from the nominal appreciation of the national currency against the euro (up 10.5 percent in January-May 2005 versus the same year-earlier period).

Commodity Prices on International Markets



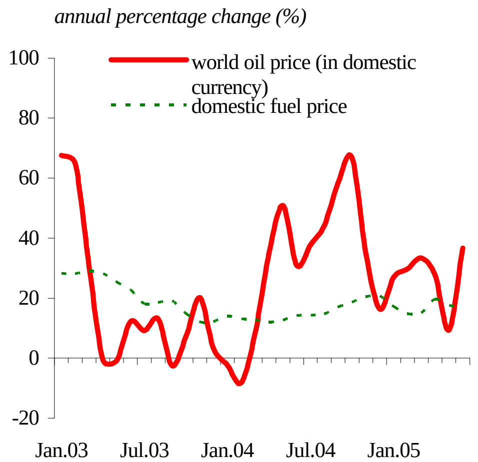
Source: IMF

EU-25 IPPI and Its Components



Source: Eurostat *) April - May

Oil and Fuel Prices



Source: NIS, EIA

3. Import prices and producer prices

The first quarter of 2005 saw mixed developments in cost-push inflationary pressures, given that the slowdown in the growth rate of industrial producer prices for the domestic market, the improved conditions on the agri-food market and the marginal change in prices for imported consumer and capital goods were accompanied by large movements in imported energy prices. The same trends in prices seem to persist in 2005 Q2 as well, save prices for vegetal products which are expected to see a trend reversal.

3.1. Import prices

In 2005 Q1, import prices brought about higher pressures than in the previous quarter, as the growth rate of the unit value of imports was faster than in 2004 Q4 (5.9 percent versus 3.6 percent). Given the small movements in the unit value of imports of goods originating in the European Union (Romania's main trading partner[31]), which posted an annual growth rate of merely 0.5 percent, less than one percentage point above the figure seen in the final three-month period of 2004, this development could largely be attributed to the stepped-up increase in prices for mineral products[32] supplied particularly by non-EU markets; import prices for natural gas, which rose at a faster annual pace (from 20.6 percent in 2004 Q4 to 49.3 percent), exerted the largest inflationary pressures. Import prices for the other commodity groups holding a significant share in the CPI basket – vegetal products, foodstuffs, wearing apparel and footwear – posted favourable developments; the decline or deceleration of their growth rates in the reviewed period bolstered disinflation on the domestic market.

The trends seen in 2005 Q1 are likely to continue in Q2, given that: (i) prices for natural gas on the world's markets further headed upwards in April-May, posting a cumulative growth rate of 58.3 percent as compared with the same year-ago period; (ii) the annual growth rate of oil price continued to decrease slightly (from 49.4 percent in Q1 to 45.6 percent[33] in Q2), as a result of the favourable developments in April and May[34] (the oil price resumed the upward course in June and hit a fresh high of USD 58.5 per barrel at mid-year); (iii) the pressures exerted

[31] Accounting for more than 60 percent of imports.
[32] Ore, coal, crude oil, petroleum products, natural gas.
[33] Based on prices of Brent oil.
[34] Following the sharp rise in early April which fed through instantly into domestic fuel prices.

by import prices of industrial goods remained low[35], mainly in capital goods and consumer goods sub-sectors.

The developments in the exchange rate of the *leu* had different effects on domestic prices in 2005 Q1. On the one hand, the nominal appreciation of the domestic currency against the euro, which continued in Q1 and Q2 (albeit at a slower pace in the latter period), was supportive of disinflation; on the other hand, the weaker *leu* in USD terms in April-June 2005[36] enhanced the spike-up in inflationary pressures exerted by imported energy prices.

3.2. Producer prices

3.2.1. Industrial producer prices

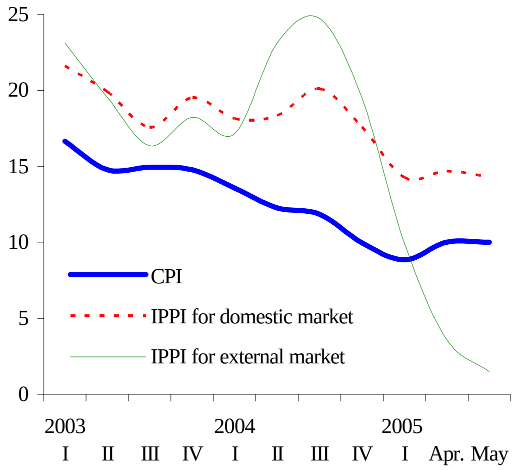
Industrial producer prices for the domestic market entered a downward trend in 2005 Q1, their annual rate of increase falling to 14.3 percent from 17.6 percent in the previous quarter. Thus, the positive gap between the growth rate of industrial producer prices and that of consumer prices narrowed. The favourable developments in some raw materials costs (meat, metals, wool) and the stronger domestic currency offset the impact of the hikes in utility prices; thus, the growth rates of producer prices slackened in most industrial sectors. A trend reversal was reported in mining, mainly in hydrocarbons extraction (where producer prices added 7.8 percentage points to 29.6 percent as compared with the previous three-month period), which further put large pressures on producer costs in the oil processing sector.

In manufacturing, the increase in producer prices posted an even sharper slowdown (4.2 percentage points to 13.7 percent) as a result of lower raw materials costs in some sectors and fiercer competition. The developments in unit labour costs constituted an additional factor that put a damper on the change in producer prices in some industries such as food, machinery and equipment, road transport means, furniture. However, in manufacturing as a whole, little progress was made as regards slowdown of the increase in unit labour costs, their annual rate standing at 7.9 percent in 2005 Q1 (slightly higher than in the previous quarter).

Industrial producer prices for the foreign market also experienced slower growth (their annual rate dropping to 9.9 percent in 2005 Q1 from 19.5 percent in 2004 Q4), due solely to the nominal appreciation of the domestic currency; when adjusted by the developments in the exchange rate, the

Consumer Prices and Industrial Producer Prices

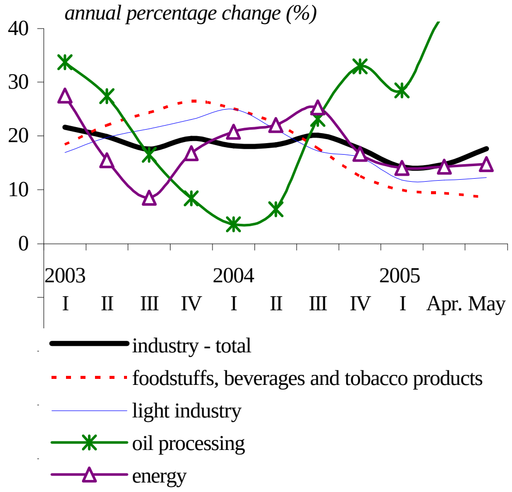
annual percentage change (%)



Source: NIS

Producer Prices* of Selected Consumer Goods

annual percentage change (%)



*) for the domestic market

Source: NIS

[35] EU25 industrial producer prices (except construction and energy) for the non-domestic market increased year on year by merely 1.4 percent in April-May 2005, after having risen by 1.9 percent in Q1.

[36] See Sub-section *Exchange rate and capital flows*.

annual rate of industrial producer prices for the foreign market stepped up 1.1 percentage points.

The second quarter of 2005 saw considerable changes in prices for natural gas and fuels[37]; however, the rate of increase of producer prices for the domestic market in most manufacturing sub-sectors stayed on a downward drift in April-May, due possibly to the stiffer competition in those sub-sectors and to the fact that part of the agreements with utility providers were concluded prior to April. As regards exports, the downtrend in industrial producer prices strengthened, due largely to developments in metallurgy and oil-processing sectors. In the latter case, the explanation for the divergent developments in producer prices for the domestic and foreign markets could lie with the alignment to a lower extent of domestic prices to those on the international market; thus, the change in the oil price fed through into domestic prices to a larger extent.

3.2.2. Agricultural producer prices

Agricultural producer prices rose 0.8 percent in the first quarter of 2005 as compared with the final quarter of 2004[38]. The main driver of this increase was the 3.4 percent hike in prices for animal products (particularly beef, poultry and milk), despite the drop by 7.7 percentage points versus 2004 Q4 in their growth rate. The price increases for animal products may further be ascribed to the contraction of domestic supply and the producers’ attempt to recover through prices their losses and/or their previous investments. The same as in the previous quarter, the nearly one percent drop in the prices for vegetal products was due to cheaper grains. By contrast, prices for fruit and vegetables posted accelerating growth rates, due possibly to poor supply, as well as to the fact that vegetable products get stale faster when they are stored improperly.

The growth rate of prices for animal products is likely to remain on a downward course in 2005 Q2. Specifically, statistical data available for April and May are indicative of the alleviating tensions on meat and milk markets, which could be detected in the previous quarter. Moreover, keener competition in those sectors, induced by the strengthening of market shares of large companies, following the takeovers and acquisitions concluded in the preceding year, is illustrative of the continuation of the above-mentioned trends. However, a trend reversal is expected in the vegetal products sector, as a result of the impact of adverse weather conditions on the supply of fruit and vegetables.

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[37] The annual growth rate of prices in hydrocarbons extraction and oil processing sectors stepped up 17 percentage points and 13.6 percentage points respectively in April-May against January-March.

[38] The data series related to agricultural producer prices is available starting with January 2004 only, so that no comparison can be made between the annual growth rates in 2004 Q4 and 2005 Q1.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In accordance with Law No. 312/2004 on the Statute of the NBR, which came into effect on 30 July 2004, the primary objective of monetary policy is "to ensure and maintain price stability". In the context of the provisions referred to in the abovementioned law, in 2005 Q2 the central bank's monetary policy stance was aimed at ensuring sustainable disinflation on short term and, especially, medium term.

Against the backdrop of a relatively lower constraint – in the latter half of the period under review – imposed on monetary policy by the higher risk of volatile capital inflows starting with 2004 H2, the central bank discontinued the reductions in the policy rate, which had been initiated in June 2004. The gradual and prudent cut in the policy rate, in keeping with the progress in disinflation, was aimed at preserving the expectations of further disinflation. The last stage of the policy rate reduction was in April 2005 when the NBR Board decided to lower the ceiling of interest rates on deposit-taking operations[39] by 2 percentage points to 12.5 percent, a level which was kept unchanged. Along with this move, the decline in the average effective interest rate on NBR deposit-taking operations was halted, steadying around a monthly average of 8 percent. Thus, the temporary gap (which has been manifest since January 2005) between the two key interest rates of the NBR narrowed but persisted through the period. The central bank considered this gap as the least harmful solution to the conflict between the need to keep on hold inflation expectations and to avert the drop in interest rates on bank deposits, on the one hand, and the primary importance attached to depressing volatile capital inflows, on the other. In this environment, the steady nominal strengthening of the domestic currency against the euro contributed significantly to maintaining tight monetary conditions.

Given that the major constraint imposed, starting 2004 H2, by the increase in potentially volatile capital inflows on monetary policy implementation continued to prevail in 2005 Q2 (especially in the first part), the central bank was confronted

[39] Taking into account the downward trend of money market rates in the last few months, the central bank decided in April to reduce the interest rate on the deposit facility to 4 percent from 5 percent and the interest rate on the lending facility to 20 percent from 25 percent.

with the well-known dilemma concerning the level of interest rate. Thus, on the one hand, the NBR was aware of the fact that a possible drop in interest rate to a level depressing capital inflows would have induced an unsustainable increase in aggregate demand; on the other hand, assuming the central bank had avoided lowering of interest rate to a level which would have provided an additional stimulus to aggregate demand, inflows of speculative capital would have been fostered. The latter solution would have represented another dilemma of the central bank which should have been tackled either by accepting a stronger appreciation of the *leu* against the euro or by enhancing the efforts and costs associated with sterilisation of capital inflows.

The NBR opted for a mixed approach, consisting in: (i) a more flexible exchange rate (November 2004), which materialised in stronger appreciation of the *leu* against the euro and (ii) gradual and prudent cut in policy rate. Moreover, the first few months of 2005 witnessed a temporary departure between the effective sterilisation rate (which was lower) and the policy rate, in order to avoid having a strong influence on inflation expectations. Even under the circumstances, the central bank had to continue to intervene in the forex market and to enhance sterilisation efforts, which had as a result a considerably lower impact of aggregate demand on inflation performance.

Against this backdrop, the NBR considered that the higher risk of potentially volatile capital inflows prevailed in early April given that, on the one hand (i) the freeing of non-residents access to *leu*-denominated time deposits was imminent and (ii) the interest rate differential between domestic and world markets was still high and, on the other, (iii) disinflation continued to follow a trajectory compatible with attaining the annual inflation target. In this environment, the central bank cut the policy rate by 2 percentage points. Moreover, the effective interest rate on sterilisation operations was set at a lower level, i.e. 8 percent; these moves were aimed at reducing investors' expectations of immediate opportunity gains provided by placements in NBR's instruments.

The lower interest rate differential between domestic and world markets that appeared to have stemmed excessive inflows of volatile capital[40] starting with the latter half of April along with the threat of failing to attain the inflation target for 2005 made the central bank halt the reduction in the policy rate in May and keep it at 12.5 percent.

[40] The volume of capital inflows declined due also to the investors' interest shifting to other financial markets.

Behind this interest rate policy stance stood the central bank's aim to minimise the second-round effects and the unfavourable impact on inflation expectations of some of the supply-side factors which had caused the halt in disinflation in April and the spike-up in inflation in Q2. The annual growth rate of consumer prices increased, reverting to two digits in April (10 percent, up 1.3 percentage points from March), mainly as a result of higher-than-expected increase in administered prices, excise duties and world oil price. Other supply-side shocks (steeper depreciation of the *leu* against the US dollar and unfavourable weather conditions) continued to feed through into consumer prices in the subsequent months, making the annual average inflation rate for the period under review (9.9 percent) stay higher than in the previous quarter.

Another argument behind the decisions of the NBR to pursue a more prudent stance in steering the interest rate was the relative weakening of the impact of the ROL/EUR rate on disinflation, given the considerable slowdown in the appreciation of the domestic currency versus the euro; the *leu* strengthened more slowly against the background of (i) the interbank segment of the foreign exchange market reverting to a deficit, which remained relatively high in the quarter under review although the foreign exchange market (including the exchange bureaux) continued to run large surpluses, (ii) the alleviation of market operators' expectations of potential strengthening of the *leu*, and to a certain extent, (iii) the central bank's foreign exchange purchases. In addition, the year-to-date nominal appreciation of the *leu* had also as an effect an increase in aggregate demand on short term. Thus, this development not only induced re-orientation of expenses from the domestic market to the foreign market, but also provided an additional stimulus to domestic absorption, especially to consumer demand, by spurring household consumption (purchase of imported goods) and depressing saving, taking into account the fast decline in interest rates on *leu*-denominated deposits along with the wealth effect of appreciation of the domestic currency; moreover, strengthening of the *leu* underpinned by its balance sheet effect the expansion of household demand for foreign currency-denominated loans, distorting household sentiment on the risks associated with such loans.

In this environment, given that the fears about the new stage of capital movements liberalisation[41] eased somewhat, the NBR's primary concern became the fast growth rate of domestic demand, thereby posing risks to macroeconomic stability.

[41] Effective from 11 April 2005, liberalisation of non-residents' access to opening *leu*-denominated time deposits proceeded smoothly, without visible effects on the foreign exchange market.

Statistical data released for this period showed the rapid rate of increase of domestic absorption in Q1, fostered mainly by the significant increase in household consumption, whose annual growth rate remained high (12.5 percent compared with 12.8 percent in the previous quarter). The main driver of this behaviour was the rise of household disposable income resulting, on the one hand, from wage hikes towards the end of 2004 in the run-up to the elections and, on the other, from the introduction of the flat tax rate with effect from January 2005. The factors which provided a stimulus to household consumption continued to be manifest in the subsequent months, the specific developments suggesting that fast growth of household consumption continued in Q2 as well. Thus, (i) the annual growth rate of net average wage remained high in real terms (13 percent in April-May); (ii) the upward trend of remittances from abroad accelerated; and (iii) the number of employees economy-wide increased at a faster pace (possibly due also to the migration of labour force from the informal sector to the formal one). As a result, the annual average rates of increase in turnover of retail trade of goods and services were higher during April-May 2005 than in the first part of the year; in addition, during this period, the hypermarkets and supermarkets revised upwards the expected level and/or the dynamics of turnover for 2005. The strong increase in household demand for imported goods contributed essentially to widening of trade deficit, which was 46.4 percent wider during January-May than in the same year-earlier period.

Behind the prudent decisions regarding policy rate stood also the relative weakening of household net financial saving. Thus, the more rapid decline in interest rates on *leu*-denominated time deposits made these placements less attractive, their annual real growth slowing down relatively although the portfolio of Treasury certificates outstanding with individuals continued to restrain. By contrast, starting with April, the trend of annual change in individuals' foreign currency deposits reverted to the upward trend; however, this move failed to fully offset the movement in *leu*-denominated deposits, thereby entailing slower growth of individuals' deposits with banks.

Household loans (especially *leu*-denominated loans) grew at a faster pace, due also to the easing of lending requirements. Thus, March through May the interest rates on *leu*-denominated loans fell faster while the range of promotional banking products expanded, particularly those providing longer maturities for new loans. Household propensity for foreign currency-denominated loans remained high, being fostered by both the stable ROL/EUR exchange rate and the fall in interest rates on such loans. The decline in interest rates on forex-denominated loans was one of the adverse effects of the central bank's decision to increase the minimum required reserve ratio on some of the foreign exchange liabilities starting with the 24 February – 23 March observance period. Moreover, the effectiveness of this step was reduced, at least temporarily, by the response of banks, which increased substantially the funds raised from the international market (by 36.2 percent or EUR 1,242.2 million) prior to the implementation of this decision. Another matter of concern for the central bank was the gradual increase in the share of consumer credit in new household loans.

2. Financial markets and monetary developments

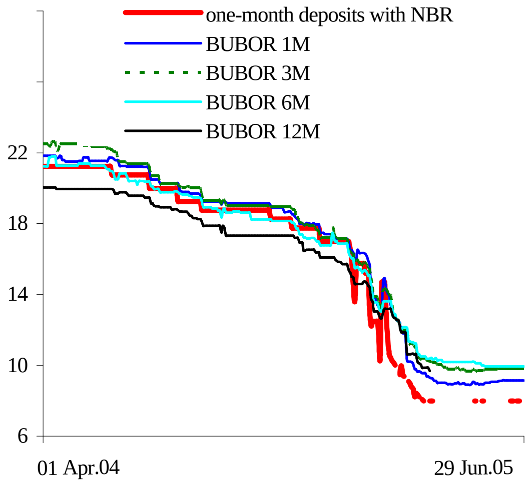
The 11 April move to allow non-residents' access to leu-denominated time deposits proceeded smoothly, without visible effects on the subsequent developments of the interbank segment of the foreign exchange market. Monetary conditions were kept tight; the leu continued to strengthen against the euro while short-term interest rates stabilised. The remonetisation of the economy continued although household saving with banks lost momentum. After declining steadily for 13 months, the growth rate of non-government credit made a U-turn in March, entering an upward trend.

2.1. Interest rates

The resumption by the central bank of the traditional manner of carrying out open market operations, tightening of monetary control and the decision to put an end to the reduction of policy rate starting with May had as a result gradual increase and, subsequently, stabilisation of interbank rates at a level much closer to that of interest rates on NBR's deposit-taking operations; thus, in June, the average interbank rate stood at 7.4 percent, compared with 5.7 percent in March.

Actual Interest Rate on Deposit-taking operations and BUBOR Rates

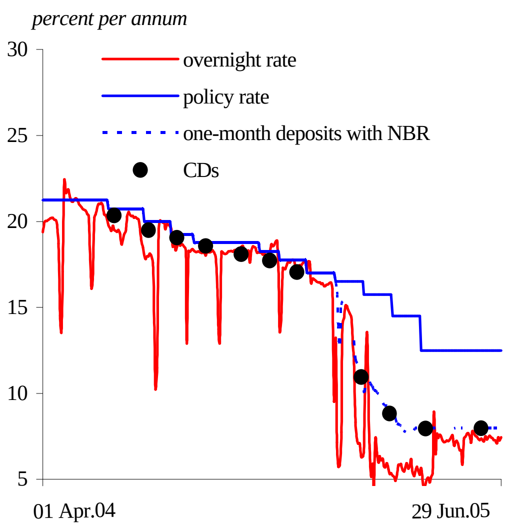
percent per annum



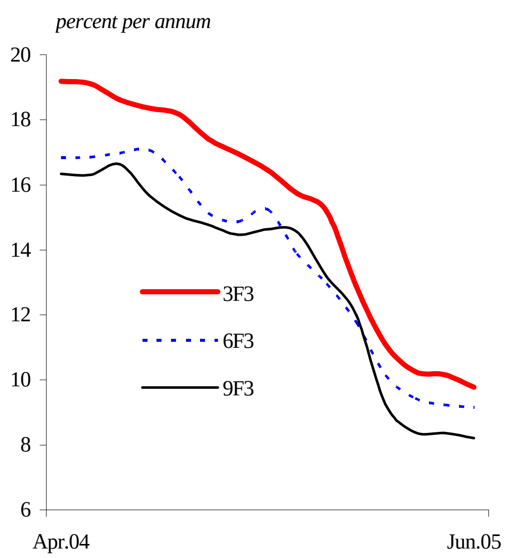
The more important role played by deposit auctions[42] in liquidity-absorbing operations provided a stimulus to bringing the average interbank rate closer to the effective sterilisation rate. In addition, the corridor within which the interbank rates fluctuated narrowed significantly; thus, the average daily interest rates on overnight transactions (which held 90 percent of total interbank transactions) fluctuated in a range of 4.5-7.8 percent, compared with 4.2-16.4 percent in Q1. Nevertheless, at the end of the 24 March – 23 April maintenance period, due to larger-than-expected fluctuation of the autonomous factors of

[42] As confirmed by the 91 percent drop in the use of the deposit facility.

Money Market Rates



Implicit Forward Rates



liquidity[43], some credit institutions ran temporary reserve deficits, being forced to resort to overnight loans whose interest rates went up occasionally to 20 percent[44].

The relatively stable interest rates over the period confined the arbitraging opportunities between various maturities of deposits, the average daily volume of interbank transactions declining by about 20 percent from the level recorded in Q1.

Money market operators' expectations of the pace of the drop in interbank rates moderated, entailing a slower decline in BUBOR rate curve (1 week - 12 months); on average, this curve stood 1.3 percentage points lower at end-June, compared with the end of Q1. The one-week and 12-month BUBOR rates fell the least, i.e. by only 0.9 percentage points and 1.3 percentage points respectively. By contrast, after recording a sharp decline in Q1, overnight rates rose, on average, by 0.22 percentage points from March; as a result, the margin between overnight rates and interest rates on deposits with longer maturities (the difference between monthly averages of 12-month BUBOR rate and overnight BUBOR rate) narrowed from 3 percentage points in March to 1.6 percentage points in June[45]. The spread between overnight BUBOR rate and the interest rates on overnight transactions narrowed on average to 0.6 percentage points in June from 2.2 percentage points in March.

The implicit forward rates, calculated on the basis of effective interest rates for June, show that interbank rates will remain unchanged in the subsequent three months (3-month BUBOR rate is expected to reach 9.8 percent in September, 0.06 percentage points lower than the current level). For December 2005 and March 2006, 3-month BUBOR rate is expected to decline by 0.6 percentage points and 1.6 percentage points respectively, compared with the level for September 2005. According to the results of the NBR survey among banks, the 12-month BUBOR rate is expected to decrease by 0.3 percentage points in August and by 1.7 percentage points until August 2006 (compared with the level recorded at end-June 2005).

Interest rates on the primary market for government securities posted an upward trend as well. However, the interest rates on 2-year bonds declined slightly (by 0.01 percentage points[46]) and

[43] Seasonal absorption of liquidity by the Treasury and increase in demand for cash specific to approaching Easter Holiday overlapped during this period.
[44] After about 2½ years when the lending facility was not resorted to, on 22 April one bank made recourse to this standing facility.
[45] The decline in interest rates on deposits with longer maturities was due also to the drop in risk premium as a result of lower volatility of interest rates.
[46] end of Q2 compared with end of Q1

those on 3-year bonds dropped by 0.2 percentage points in June compared with May.

These developments occurred amid the Ministry of Public Finance accepting at auction bids whose value was about ROL 1,923 billion higher than that of government securities falling due (unlike the previous quarter when net redemptions of government paper equalled more than ROL 18,200 billion). The 3- and 5-year bonds issued at end-June had interest rates of 7.74 percent and 7.80 percent respectively, up 0.99 percentage points and 1.30 percentage points respectively, compared with the levels recorded at end-March 2005.

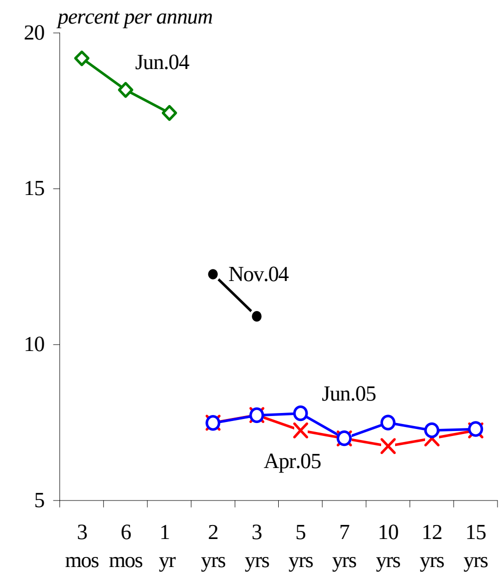
A novelty for the primary market for government securities was the issuance of bonds with maturities of 7, 10, 12 and 15 years in April. By lengthening the maturity of Treasury notes, the Ministry of Public Finance aimed to enhance borrowings on the domestic market, on the one hand, and to diversify the gamut of instruments of government securities market, on the other; the interest rates on these Treasury notes ranged from 6.75 percent to 7.50 percent during April-June.

March through May 2005, the interest rates applied by banks to non-bank non-government clients continued to decline as a pass-through effect of the sharp reduction in the NBR's interest rates in the first three months of 2005. The downward adjustment varied through the period; the interest rates on new deposits recorded the sharpest fall in April, while the interest rates on new loans declined significantly in May. The interest rates on new deposits dropped by 3.4 percentage points during March-May period, about 0.3 percentage points faster than the interest rates on new loans.

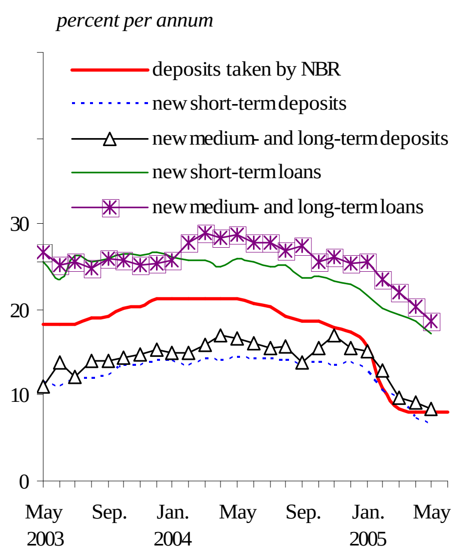
Unlike the previous period, the fall in interest rates was more pronounced in the case of individuals' deposits, reflecting the lag of the pass-through of the reduction in the NBR's interest rate; thus, the average interest rate on new time deposits of individuals edged down 4.4 percentage points while the average interest rate on new loans went down by 6.3 percentage points. The spread between the aforementioned interest rates narrowed due to the fiercer competition on the retail banking market, as banks' market share dropped as a result of the increase in the number of financial companies providing loans to households and of the diversification of the range of their promotional products.

As a result of the reduction in nominal interest rates, during the last two months of the period under review the real interest rate

Yield Curve (Treasury certificates)



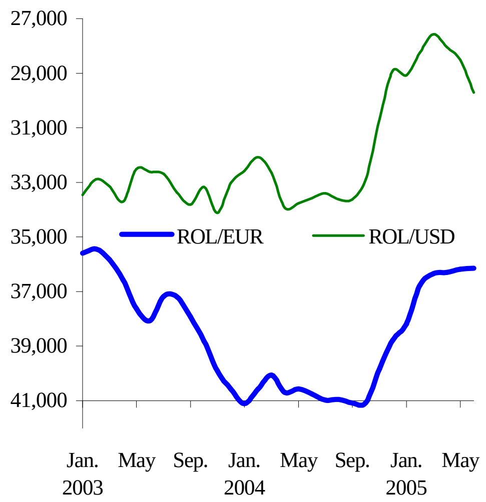
Bank Rates



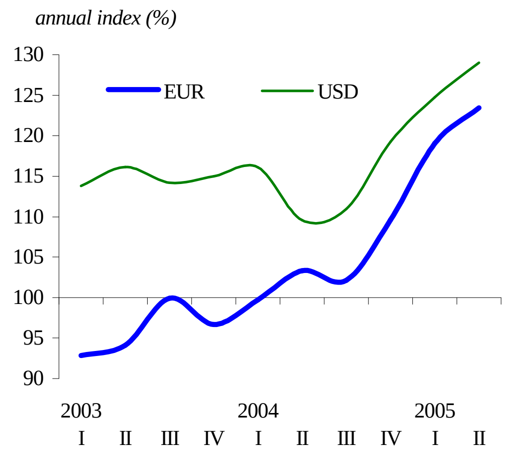
on time deposits (*ex-ante*[47] calculated) continued to drop, approaching zero.

2.2. Exchange rate and capital flows

Nominal Exchange Rate



Developments of ROL Exchange Rate*)



*) appreciation (+), depreciation (-) in real terms deflated by CPI

Source: NIS, NBR

Contrary to the public's initial expectations, liberalisation of non-residents' access to opening *leu*-denominated time deposits did not trigger instant visible effects on quantitative and price indicators of interbank foreign exchange market. The lack of the potential shocks could be attributed to both the successive policy rate cuts during the months preceding the liberalisation and the short-dated shift in the interest of Central and Eastern European financial investors to other financial markets[48], both factors inducing a relative slowdown of the pace[49] of potentially volatile capital inflows into Romania.

Under the circumstances, the *leu* continued to strengthen against the euro, but at a much slower pace. Thus, the domestic currency appreciated versus the euro by merely 0.5 percent in nominal terms and 2.9 percent in real terms in June compared with March. Following the sharp appreciation of the US dollar on the international financial markets, the domestic currency eased against the US dollar by 7.3 percent in nominal terms and 5.3 percent in real terms. In 2005 Q2, the *leu* appreciation (calculated as annual average change) consolidated in terms of both currencies (12.3 percent against the euro and 17.5 percent versus the US dollar).

Against the background of the stabilisation of the ROL/EUR rate during the period under review, its volatility lowered gradually, touching an all-time low in June. This owed much to the growing impact of forex market participants' expectations on the exchange rate of the *leu* to the detriment of the influence exerted by other factors such as the magnitude and the composition of capital inflows, the dynamics of foreign trade, and the changes to some specific regulations[50]. The re-emergence and increase of deficits on the interbank foreign exchange market, as well as the relatively higher effectiveness of central bank intervention in the market, acted as catalysts of the aforementioned development. It should be pointed out that the National Bank of Romania moved to restrain the frequency

[47] Based on the results of the NBR's survey on inflation expectations of banks.
[48] Due also to the impact of the FED's rate hikes.
[49] In 2005 Q2, non-residents' net foreign exchange sales on the interbank foreign exchange market were well below the figure seen in February-March 2005.
[50] Regulation No. 4/2005 on the foreign exchange regime and the norms for its enforcement (which came into force on 11 April) and Circular No. 17/2005 on the adjustment of the limit on net total position of foreign exchange transactions of branches of banks, foreign legal entities, operating in Romania (which came into force on 1 June).

and particularly the volume of its interventions in the foreign exchange market.

The relative stabilisation of exchange rate movements occurred despite the adverse influence of the wider trade gap during this period, the considerable rise in payments on private external debt service and the still high volume of residents' investments abroad[51]. Nevertheless, the following factors had an opposite influence on the exchange rate movements: (i) sustained expansion in private current transfers; (ii) increase in direct investment (up 56 percent in April-May against Q1 and 51 percent against the same year-ago period); (iii) maintenance of a relatively high volume of foreign exchange inflows from short- and long-term loans and credits (slightly down compared with Q1, but up nearly 80 percent year on year); (iv) decline in foreign exchange outflows associated with residents' portfolio investments. In addition, the surge in the surplus under "errors and omissions" suggested the large underestimation of foreign exchange inflows recorded in the balance of payments for the period January-May 2005.

Key Financial Account Items (balances)

EUR million

	2004		2005	
	Q1	**5 mos**	**Q1**	**5 mos**
Financial account	**644**	**1,025**	**66**	**914**
Direct investment	**491**	**875**	**373**	**953**
residents abroad	-7	-5	8	2
non-residents in Romania	498	880	365	951
Portfolio investments	**0**	**-144**	**-123**	**68**
residents abroad	-5	-1	-138	53
non-residents in Romania	5	-143	15	15
Other capital investments	**411**	**1,051**	**1,356**	**1,889**
Medium- and long-term investment	285	543	1,321	1,746
residents abroad	19	17	-20	-22
non-residents in Romania	266	526	1,341	1,768
Short-term investment	204	350	47	434
residents abroad	-38	-74	-94	-75
non-residents in Romania	242	424	141	509

Over the near term, exchange rate developments are expected to be influenced by seasonality and incidental factors, such as: (i) seasonally-driven increase in foreign exchange supply as a result of non-residents' remittances and tourism receipts; (ii) potential increase in the attractiveness of local market investments following the decline in risk premium required by non-resident investors; (iii) possible widening of trade deficit; and to a smaller extent (iv) gradual application of the 30 percent minimum reserve ratio on foreign exchange liabilities with maturities longer than 2 years. The first two factors had already a strong impact on the supply-demand ratio on the interbank foreign exchange market, which rose to above par in July; against this backdrop, the strengthening of the domestic currency versus the euro regained momentum.

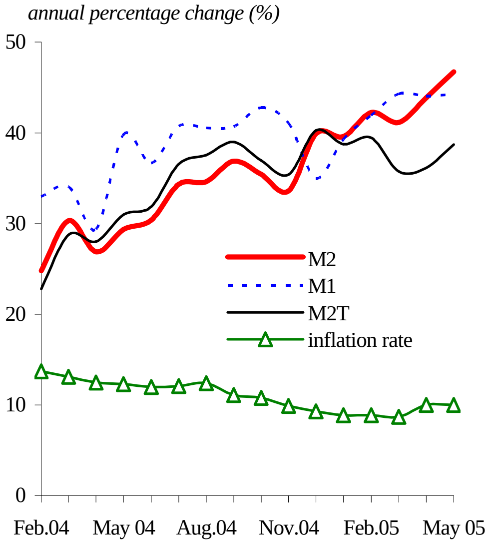
2.3. Money and credit

Money[52]

In March-May 2005, the remonetisation of the economy strengthened, while broad money (M2) further posted the highest real annual growth rate in the past nine years. Among the factors underpinning the expansion in the monetary assets of

[51] In April-May 2005, the amount of such investments doubled against 2005 Q1.
[52] Unless otherwise indicated, percentage changes refer to the annual growth rates expressed in real terms.

Broad Money and Inflation Rate



Broad Money (M2)

percent

	2004				2005		
	I	II	III	IV	I	Apr.	May.
	monthly average						
M1	22.5	24.3	25.3	24.5	22.7	23.7	23.8
Currency outside banks	12.4	13.4	13.7	12.7	11.6	12.7	12.1
ROL deposits	49.0	49.7	51.4	52.4	53.4	54.5	53.7
Foreign currency deposits	38.7	36.9	34.9	34.9	35.1	32.8	34.3

non-banks were: (i) rise in household incomes[53], (ii) further considerable capital inflows (including in the context of privatisation), (iii) maintenance of fast economic growth and upbeat outlook for economic expansion, (iv) increase in non-government credit, and (v) narrowing of the range of the financial saving instruments for the general public.

Over the period, the annual growth rate of quasi-money stayed on the uptrend and hit a 9-year high, due largely to the sizeable rise in corporate time deposits[54]. Quasi-money further grew at a pace similar to that of narrow money (M1) and even outpaced it by 3 percentage points in May. The share of M1 in M2 remained virtually unchanged from the previous year's figure, i.e. nearly 23 percent. Demand deposits posted the fastest increase of all narrow money components, driven mainly by (i) pick-up in corporate incomes, (ii) gradual decrease in the opportunity costs of narrow money, (iii) decline in cash payments (balance of card-based transactions widened by a real 10.8 percent in 2005 Q1 versus 2004 Q4), and (iv) resumption of seasonal activities.

January through April, the share of foreign exchange deposits in M2 followed a downward drift and reached a 6½-year low of 32.8 percent in April. However, May saw the share of forex deposits in broad money bouncing back to 34.3 percent.

In the March-May period, the real annual growth rate of corporate deposits[55] hit record highs, owing mainly to the fast-paced increase in *leu*-denominated corporate deposits. Nevertheless, the currency composition of corporate deposits changed in May. Thus, foreign exchange deposits rose substantially on the back of (i) privatisation proceeds[56], (ii) further downtrend in interest rates, (iii) possible slowdown in the potentially volatile capital inflows, and (iv) significant net purchases of foreign exchange by companies in order to cover massive imports and pay external private debt service. On the whole, behind the rise in corporate deposits in the period under review stood also net redemptions of government securities of the Ministry of Public Finance and the maintenance of non-government credit flows at a relatively high level.

[53] The reduction in the income tax, Easter bonuses, the granting of the "13th month" salary and pay rises in the public sector, the increase (in the run-up to elections) in allowances and pensions.
[54] Including certificates of deposit and bonds in domestic currency issued by banks.
[55] Demand deposits, time deposits, forex deposits, restricted deposits and certificates of deposit (in domestic and foreign currency).
[56] In May 2005, collected privatisation proceeds from the sale of Distrigaz Sud amounted to EUR 311 million, out of which EUR 128 million represented the value of shares and EUR 183 million the capital increase.

Conversely, the real annual growth rate of household deposits[57] slowed down starting with March, thereby reflecting the relatively weaker household demand for domestic currency for saving purposes. Considering the contraction in household investments in Treasury certificates and the maintenance of a high growth rate of household incomes, the households' relatively lower propensity for time deposits in domestic currency could be associated mainly with the drop in interest rates applied by credit institutions.

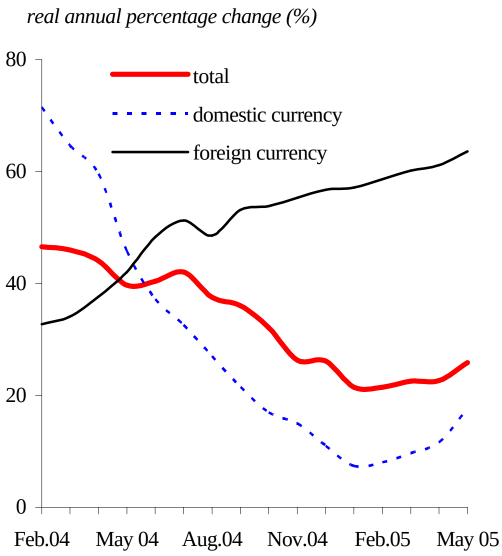
Non-government credit

In March 2005, the annual growth rate of non-government credit resumed the upward path after 13 months of almost continuous decline; the trend reversal was attributed to the faster increase in loans to households. The rise in non-government credit was particularly induced by the step-up in household disposable incomes, the improvement in the financial standing of companies and their good prospects, and the softer restrictions on lending requirements. The main drivers of the increase in credit supply were (i) keener competition in the banking system, (ii) fewer opportunities for credit institutions[58] to make alternative investments and (iii) pick-up in banks' external borrowings[59]. In addition, demand for loans was fostered by the domestic currency strengthening, and subsequently by the relatively stable exchange rate and the cut in interest rates.

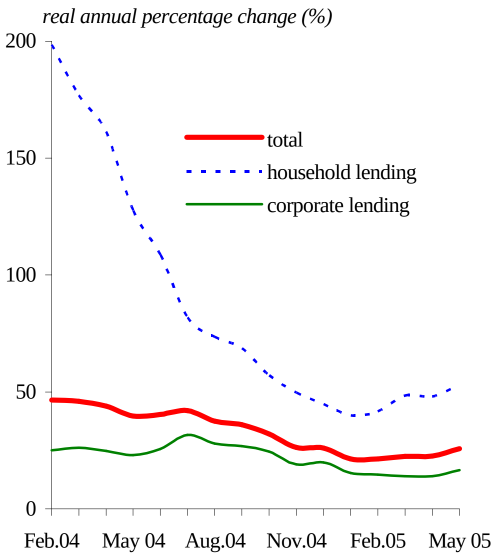
The term structure of loans underwent changes, as medium- and long-term loans gained ground, their share widening to more than half of total current loans. This development could be ascribed to the longer maturity of clients' deposits, on the one side, and to greater strides made by banks in order to accommodate their clients' demand, on the other.

Despite the tightening of the required reserve mechanism imposed on foreign exchange liabilities, forex-denominated loans (expressed in euro) further rose at a faster clip than *leu*-denominated loans, thus prevailing (especially in the case of corporate portfolio); specifically, the share of foreign exchange-denominated loans in total loans stayed virtually flat at 60 percent during March-May. Starting with February, the volume of banks' external liabilities[60] accounted for nearly two

Non-Government Credit by Currency



Non-Government Credit by Client



[57] Savings, current accounts in domestic currency and deposits in foreign exchange.
[58] Yields on foreign investments were still smaller than those on domestic loans, while government securities held by banks fell 13 percent January through May 2005.
[59] Prior to the entry into force of the rise from 0 (zero) percent to 30 percent in reserve ratio for the liabilities in foreign exchange with residual maturity longer than 2 years.
[60] Borrowings from foreign banks and foreign banks' deposits.

thirds of non-government credit in foreign exchange (against an average of 47 percent in the final three-month period of 2004).

Loans to households saw a strong rebound March through May, their annual growth rate entering an upward trend after a 12-month setback. The increase was mainly induced by the expansion of *leu*-denominated loans amid diversification of the range of promotional banking products. Households applied primarily for medium-term loans in domestic currency and long-term loans in foreign exchange. As regards non-government credit composition by borrower, consumer credit[61] in both domestic and foreign currency held the largest share of total credit.

During March-April, the growth rate of corporate loans in real terms decelerated, due to the slower rise in foreign exchange credit (including as a result of the impact the strengthening of the domestic currency against the euro had on the *leu* equivalent of loans in foreign exchange). However, the annual growth rate of corporate loans resumed the upward path in May, owing mainly to the swift rise in *leu*-denominated loans. Companies relied mainly on short-term loans in both domestic and foreign currency in order to pay for imports and cover operational costs. However, some companies resorted far more often to loans with long maturities, whose share in total corporate loans was the only one following an upward course.

In order to counteract the unfavourable aspects of the developments in non-government credit and to ensure its robust and sustainable growth in the long run, the NBR moved to take, in July, some additional measures to (i) reduce incentive for loans in foreign exchange, (ii) improve the structure of non-government credit and (iii) prevent the occurrence of some potentially prudential risks. Thus, the NBR Board decided to gradually extend[62] the implementation of the 30 percent reserve ratio on all foreign exchange liabilities regardless of the maturity and the date when the deposits were made. Moreover, the Board decided to cut[63] the reserve ratio to 16 percent, from 18 percent, for the *leu*-denominated liabilities with maturities shorter than 2 years. Another measure consisted in amending the provisions of the norms on limiting the credit risk for individuals[64] in order to tighten lending requirements.

[61] Based on data in “Financial Behaviour of Households and Companies by County” released by the NBR.
[62] The measure is to be implemented in two stages: starting with 24 July-23 August maintenance period a 15 percent ratio is applied on foreign exchange liabilities with maturities of over 2 years incurred prior to 23 February 2005, and starting with 24 August-23 September 2005 maintenance period a 30 percent ratio is applied on the above-mentioned liabilities.
[63] Starting with 24 August-23 September 2005 maintenance period.
[64] The new provisions are to enter into force on 28 August 2005.

V. OUTLOOK FOR INFLATION

According to the NBR's baseline scenario, annual inflation rate is expected to reach 7.5-8 percent at the end of 2005. With a view to achieving the inflation target for the end of 2006, the central bank should adjust the monetary policy stance in order to phase out excess demand and to re-anchor the inflation expectations to the programmed path of disinflation. The joint effect of real interest rates, real exchange rate, import prices and expectations will offset the inflationary pressures expected to arise from administered price increases in 2006.

The main risks that could endanger the achievement of the inflation target are the following: overestimation of the contractionary effect of the current level of the exchange rate on aggregate demand, widening of the current account deficit well beyond the growth of foreign investment, the need to contain fiscal deficit by raising indirect taxes significantly, fast increase in the oil price, deviation of administered price inflation from the scenario used in the forecast and rekindling of inflation expectations.

1. Introduction

The NBR's projection is based on a monetary policy scenario consistent with keeping inflation in line with the programmed downward path. One of the NBR's main monetary policy instruments is the interest rate on deposits raised from commercial banks. The short-term effectiveness of the interest rate transmission channel of monetary policy is however limited due the typical transmission lags within the economy and the financial system. By the NBR's estimations, the minimum horizon over which the policy rate can produce the desired effects on the economy is at least four quarters. For this reason, the current projections are focused on the end-2006 target of 5 percent. In the short run, the central bank uses alternative instruments to prevent substantial deviation of the inflation rate from the targeted path due to unforeseen events. For instance, the NBR may choose to intervene occasionally in the foreign exchange market or to take additional measures aimed at altering the structure and the growth rate of non-government credit.

Recent macroeconomic developments suggest excess demand that could entail inflationary pressures over the short term. This excess demand or positive output gap (see Box 2) is partly due to the delayed response of the economy to the net stimulatory effect of past real interest rates and real exchange rate.

Recently, the directions of the pressures exerted by the interest rates and the exchange rate on aggregate demand have been reversed compared to the period before 2005. The last three quarters witnessed a substantial real appreciation of the domestic currency against the euro. However, the moderation effect of the exchange rate on excess demand is partly offset by the stimulatory effect of real interest rates. The sharp reduction in interest rates over the last two quarters was largely meant to diminish the risks of speculative capital inflows, given the removal of restrictions on non-residents' access to *leu*-denominated deposits.

According to the baseline scenario, the reduction of the annual inflation rate will resume in Q3, following a temporary halt in Q2[65]. Based on currently available information, the NBR forecasts an annual inflation rate between 7.5-8 percent at the end of 2005. While exceeding the midpoint of 2005 target, the forecasted inflation lies within the target band of ±1 percentage point. The projection of the inflation rate exceeding the programmed level of 7.5 percent is largely due to administered price increases that surpassed those planned at the time the target was set, to a larger than anticipated excess demand, to the unexpectedly high increase in the oil price on the international markets, as well as to the likely effects of the recent floods on food price inflation.

The achievement of the target for year 2006 assumes the adjustment of monetary policy stance in order to fend off the effects of higher-than-targeted 2005 inflation on the inflation expectations for 2006 and to dampen excess demand. The achievement of the target is also conditional on the absence of significant shocks affecting the Romanian economy. Given that over the next six quarters the increase in administered prices is expected to be higher than the targeted headline inflation, a decelerating growth rate of market prices (CORE1) will be instrumental in the continuation of the disinflation process. The baseline scenario envisages that the decline in import prices, lower inflation expectations and shrinking excess demand will lead to slower increase in market price growth.

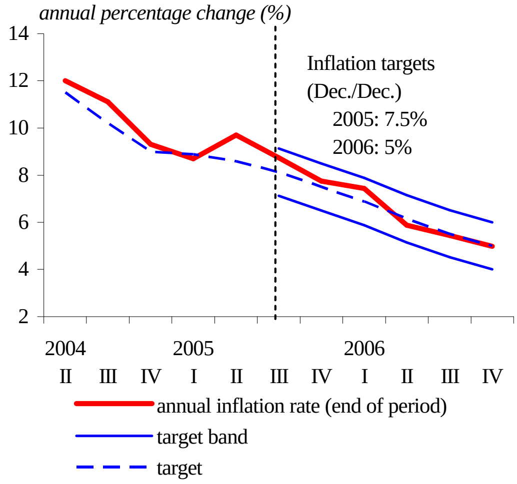
[65] Most of the second-quarter inflation flare-up was recorded in April, being attributed to the increase in administered and fuel prices, and in excise duties on some products.

2. The baseline scenario

2.1. Exogenous inflationary pressures

With a weight of 22 percent in the reference basket of the consumer price index for 2005, goods and services with administered prices exert a significant influence on inflation, including through the impact of their adjustments on inflation expectations. Over the last few years, the growth rate of administered prices was significantly higher than that of market prices. This phenomenon is expected to be manifest over the period ahead, given the necessary alignment of domestic regulated prices to cost recovery levels and, in the case of gas prices, to EU reference values. For the second half of 2005 prices for natural gas, electricity and heating are expected to increase. Although the 2006 adjustment schedule has not yet been finalised, it is assumed that the alignment of administered prices will continue. Under the scenario, administered price increases will exert further inflationary pressures throughout 2006.

Inflation Forecast



Note: ±1 percentage point on either side of targeted inflation path

Developments in external prices represent an exogenous source of inflationary pressures via the impact of the dynamics of import prices. Changes in the Eurozone harmonised consumer price index (HICP) are used as a proxy for developments in foreign prices, the Eurozone being representative for the EU economy. Eurozone projections are provided by *Consensus Forecasts*, a survey of a large number of expert forecasts. According to this source, HICP inflation will average close to 2 percent in 2005 and will be slightly lower in 2006. Given its reduced level and volatility as compared to exchange rate developments, external prices are considered to have a neutral impact on imported inflation over the forecast horizon. A significant departure from this scenario might arise in the case of a new surge in the world oil price (see Section 3. Uncertainties surrounding the baseline scenario).

Moreover, the recent floods are expected to generate some short-term inflationary pressures due to their negative impact on agricultural production. For these reasons, the baseline scenario for the third quarter took into account the increase in food prices as a result of the floods.

Box 2

Potential GDP and output gap

In the long run, the economy exhibits a tendency to grow, measured by the increase of the real Gross Domestic Product (GDP). However, this growth is not constant over time; during the business cycle, periods of expansion with rapid growth are followed by periods of slowdown with lower or even negative growth. The fluctuations of economic activity are irregular, with amplitude and duration varying from country to country as well as from one period of time to another in the same country. As a result, the identification and measurement of these fluctuations is not a simple task.

Fluctuations of GDP are the result of aggregate demand or supply shocks (i.e. impulses of change). Aggregate demand shocks change the disposable income, being generated, for instance, by fiscal policy measures (changes in the government spending and/or taxation), changes of the incentives to save and borrow (interest rate movements), or fluctuations in the international trade (exports and imports). The aggregate supply shocks usually originate in changes of producer costs (raw materials prices, wages). Given that the quantities sold (by domestic producers) cannot be different from the quantities purchased (by domestic and foreign consumers), every demand or supply shock leads to a change in the total amount of goods and services traded in the economy as measured by the GDP.

The level of GDP depends on the productive capacity of the economy which, in turn, hinges upon some fundamentals like the level of the capital stock, demographic and educational factors affecting the labour force in the economy, the technology, and the degree of economy organization. Most of these factors change only slowly over time. The most flexible factor is the number of working hours that can be hired in the labour market. Therefore, in the short run the quantity of goods and services produced in the economy can be increased (decreased) mainly by employing a higher (lower) number of working hours.

The working hours employed together with the available capital stock are combined to produce a certain amount of goods and services. If the part of the aggregate income devoted to spending increases, the previously produced amount is no longer sufficient to meet the higher demand. This additional demand requires an increase in the number of working hours employed (given the slow adjustment of the capital stock). As the amount of working hours available for hire is naturally limited and the producers compete for labour, the price on the labour market (i.e. the wage) increases. In addition, as long as the increased amount of labour employed is not matched by a corresponding upward adjustment of the capital stock, productivity decreases, with output growing less than in proportion with the working hours employed.

Both the competition among producers on the labour market and the decrease in marginal productivity due to additional working hours being employed lead to increasing unit costs. As a result, inflationary pressures start building up. For various reasons, the producers may decide to postpone the increase of their prices. As long as this is the case, GDP increases are not accompanied by actual inflation. However, once the old prices start to squeeze heavily the profits, the producers proceed to increase prices. As a result, previously accumulated inflationary pressures will give rise to actual price increases. *Ceteris paribus*, higher prices decrease the purchasing power of consumers and therefore the amount of goods and services bought in the economy (i.e. GDP). Since the quantity sold cannot exceed the quantity purchased, the output (and the quantity of labour employed) starts to adjust towards an equilibrium level where inflationary pressures fade away.

This equilibrium level of GDP at which the ratio between the capital stock and the amount of labour employed generates no inflationary pressures is called the **potential GDP**. As the potential GDP increases over time as a result of technical progress and accumulation of physical and human capital, the resulting GDP time series is known as the **GDP trend**.

As highlighted above, in the short run the actual GDP can be higher than its potential level, which implies an accumulation of inflationary pressures. Since these pressures tend to increase as output grows while prices do not change (or they increase slower than output), **the output gap,** computed as the difference between actual and potential GDP, is used as a synthetic measure of the inflationary pressures in the economy. A positive output gap (when GDP is above the potential level) reveals the existence of inflationary pressures. Conversely, a negative output gap shows deflationary pressures (downward pressures on prices). In the long run, the accumulated pressures are released, prices become flexible, and output gap always tends to zero, bringing GDP to its potential level (GDP trend).

Since inflationary pressures imply that the actual GDP level is above potential, and given that the actual GDP level equals the amount of goods and services demanded at the prevailing prices, a positive GDP gap is also called excess demand. The excess demand can be reduced or eliminated by implementing macroeconomic – monetary, fiscal or income - policies. Monetary policy can influence the excess demand by various instruments, a typical measure being to raise interest rates. The purpose of this measure is to create incentives to increase savings, so that a smaller proportion of income would be assigned to spending in the current period. Moreover, higher interest rates raise the borrowing costs, reducing expenditures financed by credit. A slower pace of spending income in the current period leads to lower demand pressures on the production, thus reducing or eliminating the output gap. As a result, the source of potential future price increases is eliminated.

Estimating the output gap is a difficult task, mainly because potential GDP is not an observable variable. Thus, knowing the actual level of total real GDP, it is not possible to directly determine what proportion of the total GDP represents potential GDP and what proportion is output gap. Excess demand is estimated indirectly, using both statistical methods and expert knowledge. This unavoidable uncertainty in estimating the potential output and the output gap is augmented by the fact that statistical data regarding the actual level of GDP are subject to revisions.

For the current projection horizon, the NBR estimates the growth rate of GDP consistent with price stability in the Romanian economy to be around 5.5 percent.

2.2. Aggregate demand pressures

2.2.1. Current aggregate demand pressures

In 2005 Q2, GDP is estimated to be above potential, signalling the build-up of inflationary pressures in the short run.

Excess demand is suggested by the dynamics of household consumption which is estimated to have remained above its medium-term trend. This estimate is corroborated by both the increase in households' disposable income, as a result of introducing the flat tax rate on personal income in January 2005, and labour market developments. Lower unemployment rate and larger payrolls compared to the recent years' trends point to labour market pressures, which are also indicated by the dynamics of real gross wage. In addition, the real M1 aggregate has outpaced its recent trend, following the increase in the volume of transactions as a result of higher aggregate disposable income. The evolution of household consumption has also been fuelled by the recovery of *leu*-denominated consumer credit starting with March 2005.

Gross fixed capital formation appears to be below the trend of the recent years. This assessment is based mainly on the specific developments in the fourth quarter of 2004. Official statistical data for that period show a sharp decrease in the investment growth rate, which implies a sudden change of the investment behaviour, atypical for the seasonal pattern. Furthermore, such a low pace of investment growth cannot be easily reconciled with the overall increase in labour demand.

Imports have been growing at a faster pace than that seen in the recent past. Meanwhile, the annual growth rate of exports was flat, partially reflecting the absence of any stimulus coming from external demand (approximated by euro area GDP). Moreover, the gap between the growth rates of imports and exports was also influenced by the large real appreciation of the domestic currency since the beginning of 2005.

2.2.2. Implications of recent exchange rate and interest rate developments

The current excess demand is partly due to the expansionary net effects of past real interest rates and real exchange rate. In 2005 Q2, the domestic currency continued to appreciate against the euro, although at a slower pace than in the previous quarter. During the first half of the year, the real appreciation was higher than the long-term trend resulting from the productivity growth differential between the Romanian economy and the Eurozone

(Balassa-Samuelson effect). This appreciation can largely be ascribed to (i) the impact of the November 2004 change in the NBR's foreign exchange market intervention policy ahead of the April 2005 liberalisation of non-residents' access to domestic currency deposits and to (ii) the positive signal following the signing of the Accession Treaty with the European Union. This assertion is backed by empirical evidence of other transition countries, which experienced strong domestic currency appreciation associated with similar events. On the other hand, the significant widening of the external deficit during the first part of the year suggests that the current level of the exchange rate is putting downward pressure on the excess demand for domestically-produced goods, especially through outlays switching towards the cheaper imports.

During 2005 Q2, the NBR cut its nominal effective interest rate by more than 3 percentage points on average compared to the previous quarter. Growing capital inflows over the recent years, along with the steady decrease of the risk premium required by investors to hold domestic-currency-denominated financial assets, led to a normal tendency of lowering real interest rates. Nevertheless, during the last two quarters, the fall in nominal interest rates was much faster than this tendency in order to reduce the risk of attracting speculative capital inflows as Romania implemented a new stage of capital account liberalisation. As a result, the NBR's real effective interest rate reached a level that could trigger expansionary effects on future aggregate demand.

Due to the transmission lags, the fast reduction in the NBR's effective interest rate during 2005 Q1 passed on with some delay to banks' lending and deposit rates. Thus, during Q2, real lending and deposit rates seem to have reached levels which exert an expansionary effect on the economic activity. However, because of the incomplete adjustment of commercial banks' interest rates, the stimulus provided by the NBR's rate is only partially transmitted to the economy. Given the slower pace of adjustment of the lending rates as compared to deposit rates, the large reduction of the NBR's rate fed through only to a small extent into borrowing costs. The faster decrease in deposit rates caused the pace of saving to slow down, thus fuelling consumer demand. In the short run, the overall effect of the dynamics of commercial banks' real interest rates on excess demand is expected to be expansionary.

However, the expansionary effect of the interest rates offsets only partially the tightness induced by the real appreciation of the domestic currency against the euro. As a result, the developments in the real interest rates and real exchange rate have been exerting a net contractionary effect on excess demand.

2.2.3. Demand pressures within the forecast horizon

Given the projected paths of interest rates, the exchange rate and the exogenous demand factors, the output gap is expected to follow a downward course over the next six quarters. Under such circumstances, the excess demand could fade away towards the second half of next year.

The current assessment of the exogenous factors – primarily foreign demand and fiscal policy – suggests a neutral impact on the excess demand over the forecast horizon[66]. According to the baseline scenario, putting the output gap on the downward track required by the continuation of disinflation and the achievement of next year's inflation target are conditional on the relative tightening of the combined countercyclical effect of interest rates and the exchange rate. The exchange rate is expected to maintain its moderating effect on the increase in aggregate demand. Moderate real interest rate pressures are projected to augment this effect in the course of next year.

In accordance with the baseline projection, the domestic currency will be facing both appreciation pressures – due to fundamental and incidental factors – and depreciation pressures induced mainly by the demand for foreign currency associated with the trade deficit. In the short term, the factors in the first group are projected to prevail, while in the latter part of the projection horizon their pressure is more likely to ease. Among these factors, the short-term nominal interest rate differential between the domestic and the European (as proxy for foreign) markets is anticipated to remain positive. However, this differential is expected to shrink in the course of 2006 due to a diminishing inflation gap between the Romanian and advanced economies, the likely ECB[67] and Fed rate hikes, as well as to a slight reduction, over the year as a whole, in the real interest rate differential[68].

Changes in interest rates applied by commercial banks to non-government clients will continue to follow the adjustments of the NBR's effective interest rate. Deposit rates will adapt more quickly to the signal sent by the NBR rate, while interest rates

[66] The early effects of the tax changes performed at the beginning of the year were incorporated in the evaluation of the output gap for the current period – see Section 2.2.1.

[67] At its latest monetary policy meeting, the ECB left its key interest rate unchanged at 2 percent (a level which had been set in June 2003). It is anticipated that relevant interbank rates for the European money market (EURIBOR 3M) will remain constant in 2005, but they will pick up slowly during 2006 (Sources: Bloomberg, Consensus Forecasts, central banks).

[68] Considering the yields on *leu*-denominated time deposits as representative for short-term rates, a marginal effect towards the reduction in the interest rate differential could also be attributed to the 6 percentage point increase in the tax on income from individuals' savings which is due for January 2006.

on *leu*-denominated loans to non-government are expected to display a somewhat higher inertia in capturing this signal. According to the central projection, the NBR interest rate will follow a trajectory consistent with attaining the inflation target, which involves moderately positive real interest rate levels over the reference period.

As regards the exogenous demand factors, a neutral fiscal policy over the forecast horizon is assumed for two reasons: on the one hand, the co-ordinates of the fiscal programme have not been clearly established for either medium or short term; on the other hand, estimating the impact of the fiscal impulse on aggregate demand implies too high a degree of approximation in the absence of a breakdown of budget execution data into aggregate demand components[69].

The level of economic activity is also influenced by foreign demand for domestic goods and services. It is assumed that foreign demand is strongly correlated with the economic activity in Romania's main trading partners, mainly EU Member States. Given the large share of Eurozone in the overall EU economy, projections on the economic growth of the former are used as proxy for future foreign demand conditions[70]. Current projections show a slight acceleration of Eurozone growth in the second half of 2005 and for the most of 2006, suggesting that the region's import demand will be recovering slowly over the forecast horizon.

2.2.4. Implications for GDP growth and aggregate demand components

The projected decline of the output gap will exert a moderating effect on the economic growth rate. Despite some positive developments in the determining factors of potential output, their impact on the actual economic growth is expected to materialise only in the long run. Specifically, the full effects of surging foreign direct investment and reduced profit tax on economic growth will more likely become manifest beyond the forecast horizon (which extends to the final quarter of 2006).

The projected paths of interest rates, exchange rate, and exogenous aggregate demand factors will produce specific effects on the aggregate demand components. Thus, the growth in household consumption is expected to slow due to the contractionary effects of rising utility prices and of the prudential and monetary policy measures aimed at curbing non-government credit growth and spurring savings. The slowdown

[69] According to ESA95.
[70] Eurozone growth projections are also provided by Consensus Forecasts.

in consumption growth is nevertheless conditional on the government's incomes policy being confined to the scope provided by next year's projected economic growth and targeted inflation.

The net effects on the dynamics of gross fixed capital formation are expected to be positive. Lower corporate tax rates, good prospects of joining the EU, and the related restructuring and improvement of infrastructure, as well as exchange rate developments favouring technology imports are expected to compensate for tighter lending requirements and slower economic growth.

On the other hand, exports are likely to come under some pressure, at least in more labour-intensive industries (such as those in light industry). The factors with potentially negative effects on these industries' external competitiveness could include the real appreciation of the domestic currency and the fierce competition of highly productive, low labour cost economies (such as China, Turkey, etc.). Although import demand in the Eurozone[71] is expected to recover to some extent, providing some impetus for Romanian exports, the relative magnitude of this effect is more likely to be small.

Import dynamics is anticipated, on the one hand, to be stimulated by the stronger *leu* and the rebound in investment, but on the other hand it is expected to be constrained by the slowing growth of domestic consumer demand.

2.3. Other influences on projected inflation

Import price[72] inflation represents a direct channel for the influence of the exchange rate on consumer prices. Import prices depend on various factors such as the prices in the country of origin (the external prices mentioned in Section 2.1. expressed in foreign currency), the exchange rate used for converting the import value into *leu*, additional transport, retail and, in some cases, processing expenses and the gross margin of import companies. Historically, however, the evolution of the exchange rate tends to be the most important determining factor of import price inflation. Its pass-through is neither instantaneous, nor evenly-distributed among the imported goods and services. Furthermore, the exchange rate pass-through is not necessarily symmetric either for an upward versus a downward

[71] Exports to Eurozone account for 60 percent of Romania's exports.
[72] We define import prices generically as the final consumer prices in domestic currency of any goods and services whose production or purchase value contains a significant cost incurred in the form of goods-and-services imports.

movement of the exchange rate[73] or for any such movement perceived as temporary versus a permanent one. On average, the forecast anticipates that the appreciation of the *leu* in the last two quarters will continue to exert a dampening impact on the inflationary pressures coming from other factors in the following periods.

Inflation expectations represent another important factor which affects core inflation. Their importance lies with their influence on wage bargaining and contractual prices for other production factors. Higher inflation expectations may feed through into such costs incurred by producers and traders, and thereafter into retail prices of goods and services.

The manner in which expectations are formed and the manner in which they respond to economic shocks have a significant bearing on the pace of disinflation. Disinflation is slower when expectations are primarily backward-looking. The role of a transparent and consistent anti-inflationary policy entailed by the inflation targeting strategy is to ensure the central bank's commitment to the inflation target, thus providing the public with a credible anchor for inflation expectations.

According to the baseline scenario, inflation expectations are projected to decline over the forecast horizon, following the track record of disinflation over the last few years. Nevertheless, with inflation still relatively high (partly due to large administered price increases), the contribution of inflation expectations to the projected quarterly rise in market prices is quite significant.

3. Uncertainties surrounding the baseline scenario

The inflation forecast is based on a set of assumptions. The possibility that any of these assumptions do not hold true generates uncertainty about the forecast and therefore the risk that the implied path of the policy rate could not bring inflation to the target. This section introduces the key elements of projection uncertainty and the relevant risks for the reference period.

The assessment of inflationary pressures and of the impact of interest rates and exchange rate on economic activity is critical to the inflation forecast. This assessment is based on estimates of unobservable variables, which makes it the first major source of uncertainties.

[73] In the case of an appreciating currency, the higher the competition and the price sensitivity of demand for a particular product, the faster the exchange rate pass-through.

Inflationary pressures may be approximated by the excess demand or the output gap (see Box 2). Potential GDP – representing the amount of goods and services that can be produced in an economy without triggering inflationary pressures – cannot be directly observed and measured. Given the known or projected value of actual GDP, an overestimation of potential GDP may lead to an underestimation of inflationary pressures. Symmetrically, underestimating potential GDP implies overestimating the inflationary pressures.

The extent to which interest rates and the exchange rate of the *leu* are accommodative or restrictive with respect to excess demand depends on the deviations of their actual values from the corresponding equilibrium levels – at which the upward and downward pressures on the demand for aggregate output in the economy offset each other. The unobservable nature of these equilibrium values gives rise to uncertainties as the changes in interest rates and the exchange rate are the very channels of sending monetary policy signals to excess demand.

For the current forecast, risks are generated by uncertainties related to both interest rates and exchange rate. The last two quarters witnessed substantial interest rate cuts and a strong appreciation of the *leu* against the euro. These sudden changes have taken place against the background of other structural adjustments across the economy, such as the introduction of the flat tax rate, the increased unpredictability of central bank interventions in the foreign exchange market, the ongoing capital account liberalisation, and the rise in the tax on income from savings. During a period of drastic changes in economic incentives, to assess how restrictive or how accommodative interest rate and the exchange rate levels really are proves to be more difficult than usual even for the economic agents.

The risk that interest rates and the exchange rate may not have the projected impact on excess demand must therefore be seriously considered. While the risks of overestimating and underestimating the impact of interest rates on excess demand seem to be balanced, the risk of overestimating the restrictive pressures exerted by the exchange rate on the output gap seems to prevail.

Two arguments support this assessment. The first argument points to the experience of other countries with similar periods of strong and protracted real appreciation of their currencies. The persistence of appreciation suggests that it was not associated with substantial competitiveness losses, given that no subsequent corrective depreciation was recorded. The fact that the share of Romanian exports in total EU imports from outside the region has remained fairly constant for a number of periods[74], along with a steady export growth, reinforces the argument.

The impact of the appreciation of the *leu* against the euro might have been weakened by wealth and balance sheet effects as well. The appreciation acts towards reducing the cost of foreign currency borrowing in terms of home currency, which makes it cheaper for debtors to take loans (by way of increasing the euro value of the companies' balance sheet net assets) and to reimburse and to pay interest on such loans. This has positive effects on the disposable income of debtors, easing the downward pressure exerted by the appreciating domestic currency on consumption and investment.

The second source of uncertainties derives from contingent future events that were not considered in the baseline scenario due to their unsystematic and therefore unpredictable nature. It follows that a prudent approach to the forecasting process requires the identification of particular events that would imply significant risks to the achievement of the inflation target at end-2006.

Such an unfavourable hypothetical event could be represented by the worsening of investor sentiment regarding Romania's sovereign risk. A possible implication would be the growth rate of capital inflows falling well below that of the current account deficit. From the point of view of the achievement of the inflation target, this may induce the risk of a substantial depreciation of the domestic currency over the forecast horizon. This depreciation would feed through into inflation via soaring import prices and it would also ease the exchange rate pressure on excess demand. Under such circumstances, attaining the inflation target of 5 percent at the end of 2006 would be more difficult. According to this scenario, the burden of reducing excess demand would be borne entirely by interest rates, implying substantially higher policy rates (depending on the magnitude of the depreciation).

Hypothetical increases of indirect taxes in order to limit the budget deficit for 2006 may also hurt the chances of achieving the inflation target. One such measure, already under public scrutiny, would be the increase of the value added tax. Since a hike in VAT would have a substantial impact on prices, its implementation would require an upward adjustment of the inflation target, consistent with the magnitude of the tax increase. Even so, considerably higher interest rates and a more pronounced appreciation of the local currency compared to the

[74] The average export share for the first 5 months of 2005 was 1.3 percent, which is similar to the average value for 2004 as a whole.

baseline scenario may be needed to attain the new target. Sharp policy tightening would be required because a possibly delayed announcement of the VAT change would limit the scope for a proactive gradual and well-timed response of the policy rate.

The third source of uncertainties is related to forecasts/scenarios for the exogenous variables included in the projection. An important risk may arise if administered price adjustments were to substantially deviate from the baseline scenario. Another commonly relevant risk is represented by a substantial rise of oil prices throughout the reference period. Rapidly soaring oil prices would put a double pressure on domestic prices. First, they would directly impact domestic fuel prices, which have recently become increasingly correlated with the international prices. Second, an indirect effect would come from higher international crude oil prices giving rise to inflationary pressures in the economies of Romania’s trading partners. As a result, domestic import prices would rise, putting upward pressure on consumer prices.

Last but not least, a potential risk comes from the uncertainties surrounding the formation of inflation expectations. Possible deviations from the baseline scenario might be caused by changes in inflation expectations following adjustments of administered prices, VAT, or other indirect taxes. The uncertainties regarding the second-round effects of such measures and the pace at which disinflation would subsequently resume could push inflation expectations sharply higher. The usual risk-averse behaviour of the public may turn these expectations into actual price increases, for instance through wage bargaining settlements resulting in wage growth rates exceeding actual productivity gains. Moreover, given the relatively low nominal interest rates on time deposits, reignited inflation expectations could lead to negative *ex ant*e real interest rates. As a result, shrinking savings and higher consumption-induced excess demand would put additional upward pressure on prices.

4. Policy assessment

According to the forecast on price developments, the achievement of the inflation target for end-2006 requires tighter monetary conditions over the forecast horizon. Moreover, according to the baseline scenario, the annual inflation rate will exceed in December the inflation target for 2005, despite the likely immediate tightening of monetary policy. This development would be ascribed, on the one hand, to the ineffectiveness of monetary policy signals in the short run as they pass, via aggregate demand, onto the rate of increase of prices with a certain time lag; under the current circumstances, this lag is estimated to be around 12-16 months, slightly shorter than that specific to advanced economies. On the other hand, the overshooting of the inflation target for 2005 will stem from the impact of supply-side factors on consumer prices, which proves to be stronger than initially estimated (larger-than-anticipated increases in administered prices, unexpectedly sharp rises in world oil prices, the likely effects of recent floods and of adverse weather conditions on the prices of farm produce).

Given these conditions, there are several reasons for the relative tightening of monetary conditions. First, excess aggregate demand entered, in 2005 Q2, an upward path which looks set to continue into the subsequent period. This implies the risk of a larger inflationary potential that may subsequently materialise in higher prices. The prompt remedial measures of monetary policy are all the more necessary as the margin for manoeuvre of fiscal policy, and particularly incomes policy, is almost inexistent in 2005, given that the major decisions in the field have already been taken by the government. Although the inflationary potential of domestic demand generated mainly by private consumption – the engine of economic growth over the last quarters – was partly offset by larger imports and wider trade deficit, it might flare up in the absence of tighter monetary policy stance as a result of (i) the possible change in the structure of household consumption determined by the partial shift of household excess demand to the domestic market, services market included; (ii) the high likelihood of a relative fall in self-consumption given the dismal performance of agriculture in the summer of 2005; (iii) the potential rise in imports of foodstuffs (fruit and vegetables) whose prices are much more sensitive to high demand-pull inflationary pressures; (iv) the potential increase in demand for goods and services needed for the reconstruction – backed by budget allowances and grants-in-aid – of flood-damaged households.

Another reason in favour of implementing tighter monetary policy measures is the need to counteract the second-round effects of (i) large administered price increases due in the latter half of 2005 and during 2006, as well as of (ii) the hikes in food prices generated by the recent floods and adverse weather conditions. Furthermore, tighter monetary conditions represent, for the period ahead, the only efficient means to curb and anchor inflation expectations – the main disinflation channel – as they heightened in the recent months due to the impact of both demand-side and supply-side factors.

An additional reason for further tightening of monetary policy in the period ahead is the need to halt and reverse the downward trend of household financial savings, whose likely extension might fuel household consumption and the ensuing inflationary pressures; in the longer run, the households' lower propensity for saving might put a break on the recovery of bank intermediation and might reduce the prospective growth of investment.

Monetary policy tightening might, at least at the beginning of the period, adversely affect the trade deficit, entailing the risk of its widening to levels beyond the sustainability of the balance of payments and implicitly that of disinflation in the medium run. Specifically, despite the moderate impact it might have on imported inflation, the unsustainably fast strengthening of the domestic currency against the euro, which might follow the implementation of the NBR's decision, would have dire consequences such as:

a) the wiping-out of the comparative advantage of Romanian exports, if the exchange rate of the *leu* were to near or even touch the level inflicting losses on exporters. However, the contractionary effect of the strengthening of the *leu* on exports and implicitly on economic growth could be considerably alleviated by (i) the restructuring process exporters would initiate under exchange rate pressures; (ii) the shift in focus towards the domestic market of the producers facing narrower external market shares; (iii) the possible overestimation of the current tightness of the exchange rate;

b) the boost to domestic aggregate demand (see Chapter IV "Monetary policy and financial developments") or only to demand for imports, due also to the increase in forex-denominated loans, which might continue despite the implementation by the central bank of the measures to contain foreign exchange lending.

The risky consequence – in terms of disinflation – of such developments would be a relatively abrupt adjustment of the exchange rate of the *leu* and of its trajectory.

The concerns to ensure proper conditions for putting the annual inflation rate back on the projected path as quickly as possible are opposed, during this period, by the mounting worries generated by re-emergence and increase of the foreign exchange surplus on the interbank market. The attention attached to this development was triggered by the clear indications regarding the discontinuance of outflows and the resumption of potentially speculative capital inflows, which might be attributed to the downward adjustment in risk premiums required by non-residents on the Romanian market. The aforementioned assumption, along with that of maintaining the low attractiveness of world financial markets, at least in the short run, points to the likelihood of larger volatile capital inflows in the subsequent period. In this context, a tighter monetary policy stance could bring about either a faster and sharper appreciation of the *leu* (which would entail, on a larger scale, the effects presented in the previous scenario) or the central bank's resort to massive sterilisation of capital inflows, which would cause the monetary authority to incur considerable financial and credibility costs.

The assessment by the NBR Board of the risks the monetary policy will have to address in an attempt to attain the 2006 inflation target shows clearly the need for monetary policy tightening. At the same time, however, the persistent constraint exerted by the risk of potentially speculative capital inflows on interest rate policy and liquidity policy calls for the central bank to specifically tailor the use of its monetary policy tools. Furthermore, considering the adoption of inflation targeting in August 2005, with the expectations channel of monetary policy becoming more important and complementing the removal of the structural component of excess demand, the NBR Board has reiterated the need to increase the transparency and consistency of monetary policy signals. Against this background, with a view to boosting the signalling role of the policy rate, the NBR Board has decided to eliminate the temporary departure between the policy rate and the effective sterilisation rate by unifying them at a level of 8.5 percent, half of a percentage point higher than the average effective interest rate on sterilisation operations in July. Concurrently, the NBR Board has decided to closely monitor any developments that might affect the path of future disinflation, standing ready to take appropriate and prompt remedial measures.