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and National Bank of Romania supplied data.

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. Apart from 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 eight-quarter time horizon and the uncertainties and associated risks, as well as a section dedicated to monetary policy assessment.

Inflation Report was completed on 6 February 2006 and approved by the NBR Board in its meeting of 8 February 2006.

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)
EUROSTAT	Statistical Office of the European Communities
GCF	Gross Capital Formation
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
NSC	National Securities Commission
NUOCI	National Union of the Organization for Collective Investment
ON	overnight
OPEC	Organisation of Petroleum Exporting Countries
ULC	unit labour cost
1W	one week
12M	12 months

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I. SUMMARY

The disinflation process came to a relative standstill in 2005 Q4; the annual inflation rate was 8.6 percent in December, exceeding the forecasted figure by 0.5 percentage points and marginally overshooting the upper limit of the target band of ±1 percentage point around the 7.5 percent target for 2005.

The deviation of inflation rate from the trajectory forecasted for 2005 Q4 was due to higher-than-expected hikes in administered prices and volatile food prices; conversely, CORE2 inflation, which monetary policy is better able to influence effectively, stayed on a downward path, with a stronger decrease in the last part of 2005, partly offsetting the impact of the other above-mentioned components on the growth rate of consumer prices. However, disinflation consolidated when considering the average annual inflation rate, which in 2005 stood at 9 percent, substantially lower than the 11.9 percent rate recorded in 2004.

In 2005 Q3, the rate of increase of aggregate demand was still considerably high, although the annual GDP growth rate continued to decelerate under the impact of supply-side shocks; household actual final consumption expanded by 7 percent from the same period of the previous year, while gross fixed capital formation rose by 10.5 percent. In 2005 Q4, the persistently high growth rate of wages and the accelerated expansion in household credit continued to be the main drivers of buoyant demand.

Against this background, monetary policy continued to face major challenges in 2005 Q4. On the one hand, the growth rate of consumption remained unsustainable as regards ensuring medium- and long-term disinflation and maintaining major macroeconomic equilibria. On the other hand, the use of standard monetary policy instruments continued to be strongly hampered by both the imperfect monetary transmission mechanism – due to the net debtor position of the central bank and the large share of foreign exchange-denominated credit in non-government credit – and the risk of a resurgence of substantial volatile capital inflows. The National Bank of Romania’s response was to firmly use the available array of instruments, especially those less likely to stimulate capital inflows, in order to tighten monetary conditions over a longer term and prevent the worsening of inflation expectations: the gradual increase in the volume of liquidity sterilized through open market operations, inducing a rise in the effective sterilization rate, as well as the increase in minimum reserve requirements on foreign exchange-denominated liabilities of credit institutions to 35 percent from 30 percent. To the same end, the NBR completed the draft law regulating the lending activity of non-bank financial institutions.

The Board of the National Bank of Romania assessed the pros and the cons of the revision of the 2006 target, given the unfavourable near-term inflation outlook arising from the projection scenarios, and decided to leave the current short- and medium-term inflation targets unchanged at 5 percent ±1 percentage point for 2006 and at 4 percent ±1 percentage point for 2007. This option relied on the following arguments:

– the central bank's commitment to attain the inflation target for 2007, an ambitious goal that implies significant economic costs, reaffirming the NBR's focus of attention on achieving the disinflation trajectory in the medium term – a time horizon during which monetary policy tools are more effective – by using the entire available array of instruments. Consequently, despite the fact that, in the near term, the projected inflation rate constantly remains above the programmed disinflation path, the deviation from the 2006 inflation target is perceived to be temporary, given the firm and proactive stance of monetary policy backed by prudent wage and fiscal policies;

– the need to better anchor inflation expectations and to guide economic agents' decisions accordingly, considering that a possible revision of the 2006 inflation target would lead to a significant worsening of medium-term disinflation performance, thereby complicating the future conduct of monetary policy;

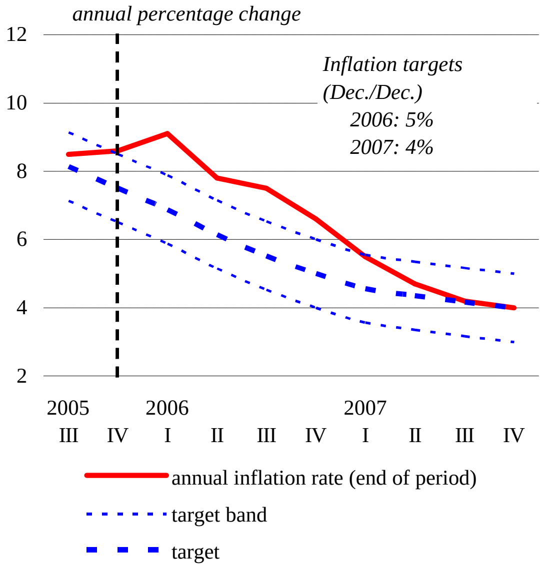
– the need for the NBR to take prompt and firm measures, considering that the effects of monetary policy measures on prices, via aggregate demand, become manifest with a time-lag.

The baseline scenario of the projection on medium-term macroeconomic developments (which was extended to eight quarters, from six quarters previously, coming into line with the monetary policy horizon), compared to the previous forecast, assumes stronger increases in volatile food prices, also due to the change in the CPI basket structure, and an upward revision of the projected exchange rate. The baseline scenario suggests a deterioration of disinflation prospects in the short run, with the annual rate of projected inflation overshooting the end-2006 target by around 1.6 percentage points. The inflation outlook improves, however, in 2007 as a result of the implementation of a consistent and austere macroeconomic policy mix, the dissipation of the impact of unfavourable supply-side shocks, as well as of the improvement of inflation expectations; therefore, in the latter half of the year, disinflation is expected to re-enter a path consistent with the attainment of the 4 percent inflation target. During the projection horizon, the expected deceleration of inflation will rely to a large extent on the further decline in excess demand to negative levels, under the impact of tighter monetary conditions in the context of the implementation of a set of restrictive economic policies.

The invalidation of some of the assumptions underlying this scenario could, however, cause a deviation from the baseline trajectory of inflation. Adverse developments could be brought about by insufficient tightening of fiscal and wage policies, a higher-than-projected exchange rate of the RON and a worsening of inflation expectations under the combined effect of price adjustments and the occurrence of other potential shocks. Additional risks – to inflation expectations as well – may arise from steeper increases in energy and some food prices, as well as from sharper hikes in administered prices or changes in their implementation timetable. Furthermore, another major risk is the possibly low effectiveness of tighter monetary policy measures on credit growth, along with a potential resurgence of large volatile capital inflows.

The comprehensive assessment of the medium-term forecast and of the numerous difficulties and risks entailed by the implementation of the ambitious disinflation programme, which the central bank is committed to, has led the NBR Board to reaffirm that it stands ready to further use the entire available array of instruments in a concerted and proactive manner for containing the growth of aggregate demand and to alleviate inflation expectations, which implies taking appropriate and prompt measures. Hence, in its meeting of 8 February 2006, the NBR Board decided to raise the monetary policy rate to 8.5 percent from 7.5 percent, and to continue to significantly sterilize excess liquidity via open market operations. Moreover, the NBR Board decided to increase minimum reserve requirements on foreign exchange-denominated liabilities of credit institutions to 40 percent from 35 percent, starting with the 24 March-23 April 2006 maintenance period and also decided to maintain the prudential measures adopted in order to contain non-government credit expansion, especially in what concerns its foreign exchange component, and to accelerate the implementation of legislation regulating the lending activity of non-bank financial institutions.

Inflation Forecast

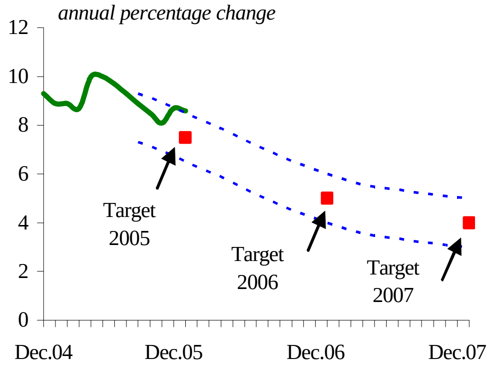


Note: ±1 percentage point around the (dis)inflation path

Furthermore, the NBR Board reiterated its commitment to take prompt measures in response to macroeconomic developments that could jeopardize achieving the programmed medium-term disinflation path.

II. INFLATION DEVELOPMENTS

Inflation Developments



Note: ±1 percentage point around the (dis)inflation path

Source: NIS, NBR calculations

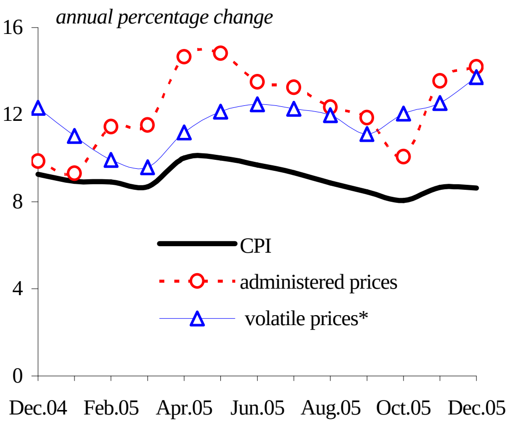
Administered Prices versus Market Prices

annual percentage change

	2004	2005			
	IV	I	II	III	IV
Inflation Rate	**10.0**	**8.8**	**9.9**	**8.9**	**8.4**
Administered prices	**11.2**	**10.8**	**14.3**	**12.5**	**12.6**
1. Non-food items:	**12.1**	**12.0**	**16.5**	**14.7**	**13.0**
electricity	17.7	12.5	12.5	9.6	9.6
heating	10.4	12.0	12.0	12.0	15.0
natural gas	22.2	21.6	45.2	45.3	36.4
medicines	–6.9	1.4	1.0	–1.3	–4.9
2. Services, of which:	**9.8**	**8.9**	**11.0**	**9.1**	**11.8**
water, sewerage, refuse collection	23.4	22.4	27.8	27.4	26.0
telephony	–0.1	3.1	4.3	–1.0	4.8
passenger railway transport	19.2	14.6	12.0	9.9	8.7
(passenger) city transport	17.0	16.3	21.0	25.9	22.2
Market prices (CORE1)	**9.6**	**8.3**	**8.7**	**7.9**	**7.3**

Source: NIS, NBR calculations

Inflation Rate



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

Source: NIS, NBR calculations

At end-2005, annual inflation rate ran at 8.6 percent[1], marginally overshooting the upper limit of the target band of ±1 percentage point around the 7.5 percent target (the actual level was also 0.5 percentage points above the forecast published in the November Inflation Report[2]). Given that in 2005 Q3 the annual inflation rate stayed within the target band, the deviation was due mainly to the unexpectedly large supply-side shocks in the final months of 2005; the impact of such shocks was nonetheless augmented by excess demand. Even though 2005 Q4 saw no progress in disinflation measured by the CPI, CORE2 disinflation continued at a faster-than-expected pace.

Over the period under review, the annual inflation rate witnessed uneven developments, its downward trend (from 10 percent in May 2005 to a low[3] of 8.1 percent in October) being reversed by the November increase in the national heating price (20 percent). The delay in implementing this measure (from July to November) caused its base effect to contribute to both the decline in year-on-year inflation in October and the 0.6 percentage point rise of this indicator one month later. Nevertheless, the stronger growth of administered prices in 2005 Q4 can be ascribed not only to the above-mentioned adjustment, but also to the rising trend in RON/EUR quotations manifest as early as September, which had a direct impact on the change in prices geared to the exchange rate, fixed telephony prices in particular.

The products with volatile prices continued to have an unfavourable impact on the general price level, as their annual dynamics outpaced steadily the CPI growth by 4 to 5 percentage points. Behind this stood solely the speed-up in the growth rate of food prices, i.e. vegetables, fruit, eggs[4], as a result of incidental factors, namely adverse weather conditions and bird flu, which led to a squeeze in supply and shifts in the demand structure[5]. Had these partly-anticipated shocks not occurred, year-end inflation rate would have stood below the actual level by roughly 0.8 percentage points. By contrast, fuel prices had a positive influence on the general price level, as the alleviation

[1] However, the average annual inflation rate dropped by 2.9 percentage points over the previous year, reaching for the first time in 15 years a single-digit reading, i.e. 9 percent.
[2] Based on actual data by end-August 2005.
[3] From December 1990 onwards.
[4] In 2005 Q4, the price of eggs surged by 45.4 percent, accounting for almost one fourth of the inflation rate in the reported period.
[5] To the detriment of small agri-food producers.

of tensions on the world oil market pushed domestic fuel prices lower; hence, the differential between the annual dynamics of such prices and the annual inflation rate fell to 0.4 percentage points in 2005 Q4 compared with approximately 8 percentage points in 2005 Q3.

Nonetheless, disinflation continued in case of CORE2, which fell to 5.6 percent at year-end 2005, down 1.1 percentage points from the September figure. Moreover, the downward adjustment in the reviewed period was 0.2 percentage points larger than in the previous period. It should be pointed out that this development occurred amid the following: (i) rising excess demand – as illustrated by the increase in positive output gap[6] compared with the prior quarter and (ii) the trend reversal of the exchange rate, inducing the return to positive values of the imported inflation contribution to the change in consumer prices in Q4 (after staying negative during the previous three quarters). Therefore, the positive outcome may be associated with the keener competition along the entire production and delivery chain, as well as in the case of some food items, with favourable movements in external prices and some incidental influences[7]. This inference is supported by the fact that CORE2 disinflation owed almost entirely to prices of foodstuffs (other than vegetables, fruit, eggs), while the contribution of non-food prices was only marginal and that of services was negative (the explanation for the developments in non-food and services prices could lie with the stronger pressure from excess demand and increased sensitiveness to exchange rate movements, as well as with the Balassa-Samuelson effect in case of services prices). Although it is difficult to assess accurately the second-round effects of the adjustments in administered prices, the calculations made so far hint at a relatively lower magnitude of such effects[8] against the previous quarter, which helped, to some extent, the downtrend in core inflation to continue.

Another important determinant of inflation is represented by inflation expectations; yet, in the final quarter of 2005, their impact should not be regarded as a favourable one, as the opinions concerning their direction range from "neutral" to "unfavourable". On the one hand, the anticipations of managers in manufacturing and trade, as illustrated by the outcome of the

[6] Based on quarterly changes.
[7] Bird flu outbreaks (which dampened both demand for and supply of poultry following the measures taken to contain the effects of epizootics); update of grants-in-aid to milk producers.
[8] Given that second-round effects of administered price shocks are almost fully manifest during the six months following their occurrence, the difference between the two quarters subject to comparison arises basically from the fact that the impact of the April shock, the strongest in 2005, was no longer felt in Q4.

CPI by Category of Products

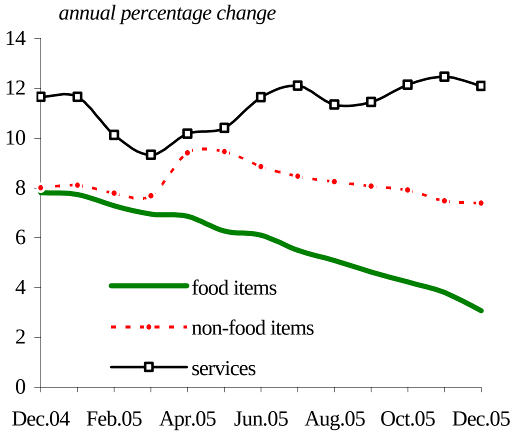
annual percentage change

	2004	2005			
	IV	I	II	III	IV
Food, beverages, tobacco	9.8	8.1	8.0	6.8	7.2
Wearing apparel and footwear	6.0	5.5	4.9	4.2	4.0
Household appliances, furniture	6.7	6.5	6.0	5.0	4.0
Fuels	20.1	15.8	18.3	16.9	10.9
Utility expenses*	18.4	16.5	23.0	21.8	19.9
Healthcare	0.9	4.9	4.5	3.0	1.1
Transport	15.8	15.3	19.0	21.2	19.9
Post and telecoms	1.0	-0.7	-0.4	-2.3	3.4
Leisure and culture	8.7	8.5	7.5	7.5	7.6
Other goods and services	6.6	6.9	6.3	5.2	4.6

*rent, water, sewerage, refuse collection, electricity, heating, gas

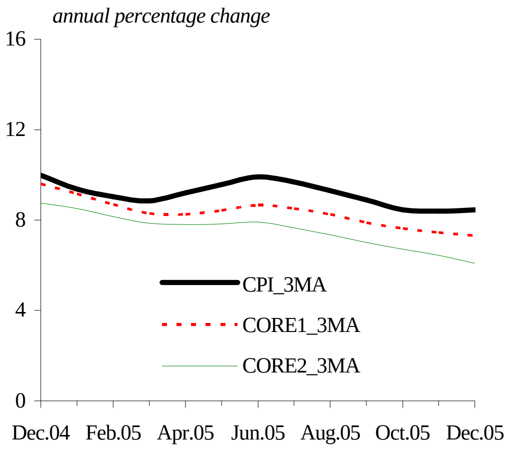
Source: NIS, NBR calculations

CORE2 by Group of Commodities



Source: NIS, NBR calculations

Trend* in Inflation Rate

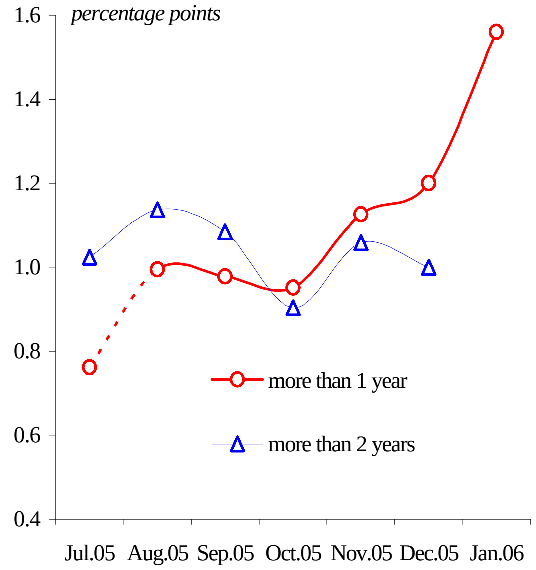


*) compiled on a 3-month moving-average basis
CORE1 (which strips out administered prices)
CORE2 (which strips out administered and volatile prices)

Source: NIS, NBR calculations

NIS business survey, were generally supportive of disinflation[9], staying at a level similar to that recorded in the previous quarter; however, October saw a deterioration of the balance of answers[10], which could be associated with the short-dated reversal in the nominal appreciation trend of the *leu* against the major currencies.

Deviation of Expected Inflation from Annual Inflation Target



On the other hand, the results of the business survey conducted by the National Bank of Romania among bank analysts provide a less bright picture. Even though the survey results also point to the continuation of disinflation, inflation expectations worsened, as shown by the steady widening, starting with October, of the gap between the anticipated 12-month inflation rate and the inflation path consistent with the year-end targets set by the central bank.

At end-2005, annual inflation rate surpassed by 0.5 percentage points the short-term forecast presented in the November Inflation Report. While core inflation was lower than the forecasted figure, the deviation was solely due to the unexpectedly large shocks affecting some exogenous variables. The largest slippage was recorded by volatile food prices (vegetables, fruit, eggs), whose fourth-quarter performance pushed their annual growth rate to 17.6 percent (December/December), 6.8 percentage points above the forecast. The actual and the forecasted exchange rate paths also differed notably, as the domestic currency softened in nominal terms versus the euro by 4 percent (December/September), contrary to the stable exchange rate considered by the projection. A contribution to the above-mentioned deviation, albeit to a smaller extent, had also administered prices; the difference between their actual annual growth rate and the projected rate was due to the following factors: (i) the adverse impact of exchange rate movements on prices for fixed telephony and medicines (to which added, in the latter case, the difficulties in assessing the impact of the changes made by the Ministry of Health to the calculation method for retail prices for medicines[11]) and (ii) larger-than-expected increase in prices of local public services.

[9] Moreover, the survey results pinpoint lower and more stable expectations in industry compared to those in trade.

[10] Calculated as the difference between the balance of answers indicating a faster growth of prices than in the previous period and the balance of answers indicating different opinions.

[11] Order No. 924/31 August 2005 on the containment of the gross margin and the removal of the depreciation margin included in the former calculation of medicine prices.

III. ECONOMIC DEVELOPMENTS

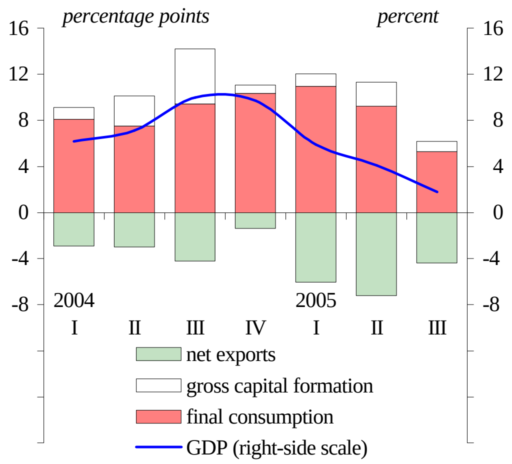
1. Demand and supply

The third quarter of 2005 saw further slowdown of GDP growth, to one of the lowest levels in the last 6 years, i.e. 1.8 percent[12]*, falling 0.4 percentage points below the forecasted figure. The pattern of economic growth changed, with investment becoming the fastest-growing component of aggregate demand amid slackening final consumption. On the supply side, the performance of agriculture further put a dent on economic expansion; leaving aside the impact of agricultural production, annual GDP growth accelerated by 0.7 percentage points against the previous quarter. Nevertheless, for the third successive quarter, the annual growth rate of the industrial sector slowed, reaching merely 0.8 percent in Q3.*

1.1. Demand

Against the backdrop of slower growth of final consumption and steep decline in stocks of finished goods, the annual pace of increase of domestic demand decelerated to 5.8 percent from 10.2 percent in the preceding quarter. Conversely, the annual growth rate of investment accelerated by 1.5 percentage points; thus, after three consecutive quarters when final consumption was the fastest-expanding component of domestic demand, it was investment that saw the highest rate of increase. The negative contribution of net external demand to GDP growth diminished, yet this development could not be attributed to a significant rise in competitiveness of key exports.

Contribution of Demand Components to GDP Growth

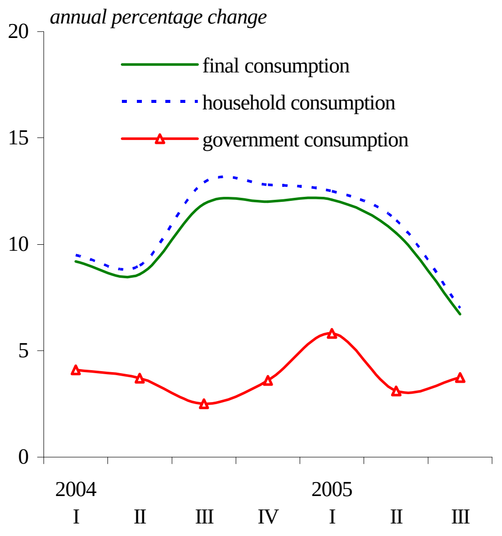


Source: NIS, NBR calculations

1.1.1. Consumer demand

Although the slowdown in the growth rate of final consumption (to 6.7 percent from 10.5 percent in the previous quarter) was accompanied by a slower advance of household purchases of goods and services, this development is rather unlikely to be associated with the lower inflationary pressures induced by consumer demand in Q3.

Actual Final Consumption

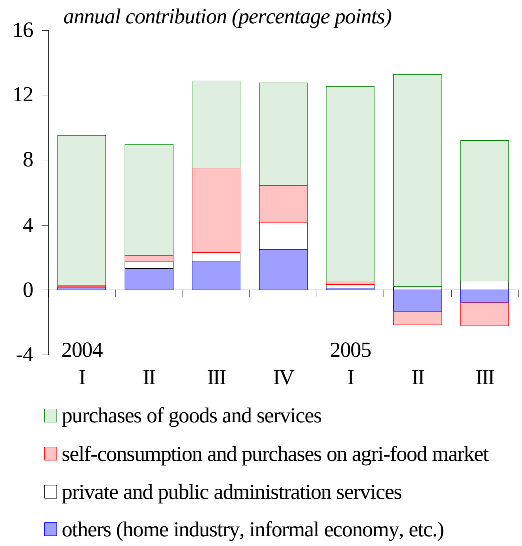


Source: NIS

[12] Unless otherwise indicated, the growth rates in this section are annual percentage changes.

Household consumer demand

Household Final Consumption Growth



Source: NIS, NBR calculations

Unlike 2005 Q2, the slowdown in the annual growth rate of household actual final consumption (by 4.1 percentage points to 7 percent) was induced not only by the decline in self-consumption and purchases on the agri-food market (against the background of a strong base effect and adverse weather conditions in 2005) but also by the slower growth rate of purchases of goods (down 5.2 percentage points to 18.9 percent). Nevertheless, this development is hardly a sign of weaker consumer demand, given, on the one hand, the seeming acceleration of the annual rate of increase of household disposable income[13] – only partly offset by the slower growth rate of new short- and medium-term loans granted by banks to households[14] and, on the other, the incidental constraints from the supply side (disturbances in trade activity caused by wide-spread floods).

Household appetite for consumption was further manifest in Q3, being also fuelled by a weaker propensity for saving against the background of unattractive deposit rates (the increase in the capital market activity – seen by both the Bucharest Stock Exchange and undertakings for collective investment – offset only to a small extent the drop in the flow of deposits with banks[15], as the amounts invested and the number of investors were significantly lower[16]; the option for real-estate investments had little impact on the saving propensity, given the steep increase in prices over the last few years which caused the real-estate market to stall in 2005).

A similar conclusion is drawn from the assessment of developments in the turnover of the trade sector, which show that even though the growth rate of sales of consumer goods decelerated compared with that recorded in the previous quarter, it remained high (non-durables and durables increasing

[13] Estimated based on the sum of total incomes from wages, social transfers (state social security, unemployment benefits and health insurance), remittances from abroad and private current transfers from non-residents.

[14] from 62.8 percent to 36.7 percent in real terms. However, mention should be made that medium-term loans cannot be considered entirely as consumer credit, as they may be destined, for example, to purchase land or modernise buildings.

[15] The annual growth rate of new time deposits made by individuals in Q3 continued to decelerate compared to the same year-earlier period (-7.1 percent in real terms); from the viewpoint of balances, the annual growth rate remained in the positive territory (7.6 percent), but fell considerably below the previous quarter's level (11.5 percent).

[16] At end-September 2005, the total value of UCITS funds owned by some natural entities stood for only 0.4 percent of the balance of time deposits of individuals with banks, whereas the number of investors in this type of securities did not exceed 70,000. Although investments in shares involve greater risk, individuals are by far more active in the BSE, the market value of their assets exceeding 20-25 percent of the balance of deposits with banks, the small number of investors (10,000) notwithstanding. (Source: NSC, NUOCI)

by about 17 percent and 27 percent respectively). The downtrend in the growth of sales of non-durables was more conspicuous than that in sales of durables, owing to the still keen interest of individuals in the latter type of purchases.

The slowdown in the growth rate of private consumption was mitigated by: (i) market services, whose growth rate accelerated by 3.8 percentage points to 14 percent – due to the increased consumption of electricity and to developments in communications (particularly the Internet), transports (road extension as a result of some roads becoming inaccessible) and gambling (however, mention should be made that significant inflationary pressures came only from transport-related spending); (ii) expenditures for individual consumption by public and private administration to compensate for damages and losses suffered by individuals following floods.

As concerns the source of goods for household consumption, in Q3, domestic supply continued to lose ground in favour of imports. This tendency was especially manifest in the case of *non-durables* (steep slowdown in the growth rate of the turnover in the food industry and light industry along with a step-up of about 2 percentage points in the growth rate of the physical volume of such imports[17]). In Q3, Romanian companies continued to post a faster increase in sales of *durables* on the domestic market than in sales of non-durables, in spite of a slowdown in the growth rate compared with the previous quarter to 12.7 percent from 26.2 percent. Deceleration of the growth rate was even more pronounced, considering the road transport means[18]; however, mention should be made that the decline by almost 6 times in the growth rate of turnover of road transport means on the domestic market was strongly affected by one-off factors (for instance, leaving behind the peak of sales within the Nationwide Programme to renew the fleet of vehicles) and the base effect arising from the launch on the market of the new Dacia Logan model in September 2004. Nevertheless, imports of durables rose further at a fast pace (to nearly 50 percent in the case of autovehicles).

[17] In the absence of statistical data on the change in the volume of imports by group of goods, estimates were based on the value and unit value index of products in the Classified List (C.L.).

[18] Available data do not allow a differentiation between autovehicles for household consumption and those purchased by the corporate and public sectors (which, according to National Accounts Methodology, contribute to gross fixed capital formation).

Government consumer demand

General government actual final consumption went up somewhat at a faster rate than in the previous quarter (3.7 percent), possibly owing to similar developments in the number of public sector employees.

Budgetary developments

In 2005 Q3, the consolidated general government budget ended again on a surplus (0.4 percent of GDP)[19], hinting at the authorities' further tight stance as regards government investment expenditures.

In year-on-year comparison, both revenues and expenditures saw a decline of roughly 0.1 of a percentage point in their shares in GDP.

Thus, budget revenues were still affected by the introduction of flat tax rate (16 percent), which caused the weights of receipts from profit tax and income tax to narrow by 0.2 percentage points of GDP each; in addition, the weight of other indirect taxes fell by 0.1 of a percentage point. The drop in these revenues was partly offset by the rise in receipts from VAT and social security contributions, up 0.3 percentage points and 0.1 percentage points of GDP respectively, as a result of larger retail sales, as well as wage and payroll growth.

Although most categories of expenditures contracted as a percentage of GDP, the shares of material expenditures and staff costs increased by 0.2 percentage points and 0.1 percentage points respectively of GDP. Against this backdrop, the primary surplus of the consolidated general government budget dropped slightly both quarter on quarter and year on year, reaching 0.6 percent of GDP.

During the final quarter of 2005, the third budget revision in the first half of November left its mark on the consolidated general government budget. The move was aimed at lowering (by 1.5 percentage points) the projected levels of revenues and expenditures (to 29.5 percent of GDP and 30.5 percent of GDP respectively), the projected year-end budget deficit being left unchanged. Part of public spending was redistributed; the outlays intended for the National Health Insurance Fund in order to pay off debts incurred by the social health insurance, as well as expenditures for education, social protection, operation of public institutions, reconstruction of flood-damaged

[19] The share-to-GDP remained virtually unchanged as compared to the same year-ago period.

infrastructure, and outlays for some subsidies on goods and activities posted increases. By contrast, environment- and integration-related spending was curtailed.

Although the preliminary data show that the actual consolidated general government budget deficit for end-2005 ran below the planned figure, i.e. 0.8 percent of GDP compared with 1 percent of GDP, the easing of fiscal policy in Q4 (particularly in December) was the most pronounced over the past few years, putting additional pressure on demand during the period.

1.1.2. Investment demand

In Q3, the growth rate of gross fixed capital formation rose at a faster pace than in Q2 (by 1.5 percentage points to 10.5 percent), the strongly negative base effect notwithstanding (in 2004 Q3, this indicator posted an annual increase of 17.3 percent, i.e. the highest level in the expansion period of the present economic cycle). The development was underpinned primarily by new construction works and capital repairs, especially in *residential buildings* and *engineering works* (partly associated with attempts to remove flood effects).

As for investment in equipment, the growth rate slowed down significantly, this development possibly being accompanied by the strengthening of import contribution to meeting investment demand[20]. Behind the slowdown in equipment investment stood mainly the decrease in the own resources of the corporate sector, against the background of poor performance in industrial output throughout 2005. In addition, the uncertainties surrounding future developments in the industrial activity must have been a reason why many companies resorted less often to alternative financing sources[21].

As regards the second component of gross capital formation, after 10 quarters during which the contribution of stock changes to GDP growth did not exceed ±0.5 percentage points, it reached -1.9 percentage points in 2005 Q3 against the background of the sharp contraction of stocks of agricultural

Investment

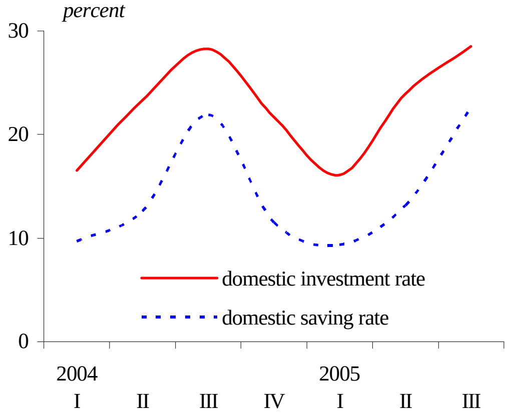
annual percentage change

	Year	I	II	III	IV
Total	2004	7.2	12.0	18.1	1.7
	2005	5.8	10.7	11.3	
- new construction	2004	7.6	9.6	13.3	6.9
works	2005	2.2	9.4	11.1	
- equipment	2004	14.9	26.4	38.4	5.5
	2005	9.6	12.8	8.1	
- others*	2004	–30.7	–40.2	–38.8	–37.6
	2005	–4.9	1.0	41.0	

* vineyards, orchards, afforestations, livestock purchases

Source: NIS

Investment Rate and Saving Rate



Note: domestic investment rate is the ratio of gross capital formation to GDP; domestic saving rate is the difference between GDP and final consumption as a share of GDP

Source: NIS, NBR calculations

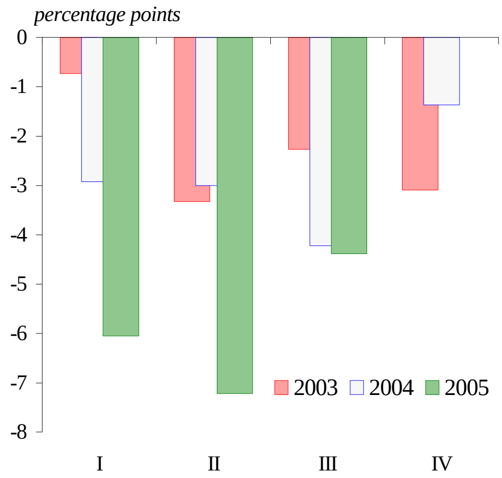
[20] Compared with Q2, the annual growth rate of the turnover in industries producing capital goods (including transport means) for the domestic market slowed down to less than half (to 9.1 percent), as a result of developments in most components of this group, while the dynamics of the physical volume of imports of capital goods declined more slowly, remaining however very fast (more than 20 percent).

[21] New loans in RON and foreign currency granted to legal entities on a period longer than one year witnessed a slower annual growth rate, from 66.1 percent to 49.5 percent in real terms; as concerns leasing purchases, the weight of industrial and agricultural equipment remained very low (around 6 percent according to the 9-month assessment made by the Association of Leasing Companies of Romania) in spite of the expansion of the leasing market in Q3 as well.

products. However, mention should be made that the said indicator recorded similar levels also during other years when adverse agricultural conditions (such as the drought in 2002) were followed by normal agricultural years. Under the circumstances, the rate of increase of domestic demand fell to 5.8 percent although final consumption and gross fixed capital formation posted higher growth rates.

1.1.3. Net external demand

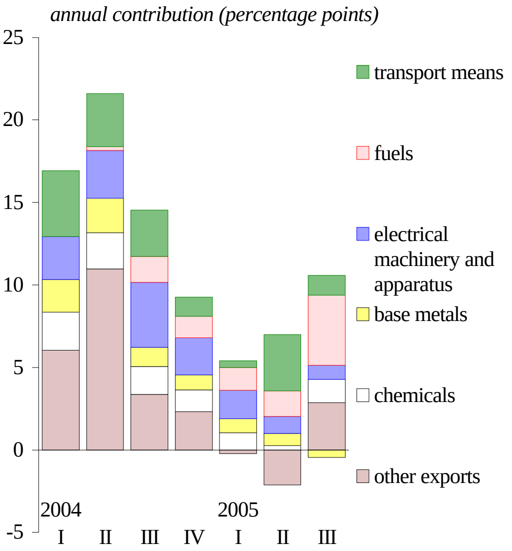
Net External Demand Contribution to GDP Growth



Source: NIS, NBR

The negative contribution of net external demand to GDP growth improved from 7.2 percentage points to 4.4 percentage points, following the relative upturn in exports (8.4 percent, up 5.1 percentage points versus the growth rate recorded in Q2). However, mention should be made that this faster growth rate was attributable to the absence of the base effect which left its mark in the previous quarter[22] rather than to current developments; thus, calculated based on seasonally-adjusted series, in Q3, the quarter-on-quarter change was only +1.9 percent compared to 4.1 percent in Q2. Exports were further affected by: (i) lower competitiveness of some products holding a large share in total exports (electrical machinery and apparatus; chemicals; light industry products[23]) and (ii) competition from Asian countries (following liberalisation, in early 2005, of world textile market).

Dynamics of Export Physical Volume



Source: NIS, NBR calculations

The growth rate of imports (17.4 percent) remained at a level similar to that recorded in the first two quarters of 2005; the development was fuelled by the further nominal strengthening of the domestic currency. Associated with the slowdown in industrial output, the persistently high growth rate of imports suggests a more considerable contribution of imports to meeting consumer demand (final and intermediate) and investment demand.

The same as in the previous quarter, foreign trade featured high concentration; more than 75 percent of the annual change in the physical volume of exports and imports of goods was accounted for by fuels and mechanical devices, electrical machinery and apparatus (in the case of exports) and by chemicals, base metals, transport means and mechanical devices, electrical machinery and apparatus (in the case of imports).

[22] In 2004 Q2, the volume of exports of goods and services rose by 10.9 percent versus the previous quarter (seasonally-adjusted series; NBR calculations).

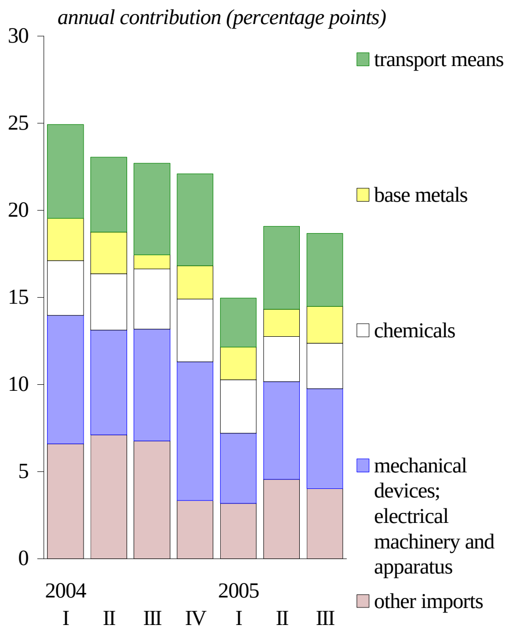
[23] In Q3, real ULC index in the said industries ranged between 103.9 percent and 140.1 percent compared to the same year-earlier period.

1.2. Supply

The same as in the first two quarters of 2005, agriculture was the main culprit for the slowdown in economic growth, as losses caused by adverse weather conditions led to a 14.7 percent drop in gross value added of this sector.

In addition, industrial activity posted a sharper downward trend, as shown by the low annual growth rate of gross value added (only 0.8 percent), contributing merely 0.2 percentage points to GDP growth (the lowest reading over the past six years). The slower growth rate in industry may be the result of: (i) decelerating growth rate of exports of some outward-oriented industries (metallurgy, light industry, furniture industry); (ii) stiffer competition from competitive imports, enhanced by further nominal appreciation of the domestic currency against major currencies; (iii) negative impact of floods on supply and delivery of industrial companies, as well as on the extractive sector output; (iv) cut in losses in mining (closure of some loss-making units of the major hydrocarbon extraction company) and chemical industry (the volume of fertilizer output became conditional upon the coverage through prices of expenses which increased owing to the hike in the price of natural gas)[24].

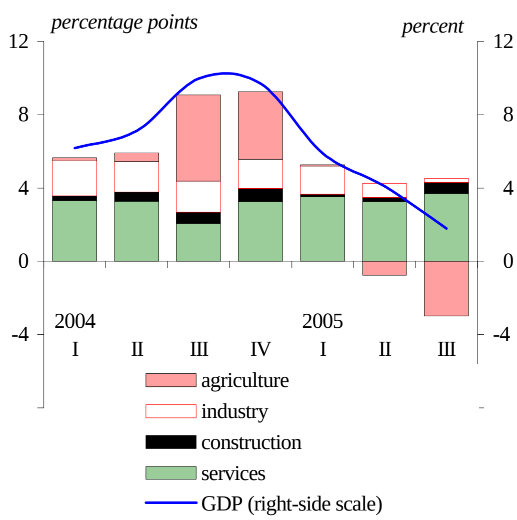
Dynamics of Import Physical Volume



Source: NIS, NBR calculations

The annual growth rates of gross value added in construction and services stood markedly higher than in the first half of 2005, i.e. 10.4 percent and 9.9 percent respectively. In construction, developments in the residential buildings and engineering works sub-sectors were attributable to the steps taken to remove flood effects. As for services, the available data do not allow identification of activities which underpinned the acceleration of the growth rate given that: (i) the growth rate of retail trade turnover slowed, (ii) developments in wholesale trade and services to companies are associated with those recorded by the other economic sectors, and (iii) banking and insurance operations experienced a marked slowdown in the growth rate[25]; therefore, the remaining sectors that may have recorded an improved performance were transports, telecommunications and public utility services.

Contribution of Main Supply Components to GDP Growth



Source: NIS, NBR calculations

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[24] Mining output decreased at a faster pace than in Q2 (from -3.9 percent to -7.5 percent, annual changes), while the output of chemical industry dropped 17 percent after having recorded a positive annual growth rate of 2.1 percent in the previous quarter. The negative growth rate of the output in chemical industry was the result of both the closure of the main fertilizer producer and the base effect (in 2004 Q3 the annual growth rate was extremely high, i.e. +54 percent).

[25] Gross value added of indirectly-measured financial intermediation services edged up 2.3 percent compared to 15.3 percent in the previous quarter.

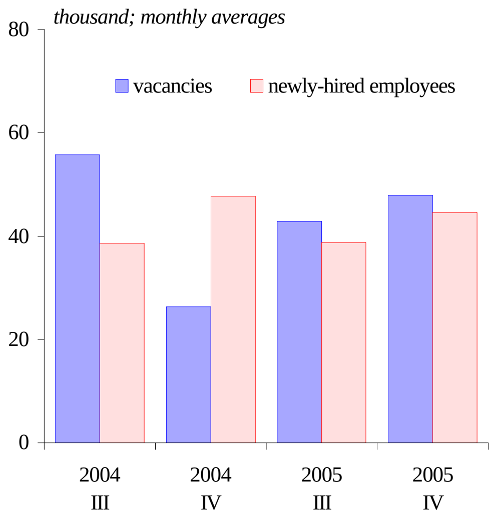
2. Labour market

Conditions on the labour market further fuelled the pressures that staff costs and consumer demand put on prices. On the one hand, the rigidity of wages across the industry, despite productivity growth rates persistently lower than those in the January 2003-March 2005 period and the upturn in labour demand in 2005 Q4 make highly unlikely any adjustments of these costs in the final months of the year. On the other hand, in 2005 Q3 and the first months of Q4 there were indications of accelerated annual growth rate of household disposable income which was attributable mainly to remittances from abroad and to private transfers by non-residents.

2.1. Labour force

The easing of pressures on the labour market in 2005 Q3, as already signalled by the November 2005 Inflation Report, was confirmed by the statistical data provided by the National Employment Agency (NEA), but appears to have been short-lived.

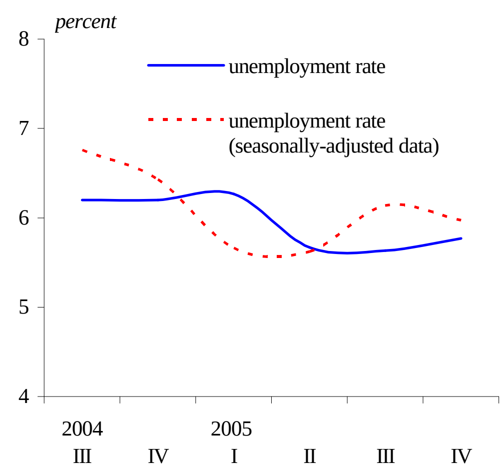
Number of Vacancies and Number of Filled Vacancies



Source: NEA

Thus, 2005 Q3 was the fourth successive quarter during which excess labour demand declined, as mirrored by the 23 percent drop in the number of vacancies year on year. The number of lay-offs was however relatively low, the 10 percent increase in annual terms being driven by the base effect (excluding the 2004 Q3 figure, this indicator hit a 3-year low in the period under review). The lay-offs occurred mainly in industry on the background of slowdown in activity, while in construction and services sectors the number of employees experienced faster annual increases. On the supply side, there were also indications of an easing of labour market conditions; thus, the number of jobs declined twice as slowly as in the same period a year earlier, while the seasonally-adjusted unemployment rate went up.

Unemployment Rate



Source: NEA, NBR calculations

Statistical data available for 2005 Q4 suggest that labour demand rebounded, as illustrated by (i) the larger number of vacancies after four consecutive quarters of decline; (ii) the roughly 10 percent rise in the number of hirings from among jobseekers (November saw the highest figure in the last two years) and therefore the interruption of the upward trend in seasonally-adjusted unemployment rate.

The chief reason behind this development was probably the development of services, where payrolls posted a faster annual growth rate in October and November. The growth rate of employees in construction remained high, although it decreased slightly against the previous quarter, while labour contraction in industry grew stronger.

It is however difficult to assess the extent to which the workers made redundant in industry could be absorbed by the services sector, taking into account the small number of people attending training and retraining courses (less than 10 percent of total number of jobless at end-September), the low employment rate of the jobless that had completed such courses (below 30 percent), and the low regional mobility (persistently high unemployment rates in some counties). Therefore, the additional labour demand might not be met promptly, putting upward pressures on wages that might feed through into prices, unless these increases are matched by productivity gains.

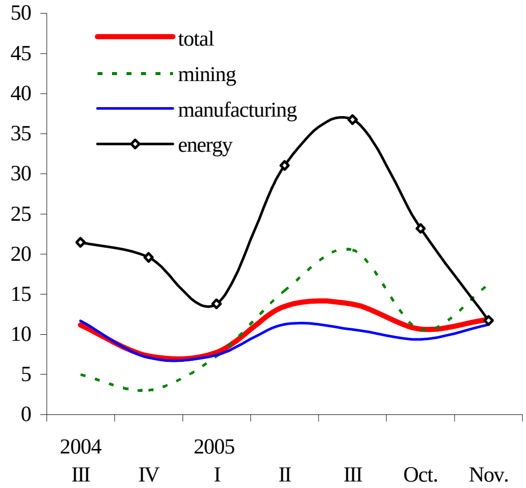
2.2. Incomes

In 2005 Q3, gross average wage economy-wide was affected only by incidental factors[26], with the annual growth of nominal wages maintaining a brisk pace (17.5 percent). Changes up to 10 percentage points above the average were detected in the budgetary, mining and energy sectors, following wage hikes and bonuses paid in 2005, as well as in construction as a result of strong labour demand to rehabilitate the flood-damaged houses and infrastructure.

The rigidity of wages in industry caused the annual rate of increase of nominal ULC to post a level similar to that recorded in 2005 Q2, yet higher than that recorded in the January 2003-March 2005 period. The slight deceleration of wage growth in manufacturing was fully offset by the nearly 5 percentage point step-up in the growth of such costs in both mining and energy sectors. Moreover, ULC pressures in the consumer goods sector remained above the average in manufacturing, lower growth rates being recorded only in printing and furniture sub-sectors. Under the conditions, for the first time in the last three years, in 2005 Q3, average productivity gains across the industry[27] did not match the annual rise in gross real wage (deflated by IPPI for the domestic market); in the energy sector, the negative gap between the growth rates of the two indicators (more than 20 percentage points) widened alarmingly, amid the 9 percent drop in labour productivity and the 12 percent hike in real wages.

Unit Labour Costs in Industry

annual percentage change



Source: NIS, NBR calculations

Labour Productivity and Real Gross Wage in Industry

annual percentage change

	2004		2005				
	III	IV	I	II	III	Oct.	Nov.
Labour productivity	10.5	13.7	7.1	2.7	2.9	6.0	5.6
Real gross average wage*	2.3	3.8	1.0	2.3	5.4	5.7	6.6
Real gross average wage**	-1.5	2.1	5.0	13.8	18.1	19.0	17.0

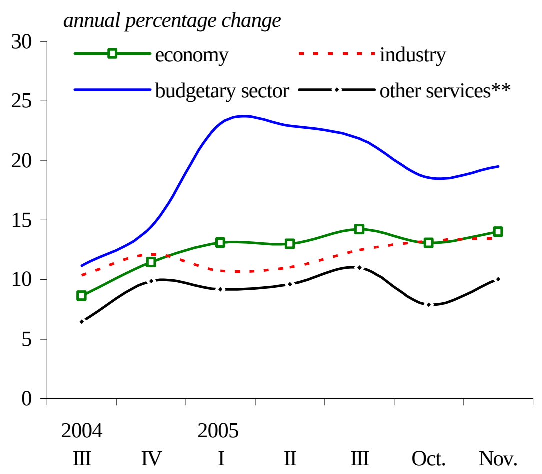
*) deflated by industrial producer price index for domestic market

**) deflated by industrial producer price index for external market

Source: NIS, NBR calculations

[26] Payment of holiday entitlements, monthly bonuses, and other financial incentives, such as the bonus granted on the occasion of the Oilman's Day in hydrocarbon extraction and oil processing sub-sectors.
[27] The annual growth rate of labour productivity might be higher than that calculated based on information provided by the NIS, given that business surveys constantly indicate substantial staff cuts that could be only partly reflected by statistical data, should these adjustments also include the staff lacking employment record.

Net Real Wage*



*) deflated by CPI
**) data comparability has been, to some extent, affected by NIS changes to the structure of the number of employees and wages by sub-sector (August 2005)

Source: NIS, NBR calculations

In most consumer goods sectors, data available for 2005 Q4 (October and November) do not indicate any changes from the previous quarter, the slower annual growth rate of ULC across industry being generated by developments in mining and energy sectors, where the drop in productivity came to a halt; the relative improvement of ULC in these sectors appears to be generated by incidental factors rather than by lasting structural adjustments.

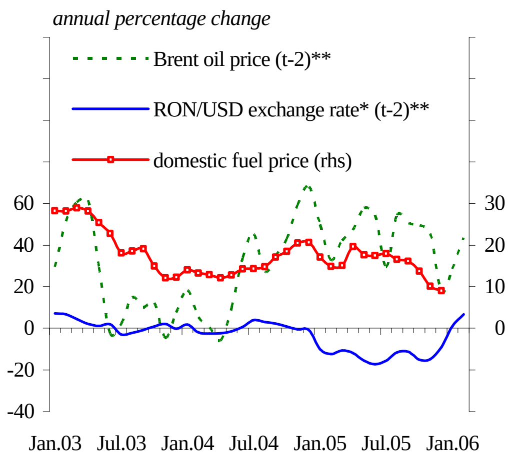
On the demand side, during the period under review, the annual growth of real disposable income[28] of households most likely stepped up, the estimate for the October-November period indicating the twofold increase in the 2005 Q2 figure; remittances from abroad were the key driver of this development, yet the other components[29] posted higher annual growth rates as well.

3. Import prices and producer prices

The same as in the previous quarter, 2005 Q3 saw the continuation of industrial producer price disinflation and of pressures exerted by external energy prices; in Q3, such pressures were accompanied by unfavourable developments in import prices of certain consumer goods. In the last part of 2005, trend reversals are foreseen for certain price categories amid the easing of world oil market and discontinuation of the appreciation trend of the domestic currency against the euro. Furthermore, the growth rates of prices for fruit and vegetables are expected to stay high, whereas prices for animal products and other vegetal products are estimated to continue posting positive trends.

3.1. Import prices

Oil and Fuel Prices



*) (-) RON appreciation, (+) RON depreciation
**) time lag attributed to the 45-day manufacturing cycle

Source: NIS, EIA

In July-September 2005, external prices brought about larger inflationary pressures, the annual unit value index of imports rising by 1.2 percentage points versus the previous quarter to 105.4 percent. The swifter pace of increase was driven mainly by the hikes in prices of energy products (oil, petroleum products, natural gas), yet “vegetal products”, “wearing apparel” and “footwear” groups also made a significant contribution to this rise. However, most commodity groups holding substantial shares in the CPI basket showed favourable

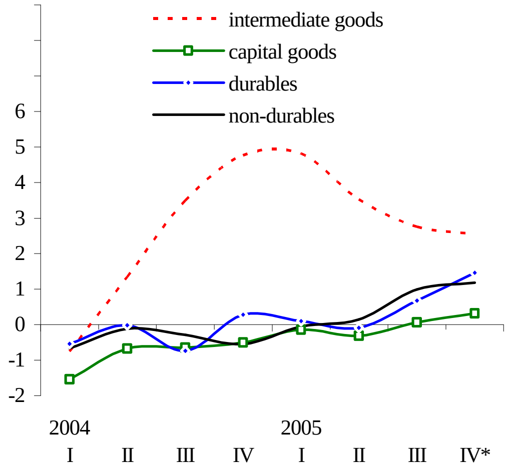
[28] Estimated based on the sum of wage earnings (net wages weighted by the number of employees), incomes from budgetary and extra-budgetary funds (state social security, unemployment benefit, health insurance), remittances from abroad, and current private transfers by non-residents.
[29] Real growth of wage earnings accelerated only in 2005 Q3, while in October-November it decelerated slightly.

developments, as the unit value indices pointed to lower import prices for fruit, foodstuffs, beverages, tobacco products, pharmaceuticals, and the 10 percentage point deceleration in the growth rate of external price for meat; in the latter case however, the annual rate of increase of prices stayed well above the average, further having a significant impact on the general price level.

However, mention should be made that the generally bright picture provided by unit value indices of consumer goods imports is different from that shown by the producer price index for EU25 exports of consumer goods (annual increase of 0.7 percent compared with a decline of 0.1 percent in 2005 Q2) owing to developments in prices for both durables and non-durables. The entire group of manufacturing prices also displayed a faster annual rate of increase (1.8 percent, up 0.3 percentage points versus Q2); the quicker growth rate of consumer goods prices was accompanied, for the first time in the past three years, by some positive changes in prices for capital goods; the annual growth rates of prices for intermediate goods remained on the downward path they had followed ever since early 2005.

EU-25 IPPI for Exports

annual percentage change



Source: Eurostat *) October - November

In 2005 Q4, the pressures induced by external prices may have eased due largely to the alleviating tensions on world oil market. Prices of industrial goods originating in EU25 improved somewhat, the growth rate of manufacturing prices decelerating to 1.5 percent in October-November (owing to the favourable impact of price movements recorded by intermediate goods). However, tensions in the natural gas market lingered, as in the final quarter of 2005 the annual growth rate of natural gas prices stood by merely half a percentage point below the third-quarter average.

The formerly positive impact the exchange rate developments had on imported inflation lowered gradually throughout 2005 H2, as the RON/USD quotations reverted in 2005 Q4 to figures close to the average for the same year-earlier period and the appreciation trend of the domestic currency against the euro was discontinued. In annual terms, the changes in the exchange rate of the RON against the two major currencies remained in positive territory, yet their magnitude in 2005 Q4 decreased to 0.83 percent for the USD and 9.7 percent for the EUR (after ranging from 12 percent to 17 percent in Q2 and Q3).

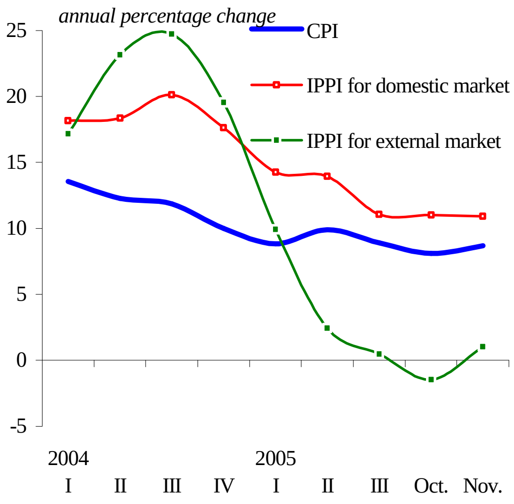
3.2. Producer prices

3.2.1. Industrial producer prices

The disinflation of industrial producer prices for the domestic market continued into 2005 Q3, with their annual growth rate dropping by another 2.9 percentage points against the previous quarter to 11.1 percent.

Unlike the past two quarters, disinflation relied in the considered period also on price developments in the energy sector, as follows: (i) in the hydrocarbon extraction sub-sector, due most probably to pressures from eligible consumers of natural gas[30], which were hit hard by the April hike in the natural gas price; (ii) in the oil processing sub-sector, owing solely to the growth rates of prices in September, when the first signs of easing tensions on the world oil market were manifest. It is worth mentioning that, despite posting the largest deceleration (3.4 percentage points versus the previous quarter), the annual growth rate of energy prices (21.2 percent) stayed well above the average industry-wide, given the retrenchment in hydrocarbon output[31], the spike-up in the world oil price and the process of bringing domestic prices into line with international prices.

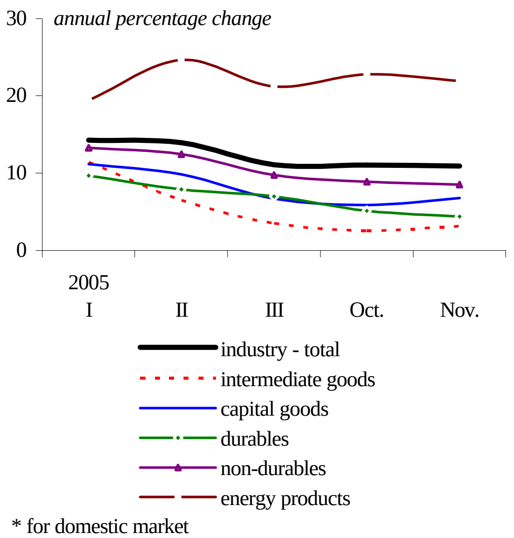
Consumer Prices and Industrial Producer Prices



Source: NIS

The same as in the previous 3-month period, the growth rate of producer prices for intermediate goods slowed down markedly, mainly on the back of developments in metallurgy prices, whose annual rate of increase fell into negative territory. The developments in prices for metal products over the past four quarters had a positive impact on raw material costs in "capital goods" group, where the annual growth rate of producer prices dropped 3.2 percentage points from the average for the previous quarter. Even though the developments in prices for metal products had a favourable impact on producer prices for durables[32] as well, the latter's annual growth rate decelerated far more slightly (0.9 percentage points); an explanation may lie with the persistently high domestic demand for durables – the annual growth rate of turnover reported by producers of durables remained high, albeit it contracted significantly compared with the previous quarter.

Industrial Producer Prices* by Main Group



* for domestic market

Source: NIS

[30] The openness of the natural gas domestic market stands at 50 percent. According to the National Regulatory Authority in Natural Gas Sector, nearly 60 percent of eligible companies in 2005 changed their supplier at least once for more profitable contracts.

[31] Industrial output in hydrocarbon extraction sub-sector was 5.9 percent lower in January-September 2005 than in the same year-earlier period.

[32] Road transport means are excluded, according to the classification by main industrial group used by the NIS.

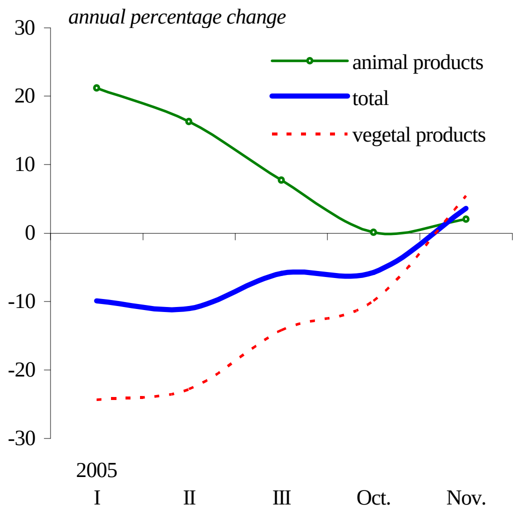
The rate of increase of prices for non-durables slowed by 2.7 percentage points, given the generally favourable influences exerted by cost items, as follows: (i) prices for main raw materials (grains, meat, wool, cotton) stuck to the downward trend on both domestic and foreign markets[33]; (ii) pressures brought about by ULC abated considerably versus the prior quarter (except for textiles sub-sector)[34], the persistently high annual growth rates notwithstanding.

Although October saw a temporary halt in the downtrend of industrial producer prices for the domestic market, the subsequent price developments failed to confirm this trend; thus, disinflation is expected to continue in 2005 Q4 as well, in the absence of any major factors that could put pressure on prices.

3.2.2. Agricultural producer prices

The annual rate of increase of agricultural producer prices remained negative in 2005 Q3 (-5.9 percent), yet its magnitude contracted significantly against the previous quarter, due solely to developments in the vegetal output. Behind this decrease stood the changes in prices for fruit and vegetables, as a result of adverse weather conditions rather than the dynamics of prices for grains which stayed strongly negative, due possibly to large stocks generated by the 2004 crops.

Agricultural Producer Prices



Source: NIS

In 2005 Q3, the annual growth rate of producer prices for animal products declined below the previous quarter's average, given that, except for poultry (the prices of which resumed the upward path), all groups of animal products further recorded favourable price developments, amid the reasonable fodder prices and keener competition (among domestic producers and induced by larger meat imports).

The reduction of the favourable impact of prices across the vegetal sector is likely to continue in 2005 Q4 as well, as the pressures exerted by prices for fruit and vegetables are expected to persist. Prices for animal products are likely to post a downward trend, owing to the slowdown in the growth rate of poultry prices caused by excess supply (due to the drop in domestic demand and discontinuation of exports following the bird flu outbreaks).

[33] See sub-section *3.2.2. Agricultural producer prices*.

[34] ULC in food and light industries increased in real terms in a range from 5.8 percent to 14.3 percent, yet at a slower pace than the average for the previous quarter (ranging between 2.4 percentage points and 11.8 percentage points).

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In November 2005, the central bank halted the implicit easing of interest rate policy. The monetary authority gradually tightened the control over liquidity in the banking system, thereby reversing the downward trend of the average interest rate on credit institutions' holdings with the central bank[35]*. However, the quarterly average of this indicator continued to decline, reaching a historical low in 2005 Q4. The effect of this decrease on monetary conditions was no longer offset by the exchange rate movements, the leu posting a significant real depreciation against the major currencies during this period. The relative easing of the broadly-defined monetary conditions was only slightly offset by the impact that the set of measures*[36] *implemented by the NBR in the previous quarter for the purpose of containing credit expansion had on liquidity across the economy; in order to strengthen this impact, the central bank raised minimum reserve requirements on foreign currency-denominated liabilities of credit institutions to 35 percent*[37] *towards the end of 2005.*

In early November 2005, the NBR Board decided to halt the implicit easing of interest rate policy, which the central bank had continued to pursue in October as well in order to fend off the risk of volatile capital inflows. Although the central bank left its key rates unchanged (the policy rate at 7.5 percent while the rate on the deposit facility and that on the lending facility at 1 percent and 14 percent respectively), the average interest rate on banks' holdings with the NBR was raised by gradually increasing the volume of liquidity mopped up through open market operations and therefore decreasing liquidity-absorbing operations through the deposit facility. The need to consolidate rapidly the upward trend of the interest rate, on the one hand, and to enhance monetary policy effectiveness, on the other, as pinpointed in its December meeting, determined the NBR Board to tighten further the control over liquidity and to increase minimum reserve requirements on foreign currency-denominated liabilities of credit institutions to 35 percent.

[35] Consisting in one-month deposits, 3-month certificates of deposit and overnight deposits (the deposit facility).
[36] Monetary policy, prudential and administrative measures (see November 2005 Inflation Report).
[37] Starting with the 24 January-23 February 2006 maintenance period.

The main reason for the shift in the conduct of interest rate policy and, subsequently, for the decision to tighten further monetary policy consisted in the deepening, at least in the short run, of macroeconomic imbalances and the increase in demand-pull inflationary pressures; against this backdrop, the NBR Board considered that the growth rate of consumption – the main component of demand – became unsustainable as regards ensuring the continuation of disinflation.

Thus, although stronger-than-expected, the contraction of the positive output gap in Q3 was short-lived; the data available for Q4 show a likely short-term rebound in excess demand, solely due to the rise in domestic demand. In addition, the slowdown in economic growth in Q3 was mainly caused by supply-side shocks, especially the decline in agricultural output and deceleration of annual growth rate of industrial output; however, the dynamics of demand potentially generating inflationary pressures (which excludes self-consumption), especially consumer demand, stayed overly high, thereby explaining the unusually large magnitude of the negative change in stocks of goods during this period (see Chapter III. *Economic developments).*

The unsustainable growth and structure of domestic demand were also reflected by the worsening of external sector performance, which continued to be a buffer for most part of excessive domestic demand pressures. The strong increase in current account deficit, which continued into Q3, reflected both the widening gap between the growth rate of domestic absorption and the rate of increase of domestic output and the yawning saving/investment deficit of the private sector, in the context of faster rise in public sector revenues than in its expenditures.

Against this background, the central bank's matter of concern was the persistency of the slowdown in household saving in domestic currency and the prospect of the continuation of this trend (assuming steadfast specific elasticity), due also to the significant reduction by banks of deposit rates in response to the prior easing of monetary control and, implicitly, of the NBR interest rate policy. Thus, during the first two months of Q4, the real annual average growth rate of household savings in domestic currency dropped to 15.9 percent from 19.3 percent in Q3. The net household saving continued to weaken given that the relative increase in the real annual average growth rate of household deposits – due solely to the accelerated growth in current accounts and foreign currency-denominated deposits[38] of households – was outpaced by the growth of household indebtedness. October through November, the real growth rate of household loans accelerated to 72.3 percent compared with 63.8 percent in Q3; total loans to households accounted for about 71.2 percent, on average, of household deposits (compared with 64.8 percent in 2005 Q3).

Therefore, the decisions adopted by the NBR Board in Q4 were aimed at bringing erosion of saving to an end and slowing credit growth, as the tighter prudential and administrative measures implemented previously by the central bank proved less effective. The impact of these measures materialised only in a faster change in non-government credit structure, with stronger increase in RON-denominated loans, whose total volume continued to rise at a faster pace (see Section 2.3. *Money and credit).* Strong growth of RON-denominated loans to households and corporate sector in Q4 was due to both the cut in bank rates and the more favourable access conditions to bank financing[39], the latter being also the result of measures to reduce foreign currency lending.

In this context, the NBR decisions were the more so substantiated as the year-end was expected to witness a likely increase in domestic demand (consumer demand in particular) above the usual seasonal limits, as a result of: (i) the payment of bonuses in December that were expected to be at least proportional to wage hikes during 2005; (ii) the increase in remittances from Romanians working abroad (specific to the period) and, especially, (iii) heavy budget spending given that in December expenditures were expected to account for 1.8 percent of GDP[40]. A possible hint at an accelerated increase in consumer demand in December and, implicitly, at the sharp widening of trade deficit was the further weakening of the *leu* against the euro, despite the resumption of opposing pressures exerted by larger capital inflows on the exchange rate. As a result, depreciation of the domestic currency, which had been registered since late September, increased (see Section 2.2. *Exchange rate and capital flows*); thus, during 2005 Q4, unlike

[38] Strengthening of the upward trend they entered starting with September may be attributed to the propensity for foreign currency-denominated saving – given the resumption of nominal depreciation of the RON against the EUR, on the one hand, and to the decision of households to deposit the advance for new foreign currency credits, on the other, the recourse to such type of financing being delayed, at least temporarily, because of tighter lending requirements imposed by the central bank.

[39] A larger range of promotional banking products and low fixed interest rates on long-term loans to households.

[40] In December, the monthly deficit of the consolidated general government budget exceeded the surplus recorded January through November, its year-end level being estimated at 0.8 percent of GDP.

the previous quarters, the exchange rate of the *leu* fuelled the growth rate of retail prices.

Another major reason behind the shift in the conduct of interest rate policy was the strong increase in cost-push inflation in 2005 Q4 and its prospective persistency at least at the beginning of 2006.

Efforts have been aimed at minimising the risks associated with the second-round effects of supply-side shocks and at fending off the worsening of inflation expectations the more so as the unfolding wage bargaining was at a critical stage. Against this backdrop, the central bank aimed to enhance the role of inflation target as an anchor by following an interest rate policy consistent with attaining the inflation target. The main supply-side shocks generating inflation during the period were the larger-than-expected adjustment in some administered prices and, especially, the strong increase in one of the volatile price groups, due mainly to the drop of agricultural output in 2005. These price increases stood for the main reason behind the pause in disinflation in November and the 0.1 percentage point overshooting of the upper limit of the target band around the 7.5 percent inflation target, given that annual CORE2 inflation posted the sharpest quarterly fall in 2005.

In order to avoid the increase in volatile capital inflows, the NBR decided to gradually tighten the interest rate policy, firming the liquidity policy accordingly. Thus, starting with November, the monetary authority abandoned the loose monetary control, which had been exerted so far, raising gradually the volume of open-market sterilisation operations; the central bank increased the volume of one-month deposit-taking operations and especially that of CDs, so that in December the average balance of such sterilization operations was 1.6 times higher than in September. As a result, banks' recourse to the deposit facility lowered steadily; during the last two ten-day periods of November, the daily average volume of overnight deposits placed with the central bank accounted for less than 30 percent of that recorded in September, this share dropping to only 6.3 percent in December.

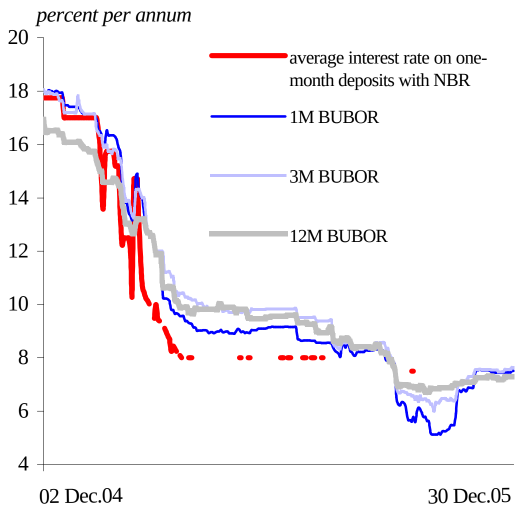
The measures to tighten monetary control caused average interest rate on banks' holdings with the central bank to enter an upward trend, reaching 6.1 percent in December 2005.

2. Financial markets and monetary developments

After a protracted decline, money market rates resumed the upward trend in November 2005; by contrast, the exchange rate of the RON moved on a linear trajectory, the initially fast depreciation of the domestic currency slowing down at year-end. Despite the noticeable slowdown in the growth of foreign currency loans, liquidity across the economy increased at a fast pace, being fuelled by the sharp rise in RON-denominated credit.

2.1. Interest rates

Interest Rate on Deposit-taking Operations and BUBOR Rates



The developments in interbank deposit rates in the final quarter of 2005 accurately illustrated the manner in which the central bank exerted control over liquidity. The persistently high volume of excess reserves in the first part of the quarter prompted credit institutions to resort heavily[41] to the deposit facility and, at the same time, acted as a disincentive on their participation in transactions in interbank deposits[42]; as a result, daily interbank deposit rates further ranged between 1.2 percent and 2 percent, a picture seen ever since the final 10-day period of September. Along with the gradual decline in excess liquidity as a result of the central bank's sizeable intervention in the money market, interbank transactions experienced a revival in November, while the spread between average interest rates on such operations, which entered an upward path, and the policy rate narrowed to about 4.4 percentage points. The upturn in daily interbank rates strengthened in December, amid the gradual rise in the average daily balance on open-market operations of the central bank; in the final month of 2005, the average interbank rate stood at 4.3 percent, one percentage point higher than in September 2005.

However, the renewed rise in interest rates was associated with wider fluctuations in interest rates on overnight transactions. The volatility of overnight rates increased sharply in the last two months of 2005, reaching an all-time high in November, under the impact of large swings in liquidity and particularly of heightened uncertainty about the developments in interest rate and volume of interbank transactions; their daily average values fluctuated within wider ranges (from 1.1-1.6 percent in October to 1.2-7.3 percent in November-December).

[41] In October, the average daily balance on the deposit facility remained close to the historical high recorded in September.
[42] Nevertheless, the daily average flow of interbank transactions was 43.3 percent higher than the minimum recorded in September.

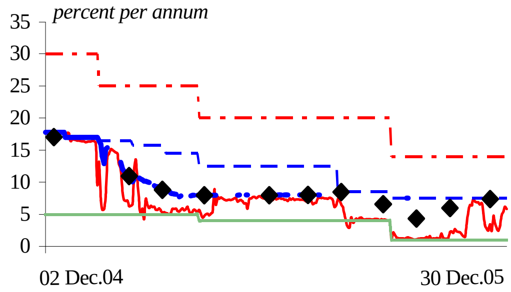
Higher interest rates caused the interbank market to regain depth in 2005 Q4, with the average daily volume of interbank transactions (the NBR excluded) doubling quarter on quarter. The surge[43] in the volume of interbank transactions was due mainly to the expansion in very short-term capital inflows, the rise in interbank rates leading to the step-up in arbitrage operations performed by non-residents[44].

The BUBOR (1M-12M) yield curve further shifted downwards[45], albeit at a much slower pace, posting again, after 10 months, a downward slope, which reflected the anticipated rate cut in the periods ahead. By contrast, average interest rates for shorter maturities, i.e. ON and 1W, bounced back, with the December average surpassing by 1.3 percentage points that recorded three months earlier. Hence, the spread between monthly averages of 12M-BUBOR and ON BUBOR rates narrowed to 1.6 percentage points in December 2005, from 3.6 percentage points in September 2005. In December, short-term rates also incorporated the additional risk of the seasonally-driven sharper movements of autonomous factors[46], pushing the difference between ON BUBOR and actual ON rates up by 0.7 percentage points.

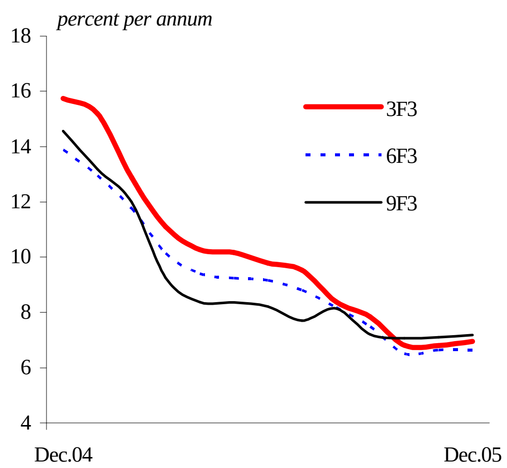
After being relatively flat in the preceding months, the implicit forward rates based on December figures indicate a steep decline in interbank rates for the next three months; the 3M-BUBOR rate for March 2006 is expected to run at 6.9 percent, 0.6 percentage points below the current level. Furthermore, the 3M- BUBOR rate is seen falling at a slower pace in June (by 0.9 percentage points against December) and rising slightly in September.

Unlike the interbank money market, the primary market for government securities was soft. In 2005 Q4, the Ministry of Public Finance refrained from issuing government securities due to both the small value of such paper falling due over the reported period (RON 51.2 million in December) and the large balance of the General Account of the Treasury.

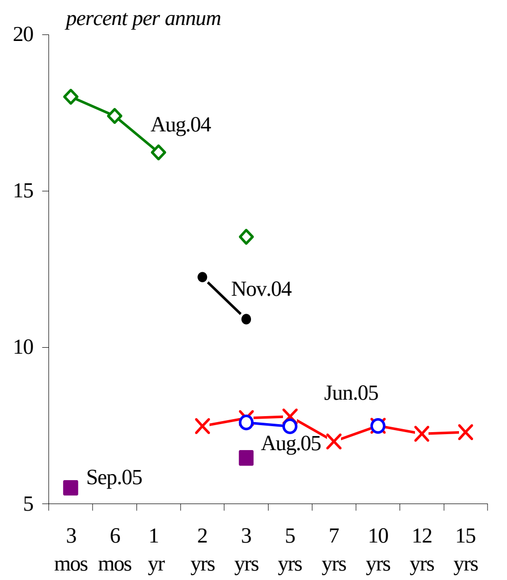
Interbank Money Market Rates



Implicit Forward Rates

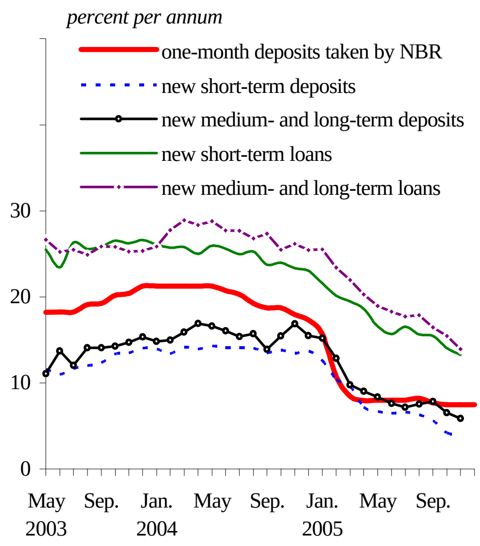


Yield Curve (Treasury certificates)

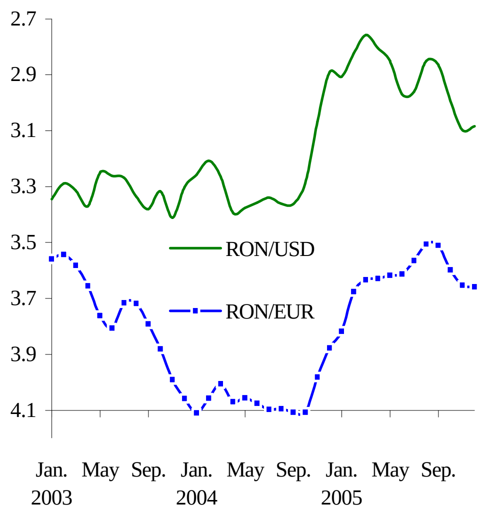


[43] The average daily volume of interbank transactions in December was 5.9 times higher than in September; furthermore, the volume of interbank transactions more than doubled as compared with the average volume of such transactions in January-July.
[44] December saw a peak in the volume of non-residents' transactions on the interbank foreign exchange market.
[45] Which was 0.8 percentage points less sharp than anticipated by implicit forward rates based on the March, June and September readings.
[46] The Treasury's liquidity injections coupled with the rise in demand for cash ahead of winter holidays.

Bank Rates



Nominal Exchange Rate



Unlike the interest rates on interbank transactions, banks' average rates applied to non-government, non-bank clients fell abruptly in November too. Behind this development stood largely the past NBR rate cuts and the sharper decline of the average interest rate on banks' holdings with the central bank. Nonetheless, this trend is expected to flatten out in the months ahead given the renewed tightening of the interest rate policy starting with November 2005.

September through November, the average interest rate on new time deposits dropped 2.3 percentage points (its real level falling into negative territory) and the average interest rate on new loans shrank by 3 percentage points. The interest rate on household credit posted the sharpest fall, i.e. 4.2 percentage points, owing to the need to offset the incomplete adjustment of average lending rates to the previous changes in the NBR's interest rate policy, on the one hand, and to the stiffer bank competition in terms of domestic currency-denominated loans[47], on the other.

2.2. Exchange rate and capital flows

In 2005 Q4, the main drivers of the RON/EUR exchange rate movements were the faster widening of trade deficit and the changes in both volume and structure of net capital inflows; behind the latter development stood the NBR's monetary policy and prudential measures, on the one hand, and the relative change in conditions on international financial markets[48], as well as the shift in investor sentiment towards Central and Eastern European markets, on the other hand.

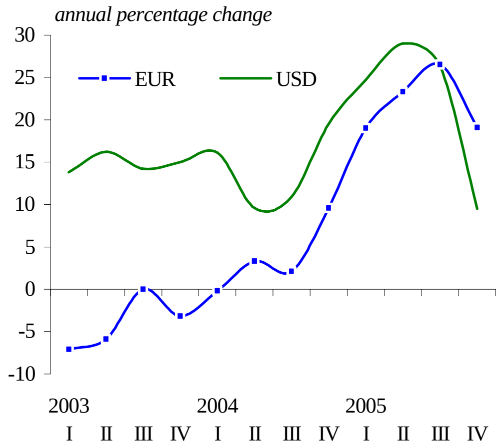
On this background, the domestic currency weakened throughout Q4, the initial fast depreciation pace decelerating towards the end of the period under review. Compared to September 2005, the RON depreciated at year-end against the EUR by 4.1 percent (1.6 percent in real terms) and against the USD by 7.3 percent (4.6 percent in real terms), as the USD maintained its strengthening trend on international financial markets. Consequently, from the perspective of the annual dynamics of exchange rate, the domestic currency continued to strengthen versus both the EUR and the USD, although the appreciation rate fell to a quarterly average of 9.7 percent, or

[47] Following the coming into force of NBR Norms No. 11/2005 on containing exposure from foreign currency-denominated loans (in late September) and the impact of the hike in the reserve ratio on foreign currency-denominated liabilities.
[48] The Fed funds rate was raised to 4 percent in November and to 4.25 in December. In addition, the ECB raised its minimum bid rate to 2.25 percent in December.

19.1 percent in real terms, and 0.9 percent, or 9.5 percent in real terms, respectively.

After experiencing a relatively long-dated strengthening, the domestic currency posted an accelerated depreciation in October (2.4 percent[49]), which was attributable to the unprecedented deterioration of the trade balance, whose deficit surged 62.3 percent from the previous month, as well as to the insufficient coverage of the rise in imports through direct investment and financial and trade credits of non-banks. The impact of these developments on the forex market and hence on the exchange rate was enhanced by the significant decline in short-term capital inflows, due to the lower domestic money market rates and the temporary shift in investor interest from Central and Eastern Europe to other financial markets; thus, the Slovak korona, the Hungarian forint, the Czech korona and the Slovenian tolar also witnessed nominal depreciation in the reported period. In addition, the domestic forex market was affected by the cap on banks' foreign currency borrowings (especially following the NBR's move to contain the concentration of exposures from forex loans[50]), with the growth rate of medium- and long-term loans recording the most significant slowdown.

Developments of RON Exchange Rate*)



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

Source: NIS, NBR

In November, the RON exchange rate was subject to strong opposing influences exerted, on the one hand, by the increase to a record-high in residents' excess demand for foreign currency and, on the other hand, by the peak of net foreign currency sales resulting from non-residents' speculative transactions. The large forex deficit of residents' transactions was triggered by the further widening of the trade deficit and the moderate capital inflows in the form of non-bank financial loans and direct investment. The increase of the deficit under "incomes" and the slower growth rate of current transfers added to the above-mentioned factors. Under the combined effect of these elements and given the central bank's decision not to intervene in the interbank forex market, the depreciation of the RON against the EUR lost momentum.

Key Financial Account Items (balances)

EUR million

	2004		2005	
	9 mos	11 mos	9 mos	11 mos
Financial account	**3,036**	**4,494**	**2,351**	**4,407**
Direct investment	**3,843**	**4,701**	**2,713**	**4,415**
residents abroad	-42	-51	-27	-21
non-residents in Romania	3,885	4,752	2,740	4,436
Portfolio investments	**-413**	**-26**	**697**	**103**
residents abroad	-322	11	100	-247
non-residents in Romania	-91	-37	597	350
Other capital investments	**2,858**	**3,512**	**4,278**	**5,180**
of which:				
medium- and long-term investment	1,578	2,088	2,531	2,952
short-term investment	754	942	758	943
currency in circulation and short-term deposits	434	408	417	724

Unlike the previous year, the domestic currency depreciated further in December, albeit at a slower pace, despite the seasonal rise in remittances from abroad and the unprecedented surge in the volume of non-residents' speculative transactions, fostered by the sharper uptrend in money market rates and the relative increase in the predictability of RON/EUR exchange

[49] The highest depreciation rate in the last 23 months.
[50] NBR Norms No. 11/2005 effective 26 September.

rate[51]. This development hints at a possible further widening of the trade deficit.

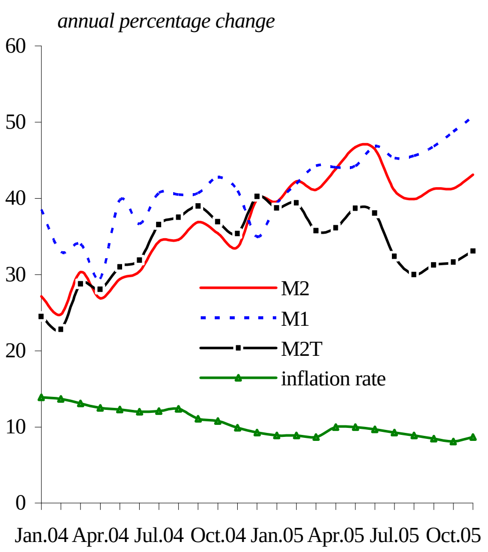
In the coming months, the RON exchange rate could witness a slightly higher volatility, amid growing opposing influences. On the one hand, the growth rate of imports is expected to remain high[52], while non-residents' direct investment will be on the rise ahead of Romania's accession to the European Union. On the other hand, the volume of banks' foreign-currency borrowings may decline further whereas short-term capital inflows may become even larger.

2.3. Money and credit

Money

In September-November 2005, the growth rate[53] of broad money (M2) regained momentum, reaching 30.9 percent, i.e. the second-highest value in the last 9½ years. The expansion of liquidity across the economy was mainly due to the increase in non-government credit, the change in households' financial asset portfolio structure[54] and the slight rise in banks' net foreign assets; starting with October, the nominal increase in M2 was also due, although to a lesser extent, to the depreciation of the RON versus the EUR.

Broad Money and Inflation Rate



The rise in M2 was spurred especially by its most liquid component (M1), the growth rate of which came in at 37.2 percent, a new record high for the past 10½ years; under the circumstances, the share of M1 in broad money reached 26.1 percent, i.e. the second consecutive peak in the last 8 years. The upsurge in narrow money occurred despite a relative slowdown in economic growth, a plausible explanation for this discrepancy being the lower opportunity cost of holding such assets; however, the rise in M1 might point to a future upturn in economic activity. This assumption is supported by developments in quasi-money, whose real annual growth pace reversed its downward drift, resuming a slightly upward trend in September.

Broad Money (M2)

percent

	2004	2005				
	IV	I	II	III	Oct.	Nov.
	monthly average					
M1	24.5	22.7	24.2	26.2	26.3	26.0
Currency outside banks	12.7	11.6	12.6	13.0	12.6	12.7
Domestic currency deposits	52.4	53.4	53.7	54.8	54.7	55.1
Foreign currency deposits	34.9	35.1	33.7	32.1	32.6	32.2

Composition of broad money by currency continued to improve, with the share of forex deposits in M2 touching the lowest average for the second consecutive time in the last

[51] The RON/EUR exchange rate volatility sank in December to its lowest value since October 2004.
[52] Partially induced by the unfavourable developments in domestic agricultural production in the reported year and the possible hike in prices of energy products.
[53] Unless otherwise indicated, percentage changes refer to the September-November average of the annual growth rates expressed in real terms.
[54] Starting with October 2005, the Ministry of Public Finance temporarily ceased the government securities issuance.

7 years, i.e. 32.2 percent. By deposit holder, the M2 structure witnessed a shift in the growth rate of household deposits, which reverted to an upward trend in the period under review. However, the composition of these placements deteriorated amid faster increases in forex deposits and RON-denominated current accounts and the significantly slower growth rate of RON-denominated household savings. These opposing developments were due, on the one hand, to the steeper drop in interest rates on time deposits and the depreciation of the RON against the EUR and, on the other hand, to the use of e-payment instruments on a wider scale (also as a result of more diversified promotional offers for credit cards, particularly towards the end of the reported period); against this backdrop, the share of holdings on current accounts in total RON-denominated deposits of households peaked at 11.8 percent (on average) during the period under review.

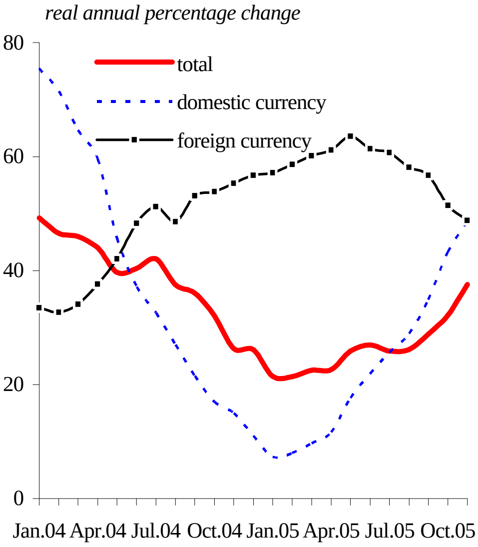
Corporate deposits[55] were further the more dynamic component of broad money, although they posted a slightly slower pace of increase, mainly due to the slower rise of foreign currency-denominated deposits. Among the determinants of this development were the following: (i) the surge of payments related to seasonal imports (also suggested by the large net purchases of foreign currency made by resident legal entities), (ii) settlement of amounts representing quarterly payments to the government budget, (iii) government securities transactions between companies and banks, as well as (iv) the companies' possibly higher resort to cash as a payment instrument, fostered by the decline in interest rates and the absence of constraints on cash ceilings[56].

Non-government credit

The real annual growth rate of non-government credit September through November 2005 saw a gradual step-up, with its average reaching a peak for the past year, i.e. 32.9 percent.

However, the dynamics of RON-denominated and foreign currency-denominated loans witnessed significantly diverging trends, which reflected the impact of constraints exerted by the central bank's measures on foreign currency-denominated loan supply, on the one hand, and the effect of the *de facto* easing of the interest rate policy in the previous period, on the other. The NBR's prudential and administrative measures, as well as the tighter required reserve mechanism deterred the local banks' propensity for new financing sources from international

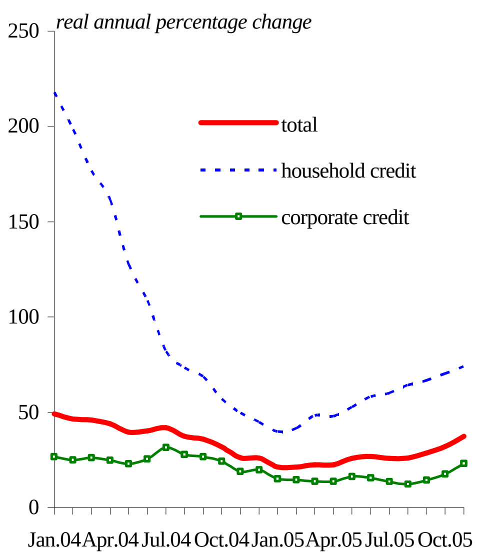
Non-Government Credit by Currency



[55] Calculated by adding up the companies' time deposits, certificates of deposit and restricted deposits.
[56] Law No. 507/17 November 2004 on the removal of the companies' cash ceiling.

markets; furthermore, in order to comply with the provisions of the new regulations on forex loans[57], some credit institutions transferred part of their own forex loan portfolio to their parent banks' balance sheets (also repaying the foreign loans used for the financing thereof), while others took steps to increase their share capital. Under the circumstances, the pace of increase of forex loans decelerated, while that of RON-denominated loans witnessed a sharply upward trend, so that the annual changes of the two components almost converged in November (for the first time in the last year and a half). The share of foreign currency-denominated loans in total non-government credit followed a downward path, yet it stayed at a relatively high level (57.7 percent on average, during the period under review).

Non-Government Credit by Client



The swift rise in RON-denominated loans in the reported period was due, on the one hand, to banks' more diversified loan supply, against the backdrop of: (i) fiercer competition among banks (including as a result of containing foreign currency lending), as reflected also by the active promotional campaigns, and (ii) the contraction in the array of investment instruments, given the decline in the volume of liquidity sterilized by the central bank. On the other hand, the demand for loans increased, being bolstered especially by lower lending rates.

By borrower, household loans were the most dynamic, as they continued to grow faster, particularly due to the development of RON-denominated consumer loans[58], which became more readily-available, given that, in order to comply with the provisions of the new lending norms issued by the NBR[59], commercial banks extended financing terms, while providing the possibility of choosing fixed interest rates, which are considerably lower than variable interest rates. Conversely, the average annual change of the balance on households' forex loans witnessed a steeper downward trend.

Credits extended to companies resumed the upward path following the faster growth pace of the RON-denominated component; in October, for the first time in the last year and a half, the annual growth rate of corporate loans in domestic currency surpassed that of forex credits. The latter's slowdown – occurring in spite of a record volume of imports (energy

[57] NBR Norms No. 11/2005 on containing the concentration of exposures from forex loans, effective 26 September 2005.
[58] According to data in NBR's "Financial Behaviour of Households and Companies by County" based on the information provided by credit institutions, except CREDITCOOP.
[59] NBR Norms No. 10/2005 on limiting credit risk attached to household loans (effective 28 August 2005).

imports included[60]) – could be indicative of the commercial companies' increased resort to external financing sources (in September-October), as well as of an adjustment in banks' monetary balance sheets following the measures adopted by the central bank to contain the expansion of foreign currency-denominated loans. The change in the composition of corporate loans by currency had only a marginal impact on their term structure; thus, the share of long-term loans in total non-government credit continued its upward trend, which might hint at a consolidation of investment activity.

[60] According to data supplied by the Credit Information Bureau, in September-November, the average volume of new loans extended to certain sectors (crude oil and coal processing, energy and natural gas) was 1.6 times higher than the average flow of loans granted to these sectors in the first eleven months of 2005.

V. INFLATION OUTLOOK

The baseline scenario of the projection shows that at the end of 2006 annual inflation rate will run about 1.6 percentage points above the 5 percent target. The upward revision of the November projection (6 percent) is due mainly to higher-than-expected increases in volatile prices of food items and a higher forecasted exchange rate of the RON for the entire year, compared with the previous forecasts. A strong resumption of disinflation in the latter half of 2006, beyond the peak impact of the adverse supply-side shocks and supported by a consistent mix of tight macroeconomic policies should allow bringing inflation down to the 2007 target of 4 percent.

Throughout the projection horizon, the reduction of inflation will be supported by a continuous decline in excess demand down to negative levels, under the impact of tight real monetary conditions. The disinflationary effect of the appreciation of the RON will prevail through 2006, putting downward pressure on aggregate demand and exerting a favourable influence on import prices. In 2007, interest rates will play the main part in controlling aggregate demand and, according to the projection, disinflation should also benefit from bringing expectations back to a trajectory consistent with the inflation target.

The main risks of deviation from the projected inflation path could be generated by: a more expansionary stance of fiscal and wage policies than currently projected , large deviations of the RON exchange rate from the projected trajectory; new unexpected shocks from price movements of some food and energy products, increases in administered prices which may differ in terms of magnitude and timing from the forecast assumptions as well as a possible increase in inflation expectations inertia under the combined impact of recent price shocks and overshooting of inflation targets for 2005 and 2006.

1. The baseline scenario of the projection

1.1. Introduction

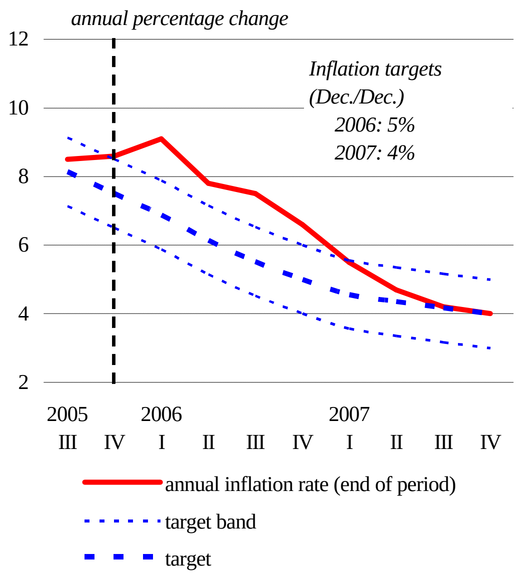
The baseline scenario is built around an NBR interest rate path consistent, over the medium term, with the programmed downward path of inflation. The policy rate set by the NBR Board could deviate from the projection as a result of the assessment of risks and uncertainties associated with the baseline scenario, of tactical considerations regarding monetary policy (e.g., the possibility of using alternative instruments to achieve the same objective) or as a response to the impact of unforeseen events.

In order to more accurately reflect the transmission of monetary policy in case of temporary exogenous shocks as well as the importance attached by the NBR to medium-term inflation developments, the current projection extends over a longer horizon, i.e. by the end of 2007. Under the circumstances, the risks and uncertainties associated with the baseline scenario increase as we draw near the end of the projection horizon. Among their sources, the lack of more accurate details concerning adjustments of administered prices and fiscal and wage policies in 2007 is considered as particularly relevant. Moreover, the longer the projection horizon, the higher the likelihood of unforeseen events to occur.

1.2. Inflation projection

According to the baseline scenario, end-2006 annual consumer price inflation is projected to lie above the upper bound of the ±1 percentage point fluctuation band around the 5 percent inflation target. Starting with 2007 Q1, annual inflation rate is projected to return to the target band and reach levels consistent with the year-end target of 4 percent. Compared with the previous quarter's forecast (November Inflation Report), the projected inflation path for the end of 2006 is about 0.6 percentage points higher (6.6 percent compared with 6 percent). This is mainly the result of significant upward revision of inflation estimates for volatile prices of food items (vegetables, fruit and eggs) and of the weaker RON than in the previous forecast.

Inflation Forecast



Note: ±1 percentage point around the (dis)inflation path

Table 5.1. Annual inflation rate (end of period)

	Q1 2006	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007
Target				5.0				4.0
Projected target	9.1	7.8	7.5	6.6	5.5	4.7	4.2	4.0

A temporary halt in the decrease of the annual inflation rate is projected for 2006 Q1, due to the following factors:

- The adjustment of administered prices, particularly the price of natural gas, at the onset of 2006;

- The impact of weaker agricultural supply on the volatile food prices following the previous year's natural calamities;

- A temporary slippage of inflation expectations due to the perceived impact of the above-mentioned price increases as well as to the overshooting of the inflation target for 2005;

- The effects of the relatively loose monetary conditions in late 2005 as well as of the positive excess demand from the same period, fostered by significant public spending in December 2005.

Beside these factors, in the first three quarters of 2006 the annual inflation rate will also reflect the statistical effect[61] of the considerable price increases of vegetables, fruit and eggs in the final quarter of 2005[62], given that these prices are highly unlikely to fall back to pre-calamity levels. Provided that the agricultural output of such food items returns to normal levels, this statistical effect will reverse in 2006 Q4 and 2007 Q1, pushing down substantially the annual inflation rates for the prices of vegetables, fruit and eggs and, further on, headline inflation rates.

In accordance with the projection, the disinflation of consumer prices will be resumed starting with 2006 Q2, at a rate anticipated to gain momentum in the latter part of the projection horizon.

CORE2 inflation is expected to fall at a sustained pace and to stabilise at around 2 percent at the end of the forecast horizon. Over the projection horizon, the downturn in CORE2 inflation will largely be driven by the movements in both import prices and excess demand. In view of the stronger RON, import price dynamics will help reduce inflationary pressures and indirectly contribute to taming inflation expectations throughout most of 2006. Moreover, excess demand will see a gradual contraction, thereby providing support to the disinflation process of CORE2 prices.

During 2007, the output gap is expected to be maintained in negative territory and thus to offset to a large extent the trend reversal of import prices prompted by the halt in the RON appreciation due to external competitiveness pressures. The resumption of the downturn in inflation starting with 2006 Q2, supported by a set of consistent disinflationary policies, will help bring inflation expectations onto a downward path. The strengthening disinflation will boost the contribution of

[61] Annual inflation rate is calculated as the sum of monthly rates, or the sum of quarterly rates. Hence, the stunning fourth-quarter food price increase is incorporated in the calculation of annual inflation rates for 2006 Q1-3.
[62] The largest impact is expected for annual inflation rate in 2006 Q2.

inflation expectations to curbing inflation during 2007, paving the way for its converging towards the year-end target.

The upward dynamics in administered prices will remain strong throughout the projection horizon. Inflationary pressures exerted by administered prices and prices for vegetables, fruit and eggs will however be partly offset in 2006 by the developments in fuel prices (as the forecast assumes a stable oil price) and in CORE2 prices. For 2007, a trend reversal between fuel price inflation and fruit, vegetables and eggs price inflation is expected, considering that the former will accelerate slightly and the latter will slow sizeably compared to 2006.

1.3. Exogenous inflationary pressures

Continuing the previous years' trend, the growth rate of administered prices is expected to be well above that of market prices during the projection horizon, due largely to the adjustments of energy and natural gas prices, which should be liberalised gradually (see Table 5.2). For natural gas, domestic producer prices must be brought progressively in line with import prices. Even though the adjustment calendar envisages significant price increases, it cannot provide full liberalisation of natural gas market by end-2007. As regards the price of heating, the baseline scenario assumes price hikes that are evenly distributed during 2006 and 2007 and takes into account the likely consequences of removing the national reference price (due for 2007 Q3). Electricity price is envisaged to be fully liberalised by July 2007. In light of the above and of the fact that administered prices account for nearly 22 percent of the CPI, their adjustments are estimated to contribute 2.6 percentage points and 1.7 percentage points to the forecasted annual inflation rate in 2006 and 2007 respectively.

The current scenario for administered prices differs from the previous quarter's forecast to the extent that it assumes a different quarterly distribution of price increases during 2006 and it includes new assumptions on the dynamics of administered prices in 2007.

Table 5.2. The scenario for the developments in administered prices points to a faster increase than in the case of market prices.

Natural gas		Heating		Electricity	
2006	2007	2006	2007	2006	2007
36.5%	17.9%	20%	20%	3.9%	3.8%

The prices of fresh fruit and vegetables and eggs are highly volatile and show a pronounced seasonal pattern, being strongly influenced by supply conditions. These features complicate further the forecasting exercise. Following the falling crop of 2005 (largely as a result of floods), these prices are expected to go up markedly in the first quarters of 2006; the 2006 harvest is anticipated to improve supply conditions and reduce upward pressures on such prices starting with 2006 Q3. The price of eggs is one of the most volatile items included in the CPI. Its strong seasonal pattern[63] is the main driver of the forecast, which takes into account significant price hikes in Q3 and Q4, and a decline in Q2. For the whole category of fruit, vegetables and eggs prices, the projection assumes an annual inflation rate nearly twice as high as the level estimated in the previous Inflation Report.

High oil price volatility makes the forecast of the oil price more difficult, the more so as its medium-term trend – caused by demand rising faster than supply – runs counter to the short-term trend, which hints at a downward correction of the price increases seen in 2005. In view of the diverging expert opinions, the scenario assumes unchanged oil prices over the projection horizon. Based on this scenario and on the anticipated movements in the RON exchange rate, the inflation forecast for fuel prices shows a low level throughout 2006. For 2007, a slight increase in the fuel price is envisaged, with fuel price inflation following a trend close to that of the CPI.

Recent price developments in the euro area illustrate the effects of previous oil price increases. Compared with the previous quarter, the annual HICP inflation was revised upwards for the entire forecasting period chiefly as a result of the higher oil price feeding through into production costs. As a consequence, compared with the previous projection, the impact of foreign prices on import prices is seen as slightly stronger, especially in the second half of the forecasting cycle.

1.4. Aggregate demand pressures

1.4.1. Current aggregate demand pressures

After falling more steeply in Q3 than expected in the previous *Inflation Report*[64], the growth rate of real GDP is foreseen to pick up in Q4. Under the circumstances, excess demand is estimated to revert to the levels reached in the first six months. The positive output gap in Q4 fuels short term demand side inflationary pressures.

[63] For instance, the seasonally-driven cut in the price of eggs in 2006 Q2 is expected to offset to some extent the inflationary pressures exerted by scant supply of fruit and vegetables.
[64] See Chapter III. Economic developments (*1. Demand and supply*)

Current excess demand is generated, on the one hand, by the lagged effect of the levels of interest rates and exchange rate in the previous quarters and, on the other hand, by the effect of both demand side shocks (such as changes in fiscal policy) and supply side shocks (such as lower agricultural output caused by adverse weather conditions). The steady decline in interest rates on deposits and loans experienced in the previous quarters fostered excess demand in the current period. However, the impact of interest rates was offset by the strengthening of the domestic currency up to Q3, which restricted net exports and thereby economic performance in Q4. Previous changes in cost of foreign currency borrowing had virtually a neutral impact on excess demand. The expansion of excess demand in Q4 was boosted primarily by the strong fiscal impulse in the last two months of 2005.

Regarding GDP components, gross fixed capital formation is expected to witness further fast-paced increase in Q4. Hence, the main driver of economic growth will continue to be investment rather than private consumption, which had played that role until Q2. The strong increase in investment in Q4 comes along with an above-trend increase in the number of employees economy-wide and with favourable lending conditions for the corporate sector. In addition, excess demand has been fuelled by developments in total household disposable income caused by the significant increase in net wages and in the number of employees economy-wide over the last few quarters.

The rise in income, along with increasingly favourable lending conditions (readily-available loans and lower lending rates) led to an expansion in non-government credit (particularly, the short-term household credit), thereby stimulating an increase in consumption. Moreover, the decrease in deposit rates and the above trend rise in real M1 point to a step-up in transactions and a switch of disposable income spending towards consumption. Nevertheless, a significant part of demand is further directed to imported goods and, therefore, imports are expected to increase at a fast pace in Q4 as well. Exports continue to expand at a slower rate, thus net exports keep weighing down on excess demand in the reviewed period.

As real GDP for Q3 turned out lower than expected, the output gap in the previous Inflation Report was revised downwards[65].

[65] Statistical data on GDP development are published 70 days after the end of the considered quarter. Thus, the output gap for the current quarter can be assessed only based on estimates. The inherent differences between forecasts used for the assessment and the data released call for a revision of the excess demand estimate.

Therefore, in Q3, the output gap fell below the levels recorded in the first half of 2005, staying however in positive territory.

A decrease in output gap does not always lead to a decline in inflation. Negative shocks from the supply side (such as lower output after floods, higher administered prices, fuel prices, fruit, vegetables and eggs prices, etc.) cause a fall in the surplus of output over potential GDP alongside a pick-up in prices. In Q3, the slowdown in GDP growth owed mainly to such negative developments in aggregate supply. In this respect, losses in agriculture, caused by adverse weather conditions, were the main factor depressing supply. Also, industrial output recorded a modest performance, while both the capacity utilization rate and the number of employees industry-wide were below the medium-term trend[66]. The shocks generated to a great extent by supply-side factors have fed through especially into increases of prices which are not influenced by the monetary policy (prices of fuels, vegetables, fruit and eggs), a process that continues in Q4. Thus, inflationary pressures stemmed not only from demand, but also from adverse transitory aggregate supply shocks.

1.4.2. Implications of recent exchange rate and interest rate developments

Exchange rate movements have two-way effects on excess demand. The first effect has a direct impact on net exports, while the second one has an indirect impact, through the wealth and balance sheet effects[67]. The impact of the second channel works in opposite direction to the impact of the net export channel. As a result, while a real appreciation of the RON puts downward pressure on the economic activity (by influencing net exports), through wealth and balance sheet effects it boosts foreign exchange loans (by lowering borrowing costs in domestic currency), thus fuelling aggregate demand.

In 2005 Q4, the effective exchange rate[68] of the domestic currency has depreciated versus Q3 in both nominal and real terms, discontinuing the appreciation trend that had started in 2004 Q4. The weakening of the RON removed to a large extent the downward pressure the exchange rate had previously put on demand for domestic production. Consequently, the direct effect (related to net exports) of the real exchange rate on output gap and implicitly on short-term inflationary pressures has

[66] For further details on significant changes in GDP components in the previous quarter see section *1. Demand and supply*.
[67] See the Box on "Wealth and balance sheet effects" in Inflation Report No. 2/2005.
[68] Calculated as an average of the exchange rates of the domestic currency against the euro and the US dollar respectively, according to the weights of the two currencies in Romania's foreign trade.

become roughly neutral. However, the fourth-quarter RON depreciation triggers higher foreign currency borrowing costs in domestic currency, which has a contractionary effect on aggregate demand. Thus, by tightening foreign currency borrowing conditions, the overall effect of the exchange rate remains slightly contractionary.

Nevertheless, nominal depreciation of the domestic currency brings about larger inflationary pressures directly via import prices.

The depreciation of the RON in 2005 Q4 offset only in part the considerable strengthening seen in the previous quarters, so that the effective exchange rate further shows significant appreciation as compared to the same year-earlier period. The limited magnitude of the depreciation lends support to the assumption according to which the fast drop in early 2005 was largely a normal adjustment of the exchange rate to changes in economic conditions relevant for the foreign exchange market (rise in sustainable capital inflows, adjustment of the NBR's forex market intervention policy, capital account liberalisation, and improved outlook for Romania's joining the European Union). Considering the prompt response of financial markets, the foreign exchange market included, the effect induced by such events is estimated to have already fed through into the exchange rate. As a result, the long-term fundamental factors (such as the productivity growth rate differential between Romania and its trading partners), which are expected to regain prevalence gradually, along with capital inflows related to Romania's accession to the EU will determine the medium-term path of the exchange rate.

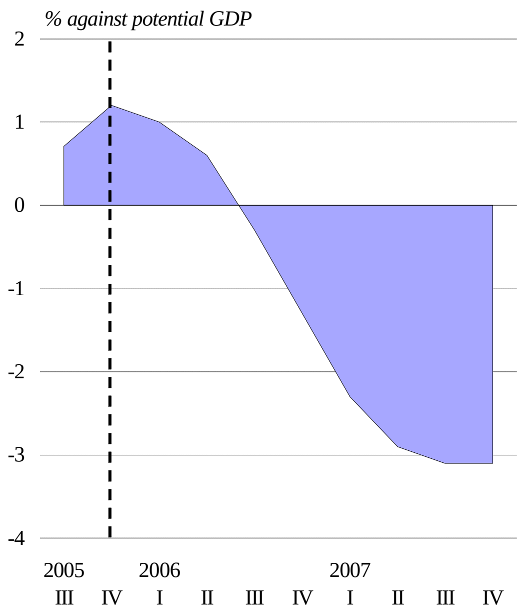
The NBR left the policy rate unchanged at 7.5 percent in the final quarter of 2005. *Ceteris paribus*, recent developments in the NBR's interest rate further generate expansionary effects on the economic activity.

The NBR sterilization rate affects real economy only indirectly, through commercial banks' deposit and lending rates, which continued to decline in 2005 Q4, following the change in the central bank's policy in the prior quarters. As a result, real economy and inflation are currently influenced to a larger extent than in the prior quarters by the effect of the NBR's interest rate which fed through into commercial banks' interest rates. The expansionary effect of the real deposit rates on real economy increased in the quarter under review. Real lending rates, which posted a sharper drop than real deposit rates, are also seen to spur economic activity starting with 2005 Q4. Consequently, the expansionary effect of banks' interest rates on excess demand heightened in the final quarter of 2005.

The stronger stimulative effect of interest rates, associated with the weaker contractionary effect of the real exchange rate, leads to the loosening of their cumulative effect on excess demand in the near term.

1.4.3. Demand pressures within the projection horizon

GDP Deviation



Similar to the previous Inflation Reports, the current projection envisages the elimination of excess demand by mid-2006. Specifically, aggregate demand-induced inflationary pressures are expected to be phased out, following the reduction of the expansionary effect of interest rates on aggregate demand, the real appreciation of the domestic currency, the adoption by the NBR of a set of measures aimed at containing non-government credit growth, a neutral wage policy, and a tight fiscal policy.

The estimate for excess demand in 2006 Q1 is higher than in the prior projection because of the impact of fiscal policy: heavy public spending in December 2005 exceeded by far the forecast assumptions of the November Inflation Report. However, excess demand is expected to decline at a faster pace than previously forecasted, particularly following the revision of the contractionary impact of the measures aimed at containing foreign currency lending and of the real appreciation of the RON on aggregate demand.

In accordance with the projection, after the brief depreciation episode in 2005 Q4, the domestic currency will resume its real appreciation, bolstered by short-term capital inflows and by increasing foreign direct investment. The favourable productivity growth rate differential between Romania and the EU – Romania's main trading partner – will exert real appreciation pressures throughout the projection period. During 2006, a wider interest rate differential will foster a significant rise in the real value of the domestic currency. As the disinflation process continues during 2007, the predictable cuts in interest rates on RON-denominated financial instruments, along with expected higher interest rates on international financial markets, will ease the upward pressures on the domestic currency.

The projection foresees a narrowing interest rate spread, partly as a result of stronger competition brought about by changes in banks' ownership. The average nominal deposit rate is expected to rise, pushing real rates into positive territory towards the end of 2006. The evolution of deposit rates will be linked to the expected rise in money market rates, under the impact of the NBR's policy rate movements set on a path consistent with meeting the 2007 year-end inflation target.

In response to monetary policy impulses, the decline in lending rates is foreseen to decelerate markedly as compared to 2005. As a result, the projection shows that the average lending rate will go down slightly in line with the decrease in inflation, thus remaining relatively steady in real terms throughout the projection horizon. Lending rates may also decline due to strict requirements for lending in foreign currency which will probably encourage the commercial banks to further shift their focus towards granting loans in domestic currency.

The NBR has announced the adoption of a set of measures aimed at slowing down non-government credit growth. The main decisions have been the following: a 5 percentage point rise in the reserve requirements on foreign currency denominated liabilities effective 2006 Q1 and hastening the adoption of legislation regulating the lending activity of non-bank financial institutions. The first measure is expected to increase the cost of foreign currency borrowing, adding to the pressures exerted upon the dynamics of foreign currency lending by the administrative restrictions implemented in 2005 Q3. Consequently, the monetary policy transmission mechanism will probably witness a weakening of the wealth and balance sheet effects of the real RON appreciation[69]. The second measure, i.e. the aforementioned new legislation, is anticipated to enhance the central bank's ability to influence the dynamics of consumer credit, by imposing stricter requirements for loans issued by non-bank financial institutions.

Fiscal policy has an impact on the inflation forecast through the estimated effects of revenue collection and public spending on aggregate demand. The projected budget deficits account for 0.5 percent of GDP for 2006 (specified in the State Budget Law approved by Parliament) and 1 percent of GDP for 2007 (as in the 2005 Pre-Accession Economic Programme). According to current estimates, attaining these policy goals will result in curbing the fiscal-driven output gap during 2006 and 2007.

Wage policy in 2006 is expected to be tighter than in 2005, as a result of the projected reduction in the frequency and magnitude of pay rises.

Gross fixed capital formation is anticipated to be the main driver of economic growth. Despite their gradual easing in 2007, relatively tight monetary conditions throughout the projection horizon will lead to an anticipated deceleration in economic growth for 2007.

[69] See Section 1.4.2 in this Chapter and the Box on “Wealth and balance sheet effects” in Inflation Report No. 2/2005, p.43.

The factors affecting consumption are expected to have mixed effects. Among the consumption-boosting factors in 2006 are the real appreciation of domestic currency, initially negative real deposit rates, and the relatively stimulative lending rates. The first factor spurs consumption through lower import prices, as well as through the wealth and balance sheet effects. The second factor prompts households to focus on consumption rather than saving, while the third factor stimulates, *ceteris paribus*, the expansion of consumer credit. The measures adopted by the NBR in order to tame foreign currency credit and RON-denominated consumer credit as well as the tighter wage policy are expected to slow down consumption growth throughout the projection horizon. Following the gradual elimination of the three aforementioned boosting factors, consumption is forecasted to grow at a slower rate in 2007.

As in the November 2005 Inflation Report, gross fixed capital formation is expected to show strong growth. The main driving forces are the significant flows of foreign direct investment expected to enter Romania considering the country's EU accession prospects, the favourable taxation of profits, and the relative decline in unit labour costs, as compared to other EU Member States. Real lending rates are expected to help foster capital investments in the first part of the projection horizon.

Imports are anticipated to grow considerably in 2006, mainly because of the negative shocks that have affected domestic supply during the past year. Thus, the 2005 agricultural output that was hit by floods and the deceleration in industrial production growth determine domestic demand to rely more extensively on imports[70]. Moreover, imports are expected to be fostered by the real appreciation of the domestic currency, as well as by the expansionary real interest rates in the first part of the projection period. The elimination of the temporary shortfall of agricultural production, along with the slowdown in real RON appreciation, and the higher real interest rates will lead to a deceleration of import growth in 2007.

External demand and real appreciation of the domestic currency are estimated to affect exports during the projection horizon. Against the backdrop of improved forecasts for the EU economy, the rebound in external demand is expected to boost Romania's exports. However, the strengthening in real terms of the domestic currency is foreseen to put a dent on export growth. The impact of this factor is estimated to lower considerably in 2007, thereby fostering exports to a larger extent than in 2006. The expected dynamics of imports and exports is indicative of a possible widening of Romania's trade deficit in 2006 against 2005 and of a slight reduction in 2007.

[70] Agricultural output in 2006 H2 is expected to increase the supply of agrifoodstuffs.

2. Uncertainties surrounding the central projection

Given the hypothetical nature of the assumptions employed for the baseline scenario, the projection-related risks need to be assessed, especially in the context of the extended forecast horizon. For the current projection, the major risks of deviations from the inflation path appear to be generated by developments in excess demand and in the exchange rate, as well as by the lingering effect that the overshooting of the 2005 inflation target and the sharp upsurge in energy and some food prices might have on inflation expectations.

The baseline scenario shows the elimination of excess demand during 2006 and the maintenance of a negative output gap in 2007. These developments are conditional upon the projected stance of monetary, fiscal and wage policies, as well as upon the absence of any unanticipated shocks. If the stance of these policies and their effectiveness in slowing down the excessive rise in aggregate demand were different from those projected, excess demand might be maintained over a longer period. The main effect of positive output gaps would be a temporary increase in CORE2 inflation. This would result in higher-than-projected headline inflation, jeopardising the achievement of the 2007 target. Among the factors that might generate such a scenario are included deviations of fiscal and wage policies from the projection assumptions.

The baseline scenario takes into account a tight fiscal policy, based on a budget deficit of 0.5 percent of GDP in 2006 and of 1 percent of GDP in 2007. In the event the authorities embarked upon a more ambitious investment plan than that envisaged by the 2006 budget, the 0.5 percent deficit projected for 2006 would be exceeded, thus affecting the pace of increase of aggregate demand. For 2007, no officially binding budgetary programme is yet in place to lock in a commitment for a deficit within 1 percent of GDP. It is generally known that 2007 will see numerous pressures in the light of the following: the budgetary effort related to Romania's accession to the European Union (in case it occurs next year)[71], a lower share of public revenues in GDP due to a cyclical decline in the latter's growth rate, the pressures on expenditures coming from some socially-oriented sectors (e.g. education, healthcare, etc.), as well as the need to carry on the investment programmes scheduled to start in 2006.

[71] For instance, Romania's contribution to the European Union budget in 2007 is estimated by the government at EUR 1.34 billion (according to the Pre-Accession Economic Programme for 2005).

The baseline scenario assumes moderate wage increases, aimed to prevent any rise in labour incomes that might prove to be inconsistent with the projected inflation rate and productivity growth. Any wage policy slippage could lead to unsustainable hikes in real disposable incomes fuelling inflationary pressures.

Other potential risks to inflation stem from those projection items known to have a generally higher volatility, such as: the prices of some foodstuffs whose supply is strongly influenced by weather conditions, the international prices of crude oil and natural gas, certain administered prices, and foreign capital flows. The effects engendered by foreign capital flows may materialise in abrupt exchange rate fluctuations. An adverse change in foreign investors' sentiment concerning the Romanian markets might put a halt to foreign capital inflows and/or lead to relatively large outflows, thus entailing an accelerated depreciation of the domestic currency and inflationary pressures through higher import prices.

On the other hand, additional foreign capital inflows could generate episodes of domestic currency appreciation that might not necessarily entail a corresponding decrease in the prices of imported goods, to the extent to which exchange rate gains are incorporated into importers' margins. This phenomenon could be due, for instance, either to exchange rate movements being perceived as merely temporary or to some importers' reluctance to lower selling prices amid strong demand and the same degree of competition over the short run. In such a case, the baseline scenario might overestimate the contribution of import price dynamics to disinflation.

A major source of uncertainty is represented by the adjustments in administered prices and in some indirect taxes (e.g. excise duties on petroleum products). The deviation of such adjustments, in terms of both magnitude and quarterly distribution, from the baseline scenario assumptions may entail significant deviations of actual inflation from the projected path.

In addition, major risks arise from the possible implications that recent and future developments in inflation might have on expectations. Thus, overshooting the 2005 inflation target and maintaining a high inflation rate throughout 2006, due mainly to hikes in the prices of goods holding a large share in the CPI basket (vegetables, fruit, eggs or energy), are as many factors that could contribute to worsening of the public's inflation expectations. Since expectations are unobservable – for want of representative surveys to cover the entire range of relevant economic agents –, their impact on inflation developments is always difficult to assess. The difficulty in identifying shifts in expectations could lead to a delayed response of the NBR in the attempt to counter their effects and to attain the medium-term inflation target.

Under an even more pessimistic scenario, the worsening of expectations could persist, being reflected, for instance, by a change in the price-setting mechanism: past inflation developments may be given systematically larger credit, to the detriment of the announced inflation targets. In other words, expectations could become backward-looking rather than forward-looking, which would significantly hamper efforts to curb inflation down to levels capable of ensuring price stability.

3. Policy assessment

The assessment by the National Bank of Romania Board of the recent medium-term macroeconomic projections and of their impact on the conduct of monetary policy was based on the discussions concerning the appropriateness and/or the need to resort to the upward revision of the inflation target for 2006 and, possibly, of the projected path of medium-term disinflation. After making an in-depth analysis of the numerous projection scenarios, as well as of the pros and the cons of the revision, the NBR Board decided to leave the current short- and medium-term inflation targets unchanged at 5 percent ±1 percentage point for 2006 and at 4 percent ±1 percentage point for 2007.

The NBR Board has deemed this decision as the most appropriate, in line with the principles and the requirements of the recently adopted inflation targeting strategy, and implicitly as the one that lends credibility to the central bank and its actions – a key element for anchoring medium-term expectations, as well as for ensuring and maintaining price stability. By taking this decision, the NBR intended, on the one hand, to show its commitment to attain the inflation target and, on the other hand, to reaffirm that its focus of attention is kept on the longer time horizon inflation target which can be influenced by resorting to monetary policy instruments. Moreover, behind the NBR Board's decision to keep inflation target unchanged stood its improved capacity to simultaneously meet the requirements regarding the following:

1. Ensuring continuation of medium-term disinflation at a relatively brisk pace and a more rapid convergence of inflation rate to the level required by EU criteria;

2. Enhancing the capacity of the NBR to anchor medium-term inflation expectations, thereby proving that the slight deviation

from the upper limit of the target band for 2005 is not a sign of the weakening of the bank's commitment to attain the inflation target in the medium run;

3. Restoration and strengthening of the central bank's credibility, as the NBR Board avoids to resort, for the second consecutive year, to the revision of the short-term inflation target and, implicitly, leaves unchanged the projected trajectory of medium-term disinflation;

4. Further support for the NBR's decision to use the entire available array of instruments with a view to making disinflation re-enter the programmed path within two years.

Consequently, this decision implies the NBR Board's commitment to bring inflation rate back to the programmed disinflation path by the end of 2007. In the short run, inflation rate will further overshoot markedly the inflation target despite the relative increase in monetary policy restrictiveness implied by medium-term forecast. The key argument underlying the central bank's willingness to accept the deviation from the target is its temporary nature, as it is induced mainly by the high estimated growth rates of administered prices, and particularly of volatile prices (higher than those taken into account two years earlier when the inflation target for 2006 was set at 5 percent). As a matter of fact, according to the projection, monetary policy measures will accommodate only in part supply-side shocks in 2006, given that the forecasted effects of these shocks on the growth rate of prices are higher than the accepted deviation of inflation rate. Another reason for the central bank's decision is the limited capacity of monetary policy to counteract, in the short run, the effect of the relatively persistent inflation and, hence, the impact that price increases in 2005 will have on price developments in 2006, which is another determinant of overshooting the inflation target for 2006. Other factors in favour of the partial accommodation of supply-side shocks in 2006 are the following:

1. The considerable time lag needed for the effective transmission of monetary policy impulses to demand and, implicitly, to the growth rate of prices;

2. The possibility to minimise the fluctuations of the monetary policy stance, and particularly those of economic activity and social conditions;

3. The low risk of worsening of medium-term expectations given the NBR's prompt actions to bring inflation back to the projected trajectory in 2007.

Although it implies a partial accommodation of supply-side shocks via the monetary policy in 2006, the decision of the NBR Board to leave the inflation targets unchanged and to lower the annual inflation rate to 4 percent in 2007 is an ambitious goal as it implies significant economic costs. Thus, according to the baseline scenario of the projection, excess demand will have to be eliminated by mid-2006 so that in the subsequent quarters economic growth should decline gradually below its potential level. Putting aggregate demand on such track is conditional upon the fast tightening of monetary policy – given the time lags inherent to the transmission of its impulses – and upon more restrictive fiscal and income policies. The prompt and firm response of monetary policy in the current context is all the more imperative as it has to substantiate the NBR's decision to attain the medium-term inflation target and thus to prevent the worsening of inflation expectations that might be entailed by the deviation from the inflation target in 2005 and 2006. The economic costs of disinflation may decrease if inflation expectations are effectively anchored.

Another reason for further tightening of monetary policy initiated in November is the need to put a break on the widening of saving/investment deficit of the private sector, this development being one of the indications of the currently unsustainable growth rate of household consumption. Under these conditions, the effectiveness of the NBR's influence on consumer behaviour could be enhanced by tightening of the interest rate policy, this measure being aimed at both calming down household demand for loans and boosting household saving to the detriment of consumption. Specifically, interest rate policy tightening would consolidate the restrictiveness that the set of prudential and administrative measures implemented by the central bank in 2005 started to exert on lending, as well as the recent tightening of reserve requirements regime concerning foreign currency deposits.

As in the preceding quarters, fast monetary policy tightening is also required to counter the second-round effects of supply-side shocks that will persist especially in the first half of 2006. The National Bank of Romania has been particularly concerned over the magnitude of such shocks, which is in some cases larger than that recorded in 2005. Thus, the increase in a certain category of volatile prices is expected to be well above that of 2005, whereas the magnitude of major administered price adjustments due for 2006 is broadly similar to that seen in 2005. In addition, the central bank has showed concern for the high sensitiveness of inflation expectations to the impact of the above-mentioned factors, as well as to the recent performance of policies meant to prevent inflation rate from veering off the track; thus, anchoring inflation expectations and turning them into disinflation-boosting factors require a firm stance of the central bank, especially when considering the overshooting of the 2005 inflation target.

From the perspective of the specifics of monetary policy transmission mechanism, tightening of the central bank's monetary policy also implies taking stricter measures aimed at containing foreign currency-denominated credit expansion; this reaction also implies the need to underpin the consolidation of the operation and effectiveness of the RON-denominated credit channel and implicitly of the interest rate channel. Reinforcement of the means for limiting the rise in foreign exchange non-government credit is all the more justified as credit institutions have recently developed behaviour patterns that allow them to circumvent the constraints already imposed by the measures previously adopted by the National Bank of Romania.

The major risk of monetary policy tightening meant to bring annual inflation rate down to 4 percent in 2007 continues to be the possible resurgence in volatile capital inflows, especially the ensuing likelihood of heightening pressure on the exchange rate. Thus, although the record high in non-residents' turnover on the domestic forex market[72] in 2005 Q4 did not affect significantly the exchange rate of the domestic currency[73], the possible increase in volatile capital inflows – amid the renewed growth of interest-rate differential – could exacerbate pressures on the domestic currency, considering the change in domestic forex market conditions and particularly in the participants' expectations at the onset of 2006. The expectations are mostly fed by the favourable prospects of Romania's joining the European Union which, *inter alia*, appear set to stimulate a record volume of foreign direct investment and, in the months ahead, by the liberalisation of non-residents' access to operations in government securities. The concern is augmented by the fact that the central bank agreed to incur substantial credibility costs in the latter half of 2005 in an effort to put a damper on volatile capital flows. Resurgence of speculative capital flows could entail either a faster RON appreciation rate or a considerable increase in sterilization operations, along with larger costs incurred by the National Bank of Romania; assuming that future capital inflows exceed markedly the previous ones, both effects could materialise simultaneously.

Also from this perspective, another risk induced by monetary policy tightening could be the likely adverse effect on the trade

[72] In December 2005, turnover of non-residents' transactions on the interbank forex market was two times larger than the turnover of non-bank residents' transactions.
[73] In 2005 Q4, the domestic currency softened steadily against the euro.

balance that might be generated by the possible drop in the RON exchange rate below the level considered as sustainable according to the assessments of the National Bank of Romania Board. An overly-large appreciation of the domestic currency could push the trade deficit to levels inconsistent with balance-of-payments sustainability, thereby jeopardising medium-term disinflation. Even though it could slow imported inflation rate and cushion inflation expectations, the accelerated appreciation of the RON/EUR exchange rate, that might result from the interest-rate policy tightening, could have some unfavourable consequences, namely:

a) Erosion of external competitiveness of exports if productivity gains in outward-oriented sectors failed to offset the effect of the stronger RON. The ensuing contractionary impact on exports and implicitly on economic expansion could however be considerably reduced by (i) restructuring efforts made by the exporters that come under pressure from exchange rate; (ii) trade diversion towards the domestic market by the producers facing contraction in foreign market shares; (iii) the possible overestimation of the restrictiveness of the forecasted exchange rate.

b) Increase in total domestic demand or in demand for imports only.

From the perspective of medium-term disinflation, the risks are related to the fact that such developments could cause a relatively abrupt adjustment of the RON exchange rate and its trajectory. Such an adjustment of the exchange rate of the domestic currency could also pose risks to financial stability and implicitly to sustained economic growth over the medium and long run.

The comprehensive assessment of the medium-term forecast and of the numerous difficulties and risks entailed by the implementation of the ambitious disinflation programme, which the central bank is committed to, has led the NBR Board to reaffirm that it stands ready to further use the entire available array of instruments in a concerted and proactive manner for containing the growth of aggregate demand and alleviating inflation expectations, which implies taking appropriate and prompt measures. Hence, in its meeting of 8 February 2006, the NBR Board decided to raise the monetary policy rate to 8.5 percent from 7.5 percent, and to continue to significantly sterilize excess liquidity via open market operations. Moreover, the NBR Board decided to increase minimum reserve requirements on foreign exchange-denominated liabilities of credit institutions to 40 percent from 35 percent, starting with the 24 March-23 April 2006 maintenance period, to keep in place the prudential measures adopted in order to contain non-government credit expansion, especially in what concerns its foreign exchange component, and to accelerate the implementation of legislation regulating the lending activity of non-bank financial institutions. Furthermore, the NBR Board reiterated its commitment to take prompt measures in response to macroeconomic developments that could jeopardize achieving the programmed medium-term disinflation path.