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N O T E

The National Institute of Statistics, Ministry of Public Finance,
Ministry of Labour, Social Solidarity and Family,
National Employment Agency, EUROSTAT,
IMF, U.S. Department of Energy
and National Bank of Romania supplied data.

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

Phone: 40 21/312 43 75; fax: 40 21/314 97 52
25, Lipscani St., 030031 Bucharest – Romania

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 10 May 2006 and approved by the NBR Board in its meeting of 11 May 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
BSE	Bucharest Stock Exchange
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
MAFRD	Ministry of Agriculture, Forests and Rural Development
MLSSF	Ministry of Labour, Social Solidarity and Family
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
OCI	Organisation for Collective Investment
ON	overnight
OPEC	Organisation of Petroleum Exporting Countries
ULC	unit labour cost
1W	one week
12M	12 months

Contents

I. SUMMARY

Disinflation continued in 2006 Q1, with the 12-month inflation rate dropping to 8.4 percent in March 2006, down 0.2 percentage points against December 2005 and 0.7 percentage points lower than forecast in the February 2006 Inflation Report. The deceleration in inflation was mainly due to the slowdown in the growth rate of administered prices – excluding energy prices – which reflected the favourable impact of the nominal appreciation of the RON. Meanwhile, the downward trend of CORE2 inflation came to a halt, its annual rate running at 5.6 percent in March 2006, the same figure as that recorded at end-2005. Disinflation accelerated in April, but the decline in the 12-month rate of both headline and CORE2 inflation was due solely to a base effect. By contrast, current developments, as illustrated by month-on-month changes, were relatively less favourable, with a flat CORE2 inflation and a doubling of headline inflation.

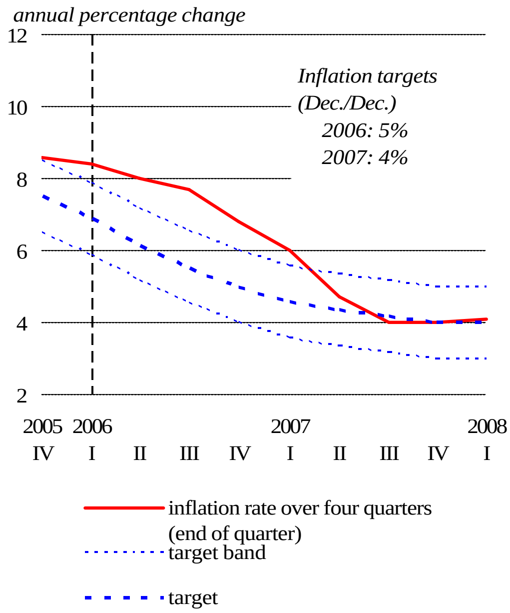
After a relatively persistent decline, GDP rose in 2005 Q4 at a faster rate of 4.3 percent (compared with 2.4 percent in the previous quarter). The resumption of excess demand growth was largely due to a rapid increase in investment and government consumption and, to a lower extent, household consumption, which rose at a slower pace during the period. However, household consumer demand continued to exert inflationary pressures due to faster dynamics of its main component, i.e. purchases of goods, as compared to the previous quarter.

Facing the prospect of a persistently unsustainable pace of consumption growth with attendant inflationary pressures, on the one hand, and the consequent risk of extending the time horizon needed to eliminate excess demand, on the other, the central bank continued to tighten monetary policy in 2006 Q1 by resorting to its entire array of available instruments. Thus, in February 2006, the central bank raised the monetary policy rate to 8.5 percent, augmenting the impact of this measure on the financial market by tightening control over money market liquidity. Moreover, in order to further tighten monetary policy and increase the effectiveness of the monetary transmission mechanism, in March the NBR raised, for the second time in 2006 Q1, the minimum reserve requirements on foreign exchange-denominated liabilities of credit institutions, up to 40 percent. In addition, the monetary authority kept in place the prudential measures aimed at containing non-government credit expansion – especially in what concerns its foreign exchange component – and decided to accelerate the implementation of legislation on regulating and supervising the lending activity of non-bank financial institutions.

In the updated medium-term macroeconomic projection, the inflation rate in 2006 lies above the previously forecasted level. The upward revision of the inflation rate projection is explained mainly by the increase in indirect taxes on tobacco and alcohol in 2006 Q2, accompanied by worsening inflation expectations. Excess demand will also continue to exert additional inflationary pressures. Its magnitude and persistence are expected to increase compared with the previous forecast, partly due to a relative easing of fiscal policy in the next quarters of the current year. The substantial inflationary impact of these factors will offset the favourable influence of the lower-than-forecasted magnitude of administered price adjustments for 2006. Thus, the 12-month CPI inflation rate is forecasted to run at 6.8 percent at the end of 2006, 1.8 percentage points higher than the target (0.2 percentage points above the previous projection). The projected disinflation trend will nevertheless accelerate in 2007, mainly as a result of excess demand being brought down to significantly negative values and of improved inflation expectations; under the circumstances, in the latter half of 2007 the annual inflation rate is projected to be back within the ±1 percentage point band around the central target.

This requires tighter macroeconomic policies, with broadly-defined monetary conditions growing more restrictive than implied by the previous forecast, including through stronger effects of the prudential and administrative measures implemented by the NBR in the previous quarters.

Inflation Forecast



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

Similarly to the previous forecasting rounds, the balance of risks associated with the current projection appears to be clearly biased towards factors that may slow down disinflation. The main sources of risk and uncertainty – especially through their impact on inflation expectations – are related to the timetable and magnitude of administered price adjustments, as well as to the changes the fiscal regime might undergo in the period ahead. In addition, less prudent than projected fiscal and/or income policy might cause the expected downtrend in excess demand to slow down or even come to a halt. A similar impact might be exerted by a possible overestimation of the projected tightness of monetary conditions, due to underestimating the transmission lag of monetary policy tightening through to bank lending rates amid increased competition in the banking sector. Furthermore, a higher-than-expected rise in both long- and short-term foreign capital inflows might entail larger excess aggregate demand in the short run. The higher-than-expected hikes in the international prices for oil and natural gas, and in some food prices, might also contribute to a slowdown or even a halt in disinflation within the forecast horizon.

In view of the numerous inflationary risks identified in the context of assessing the medium-term macroeconomic projection, the NBR Board decided to maintain a restrictive monetary policy stance for a longer period of time while the disinflation process progresses. Thus, in its meeting of 11 May 2006, the NBR Board decided to maintain the monetary policy rate at 8.5 percent per annum, a decision which, on the background of a consolidation of disinflation, will increase the restrictiveness of monetary conditions. Concurrently, the NBR Board decided to continue its policy of firm money market liquidity control and to closely monitor developments in RON-denominated credit, as well as in the growth of total non-government credit. Moreover, the NBR Board reiterated its commitment to take prompt measures – by resorting to its entire array of available instruments – in response to macroeconomic developments that could jeopardize the programmed medium-term disinflation path.

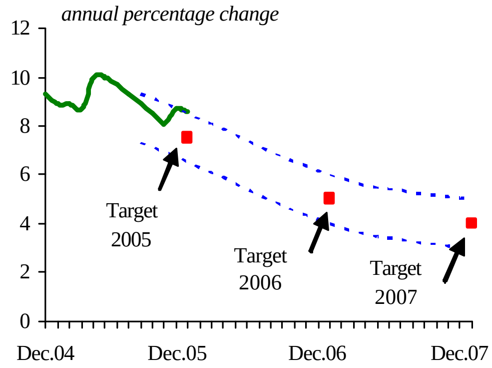
II. INFLATION DEVELOPMENTS

At end-March 2006, the 12-month growth rate of consumer prices stood at 8.4 percent, down 0.2 percentage points from end-2005 (even though the forecast included in the February Inflation Report pointed to a temporary pause in disinflation in 2006 Q1). Nevertheless, annual CPI still exceeded the ±1 percentage point band around the 5 percent target throughout the first quarter, yet it re-entered this band in April, when the 12-month inflation rate was down to 6.92 percent. The same as in the previous quarter, persistent excess demand helped the pass-through of the supply-side shocks affecting the first three months of 2006 (administered price adjustments, short supply of some farm products, the present impact of future tax changes).

After the January flare-up following the hikes in electricity and gas prices (1.9 percent and 17.2 percent[1] respectively), the 12-month inflation rate dropped below the end-2005 figure in February and March. This development owed mostly to disinflation recorded by products with administered prices (except energy) such as medicines and telephony services, following the nominal appreciation trend of the domestic currency. Disinflation accelerated in April, but the decline in the 12-month rate of both headline and CORE2 inflation was attributable exclusively to a base effect[2]. By contrast, current developments, as illustrated by month-on-month changes, were relatively less favourable, with a flat CORE2 inflation and a doubling of headline inflation (largely as a result of supply-side shocks associated with another gas price adjustment, a renewed upturn in fuel price and costlier bakery products[3]).

In 2006 Q1, the products with volatile prices continued to have a detrimental impact on the general price level, as their 12-month dynamics outpaced steadily the average consumer price growth by more than 5 percentage points. It is worth mentioning that the persistently high rate of increase can also be attributed to a base effect, the halving of the quarterly change in volatile prices reflecting better-than-anticipated developments of food and fuel prices. The main contributor to this state of affairs was the stronger domestic currency as well; adding to this were the steep decline in the oil price on world markets in

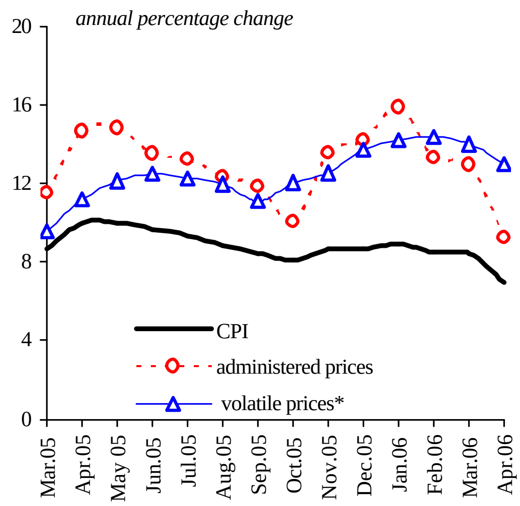
Inflation Developments



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

Source: NIS, NBR calculations

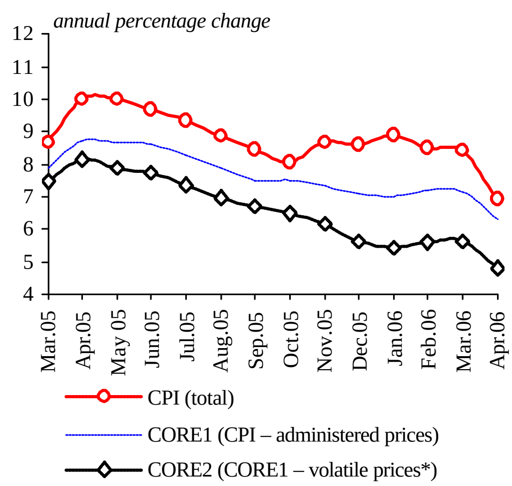
Inflation Rate



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

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation



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

Source: NIS, NBR calculations

[1] Month-to-month changes.
[2] Associated with the steep increase of gas price in April 2005 (after the modification of the billing system, as well as higher and earlier than scheduled increases in excise duties levied on tobacco products and fuels).
[3] As a direct effect of hikes in raw materials and utility prices.

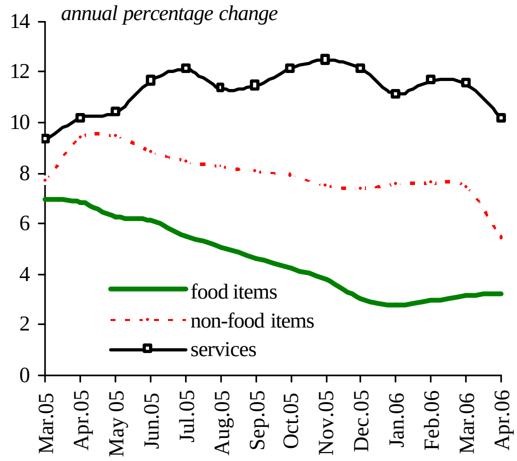
Administered Prices versus Market Prices

annual percentage change; end of period

	2005				2006
	I	II	III	IV	I
Inflation Rate	**8.7**	**9.7**	**8.5**	**8.6**	**8.4**
Administered prices	**11.5**	**13.5**	**11.9**	**14.2**	**13.0**
1. Non-food items:	**12.1**	**15.7**	**14.4**	**14.1**	**15.9**
electricity	12.5	12.5	9.6	9.6	7.0
heating	12.0	12.0	12.0	20.0	20.0
natural gas	21.6	41.9	45.3	36.4	52.2
medicines	1.7	–0.3	–2.4	–5.1	–5.5
2. Services, of which:	**10.7**	**10.3**	**8.1**	**14.1**	**8.2**
water, sewerage, refuse collection	23.2	27.3	25.6	25.8	24.8
telephony	3.7	–0.6	–3.7	8.5	–3.4
passenger railway transport	12.0	12.0	14.9	8.7	8.7
(passenger) city transport	16.4	24.5	23.2	23.2	20.5
Market prices (CORE1)	**7.9**	**8.6**	**7.5**	**7.1**	**7.2**

Source: NIS, NBR calculations

CORE2 by Group of Commodities



Source: NIS, NBR calculations

CPI by Category of Products

annual percentage change; end of period

	2005				2006
	I	II	III	IV	I
Food, beverages, tobacco	7.8	8.1	6.2	7.5	6.8
Wearing apparel and footwear	5.4	4.6	4.0	3.9	3.8
Household appliances, furniture	6.3	5.9	4.5	3.6	2.8
Fuels	15.1	17.5	16.2	9.0	9.4
Utility expenses*	16.6	22.2	21.4	20.8	23.0
Healthcare	5.0	3.7	2.4	1.0	0.2
Transport	15.4	20.4	20.9	19.7	16.6
Post and telecoms	0.7	-0.3	-3.1	6.8	0.6
Leisure and culture	8.3	7.3	7.6	7.9	7.0
Other goods and services	6.6	5.9	4.9	4.1	6.5

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

Source: NIS, NBR calculations

the first half of February and the reversal of the demand-supply ratio on the eggs[4] market.

CORE2 disinflation stalled in 2006 Q1, with the 12-month rate of 5.6 percent in March equalling the end-2005 figure, as the slightly faster pace recorded by goods prices offset the slower growth of services prices.

The supply-side shocks, namely costlier foodstuffs and the tobacco producers' decision to gradually factor into their prices the hike in excise duties scheduled for July, have been dominant. This assumption relies on the fact that the removal of the above-mentioned impact underscored the presence of disinflation for both groups (0.8 percentage points for food prices and 0.3 percentage points for non-food prices).

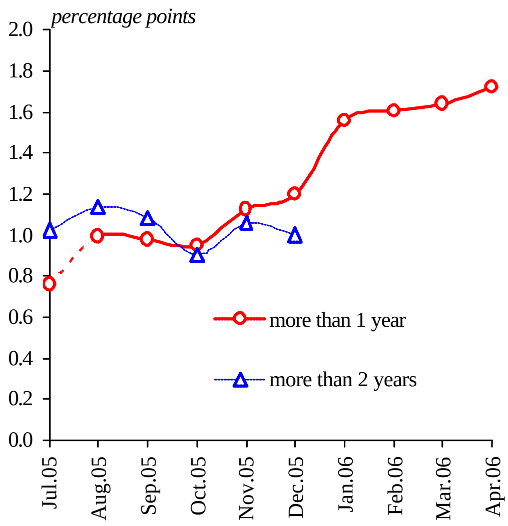
Excess demand continued to hamper disinflation, with the output gap remaining in positive territory, albeit shrinking somewhat compared with the previous quarter; in fact, the drop was more likely associated with the negative supply-side shock stemming from weak farm production in 2005. Nevertheless, the same as in the previous quarters, the keener competition in the retail sector, also positively impacting competition in the productive sector, contained the inflationary pressures exerted by the larger consumer demand. Moreover, competition in the productive sector was fostered by the interest in imported goods as a result of nominal strengthening of the domestic currency.

Flat or even deteriorating inflation expectations during the first quarter of 2006, as shown by the available business surveys, may also have slowed disinflation. The NIS and the NBR business surveys point to a larger share of respondents in manufacturing reporting their intention to put up prices, whereas the estimates on producer price growth made by the industrial operators participating in the survey conducted by the Group of Applied Economics resemble those made in 2005 Q4. The NBR's survey among bank analysts pinpoints uncertainties surrounding the pace of disinflation, with the difference between the expected inflation rate for the 12-month horizon and the trajectory of inflation compatible with the central bank's annual targets widening by another 0.4 percentage points[5] in the period under review.

[4] The price of eggs plunged by 32.6 percent in March 2006 compared with December 2005, contributing 0.3 percentage points to the decline in inflation rate in the reported period.
[5] March 2006 versus December 2005.

At end-March 2006, 12-month inflation rate was 0.7 percentage points below the forecast in the February Inflation Report[6]. The deviation was particularly due to the strengthening of RON-EUR exchange rate to lower than expected levels, amid capital inflows, particularly direct investment and remittances from Romanians working abroad. As a result, first-quarter nominal appreciation of the RON against the EUR stood at 4.3 percent (March 2006/December 2005), at odds with the stable path considered when preparing the forecast. The sharply downward trend in the exchange rate caused disinflation of administered prices geared to the exchange rate (medicines, fixed telephony) and limited the inflationary impact on prices of fruit and vegetables of the previous year's short supply of farm produce. Given the circumstances, the 12-month growth rates of both administered prices and volatile food prices were below the rates projected for March 2006 (by 0.6 percent and 4.2 percent respectively). Similarly, the actual 12-month rate of increase of the fuel price was lower than expected (0.4 percentage points below the forecast), as a result of exchange rate appreciation and dwindling world oil prices.

Deviation of Expected Inflation from Annual Inflation Target

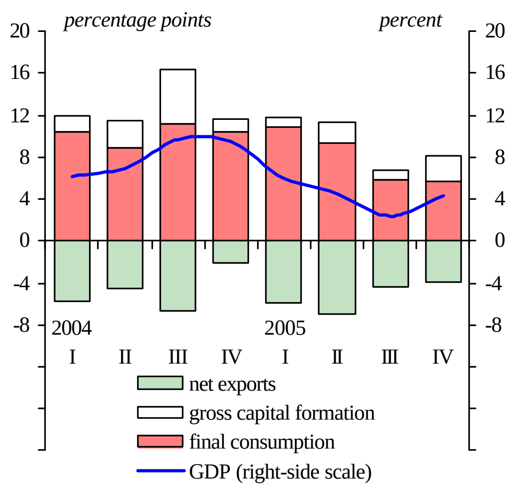


[6] Effective data until December 2005 included.

III. ECONOMIC DEVELOPMENTS

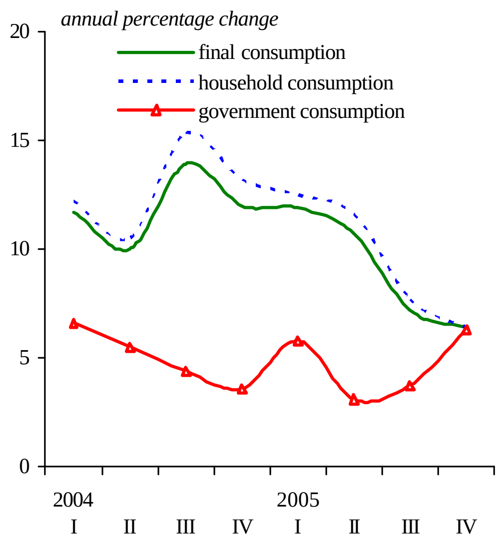
1. Demand and supply

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

Actual Final Consumption



Source: NIS

The fourth quarter of 2005 witnessed a turnaround in GDP growth, which stepped up 1.5 percentage points above the forecasted figure to 4.3 percent[7], after having decelerated in the previous quarters of the year. The pattern of economic growth remained unchanged from the prior quarter, with investment and to some extent exports posting faster increase while final consumption growth slowed. However, consumer demand continued to exert inflationary pressures. On the supply side, economic growth continued to be negatively affected by the poor crops whilst the industrial sector, albeit picking up slightly compared with the previous quarter, still displayed one of its weakest performances in the past seven years.

1.1. Demand

In 2005 Q4, the pick-up in the 12-month growth rate of GDP (1.9 percentage points above the revised figure of 2.4 percent in the previous quarter) hinged on two of the components of domestic demand (gross fixed capital formation and government consumption), but also on the narrowing negative spread between the growth rates of the components of net external demand, largely as a result of faster increase in exports of goods and services. By contrast, the 12-month growth rate of private consumption slowed down a further 1.3 percentage points and the change in stocks increased its negative contribution to GDP growth, reflecting the sharp depletion of farm produce reserves.

1.1.1. Consumer demand

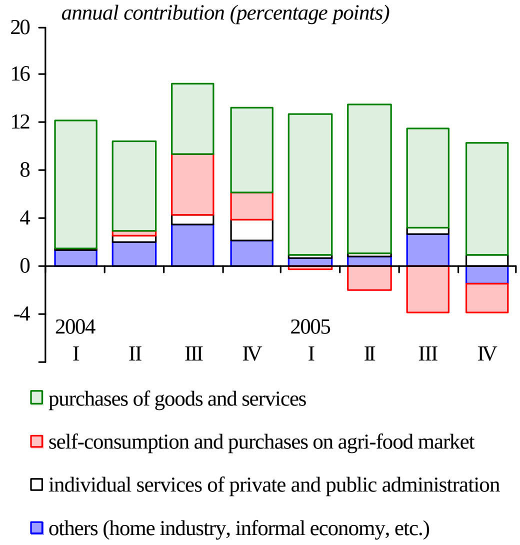
The slowdown in the growth rate of final consumption did not cause the inflationary potential of consumer demand to subside, as the volume of goods purchases and that of some services at market prices (hotels and restaurants in particular) saw faster 12-month growth rates in quarter-on-quarter comparison.

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

Household consumer demand

The slowdown to 6.4 percent in the growth rate of household actual final consumption was attributed mainly to the poor performance in agriculture as reflected not only by the persistent decline in self-consumption and purchases on the agri-food market (-14.3 percent) but also by the sharp fall in the consumption of goods manufactured in home industry[8], which led to a 12 percent drop under *other consumptions* (compared with +19.1 percent in 2005 Q3). The slowdown was also due to a lower growth rate of services (7.3 percent, i.e. half of the previous quarter's reading) chiefly owing to the flagging demand for *transports.* Conversely, the growth rate of purchases of goods accelerated 1.1 percentage points to 20 percent, pointing to further inflationary pressure from consumer demand. Inflationary pressures were also exerted, albeit to a lesser extent, by the acceleration in the growth rate of expenditures for individual consumption by public and private administration (5.9 percent), possibly as a result of ongoing operations aimed at compensating for damages suffered by flood victims.

Household Final Consumption Growth



Source: NIS, NBR calculations

Sales of goods and services witnessed robust growth on the background of: (i) persistently high growth rate of household disposable income (due to a considerable extent to inflows from abroad in terms of work remittances and current transfers) and (ii) lower interest in investment on financial markets, as illustrated by the steeper decline in bank deposits (following the low level of deposit rates), only partly offset by the upturn in investment in shares quoted on the Bucharest Stock Exchange, UCITS (Undertakings for Collective Investment in Transferable Securities) and insurance policies, the last three categories accounting for a lower weight in the household financial portfolio[9]. In addition, real-estate investment, already discouraged by the surge in prices over the last few years, was heavily hit by the measures adopted by the NBR with a view to containing household credit expansion, especially in what concerns foreign currency loans; the annual growth rate of new long-term loans to households, although still very high (roughly 117 percent in real terms), slowed to less than half of the level recorded in 2005 Q3.

[8] As defined by household processing of basic foodstuffs (either self-produced or purchased goods).

[9] In 2005, bank deposits accounted for more than 58 percent of the total value of saving-investment instruments used by households, while investment in quoted shares, mutual funds and insurance policies took cumulatively nearly 20 percent thereof (according to a research study by UniCredit Group). As concerns the development of new time deposits of individuals in 2005 Q4, the change in real terms remained negative (-9 percent compared to -7.1 percent in the previous quarter).

The NBR regulations also limited households' resort to bank loans for purchases of durables; in real terms, the annual growth rate of new medium- and short-term loans to individuals slowed from 36.7 percent in 2005 Q3 to 15.2 percent in 2005 Q4[10]. Loans granted by commercial banks represented probably the only channel to ease household appetite for consumption, given that non-bank financing (leasing, specialised credit companies) does not appear to have recorded the same development as illustrated not only by market signals but also by the persistently fast growth rate of sales of durables (more than 27 percent, i.e. close to the previous quarter's reading). Under the circumstances, purchases of durables remained the fastest growing retail segment in Q4, in spite of the 2 percentage point acceleration in the growth rate of sales of non-durables (to about 18 percent).

As for the market of origin of consumer goods, fourth-quarter imports continued to witness the trend recorded in the first nine months, contributing increasingly to meeting domestic demand. Thus, while the growth rate of domestic supply of non-durables slowed down and that of durables (including auto vehicles) dropped to negative values[11] for the first time in 2005, the volume of imports of consumer goods appeared to continue to grow at a fast pace (with the index of the physical volume of imports of motorcars recording the highest growth rate in Q4 as well, i.e. more than 140 percent)[12].

Government consumer demand

General government final consumption expenditures rose at a faster pace than in Q3 (up 6.3 percent) – an unexpected development, considering the base effect associated with general elections in the last part of 2004 and the insignificant fluctuation in the growth rate of the number of public sector employees.

[10] However, mention should be made that medium-term loans are not exclusively granted for consumption, but also for real-estate investment (land purchases, repair works).

[11] Turnover of non-durables industry for the domestic market went up 5.6 percent in Q4 compared to 9.9 percent in the previous quarter; the growth rate of durables (excluding auto vehicles) declined from +12.7 percent to -1 percent, while that of auto vehicles fell from +4.8 percent to -4.5 percent (mention should be made that the information on the latter category refers to the whole output of road transport means for both household consumption and modernisation of the vehicle fleet in the public and corporate sectors).

[12] 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 included in the Combined Nomenclature (C.N.).

Budgetary developments

According to expectations, in 2005 Q4, expenditures of the general government increased markedly, thereby boosting domestic demand in the short run. The impact of budget implementation on domestic absorption was the more so significant as, unlike the previous quarters, in the considered period the government budget ended on deficit[13] which was almost two times higher than that recorded in 2004 Q4 (1.5 percent versus 0.8 percent of GDP). Thus, 2005 recorded a deficit of 0.8 percent of GDP, i.e. 0.2 percentage points below the projected level and 0.4 percentage points below the deficit recorded in 2004.

In Q4, expenditure growth (16.6 percent in real terms against the same year-ago-quarter) was not evenly distributed over the period, as 46.5 percent of total expenditures were incurred in December, the monthly deficit peaking at 1.8 percent of GDP. Considerable increases saw especially material expenditures (38.2 percent compared to 11.2 percent in Q3) and transfers (24.6 percent compared to an average growth rate of 3.3 percent in the first three quarters); additional budget assignments destined to pay off outstanding debts in the social health insurance system contributed to a large extent to the expansion of material expenditures. By contrast, the growth rate of staff costs slowed down to 6.8 percent, i.e. half of the average for the first three quarters, owing also to the base effect arising from pay increases in the public sector granted in 2004 Q4[14]. Interest payments on public debt continued to decline at the same fast pace as in the previous quarter (-30.1 percent) as a result of lower volume of newly-issued government securities, longer maturities and further falling interest rates on government securities. Capital expenditures plunged 12.3 percent pointing to the drop in government spending on investment, a trend which was manifest for most of 2005[15].

Consolidated general government budget revenues went up 7.9 percent in 2005 Q4, the slight acceleration in their growth rate against the previous quarter being attributable mainly to the rise in VAT collections (38.7 percent versus 25.4 percent in the previous quarter) and customs duty collections (29 percent), associated with fast increase in the consumption of goods and services, and in imports. Conversely, transfers from profit tax and income tax diminished by 22.9 percent and 12.9 percent respectively, versus the same period of the previous year, following the introduction of the flat tax rate.

[13] In the first three quarters, budget implementation ended on surpluses ranging from 0.1 percent to 0.4 percent of GDP.

[14] In 2004 Q4, wages in education were raised in a range from 13 percent to 38 percent, while those of public servants rose by 20 percent.

[15] In Q2 and Q3, capital expenditures incurred by the public administration posted annual decreases of 35.5 percent and 6.7 percent respectively.

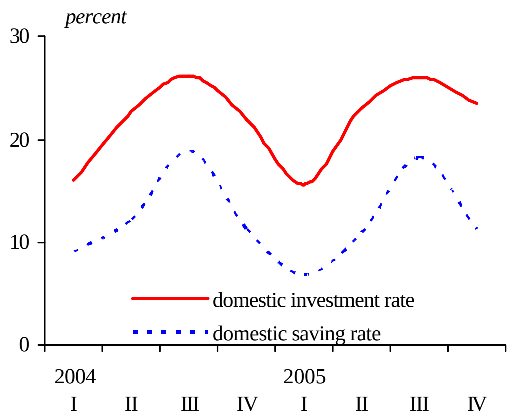
Investment

annual percentage change

	Year	I	II	III	IV
Total	2004	7.2	12.0	18.1	1.7
	2005	5.8	10.7	13.0	17.5
- new construction works	2004	7.6	9.6	13.3	6.9
	2005	2.2	9.4	8.8	15.3
- equipment	2004	14.9	26.4	38.4	5.5
	2005	9.6	12.8	15.7	15.7
- others*	2004	–30.7	–40.2	–38.8	–37.6
	2005	–4.9	1.0	27.0	48.2

* 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

1.1.2. Investment demand

The same as in the previous quarter, gross fixed capital formation was the fastest-growing component of domestic demand; however, the sustainability of this trend is questionable, given that the record high annual growth rate (21.3 percent)[16] occurred on the background of a base effect. Moreover, the increase in investment was largely the result of rehabilitation works in flood-damaged areas – new construction works (15.3 percent) and capital repairs (about 16 percent). As for equipment investment, its annual growth rate, albeit still high (15.7 percent), remained unchanged from the previous quarter.

As concerns financing sources, the rise in purchases of equipment (including transport means) was the result of both the increase in own resources (against the background of further favourable effect of fiscal easing after the introduction of the flat tax rate on 1 January 2005) and the expansion of bank loans[17], particularly RON-denominated loans (following, on the one hand, the drop in interest rates on such loans and, on the other, the slowdown in the appreciation of the domestic currency versus major currencies and the steep contraction in the range of foreign-denominated bank loans owing to the tight measures adopted by the NBR; mention should be also made that in Q4 the balance of foreign borrowings declined by 10.2 percent in real terms).

Investment for retooling in the main economic sectors does not show an improvement in the contribution of industry, considering the slowdown in the growth rate of both own sources (as reflected by the poor performance of output throughout 2005) and funds raised (the balance of loans taken from Romanian banks edged up only 1.4 percent in real terms, i.e. the lowest growth rate in 2005[18]).

[16] This is the highest reading seen in the period for which ESA95 quarterly series are available (1999-2005).
[17] According to the Credit Information Bureau, the annual growth rate of loans for equipment accelerated by 9.6 percentage points versus Q3 to 27.8 percent (real change).
[18] Calculations are based on the data released by the Credit Risk Bureau. Although this indicator includes short-term loans and loans for construction works as well, its use in assessing the developments in purchases of industrial equipment does not change the conclusion, taking into account the fact that services – holding more than 50 percent of loans taken by the corporate sector – witnessed a significantly higher growth rate of loans than industry (+32.8 percent, up 6.8 percentage points versus Q3).

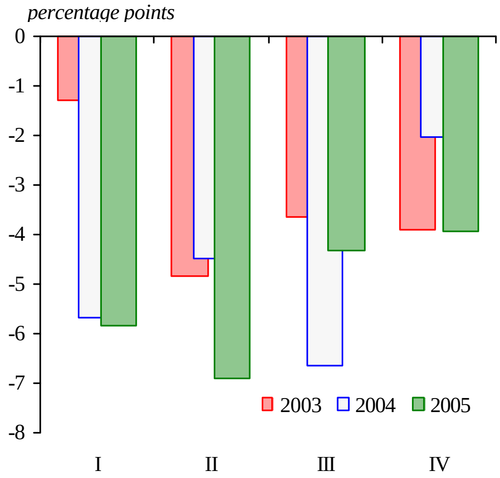
The same as in Q3, equipment purchases from abroad probably rose faster than those of domestically-manufactured capital goods[19].

Despite the outstanding annual growth rate recorded by investment in Q4, gross capital formation contributed only 2.5 percentage points to economic growth, given that the change in stocks led to an even wider gap in GDP growth than in Q3 (from -1.8 percentage points to -2 percentage points); this development was attributed to the severe drop in reserves of agricultural products, following the poor vegetal output in 2005.

1.1.3. Net external demand

In 2005 Q4, exports witnessed further upsurge and the annual growth rate of imports remained unchanged from the average for the first three quarters of the year, causing the negative contribution of net external demand to GDP growth to reach the lowest level for 2005, i.e. -3.9 percentage points. This development is likely to continue in 2006 Q1, as trade balance data point to a faster increase in the value of exports than in that of imports.

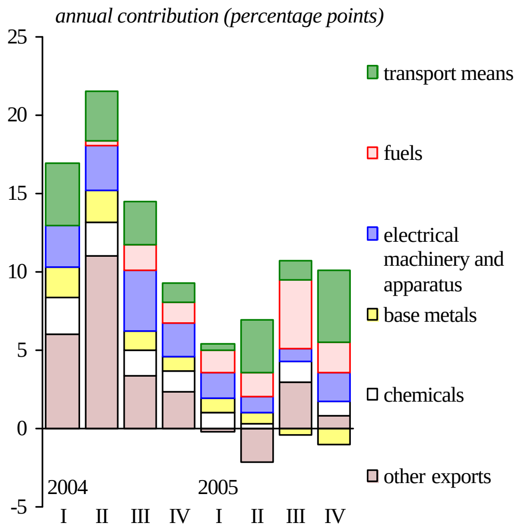
Net External Demand Contribution to GDP Growth



Source: NIS, NBR

As compared with the previous quarter, the 12-month growth rate of exports of goods and services accelerated by another 1.4 percentage points in 2005 Q4 (to 9.8 percent). The swift increase in exports was also mirrored by current developments, the seasonally-adjusted data[20] indicating that the quarterly growth rate of exports further exceeded 3 percent in October-December 2005. As concerns the structure of exports, it is worth mentioning that "mechanical devices, electrical machinery and apparatus" came to hold the largest share in export values (19.5 percent), to the detriment of "textiles"; this development was foreseeable, taking into consideration the stiffer competition from Asian countries that the Romanian light industry had to face following liberalisation of world textile market in early 2005.

Dynamics of Export Physical Volume



Source: NIS, NBR calculations

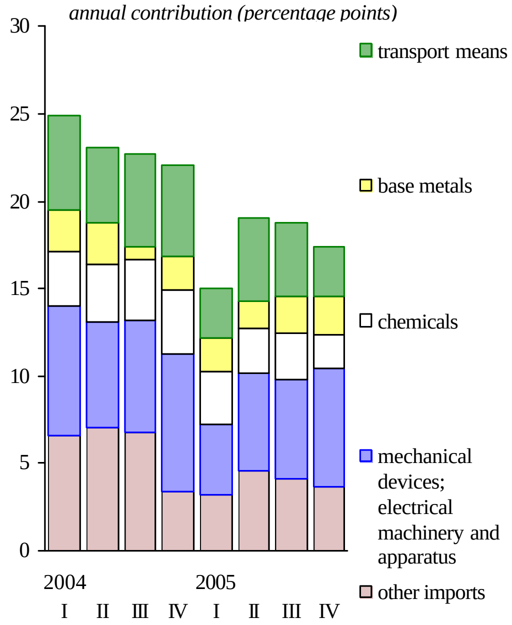
The real growth rate of imports of goods and services stayed at a level similar to that recorded in the previous quarter, i.e. 17.2 percent. Nevertheless, since the rapid increase in both purchases of goods by households and investment was not accompanied by a rise in domestic production, imports are most likely to have contributed more substantially to meeting demand (including

[19] In Q4, the annual growth rate of the turnover in industries producing capital goods (including transport means) for the domestic market slowed down to merely 4 percent (less than half the previous quarter's level); as concerns imports, the slowdown of their annual growth pace weakened, so that the growth rate of the physical volume remained above 20 percent.

[20] NBR calculations.

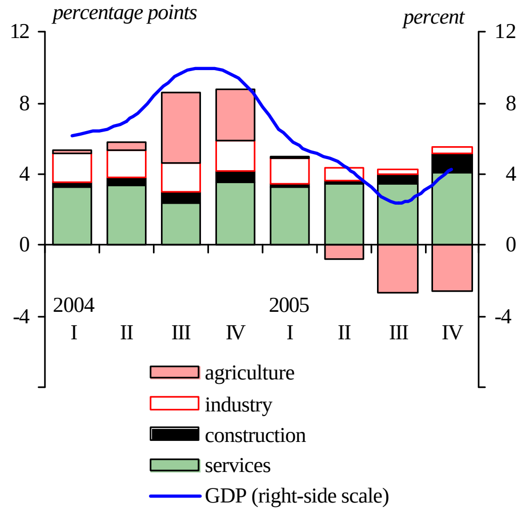
Dynamics of Import Physical Volume

annual contribution (percentage points)



Source: NIS, NBR calculations

Contribution of Main Supply Components to GDP Growth



Source: NIS, NBR calculations

demand for goods for productive purposes, except energy products, in which case larger supply for the domestic market caused related imports to drop by more than 5 percent[21]).

Foreign trade featured high concentration in 2005 Q4 as well. The annual increase in the physical volume of exports was due solely to developments in three commodity groups – “mechanical devices, electrical machinery and apparatus”, “transport means” and “mineral products” – whereas nearly 80 percent of the real growth in imports was accounted for by four commodity groups, i.e. “mechanical devices, electrical machinery and apparatus”, “transport means”, “base metals” and “chemicals”.

1.2. Supply

The same as in the first three quarters, in 2005 Q4, the decline in gross value added in agriculture (-16.4 percent) was the main culprit for the slowdown in GDP growth, against the background of adverse weather conditions and the base effect associated with the bumper crop in 2004.

Although industry saw a slightly higher growth rate than in the previous quarter, it continued to record one of the poorest performances over the past seven years (the volume index of gross value added stood at 101.7 percent). The sluggish industrial activity may be further attributed to: (i) significant fall in the volume of products manufactured under OPT arrangements; (ii) less favourable external environment (following textile trade liberalization and lower demand for metal and chemical products); (iii) heightened competition of competitive imports; (iv) restructuring of the mining sector.

Gross value added in construction rose by 13.5 percent, up 3.1 percentage points versus Q3. Behind this increase stood the developments in residential, non-residential and engineering works, with the last sub-sector witnessing the best performance (the annual growth rate accelerated by about 8 percentage points to more than 25 percent versus the previous quarter) amid the actions taken to remove flood effects.

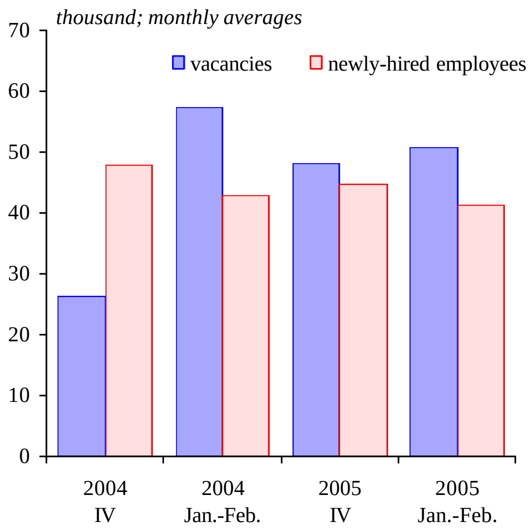
As for services, the 9.2 percent growth rate of gross value added was due mainly to developments in retail trade, telecommunications, IT, real-estate transactions, hotels and restaurants; in these sectors, the real growth rates of turnover stepped up, ranging from 20 percent to 50 percent.

[21] Whilst in 2005 Q4, turnover of intermediate goods industry for the domestic market saw further reduction (down 9.5 percent versus the same year-earlier period), in the case of energy products the dynamics reverted to positive values (4.7 percent, after staying in the negative territory for six quarters), due to the strenuous efforts to build up the natural gas stock for the cold season (the demand was nearly 10 percent higher than in the previous year), on the one hand, and to the heftier output of hydroelectric energy owing to heavy rainfalls, on the other.

2. Labour market

The outset of 2006 saw a decrease of the pressures that labour market conditions put on industrial production costs and consumer demand[22]*. The downward adjustment of the annual growth rate of the gross wage across industry caused a similar trend in the change in nominal ULC, although the influence was not manifest in every consumer goods sub-sector. On the demand side, the slowdown in the annual growth rate of economy-wide net wage (due to the base effect driven by the introduction of the flat tax rate in January 2005) and the decline, in annual terms, of the other components of household disposable income entailed the severe drop in its dynamics with an alleviating impact on consumption.*

Number of Vacancies and Number of Filled Vacancies



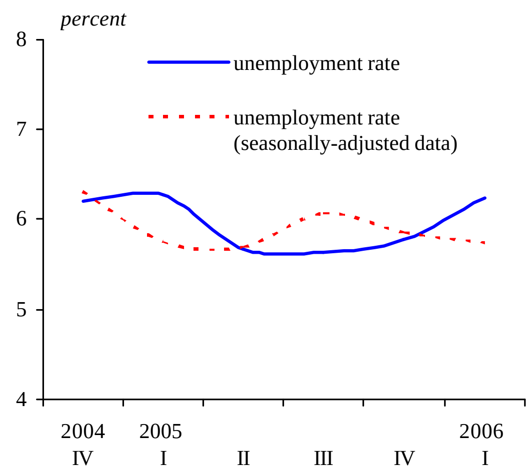
Source: NEA

2.1. Labour force

The statistical data provided by the National Employment Agency (NEA) show that the downtrend in excess labour demand, which had come to a halt in 2005 Q4, was resumed in January-February 2006. The inference derives from the negative annual growth rate of vacancies identified by the NEA and of the hirings intermediated by this institution (-11.2 percent and -3.5 percent respectively). Moreover, retrenchment of staff did not consist only in the slower absorption of workforce, it also affected the number of employees; the number of lay-offs, particularly mass dismissals, rose from the same year-ago period. The changes in the number of employees indicate that the services sector further created jobs and industrial enterprises moved to take additional measures aimed at restructuring their activity (also by cutting payrolls) in order to bring labour productivity to an adequate level.

Despite the worsening of unemployment flows[23] in January-February 2006, the unemployed labour force was relatively low, as illustrated by (i) the number of jobless that was slightly lower than that recorded in the same year-ago period and (ii) the fall in the seasonally-adjusted unemployment rate (5.8 percent) by 0.1 percentage points from the figure for the prior quarter. This state of affairs could contain the alleviating effect on wage hikes that should follow the easing of the pressures exerted by labour demand.

Unemployment Rate



Source: NEA, NBR calculations

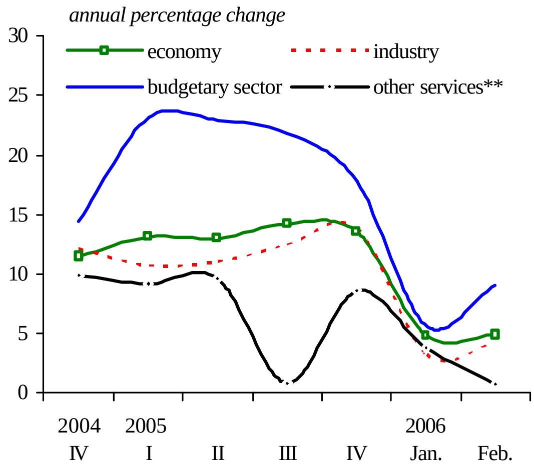
[22] Compared to 2005 Q4.
[23] Drop in unemployment outflows concurrently with the increase in unemployment inflows.

2.2. Incomes

In 2005 Q1-Q4, the annual average growth rate of gross wage economy-wide remained high, exceeding 16 percent in nominal terms, although the introduction of the flat tax rate entailed a considerable growth of net average wage (its annual growth rate was about 7 percentage points higher than that of the gross wage).

Statistical data for early 2006[24] show only a marginal slowdown in the growth rate of gross wage (15.9 percent), although the rise in gross minimum wage economy-wide was only 6.5 percent (up to RON 330); the main reason was the 11.3 percent pay rise granted in the budgetary sector (5 percent in February and 6 percent in September[25]); other possible reasons were the employers' difficulties to find adequately skilled staff, amid a lower unemployment rate, and higher inflation expectations. The change in net nominal wage was however strongly influenced by the base effect due to the introduction of the flat tax rate, so that the related annual growth rate moved down 9.2 percentage points from the previous quarter, to 14 percent.

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

The growth rate of wages in the budgetary sector, albeit on the wane, was still the heftiest among the key economic sectors. As concerns industry, the growth rate of wages was below the average, since the accelerating trend[26] seen in 2005 Q2-Q4 reversed.

Following the revision of labour productivity figures for January-November 2005 and the release of statistical data for December, the analysis of nominal ULC highlights the validity of inferences for 2005 Q4 presented in the November 2005 Inflation Report. Thus, the annual growth rate of nominal ULC across industry moved down from the previous quarter (by 2.6 percentage points) due to improved labour productivity particularly in mining and energy sectors and, to a lesser extent, in manufacturing, amid mixed output performance of consumer goods sub-sectors. In January-February 2006, the downtrend in the growth rate of ULC gained momentum, yet this time the chief driver was the slowdown in the annual rate of increase of gross wage by 3.3 percentage points, compared to that for 2005 Q4, while productivity gains made only a small contribution.

[24] January-February 2006.

[25] Percentage changes from the prior month.

[26] Undesirable and unsustainable trend given the poor performance and uncertain prospects for the production activity.

In manufacturing, the annual growth rate of nominal ULC declined to 6.8 percent (a level similar to the average), partly as a result of the negative or strongly decelerating growth rates in some consumer goods sub-sectors (food industry, furniture, light industry). Nevertheless, it is worth mentioning the persistence of heavy pressures on producer prices in tobacco processing and the light industry, where the deviation from the average of the sector goes up as much as 17 percentage points.

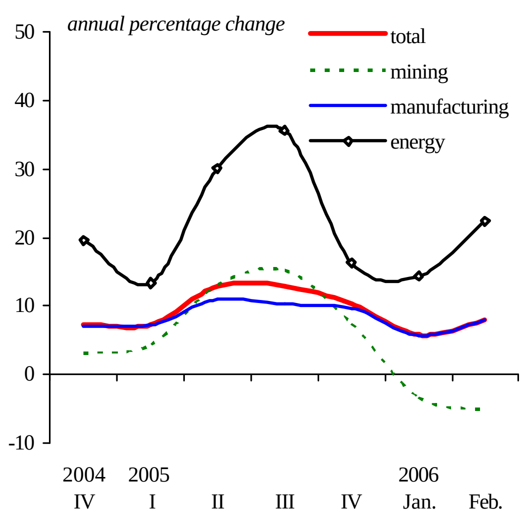
Although developments by sector were still uneven, it is worth noting that, across manufacturing, the gap between the annual growth rate of labour productivity and that of gross wages (deflated by IPPI for the domestic market) re-entered positive territory (2.7 percentage points) during January-February 2006, after staying in negative territory for two quarters in a row. It should also be mentioned the positive gap of 35.8 percentage points in mining, thanks to the measures taken to increase efficiency, which resulted in substantial productivity gains, and to the present conditions in the hydrocarbon extraction sub-sector, which allowed price increases that outpaced wage hikes by far.

On the demand side, the rectified data for 2005 Q4 show a slight pick-up in the annual growth rate of real disposable income[27] of households (due solely to the evolution of work remittances and current transfers from abroad). Nevertheless, the annual growth rate of real disposable income declined sharply in January-February 2006 (-12.5 percentage points from 2005 Q4), amid the slowing growth rate of wage earnings and the declines (in annual terms) detected for incomes from budgetary and extra-budgetary funds and incomes from abroad.

3. Import prices and producer prices

In 2005 Q4, disinflation measured by industrial producer prices for the domestic market slowed down, while in the case of prices for agrifood items it came to a halt due to the pressures exerted by the rapid growth rates of prices for vegetables; import prices further had a favourable impact, albeit to a significantly lower extent than in the previous quarter, owing mainly to exchange rate developments. The first quarter of 2006 saw the discontinuation of the downtrend in the annual growth rate of industrial producer prices and the increase in pressures coming from import prices.

Unit Labour Costs in Industry



Source: NIS, NBR calculations

Labour Productivity and Real Gross Wage in Industry

annual percentage change

	2004	2005				2006	
	IV	I	II	III	IV	Jan.	Feb.
Labour productivity	13.7	7.6	3.2	3.7	7.0	7.9	7.0
Real gross average wage*	3.8	1.0	2.3	5.4	6.6	3.3	2.8
Real gross average wage**	2.1	5.0	13.8	16.5	15.9	6.3	6.4

*) deflated by industrial producer price index for domestic market

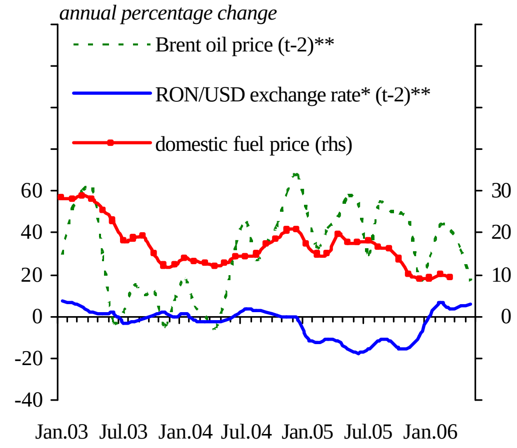
**) deflated by industrial producer price index for external market

Source: NIS, NBR calculations

[27] Estimate 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, and health insurance), work remittances from abroad and current private transfers by non-residents.

Oil and Fuel Prices

annual percentage change



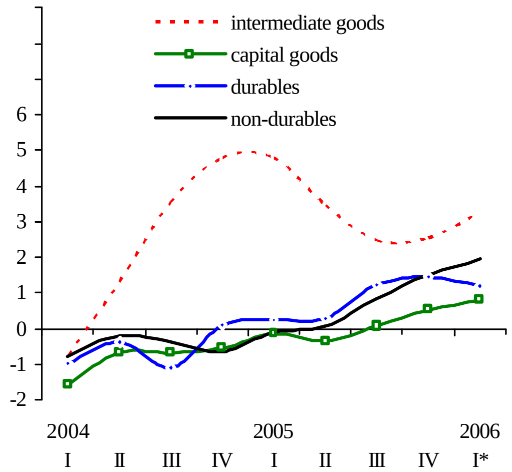
*) (-) RON appreciation, (+) RON depreciation

**) time lag attributed to the 45-day manufacturing cycle

Source: NIS, EIA

EU-25 Industrial Producer Prices for Exports

annual percentage change



Source: Eurostat *) January - February

3.1. Import prices

Import prices continued to have a favourable impact on domestic prices, but its magnitude decreased in the final quarter of 2005, due largely to the slowdown in the appreciation trend of the domestic currency against the major currencies[28]. Thus, the deflator of imports of goods and services stayed below par, yet its value was considerably higher than that in 2005 Q3 (98.1 percent compared with 92.2 percent). Deflation may have been driven solely by the stronger RON, as the unit value index of imports (up from 105.4 percent in Q3 to 106 percent in Q4) indicated heightened pressures from external prices. It is worth mentioning that the rise in the annual unit value index of imports was mainly due to price developments recorded by some commodity groups holding a large share in the CPI basket, such as "vegetal products", "foodstuffs, tobacco and alcohol", "chemicals" (pharmaceuticals in particular). Prices for mineral products (fuels included) and meat did not exert additional pressures as compared with 2005 Q3, but their growth rates remained high (42.4 percent and 11.4 percent respectively), largely contributing to the high dynamics of external prices.

The unit value index of imports from the EU increased as well, albeit to much lower levels (101 percent in 2005 Q4, up from 100.1 percent). The building up of inflationary pressures is also illustrated by the rise to 101.3 percent (from 100.9 percent in the previous quarter) in the annual index of industrial producer prices for EU exports (construction and energy excluded). This development mostly affected capital goods and consumer goods[29], the two groups posting an increase in external demand, spurred by faster global economic expansion.

Data available for January-March 2006 also indicate mounting pressures from external prices. As regards prices for energy products, the favourable impact of the relative easing of the natural gas market conditions[30] was offset by the heightened tensions on the world oil market (although the annual growth rate of prices remained unchanged as compared to 2005 Q4, the quarterly price change indicates a surge in the oil price in the current period[31]). The growth rate of prices of industrial goods

[28] 9.7 percent versus the EUR and 0.8 percent versus the USD in 2005 Q4, as compared with 16.2 percent and 16 percent respectively in 2005 Q3; annual rates.

[29] Growth rates of prices in the two sectors increased 7.8 times and 1.8 times respectively compared with 2005 Q3; however, the figure is considerably below par in the case of capital goods.

[30] The annual price change narrowed by 9 percentage points versus the previous quarter to 51.4 percent and the quarterly price change by 3.5 percentage points to 10 percent.

[31] The impact on domestic prices was mitigated by the fact that part of this increase occurred in the latter half of the quarter and its effect on domestic prices is more likely to be manifest in 2006 Q2.

originating in the EU stayed on the uptrend seen in the last part of 2005, the average price dynamics in manufacturing adding another 0.4 percentage points to 2.1 percent in January-March 2006; although the annual growth rate of prices for intermediate, capital and consumer goods underwent significantly positive changes, the prices for intermediate goods were the most affected this time. However, further nominal strengthening of the domestic currency continued to mitigate the negative impact of such developments on domestic prices.

3.2. Producer prices

3.2.1. Industrial producer prices

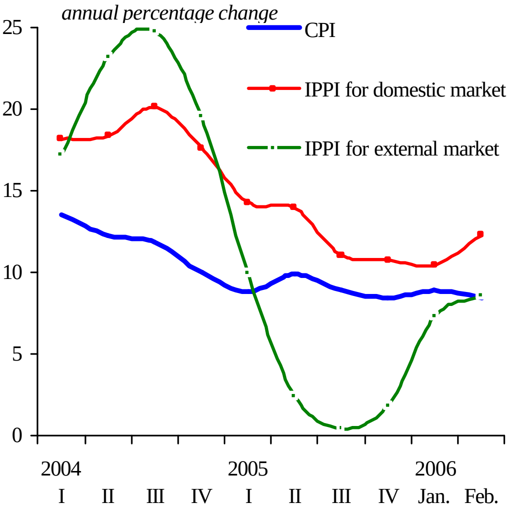
The same as in the previous four quarters, the annual growth rate of industrial producer prices for the domestic market continued to decelerate in October-December 2005, but at a slower pace (0.3 percentage points to 10.8 percent), on the background of mixed developments in the main groups.

Price dynamics for capital goods accelerated marginally (half of a percentage point) to 7.2 percent from 2005 Q3. This trend reversal was largely attributed to the slower appreciation pace of the domestic currency versus the euro, taking into account that the trajectory in prices for this commodity group was induced by road transport means sub-sector, where prices are generally expressed in euro.

Despite the weakening tensions on the world oil market, the annual change in prices for energy products delivered to the domestic market remained virtually unchanged from the level recorded in the previous quarter (21.4 percent). The favourable impact exerted by prices in the oil processing sub-sector (the growth rate of which decelerated by 4.1 percentage points compared with the average for the previous quarter) was offset by the opposite development of prices in the hydrocarbon extraction sub-sector (up 3.7 percentage points), due possibly to the larger volume of investment in drilling made during this period by Petrom[32], Romania's major oil company.

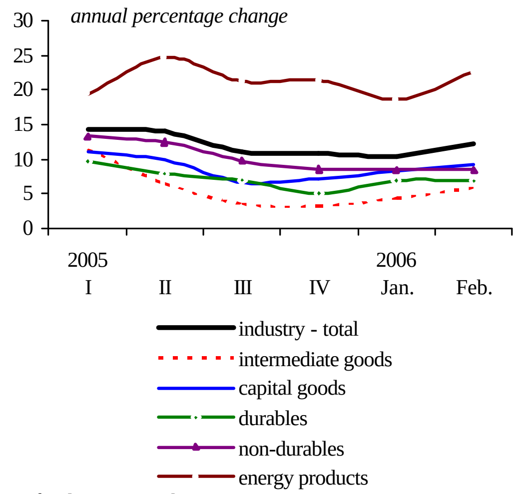
The annual growth rates of producer prices for durables and non-durables – holding the largest share in the CPI basket – continued to slow down (by 2 percentage points and 1.2 percentage points respectively), due to the weaker dynamics of domestic demand, particularly in the case of durables[33]. Conversely, the favourable contribution of prices for raw

Consumer Prices and Industrial Producer Prices



Source: NIS

Industrial Producer Prices* by Main Group



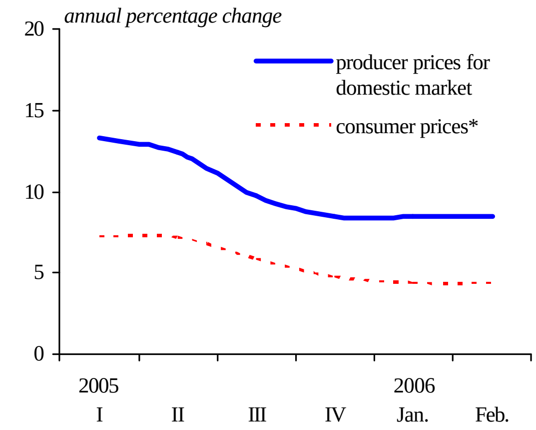
* for domestic market

Source: NIS

[32] Nearly 31 percent of the volume of investment in drilling and production planned by Petrom for 2005 were made in Q4 compared with 9.8 percent in Q3.
[33] The average annual growth of turnover of durables industry for the domestic market plunged to -1 percent in 2005 Q4 from 26.2 percent in Q2.

materials seems to dwindle[34], while the developments in ULC point to rising pressures in some of the main industrial sub-sectors[35]. In 2005 Q4, the gap between producer prices and consumer prices for non-durables[36] narrowed to 3.7 percentage points (compared with 3.9 percentage points in the previous quarter).

Non-durables Prices



* To identify industrial non-durables, the following food and non-food items were removed from the CPI basket: fruit, vegetables, household appliances, cultural and leisure products, fuels, electricity, gas and central heating, and other non-food items.

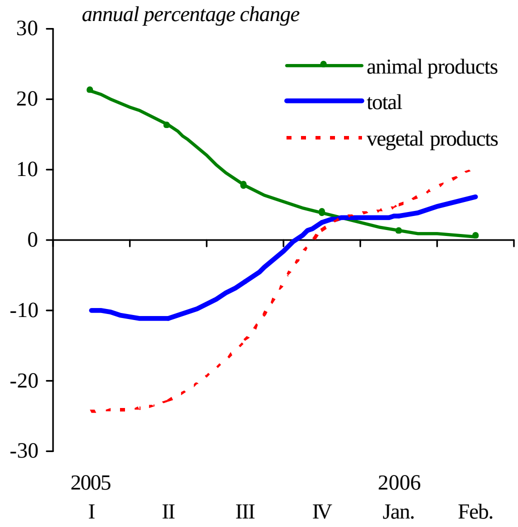
Source: NIS, NBR calculations

In the first quarter of 2006, the disinflation trend might come to a halt, amid further tensions building up in the hydrocarbon extraction sub-sector and the feeding through into other prices of costlier utilities and pressures from some raw material prices on foreign markets, which have been manifest ever since 2005 Q4[37].

3.2.2. Agricultural producer prices

In 2005 Q4, the annual rate of increase of agricultural producer prices reverted to positive values (+2.3 percent against the same year-ago period), due solely to developments in vegetal output (+1.2 percent, compared with -14.3 percent in 2005 Q3). Although prices for grains continued to decrease (by as much as 38.8 percent), prices for vegetables increased as much as 32.6 percent versus the same year-ago period, as a result of the negative supply-side shocks generated by adverse weather conditions. The current developments also indicate mounting pressures, as prices for agri-food items rose by 10.5 percent against 2005 Q3 and prices for vegetal products by 13.1 percent.

Agricultural Producer Prices



Source: NIS

The annual growth rate of prices for animal products continued to decelerate (to 3.8 percent), 3.8 percentage points below the average for the previous quarter; except price dynamics for eggs, which resumed the upward trend, that for the products in all the other groups stayed on a downward path. The main influence was exerted by the price for pork (its annual rate of increase turned negative to -3.2 percent) and for poultry, the

[34] Mainly the contribution of imported raw materials; see Section *3.1. Import prices*.
[35] The average annual change of nominal ULC increased significantly in textiles (19.7 percentage points to 34.6 percent) and furniture (27.7 percentage points to 15.4 percent); in other sub-sectors, despite the deceleration in the annual growth rates as compared with the previous quarter, values are still high (12.2 percent in food industry, 14.2 percent in wearing apparel, 28.2 percent in leather products).
[36] In order to establish the relation between producer prices and consumer prices for non-durables, the following food and non-food items were removed from the CPI basket: fruit, vegetables, household appliances, cultural and leisure products, fuels, electricity, gas and central heating, and other non-food items.
[37] According to IMF statistics, in 2005 Q4, the metal price increased at a faster annual pace (4 percentage points compared with Q3 to 29.7 percent), whilst the cotton price rose by 14.1 percent (compared with -1.9 percent in Q3). The first two months of 2006 saw the consolidation of these trends.

annual growth rate of which decelerated (by 11.7 percentage points to 9.2 percent). Behind these developments stood mostly the competition from imports and the excess domestic supply amid the slower pace of increase of demand.

Prices for some agri-food items stick to the upward path, owing to pressures from prices for fruit and vegetables and the gradual alleviation of the favourable impact of price for grains. Prices for animal products are not expected to witness tensions that might entail trend reversals as compared with 2005 Q4.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In 2006 Q1, the central bank continued to tighten monetary policy, raising the monetary policy rate by one percentage point and enhancing the firmness of monetary control. Behind the relative tightening of the broadly-defined monetary conditions in Q1 stood also the RON/EUR exchange rate, which resumed the downward trend, the increase in minimum reserve requirements on foreign exchange-denominated liabilities to 35 percent starting with 24 January, and the effects of the prudential and administrative measures implemented by the central bank in the latter half of 2005. In order to consolidate the increased restrictiveness of monetary conditions, the NBR raised further the minimum reserve requirements on foreign exchange-denominated liabilities towards the end of 2006 Q1.

Monetary policy tightening, which started in November 2005, continued in 2006 Q1; thus, the NBR Board adopted and implemented several decisions meant to enhance the restrictiveness of the broadly-defined monetary conditions and, implicitly, to ensure that disinflation follows a path consistent with the programmed trajectory. Thus, in February 2006, the NBR raised the monetary policy rate to 8.5 percent, augmenting the impact of this measure on the financial market by tightening the control over money market liquidity; moreover, the central bank increased the minimum reserve requirements on foreign exchange-denominated liabilities of credit institutions to 40 percent starting with 24 March 2006. In addition, the NBR decided to keep in place the prudential measures aimed at containing non-government credit expansion, especially in what concerns its foreign exchange component, and showed its readiness to accelerate the implementation of legislation regulating the lending activity of non-bank financial institutions.

Behind the tightening of monetary policy in the first two months of 2006 stood mainly the need to contain the growth rate of aggregate demand, especially the dynamics of household consumption, which at least in the short run was likely to continue to exert inflationary pressures. In March 2006, the central bank reiterated its decision to further tighten monetary conditions in response to higher-than-expected increase in excess demand in 2005 Q4 and, hence, to the possible extension of the time horizon needed to eliminate the positive output gap and the attendant inflationary pressures. The rise in excess demand continued to represent a matter of concern for the central bank, given that this state of affairs occurred despite further adverse effects of supply-side shocks on GDP dynamics, which enhanced the inflationary pressures exerted by the pattern of economic growth. The same as in the previous quarter, potential inflationary pressures generated by fast growth rate of the main components of domestic demand were only partly offset by the increase in negative change in stocks and the widening of trade deficit.

Inflationary pressures were mostly fuelled by private consumption, given that, although its expansion slowed slightly (due mainly to the decline in self-consumption and consumption of self-made products), the annual growth rate of household purchases of goods outpaced that recorded in 2005 Q3 (see Chapter III *Economic developments*). Moreover, the evolution of some relevant statistical indicators in the first few months of 2006 revealed further strong consumption and the risk of its persistence in the period ahead. Thus, despite the deceleration in the growth rate of household disposable incomes, the growth rate of turnover of retail trade sector accelerated strongly January through February 2006 (except for sales of motor vehicles and motorcycles); however, this development was associated with the resumption in this period of the downward trend in household net saving.

In this context, the central bank decided to tighten the interest rate policy in order to calm down the fast pace of increase in RON-denominated credit; the stepped-up increase in RON-denominated loans to individuals offset the relative deceleration in the pace of foreign exchange loans, making the annual growth rate of total household loans re-enter an upward path. The rise in household demand for RON-denominated loans was stimulated by more favourable access conditions to bank lending, in response to heightened competition among banks, which materialised in the sharp decline in lending rates and the launch of promotional banking products or extension of promotional offers launched during the winter holidays (longer grace periods and higher lending ceilings, along with extension of maturity). Under the impact of these factors, the annual real growth rate of new RON-denominated loans to households accelerated strongly, with their average annual growth rate reaching 250.2 percent in the first two months of 2006, compared with 163.4 percent in 2005 Q4; simultaneously, the average annual growth rate of the balance of new RON-denominated loans to households rose in real terms to 83.9 percent from 62.5 percent. Conversely, the dynamics of foreign exchange-denominated loans to households continued to decelerate following the NBR measures implemented in the last part of 2005; the average monthly flow of these loans (expressed in euro) continued to post values lower than those recorded in the same year-earlier period, declining slightly from 2005 Q4.

Behind the increase in the policy rate stood also the need to put an end to the erosion of saving in domestic currency given that in the last few months interest rates on time deposits of individuals were rather volatile, with no clear upward trend perceivable yet. Against this background, acceleration of the annual growth rate of balance on household savings in December 2005 proved to be a one-off phenomenon, being followed by deceleration in their real growth rate from 15.6 percent in 2005 Q4 to 10.5 percent in January and February 2006. Conversely, foreign exchange-denominated deposits of households (expressed in euro) continued to grow at a relatively fast pace, households' propensity for saving in foreign currency being further influenced by the depreciation of the RON in the last part of 2005.

The same as in the previous periods, monetary policy tightening was also aimed at alleviating the impact of current and future supply-side shocks, especially adjustments of administered prices and possible increases in volatile prices. In 2006 Q1, the most significant adjustments were recorded by prices of natural gas and electricity (17.2 percent and 1.9 percent respectively, in January 2006), leading to the temporary halt in the downward trend of the 12-month inflation rate (which rose to 8.9 percent). Behind the higher annual inflation rate stood also the increases in volatile prices, which continued to reflect the impact of weak agricultural output in 2005. Nevertheless, the annual inflation rate resumed the downward trend, dropping to 8.4 percent in March 2006, down 0.2 percentage points against December 2005 and 0.7 percentage points lower than the forecast in the February 2006 Inflation Report. However, some signs of worsening of producers' and financial institutions' inflation expectations represented another reason behind the central bank's decisions to increase the restrictiveness of monetary conditions.

Monetary policy tightening in the first part of 2006 Q1 materialised in a firmer control over money market liquidity, the central bank continuing to resort mainly to open-market operations (one-month deposit-taking operations and certificates of deposit) in order to mop up excess liquidity; in this context, banks' resort to the deposit facility declined to marginal figures, relatively similar to those traditionally recorded, while the average interest rate on banks' holdings with the central bank stayed on an upward trend.

In order to consolidate this trajectory, the central bank raised the monetary policy rate by one percentage point to 8.5 percent in February 2006. Simultaneously, the monetary authority gradually enhanced the role of its main monetary policy tool, i.e. one-month deposit-taking operations, the average balance of such operations reaching in March 2006 about 62 percent of the average monthly balance of banks' holdings with the central bank. The effectiveness of the monetary control was also increased by the NBR decision to set a timetable of auctions for deposit-taking operations (once a week). Against this backdrop, the average interest rate on banks' holdings with the NBR continued to increase, this trend feeding through into interbank rates.

Money market rates entered the upward trend in a period featuring, broadly, an upturn in international investors' interest in Central and East European financial markets (see Subsection *2.2. Exchange rate and capital flows*), which translated into the resurgence of volatile capital inflows on the domestic market. The average volume of non-residents' transactions on the interbank foreign exchange market during January-March 2006 outpaced almost 1.7 times that recorded in 2005 Q4, so that despite the sharp widening of trade deficit, the RON resumed its nominal strengthening versus the EUR as early as January 2006, thus contributing to the relative tightening of monetary conditions.

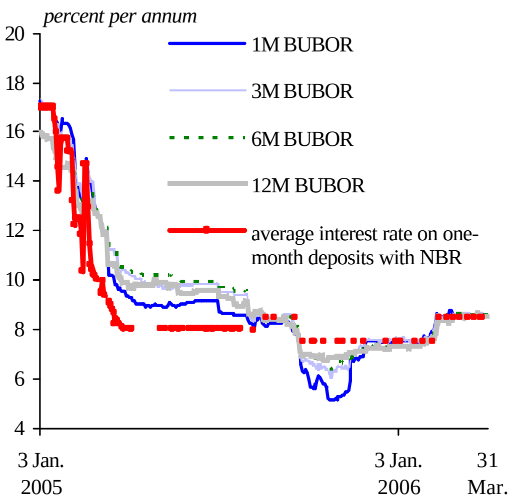
In order to offset the stimulative impact of the RON/EUR rate movements on foreign currency-denominated credit, the NBR Board decided in February 2006 to increase the minimum reserve requirements on foreign exchange-denominated liabilities of credit institutions to 40 percent from 35 percent, starting with the 24 March – 23 April 2006 maintenance period. This measure was also intended to consolidate the limiting effect that the prudential and administrative measures previously adopted by the NBR had on the dynamics of foreign currency-denominated credit.

2. Financial markets and monetary developments

The monetary policy rate hike and the tightening of monetary control contributed to the strengthening of the upward trend of interbank rates; the domestic currency exchange rate reversed its trajectory, the RON appreciating significantly in nominal terms versus the EUR in 2006 Q1. Non-government credit growth accelerated starting with January, becoming again the main determinant of monetary expansion; however, the dynamics of liquidity across the economy slowed down, due mainly to the waning base effect induced by the Petrom privatization.

2.1. Interest rates

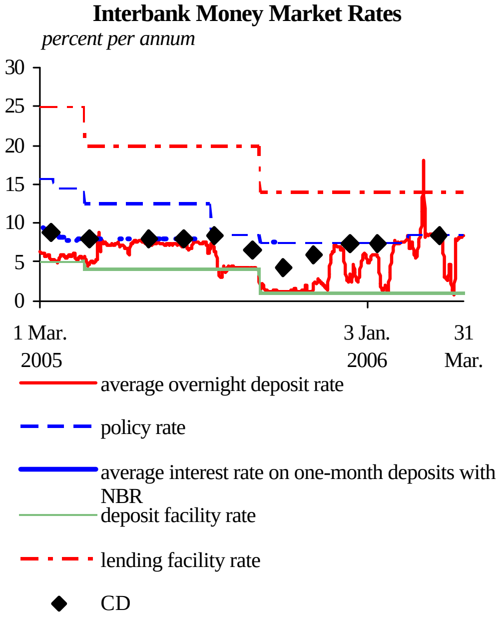
Interest Rate on Deposit-taking Operations and BUBOR Rates



The policy rate hike and further substantial sterilization of excess liquidity in the interbank market via open-market operations helped consolidate the upward path of interest rates on interbank transactions, causing the spread between interbank rates and interest rates on one-month deposits with the central bank to narrow. Over the period, the average interest rate on interbank deposits rose by 2.9 percentage points against 2005 Q4, reaching 6.5 percent.

The development of interest rates on interbank deposits was, however, uneven. Thus, in the first part of the period under review, they posted sharp volatility entailed by the seasonal increase in fluctuations of autonomous factors of liquidity and by the persistence of uncertainties surrounding the frequency of deposit auctions and the volume of liquidity to be allotted by the NBR; against this backdrop, in January 2006, interest rates went up slightly, the spread between interbank rates and the policy rate remaining relatively wide (2.7 percentage points). Interbank rates rose by 3.7 percentage points in February, when the rise in the policy rate, the tighter control over liquidity – by significant sterilization of excess liquidity through open-market operations, especially one-month deposit-taking operations – and large soaking-up operations performed by the Treasury led to an increase in interest rates on interbank deposits, which averaged out at 8.46 percent.

Interbank Money Market Rates



Starting with the latter half of the quarter, the development of interest rates was also influenced by the NBR decision to set a timetable of auctions for one-month deposit-taking operations (on a weekly basis, every Monday). The inherent difficulties encountered by banks in adapting their liquidity management to this change had as a result extremely large fluctuations of the quantity and price parameters of the interbank market; temporarily, transactions also showed a sharp speculative nature, the overnight rates exceeding occasionally[38], in the last ten-day period of February, the ceiling of the corridor defined by the standing facilities[39]. Subsequently, against the background of increased cautiousness of operators regarding management of resources, the interest rates on overnight deposits plummeted, occasionally falling even below the 1 percent interest rate on the deposit facility.

In this context, in 2006 Q1 overnight rates posted higher volatility than in the previous quarter; simultaneously, their

[38] Overnight rates peaked at 29.5 percent.
[39] After 9 months, the lending facility was again resorted to in February 2006, for speculative purposes as well.

daily average values fluctuated within wider ranges (from 1.1-7.3 percent to 0.8-18.1 percent).

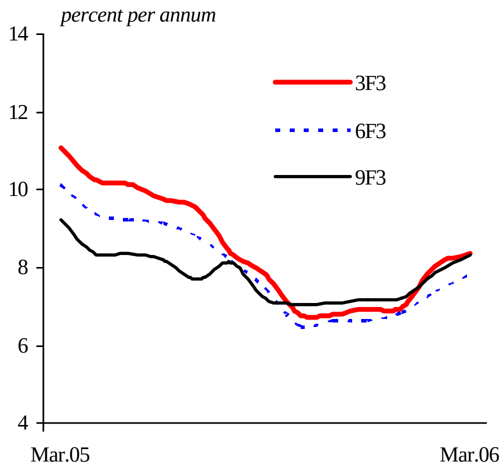
The fall in the (1M-12M) BUBOR yield curve came to a halt[40], reaching in March a level 1.2 percentage points higher than that recorded in December 2005; however, the slope remained negative, suggesting the anticipated decline in interest rates in the periods ahead. Average interest rates for shorter maturities, i.e. ON and 1W, increased as well, with the March average surpassing by 1.22 percentage points that recorded in December 2005. As a result, the spread between monthly averages of 12M-BUBOR and ON BUBOR rates narrowed by 0.5 percentage points to 90 basis points due to a relatively lower uncertainty of market operators and lesser impact of autonomous factors of liquidity.

The implicit forward rates (calculated on the basis of March quotations) indicate a slowdown in the downward trend of interbank rates in the next three months; the 3M-BUBOR rate is expected to run at 8.4 percent in June 2006 (0.3 percentage points below the March level). Accordingly, the 3M-BUBOR rate is seen falling at a faster pace in September (by 0.8 percentage points against March) and rebounding to the June level in December.

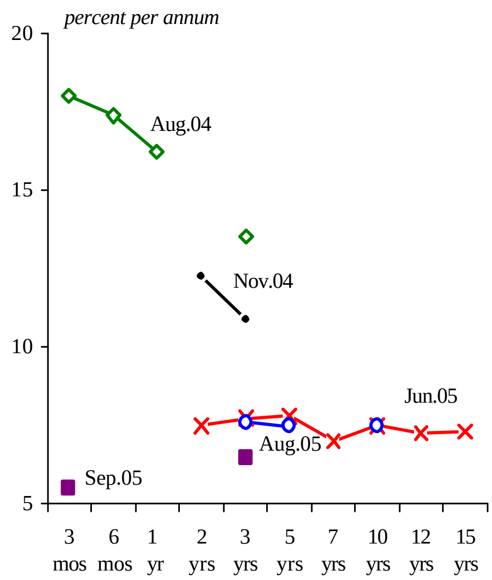
As in the previous quarter, the activity on the primary market for government securities was sluggish; the Ministry of Public Finance cancelled two auctions for Treasury certificates[41] scheduled for February and March (according to the provisional calendar disclosed at end-2005). Over the reported period, the value of government securities falling due was extremely low, i.e. RON 20 million, while budget execution generated significant holdings in the General Account of the Treasury.

Banks' average interest rates on new deposits and loans to non-government, non-bank clients witnessed an unusual behaviour, as they moved in opposite directions December 2005 through February 2006; thus, the average lending rate dropped 1.1 percentage points, whereas the average interest rate on time deposits inched up 0.9 percentage points. These developments reflected the impact of a more restrictive monetary policy and stiffer bank competition, namely the more aggressive strategies that some credit institutions resorted to in order to expand their market share.

Implicit Forward Rates

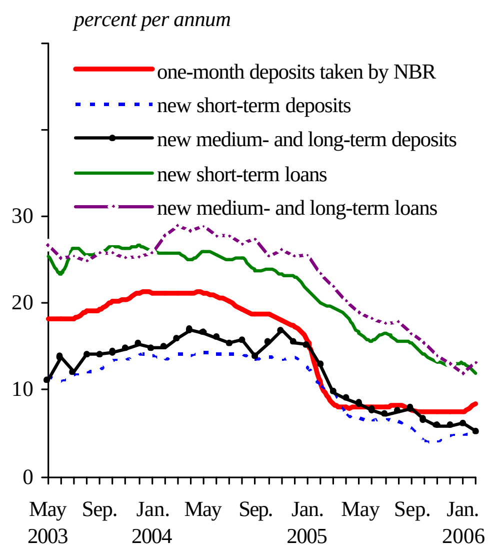


Yield Curve (Treasury certificates)

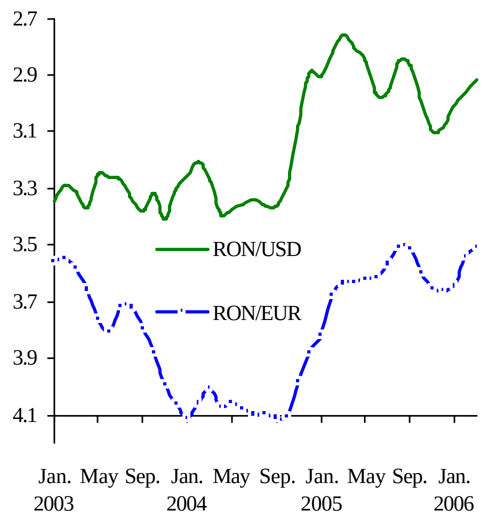


[40] Invalidating the forecast on implicit forward rates calculated on the basis of December quotations.
[41] The most recent issue of government securities dates back to September 2005.

Bank Rates



Nominal Exchange Rate



Interest rates followed the same asymmetrical trends from the perspective of the credit institutions' main client segments. Thus, the decline in the average interest rate on new loans to households came to a halt in February, when it picked up 1.4 percentage points; conversely, interest rates on corporate loans stuck to their downward drift throughout the period under review, their average level diminishing 1.3 percentage points in February versus November 2005. The average interest rates on time deposits witnessed opposing developments, as their upturn – in case of household placements – was manifest only in the first two months of the reported period.

2.2. Exchange rate and capital flows

In 2006 Q1, the main drivers of the RON/EUR exchange rate movements were the following: the seasonal narrowing of trade deficit, the increase in direct investment flows, and the impact of NBR decisions on the capital inflows which are sensitive to monetary policy instruments. Towards the end of the period under review, exchange rate developments were also influenced by the temporary decline in speculative capital inflows due to higher interest rates on the major international markets.

Thus, after four months of continued depreciation, the domestic currency re-entered in January the nominal appreciation trend against the euro, the initial fast pace decelerating in the last month of the reported period. Compared to December 2005, the RON strengthened against the EUR by 4.3 percent (5.9 percent in real terms) and against the USD by 5.7 percent (7.3 percent in real terms), as the USD depreciated slightly versus the EUR. Conversely, calculated as an average annual change for 2005 Q4, the appreciation rate of the domestic currency versus the EUR further decelerated (4.1 percent in nominal terms and 13.1 percent in real terms), while the RON even witnessed a decline in nominal terms against the USD for the first time in the last six quarters.

Behind the turning point in the RON/EUR exchange rate recorded in January stood mainly the halving of the current account deficit versus the previous month, owing primarily to the seasonal contraction in the trade deficit[42], and the larger coverage of this deficit through direct and portfolio investments[43]. The impact of these developments was enhanced by the rise in short-term loans[44] of banks and corporate sector,

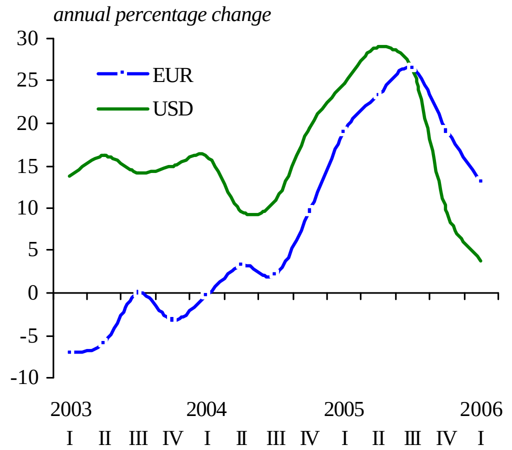
[42] In January 2006, the trade deficit lowered 57.5 percent month on month, yet it surged 91.1 percent from the same year-ago period.
[43] Direct and portfolio investments covered 216 percent of the current account deficit (158 percent in December 2005 and 133 percent in January 2005 respectively).
[44] On the rise compared to both the fourth-quarter average and January 2005.

as well as by the slight increase in deposits of non-residents in Romania, including deposits in RON, which were given a boost by the higher domestic money market rates[45]. On the other hand, medium- and long-term financial credits of banks dwindled, possibly as a result of the increase – starting with January – in minimum reserve requirements on foreign exchange-denominated liabilities and the enforcement of the norms on containing the concentration of exposures from forex loans.

February saw faster RON appreciation, mainly due to larger volatile capital inflows[46] fuelled by the wider differential between domestic and international money market rates[47] and by expectations that the downward trend of the RON/EUR exchange rate will continue; furthermore, the strengthening of the domestic currency might have also been due to the dynamics of direct and portfolio investment inflows and of financial credits, which offset the impact of a wider trade deficit. Hence, the RON witnessed the largest appreciation against the EUR in the last 12 months, i.e. 2.9 percent.

The shift in foreign investors' sentiment concerning financial markets returns in emerging economies[48] as well as the interest rate hikes decided by the Fed and the ECB in March[49] led to considerable adjustments of the speculative positions in Central and Eastern Europe[50]. The leu was also affected by these adjustments, recording a marked decline against the EUR in the first half of March. However, in the latter part of the reported period, the exchange rate stabilised somewhat, as the downward drift was interrupted by the relative softening of investor wariness and expectations of higher interbank rates following the central bank's tight control over liquidity across the banking system. Against this backdrop, the RON strengthened further in nominal terms versus the EUR, posting a 0.9 percent change in March.

Developments of RON Exchange Rate*)



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

Source: NIS, NBR

Key Financial Account Items (balances)

EUR million

	2005 2 mos	2006 2 mos
Financial account	**409**	**578**
Direct investment	**521**	**1,055**
residents abroad	8	55
non-residents in Romania	513	1,000
Portfolio investments	**-92**	**256**
residents abroad	-123	158
non-residents in Romania	31	98
Other capital investments	**1,043**	**197**
of which:		
medium- and long-term investment	1,097	50
short-term investment	175	-178
currency in circulation and short-term deposits	-822	342

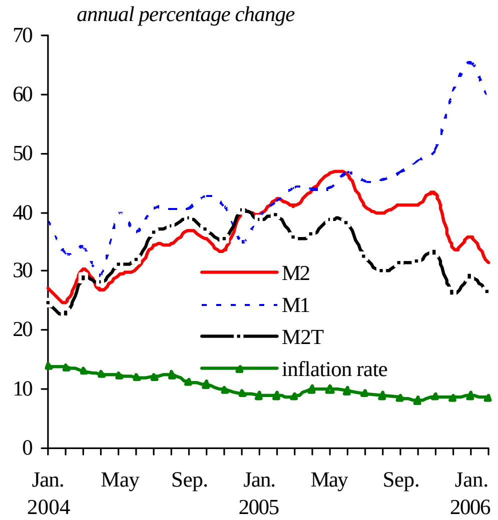
[45] The period under review saw a shift in investor interest to other Central and East European currencies as well, since the Czech *koruna*, the Slovak *koruna*, the Croatian *kuna* and the Slovenian *tolar* all strengthened in nominal terms.
[46] The volume of non-residents' net foreign currency sales was the second largest on the interbank forex market, i.e. EUR 228 million.
[47] Following the decision taken by the NBR Board on 8 February to raise the monetary policy rate.
[48] Brought about by the crisis that hit the Icelandic *króna* at end-February and fuelled by political uncertainties in some countries in the region (Poland, Hungary, Slovakia).
[49] The ECB raised its minimum bid rate by 0.25 percentage points on 8 March, while the Fed funds rate was also raised by 0.25 percentage points on 28 March.
[50] Against this backdrop, the currencies of most countries in the region softened in nominal terms and became more volatile, with the Hungarian *forint* posting the sharpest weakening.

In the coming months, the volatility of the RON exchange rate might return to higher values, owing to possibly abrupt changes in investor strategies, as a result of political changes in Central and Eastern Europe and the likelihood of further hikes in interest rates on the major international financial markets. Moreover, the exchange rate trajectory could also reflect the opposing influences of the seasonal rise in non-residents' remittances from abroad and the persistently high growth rate of direct and portfolio investments, on the one hand, and by the possible decline in financial credits of banks and the faster increase in imports, on the other hand. The prevalence of some of these factors in the first part of April made the RON exchange rate resume the appreciation trend which had started in January.

2.3. Money and credit

Money

Broad Money and Inflation Rate



Source: NIS, NBR

In December 2005 – February 2006, the expansion of broad money (M2) witnessed a significant slowdown[51] due to the deceleration of its 12-month growth rate in the first month of the period under review; this drop was mainly induced by a base effect generated by the noticeable rise of M2 in December 2004 following the increase in Petrom's share capital[52]. The slacker growth rate of M2 in the reported period was also due to other specific factors influencing the volume of liquidity across the economy, the most important being: (i) the steep drop (only partially induced by the above-mentioned base effect) in the pace of increase of banking system's net foreign assets, (ii) the steadfast change in companies' financial asset portfolio structure, and (iii) the fall in the RON equivalent of foreign currency-denominated liabilities due to the nominal appreciation of the RON versus the EUR. Non-government credit exerted a contractionary impact on the rise of M2 only in December 2005, whereas in the ensuing months it regained its role as the main driver of monetary expansion. An opposing influence was exerted by net government credit (namely the change in government deposits) which, after steadily fuelling the M2 rise in December 2005, deterred yet again the growth rate of broad money in the following months.

Broad Money (M2)

percent

	2005				2006	
	I	II	III	IV	Jan.	Feb.
	monthly average					
M1	22.7	24.2	26.2	26.9	27.5	27.4
Currency outside banks	11.6	12.6	13.0	12.8	27.5	27.4
Domestic currency deposits	53.4	53.7	54.8	55.6	56.7	56.3
Foreign currency deposits	35.1	33.7	32.1	31.6	30.5	30.6

Judging by the developments in its components, the pace of M2 expansion decelerated owing solely to the performance of quasi-money; conversely, the 12-month growth rate of narrow

[51] Unless otherwise indicated, percentage changes refer to the December 2005 - February 2006 average of the 12-month growth rates in real terms.
[52] Pursuant to the privatisation contract concluded with OMV, the Austrian company increased Petrom's share capital by about EUR 830 million in December 2004.

money (M1) witnessed a considerable upsurge amid the still low opportunity cost of holding funds and stronger demand for narrow money. However, towards the end of the period under review, the annual growth rates of the most liquid components of broad money flattened out; instead, non-banks' government securities portfolio increased and their volume of forex deposits picked up considerably. Despite this pick-up, composition of broad money by currency continued to improve, with the share of forex deposits in M2 touching the lowest average in the last 7½ years.

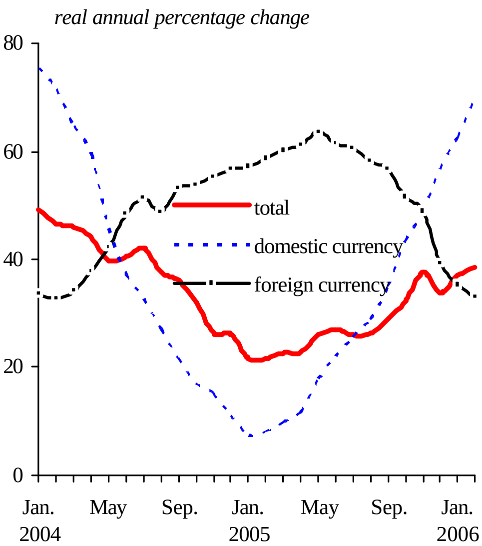
The slower rise of M2 was mainly due to corporate deposits[53], whose pace of increase decelerated under the stronger seasonal impact of the following developments: (i) settlement of quarterly payments to the government budget, (ii) payment of imports and other payments related to the external debt service, and (iii) payment of end-of-year bonuses, especially in the private sector. The joint action of these factors alleviated the expansionary impact of faster growth rate of corporate loans and heavier public spending in December 2005.

Conversely, the rate of increase of total household deposits came to a relative standstill amid opposing developments in the various categories of placements. Thus, while the growth of RON-denominated household savings decelerated further, that of forex deposits witnessed an upward trend. The growth rate of household current accounts remained relatively flat, since the effects on wage earnings following the introduction of the flat tax rate at the onset of 2005 faded; nonetheless, the share of holdings on current accounts in total placements of households rose gradually to record highs.

Non-government credit

The annual growth rate[54] of non-government credit December 2005 through February 2006 picked up further, yet at a much slower pace than in the previous period. The relative slowdown was due solely to the performance of forex loans, whose volume dropped under the impact of the NBR's restrictive measures[55]; consequently, the growth rate of foreign liabilities of commercial banks, i.e. the main financing source for foreign currency-denominated loans, came to a halt in January 2006. Conversely, RON-denominated loans stayed on a sharply upward trend, with their annual growth rate surging by more

Non-Government Credit by Currency

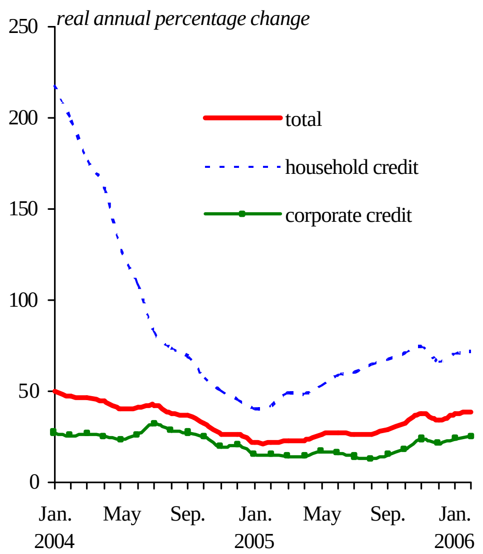


[53] Including restricted deposits and certificates of deposit.
[54] Unless otherwise indicated, percentage changes refer to the December 2005 – February 2006 average of the 12-month growth rates in real terms.
[55] NBR Norms No. 11/2005 on containing the concentration of exposures from forex loans, effective 26 September 2005, and the hike in the required reserve ratio on foreign currency-denominated liabilities (from 30 percent to 35 percent starting with 24 January – 23 February 2006 maintenance period).

than 20 percentage points. The main drivers behind the stronger demand for RON-denominated loans continued to be the drop in lending rates, the fast-paced increase in disposable income of households, and the improved financial standing of companies. The supply of RON-denominated loans was spurred mainly by (i) fiercer competition among commercial banks (entailing more aggressive strategies to expand their market share, including through more sophisticated lending products), (ii) the favourable outlook on economic developments and creditworthiness of prospective clients, and (iii) the declining risk of adverse selection.

Against this backdrop, RON-denominated non-government credit acted as the major driving force of monetary expansion, while the share of foreign currency-denominated loans in total non-government credit followed a downward path, touching a 9-year low on average for the period under review.

Non-Government Credit by Client



Similarly to the previous periods, household loans witnessed the highest annual growth rates. However, the actual readings were slightly below those of the previous quarter, due to the noticeable impact exerted in December 2005 by the portfolio restructuring at a commercial bank, when a significant volume of forex loans to households was transferred to the balance sheet of some foreign financial institutions. Although RON-denominated mortgage and housing loans saw the fastest growth rates, consumer loans[56] still accounted for more than three quarters of household loans; it is noteworthy that some credit institutions added further incentives to such loans, namely the temporary drop in lending rates, extended repayment terms and higher credit ceilings.

Conversely, the annual growth rate of corporate loans continued to pick up during the period under review, particularly due to the rise in RON-denominated medium- and long-term loans, boosted by the steeper decline in lending rates. On the other hand, the annual pace of increase of foreign currency-denominated corporate loans decelerated, following the relative tightening of lending terms.

[56] According to data in NBR's "Financial Behaviour of Households and Companies by County" based on the information provided by credit institutions, except CREDITCOOP.

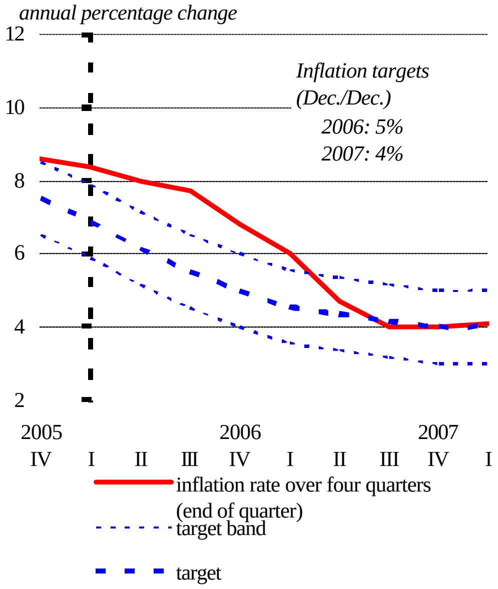
V. INFLATION OUTLOOK

The baseline scenario of the projection places the annual inflation rate at 1.8 percentage points above the 5 percent target for end-2006. The upward revision of the February projection (6.6 percent) is due mainly to the anticipated impact of the 'vice tax' on tobacco and refined alcohol in the second quarter. The increase in prices due to this indirect tax offsets the favorable impact of a slower than previously anticipated pace of administered price adjustments for 2006. The effect of these price increases on inflationary expectations, the fiscal policy easing in 2006 Q2-Q4, as well as the rescheduling of some increases in administered prices for end-2007 and the beginning of 2008 imply a tighter monetary policy stance than previously envisaged over the entire projection horizon, in order to set the ground for achieving the targeted inflation rate of 4 percent at the end of 2007.

Throughout the projection horizon, the disinflation process will be supported by a continuous decline in excess demand down to negative levels, under the impact of tight real monetary conditions. Among these, the disinflationary effect of exchange rate developments will prevail through 2006 and in the beginning of 2007, putting downward pressure on aggregate demand growth and exerting a favorable influence on import prices. In the second half of the projection interval, interest rates will have a more prominent role in controlling aggregate demand. Disinflation within that period should also benefit from a gradual adjustment of expectations towards a path consistent with the inflation target.

The main risks which may push inflation off its projected track are generated by substantial uncertainties regarding: (i) the timetable as well as the first and second-round effects of adjustments in administered prices and taxes with significant impact on inflation, (ii) the future stance of fiscal and incomes policies, (iii) the fluctuations in international prices of oil and natural gas and the way they are incorporated in domestic prices of fuel and energy, (iv) the magnitude and nature of capital flows throughout the projection horizon.

Inflation Forecast



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

1. The baseline scenario of the forecast

1.1. Inflation forecast

The baseline scenario forecasts an annual CPI inflation rate above the upper bound of the ±1 percentage point band around the 2006 year-end target of 5 percent. Starting with the second quarter of 2007, CPI inflation is forecasted to re-enter the target band and to follow a path consistent with attaining the 4 percent target by the end of 2007. The inflation rate projected for the end of 2006 lies approximately 0.2 percentage points above the February Inflation Report's forecast (6.8 percent versus 6.6 percent). The upward correction has been prompted by the introduction of the vice tax on tobacco and refined alcohol products and by changes in excise duties. These price shocks offset the disinflation gains stemming from the lower-than-forecasted inflation level recorded in the first quarter of 2006 and from re-scheduled lower increases in administered prices for the last three quarters of 2006[57].

Table 5.1. Annual inflation rate (end of period)

Period	Q2 2006	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008
Target			5.0				4.0	
Forecast	8.0	7.7	6.8	6.0	4.7	4.0	4.0	4.1

The 2006 Q1 inflation rate was lower than forecasted in the February 2006 Inflation Report, mainly due to the nominal appreciation of the domestic currency and the lower-than-expected rises in volatile food prices (vegetables, fruit, and eggs). The nominal appreciation of the RON fed through into lower services prices and euro-denominated excise duties. However, the recent disinflation gain does not improve the outlook for the 2006 end-of-year annual inflation, being offset by the introduction of a vice tax on tobacco and refined alcohol products in the second quarter, to be imposed in the form of higher excise duties. The overall forecasted impact of these tax changes on the 2006 annual CPI is currently estimated at around 1.1 percentage points[58]. As a consequence of the combined effects of all factors, the currently projected annual increases in the CPI for the period 2006 Q2-Q4 lie 0.2 percentage points

[57] The largest difference between the current and the previous administered prices scenario occurs for the 2006 Q2 price increases.
[58] The impact is computed as the cumulative increases in CPI inflation for 2006 Q2-Q4 following the introduction of the vice tax, against the hypothetical case the excise duties had increased according to the calendar set jointly by the Romanian Government and the European Commission. The computation uses the CPI shares of 4.04 percent for tobacco products and 0.27 percent for refined alcohol beverages published by the NIS.

above the February forecast. The accelerated disinflation projected for 2006 Q4 (of 0.9 percentage points) is attributed to a base effect[59], a timetable assuming less administered price adjustments and a lower projected CORE2 inflation induced by tighter monetary policy. Starting with 2007 Q2, the forecasted inflation re-enters the target band. Assuming that the current scenarios regarding administered prices and other exogenous variables materialize, the projected acceleration of disinflation throughout 2007 would allow attainment of the 4 percent target by the end of the year.

The projection of CORE2 inflation is influenced by the introduction of the vice tax on tobacco and alcohol products, the evolution of inflation expectations, import prices, and the output gap. In the current forecast, inflation expectations are the main driver of inflationary pressures. Although the prices of tobacco and products based on refined alcohol comprise an administered component (excise duties), they are nevertheless included in the CORE2 "underlying" inflation measure. Despite their one-off character, increases in these prices in the second and third quarters of 2006 will affect the overall consumer price index and therefore may lead to an increase in inflation expectations. The effects of this year's changes in tobacco and alcohol prices are estimated to be completely phased out only during the first quarter of 2007. Considering also the lagged effects of the recent nominal appreciation of the domestic currency, import prices are not expected to fuel domestic inflation over the forecast horizon. The excess aggregate demand – as measured by the positive output gap with respect to potential GDP – will on the other hand continue to exert inflationary pressures until the end of 2006. On the whole, in spite of direct and indirect influences of the increase in excise duties and of higher administered and volatile prices, forecasted CORE2 inflation rate will decline to close to 2.5 percent by the end of 2007, a level deemed compatible with price stability.

The output gap – as a measure of aggregate demand inflationary pressures – is projected to gradually decline from its current positive level and turn negative in the first quarter of 2007. This development is the result of tighter monetary conditions, including administrative measures aimed at limiting foreign currency credit and new restrictive regulations governing the activity of non-bank financial institutions. Meeting the 2007 inflation target requires the expansion of the aggregate demand to be contained throughout the year (to the extent of rendering

[59] The annual inflation rate is computed by compounding quarterly inflation rates in four consecutive quarters. The annual inflation rate for the fourth quarter of 2006 thus escapes the "burden" of 2005 Q4's unusually high inflation rate (of 10.6 percent in annualized terms).

the output gap negative), thus implying slower projected economic growth as compared to previous years.

The convergence of administered prices to EU levels is expected to continue after 1 January 2007. Moreover, since the February Inflation Report, some of the anticipated administered price increases have been moved from 2006 to 2007. The energy and natural gas prices will continue to rise faster than core inflation (CORE2). Since heating prices will be set from now on by local rather than central authorities, their impact on the inflation rate is harder to gauge. The forecast allows for further inflation effects of volatile food prices, related to some extent to the recent floods. Better crops in 2007 may alleviate further increases in volatile food prices. At the beginning of the forecast period, domestic fuel prices are expected to be driven upward by the pressures on international oil prices stemming from surging global demand and a tense international political climate. For the remainder of 2006, the forecast assumes stabilization of international fuel prices with no further pressures upon domestic prices. For 2007, domestic fuel prices are expected to rise slightly, following the gradual reduction of appreciation pressures on the domestic currency.

1.2. Exogenous inflationary pressures

As in the previous Inflation Report, administered price dynamics is projected to be above that of market prices. The current scenario for administered price inflation is however different in magnitude from that considered in the previous projection exercise, due to revision by the regulatory agencies of the adjustment timetable for natural gas, heating and electricity prices. Administered price annual inflation rate[60] in the baseline scenario is expected to be 9.1 percent in 2006 (compared with 11.7 percent in the February projection) and 8.8 percent in 2007 (compared with the previously forecasted 7.6 percent). The current projection also incorporates the available information regarding administered price inflation in the first quarter of 2008 (an increase of 7 percent in the natural gas price and 4.5 percent in the electricity price).

Table 5.2. The scenario for the development of administered prices

Natural gas		Heating		Electricity	
2006	2007	2006	2007	2006	2007
29.9%	17.9%	10.0%	15.0%	4.3%	6.6%

[60] The fourth quarter of the current year relative to the fourth quarter of the previous year.

According to the baseline scenario's assumptions, the price for natural gas from domestic production should be aligned with import prices by the end of 2008. The projections are also consistent with a full liberalization of the electricity market until the beginning of 2007 and a partial liberalization of the heating price, along with the removal of the nationwide reference tariff.

The prices of fresh fruit, vegetables and eggs are expected to rise by about 10 percent in 2006, consistent with the assumption that domestic supply will not rebound completely during this year. In 2007, assuming an agricultural production unaffected by adverse weather conditions, the inflation rate of these volatile food items should continue to decline at a sustained pace (to about 6 percent). These price changes are largely in line with the previous forecast. However, the high volatility of this price group, further exacerbated by the recently unfavourable weather conditions, makes their projected scenario less certain than in the case of other CPI components.

Uncertainties about the direction and magnitude of oil price movements prompted, as in the previous projection, the adoption of an unchanged price assumption for this commodity (at April's price level). Under these circumstances, projected fuel prices will only record small variations over the entire projection horizon. At the end of the current year, the fuel price is to remain relatively constant compared to the similar period of the previous year. The increases in the oil import price (denominated in US dollars) are presumed to be alleviated, in the first part of the year, by USD depreciation against the EUR and implicitly against the RON. The domestic currency's rise against the EUR since the beginning of the year could in its turn exert a favorable influence on the fuel prices as far ahead as the third quarter of 2006, because excise duties and other taxes on petroleum products are denominated in EUR and converted into RON using the exchange rate on the last day of the previous quarter[61]. For 2007, given the assumed stabilization of the international oil price and the reduction of appreciation pressure on the domestic currency, the average domestic fuel price is projected to post a slight increase over its end-2006 level, similar to CORE2 prices.

In the current forecast, the weights of the different CPI components were updated to the new values published by the National Institute of Statistics (NIS). The CPI weights for administered prices and the prices of vegetables, fruit and eggs

[61] The fuel price impact of the increase due for 1 July in the excise duty on leaded gasoline is estimated to be quite low given the small share of this variety in total gasoline consumption.

were diminished from 22 percent to 20.55 percent and from 7.71 percent to 7.24 percent respectively, while the weight assigned to fuel prices was increased from 6.75 percent to 7.24 percent. According to currently available information, the total contribution of these three items to the forecasted annual inflation, using the new CPI shares, amounts to around 2.8 percentage points for 2006 and around 2.4 percentage points for 2007.

The scenario for Euro area inflation shows a slightly higher level than that of the previous projection over the whole forecast horizon. The faster dynamics, corroborated with a probable easing of RON appreciation pressures in the second half of the projection horizon, should lead to a slight increase in the import prices of the period, with their trend changing during 2006.

The current projection includes rises in the prices of cigarettes, tobacco and refined alcohol so as to reflect legislation changes affecting the level of indirect taxes. According to the EU agreed excise duty adjustment timetable, a level of EUR 64 per 1,000 cigarettes should be attained by 2009. Apart from the price changes set out in this timetable, the Parliament decided to introduce the vice tax which should generate the revenues for a special fund at the disposal of the Health Ministry. According to a Government Ordinance[62], this tax was included as part of the unitary excise duty on cigarettes and alcohol. The effects of the vice tax on CPI inflation are mitigated in case of products based on refined alcohol by their small weight in the CPI basket (0.27 percent). The levying of the vice tax on cigarettes on the other hand constitutes a significant change of the excise duty adjustment timetable agreed with the EU. For 2006, the anticipated rises in the forecasted cigarette prices are expected to exceed by almost 20 percentage points the levels suggested by the previous EU-sanctioned excise duty adjustment timetable[63]. Taken separately, the excise duty change of 1 July 2006 is not expected to have an important effect on cigarette prices.

[62] Government Emergency Ordinance amending and supplementing Law No. 571/2003 on Tax Code, published in *Monitorul Oficial al României* No. 374 of May 2, 2006, Part One.

[63] According to the Emergency Ordinance regarding the amendment of Tax Code, the unitary excise duty was increased to EUR 15.53 per 1,000 cigarettes (from EUR 9.1 initially) starting 2 May 2006, and to EUR 16.28 per 1,000 cigarettes (instead of EUR 11.47) starting 1 July. The difference between the new values and those in the initial timetable, augmented by the levels of the *ad-valorem* excise duty, applied as a percentage (currently 30 percent) of the purchase price (including the unitary excise duty), represents in fact the vice tax of EUR 10 EUR per 1,000 cigarettes. Applying the same algorithm, from 1 July 2007 the level of the unitary excise duty is forecasted to rise to EUR 23.5 against the previously planned EUR 17.

The heftiest cigarette price increases are anticipated to occur in the second quarter of 2006. Although these price increases relate to only one category of products, their magnitude is projected to determine a surge of inflation expectations. Accordingly, the forecast anticipates that effects on the consumer price inflation rate of the introduction of the vice tax and the modification of excise duties on tobacco and alcohol would span over four quarters. In this scenario, the projected inflation rate for 2006 is about 1.1 percentage points higher than it would have been in the case no vice tax had been introduced.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

The quarterly growth rate of real GDP is expected to slow down in 2006 Q1, leading to a slight decline in excess demand. However, as real GDP is still above potential in the current quarter, short-term inflationary pressures continue to be originated from the demand side. Adverse transitory aggregate supply shocks are also producing additional inflationary effects.

Due to the time lag inherent to the transmission of monetary policy impulses to the economy, the current output gap is generated mainly by the cumulative effect of past developments in interest rates and exchange rate. Gradually declining interest rates on loans and deposits over the last quarters had a positive contribution to the current excess demand, which was offset by the restrictive impact of the appreciation of the domestic currency for most of the previous year. The current level of the output gap also incorporates the relative tightening of fiscal policy, which registered a general consolidated budget surplus of 0.7 percent of annual GDP in 2006 Q1 after the 1.5 percent deficit seen in the fourth quarter of 2005.

The slowdown of real GDP growth translates into lower excess demand. However, the output gap decrease was caused not only by inflation-reducing developments on the demand side, but also by a negative shock on aggregate supply, stemming from lower agricultural output as a result of floods and generally adverse weather conditions. The narrowing of the output gap is accompanied by price increases at the time of the impact of the respective shocks on the markets. Specifically, in 2005 Q4 and 2006 Q1 a decrease in consumption of self-made products occurred due to the depletion of the existing stocks unmatched by offsetting increases in last year’s agricultural output.

Although lower than in the previous quarter as a result of the supply-side shock and of the short run fiscal policy tightening, first-quarter output gap was still close to the levels recorded in 2005, continuing to fuel inflationary pressures. Consequently, present price increases due to the transitory negative supply-side shocks complement the existing short-term inflationary pressures stemming from aggregate demand.

As regards real GDP components, the estimated growth of gross fixed capital formation continues to slow down in Q1. However, the growth rate is still high, fueling the current positive output gap. The high level of gross fixed capital formation is partially sustained by rising capital expenditure, along with the above trend increase in economy-wide employment. The fast real growth of companies' demand deposits in the first quarter of 2006 may point to the existence of available funds for investment. In agreement with these, the weight of imports of capital goods in total imports has increased.

Final consumption is also estimated to be relatively high in the current quarter, with labor market conditions being a major driver of the contribution of consumption to maintaining a positive output gap. The high level of disposable income, resulting from the rise in the economy-wide number of employees above the recent trend together with net wage dynamics may uphold private consumption. Moreover, real M1 remains above its historical trend, pointing to stepped-up transactions and to a switch of disposable income spending towards consumption.

Exports have continued to grow, their first-quarter value being 22 percent higher than the corresponding figure for the previous year. This evolution is backed, *inter alia*, by the lower ULC and rising labor productivity in industry. These developments could lead to an acceleration of industrial production growth, with positive effects on exports. Still, imports continued to be both higher and faster growing (displaying a growth rate of about 28 percent in the first quarter of 2006 compared to the same year-ago period) than exports. As a result, net exports continue to put downward pressure on excess demand.

1.3.2. Implications of recent exchange rate and interest rate developments

The domestic currency regained strength in 2006 Q1, its real and nominal appreciation offsetting most of the previous quarter's depreciation. Consequently, the exchange rate became restrictive again, putting downward pressure on excess demand and reducing inflationary pressures, without exerting a significant influence on the overall performance of exports. In addition, nominal appreciation of the domestic currency directly leads to lower inflationary pressures via import prices.

Thus, the exchange rate continued to have an important contribution to disinflation via its restrictive impact on the output gap. Conversely, through wealth and balance sheet effects[64] the RON appreciation worked in the opposite direction. In the period under review, the RON appreciation leads to lower domestic currency costs of foreign currency borrowing, thus fueling aggregate demand. However, following the NBR's administrative measures[65] aimed at limiting foreign currency credit growth, the impact of the exchange rate on aggregate demand through this transmission channel is likely to weaken (indicated by the decline of the foreign currency credit as a percentage of total non-government credit, from about 60 percent in March 2005 to around 50 percent in March 2006). Altogether, the cumulative effect of the appreciation of the domestic currency on economic activity in 2006 Q1 was slightly restrictive.

The fast RON appreciation over the last quarters reflected fundamental adjustments of the exchange rate to the events which shaped Romania's economic environment (improved outlook for Romania's joining the European Union, the rise in sustainable capital inflows). Once these necessary adjustments have been completed, the productivity differential over trade partners should regain prevalence in determining exchange rate dynamics in the medium and long run, further persistent effects being expected to emerge contingent upon sustainable capital inflows.

In order to offset inflationary pressures and bring inflation to the target within the forecast horizon, the NBR raised the policy rate in February 2006 and continued the policy of substantial sterilization of excess liquidity via open-market operations. *Ceteris paribus*, increasing the interest rate and sterilization volumes partially reduced their stimulative effect on the real economy as compared to the previous period.

The NBR's policy rate has an indirect effect on the real economy, through commercial banks' deposit and lending rates,

[64] See the Box on "Wealth and Balance Sheet Effects" in Inflation Report No. 2/2005.

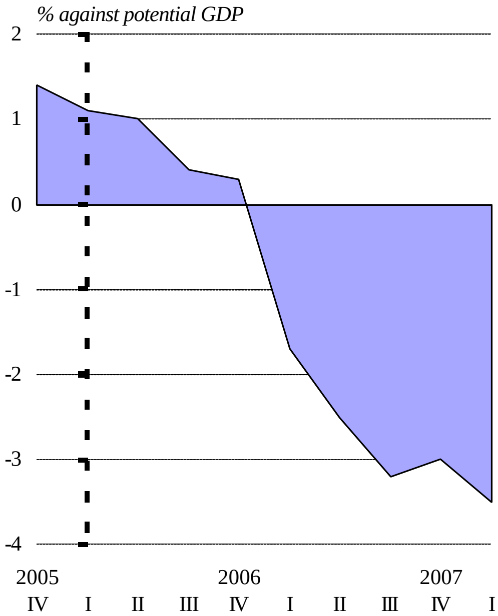
[65] The measures laid down in Norms No. 11 of 8 September 2005 regarding the concentration of exposures from forex loans, as well as the gradual increase of the required reserve ratio on foreign currency-denominated liabilities.

as well as by influencing the inflation expectations of economic agents. According to the characteristics of NBR's policy transmission mechanism, commercial banks' rates adjust sluggishly to the NBR's policy rate changes, partly due to the NBR's position of net debtor *vis-à-vis* the banking system. Thus, the nominal deposit rate stopped falling, while the real deposit rate increased. With a slower nominal adjustment to NBR's interest rate reduction over the previous quarters, partly due to stronger competition in the banking system, the real lending rate continued to decline slowly in the period under review. Overall, commercial banks' interest rates for non-bank non-government clients continue to exert expansionary effects on excess demand, yet less sharp than in the previous quarter.

Taking into account the significant appreciation of the domestic currency, the combined effect of real exchange rate strengthening and of the developments in real interest rates lead to a reduction of excess demand in the economy over the projection horizon.

1.3.3. Demand pressures within the projection horizon

GDP Deviation



In the baseline scenario, the excess demand is projected to decline gradually over the following quarters, and be completely eliminated at the beginning of next year. Throughout 2006, this will be largely due to the restrictive effect of real RON appreciation on aggregate demand. In the second year of the projection, tight real monetary conditions over the full array of instruments should lead to a steep reduction of the output gap with a significant disinflationary impact.

The current projection indicates more substantial and persistent demand-side inflationary pressures, implying a two-quarter delay for the closing of the positive output gap, as compared to the previous forecast. This is attributed, for the most part, to a reassessment for the current year of the impact of domestic fiscal policy on aggregate demand. The forecast in the February Inflation Report was assuming a consolidated budget deficit in the first quarter of 2006, while actual data for this period showed a surplus of around 0.7 percent of GDP. Under these circumstances, to attain the government's 2006 deficit target of 0.9 percent of GDP, fiscal policy will have to ease over the last three quarters of the year. Another explanation for the higher projected output gap involves the upward revision of GDP figures for 2004 and the first three quarters of 2005 and the higher-than-forecasted preliminary GDP published for the fourth quarter of the same year. These revisions implied a slightly upward adjustment of the initial conditions for excess demand as compared to the February Inflation Report.

Forecasted real monetary conditions are tighter than in the previous projection, feeding into a gradual decline of excess demand throughout the forecast horizon. Bringing inflation down to target by the end of 2007 implies higher than previously projected domestic currency interest rates. The interest rate differential between RON-denominated deposits and EUR-denominated short-term instruments is expected to remain positive, despite the anticipated increase in European money market rates[66]. The favorable prospects for EU membership will further boost inflows of both foreign direct and short-term investments and increase supply-side pressures on the foreign exchange market. Additional real appreciation effects will continue to be generated by the positive productivity differential between Romania and EU as its main trading partner. However, it is expected that the high level and dynamics of the trade deficit would significantly lessen the real appreciation pressures coming from the aforementioned factors.

In accordance with the baseline scenario, the narrowing of the spread between the lending and deposit rates is expected to continue, with a slight loss of momentum in the second part of the forecast horizon. The narrowing of the spread is anticipated to be mainly the result of a reduction in average nominal lending rates. Tighter monetary policy should help slowdown the downward trend of lending rates and induce an increase of banks' average deposit rate during the first few quarters of the forecast. Given the projected developments in nominal rates and inflation, real interest rates on banks' deposits and loans are expected to exert restrictive effects on aggregate demand during 2007.

Compared to the February Inflation Report's projection, the impact of fiscal policy on aggregate demand has been updated in the current baseline scenario to incorporate the revised 2006 budget deficit figure of 0.9 percent, as recently approved by the Parliament. For 2007, the 1 percent deficit-to-GDP assumption remains unchanged from the previous forecast – consistent with the 2005 Pre-Accession Economic Program. Taking into account the above-mentioned assumptions, as well as the effect of the business cycle on budgetary developments, fiscal policy should have an overall restrictive effect on excess demand, less pronounced in 2006 (due to the foreseen fiscal easing in 2006 Q1-Q4) but stronger in 2007.

[66] Projections published in the *Consensus Forecasts* point to an increase of about 1 percentage point in the 3-month EURIBOR over the forecast horizon.

Over the medium term, price stability represents a prerequisite for sustained economic growth. At shorter time horizons, however, the disinflation strategy could exert effects on economic growth running counter to those in the medium run. For 2006, the current projection assumes a slightly higher economic growth than in 2005, boosted primarily by the dynamics of gross fixed capital formation. In the following year, the effort implied by the forecasted return of inflation within the target band would induce a relative slowdown of economic growth, under the impact of tight real monetary conditions accumulated from previous periods, as well as of complementary fiscal and wage policies, in the context of the mix of macroeconomic policies.

Consumption, the main component of aggregate demand, will continue to reflect in the short run the second-round effects of last year's adverse supply shocks. In the first part of the projection period, consumer demand for agri-foodstuffs is expected to be met mainly through imported goods, but this process should gradually reverse insofar as domestic supply of farm produce is restored, a development which is expected to occur in the second half of this year. For next year, overall household consumption growth should decelerate under the burden of tighter real monetary conditions.

Similar to the previous Inflation Report, gross fixed capital formation is expected to rank among the most dynamic components of domestic aggregate demand. In the context of Romania's anticipated EU accession, its growth will be further sustained by significant flows of foreign direct investment and the undertaking of infrastructure projects financed from the state budget[67], as well as jointly financed from EU funds. The combined impact of the aforementioned factors is expected to outweigh the temporarily restrictive effect exerted by the lending rates over the projection horizon,

The expected increase in imports in the first part of the forecasting horizon will be the result of an increase in the share of domestic demand met by imported goods, of the real RON appreciation, as well as of stimulative real interest rates. At the same time, exports should be boosted by the favorable dynamics in external demand, as well as by further productivity gains. A more restrictive effect of real RON appreciation is expected for the first part of the projection horizon.

[67] Financing needs for these projects were to a certain extent covered by the budget revision recently approved by the Parliament. These resources will be supplemented by pre-accession funds supplied to Romania by the European Union.

1.4. Risks and uncertainties surrounding the projection

The main elements of uncertainty in the current projection stem from the following sources:

- frequent changes of the adjustment calendar for administered prices and potential tax adjustments with a significant impact on inflation – especially in the case of indirect taxes;
- the assessment of second-round effects of price increases related to these adjustments and to other supply-side shocks (for instance, price effects due to poor agricultural production);
- the projection of the output gap, also affected by potential changes to fiscal and wage policies;
- international price movements of oil and natural gas, as well as their feeding through into domestic prices of fuel and energy.

Considering the experience with the previous forecasts, administered price adjustments have been a constant source of uncertainty. In the baseline scenario, their cumulative increase for 2006 (the closest annual forecast horizon) has been revised downwards by 2.6 percentage points versus the previous Inflation Report projection. Given the nature of such price adjustments, deriving from a catching-up process for a number of reference prices negotiated with the European Union, their downward revision implies the postponement of already-planned price increases. In the baseline scenario of the current projection this is accounted for by an upward revision of administered price adjustments for 2007 and 2008. It should be mentioned though that the frequent rescheduling of administered price changes weighs heavily on the predictability of the disinflation process and on its management through the tools of monetary policy. Such difficulty arises from the fact that relatively long time lags are needed for policy tools to prove completely effective. Prior knowledge of events that the central bank must react to has therefore a crucial importance for an adequate monetary policy conduct.

A similarly high degree of uncertainty can be associated with indirect tax changes. The example of the recent introduction of the vice tax is quite relevant in this respect since, together with its last minute inclusion in the excise duty on tobacco products, this fiscal measure has unexpectedly overlapped the schedule of tax adjustments that had been previously negotiated with the European Union.

At the projection's cut-off time, the quoted price of Brent crude oil was USD 72.5 per barrel, exceeding by roughly 27 percent its average in the last quarter of 2005 and by about 8 percent its historical high attained in that year. If this trend were to continue, inflation risks could emerge through higher import prices of oil and natural gas, on the one hand, and higher prices of all imported goods, on the other. The impact of all these price increases is nevertheless not automatically transmitted to domestic prices as it may be at times offset by favorable exchange rate movements. For example, the average price of domestic fuel recorded a mere 0.15 percentage point cumulative inflation in the first three months of 2006, despite a much larger surge in international oil prices in the same period.

The current projection of the output gap has been revised since the last Inflation Report on the upside for the rest of 2006 and on the downside for the subsequent four quarters. As always, projections for later periods are more uncertain than near term ones, requiring an assessment of the risks of overstating the projected decline of the output gap. The factors that may act in that direction include:

– incomes distributed by the public sector could veer off from the current indexation schedule;

– wage dynamics may prove quite rigid when required to adapt to possibly lower productivity growth rates;

– public sector budgets may run higher deficits in the next few years than is currently envisaged;

– keen competition in the banking sector may cause a diluted transmission of monetary policy signals and a continuation of fast credit growth, in spite of the restrictive measures adopted by the central bank;

– deposit rates may prove slower to adjust to the recent hike of the NBR interest rate than currently projected;

– larger capital inflows, inclusive of FDI and EU pre-accession and structural funds, may uphold an aggregate excess demand over the short term (whereas, in the long run, sustainable capital inflows support GDP growth through gains in productivity and competitiveness).

The combined influence of the above-mentioned or other factors might result in excess demand persisting even throughout 2007. With the closing of the output gap and the concurrent slowdown of economic growth thus postponed, the projected disinflation would be deferred for the next period. Under such a scenario, the Romanian economy's convergence towards the euro area would inevitably be slowed down.

2. Policy assessment

Recent economic developments as well as the assumptions underlying the current macroeconomic forecast have revealed the emergence of additional risks to maintaining the growth rate of consumer prices on the projected trajectory. In this context, the NBR Board's decision in January to leave the inflation targets unchanged and lower the 12-month inflation rate to 4 percent for end-2007 is even more ambitious, including from the viewpoint of the economic costs attached thereto.

The major risk identified by assessing the implications of the new forecast is the persistence of the projected excess demand above the previously projected levels and over a longer time horizon, i.e. by the end of 2006. Therefore, the achievement of the National Bank of Romania's biannual disinflation programme assumes the below-potential drop in economic growth during 2007 to be sharper than originally forecasted – the adverse impact of this development on GDP growth rate could only be mitigated by implementing a rapid structural reform programme aimed at boosting the output gap. In view of the easing of fiscal policy earlier this year and the narrowing of the room for manoeuvre of income policy, the NBR's task of putting aggregate demand on such track appears even more difficult. For this purpose, not only tighter monetary policy – substantiated by the inherent monetary policy transmission lags – is required, but also the maintenance of this stance for a longer time, the effectiveness of the central bank's measures being contingent upon the consistency of both the stance and the signals sent by the monetary authority.

The steady concern of the National Bank of Romania related to the expansion of aggregate demand is the size of private-sector saving/investment deficit (matched by the current account deficit) and its upward trend, both of them constituting signs of the currently unsustainable rate of increase of household consumption. From this perspective, monetary conditions should be tightened further in order to rein in household demand for loans, on the one hand, and boost household saving to the detriment of consumption, on the other. Tighter monetary conditions would alleviate the effect of substituting foreign currency-denominated loans by RON-denominated loans, which has been buttressed in recent months by the constraints on foreign currency-denominated loans exerted by the NBR's administrative measures implemented in 2005 and by the increase in the minimum reserve ratio on foreign currency-denominated liabilities of credit institutions in 2006 Q1.

Another major risk stemming from the recent inflation forecast is the potential far-reaching, long-lasting impact on the general level of prices and economic agents' expectations of the approaching hike in prices of cigarettes, tobacco products and alcohol; the substantial surge in those prices will be the result of implementing the latest pieces of legislation passed by the Parliament whereby the total value of indirect taxes, vice tax included, on these products was raised in order to create an additional source of revenues for the Ministry of Health. The central bank's concern over these price hikes is due to both their major impact on inflation rate (+1.1 percentage points above the 2006 inflation forecast) and the possible worsening of inflation expectations, which could jeopardise the disinflation trend even over a longer time horizon. Given the circumstances, further tightening of monetary policy stance by keeping in place restrictive monetary conditions for a longer time, along with progress in disinflation, is required, not only to offset – via gradual dampening of aggregate demand – the effect these price hikes have on CORE2 inflation rate, but also to put a brake on its pass-through via inflation expectations.

A major source of uncertainties and, all the more so, risks for monetary policy conduct and for attainment of inflation target continues to be related to the timetable and magnitude of administered price adjustments and the relatively frequent adjustments of this timetable. The need to counter the potential inflation expectations brought about by this context calls for increased restrictiveness of monetary policy and the maintenance of an extremely cautious stance over a longer time, as well as the prevention of a stop-and-go behaviour of the National Bank of Romania. Even in such circumstances, the efficient anchoring of inflation expectations and the avoidance of undermining central bank credibility are conditional upon the minimisation of uncertainties over the magnitude and timing of future administered price adjustments. For this purpose, the National Bank of Romania has recently started talks with government officials and representatives of the energy regulatory authority in an attempt at drafting a stable, multi-annual programme for administered price adjustment to which the authorities should be publicly committed. As in the previous quarters, monetary policy tightening will also be required for annihilating second-round effects of other supply-side shocks that could become manifest in 2006, i.e. increases in volatile food prices.

The major risks of monetary policy tightening continue to be the possible resurgence of volatile capital inflows, which are sensitive to interest rate movements, and the likelihood of heightening pressures such inflows put on the exchange rate of the RON. However, the relative influence of such risks, especially those related to the exchange rate, is seen declining slightly, as despite the further rise in non-residents' traded volumes on the foreign exchange market, the exchange rate of the domestic currency appears not to have veered off from the economic fundamentals in the early months of 2006. In addition, in the near term, the impact of the factors fostering capital inflows could be cushioned somewhat following the influence of two categories of factors. The first one would include the possible maintenance, at least temporarily, of investor wariness about emerging markets and particularly the likely continuation of interest rate increases in the main international financial markets. The second one includes the possible narrowing of the expected nominal appreciation margin of the RON versus the EUR. Financial investor expectations of a stronger RON are likely to be boosted after the EU gives the nod to Romania's joining the community in 2007, an event which might bring in substantial capital inflows, i.e. foreign direct investment and structural funds.

In view of the numerous inflationary risks identified in the context of assessing the medium-term macroeconomic projection, the NBR Board decided to maintain a restrictive monetary policy stance for a longer period of time while the disinflation process progresses. Thus, in its meeting of 11 May 2006, the NBR Board decided to maintain the monetary policy rate at 8.5 percent per annum, a decision which, on the background of a consolidation of disinflation, will increase the restrictiveness of monetary conditions. Concurrently, the NBR Board decided to continue its policy of firm money market liquidity control and to closely monitor developments in RON-denominated credit, as well as in the growth of total non-government credit. Moreover, the NBR Board reiterated its commitment to take prompt measures – by resorting to its entire array of available instruments – in response to macroeconomic developments that could jeopardise the programmed medium-term disinflation path.