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

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

Inflation Report was completed on 9 August 2006 and approved by the NBR Board in its meeting of 10 August 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 Energy Regulatory Authority
ANRGN	National Authority for Regulation in Natural Gas Sector
BSE	Bucharest Stock Exchange
CPI	Consumer Price Index
DGECFIN	Directorate-General for Economic and Financial Affairs
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
GEA	Group of Applied Economics
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
OCI	Organisation for Collective Investment
ON	overnight
OPEC	Organisation of Petroleum Exporting Countries
ULC	unit labour cost
1W	one week
12M	12 months

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I. SUMMARY

Disinflation accelerated in 2006 Q2, with the 12-month inflation rate dropping to 7.1 percent in June, down 1.3 percentage points against March 2006 and 0.9 percentage points lower than forecast in the May 2006 Inflation Report. This trend was further confirmed by the July inflation figure, despite the presence of a base effect: 12-month CPI inflation reached 6.2 percent, while 7-month CPI inflation was 2.8 percent. Faster disinflation was mainly due to considerably slower rises in administered and volatile prices, whose effects ran counter to the inflationary impact of the newly introduced indirect tax on alcohol and tobacco products. Quarterly rates of core inflation adjusted for the "vice tax" have nevertheless posted a slower downtrend, reflecting the maintenance of inflation expectations, slower appreciation of the RON against the euro, and the persistence of excess demand in the previous quarter.

The 2006 Q1 rise in aggregate demand and the related persistence of a positive output gap were primarily caused by household consumption, whose annual rate of increase of 10.9 percent was 4.5 percentage points higher than in the previous quarter. As a result, even with gross fixed capital formation and government consumption posting slower annual growth rates, the economy expanded in 2006 Q1 at a faster-than-expected pace of 6.9 percent, 2.6 percentage points above the figure for 2005 Q4.

The persistence of inflationary risks associated with the current macroeconomic context, largely as a result of the hike in some indirect taxes and of overly rapid expansion in domestic demand, prompted the National Bank of Romania Board to continue to gradually tighten monetary policy during 2006 Q2. By exercising firm control over money market liquidity, the central bank has put the average interest rates on credit institutions' placements with the NBR and hence the interbank market rates on an upward course since the beginning of the period. In late June, the NBR Board took additional measures to make monetary conditions more restrictive. Specifically, the monetary policy rate was raised by 0.25 percentage points to 8.75 percent per annum and – in order to enhance the impact of this decision on the growth of the domestic currency-denominated component of non-government credit – the minimum reserve requirements on RON-denominated liabilities were increased to 20 percent from 16 percent.

The monetary authority's firm response was aimed at slowing down the speed of growth of credit in domestic currency, thereby complementing the effect of foreign currency-denominated credit being substituted by RON-denominated credit, with the latter markedly boosted by the constraints imposed on foreign exchange lending through the National Bank of Romania's administrative and prudential measures and via tightening minimum reserve requirements on foreign exchange liabilities. Over the past few months, the annual growth rates of these two classes of bank assets exhibited increasingly diverging trends, as reflected by the gradual narrowing of the share of foreign currency-denominated loans in total credit. Through these measures, the National Bank of Romania sought to contain the overall expansion of credit, given that the real annual growth rate of total non-government credit hit 2-year highs in Q2.

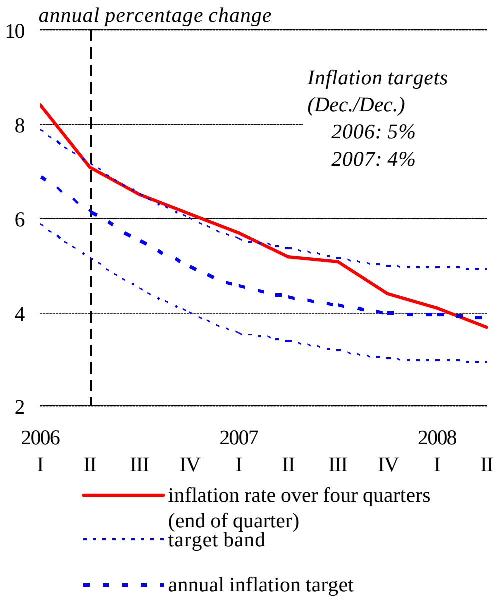
Against the background of the current quarterly forecasting round, the National Bank of Romania Board began preparations to configure and set, after consultation with Government, the 2008 inflation target. Following the assessment of the various projection scenarios, the key assumptions underlying these scenarios, and of the major risks and uncertainties surrounding medium-term inflation, the 2008 inflation target was set at 3.8 percent ±1 percentage point.

From the central bank's perspective, the choice of this target was made in accordance with the principles and requirements of inflation targeting. On one hand, the target is in line with the need to continue the disinflation process towards an inflation level sustainable over the medium term and subsequently to ensure timely fulfilment of the inflation criterion laid down in the Maastricht Treaty, as well as compliance with the European Central Bank's quantitative definition of price stability. On the other hand, this inflation target is indicative of the National Bank of Romania's concern for dealing with realistic and credible goals, considering that in 2008 the pace of disinflation is expected to be slowed down by several factors outside the central bank's authority, such as (i) the delaying for 2008 of some substantial adjustments of administered prices, (ii) further price increases as a result of the ongoing convergence of the Romanian economy, and (iii) the inertia of inflation expectations.

The baseline scenario of the current projection of medium-term macroeconomic developments indicates a change in the pattern of disinflation, with faster disinflation in the first part of the forecast horizon compared with the previous projection and a slowdown towards end-2007. The 12-month inflation rate is expected to reach 6.1 percent at end-2006, approaching the upper limit of the target band. The drop in the expected inflation rate (by 0.7 percentage points as compared to the previous forecasting round) is mainly due to a comparatively smaller projected cumulative impact of administered prices, volatile food prices and the implementation of the "vice tax". The favourable effect of the downward revision of this impact on the inflation forecast more than offsets the projected adverse influence of the recent slowdown in domestic currency appreciation and that of the latest revision of Government's deficit target for 2006 up to 2.5 percent of GDP, which are expected to result in relatively higher imported inflation and stronger excess demand pressures. However, the adverse effects of exchange rate movements and of the fiscal easing in 2006 will prevail during 2007, with the expansionary impact of the latter carrying over into early 2007. Moreover, even though the increase in public spending following the budget revision is to be initially channelled mostly towards investment, the ensuing shock will impact consumer demand and induce inflationary pressures. As a result, the annual rate of CORE2 inflation at end-2006 is expected to be lower than previously forecasted, but its downward trend will slow down to some extent in 2007. This deceleration of CORE2 inflation, albeit at a slower pace, will be driven by the steady decline in excess demand under the impact of more restrictive monetary conditions, as the positive output gap is expected to be eliminated with a one-quarter delay compared to the previous forecast.

The main risks associated with the current projection derive from the uncertainties surrounding the baseline scenario of the projection, most of which are likely to slow down disinflation. The first major source of uncertainty – at the same time a key source of demand-side pressures and of worsening inflation expectations – is related to the stance of fiscal policy over the next two years. There is a risk of further fiscal easing – with regard to both capital and current expenditures – and implicitly of persistently wider fiscal deficits; these risks may be higher in case of early elections within the forecast horizon. In this context, the risk of income policy slippages in the public sector is also looming. If resorted to, either of these policy responses would increase domestic demand and fuel the pressures on aggregate prices and on the current account deficit. The deceleration of inflation could also be hampered by a sharp rise in international prices of crude oil and natural gas, its impact being strengthened by a possibly more substantial slowdown in RON appreciation as a result of changing investor sentiment regarding the Romanian financial market, in the broader context of repositioning in emerging markets. Other major sources of uncertainty that are likely to generate inflationary pressures include the magnitude and the calendar of administered price adjustments as well as the schedule of aligning indirect taxes with the levels mentioned under the agreements concluded with the EU. The minimization of uncertainties in the first category – a basic prerequisite for correctly setting monetary conditions and, implicitly, for anchoring inflation expectations – requires that the Government and the regulatory authorities in the energy field should complete a firm multi-annual program for administered price adjustments. Another major uncertainty is the impact that the adoption by Romania of the Common Agricultural Policy once the country joins the EU might have on some agrifood prices.

Inflation Forecast

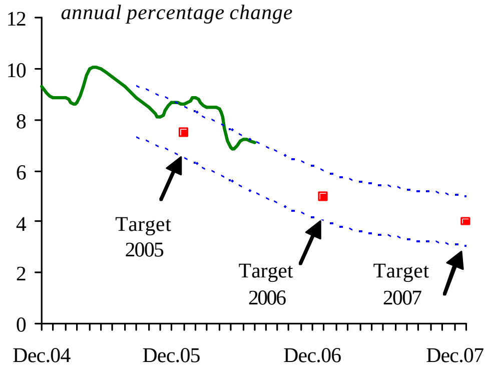


Note: ±1 percentage point around the (dis)inflation path

The assessment by the National Bank of Romania Board of the current macroeconomic environment and of the medium-term projection has underscored the inflationary risk posed by the potential increase in excess demand in the near run, mainly as a result of fiscal easing. At the same time, however, the National Bank of Romania Board has considered that, given the time-frame needed for the effects of the increase to 20 percent in the minimum reserve requirements on RON-denominated liabilities to become completely manifest, real monetary conditions remain adequate for keeping disinflation on a trajectory compatible with staying within the target band set for 2007. Hence, in its meeting of 9 August 2006, the National Bank of Romania Board has decided to maintain the monetary policy rate at 8.75 percent per annum and to continue to pursue a firm control over money market liquidity. Moreover, the Board has reaffirmed that it will continue to vigilantly monitor non-government credit expansion and the prices of certain broad asset classes in order to identify and take prompt monetary policy measures against developments that might entail risks to disinflation.

II. INFLATION DEVELOPMENTS

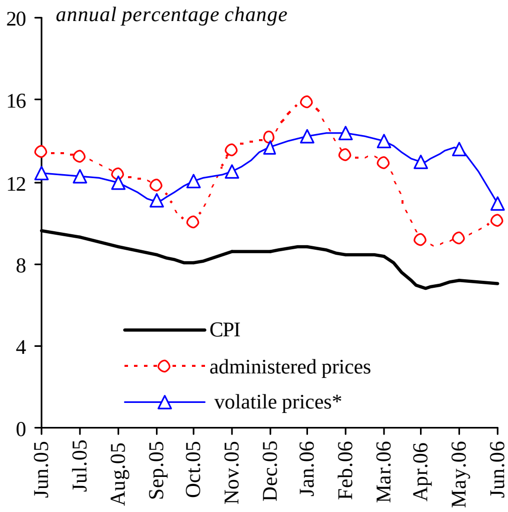
Inflation Developments



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

Administered Prices versus Market Prices

annual percentage change; end of period

	2005			2006	
	II	**III**	**IV**	**I**	**II**
Inflation Rate	**9.7**	**8.5**	**8.6**	**8.4**	**7.1**
Administered prices*	**13.5**	**11.9**	**14.2**	**13.0**	**10.1**
1. Non-food items*:	**15.7**	**14.4**	**14.1**	**15.9**	**11.4**
electricity	12.5	9.6	9.6	7.0	7.0
heating	12.0	12.0	20.0	20.0	20.0
natural gas	41.9	45.3	36.4	52.2	28.5
medicines	–0.3	–2.4	–5.1	–5.5	–5.3
2. Services*, of which:	**10.3**	**8.1**	**14.1**	**8.2**	**8.0**
water, sewerage, sanitation	27.3	25.6	25.8	24.8	24.9
telephony	–0.6	–3.7	8.4	–3.5	–2.0
passenger railway transport	12.0	14.9	8.7	8.7	11.6
(passenger) city transport	24.5	23.2	23.2	20.5	12.1
Market prices (CORE1)	**8.0**	**6.7**	**6.7**	**6.6**	**5.8**

* NBR calculations

Source: NIS (CORE1 figures published in the previous Inflation Reports were NBR estimates).

Disinflation continued in 2006 Q2, at a rate faster than that expected under the National Bank of Romania's forecast presented in the May 2006 Inflation Report; the annual rate of increase of consumer prices ran at 7.11 percent at end-June 2006, 1.30 percentage points below the end-March figure and 0.9 percentage points beneath the projected level. However, this performance was largely attributed to the base effect which became manifest in April, as quarterly changes in core inflation highlighted a slowdown of disinflation. The major reasons behind the above-mentioned development were the persistent excess demand, the slower nominal appreciation rate of the RON against the EUR, and the resistance from lingering inflation expectations among businesspeople.

In Q2, the annual rate of increase of consumer prices slowed markedly, yet the magnitude of this performance hints not only at the progress in disinflation, but also at the base effect associated with (i) the sharp increase in the natural gas price following the change in the billing system in April 2005 and (ii) earlier-than-scheduled implementation of the calendar for raising excise duties on tobacco products and fuels in terms of both timing – from July 2005 to April 2005 – and percentage. Thus, after the stunning deceleration seen in April (from 8.41 percent in March to 6.92 percent in April), which caused a short-lived fall of the 12-month inflation rate within the target band, the CPI reverted to above-band levels in the following months; the introduction of 'vice tax' on alcohol and tobacco products added to the fading base effect.

Even though the positive impact of energy products was partially offset by the pressures exerted by other CPI basket components, such as telephony services, railway transport, water, sewerage, sanitation, towards the end of the period in particular, administered prices (down 2.81 percentage points over end-March 2006) played the largest part in driving consumer prices down.

Moreover, volatile prices also underpinned disinflation in Q2, with their annual growth rate shedding 3 percentage points on Q1 in June 2006. Above average figures were still recorded in Q2 (ranging from 4 to 6 percentage points) as a result of previous strains on seasonal products.

From the perspective of current developments, i.e. the drop from 2.16 percent to 1.51 percent in seasonally-adjusted quarterly growth rates, disinflation recorded by volatile prices of vegetables, fruit and eggs had a major impact on the CPI performance. The fuel price was hit hard by the all-time highs in the oil price on foreign markets seen in early May.

Core inflation posted marginal progress, although the faulty way of defining CORE2[1] required additional adjustments for better capturing this development. Even though annual CORE2 rate was 0.47 percentage points lower in June than in March, the pick-up in the quarterly growth rate (from 0.9 percent to 1.2 percent) is indicative of currently weak performance. Nevertheless, by eliminating the effects of ‘vice tax’[2] introduction, it is noteworthy the steady drop during the second quarter of 2006 in annual core inflation, down to 3.72 percent in June, 0.76 percentage points below the first-quarter reading.

Although this development was manifest under the groups of goods and services that are the most sensitive to demand-side pressures – non-food items (stripping out energy, fuels and tobacco) and services (excluding those with administered prices) –, it could not be associated with a decline in excess demand (output gap remained positive, with NBR forecasts even pinpointing its increase over the past year). The chief drivers of this performance were the nominal appreciation trend of the domestic currency (in annual terms) and stiffer competition, on the retail segment in particular.

In the same direction acted quarterly core inflation rates adjusted by the ‘vice tax’ effects, with the pace of adjustment falling to one fourth of the first-quarter figure. Behind this stood the still high excess demand, the slowing nominal appreciation rate of the RON (and even the shaping of a depreciation trend at the end of Q2) and the sticky inflation expectations.

Most of the survey outcomes point to investor scepticism relative to a sharper disinflation in Q2. As for price dynamics in industry, the surveys conducted by NIS/DGECFIN, NBR, GEA show positive or even increasing balance of answers compared with Q1; the bank managers polled by the National Bank of Romania are even more pessimistic, adding another 0.15 percentage points to the estimated year-end inflation rate April through June 2006.

CPI by Category of Products

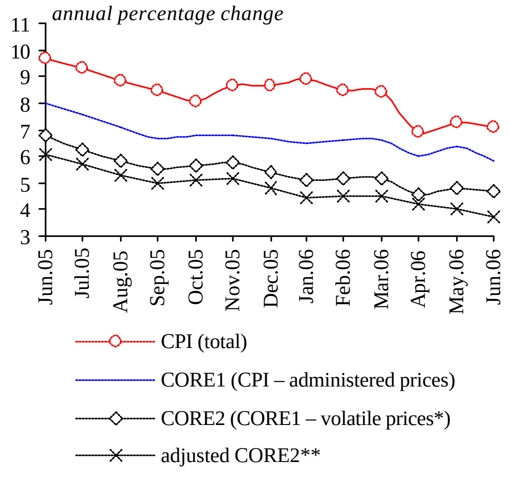
annual percentage change; end of period

	2005			2006	
	II	III	IV	I	II
Food, alcohol, tobacco	8.2	6.4	7.6	6.9	6.3
Wearing apparel and footwear	4.6	4.1	3.9	3.8	3.8
Household appliances, furniture	5.8	4.5	3.6	2.8	2.1
Fuels	17.5	16.2	9.0	9.4	6.3
Utility expenses*	22.3	21.5	20.8	23.0	17.9
Healthcare	3.7	2.4	0.9	0.1	-0.2
Transport	20.3	20.9	19.8	16.6	11.7
Post and telecoms	-0.4	-3.1	6.8	0.6	-2.1
Leisure and culture	7.3	7.4	7.8	7.0	7.1
Other goods and services	5.9	4.9	4.0	6.3	6.6

* rent, water, sewerage, sanitation, electricity, heating, natural gas

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation



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

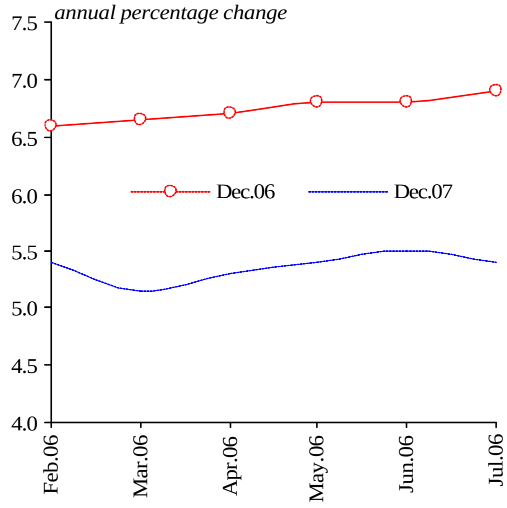
**) the influence of vice tax is removed

Source: NIS, NBR calculations

[1] According to the classical definition, core inflation excludes not only the change in administered prices and highly volatile prices, but also the influence of indirect tax changes. In the absence of information for separating such an influence and considering its selective feature (excise duty changes impact only one month every year), the NBR chose to remove the first two components in order to limit the definition of core inflation. Moreover, when the CORE2 components were established, shocks as big as ‘vice tax’ were not taken into account.

[2] Inflation recorded under “tobacco” and “alcohol” was due to this measure alone.

Expected Inflation



At end-June 2006, 12-month inflation rate was 0.9 percentage points below the forecast in the May Inflation Report[3]. The deviation was generated by (i) the overestimation of the rise in volatile prices (for eggs in particular, as the announcement of the first bird flu outbreak in a chicken farm and the ensuing negative effects on demand occurred after drafting the forecast) and (ii) the full impact of 'vice tax' introduction being manifest in Q2 (when the forecast was made, there was no news of the tobacco producers' intention to end the second stage of price increases at the beginning of Q3, once the new excise duties are applied).

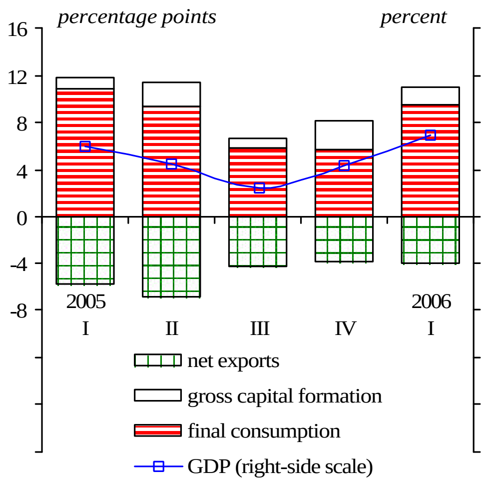
[3] Actual data until March 2006 included.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

The first quarter of 2006 saw larger-than-expected GDP growth (in constant prices) of 6.9 percent[4]*, 2.6 percentage points above the 2005 Q4 figure and 1.3 percentage points higher than the forecasted figure released in March 2006. This came along with a change in the growth pattern; exports of goods and services have become the fastest expanding component of aggregate demand after 6 quarters when either private consumption or investment spurred GDP the most. In fact, expectations presented in the May 2006 Inflation Report concerning private consumption and investment were confirmed, as excess demand persisted and the increase in gross fixed capital formation lost momentum, reaching a level comparable to that of household final consumption. On the supply side, the upturn strengthened in industry and construction, the latter sector posting unprecedented growth.*

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

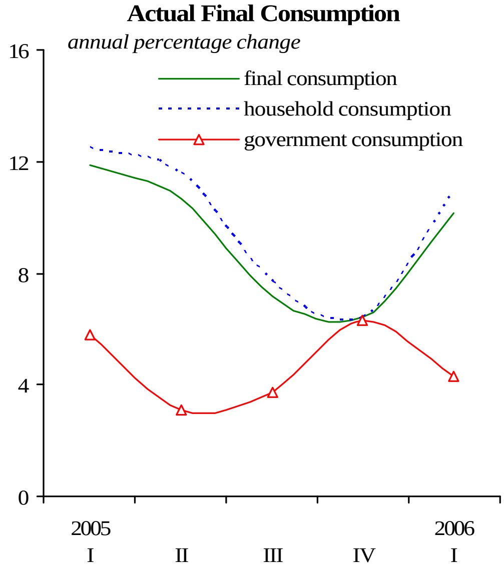
1.1. Demand

The faster first-quarter GDP expansion was driven chiefly by household consumption, given that the growth in government consumption and investment slowed down and the stunning increase in exports of goods and services could not entail a decline in negative contribution of external demand to GDP growth. The change in stocks still depressed GDP growth, albeit to a smaller extent.

1.1.1. Consumer demand

After rising by 7 percent on average in 2005 Q3 and Q4, final consumption resumed the double-digit annual growth rate in 2006 Q1. However, the trade sector failed to paint a brighter picture, as the dynamics of household purchases of goods and services decelerated for the third quarter in succession, and continued to put substantial pressure on consumer prices, the more so as the slowdowns were largely attributed to durables and services at market prices, both of them holding smaller shares in the CPI basket.

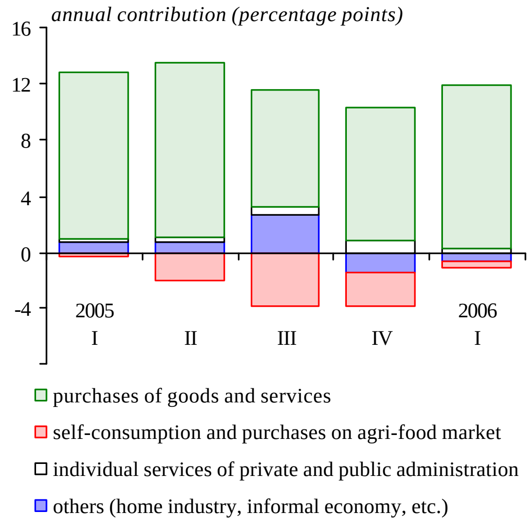
Actual Final Consumption



Source: NIS

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

Household Final Consumption Growth



Source: NIS, NBR calculations

Household consumer demand

The 4.5 percentage point increase in the growth rate of household actual final consumption to 10.9 percent was entailed mainly by the alleviation of the downtrend previously recorded by "self-consumption and purchases on the agri-food market" and "other consumptions"; the negative real growth rates posted by the two components dropped from 12-14 percent in 2005 Q4 to 7-8 percent on the background of improved performance in the stock-breeding sector – particularly self-consumption and home industry in the first three months of each year – that offset part of the persistent decline in the vegetable sector. This development, along with the halving of the weight of the two components in household final consumption[5] caused the significant decrease in the negative contribution of the two consumption categories to the annual dynamics of private consumption (from -3.9 percentage points to -1.1 percentage points).

In Q1, purchases of goods and services accounted for almost three fourths of total consumer spending. This led to an increase to +11.6 percentage points in their contribution to the growth of household final consumption, the slowdown by 1.3 percentage points to +15.6 percent in the annual growth rate notwithstanding.

Real dynamics of sales of goods and services lost momentum compared to 2005 Q4 against the background of: (i) the sharp slowdown in the growth of household disposable income (attributed widely to the base effect following the introduction of the flat tax rate on 1 January 2005)[6]; (ii) the downward trend in new short- and medium-term loans granted by commercial banks (after successive decelerations in 2005, in 2006 Q1, these loans saw a real 6 percent decrease year on year)[7]. The impact of these factors was however offset by a larger number of measures taken by retail networks and commercial banks with a

[5] Given that every year, January through March, self-consumption and purchases on the agri-food market account for the lowest share in household consumer spending, due to the seasonal nature of vegetal output.

[6] While in 2005 Q1-Q4 real earnings from wages and social transfers witnessed an average increase of 11 percent, in 2006 Q1, they posted an annual growth rate of only 6.3 percent; furthermore, remittances from abroad and private current transfers from non-residents declined by 10.9 percent in real terms compared to an average rise of +23.4 percent in 2005.

[7] Available statistical data do not allow an exact measure of consumer credit flow. The flaws of the rule of thumb employed stem chiefly from including medium-term loans for real-estate purchase or capital repair. The taking into account of short- and medium-term loans only was justified by the large weight of real-estate/mortgage loans in the structure of long-term loans, in spite of the expansion of loans for personal needs with maturities longer than 5 years. Even though banks classify loans for personal needs under consumer credit, they are usually destined for operations similar in nature to investments (real-estate purchase, down payment for real-estate/mortgage loans, house improvements).

view to cushioning the weak demand specific to the beginning of the year and to alleviating the effect of NBR Norms on containing consumer credit growth. These measures consisted mainly in price cuts, more diversified and attractive alternative payment/credit instruments (credit cards, co-branded cards), looser lending conditions offered by dedicated non-bank companies (longer grace period), etc.

In this context, households' appetite for purchasing durables and market services (particularly in "tourism" and "hotels and restaurants" sectors) diminished versus 2005 Q4 as illustrated by the deceleration by nearly 5 percentage points in the annual growth rate of sales in the former case and the stalemate in receipts in the latter case. Nevertheless, the persistently high increase in retail sales (more than 20 percent) confirms the existence of a considerable inflationary potential of consumer demand, especially given the surge by more than 7 percentage points to almost 126 percent in sales of non-durables which hold the largest share of the CPI basket.

As for the market of origin of final consumption goods, available information indicates a possible rise in households' preference for imported goods. Industrial output of both non-durables and durables for the domestic market has witnessed a weaker performance lately, whereas the growth rate of imports remained high[8].

However, mention should be made that domestic supply of durables appears to better meet demand in the future, as suggested by the first-quarter upturn in the turnover of companies producing durables for the domestic market (+9.7 percent compared with -1 percent in the previous quarter) and a sharper downtrend in producers' stocks. This assertion does not refer to the automotive sector which, January through March, saw renewed decrease in sales on the domestic market (-4.1 percent), whereas the annual growth rate of imports, albeit slower, continued to be quite fast (+34 percent).

Government consumer demand

The annual growth rate of government consumption decelerated by 2 percentage points to 4.3 percent, owing partly to slower dynamics of job creation in the public sector.

[8] The annual growth rate of non-durables sales on the domestic market decelerated from 9.9 percent in 2005 Q3 to 2.2 percent in 2006 Q1. During 2005, the growth rate of durables sales on the domestic market posted a sharper slowdown (from +26.2 percent in Q2 to -1 percent in Q4); in fact, the automotive industry witnessed successive decelerations, followed by a 4.5 decline in Q4 (relative to the output of road transport means for both consumption and investment in the corporate and budgetary sectors). The annual dynamics of the physical volume of imports of consumer goods was estimated by deflating by unit value indices for the products included in the Combined Nomenclature (C.N.).

Budgetary developments

The same as in the previous years, in the first quarter of 2006, the implementation of the consolidated general budget underwent a tightening. Thus, expenditures edged up only 2.3 percent in real terms[9] compared to the same year-ago period, while the annual rate of increase of revenues sped up markedly versus the previous three-month period (10.9 percent). As a result, in the considered period, the consolidated budget balance posted a surplus of RON 2,196 million, accounting for 0.7 percent of GDP (compared to a surplus of 0.1 percent of GDP in 2005 Q1).

Expenditures rose more slowly than in the previous quarter owing primarily to the sharp cut in investment spending (by 41.5 percent). Interest payments on public debt continued to decline (by 50.5 percent) due mainly to the decrease in government securities outstanding with the public. By contrast, staff costs went up substantially in the reviewed period, their annual growth rate reaching the highest reading in eight quarters, i.e. 20.5 percent in real terms; among the main factors underlying this development were the wage increases[10] granted in the first part of 2006 and the slight rise in the number of budgetary sector employees versus the same year-ago period.

Revenues picked up particularly due to the expansion of collections from VAT[11] (24.1 percent); nevertheless, their annual growth rate followed a downward trend January through March 2006 after a relatively slower increase in the volume of sales of goods and services for households. Conversely, collections from income tax continued to increase (12.8 percent), especially as a result of the hike in incomes, broader application of the 16 percent tax rate and waning base effect entailed by the introduction of the flat tax rate. The application of the flat tax rate starting with January 2005 had a stronger impact on transfers from profit tax (down 0.2 percent) owing to its collection on a quarterly basis. Revenues from social contributions rose by 7.1 percent (compared to an average quarterly growth of 9.8 percent in 2005); the effect of the decrease by 2 percentage points in social contribution rates owed by employers was partly offset by the step-up in wage earnings and the number of employees.

June saw the second budget revision year to date whereby the fiscal deficit target was raised to 2.5 percent of GDP[12]. The new budgetary programme provides for an increase in expenditures

[9] The comparison takes account of the budget variables for 2005 Q1, which were reclassified according to the new classification supplied by the Ministry of Public Finance effective in 2006.
[10] In January, wages in education were raised by 5.5 percent and in February, wages of other budgetary-sector employees saw a 5 percent increase.
[11] Collections from VAT account for almost 25 percent of total revenues.
[12] After the April revision, the projected budget deficit had been raised from 0.5 percent to 0.9 percent of GDP.

by RON 7,367.2 million, or 2.3 percent of GDP; additional budgetary funds are to be channelled particularly towards investment projects in education and health sectors, and in rail and road infrastructure. Part of the additional funds is aimed at paying the second tranche of outstanding wages due to the teaching staff in the state education system (almost RON 140 million) as well as at paying child benefits, farmers' pensions and heating allowances (roughly RON 400 million). Furthermore, approximately RON 515 million will be used for covering expenditures to boost the payrolls of the Ministry of Administration and Interior[13].

Under the circumstances, the increase in government spending is expected to additionally foster domestic demand in the latter half of 2006. Given the consolidated general budget surplus that built up in the first five months (1.3 percent of GDP according to available data), the risk that the effect of a looser spending policy heightens in a relatively short time is all the more pronounced.

1.1.2. Investment demand

According to expectations, the annual dynamics of gross fixed capital formation fell markedly versus the previous quarter (from 21.3 percent to 11.4 percent). Behind this development stood particularly the base effect, which had an impact on the volume index in 2005 Q4[14], and the poor performance in 2006 Q1 (quarterly change of -0.4 percent[15]; the growth rate entered negative territory starting with 2001 Q4, the only exception being the atypical development recorded at end-2004). Moreover, the structural analysis of investment highlights quality weaknesses such as the marked sluggishness in retooling (in year-on-year comparison, the volume of equipment purchases edged up only 3 percent compared to 15.7 percent in 2005 Q4.)

As concerns financing sources, in 2006 Q1, own resources for investment purposes declined somewhat, following the modest performance of industrial companies throughout 2005. Relative to borrowed funds, mention should be made that external financing saw, in real terms, a four time faster decline than in the previous quarter (the annual growth rate of medium- and long-term loans for corporates fell to -44.6 percent); in addition,

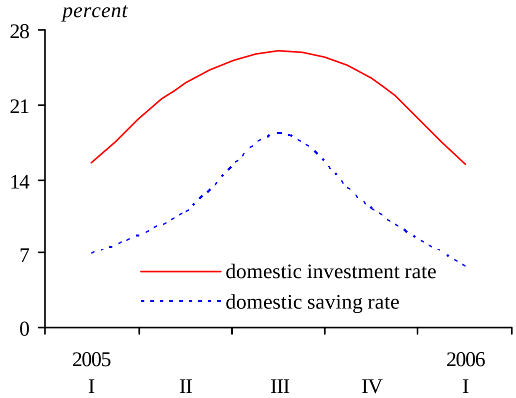
Investment

annual percentage change

	Year	I	II	III	IV
Total	2005	5.8	10.7	13.0	17.5
	2006	10.9			
- new construction works	2005	2.2	9.4	8.8	15.3
	2006	23.3			
- equipment	2005	9.6	12.8	15.7	15.7
	2006	3.0			
- others*	2005	–4.9	1.0	27.0	48.2
	2006	3.2			

* 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

[13] In order to replace the youths in compulsory military service with the people in voluntary military service following the removal of military conscription.
[14] The strong deceleration in investment growth rate in 2004 Q4 following earlier implementation of some projects amid uncertainties surrounding year-end elections.
[15] Seasonally-adjusted data; NBR calculations.

the fast rise in loans granted by local banks[16] was due to a strong base effect – flagging demand for investment loans from companies at the beginning of the previous year, given the prospect of using additional own resources for investment, following the decision to cut profit tax starting with 1 January 2005[17].

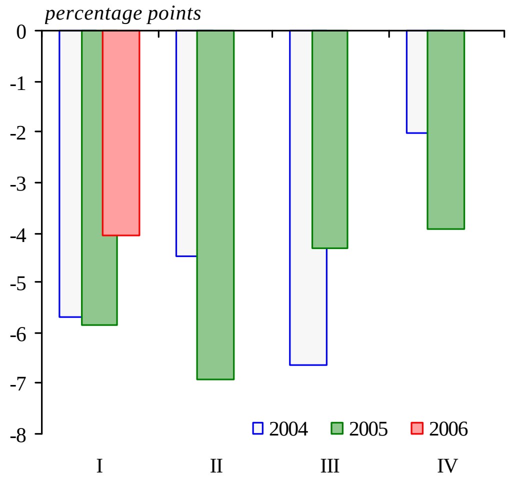
The unfavourable impact of the performance of equipment purchases on gross fixed capital formation dynamics was however alleviated by the step-up in new construction works (the annual growth rate went up 8 percentage points to 23.3 percent), bolstered by corporate and government sectors (new commercial facilities and offices, restoration of the flood-damaged infrastructure).

From the viewpoint of the origin market of capital goods (including transport means), in 2006 Q1, the contribution of domestic supply to meeting investment demand witnessed no improvement. On the contrary, after the successive decelerations in 2005 Q3 and Q4, in the reviewed period, sales of industrial capital goods on the domestic market shed 1.5 percent (for the first time over the past three years), whereas the annual growth rate of the import volume of such goods recorded minor changes.

The small contribution of gross fixed capital formation to GDP growth (1.5 percentage points) was not only the result of a more modest performance of investment, but also of further absorption of stocks, associated with the decline in reserves of agricultural products following the poor vegetal output in 2005.

1.1.3. Net external demand

Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

In 2006 Q1, the negative contribution of net external demand to GDP growth widened slightly compared to the previous quarter (from -3.9 percentage points to -4.1 percentage points). The sharper upward trend of the annual dynamics of exports failed to offset the pick-up, albeit slower, in the growth rate of imports, given the latter's considerably larger share in GDP (around 9 percentage points).

[16] In Q1, the annual growth rate of loans for equipment purchase added 9 percentage points quarter on quarter to 38.8 percent in real terms (according to data released by the Credit Risk Bureau); new medium- and long-term loans granted to legal entities grew 2.5 times to reach 86.9 percent.

[17] This assertion is supported by calculations regarding the nominal quarterly change recorded in 2005 Q1 by both the balance of loans for equipment purchase (up 3.7 percent, far below the average growth rate of 10.7 percent seen in the other quarters in 2004-2005; according to data released by the Credit Risk Bureau) and new medium- and long-term loans granted to legal entities (down 33.1 percent, with the negative growth rates posted in the other quarters in 2004-2005 remaining below 7 percent).

First-quarter volume of exports of goods and services expanded by 13 percent versus the same year-ago period (a 3.2 percentage points faster growth rate than in 2005 Q4). Nevertheless, the acceleration is unlikely to have been determined by the development in the first three months of 2006, the quarterly changes[15] showing a modest performance in the considered period (a growth rate of only 0.8 percent), on the one hand, and a slightly slower dynamics recorded in the current quarter (from 3.2 percent to 2.7 percent), on the other. Processed goods with higher value added (transport means and mechanical devices, electrical machinery and apparatus) had further the largest contribution to the increase in exports, accounting for roughly 80 percent of the total change in the physical volume; in Q1, the two groups of goods continued to see annual growth rates far higher than the average (51.7 percent and 43.7 percent respectively[18]).

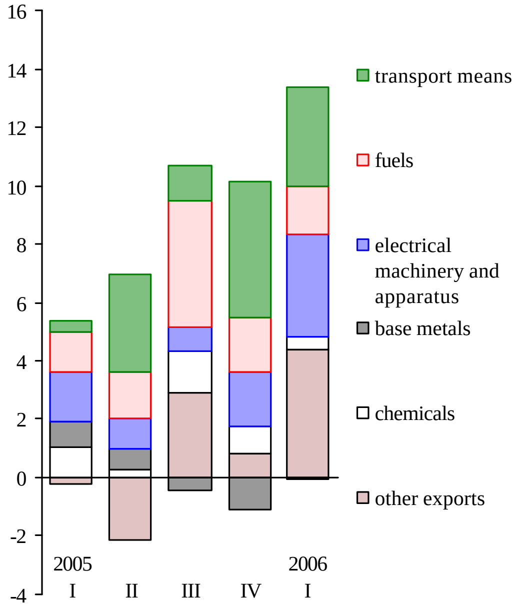
Imports of goods and services recorded a faster annual pace of increase (18.7 percent in 2006 Q1 compared to 17.2 percent in 2005 Q4). This acceleration was manifest in the quarterly development as well (from 2.5 percent to 4.1 percent[15]), being partly associated with the removal/reduction of customs duties for some agricultural and industrial products starting with the latter half of February 2006. As for import structure, some 79 percent of the annual increase in the volume of imports[18] were still propelled by only four groups ("chemicals", "base metals", "transport means" and "mechanical devices, electric machinery and apparatus").

1.2. Supply

On the supply side, in 2006 Q1, industrial activity saw a rebound, as reflected by the almost threefold increase in the annual growth rate of gross value added in this sector (4.8 percent) and by its contribution to economic growth which reverted to above par value (1.3 percentage points, after a 0.4 percentage point average in 2005 Q2-Q4). Industrial production advance was driven by faster growth rates in capital goods and durables sectors (6-8 percentage points above the average for 2005 Q4). The fastest growing sub-sectors were the following: (i) road transport means on the back of exports, as domestic demand[19] remained flat, and (ii) electrical machinery and apparatus (given that in 2005 output of this sub-sector inched up only 1.9 percent, after faring much better for two years, it might be assumed that a restructuring process has taken place and that prospects remain favourable).

Dynamics of Export Physical Volume

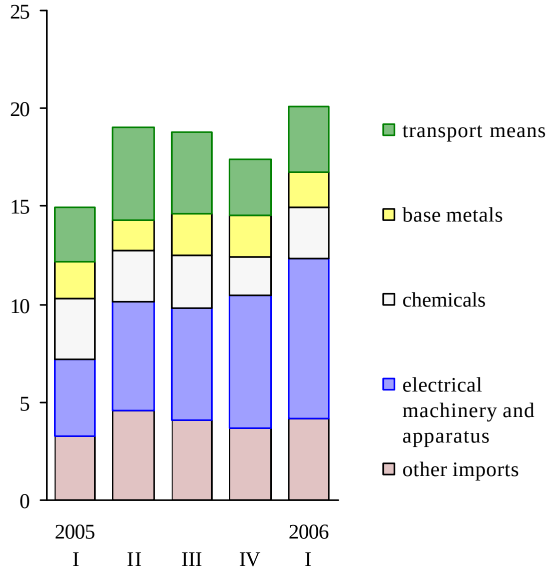
annual contribution (percentage points)



Source: NIS, NBR calculations

Dynamics of Import Physical Volume

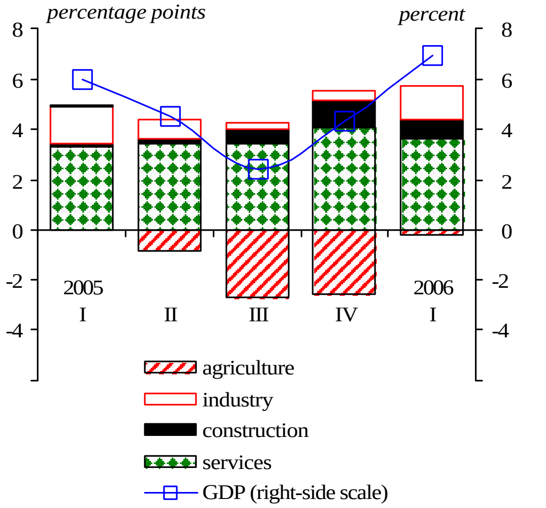
annual contribution (percentage points)



Source: NIS, NBR calculations

[18] Calculations made by deflating with unit value index.
[19] According to Automotive Manufacturers and Importers Association data for 2006 Q1, sales of domestically produced motorcars were lower than in both 2005 Q4 and the year-ago period (by 10.9 percent and 17.2 percent respectively).

Contribution of Main Supply Components to GDP Growth



Source: NIS, NBR calculations

As regards the agricultural sector, the annual growth rate of gross value added remained in negative territory (-5.3 percent), amid the considerable gap between the production growth rate (which reverted however to positive values due to the good performance of the stock-breeding sector) and the growth rate of intermediate consumption.

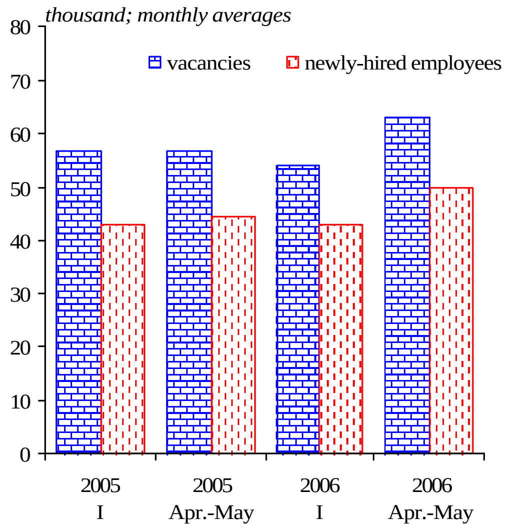
Under the impact of the above-mentioned factors[20], construction reported a stellar performance in 2006 Q1, the 20.4 percent annual growth rate representing the record high for the 1999-2006 period[21]. In contrast, annual growth rate of gross value added relative to services (6.8 percent) contracted by 2.4 percentage points quarter on quarter on the back of two factors: slower growth rate of turnover of retail trade and services to population and real growth rate of turnover of transports, telecommunications, real estate transactions and services to companies falling into negative territory.

2. Labour market

Pressures on the labour market alleviated in 2006 Q1, but data available for Q2 are indicative of the change in conditions, as also reflected by the relative slowdown in wage dynamics. The deceleration in the annual growth rate of gross wage across industry was accompanied by the increase in productivity gains (particularly in May), which led to the decline in ULC; yet, consumer goods sub-sectors posted uneven developments. Furthermore, given the substantial rigidity of wages in industry and the likely transitory nature of the rise in labour productivity in May, the sustainability of this performance is uncertain.

2.1. Labour force

Number of Vacancies and Number of Filled Vacancies



Source: NEA

Pressures on the labour market eased in 2006 Q1, as shown in the May 2006 Inflation Report. This state-of-affairs was confirmed by the statistical data provided by the NEA, yet the development was short-lived.

In April and May upward pressures were manifest on both the demand for and the supply of excess workforce. The upward trend in labour demand was illustrated mainly by the stronger absorption of workforce, the number of vacancies identified by the NEA moving up 11.1 percent year on year, and the annual growth rate of hirings intermediated by this institution was 11.6 percent, the record high since 2004. These outcomes may be attributed to the development of the services sector where the

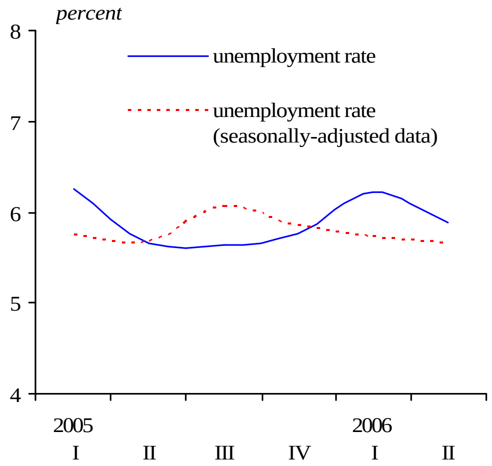
[20] See sub-section *1.1.2. Investment demand*.

[21] Quarterly data on national accounts according to ESA95 are available only starting with 1999.

number of employees rose by 5.9 percent from the same year-ago period, while workforce across industry contracted further as a result of corporate concern to restore the productivity/wage balance.

The demand-side elements that indicate the narrowing of the labour market are accompanied by similar elements on the supply side – considerable increase in unemployment outflows (9.4 percent in annual terms)[22] and the resumption of the decline in seasonally-adjusted unemployment rate (from 5.7 percent in 2006 Q1 to 5.6 percent in Q2, on average).

Unemployment Rate



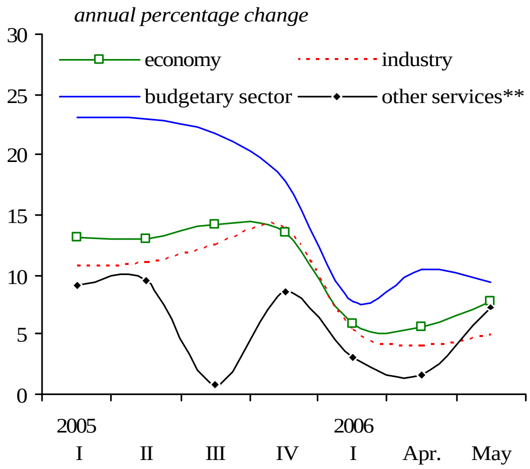
Source: NEA, NBR calculations

2.2. Incomes

Despite the relative easing of labour market conditions in 2006 Q1, the average annual growth rate of gross wage economy-wide remained unchanged at 17.2 percent in nominal terms, up 1 percentage point from 2005 Q4; heavy pressures were generated by the developments in mining[23] and services sectors, a possible explanation residing in the higher concentration of wage bargaining in March as compared with a more balanced distribution last year when they took place in March-April. In contrast, the annual change in net nominal wage declined by 8.2 percentage points from 2005 Q4 (to 15 percent), strongly affected by the base effect following the introduction of the flat rate tax in January 2005.

Statistical data for April and May indicate minor changes in the trend of wage dynamics, the growth rates of both gross and net wages (nominal terms) posting smaller declines (-0.8 percentage points as compared to the first-quarter figure); the small-scale adjustment illustrates the mounting pressures on the labour market and the persistence of employers' difficulties to find adequately skilled staff. It is noteworthy that manufacturing and trade services sectors, facing the keenest competition, witnessed annual growth rates of wages well below the average (as low as 2.7 percentage points in the case of net wage), while wages in the mining and energy sectors (oligopolic activities) and the banking sector experienced above-average annual growth rates.

Net Real Wage*



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

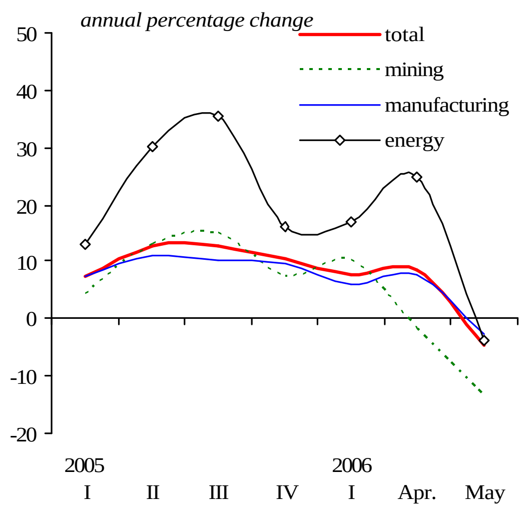
Source: NIS, NBR calculations

In terms of nominal ULC, 2006 Q1 saw renewed slowdown in the annual growth rate from the prior quarter (-2.7 percentage points to 7.6 percent), due to the performance in the mining and

[22] April and May saw high annual growth rates of both unemployment outflows (9.5 percent) and non-renewals of job applications on different grounds (9.3 percent).

[23] That were offset however across industry by the performance of manufacturing and energy sectors; in industry as a whole, the annual change in gross wage shrank by 1.6 percentage points from the average for 2005 Q4.

Unit Labour Costs in Industry



Source: NIS, NBR calculations

energy sectors, driven mainly by the slower rate of increase in gross wages to which added, in the first case, higher productivity gains. The annual growth rate of ULC across manufacturing moved down to 6 percent, falling 1.6 percentage points below the average, while in some sub-sectors the setback from 2005 Q4 allowed the ULC index to post below par values (woodworking, metallic construction, transport means other than road transport means, furniture). High ULC values were recorded in hydrocarbon extraction and oil processing, as the favourable external environment allowed wage hikes without the risk of weaker sales.

The main consumer goods sub-sectors also witnessed dismal performance, with competitiveness losses still lingering in the light industry and the food industry (despite the deceleration of ULC dynamics); the same holds for tobacco products, printing, radio, television and communication equipment, whose performance in terms of ULC got even worse.

In 2006 Q2, the downward trend in the annual growth rate of nominal ULC may strengthen, the favourable impact of the slower growth of gross wage (-2.6 percentage points during April-May) being accompanied by the surge of productivity in May (from 8.4 percent in 2006 Q1 to a 12.3 percent average in April-May).

Labour Productivity and Real Gross Wage in Industry

annual percentage change

	2005				2006		
	I	**II**	**III**	**IV**	**I**	**Apr.**	**May**
Labour productivity	7.6	3.2	3.7	7.0	8.4	4.7	19.9
Real gross average wage*	1.0	2.3	5.4	6.6	4.4	2.5	2.1
Real gross average wage**	5.0	13.8	16.5	15.9	7.8	3.3	4.3

*) deflated by industrial producer price index for domestic market

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

Source: NIS, NBR calculations

The positive gap between the annual growth rate of labour productivity and that of gross wages (deflated by IPPI for the domestic market) stayed put in 2006 Q1 and widened markedly in April-May (up to 10 percentage points), on account of large productivity gains in the last month of the considered period. Structural analysis reveals that key economic sectors experienced mixed developments; textiles, metallurgy, machinery and equipment, energy sectors still experienced negative gaps of up to 19.6 percentage points, whereas mining and hydrocarbon processing sector witnessed positive gaps of up to 33.4 percentage points, owing largely to the productivity gains. The sustainability of these outcomes is still uncertain given the rigidity of wages in industry and the transitory nature of labour productivity developments in May.

On the demand side, the data for 2006 Q1 indicate a smaller contribution of the dynamics of real disposable income[24] of households (more than 10 percentage point deceleration in the annual growth rate) to private consumption, due to the large comparison basis following the introduction of the flat rate tax

[24] Estimated based on the sum of wage earnings (net wages weighted by the number of employees), incomes from budgetary and extra-budgetary funds (state social security, unemployment benefit, and health insurance), remittances from abroad, and current private transfers from non-residents).

in 2005 and the sharp drop in remittances from Romanians working abroad. The latter factor was actually the driver of the dynamics of disposable income in April and May that reverted to negative territory (from 3.2 percent to -0.7 percent). However, the fall in inflows from abroad (remittances from Romanians working abroad and current private transfers) may have been less sharp, as the available statistical data are provisional.

3. Import prices and producer prices

In 2006 Q1, the annual growth rate of producer prices for both industrial goods and agrifood items followed an upward trend; import prices increased as well, due to developments on world markets and the slowdown in the annual appreciation pace of the domestic currency against the euro. As for price developments in Q2, the available statistical data impede the assessment of the trend in industrial producer prices, yet they provide adequate details on further pressures brought about by import prices and agricultural producer prices.

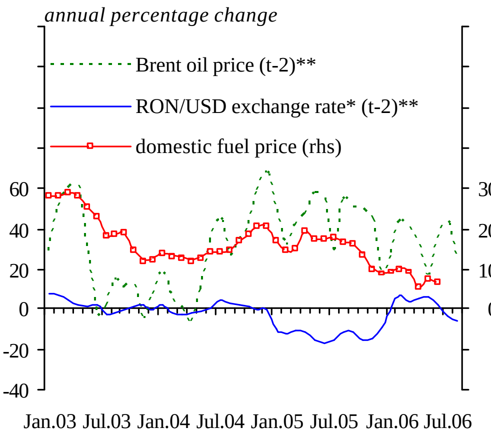
3.1. Import prices

After four quarters in which import prices exerted a favourable influence on domestic prices, 2006 Q1 saw a trend reversal, as the deflator of imports of goods and services reverted to above-par values (102.9 percent from 97.6 percent in 2005 Q4). This development was accounted for by the sharper uptrend of external prices (the unit value index of imports rose from 106 percent to 106.9 percent) and by the slowdown in the annual nominal appreciation pace of the domestic currency against the euro (from 9.7 percent in 2005 Q4 to 4.1 percent in the period under review).

Prices for energy products further recorded the highest growth rates, yet they did not foster the increase of external prices. The annual unit value index of imports of industrial goods and other raw materials from the EU was significantly lower (101.3 percent), although it rose 0.3 percentage points against the previous quarter.

Data available for April-June 2006 indicate the persistence of pressures from external prices, given the emergence of new tensions on world oil market which pushed the oil price[25] to all-

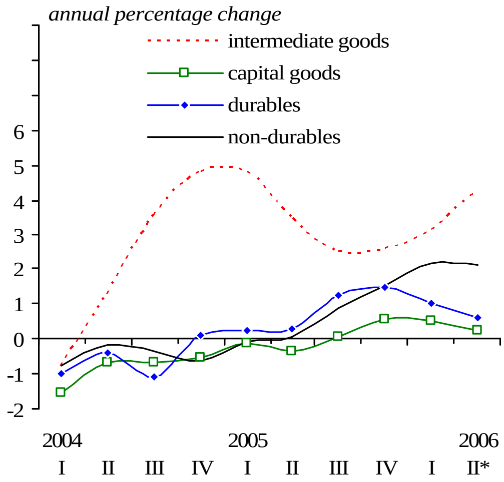
Oil and Fuel Prices



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

Source: NIS, EIA

EU-25 Industrial Producer Prices for Exports



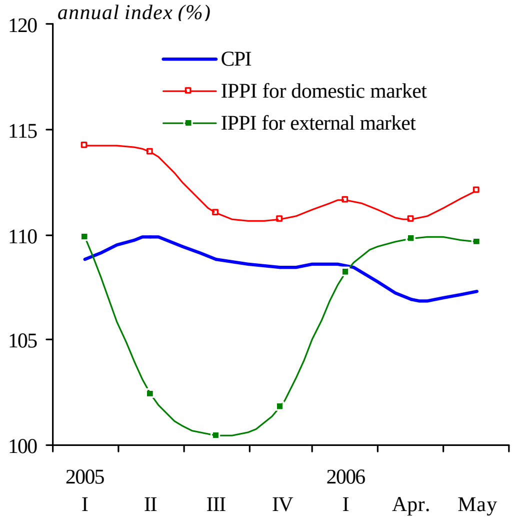
Source: Eurostat *) April - May

[25] The Brent oil price surged to USD 74.5 per barrel in early May, and then it hovered around USD 70 per barrel. Thus, the average oil price in Q2 was 34.3 percent higher than in the same year-ago period, 4.8 percentage points above the growth rate recorded in 2006 Q1.

time highs. Prices for industrial goods[26] exported by the EU accelerated their annual growth rate, the average for April-May 2006 rising to 2.6 percent, up 0.4 percentage points as compared with the previous quarter's figure (prices for intermediate goods continued to display the steepest growth rates). The rise in the aggregate price index of commodities calculated by the IMF is also indicative of similar developments, the Q2 figure (131.7 percent) surpassing by more than 5 percentage points that recorded in Q1.

The RON/USD exchange rate movements had a positive, albeit relatively moderate, impact on domestic prices, as illustrated by the domestic currency resuming the nominal appreciation trend in annual terms. The domestic currency continued its nominal strengthening versus the euro as compared with the same year-ago period, yet its depreciation in May-June 2006 was slower than in the January-March period.

Consumer Prices and Industrial Producer Prices



Source: NIS

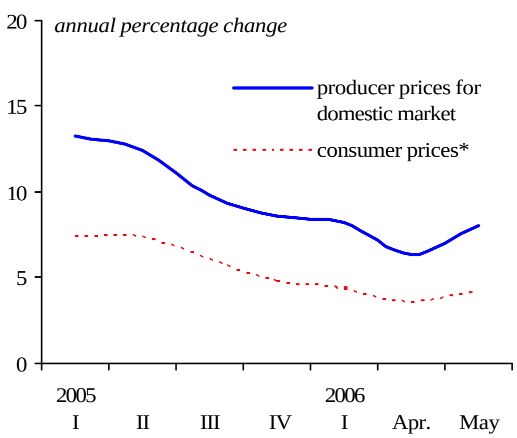
3.2. Producer prices

3.2.1. Industrial producer prices

The inflationary pressures generated by higher prices for some raw materials (metals in particular) and costlier utilities entailed the halt in disinflation of industrial producer prices for the domestic market (up 0.9 percentage points in 2006 Q1 versus the previous quarter to 11.6 percent).

Most industrial groups experienced similar price developments, though at different levels of magnitude. Non-durables sub-sector was the only one witnessing further downtrend in the annual growth rate of producer prices (dropping 0.3 percentage points to 8.2 percent). However, it is difficult to assess the impact of this performance on consumer prices, given that the key industrial sectors included in this category posted divergent developments.

Non-durables Prices



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

Source: NIS, NBR calculations

Producer prices in energy sector posted a faster rate of increase (0.4 percentage points), yet below the average in industry. However, the annual change in producer prices for energy products (up 21.7 percent) remained high. Structural analysis reveals that the impact of the slower increase in electricity[27] and

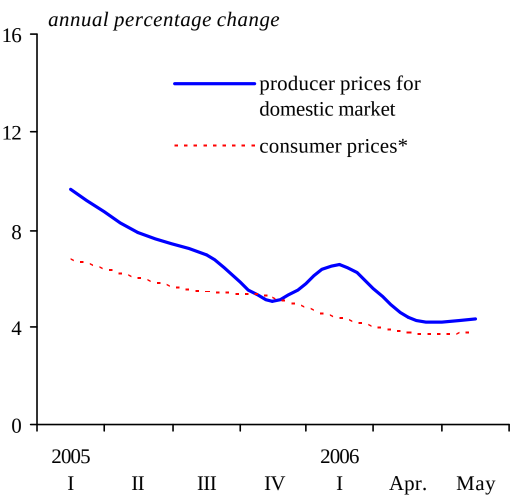
[26] In manufacturing.

[27] An explanation may be attributed to larger pressures generated by consumers, when the 2006 supply agreements were concluded. Starting with 1 July 2005, the number of eligible consumers equals nearly 600,000 as compared with roughly 2,000, which previously had the right to negotiate prices. As the decision to fully liberalise the power market for non-resident consumers was taken 18 months earlier (1 July 2005 versus 1 January 2007), part of industrial consumers may already have signed power supply agreements until year-end.

heating production costs (down 1.6 percentage points to 9.4 percent) for the group as a whole was offset by price developments in hydrocarbon extraction and processing sub-sectors. The stronger dynamics of producer prices in the hydrocarbon extraction sub-sector (up 6.5 percentage points to 46.6 percent) was largely due to February price movements, driven by developments in both demand (considerably higher consumption given the temperatures lower than in the previous year) and supply (contraction of exports amid the dispute between Russia and Ukraine, higher extraction costs induced by low temperatures); the early pay rises granted by SNP Petrom, the major hydrocarbon producer, had an additional impact on producer prices.

Disinflation of prices in durables sub-sector slowed, as the annual growth rate of producer prices accelerated to 6.6 percent (compared to 5 percent in 2005 Q4), due possibly to costlier raw materials (particularly metals) and significantly stronger domestic demand.

Durables Prices



* including household appliances, furniture and cultural and leisure products.

Source: NIS, NBR calculations

Prices in the intermediate goods sub-sector posted the most significant trend reversal as compared with the final quarter of 2005 (up 2 percentage points to 5.2 percent), owing to developments in metallurgy, where the annual growth rate of producer prices entered positive territory for the first time in the past three quarters (+0.4 percent versus -5.1 percent in 2005 Q4); this price hike may be mainly associated with the increase in metal prices on external markets[28]. Given their large share in production costs[29], the rise in prices for metals made a significant contribution to the swifter rate of increase of producer prices in capital goods sub-sectors (up 1.1 percentage points from the previous quarter to 8.3 percent).

Price developments in April-June 2006 are not entirely indicative of the possible resumption in 2006 Q2 of disinflation of industrial producer prices for the domestic market, given that the annual growth rate of prices was adjusted only marginally as compared with the first quarter of 2006, whilst tensions continue to build up in manufacturing, mainly in the hydrocarbon processing sub-sector. Nonetheless, prospects are favourable for the main non-durable industries (food industry, textiles, wearing apparel), as at mid-February the decision was

[28] According to IMF statistics, the metal price posted a faster rate of increase in 2006 Q1 than in 2005 Q4 (up 4 percentage points to 33.8 percent – the highest increase in the past year). The growth rates of prices for aluminium and copper were even higher (up 13.9 percentage points and 12.4 percentage points respectively), with copper prices hitting all-time highs.

[29] Up to 20-22 percent, according to statements made by some producers.

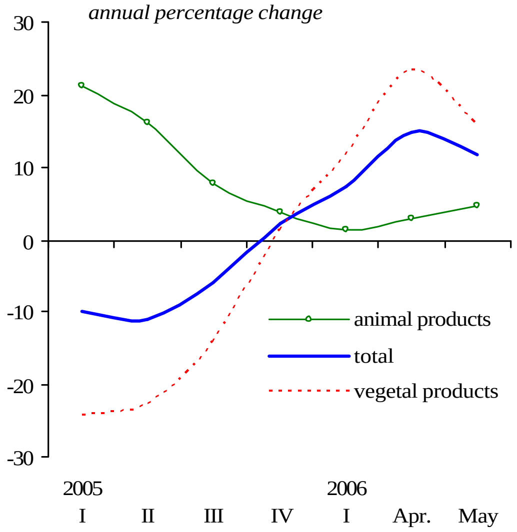
taken to cut/remove excise duties on some imports of agrifood items and industrial goods[30].

3.2.2. Agricultural producer prices

The growth rate of agricultural producer prices accelerated further in 2006 Q1 (5 percentage points to 7.3 percent), due solely to developments in vegetal output, which increased 10.5 percentage points to 11.7 percent. This development was attributable to price movements in fruit and vegetables sub-sector that was affected by scanty domestic supply, rather than to prices for grains, which further recorded negative, albeit less sharp, growth rates (down to -31.2 percent in the case of wheat). In terms of quarterly growth rates, stronger inflationary pressures are even more manifest in the case of grains, as all the categories subject to monitoring recorded positive changes (for the first time year to date).

Agricultural Producer Prices

annual percentage change



Source: NIS

In 2006 Q1, the annual growth rate of prices for animal products was 2.4 percentage points below the average for the previous quarter (+1.4 percent), except prices for poultry which added 1.7 percentage points to 10.9 percent. In this case, price movements were due solely to March developments (+34.7 percent in annual terms), possibly on the back of producers' attempts to take advantage of a relative rebound in consumption (as a result of lower bird flu fears), in order to recover part of the losses.

Furthermore, prices for poultry are not expected to witness high tensions in 2006 Q2, as price movements in this sub-sector (further high annual growth rates in April-May) are offset by developments in all the other meat categories holding large shares in the CPI basket. As regards vegetal products, the current trends are expected to continue in the case of grains and fruit and vegetables, which may further face the build-up of tensions on the backdrop of adverse weather conditions in the spring of 2006.

[30] The customs duties on some imports of raw materials for agriculture and industry approved for February-December 2006 (Government Decision No. 200/2006) were considerably lower than the base levels previously applied; moreover, some categories of goods, which were previously subject to import quotas of 333 percent, were exempted from such excises.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In 2006 Q2, the NBR continued to tighten monetary policy by raising the policy rate (by 0.25 percentage points) for the second time this year and increasing minimum reserve requirements on RON-denominated liabilities of credit institutions to 20 percent. The effective exchange rate of the RON[31]*, which suffered the impact of the large portfolio readjustment performed by financial investors during this period contributed to a lower extent to the tightening of broadly-defined monetary conditions.*

Monetary policy was gradually tightened in 2006 Q2, the measures adopted by the central bank reflecting a higher inflationary risk of macroeconomic environment. Thus, at the beginning of Q2, the NBR Board announced its decision to maintain a restrictive monetary policy stance for a longer period of time. In order to provide an underpinning to this decision, the NBR kept in place the firm control over money market liquidity, which entailed the gradual increase in average interest rate on credit institutions' holdings with the central bank and removal of the gap between the average interbank rate and the policy rate. The need to tighten further monetary conditions made the NBR raise the policy rate to 8.75 percent at the end of Q2. Moreover, in order to enhance the impact of this decision on the dynamics of non-government credit, namely on the RON-denominated credit, the monetary authority increased for the first time in 6½ years the minimum reserve requirements on RON-denominated liabilities to 20 percent from 16 percent starting with the 24 July – 23 August 2006 maintenance period.

Tightening of monetary conditions in the first part of Q2 was attributed to the relative worsening of disinflation prospects, as highlighted by the updated medium-term macroeconomic forecast. The major inflationary factors over the short run were the expected increase in some indirect taxes and, hence, the worsening of inflation expectations as well as a projected magnitude and time period of excess demand different from that considered in the previous forecasting round. The risk of an increase in demand-pull inflationary pressures had become even more conspicuous following the release of GDP data for the

[31] Calculated as the average of RON/EUR and RON/USD rates respectively, the share of the two currencies depending on their weight in Romania's foreign trade.

first quarter, which pointed to a higher-than-expected acceleration in economic growth during the period (GDP posted the highest annual growth in the last five quarters – see Chapter III. *Economic developments)*. As a result, in its meeting of 27 June, the NBR Board decided to increase the restrictiveness of monetary policy. Behind the prompt reaction of the central bank stood also the overly fast increase in household final consumption and the attendant accelerated dynamics of non-government credit, especially of its RON-denominated component.

Thus, unlike the trend detected in previous quarters, household actual final consumption posted a faster-than-expected growth rate January through March 2006 (10.9 percent compared with 6.4 percent in 2005 Q4). Although this development was attributed mainly to the relative upturn in self-consumption and other consumptions, the inflationary potential of consumer demand stood high given the fast, albeit slightly slower than in the previous quarter, pace of increase in purchases of goods and services. In addition, according to the data released subsequently, the average annual growth rate of turnover of retail trade sector and services sector reached higher values in the first two months of Q2 than in Q1. Besides the relatively higher average real growth rate of net average wage, the increase in household indebtedness to banks was yet another factor fostering consumption.

Against this background, the central bank’s decisions to tighten monetary policy and its specific manner of response were aimed at putting a brake on the fast growth of RON-denominated loans to households; the impact of credit expansion was only partly offset by the ongoing decline in the growth rate of forex loans to households, resulting in further upward trend of total household loans. Household demand for RON-denominated loans was spurred mainly by the relatively significant cut in interest rates on new loans (including loans for refinancing loans in progress), the heightened competition between credit institutions making the trajectory of these interest rates diverge from that of average interest rate on banks’ holdings with the NBR. Moreover, stronger bank competition alleviated the restrictive impact of some prudential measures previously adopted by the central bank; thus, as a result of rapid diversification of banking products for households, demand for long-term consumer loans in RON (over 5 years, with or without mortgage collateral) increased. Under the circumstances, April through May saw a rapid expansion in average flow of new RON-denominated loans to households, although their dynamics slowed relatively compared to Q1; simultaneously, the real growth rate of the balance on new RON-denominated loans to households increased steadily, reaching 110.5 percent in May.

Forex-denominated loans to households followed a divergent trend April through May, although the pace was slower than in the previous quarters; the growth rates of average monthly flows and of balance on forex-denominated loans (expressed in euro) continued to decline, yet at a slower pace than in the previous quarters.

The increase in policy rate was also aimed at entailing further rise in interest rates on RON-denominated time deposits with banks in order to provide a stimulus to saving in domestic currency; from this perspective, data available for May pointed out that the almost steady decline (starting February 2005) in the annual growth rate of household savings in RON came to a halt (due possibly to incidental factors). This state of affairs might be attributed to the following factors: (i) faster increase of wage earnings (and most likely, of remittances from abroad); (ii) slight expansion of interest rates on time deposits; and (iii) a shift in household preference as shown by the propensity to take advantage of the higher exchange rate (depreciation of the RON was seen as a short-lived and reversible phenomenon). Nevertheless, saving in foreign currency continued to grow relatively; in April and May, forex deposits of individuals rose substantially compared with the first part of 2006 (up 27.2 percent when expressed in euro), their dynamics outpacing by far that of household deposits in RON.

Behind the monetary policy tightening in the last part of the quarter under review stood also the expected expansionary effect of the substantial increase in projected budget expenditures for 2006. Thus, as a result of the unexpected upward revision of the projected budget deficit, from 0.9 percent to 2.5 percent of GDP, the highest reading in the past four years, June through December public spending will experience a significant increase, accounting for about 3.8 percent of GDP (twice as high as the figure recorded in January-May 2006).

Another matter of concern in 2006 Q2 was the expected inflationary impact, over the short-run, of the increase in indirect taxes on cigarettes, tobacco and alcohol products (including via the introduction of “vice tax”) starting with May 2006. Therefore, monetary policy tightening was also aimed at minimizing both the risk of this shock feeding through into other price categories and that of worsening of inflation expectations. The first stage of this process was conducive to the halt, in May, of the downward trend of the 12-month inflation rate, which rose to 7.26 percent from 6.92 percent in April. Conversely, during this period the supply-side factors such as administered prices and volatile prices had a lower inflationary impact than in the previous quarter, with prices increasing by only 3.47 percent in April (natural gas price) and 1.33 percent in May (fuel price). Against this background, the 12-month inflation rate dropped to 7.11 percent in June, down 1.3 percentage points against March and 0.9 percentage points lower than the forecast in the May 2006 Inflation Report.

However, survey results continued to show worsening of inflation expectations of the corporate sector and financial expectations of the corporate sector and financial institutions, which represented another reason behind the central bank's decision to maintain a prudent monetary policy stance.

Monetary policy tightening in the first part of Q2 materialised in a firmer control over money market liquidity and the increase in interest rate on banks' holdings with the central bank. Thus, the NBR made frequent resort to sterilization operations, mopping up entirely the amounts submitted by credit institutions to weekly auctions of one-month deposits. As a result, the monetary authority gradually enhanced the role of its main monetary policy tool, i.e. one-month deposit-taking operations, such operations exceeding 70 percent of the balance of banks' holdings with the central bank while banks' recourse to the deposit facility continued to post relatively low figures. Frequent sterilization of the excess liquidity and the relatively lower uncertainty of market operators about the development of autonomous factors of liquidity contributed to the increase in average interest rate on banks' holdings with the NBR (up 0.4 percentage points in June compared with March), which actually overlapped the policy rate of 8.5 percent. The firm control over liquidity was kept in place even after the raise of policy rate (on 27 June) the joint effect of these actions being set to feed through into interbank rates in the period ahead.

The exchange rate trajectory had a less restrictive impact on monetary conditions; thus, after declining for five months in a row, the RON/EUR rate increased in May and June, causing the domestic currency post a nominal depreciation of 1.2 percent against the euro in Q2 (compared with an appreciation of 4.3 percent in 2006 Q1). The exchange rate development was significantly influenced by the shift in investor interest from Central and East European markets to other financial markets (see Subsection 2.2. *Exchange rate and capital flows).* However, depreciation of the RON against the EUR was lower than that of the currencies in the region due also to relatively lower volume of short-term capital inflows on the domestic market.

BOX

Operational framework of the NBR monetary policy

The monetary policy operational framework is made up of instruments and procedures whereby the central bank implements its monetary policy with a view to achieving its primary objective. The NBR's current operational framework is the result of successive changes to the monetary policy instruments with the aim of adjusting them vis-a-vis the new developments in financial market, first and foremost in the interbank market, as well as in the economy. Moreover, the changes were aimed at incorporating into the operational framework the guiding principles, the most important of them being: (i) the principle of operational efficiency of the central bank; and (ii) the principles of simplicity, transparency and cost efficiency of monetary policy instruments. Recently, the main changes to monetary policy instruments were meant to:

– make the most and enhance the role of interest rate within the monetary policy transmission mechanism, against the backdrop of the progress in resumption of financial intermediation and deepening of money market;

– harmonise the instruments with the ECB's set of instruments, although the persistence of structural liquidity surplus requires adjustment of instruments used by the NBR to the specific conditions of domestic money market;

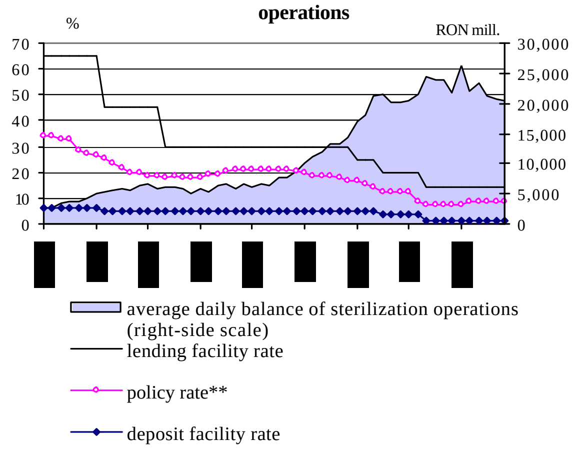
– increase the transparency and predictability of monetary policy instruments in the context of inflation targeting adopted by the NBR in August 2005.

At present, the set of instruments used *de facto* by the NBR encompasses the following:

1. Open market operations, which are the most important monetary policy instruments of the NBR; they play a role in steering interest rates, managing the liquidity conditions in the money market and signalling the stance of monetary policy. Although the array of market instruments *de jure* available to the central bank is wide, the net debtor position of the NBR vis-a-vis the banking system called for almost exclusively *de facto* use of liquidity-absorbing instruments. At present, they include:

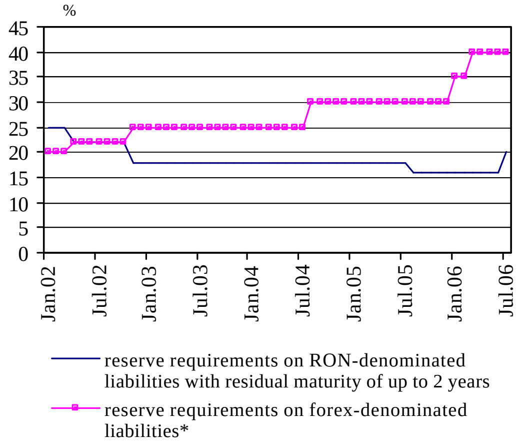
– One-month deposit-taking operations - the key monetary policy instrument. Deposit-taking operations have been used since June 1997, being executed in the form of multiple rate auctions. These operations were performed until 2003 for maturities that varied between one day and three months. Starting with May 2003, deposit-taking operations have been performed exclusively for one-month deposits. The ceiling of interest rates accepted at deposit-taking operations, as established by the NBR Board (pre-announced since August 2003), was the policy rate (see chart below); starting August 2005, the central bank switched to volume auctions; in the new context, the policy rate is the **fixed interest rate on one-month deposits**. The last change occurred in the latter half of February 2006, when the NBR Board decided to set a timetable of auctions for deposits on a weekly basis.

NBR interest rate* and volume of sterilization operations



* End of month values; ** During January-August 2005, the NBR created a temporary lag between effective interest rate on deposit operations and policy rate (see Inflation Reports).

Minimum reserve requirements ratios



* In 2005, the reserve base to which a positive reserve ratio is applied was gradually extended by including forex liabilities with residual maturity of over 2 years.

(continued)

– issuance of certificates of deposits. This instrument was introduced in June 2004 in order to mop up the mounting excess liquidity. Certificates of deposit were issued for a three-month maturity, being traded between banks on the secondary market; this instrument is used for longer-term sterilization, against the backdrop of a relatively lower liquidity premium. The NBR operations in certificates of deposit have a higher level of standardisation than deposit-taking operations; CDs are issued exclusively by auctions conducted through multiple rate procedure, on a monthly basis, and the rate of allotment accepted by the NBR may vary within ±25 percent of the pre-announced volume.

2. The NBR standing facilities. These instruments were introduced in 2000 in order to (i) absorb (deposit facility) or provide (lending facility) liquidity with overnight maturity (one day); (ii) signal the general monetary policy stance through the interest rates applied to them; and (iii) stabilise overnight interbank market rates through the corridor defined by the interest rates on standing facilities. Unlike open market operations, standing facilities are available to credit institutions at their own initiative; the use of standing facilities is larger at the end of the reserve maintenance period.

3. Minimum reserve requirements. This mechanism was introduced in 1992, being subject to gradual changes in order to adjust it to the specific framework of monetary policy implementation. In 2002, minimum reserve requirements underwent a major change, the central bank assigning this instrument the function of controlling liquidity (which is closely interlinked with management of liquidity, more specifically with sterilization of structural liquidity surplus) and that of stabilising interbank market rates. The main features of the current reserve requirements mechanism are the following:

(i) reserve base is calculated as the daily average of balances (over the observance period) of foreign currency-denominated and leu-denominated liabilities on banks' balance sheet items (except interbank liabilities, and liabilities to the NBR and core capital);

(ii) observance period and maintenance period are of one month each (the observance period starts on the 24th of previous month and ends on the 23rd of the current month);

(iii) reserve ratios may be differentiated depending on both currency-denomination of the reserves (see chart in Box) and the residual maturity of items included in the reserve base (residual maturity of up to two years or over two years);

(iv) minimum reserve requirements are set up as daily average of banks' holdings on current accounts with the NBR during the maintenance period;

(v) reserve deficit is sanctioned by penal interest rate and repeated failure to comply with reserve requirements is sanctioned by written warning, fines or restrictions imposed on the operations performed by the credit institution.

4. Interventions in foreign exchange market. Unlike the other categories of instruments used by the NBR, interventions in the foreign exchange market are not standardised. During 1997-2005, the central bank's operations on the foreign exchange market consisted mainly in foreign exchange purchases. Starting November 2004, when the central bank adjusted its foreign exchange policy in order to increase the flexibility and unpredictability of the RON exchange rate, frequency of foreign exchange purchases declined significantly. However, in the summer of 2005, the NBR had to resort to sizable intervention in the foreign exchange market in an attempt to depress large inflows of volatile capital by discouraging expectations of nominal appreciation of the domestic currency and by increasing unpredictability of the RON exchange rate; starting with the latter half of October 2005, the central bank refrained from intervening in the foreign exchange market.

2. Financial markets and monetary developments

The interbank rates continued to increase in Q2 under the impact of the central bank's firm control over liquidity and the rise in policy rate at the end of Q2. The RON/EUR exchange rate reversed its trajectory at mid-Q2, being influenced by the shift in investor interest in Central and East European emerging markets. The deceleration in annual dynamics of liquidity across the economy halted under the influence of RON-denominated non-government credit expansion.

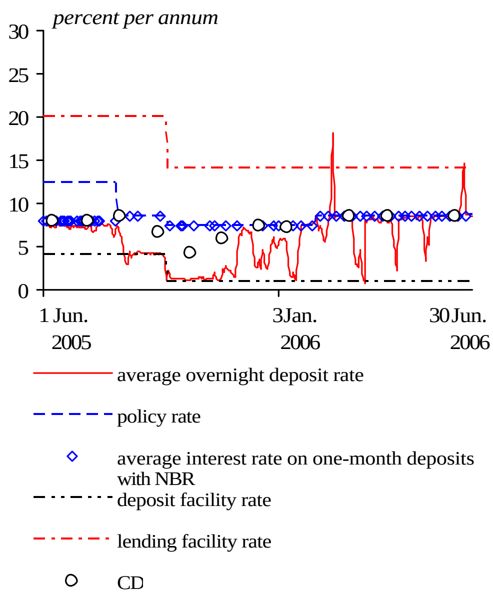
2.1. Interest rates

The interest rates on interbank deposits continued to increase in Q2 as a result of the decision of the monetary authority to continue to pursue a firm control over excess liquidity and to raise the policy rate at the end of Q2; occasionally, the rise in interest rates on interbank deposits was also due to some unexpected changes in the money market conditions. During the period under review, the average interest rate on interbank deposits rose to 8 percent, up 1.5 percentage points over the previous quarter.

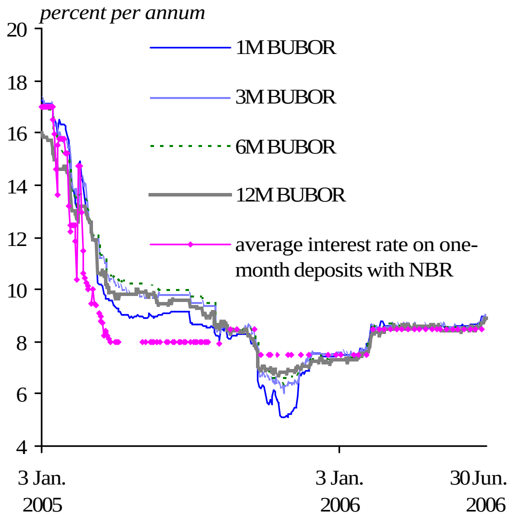
However, the slope of the trajectory of interest rates was uneven during the period under review. Thus, in April, the average interbank rate rose by 1.3 percentage points, the spread between interbank rates and policy rate narrowing. Behind this evolution stood mainly the significant sterilization of excess liquidity through deposit-taking operations and, implicitly, the gradual lowering of banks' uncertainty surrounding the outcome of auction sessions conducted by the central bank; a short-lived additional impetus to the rise in overnight rates was provided by the restrictive seasonal effect of the autonomous factors of liquidity. Subsequently, the interbank yield curve was relatively flat, with the interest rates on overnight deposits approaching the level of policy rate starting in late May. This development came to an end at the beginning of the second ten-day period of June when overnight rates posted extremely large fluctuations, increasing occasionally to 18.5 percent; this surge was caused by higher-than-expected increase in payments to the Treasury, which was driven by incidental expansion of some credit institutions' demand for overnight funds (due also to some net capital outflows).

Against this background, after four months, credit institutions resumed their resort to the lending facility though the volume of

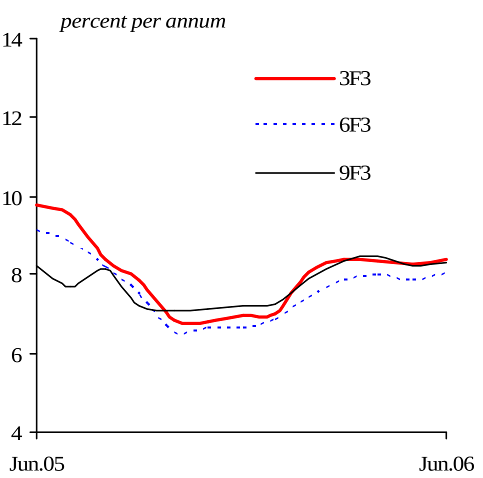
Interbank Money Market Rates



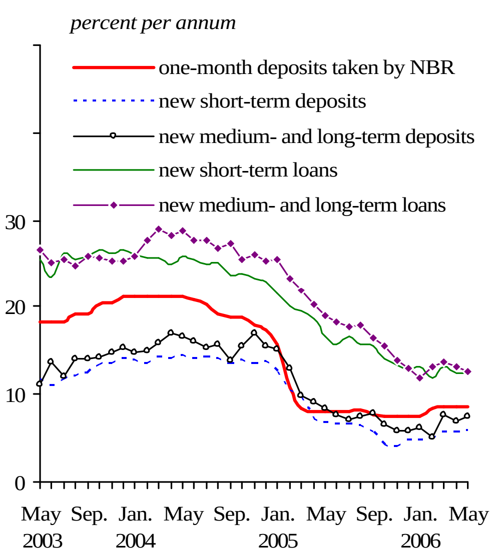
Interest Rate on Deposit-taking Operations and BUBOR Rates



Implicit Forward Rates



Bank Rates



bids was relatively low[32]. In June, the average interbank rate rose to 9.1 percent.

Nevertheless, in Q2 overnight rate volatility lowered markedly, reaching the lowest level year to date; this was due solely to higher predictability of deposit-taking operations carried out by the central bank. Moreover, average daily overnight rates fluctuated within a narrower range (from 0.8-18.1 percent to 2.2-14.6 percent).

The (1M-12M) BUBOR yield curve continued to increase relatively, going up 0.1 percentage points in June from the level recorded in March 2006. However, the slope remained negative, suggesting maintenance of expectations of decline in interest rates in the next 12 months. Average interest rates for shorter maturities, i.e. ON and 1W, increased faster, with the June average surpassing by 1.5 percentage points that recorded in March. The spread between ON BUBOR rates and interest rates on overnight transactions narrowed by 0.8 percentage points (to 14 basis points) on average, reflecting the relatively lower uncertainty of market operators about development of money market liquidity.

The implicit forward rates (calculated on the basis of June interest rates) show that interbank rates will continue to decline through the year. The 3M-BUBOR rate is expected to drop 0.3 percentage points in September 2006 from the current level of 8.4 percent and to decline further to 8 percent in December. The downward trend is likely to reverse at the beginning of 2007, the 3M-BUBOR rate being expected to increase to 8.3 percent.

The same as in the previous quarter, the Ministry of Public Finance refrained from performing any operations on the primary market for government securities, as the two auctions for bonds with maturities of 3 and 5 years – worth RON 100 million each – scheduled for May and June respectively were cancelled. Over the reported period, budget execution further provided a comfortable level of holdings in the General Account of the Treasury, while the value of government securities falling due was moderate, i.e. approximately RON 60 million.

Banks' interest rates on new deposits and loans to non-bank clients continued to exhibit divergent trends, as the impulse of the central bank's interest rate hike fed through into these variables with a certain lag. Thus, the average interest rate on new loans further declined April through May, albeit at a slower

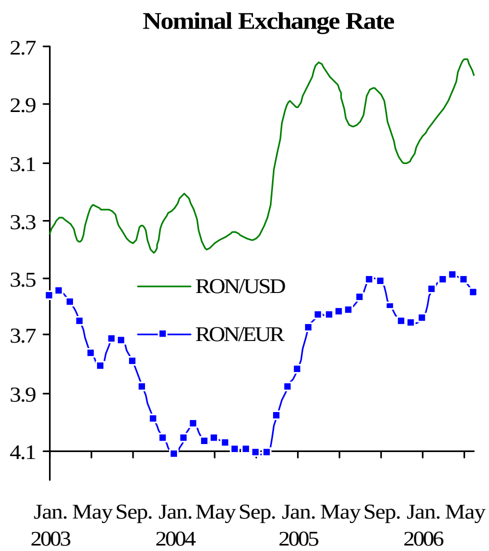
[32] One possible explanation for this development is that part of credit institutions had a low volume of eligible assets used as collateral.

pace compared to the first quarter. This development shows, on one hand, that the average interest rate on household loans stuck to the previous quarter's level, as lending rates on medium- and long-term loans moved in opposite directions (downwards and upwards respectively). On the other hand, interest costs attached to corporate loans followed a downward drift, although the fall was less sharp than in the first three months of 2006. Conversely, the average interest rates on time deposits April through May outpaced those in Q1, even though the average rates on both corporate and household deposits further witnessed opposing developments on a monthly basis.

2.2. Exchange rate and capital flows

The turbulence on emerging markets in Central and Eastern Europe following the changing investor sentiment also impacted the developments in the RON/EUR exchange rate, whose trajectory was reversed at mid-May. This change sent ripple effects – although with a certain lag and of a relatively lower magnitude[33] – onto the domestic currency, also due to the relatively smaller volume of short-term capital inflows on the domestic financial market.

Thus, after having fallen in the first part of the quarter under review[34], the RON/EUR exchange rate re-entered an upward path in May, while in June the strengthening of the domestic currency versus the euro equalled 3.1 percent compared to end-2005, or 5.9 percent in real terms; by contrast, the RON appreciated by 10.1 percent (13 percent in real terms) against the USD, given that the US currency depreciated versus the euro. Calculated as an average annual change for 2006 Q2, the appreciation of the domestic currency versus the euro further decelerated (3 percent in nominal terms and 10.4 percent in real terms), yet the RON strengthened against the USD (2.8 percent in nominal terms and 10.1 percent in real terms).



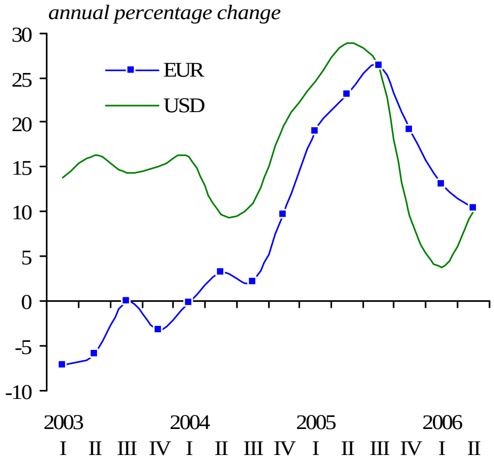
The appreciation trend of the domestic currency against the euro persisted into April mainly due to the financial investors' keen interest – starting with the latter half of March – in making placements on the domestic money market. Thus, an increasing volume of volatile capital flooded the domestic financial market amid a slight rise in money market rates and the invalidation of participants' expectations of hikes in the main central banks' interest rates during the period under review. However, the

[33] May through June, the Polish *zloty* depreciated in nominal terms against the euro by 2.6 percent, the Hungarian *forint* by 2.2 percent, the Slovak *koruna* by 1.8 percent, and the Romanian *leu* by 1.6 percent.
[34] In April, the average RON/EUR rate touched its lowest level since end-2002.

impact of these inflows on the domestic currency was cushioned by (i) the noticeable widening of the current account deficit compared to the previous month[35] (mainly due to the seasonal widening of the trade deficit and the slowdown in the pace of increase of current transfers), (ii) the relative contraction in trade deficit coverage through direct and portfolio investments[36], and (iii) the slower growth rate of long-term loans of banks and corporates. Under the circumstances, the nominal appreciation of the RON against the euro decelerated from the previous months to 0.5 percent.

Developments of RON Exchange Rate*)

annual percentage change



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

Source: NIS, NBR

Nevertheless, the RON/EUR exchange rate trajectory reversed at mid-May, with its volatility hitting record highs for the past 10 months. The main driver behind this development was the change in investor sentiment towards the risk associated with placements on emerging markets in Central and Eastern Europe; this shift occurred amid the more or less extensive worsening of economic fundamentals and less bright political outlook on these economies, and particularly by the more attractive investment alternatives on other markets[37]. Starting with the second ten-day period of the month, the domestic financial market saw significant net foreign currency outflows, against the backdrop of investors' increased propensity for low-risk financial assets[38]; amid these developments, the RON/EUR exchange rate witnessed a sudden rise on 15 May (1.6 percent). Subsequently, the downward pressures on the domestic currency waned, also due to the slower growth pace of the trade deficit and the still alert increase in inflows of direct investment and financial borrowings. Nonetheless, as a monthly average, May marked the first nominal rise in the RON/EUR average rate year to date.

Further interest rate hikes on external markets[39] in June, more frequent signs of monetary policy tightening in the euro area and the US, as well as increased scepticism over the ability of the authorities of some countries in the region to effectively deal with macroeconomic disequilibria gave renewed impetus to the contraction of investor exposures to these economies[40], thus causing higher volatility on those financial markets. This process fed through into the RON exchange rate developments

[35] In April, current account deficit soared 69 percent month on month.
[36] Direct and portfolio investments covered 99 percent of the current account deficit (122 percent in March).
[37] The Fed funds rate was raised to 5 percent on 10 May.
[38] Starting on 12 May, the currencies of the Czech Republic, Poland, Slovakia, and Hungary softened in nominal terms, with the Polish *zloty* and the Hungarian *forint* bearing the brunt of the depreciation.
[39] The ECB and the Fed increased their key rates on 8 and 29 June respectively.
[40] In June, the Hungarian *forint* weakened month on month by 3.3 percent, the Polish *zloty* by 3.1 percent, the Slovak *koruna* by 1.3 percent, and the Czech *koruna* by 0.4 percent. However, the Turkish *lira* was the hardest hit, down 8.8 percent.

with a relative lag, the resumption of net capital outflows – starting on 21 June – entailing an abrupt depreciation of the domestic currency[41]. Although this trend reversed at the end of the reported month, amid lower volatility on financial markets in the region and higher policy rate of the National Bank of Romania, the RON witnessed a marked weakening versus the euro throughout June (down 1.2 percent in nominal terms).

Over the short term, the trajectory of the RON/EUR exchange rate might further reflect the short-lived effects of the potential repositioning of financial investors on the markets in the region. However, the magnitude of this impact is expected to be relatively irrelevant, as exchange rate movements will be influenced to a larger extent by the sustained growth rate of direct investment and the seasonal rise in the supply of foreign currency from remittances and tourism receipts, on the one hand, and by the possible widening of the trade deficit, on the other hand. The impact of some of these factors was already manifest in July, when the nominal strengthening of the RON versus the EUR decelerated.

Key Financial Account Items (balances)

EUR million

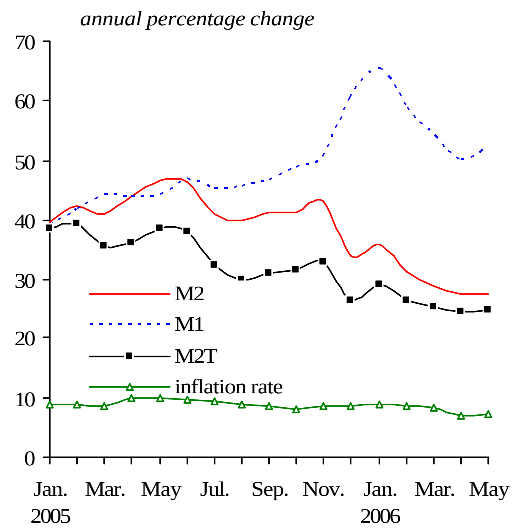
	2005 5 mos	2006 5 mos
Financial account	**1,660**	**3,092**
Direct investments	**1,547**	**2,859**
residents abroad	4	17
non-residents in Romania	1,543	2,842
Portfolio investments	**70**	**216**
residents abroad	54	110
non-residents in Romania	16	106
Other capital investments	**2,039**	**1,957**
of which:		
medium- and long-term investments	1,764	33
short-term investments	420	1,004
currency in circulation and short-term deposits	-751	1,109

2.3. Money and credit

Money

In March-May 2006, the deceleration in the expansion of broad money (M2)[42] came to a halt, due mainly to a base effect. M2 came in at 19 percent on average, a reading lower than the previous year's average, yet relatively high from a historical perspective. Developments in this monetary aggregate reflected the uptrend in economic activity in the early months of the year, on the one hand, and the non-banks' weaker saving as reflected by the performance of time deposits, on the other. As regards the M2 counterpart, non-government credit continued to be the only expansionary factor. Its impact was offset by the higher negative value of net government credit (as a result of tighter budget policy) and of "other net domestic assets" (due to the increase in RON-denominated deposits of non-residents[43]) compared to the previous period. Net foreign assets further significantly deterred the annual growth rate of broad money, in spite of the increase in foreign assets fuelled by speculative capital flows.

Broad Money and Inflation Rate



Source: NIS, NBR

[41] On 26 June, the RON/EUR exchange rate was at its highest since 20 January.
[42] Unless otherwise indicated, percentage changes refer to the March – May 2006 average of the 12-month growth rates in real terms.
[43] From a statistical viewpoint, RON-denominated foreign liabilities are recognised under "other net domestic assets".

Broad Money (M2)

percent

	2005			2006		
	II	III	IV	I	Apr.	May
	monthly average					
M1	24.2	26.2	26.9	27.4	27.9	28.4
Currency in circulation and short-	12.6	13.0	12.8	13.0	14.2	13.7
Domestic currency deposits	53.7	54.8	55.6	56.6	55.7	56.6
Foreign currency deposits	33.7	32.1	31.6	30.4	30.1	29.7

In the period under review, the main components of M2 – by currency, by financial asset, and by customer – witnessed developments quasi-similar to those recorded by broad money.

The growth rate of narrow money (M1) followed a downward path in March and April, hinting most likely at a normalisation trend and at the slight downturn in the annual dynamics of the turnover reported by companies in the retail trade and services sector. May saw renewed acceleration in M1 growth, presumably driven by the rebound in sales of goods and services which spurred money demand. However, the growth rate of the most liquid monetary aggregate further outpaced that of quasi-money more than three times, so that the share of M1 in M2 topped out at 27.9 percent, the highest average in the past 7½ years.

Composition of broad money by customer witnessed relatively similar developments as well. Thus, the pace of increase of household deposits with banks was slightly slower than in the previous period, given that the growth rate of household incomes slowed considerably and the interest rates on time deposits remained in real negative territory. However, the trend fluctuated during the period under review; thus, after hitting a 6 month-low in March, the annual growth rate of household deposits picked up in the following months. This rise was originally the result of a surge in forex deposits, while in May it was fuelled by the faster increase in RON-denominated household savings (after 14 months of quasi-steady contraction, with March and April posting the lowest readings in the last two years).

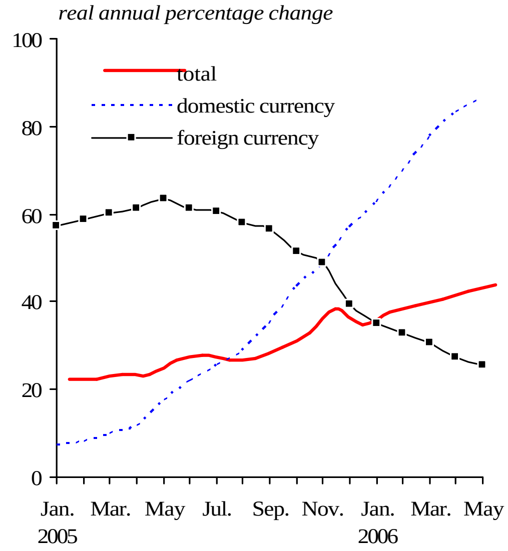
The rate of increase of corporate deposits also continued to lose momentum, albeit at a slower pace than in the previous quarter. The explanation for this performance could lie with the uplift in imports, including those related to investment, and the payment of holiday bonuses. Both RON-denominated time deposits and forex deposits reported slower growth, the latter also being hit by the base effect generated in May 2005 by the settlement of some privatisation proceeds[44]. Consequently, the dynamics of total forex deposits recorded a relatively faster downtrend, with their share in M2 bottoming out at 30 percent, the lowest average in the last 7½ years.

[44] According to a press release issued by the Ministry of Economy and Commerce, revenues from the privatisation of Distrigaz Sud amounted to EUR 310.4 million in May 2005, of which the capital increase equalled EUR 183 million.

Non-government credit

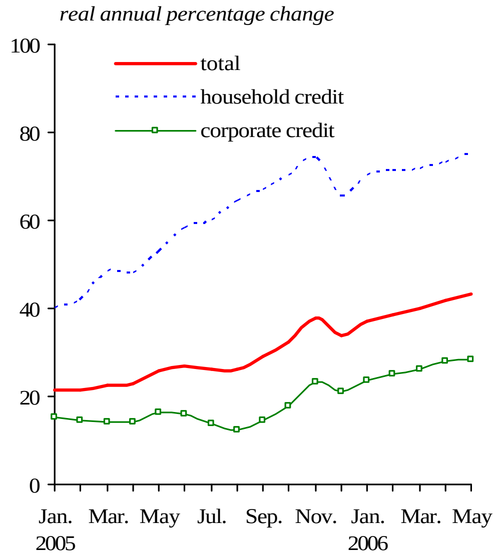
March through May 2006, non-government credit continued to be the main driver behind money creation, posting the highest growth rates[45] in the past two years (41.6 percent on average for the period under review). This performance mirrored the unprecedently fast increase in RON-denominated loans, which reached record highs in the period under review. The faster growth of lending in domestic currency was partly offset by the slowdown in forex loans expansion, whose dynamics touched a 22-month low under the impact of NBR's restrictive measures adopted in 2005. For the first time in the last nine years, foreign currency-denominated loans accounted for less than half of total non-government credit (48.7 percent on average for the reported period). The supply of non-government credit was spurred mainly by fiercer competition among commercial banks, the increasingly favourable outlook on the creditworthiness of clients, and the dwindling risk of adverse selection. Against this backdrop, despite the additional costs incurred following the rise in reserve ratio on foreign currency-denominated liabilities[46], banks further raised considerable funds from foreign markets with a view to extending forex loans. Demand for loans was boosted by the drop in lending rates and favourable expectations concerning the future incomes of households and companies.

Non-Government Credit by Currency



The brisk rise of non-government credit was due to the faster growth rate of both household and corporate loans. Thus, the pace of increase of household loans reached an 18-month high, remaining well above that of corporate loans. Under the circumstances, the share of household loans in total loans followed an upward course, peaking at 37.7 percent on average for the reported period. The composition of household loans by maturity witnessed a change, with long-term loans holding – for the first time ever – more than half of total household loans. This development may be associated with the relatively lower level – albeit on the rise – of interest rates on such loans and to the larger range of long-term loans in response to the NBR's tighter regulations on household loans enforced in 2005. The annual growth rate of corporate loans continued to pick up during the period under review, hitting record highs for the past 18 months. Although short-term loans further prevailed, long-term loan was the only component that saw its share in total corporate loans increasing, reflecting a possible upturn in investment demand.

Non-Government Credit by Client



[45] Unless otherwise indicated, percentage changes refer to the March – May 2006 average of the 12-month growth rates in real terms.

[46] The reserve ratio on foreign currency-denominated liabilities was raised from 35 percent to 40 percent starting with 24 March – 23 April 2006 maintenance period.

V. INFLATION OUTLOOK

The baseline scenario of the projection places the annual inflation rate at about 6.1 percent for end-2006. The 0.7 percentage point downward revision of the May projection (6.8 percent) is due mainly to the updating of scenarios of the effects coming mostly from the supply-side factors. These effects are caused by a timetable assuming less administered price adjustments in the first part of the projection horizon than in the previous forecast, a lower anticipated inflation rate for highly volatile food prices, and a lower-than-expected impact of the introduction of the 'vice tax' on tobacco and refined alcohol products. In 2006, the favourable effects of these factors surpasses the adverse influence of the recent exchange rate movements and of the rise in budget deficit projected for this year, entailing higher than previously forecasted increase in imported inflation and in excess demand. The adverse second-round effects of a higher exchange rate at mid-2006 and of substantial fiscal easing starting with 2006 Q3 will be stronger after the year-end, fostering higher inflationary pressures for 2007 compared with the previous projection. As a result, in order to set the ground for bringing inflation close to the targeted rate of 4 percent at the end of 2007, the current projection implies a tighter monetary policy stance than previously envisaged over the entire projection horizon.

Throughout the projection horizon, the disinflation process will be supported by the continuous decline in excess demand down to negative levels, under the impact of strict monetary conditions. The firming impact of the exchange rate and the effects of monetary policy impulses already feeding through into the interest rates will sharpen especially in 2006 Q4. According to the projection, the disinflation process should also benefit from the 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 the future stance of wage, income and fiscal policies (these risks may be augmented in case of early elections), the pressure exerted by slowdown in real appreciation of the RON as a result of persistence of cautious investor attitude regarding the Romanian financial market, the timetable as well as the first and second-round effects of adjustments in administered prices and indirect taxes with significant impact on inflation, the fluctuations in international prices of oil and natural gas and the way they are incorporated in domestic prices of fuel and energy as well as shocks affecting highly volatile food prices.

1. The baseline scenario of the forecast

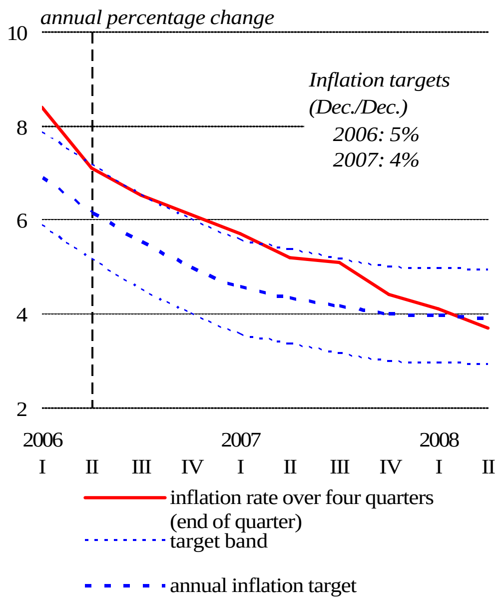
1.1. Inflation forecast

The baseline scenario of the current forecast shows that the 12-month inflation rate will stay, in the first part of the forecast horizon, close to the upper bound of the ±1 percentage point band, reaching 6.1 percent at end-2006, down 0.7 percentage points from the previous forecast. Starting with the second quarter of 2007, the 12-month CPI inflation is forecasted to enter the target band and to reach about 4.4 percent by the end of 2007.

Annual inflation rate (end of period)

Period	Q3 2006	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
Target		5.0				4.0		
Forecast	6.5	6.1	5.7	5.2	5.1	4.4	4.1	3.7

Inflation Forecast



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

Compared to the May 2006 Inflation Report, the forecasted trajectory of annual inflation rate shows:

– a lower CORE2 inflation in 2006, but higher in 2007;

– smaller administered price adjustments expected for 2006-2007 and a new scenario of price adjustments for 2008;

– a less pessimistic scenario of movements in some volatile food items (vegetables, fruit and eggs) in 2006, taking also into account the recent data released by the NIS.

CORE2 inflation is expected to be lower at end-2006 than previously forecasted due to its low level recorded in 2006 Q1 and Q2 and to reassessment of the effects of changes in tax rates on tobacco products. Over the projection horizon, the downturn in CORE2 inflation rate will continue, albeit at a slower pace than previously forecasted, owing to a less favourable impact of excess demand and exchange rate.

Compared to the previous forecast, the output gap is expected to narrow at a slower pace over the period, entailing a relatively faster economic growth both in 2006 and 2007. In accordance with the current baseline scenario, excess demand is projected to be eliminated in 2007 Q2, with a one-quarter delay compared to the previous forecast. The reasons behind this are the looser fiscal policy and slower real appreciation of the RON during 2006. However, the effects of these factors are expected to be alleviated by higher bank interest rates, reflecting both the developments in the NBR policy rate and the impact of some additional measures, such as the recent change in minimum reserve requirements on RON-denominated liabilities[47].

The upward revision of the government's deficit target for 2006 to 2.5 percent of GDP from 0.9 percent of GDP (as previously projected) is expected to result in stronger demand-side inflationary pressures. As the budget deficit is likely to build up in the last part of the year, its expansionary impact might be manifest in early 2007 as well.

The recent depreciation of currencies of emerging countries suggests investors' reassessment of risks associated with assets traded on these markets. The recent movements of the RON appear to be integrated into this context, which implies a slower real appreciation of the domestic currency than previously forecasted. Over the short run, this will result in additional inflationary pressure from import price increases. On the projection horizon, the exchange rate is expected to have a disinflationary impact, acting via imported inflation and the output gap, but to a lower extent than previously anticipated.

The evolution of administered prices and volatile prices (vegetables, fruit, eggs) contributes to a higher projected CPI inflation than CORE2 inflation over the forecast horizon. The current scenarios expect both administered prices and volatile food prices to be lower than in the previous forecast. The cumulative contribution of the dynamics of the two price categories to CPI inflation declines from 2.7 percentage points to 2 percentage points in 2006, and from 2.1 percentage points to 1.8 percentage points in 2007 respectively.

The prices of fuels (expressed in RON) reflect, in the first two quarters of the projection, the tensions on the oil market and the depreciation of the RON[48] compared with the end of 2006 Q1, thus putting inflationary pressures on CPI inflation. Over the projection horizon, as the forecast assumes a stable world oil price, fuel price inflation is expected to have a favourable impact on disinflation.

1.2. Exogenous inflationary pressures

As in the previous Inflation Report, administered prices are projected to rise faster than market prices. However, the current scenario for developments in administered prices envisages

[47] With a maturity of up to two years.
[48] Relevant when updating excise duties on fuels (expressed in EUR and paid in RON) in terms of the exchange rate quoted on the last day of the previous quarter.

downward adjustments of the increases in such prices almost throughout the projection horizon.

The scenario for the development of administered prices

The scenario for developments in administered prices

-%-

Product	Natural gas			Heating			Electricity		
Year	2006	2007	2008	2006	2007	2008	2006	2007	2008
Previous scenario	29.9	17.9	11.3	10.0	15.0	-	4.3	6.6	-
Current scenario	23.2	23.4	17.9	5.0	5.0	5.0	1.9	5.6	5.6

Thus, the annual percentage increase of administered prices is projected[49] to be around 7.4 percent (from 9.1 percent in the previous projection) in 2006, 7.1 percent (from 8.8 percent) in 2007 and 6.0 percent in 2008.

As far as electricity is concerned, the baseline scenario assumptions are based on ANRE's technical estimates, according to which – given normal hydrologic conditions throughout the year – a 5-6 percent annual increase would suffice to offset the larger production and distribution costs. The differences from the previous scenario originate in: (i) cancelling the price increase initially scheduled for July 2006; (ii) uncertainties surrounding the behaviour of the electricity market following full liberalisation (as from 2007).

Although no official information is available, under the current scenario, the price for natural gas from domestic production should be aligned with import prices by the end of 2008[50] (according to the commitments assumed to the European Commission in the first half of 2006, when a 2-year extension of the alignment period was requested). Against this backdrop, the adjustments scheduled for 2006 – but not carried out this year – are assumed to be implemented in a relatively even manner during 2007 and 2008, so that the cumulated growth for the entire 2006-2008 timeframe should not depart from the level originally set by the authorities, i.e. 79.3 percent. Given the additional corrections taken into account for the following two years, the overall increase in the price for natural gas is 9 percentage points higher in the current scenario than in the previous one.

As for the price for heating, only the information for 2006 is certain (5 percent rise as of 1 August 2006, with the impact on

[49] Calculated as average inflation in 2006 Q4 compared to 2005 Q4 for 2006, and in 2007 Q4 compared to 2006 Q4 for next year.

[50] The import price level considered by the authorities in their initial scenario was of about USD 250 per 1,000 m^3.

consumer prices estimated for October and November)[51]. Lacking any clear benchmarks with regard to the size of adjustments for 2007-2008, the current scenario assumes positive corrections similar to those for 2006.

As in the previous projection, the international oil price is estimated to stick to its average level recorded in Q2 over the projection horizon. Over the short term, the domestic currency depreciation at the end of Q2 compared with the end of Q1 (see footnote 48) and the recent hike in crude oil prices will weigh on the RON-denominated fuel price. The current projection also encompasses an increase of around 1 percent in fuel price during 2007 Q1 as a result of the expected rise in the excise duty on leaded gasoline[52].

According to the current projection, the prices of vegetables, fruit and eggs are expected to rise by 7.2 percent in 2006 and 5.1 percent in 2007, lower than the figures forecasted in the previous scenario (12.6 percent in 2006 and 5.6 percent in 2007). The drop in the 2006 forecast annual inflation rate of vegetables and fruit is mainly due to a reassessment of the impact of last year's floods, whose effect was alleviated by rising supply following the new crop; in the case of eggs prices, besides the sharper-than-expected price drop in Q2, the downward revision of the short-term projection is also attributable to the protracted negative effect that bird flu seems to have exerted on the demand for these products.

The inflationary impact of the 'vice tax' and of the higher excise duties on cigarettes and tobacco was also reassessed from the previous scenario, based on the following:

– cigarette producers resorted to more gradual price increases, protracted into Q3, so that consumers should not be faced with too big of a price shock;

– the lower-than-anticipated impact of such hikes on the cigarette and tobacco price index. The increases in prices recorded by the National Institute of Statistics fail to cover entirely the higher taxes levied on these products. This may be due to the producers' strategy to accept a certain drop in profit per product so as to maintain their volume of sales

[51] The 2007-2008 forecast is rendered more difficult by the removal of the nationwide reference price starting July 2006 and assigning to local authorities the task of determining the price for heating. Thus, local reference prices might be adjusted in theory any time during the year, still the regulating authority in the field estimates that the current behaviour (raising the price once a year) will persist in the two years ahead.

[52] Given the small share of this variety in total gasoline consumption, the quarterly rise in excise duties does not have a significant effect on aggregate fuel price inflation. In terms of annual inflation, the impact of this hike on fuel prices is of about 0.2 percentage points in 2007 Q1.

and market shares. Other possible reasons for this discrepancy are the stocks of cigarettes at distributor level or the sale of imported cigarettes without paying customs duties.

As a result, the impact of amendments to fiscal legislation on tobacco and cigarette prices is 3.6 percentage point lower in 2006 compared to the previous forecast. Consequently, the forecasted contribution of these changes to annual CPI inflation for end-2006 underwent a downward revision by approximately 0.2 percentage points from the previous projection (from around 1.1 percentage points to about 0.9 percentage points).

The hikes in excise duties usually expected in July have yet to be disclosed for 2007. Given the authorities' commitment to attain the EU excise duty level (EUR 64 per 1,000 cigarettes) by the end of 2010, the current projection assumes a 12.5 percent rise in the price of tobacco and cigarettes for July 2007 in order to reach a total excise duty level of EUR 35.3 per 1,000 cigarettes[53].

Compared with the previous Inflation Report, the current projection is based on revised data on the inflation rate in the European Monetary Union. The projections published in the Consensus Forecasts for the last two quarters of 2006 and for 2007 Q1 have been revised upwards by 0.3-0.4 percentage points, along with a stronger eurozone economic growth. Ceteris paribus, the anticipated impact on the projection is the increase in import prices.

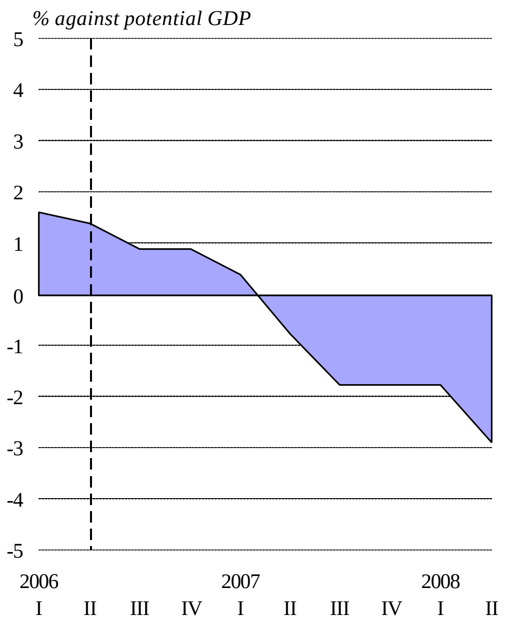
1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

The quarterly growth rate of real GDP is projected to slow down somewhat in 2006 Q2. The persistence of the positive output gap entails further short-term inflationary pressures induced by aggregate demand. Given the faster-than-anticipated pace of increase of the GDP in 2006 Q1, the decrease in the positive output gap foreseen in the previous Inflation Report no longer materialized.

Due to the time lag inherent to the transmission of monetary policy impulses, second-quarter excess demand is generated mainly by the cumulative effect of previous quarters' developments in the exchange rate and the lending and deposit

GDP Deviation



[53] Corresponding to a unitary excise duty of EUR 20.8 per 1,000 cigarettes and to a specific excise duty of 27 percent. Current levels (for July 2006) stand at EUR 16.28 per 1,000 cigarettes and 29 percent respectively.

rates of commercial banks. In the previous quarters, lending and deposit rates passed through to the current excess demand the stimulative effect of the policy rate. This development was offset by the real appreciation of the domestic currency – which had a restrictive impact through the net export channel – and by the administrative and prudential monetary policy measures (particularly the increase in the minimum reserve requirements on RON- and foreign currency-denominated liabilities).

As regards GDP components, final consumption is estimated to stay relatively high in the reported period compared to the recent years' average trend. The high level of consumption reflects mainly the surge in household final consumption recorded in the past few quarters, supported also by labour market conditions. Thus, the number of employees and the real net average wage economy-wide lie above the medium-term trend, with a positive effect on household disposable incomes. Moreover, both the rapid increase in short- and medium-term non-government credit to households in 2006 H1 and the developments in real M1, pointing to stepped-up transactions, validate the assumption that excess demand is fuelled by final household consumption. On the other hand, the balance of the consolidated general budget shows a surplus of 1.12 percent of GDP in the first 6 months of the year under review, which causes aggregate demand to shrink.

The growth of gross fixed capital formation is expected to re-enter positive territory during the second quarter, getting in line with its average trend in recent years. Favourable lending conditions for economic agents together with the drop in ULC suggest the high potential investment growth rate will carry on in the following quarters.

Imports continue to be high, upheld by labour market conditions and the brisk rise in non-government credit. The current level of exports is below the medium-term trend, but their pace of increase is estimated to speed up in the second quarter. The favourable outlook on exports also relies on the reduction in ULC. Overall, the 12-month growth rate of exports still lags behind that of imports, so that net exports continue to put downward pressure on excess demand.

1.3.2. Implications of recent exchange rate and interest rate developments

After resuming the upward movement in 2006 Q1, the domestic currency continued to appreciate for most of the second quarter of 2006. Its depreciation in late June, following the changing investor sentiment towards emerging markets, occurred too late to have a significant impact on the average exchange rate in

2006 Q2. Moreover, this depreciation, albeit rapid and large, came to a halt and was partly reversed after only a few days.

The RON appreciation recorded in 2006 Q2 led to the strengthening of the restrictive effect of the real exchange rate transmitted via the net export channel. Thus, given the timeframe needed for this effect to become fully manifest across real economy, the real exchange rate acts as a disincentive on excess demand over the following quarters, having an indirect contribution to the compression of demand-pull inflationary pressures. On the other hand, the impact of the exchange rate was stimulative in the second quarter of 2006, via wealth and balance sheet effects[54], thus offsetting part of the restrictive effect produced by the net export channel. A stronger RON entailed lower foreign currency borrowing costs in local currency, which has an expansionary effect on aggregate demand. However, the cumulative effect of the measures the National Bank of Romania took to contain foreign currency credit growth (high minimum reserve requirements on foreign currency-denominated liabilities and limitation of maximum exposure from forex loans) diminishes the importance of this transmission channel. Thus, the net effect of the exchange rate on economic activity in 2006 Q2 was restrictive. Moreover, nominal appreciation of the domestic currency helped mitigate inflationary pressures in the short term via import prices.

The sustainable real appreciation pace of the domestic currency is expected to keep slowing down compared to the high levels seen during 2005 and to approach the levels determined by medium-term fundamental factors (productivity differential as against the major trade partners, medium- and long-term capital inflows). The reduction in the sustainable appreciation rate is due to the fading effect of the events that weighed heavily on the exchange rate at end-2004 and in early 2005 (liberalisation of non-residents' access to RON-denominated deposits, the change in the central bank's policy of intervention in the foreign exchange market).

In 2006 Q2, the National Bank of Romania left the policy rate unchanged at 8.5 percent[55] and raised considerably the volume of sterilization operations, entailing a tighter monetary policy stance than in the previous quarter. As a result, the stimulative impact of the policy rate on excess demand in the next quarters continued to contract.

[54] See the Box on "Wealth and balance sheet effects" in Inflation Report No. 2/2005.

[55] The NBR Board decisions, taken on 27 June 2006, to raise the policy rate to 8.75 percent and to increase the minimum reserve requirements on RON-denominated liabilities with maturities of up to two years will produce effects starting in 2006 Q3.

The NBR's policy rate affects the real economy only indirectly, through commercial banks' deposit and lending rates. This indirect effect feeds through into banks' interest rates with a lag because of the timeframe needed for bank interest rates to adjust to the changes in the NBR's policy (the central bank's position of net debtor vis-à-vis the banking system, along with other factors, play a significant part in such transmission lags). Thus, the nominal deposit rate increased, while the lending rate continued to decrease slightly in 2006 Q2, which is indicative of its slower adjustment to the drop in the NBR's interest rate in the previous quarters and of stronger competition in the banking system. Overall, the stimulative impact of commercial banks' interest rates on the real economy diminished in this quarter too. Nonetheless, commercial banks' interest rates continued to have a less restrictive effect than that implied by the NBR's interest rate on excess demand and inflation.

Following the combined effect of the analysed factors, during the second quarter of 2006, the joint restrictive impact of domestic currency appreciation and real interest rates on excess demand over the following quarters gathered strength.

1.3.3. Demand pressures within the projection horizon

The baseline scenario foresees a more sluggish and less pronounced decline of the output gap compared to the scenario shown in the May Inflation Report. The deviation from that path is mainly due to a weaker real exchange rate, as well as to a larger fiscal deficit than in the previous projection. Thus, taking into account the higher level of the EUR/RON exchange rate in the current period, entailing less restrictive effects on net exports, and the revision of the government's deficit target for 2006 to 2.5 percent of GDP from 0.9 percent, which will foster government demand, the positive output gap is expected to be eliminated with a one-quarter delay compared to the previous forecasting round, i.e. in 2007 Q2. Over the entire projection horizon, the output gap is still anticipated to follow a downward trend, in line with the increased tightening of real monetary conditions via more restrictive bank interest rates as well as the resumption and relative acceleration of real appreciation of the domestic currency.

The temporary depreciation of the RON in May-June 2006, initially occurring alongside non-residents' net capital outflows, could not be entirely attributed to the change in the interest rate differential between interest rates on short-term assets in RON and those on similar instruments denominated in EUR or

USD[56]. For this reason, the rise in the nominal EUR/RON exchange rate was associated with a broader increase in the currency risk premium[57], following the international investors' reassessment of risk attached to investments on most emerging markets. The baseline scenario envisages that the risk premium will revert to the level estimated for 2006 Q2 no sooner than towards the end of the forecast horizon, i.e. after eight quarters. In these circumstances, the projection assumes, at least for the first part of the horizon, a slower-than-projected real appreciation of the domestic currency, implying a relatively less restrictive anticipated effect of the real exchange rate on excess demand. Nevertheless, under the baseline scenario, real strengthening of the RON will continue to be an important constituent of the restrictive mix of real monetary conditions meant to bring the decrease in the output gap onto a path compatible with that of programmed disinflation.

Banks' interest rates are expected in their turn to carry the restrictive impulses of the mix of monetary policy measures forecasted in the reference period. Given the excess liquidity in the banking system, the recent increase in minimum reserve requirements (MRR) on RON-denominated liabilities is seen producing effects mainly through the banks' interest rates. The hike in the minimum reserve requirement ratio may be viewed as an increase in intermediation costs that would prompt offsetting movements in deposit and lending rates. In the former case, the baseline scenario predicts that overall the reduction of the optimal interest rate due to the hike of the MRR ratio will be offset by the impact of the policy rate rise from 8.5 percent to 8.75 percent; meanwhile the deposit rate will be affected in the near run by the impact of the uneven distribution of the excess liquidity on interbank rates. As for non-government credit, both measures taken by the National Bank of Romania should in the short term favour an increase in borrowing costs and/or other fees and charges levied by banks. During the entire projection timeframe, given the impact of the forecasted developments in NBR's interest rate, real deposit and lending rates of banks are anticipated to reach restrictive levels from the perspective of the effect on output gap dynamics.

In the current projection, the impact of fiscal policy on aggregate demand was assessed based on different benchmarks compared to the previous projection, following the latest

[56] Although the differential between the NBR's interest rate and 3-month EURIBOR (LIBOR) dropped from an average of 5.9 (3.7) percentage points in February to 5.6 (3.3) percentage points in June 2006, the RON depreciated more sharply in the considered months against the euro, i.e. almost 2.5 percent (end of period).

[57] The currency risk premium is defined as the difference between the actual exchange rate in a certain period and its level deducted from the uncovered interest rate parity condition.

revision of the Government's deficit target for 2006 up to 2.5 percent of GDP and the anticipated setting of the 2007 deficit target above the one-percent level laid down in the 2005 Pre-Accession Economic Program. Thus, the projection for the current year incorporates a looser fiscal policy than that expected in the May Inflation Report. Moreover, in view of the fact that a considerable deficit, i.e. 2-3 percent of GDP, could build up in the last months of the year (considering the track record of the previous years), its impact on aggregate demand, and implicitly on inflation, was spread over two periods, extending somewhat into 2007 Q1. The effect of the new fiscal policy stance consists in eliminating the forecasted excess demand with a one-quarter delay. In the absence of an official target, the working assumption adopted for next year envisages the maintenance of the consolidated budget deficit close to the level in the current year, i.e. 2-3 percent of GDP. Under the circumstances, in 2007, the impact of fiscal policy on the output gap would remain relatively unchanged from that included in the previous projection.

Compared to the baseline scenario in the May Inflation Report, the higher trajectory of the output gap implies a faster pace of forecasted economic growth over the considered horizon. For 2006, the revision of the growth forecast was also based on the updating consistent with the most recent data released by the NIS for Q1, which turned out above the expectations of the May Inflation Report. According to the projection, 2007 GDP growth will post a relative slowdown and the output gap will enter negative territory in the latter half of the year.

Assuming that the economic growth rate witnesses a gradual slowdown, the main component of GDP, i.e. household and public administration consumption, is expected to expand at a relatively slower pace. The main drivers of such a development would include (i) the deceleration of non-government credit growth under the impact of the prudential measures adopted by the NBR and that of more restrictive conditions from interest rates and/or other borrowing costs[58] and (ii) the rebound in saving once interest rates on time deposits revert to positive levels in real terms. A larger increase in government spending, assuming that a considerable share of the additional funds earmarked by the revision are channelled towards consumption, would work in the opposite direction.

In this context, gross fixed capital formation is expected to remain the fastest-growing GDP component on account of investments made by Romanian companies, fostered by

[58] Particularly various types of fees charged by banks when granting loans or during the loan period.

Romania's approaching integration into the European Union, and the potential step-up in foreign direct investments. The channelling of some additional budget expenditures towards investment and the unfolding of a larger number of programmes co-financed by the European Union will also spur gross fixed capital formation.

The recent exchange rate movements are expected to slow down to some extent the widening of the trade deficit recorded in the first part of the year, boosting exports and deterring imports in relative terms. Exports are seen recording a positive development in 2006 also as a result of more favourable prospects of imports of euro area economies, given that, according to Consensus Forecasts, their forecasted dynamics underwent an upward revision of one percentage point at end-June versus end-March. As concerns the second part of the projection horizon, both the more restrictive exchange rate and the forecasted slowdown in economic growth across the euro area are likely to put renewed pressures on the trade balance.

1.4. Risks and uncertainties surrounding the projection

The baseline scenario is built around some assumptions implying an intrinsic uncertainty. The most uncertain elements which pose potential risks to the current projection stem from the following sources:

– the potential widening of the domestic imbalance between aggregate demand and supply on the back of sizable slippages in fiscal policy, which may deepen further in the event of early elections within the projection horizon. The fiscal easing would exacerbate both domestic demand-side pressures and external imbalances, as part of stronger demand may underpin a more rapid growth in imports than in exports, thereby inducing a wider trade deficit;

– the deteriorating foreign investor sentiment regarding the return on and the risks associated to investments in instruments issued and traded on emerging markets, which may persist for longer periods of time; a focal point of the changing investor sentiment could be the current account deficit, whose worsening over the forecast horizon might create additional pressures of slowing domestic currency appreciation;

– the uncertainty surrounding the current scenarios for the adjustments of administered prices and prices for vegetables, fruit and eggs within the projection horizon. For administered prices, revisions may be attributed to an altered calendar of price adjustments and exchange rate developments different from those envisaged in the baseline scenario, whereas weather conditions other than those considered normal may induce changes in the price scenario for vegetables, fruit and eggs;

– in close connection to the type of uncertainty mentioned in the previous paragraph, there are further unknowns regarding the subsequent stages of aligning indirect taxes (particularly excise duties on tobacco and cigarettes, as well as on energy products) with the levels mentioned under the agreements concluded with the EU.

The repeated revisions of fiscal policy spur uncertainty for any fiscal coordinates of the baseline scenario. Moreover, the increasing frequency of budget revisions over the recent time periods requires caution in dealing even with an official scenario regarding the future design of fiscal policy. Another element of uncertainty for the co-ordinates of the baseline scenario might emerge in the case of early elections within the forecast horizon. Such a risk might entail, on the one hand, a faster-than-expected increase in budget expenditures than in budget revenues and, on the other hand, the change in the structure of government expenditures, by increasing current (consumption-related) expenditures rather than capital (investment-related) expenditures. Under such circumstances, a looser fiscal policy might put additional inflationary pressures, by pushing excess demand beyond the level projected in the baseline scenario. The implementation of measures that the central bank would take in order to maintain inflation close to the projected targets would require further tightening of monetary policy, i.e. the increase in the restrictiveness of real monetary conditions, as compared to the baseline scenario.

Other sources fuelling inflation via stronger excess demand or through its delayed elimination, some of which were also mentioned in the May 2006 Inflation Report, include:

– slippages in the public sector incomes policy (possibly exacerbated in the event of early elections);

– unsustainably faster economic growth in the real sector (prolonging the uptrend manifest in the first two quarters of 2006);

– keen competition on the banking market, which could uphold the swift pace of credit growth, despite the restrictive measures taken by the NBR.

A high degree of uncertainty is also associated with the risk premium for investments in instruments traded on emerging markets. One of the alternative assumptions envisages the risk premium to exceed a level deemed compatible with the combination of the real interest rate trend and the real appreciation trend, as well as the elimination of this risk margin over a longer-term horizon. The higher levels of the risk premium would entail a real appreciation of the domestic currency slower than that mentioned in the baseline scenario, thus heightening inflationary pressures, particularly in the second half of the forecast horizon.

The following factors may partly offset the pressures of slowing the real appreciation of the domestic currency:

– further capital inflows in the form of foreign direct investment;

– possible diversification of foreign investors' portfolios, following the final stage of capital account liberalisation in September 2006;

– maintenance or expansion of current transfers, i.e. remittances from Romanians working abroad, etc.

Should the impact of the first category of factors prevail, economic growth would be higher than projected, amid however a less ambitious disinflation path.

Considering the latest forecasting rounds, the magnitude and calendar of administered price adjustments, particularly prices for energy, represent a constant source of uncertainty for the baseline scenario. The smaller increase in the price for natural gas in July 2006 compared to the prior projection suggests that price adjustments may have a time profile different from that mentioned in the baseline scenario, which would entail unexpected inflationary pressures on the supply side, facing the central bank with a new challenge for its monetary policy. An additional source of uncertainty may be the potential hike in the natural gas price on world markets, which is a plausible scenario if we think back of that price rising continuously for the past two years. This might bring about the growth of import prices for natural gas, on the one hand, and the change in the factors underlying the gradual alignment of domestic gas prices with import prices[59], on the other hand. As for the other categories of energy products with administered prices: in the case of heating, the uncertainties arise from the difficulties of measuring the impact of the recent decision on the decentralisation at local government level of the power to set the reference prices; in the case of electricity, the uncertainties arise from the future dynamics of some variables that are mostly

[59] The price of natural gas for end-users is calculated as a weighted average of domestic producer prices and import prices, in terms of their weight in total supply.

exogenous, i.e. hydrological conditions of the year. Given the fewer information available for price adjustments in 2007-2008, the above-mentioned risk elements are more likely to become manifest in the second part of the projection horizon.

Taking account of the higher volatility of prices for vegetables, fruit and eggs in the past 2 years, the risks associated with their evolution may appear in case of weather conditions other than those considered normal. For shorter-term projection horizons, the persistence of the favourable trend in food prices in general may lead to a lower inflation rate than that forecasted in the baseline scenario.

Starting with the date of Romania's accession to the EU – 1 January 2007 in the baseline scenario – a particular element of uncertainty might arise from the implementation of the provisions of the Common Agricultural Policy (CAP)[60]. The income effect triggered by direct subsidies granted to Romanian farmers, as well as the convergence towards certain reference levels of the prices for particular agricultural products[61], where these prices are higher than domestic producer prices, might push inflationary pressures beyond the level forecasted in the baseline scenario. As for food items whose domestic prices are lower than in the EU, but are exempted from the CAP provisions on market intervention, potential price increases might be induced by stronger demand-side pressures from EU Member States following Romania's accession. Another effect of implementing CAP provisions is the enforcement of the common policy on customs regime, which often requires the tightening of tariff and non-tariff customs barriers imposed on products originating in third countries and may entail the rise in prices paid by domestic consumers for such imported goods. Benefiting from the experience of countries that have already completed these stages and taking account of the transition periods negotiated by Romania concerning the implementation of some CAP provisions, the above-mentioned effects of higher inflationary pressures are expected to span over a longer time period, having only a moderate impact in the first years of EU membership.

Similarly to the assumptions made in the May 2006 Inflation Report, the forecasted oil price developments during the

[60] In the case of Romania, the impact on food prices might be stronger than in Poland, Hungary or the Czech Republic after joining the EU, particularly considering the still relatively large share of agricultural production in total value added (roughly 10 percent of GDP in the case of Romania as compared to 3-5 percent in the aforementioned countries).

[61] According to the instruments used by the CAP, where market prices for some agricultural prices classified as such are below certain reference levels for a certain period of time, the authorities may take measures to push prices up to reference levels.

projection horizon must be considered with a relatively high degree of uncertainty. Although the oil price envisaged in the baseline scenario of the current projection is higher than that in the May forecasting round (USD 69.5 per barrel versus USD 61.7 per barrel), it may escalate rapidly, as the recent warfare in the Middle East cannot be removed from among the influential factors. The mix between such a scenario and a possibly slower real appreciation of the domestic currency might generate a significant risk, given the dynamics of fuel prices whose inflationary impact would be stronger than that in the baseline scenario.

The overall assessment of the envisaged elements of uncertainty points to a potential boost of inflationary pressures, particularly in the latter half of the projection horizon (2007 and 2008). For 2006, the impact of risk factors is more closely and more evenly distributed around the projected path of the baseline scenario, as the continuation of the favourable developments in food prices could bring the annual inflation rate inside the target band.

2. Policy assessment

Given the unfolding of the current quarterly medium-term forecasting round and the drafting of the August 2006 Inflation Report, the NBR Board initiated and carried out, together with the Government, the assessments underlying the 2008 inflation target[62]. According to the NBR, the joint announcement (with the Government) of the inflation target is a basic principle of inflation targeting that enhances its efficacy by providing a stronger underpinning to monetary policy (from fiscal, incomes and structural policies) and firmer anchoring of companies' expectations, which are thus more evenly distributed. Following the discussions on various forecast scenarios, on key assumptions underlying their preparation (including those regarding the Government's economic policy variables) and major risk and uncertainties surrounding medium-term inflation performance, the 2008 inflation target was set at 3.8 percent ±1 percentage point.

From the perspective of the National Bank of Romania, this figure matches best the principles and requirements of inflation targeting strategy. In these circumstances, it enhances credibility of the central bank and its actions, which is essential in anchoring medium-term expectations as well as in attaining

[62] In view of the inflation targeting strategy, the authorities of a country recording disinflation set, as a rule, multi-annual inflation targets; considering the experience gained by these authorities, the appropriate time for formulating and announcing the NBR's inflation target for 2008 is August-November 2006.

and maintaining price stability. On the one hand, the inflation target set for 2008 is in line with need to continue disinflation and ensure a relatively fast reduction of inflation towards a sustainable level over the medium term, and subsequently to secure the fulfilment of the inflation criterion laid down in the Maastricht Treaty, as well as compliance with the European Central Bank's quantitative definition of price stability; moreover, by its capability to have a favourable impact on inflation expectations, the 2008 inflation target may contribute to the relative reduction in costs associated with the achievement of the 2007 inflation target.

On the other hand, the 2008 inflation target – seemingly less ambitious – reflects the central bank's concern for strengthening its credibility by attaining the targeted inflation. In 2008, the pace of disinflation is expected to be slowed markedly by some factors outside the National Bank of Romania's authority, such as:

– delaying for 2008 of some substantial administered price adjustments that were originally scheduled for implementation in 2006 and 2007. According to the latest scenario, the magnitude of such adjustments in 2008 will only slightly be smaller than that established for 2007;

– further increases in prices for both tradables and non-tradables as a result of the ongoing convergence of the Romanian economy (including also the Balassa-Samuelson effect);

– persistence of inflation and difficulty to continue disinflation, given that annual increase of prices reached relatively low levels. Among the culprits there are supply/cost side factors, i.e. gradual and sluggish accommodation of labour market parameters to a low inflation economic environment (due also to sticky wages on their way down). Another explanation lies with the inertia of inflation expectations and the difficulty to mitigate them in an economic environment plagued by the persistent adjustments of administered and relative prices induced, inter alia, by the Balassa-Samuelson effect. The difficulty in mitigating inflation expectations also arises from Romania's high-inflation track record and the unanticipated persistence of large excess demand, which makes it even harder to remove, possibly due to the convergence process.

From this final perspective, the 2008 and the 2007 inflation targets are viewed as ambitious, yet feasible, given their interconnections. This feature was again highlighted by the recent economic developments and the revised projection of medium-term macroeconomic performance, which hinted at the large persistent excess demand that constitutes the major inflationary risk in the near run and is therefore the major matter of concern for the NBR Board. The further increase of the level and projected time period of the positive output gap compared with the previous forecast can largely be attributed, during the current forecasting round, to the impact of the unexpectedly large easing of fiscal policy earlier this year. Moreover, the largest part of public spending should be incurred in the final months of 2006, which will boost excess demand during two quarters at least; although most of the increase in public spending will initially be channelled towards investment, the ensuing shock will feed through to consumer demand and implicitly will induce inflationary pressures.

In order to prevent short-term deterioration of the macroeconomic environment following the adverse shock of the fiscal easing, the monetary policy stance should not only be tightened, but also maintained as such for a longer period, although the monetary policy will virtually take over the "burden" of pushing excess demand into negative territory, in line with attaining the inflation targets for 2007 and 2008. In this context, further monetary policy tightening is needed to put a halt to the worsening trend of inflation expectations that became manifest over the past few months due also to the announcement and implementation of indirect tax hikes and the recent budget revision.

Adding to the NBR's concerns was the persistently unsustainable growth of household consumption and its withstanding the impact of potentially contractionary factors such as the monetary authority's measures aimed at containing credit growth. The still robust consumption, purchases of goods in particular, despite the deceleration in growth of wage earnings and remittances from abroad, points to the lasting nature of the shift in consumption bias, which is also confirmed by the protracted weakness in household savings with banks and especially by the sharp fall in the saving rate over the past few quarters. These developments appear to be indicative of stronger optimistic expectations of households relative to the economic outlook rather than lagged effects of the previous period marked by subdued consumption that lasted until the beginning of this decade. Moreover, consumption could have been boosted by the relative deceleration, over the recent months, in the dynamics of adjustment related to utility bills and the unattractive returns on bank saving instruments.

In this context, bringing private consumption growth back to sustainable parameters requires more efficient actions aimed at cushioning household credit demand, on the one hand, and boosting household savings, on the other, which would call for firmer interest rate policy. However, since the recent monetary policy tightening did not wear off, a solution would be a temporary wait-and-see approach to the effects of the decisions made by the NBR Board in June, all the more as the decision to raise the minimum reserve requirements on RON-denominated liabilities to 20 percent came into effect no sooner than 24 July 2006.

By contrast, key supply-side factors, i.e. administered and volatile prices, will continue to have a lower inflationary impact given that administered price adjustments originally planned for the following three months of 2006 were delayed for the coming years and the short-term developments of some volatile food prices improved compared with the previous projection as a result of favourable response on the supply side. Nonetheless, these factors are likely to generate short-lived leeway for the general price index because of the still sizeable magnitude of price adjustments due for 2007 and 2008, the uncertainties brought about by the inconsistent adjustment timetable and the vulnerability of agricultural output and implicitly food prices to weather conditions. Even though the developments in these variables that are outside the central bank's authority do not call for a tightening of monetary conditions in the near term, they need to be backed by a cautious monetary policy stance and vigilant monitoring by the National Bank of Romania for preventing unfavourable expectations. Moreover, such a monetary policy stance is needed to minimise the potential second-round effects of shocks induced by administered price adjustments scheduled for 2006, their relatively lower-than-anticipated magnitude notwithstanding.

From the perspective of recent developments, the risk of resurgence in volatile capital inflows, assuming monetary policy tightening and in the context of full capital account liberalisation, is relatively reduced by both the maintenance, at least for some time, of investor reluctance to emerging markets and the very likely continuation of interest rate increases on the main international financial markets. Investor perception on the risk emanating from domestic market investments and from the expected margin of appreciation of the RON versus the EUR could, however, be substantially readjusted if in September Romania's accession date is set for 1 January 2007, which might bring in substantial capital inflows, i.e. foreign direct investment and borrowings.

The assessment by the National Bank of Romania Board of the current macroeconomic environment and of the medium-term projection has underscored the inflationary risk posed by the potential increase in excess demand in the near run, mainly as a result of fiscal easing. At the same time, however, the National Bank of Romania Board has considered that, given the time-frame needed for the effects of the increase to 20 percent in the minimum reserve requirements on RON-denominated liabilities to become completely manifest, real monetary conditions remain adequate for keeping disinflation on a trajectory compatible with staying within the target band set for 2007. Hence, in its meeting of 9 August 2006, the National Bank of Romania Board has decided to maintain the policy rate at 8.75 percent per annum and to continue to pursue a firm control over money market liquidity. Moreover, the Board has reaffirmed that it will continue to vigilantly monitor non-government credit expansion and the prices of certain broad asset classes in order to identify and take prompt monetary policy measures against developments that might entail risks to disinflation.