NATIONAL BANK OF ROMANIA

INFLATION REPORT

November 2006

Year II, No. 6

New series

ISSN 1582-2931

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 approved by the NBR Board in its meeting of 10 November 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
ECB	European Central Bank
EIA	Energy Information Administration (within the U.S. Department of Energy)
EUROSTAT	Statistical Office of the European Communities
FED	Federal Reserve System
GCF	Gross Capital Formation
HICP	Harmonised Index of Consumer Prices
IFS	International Financial Statistics
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MAFRD	Ministry of Agriculture, Forests and Rural Development
MLSSF	Ministry of Labour, Social Solidarity and Family
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
NSC	National Securities Commission
OCI	Organisation for Collective Investment
ON	overnight
OPEC	Organisation of Petroleum Exporting Countries
ULC	unit labour cost
1W	one week
12M	12 months

Contents

I. SUMMARY

In 2006 Q3, the pace of disinflation accelerated markedly, with the 12-month inflation rate dropping to 5.48 percent in September, down 1.63 percentage points from the June level and one percentage point lower than forecasted in the August 2006 Inflation Report. This development was mainly due to the slower-than-expected growth of volatile prices and to the relatively more sluggish dynamics of administered prices. The deceleration in inflation was also ascribed to core inflation (corrected for indirect tax effects), the annual rate of which went down due to the favourable impact of tight monetary and fiscal policies that also improved inflation expectations, amid stronger competition in the retail market associated with a more resilient aggregate supply. The influence of these factors was confirmed by the annual inflation rate, which continued to fall, reaching 4.8 percent in October 2006.

Nevertheless, the inflationary potential of demand remained high, given that the economy continued to expand at a fast pace in 2006 Q2, posting an annual growth rate of 7.8 percent against 6.9 percent in 2006 Q1, and actual GDP was still above potential GDP despite the upward revision of the latter. Although the driver of economic growth was household consumption (12.7 percent), fuelled mainly by fast growing wages as well as bank and non-bank loans to households, it was sustainably complemented in 2006 Q2 by a similar growth rate of gross fixed capital formation (12.2 percent), which is expected to contribute to the expansion of aggregate supply in the period ahead.

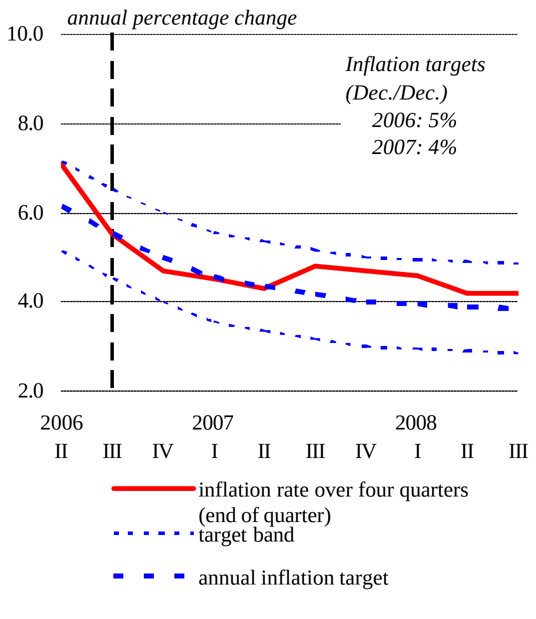
Against this background, at the beginning of 2006 Q3, monetary policy tightened through the implementation of the measures taken by the NBR Board in late June, namely to raise the monetary policy rate by a quarter of a percentage point and to increase by 4 percentage points the reserve requirements on RON-denominated liabilities with maturities of up to 2 years. During July-September, the monetary policy rate was maintained at 8.75 percent. This proactive decision of the NBR Board was primarily substantiated by the anticipation of an annual inflation rate falling below its forecasted year-end level; the significant increase in the restrictiveness of monetary conditions induced by the higher real monetary policy rate – amid faster disinflation in 2006 Q3 – was only temporarily alleviated by the slight real depreciation of the domestic currency versus the euro against the previous quarter. Another reason for the interest rate policy decision was the time lag needed for the full transmission of the effect of previously adopted monetary policy measures, as the NBR Board opted for closely monitoring economic developments, including the effects of its recent policy measures, in order to be able to take prompt action in the event of a potentially substantial increase in demand-pull inflationary pressures calling for a recalibration of monetary policy parameters. During the considered period, the National Bank of Romania continued to exercise firm control over money market liquidity by systematically mopping up excess liquidity via open-market operations.

The baseline scenario of the current forecast of medium-term macroeconomic developments shows an improvement of the inflation outlook in the first part of the forecast horizon, with the projected annual inflation rate for December 2006 falling below the mid-point of the inflation target, i.e. around 4.7 percent; the substantial downward revision (by about 1.4 percentage points) of the previous year-end inflation forecast is largely due to incorporating the favourable effect of the sharp decline in the dynamics of volatile food prices during 2006 H2. The relative alleviation of inflation expectations during 2006 H2 will help the disinflation trajectory fall below the previously forecasted level throughout 2007 Q1-Q3. By contrast, in the second part of the projection horizon, the annual inflation rate is expected to be higher than previously forecasted amid the action of adverse factors. These include larger and more persistent pressures exerted by the relative increase in excess demand in the first three quarters of the projection horizon, also as a result of fiscal policy easing, and a stronger impact of adjustments in administered prices and some indirect taxes. Against the background of lower inflation expectations, the annual rate of

CORE2 inflation for most of the projection horizon is expected to be lower than forecasted in the August 2006 Inflation Report. Deceleration of CORE2 inflation will also be underpinned by the gradual narrowing of the output gap under the impact of persistently tight monetary conditions; this indicator should fall into negative territory starting with 2007 Q3. The annual core inflation rate will be affected by the effects of higher excise duties on tobacco products, its downtrend being expected to post a short-lived reversal at mid-2008.

The balance of risks and uncertainties associated with the current projection of macroeconomic developments continues to be clearly biased towards factors that may slow down disinflation. Similar to the previous forecasting round, one of the major risks causing aggregate demand to exert higher inflationary pressures is the possibly larger-than-anticipated fiscal policy easing in 2007. The sharper expansionary stance of fiscal policy might arise from both larger-than-projected widening of fiscal deficit because of revenue undershooting and the change in the structure of public spending, by raising current (consumption-related) expenditures to the detriment of capital (investment-related) expenditures. In 2007, demand-pull and cost-push inflationary pressures could be additionally fuelled by the possibly higher-than-projected wage increases in both public and private sectors. This risk is heightened by the recent labour market tightening, especially as regards skilled staff. The likelihood of these risks to materialise is higher in the case of early elections within the forecast horizon. Aside from larger inflationary pressures, the overly high domestic demand might entail an unsustainable widening of the current account deficit, whose potential correction would reignite inflation and/or increase, over the medium run, the cost of disinflation in terms of economic growth. The risk that inflation rate may deviate from the projected trajectory is heightened by the uncertainties surrounding the magnitude and the calendar of administered price adjustments, the schedule of aligning indirect taxes to the levels stipulated under the agreements concluded with the EU, as well as the dynamics of volatile food prices.

Inflation Forecast



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

The assessment by the National Bank of Romania Board of the assumptions and results of the updated projection of macroeconomic developments has underscored a stronger effect of the action of some potentially inflation-generating factors, on both demand side and supply side, in the upcoming quarters; such an impact makes it even more difficult for the National Bank of Romania to attain its medium-term inflation targets. From this perspective, the National Bank of Romania Board shows concern over the major inflationary risks induced by the increase in projected excess demand in the near term – due largely to fiscal policy easing in the period ahead – and by the further significant adjustments in some administered prices and hikes in some indirect taxes during the projection horizon. In this context, the National Bank of Romania Board has decided to maintain the monetary policy rate at 8.75 percent per annum and continue to pursue a firm control over money market liquidity. Moreover, the Board has decided to maintain a restrictive monetary policy stance for a longer time-span, also as a measure aimed at offsetting some unexpected slippages of wage and fiscal policies. In addition, the National Bank of Romania 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 pose risks to disinflation.

II. INFLATION DEVELOPMENTS

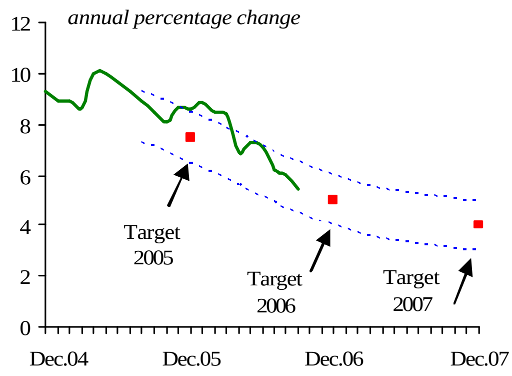
During the third quarter of 2006, disinflation continued at a pace much faster than expected under the National Bank of Romania's forecast presented in the August 2006 Inflation Report; the 12-month inflation rate stood at 5.48 percent at end-September 2006, 1.63 percentage points below the mid-year figure and one percentage point beneath the projected level. The annual growth rates of administered prices and CORE2 inflation, calculated by eliminating the influence of indirect tax changes, decelerated slightly, yet the driver of disinflation was the larger-than-expected, persistent deflation seen in the case of fruit and vegetables, mostly as a result of this year's bountiful crops.

In 2006 Q3, the annual inflation rate declined markedly and moved within the target band for the entire period under review, after staying above its upper bound in May and June. In September, the 12-month CPI slid into the lower half of the target band for the first time ever.

The main driving force for disinflation was the performance of volatile prices, whose annual rate of increase slowed considerably (7.93 percentage points to 3.07 percent). As a matter of fact, the third quarter of 2006 is the very first three-month period since August 2005 (when the National Bank of Romania switched to inflation targeting) at the end of which the annual pace of increase of volatile prices falls below the average level. This performance was mainly due to cheaper vegetal products (down 17.48 percent in July-September) against the backdrop of a bumper agricultural year. Another favourable development was the moderate monthly growth rate of fuel prices (between 0.4 percent and 0.7 percent) thanks to lower world oil prices; given the significant base effect (associated with the steep increase in oil price in the same year-ago period), fuel prices posted an annual growth rate of 2.64 percent in September 2006, down 3.67 percentage points over June 2006.

Administered prices, the key driver of second-quarter progress in disinflation, posted a far slower reduction in their annual growth rate (-0.64 percentage points, September/June 2006). The increase in monthly Romtelecom subscriptions (by 8.56 percent starting mid-August) offset to a large extent the positive impact of developments recorded by prices for energy, railway and city transport, water, sewerage, sanitation, even though the price rises displayed by these groups were well below those witnessed in the same year-ago period and in the previous quarter.

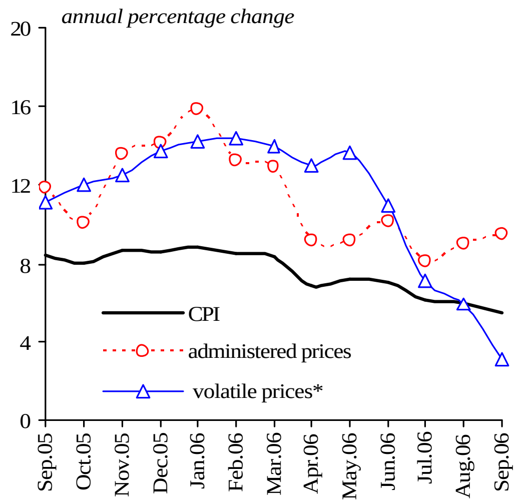
Inflation Developments



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		
	III	**IV**	**I**	**II**	**III**
Inflation Rate	**8.5**	**8.6**	**8.4**	**7.1**	**5.5**
Administered prices*	**11.9**	**14.2**	**13.0**	**10.1**	**9.5**
1. Non-food items*:	**14.4**	**14.1**	**15.9**	**11.4**	**8.4**
electricity	9.6	9.6	7.0	7.0	1.9
heating	12.0	20.0	20.0	20.0	20.0
natural gas	45.3	36.4	52.2	28.5	21.4
medicines	–2.4	–5.1	–5.5	–5.3	–4.0
2. Services*, of which:	**8.1**	**14.1**	**8.2**	**8.0**	**11.3**
water, sewerage, sanitation	25.6	25.8	24.8	24.9	20.3
telephony	–3.7	8.5	–3.4	–2.0	10.5
passenger railway transport	14.9	8.7	8.7	11.6	5.1
(passenger) city transport	23.2	23.2	20.5	12.1	7.1
Market prices (CORE1)	**6.7**	**6.7**	**6.6**	**5.8**	**4.3**
CORE2**	**5.5**	**5.4**	**5.2**	**4.7**	**4.9**

*) NBR calculations; **) CORE1 - volatile prices

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

CPI by Category of Products

annual percentage change; end of period

	2005		2006		
	III	IV	I	II	III
Food, alcohol, tobacco	6.4	7.6	6.9	6.3	4.7
Wearing apparel and footwear	4.1	3.9	3.8	3.8	3.8
Household appliances, furniture	4.5	3.6	2.8	2.1	1.9
Fuels	16.2	9.0	9.4	6.3	2.6
Utility expenses*	21.5	20.8	23.0	17.9	13.4
Healthcare	2.4	0.9	0.1	-0.2	0.0
Transport	20.9	19.8	16.6	11.7	7.0
Post and telecoms	-3.1	6.8	0.6	-2.1	4.2
Leisure and culture	7.4	7.8	7.0	7.1	5.8
Other goods and services	4.9	4.0	6.3	6.6	5.7

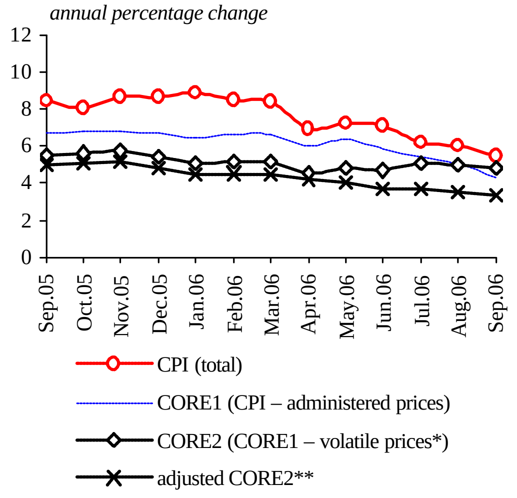
* rent, water, sewerage, sanitation, electricity, heating, natural gas

Source: NIS, NBR calculations

As for core inflation, the slight upturn in CORE2 component (at an annual growth rate of 4.85 percent in September against 4.69 percent in June) is no indication of higher inflationary pressures induced by consumer demand. The upturn was solely ascribable to the implementation of the last stage of 'vice tax' during July, when excise duties were raised, causing the annual growth rate of prices for tobacco and alcohol to quicken to 22.86 percent at the end of 2006 Q3. The effects of indirect tax changes left aside, core inflation declined steadily during the reported quarter, from 3.72 percent in June to 3.34 percent in September. Given the persistent excess demand, as shown by the positive output gap, the drop in adjusted CORE2 inflation can largely be attributed, similar to the previous quarters, to stronger competition in the retail sector, whose structure shifts rapidly as a result of steady increase in the share of chain stores in total retail trade (according to a research made by GfK Romania in September 2006, this share is expected to grow to about 50 percent in 2010, from 27 percent in 2005).

While in the previous three-month periods inflation expectations hampered disinflation, the bank survey conducted by the National Bank of Romania pinpoints that the third quarter of 2006 saw a trend reversal, with such expectations helping curb inflation. Thus, after deteriorating gradually until July, the expectations of annual inflation rate for December 2006 improved somewhat in August to reach 6.4 percent in September, compared with 6.9 percent in July.

Headline Inflation and CORE Inflation



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

**) the influence of vice tax is removed

Source: NIS, NBR calculations

At end-September 2006, 12-month inflation rate was one percentage point below the forecast in the August 2006 Inflation Report[1]. The deviation was generated mainly by overestimation of the rise in volatile prices, as the prices for "fruit" and "vegetables" fell at a much faster-than-projected rate during the summer months. Moreover, the deviation from the forecast was also underpinned by more favourable RON-EUR exchange rate movements (0.6 percent appreciation of the domestic currency[2] compared with the relatively steady trajectory incorporated in the forecast). By contrast, the quarterly changes in the other exogenous variables, such as administered prices, fuel price, net wages, were slightly above the forecasted figures (peaking at 0.9 percentage points in the case of administered prices as a result of the unexpected hike in monthly Romtelecom subscriptions).

[1] Effective data until March included.

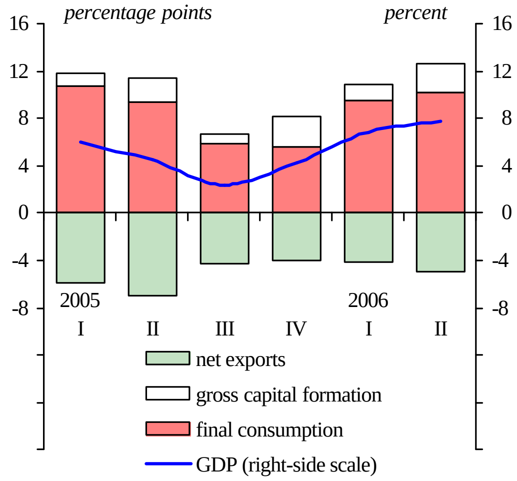
[2] September/June 2006.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2006 Q2, real GDP rose by 7.8 percent[3], 0.9 percentage points above the first-quarter figure and the forecasted figure released in the August 2006 Inflation Report. The growth pattern reverted to its features seen in 2005 Q1-Q4, as exports were no longer the fastest expanding component of aggregate demand. The improved GDP performance hinged on private consumption, slightly ahead of investment. On the supply side, the upswing strengthened in industry and agriculture; the former sector saw a consolidation of the upward trend in its annual growth rate and the latter sector rebounded after 12 months of successive declines.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

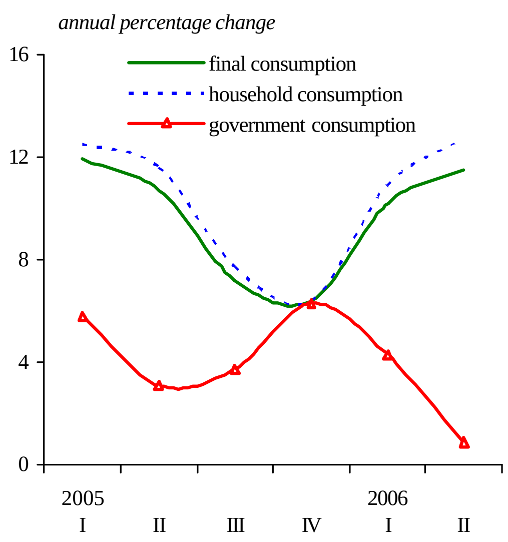
1.1. Demand

The second-quarter acceleration in annual GDP growth (0.9 percentage points) was driven solely by the key components of domestic demand, i.e. household final consumption and gross fixed capital formation. Conversely, the growth rate of government consumption lost momentum, stocks stayed on a downward path, whereas the negative contribution of net external demand to GDP growth widened amid the decelerating growth in exports of goods and services.

1.1.1. Consumer demand

The rate of increase of final consumption added 1.3 percentage points to reach 11.5 percent in 2006 Q2. Behind this development stood the pick-up in purchases of goods and services, which is indicative of consumer demand putting further pressure on inflation rate, a fact confirmed by the still fast growth of turnover of non-durables that hold the largest share in the CPI basket.

Actual Final Consumption



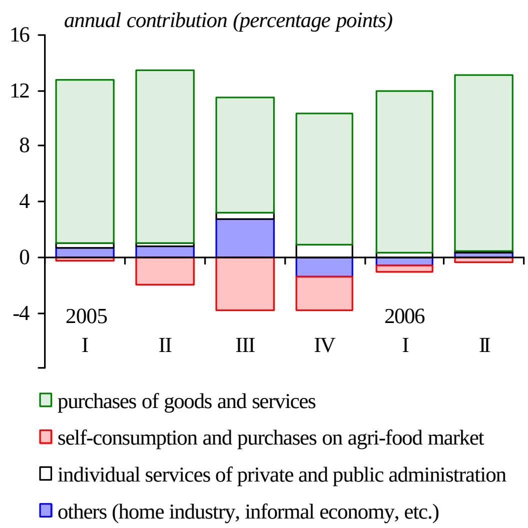
Source: NIS

Household consumer demand

The 12.7 percent acceleration in the growth rate of household final consumption was prompted by all components of household expenses, i.e. "household purchases of goods and services" (up 3.8 percentage points), "self-consumption and purchases on the agrifood market" (whose downtrend slowed by 4 percentage points, particularly due to the plentiful supply of

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

Household Final Consumption Growth



Source: NIS, NBR calculations

seasonal fruit and vegetables, while consumption of meat and eggs from own sources was severely hit by a new episode of bird flu) and "others"[4] (the growth rate of which rebounded after two quarters of successive declines). In contrast, the dynamics of expenditures for individual consumption by public and private administration lost momentum, most likely as a result of the base effect associated with the aids granted to families whose dwellings were damaged by floods in 2005 Q2.

Given the circumstances, the inflationary potential of consumer demand remained high in 2006 Q2, as indicated by the fast-paced turnover of non-durables (still at a rate exceeding 20 percent) and, to a smaller extent, by the speed-up of 7-8 percentage points in the annual growth rate of durables sales and market services (their influence on inflation rate is relatively low due to the small weights of these categories in the CPI basket). A stronger quarter-on-quarter performance in terms of volume also witnessed household outlays for utilities, transport, postal services and telecommunication, yet inflationary pressures fuelled by the rising demand were kept at bay, owing generally to supply-induced movements in such prices.

As surprising as it may seem, the faster growth pace of purchases of goods and services in Q2 was not matched by a similar performance of disposable income[5], the annual rate of which dropped to 2.5 percent from 4 percent in Q1. The explanation lies with the fact that the sharper real decline in inflows from abroad (from -7.5 percent to -13.4 percent), the root cause of the decelerating growth of disposable income, was entirely attributable to the base effect arising from residents' remittances destined to help their relatives afflicted by floods (in 2006 Q2, this component saw a real growth rate of 14.3 percent compared with the previous quarter). The performance was not replicated by consumption, as the funds were intended chiefly for investment, namely works for restoring the damaged households.

During the second quarter of 2006, the downturn in new short- and medium-term loans[6] granted by commercial banks

[4] Chiefly home industry, informal economy, imputed rent.

[5] Estimates based on the sum of total incomes from wages (net wages weighted by the number of employees), from budgetary and extra-budgetary sources (state social security, unemployment benefit, health insurance), remittances from Romanians working abroad and private current transfers by non-residents.

[6] 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).

continued (-11 percent, real change), hinting at a possible market saturation as regards consumer credit (partly due to the restrictions imposed by the National Bank of Romania). To counter this decision, large retailers and commercial banks moved to improve supply in terms of size and quality. Such measures encompassed the expansion of the commercial networks, the launch of promotional campaigns, the diversification of credit/payment instruments, rebranding included, softer lending terms and conditions offered by non-bank financial companies (particularly specialised consumer credit companies and leasing firms), etc.

Households' appetite for purchasing imported goods remained high in Q2 too, thus hurting domestic supply further. Even though the annual increase in domestic sales of non-durables doubled against the first quarter of 2006, the second-quarter figure (4.4 percent) was well below the import figure (about 18 percent[7]). A negative spread was also recorded between the growth rates of durables on domestic and international markets[8]. Motorcar purchases represented the only exception; their faster annual growth rate compared with the first quarter of 2006 owed to the halt of the decline in sales of Romanian-made cars[9]. This trend, associated with the slower dynamics of sales of imported goods, led to the strengthening of the progress manifest since the beginning of this year, i.e. the number of domestically-produced motorcars sold has outrun yet again that of foreign brands.

Government consumer demand

The annual growth rate of government consumption decelerated in Q2 as well, from 4.3 percent to 0.9 percent against the background of a slower dynamics of job creation in the public sector.

Budgetary developments

In Q2, the implementation of the budget was not among the main factors fostering demand as the primary surplus of the consolidated general budget remained at a level similar to that

[7] Estimates on the growth of physical volume of imports/exports use the unit value index in foreign trade as a deflator.

[8] In keeping with available data, in 2006 Q1 and Q2, the annual dynamics of domestic sales of durables, except auto vehicles (9.7 percent and 4.5 percent respectively) was less than half the growth rates of physical volume of imports recorded by three commodity groups in the Combined Nomenclature, which include durables, excluding motorcars (electrical machinery and apparatus, precision and optical instruments, etc., and various merchandise, where furniture holds the largest share).

[9] According to the Statistical Bulletin released by the Automotive Manufacturers and Importers Association.

in Q1 (0.8 percent of GDP) in spite of a relative narrowing of total surplus (from 0.7 percent to 0.4 percent of GDP). The annual growth rate in real terms[10] of revenues was relatively unchanged[11] (10.3 percent) compared to the first three months of 2006, whereas that of primary expenditures rose somewhat to 9.6 percent owing also to a base effect.

The base effect was manifest in capital expenditures whose annual growth rate stood at 49.7 percent in 2006 Q2 after a sharp fall in the same year-ago period. However, investment spending rose at a slow pace, the cumulative volume for the first six months accounting for only one fourth of the annual volume (provided for in the initial budget). A significant increase was detected in the annual growth rate of social security transfers (11.9 percent compared to 1.3 percent in Q1); nevertheless, the annual change of the total volume of transfers was on a slight downtrend compared to the previous quarter (from 6.3 percent to 5.2 percent). Furthermore, staff costs rose at a fast pace, i.e. 18.4 percent, although on a slight decrease compared to the first quarter of 2006.

In Q2, the rise in consolidated general budget revenues was bolstered by the significant expansion of revenues from the tax on wage and income (up 38.9 percent). Revenues from social security contributions continued to have a favourable impact on the dynamics of collections, as their annual growth rate accelerated 2.4 percentage points quarter on quarter to 9.5 percent given that the step-up in wage earnings and in the number of employees offset the impact of the decrease in 2006 in social contribution rates owed by employers. Likewise, VAT revenues picked up 11.4 percent; however, their growth rate was slower than that in the previous period (24.1 percent in the previous quarter and 29.0 percent – the average for the past four quarters) the rise in household purchases of goods and services in the reviewed period notwithstanding.

The third budget revision year to date was approved at end-August. Although the projected volume of revenues was raised by RON 1,747.3 million – mainly based on higher tax collections – the fiscal deficit target for 2006 was not lowered, as expenditures were increased by RON 2,176.5 million (0.7 percent of GDP). Thus, the projected budget deficit went up approximately RON 430 million, its share in GDP staying

[10] Unless otherwise indicated, percentage changes refer to the annual growth rate in real terms.

[11] The comparison takes account of the budget variables for 2005 Q1 and Q2, which were reclassified according to the new classification supplied by the Ministry of Public Finance effective in 2006.

nonetheless at 2.5 percent, as a result of the upward revision of the forecasted nominal value of this indicator.

The largest part of additional budgetary funds was channelled towards education in order to finance infrastructure investment (RON 715.4 million) and pay the wages of the teaching staff in the secondary school education (RON 400 million). Additional funds were also earmarked for social security (RON 563 million), the rural infrastructure development programme (RON 200 million), the reconstruction of flood-damaged areas (RON 200 million), as well as for the support of farmers (RON 130 million).

1.1.2. Investment demand

In Q2, gross fixed capital formation contributed as well to the increase in GDP growth rate. The acceleration of the annual growth rate of this indicator compared to the previous three-month period (0.8 percentage points to 12.2 percent) was also due to the developments recorded in Q2, when the quarterly growth rate of gross fixed capital formation reverted to positive values (8 percent[12]). In quarter-on-quarter comparison, capital investment witnessed an improvement in terms of quality, as the annual growth rate of equipment purchases rose by more than 6 times (18.1 percent), contributing the most to investment dynamics. Conversely, the volume of new construction works and that of capital repairs recorded much lower growth rates than in Q1 (11.1 percent and about 3 percent respectively, annual changes). This development is ascribable particularly to the infrastructure segment, most likely as a result of the slowdown in the works meant to remove the flood effects in the latter half of 2005.

Behind the expansion in retooling stood the raising of own financing resources – against the background of the upturn in industrial output and the strengthening of services sector – and of resources borrowed from the Romanian banking system, through leasing agreements, and from foreign banks[13]. Likewise, foreign direct investment made over the last few years and non-redeemable inflows (SAPARD, ISPA) continued

[12] Seasonally adjusted data.

[13] In Q2, the annual growth rate of loans for equipment purchases accelerated by more than 10 percentage points compared to the previous quarter to reach 52.6 percent (real change; data released by the Credit Risk Bureau); likewise, new medium- and long-term loans to legal entities on the domestic banking market went up by more than 50 percent. Financing through leasing agreements seems to have gained ground, considering that at end-H1 the share of "industrial equipment" in total portfolio of agreements concluded by LCAR (Leasing Companies Association in Romania) member companies rose to 9.2 percent compared to 4.7 percent in Q1. As for external funding, the annual growth rate of medium- and long-term corporate loans recorded a trend reversal compared to Q1 (up 35.2 percent, in real terms).

Investment

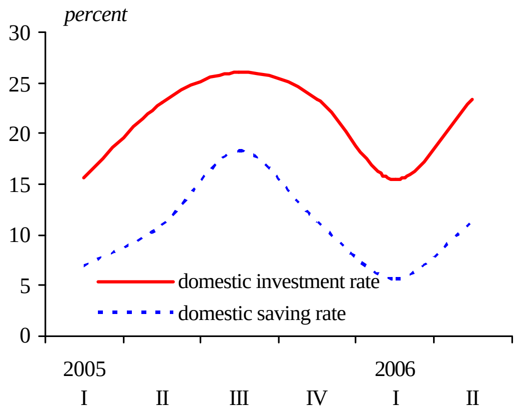
annual percentage change

	Year	I	II	III	IV
Total	2005	5.8	10.7	13.0	17.5
	2006	10.8	14.2		
- new construction works	2005	2.2	9.4	8.8	15.3
	2006	23.5	11.1		
- equipment	2005	9.6	12.8	15.7	15.7
	2006	2.9	18.1		
- others*	2005	–4.9	1.0	27.0	48.2
	2006	2.5	4.3		

* vineyards, orchards, afforestations, livestock purchases

Source: NIS

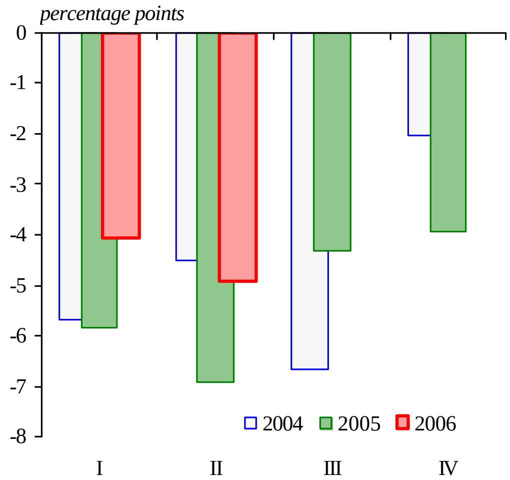
Investment Rate and Saving Rate



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

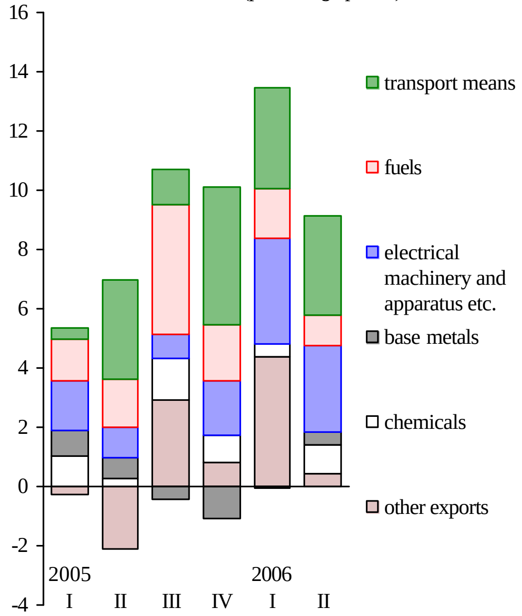
Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

Dynamics of Export Physical Volume

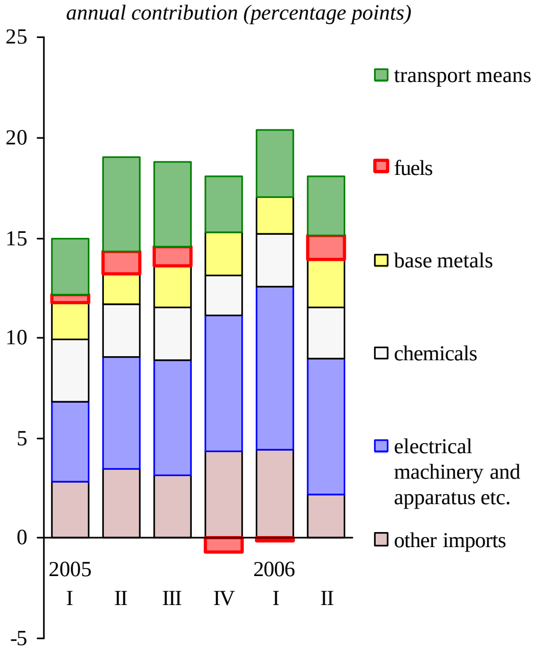
annual contribution (percentage points)



Source: NIS, NBR calculations

Dynamics of Import Physical Volume

annual contribution (percentage points)



Source: NIS, NBR calculations

to have an increasing contribution to retooling, being also boosted by Romania's forthcoming integration with the European Union.

As concerns real-estate investment, excess demand persisted into Q2 as well, in spite of the pick-up to 11 percent in the annual growth rate of residential and non-residential construction works.

The same as in the case of consumer goods, imported capital goods were increasingly preferred to domestic capital goods. Thus, whereas the dynamics of domestic supply of capital goods continued to see no rebound in the period under review[14], purchases of imported capital goods grew further at a fast pace (the physical volume of "mechanical and electrical machinery and apparatus" went up to 30.7 percent and that of "transport means" reached 27.5 percent)[7].

1.1.3. Net external demand

In 2006 Q2, the negative contribution of net external demand to GDP growth widened by 0.8 percentage points versus Q1 to reach -4.9 percentage points. The slowdown in the annual dynamics of exports of goods and services (from 13 percent to 10.5 percent) was by far more pronounced than that recorded by imports thereof (from 18.7 percent to 18 percent). The deceleration in the annual growth rate of exports was also due to developments in Q2, when the quarterly pace of increase posted the lowest reading over the past five quarters (1.1 percent compared to 3 percent in 2006 Q1[12]).

Trade balance data show a weaker performance of the physical volume of exports for most groups of goods[15]; the annual growth rate of "mechanical and electrical machinery and apparatus" recorded the strongest deceleration, i.e. +25 percent compared to +45.7 percent in Q1[7]). Nevertheless, this heading together with "transport means" continued to account for almost 86 percent of the increase in exports, being among the fastest-growing groups of exported goods in the reviewed period as well.

As for imports, their concentration stood further below that of

[14] After the slowdown in the annual growth rate in 2005 Q3 and Q4, in 2006 Q1, sales of capital goods for the domestic market went down for the first time over the past three years, their fall accelerating in Q2 (down 3.5 percent). The contribution of domestic manufacturers to retooling of the economy was even more modest considering the 4 percent dynamics of "road transport means" (included under "capital goods" according to the methodology for the classification of main industrial groups).

[15] Out of the total of 20 groups of goods, only five witnessed increases in the annual growth rate of the physical volume, namely "animal and animal products", "fats and vegetal or animal oils", "chemicals", "paper, cardboard and products thereof" and "base metals".

exports, since five groups of goods ("mechanical and electrical machinery and apparatus", "transport means", "chemicals", "base metals" and "fuels") accounted for more than 80 percent of the overall growth of imports.

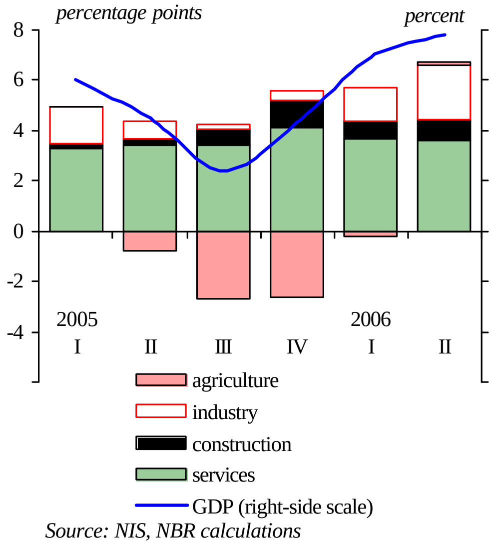
1.2. Supply

On the supply side, in Q2, the growth rate of gross value added in industry accelerated to 7.8 percent (one of the fastest paces of increase over the past 8 years), outpacing slightly that of services. The expansion of the industrial production was propelled by the main three sectors: mining, manufacturing and energy. Mention should be made that the fastest growing sub-sectors were: (i) food industry, which benefited over the past few years by the increasing foreign investments, due to investors being interested in the market potential and also by considerable funds granted via the SAPARD programme; (ii) metallurgy, whose upturn was due mainly to domestic demand from industrial and construction companies; (iii) electrical machinery and apparatus and (iv) road transport means. The significant growth rate of the last two sub-sectors was due particularly to exports, as the dynamics of the turnover recorded by export-oriented output continued to surpass by far the turnover recorded by domestic-oriented output (44.1 percent and 50.2 percent respectively).

In Q2, after four quarters of consecutive decrease, gross value added in agriculture expanded by 2.1 percent year on year. Nevertheless, mention should be made that this development was due solely to the drop in the intermediate consumption of the sub-sector. The output volume posted a slight decline, the pick-up in the vegetal output attributed to a base effect (the adverse weather conditions in 2005 Q2) being not large enough to offset the negative growth rate of animal output which was severely dampened by the bird flu recurrence.

The growth rate of gross value added in services accelerated to 7.5 percent, chiefly on the back of retail trade, transports, telecommunications, real-estate transactions and services to companies, whose annual growth rates of turnover were higher than in Q1. Although in the period under review gross value added in construction was lower than that in Q1[16], this sub-

Contribution of Main Supply Components to GDP Growth

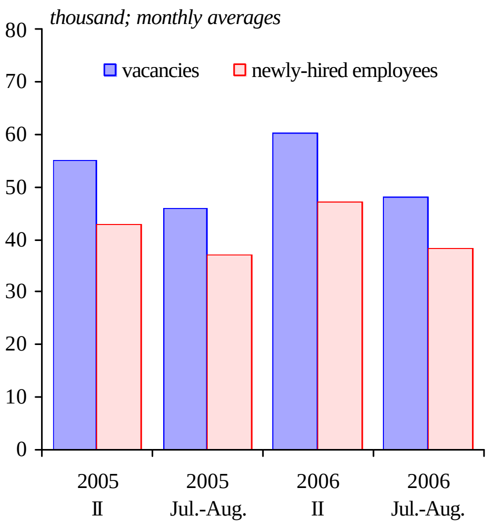


Source: NIS, NBR calculations

[16] In 2006 Q1, the record growth rate of gross value added in construction (20.4 percent) was due not only to the step-up in construction works in the aftermath of floods in the second half of 2005, but also to a base effect. This base effect (the severe slowdown in activity in the first months of 2005) was the result of: (i) cessation of works unfolded via the National Housing Agency (NHA) owing to the lack of funds; (ii) interruption of projects, mainly following the unclear legal status of some lands; (iii) the delay in concluding contracts as a result of both the recalculation of selling prices after the considerable appreciation of the RON versus the euro and the related renegotiation.

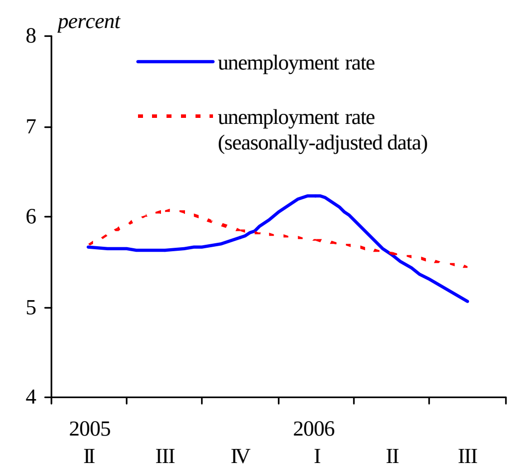
sector continued to witness a remarkable performance (14.2 percent). Behind this development stood particularly the construction of residential complexes (at present, the supply thereof focuses on meeting the demand from households with average incomes) and also of outlets, warehouses and office buildings.

Number of Vacancies and Number of Filled Vacancies



Source: NEA

Unemployment Rate



Source: NEA, NBR calculations

2. Labour market

2.1. Labour force

Pressures on the labour market remained high in 2006 Q2, and the statistical data for July and August indicate they are set to heighten further. Wages continued to increase at a brisk pace, yet across industry, substantial productivity gains contained competitiveness losses, allowing a marked drop in ULC.

In 2006 Q2, pressures on the labour market built up, due to the following: (i) seasonally-adjusted unemployment rate moved down to a minimum level of 5.6 percent; (ii) hirings from among the unemployed saw a threefold increase as compared to lay-offs; (iii) about 50 thousand job seekers did not renew their applications for a job (+11.6 percent from the same year-ago period; positive annual growth rate for the first time in the last 10 quarters), possibly opting for finding a job on their own or leaving to work abroad.

Pressures also arose from labour demand, the number of vacancies identified by the NEA and that of hirings made by the agency of this institution increasing to 10 percent from 2005 Q2. Similar to the prior quarter, the diversification of services played a major role in the absorption of workforce, while, in industry and construction, the number of employees kept decreasing. Despite staff adjustments, activity in industry and construction remained robust which is indicative of higher labour productivity.

Developments in 2006 Q3 illustrate the further narrowing of the labour market as compared to the prior quarter, with both registered unemployment rate and seasonally-adjusted unemployment rate posting sharp falls (to 5.1 percent and 5.4 percent respectively), while in July-August unemployment outflows saw the highest annual growth rate in the last couple of years. In this context, it is less likely that wage dynamics slow down in 2006 Q3 and that pressures on the consumption of goods and services ease as compared to 2006 H1.

2.2. Incomes

In 2006 Q2, gross average wage economy-wide further posted a fast annual growth rate (16.9 percent in nominal terms) due chiefly to incidental factors (Easter bonuses, monthly bonuses or profit sharing bonuses). Above-average percentage changes were recorded in the public sector and construction (by as much as 3.9 percentage points), associated in the case of construction with the difficulties employers encountered in recruiting properly skilled staff, amid expansion in activity and the migration of workforce abroad.

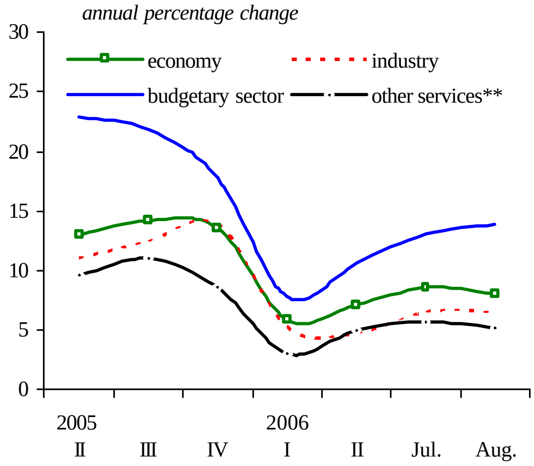
The annual change in gross wages across industry dropped 2.2 percentage points quarter over quarter, due solely to the performance in mining and energy sectors. Against this backdrop, ULC pressures kept easing – annual growth rate of +1.1 percent, 6.5 percentage points below the prior quarter's figure –, but substantial productivity gains made the largest contribution. Although the above-par value is indicative of pressures from this component of production costs, the large deviation from the growth rate of such costs (-10.5 percentage points) makes this influence less consequential (even on the wane as compared to the average values in the last four quarters).

The mining sector showed top performance (below-par ULC index), yet its sustainability is still uncertain given the high volatility of wages in the key sub-sectors. In manufacturing, the ULC index declined to 101.7 percent (106 percent in 2006 Q1), owing largely to accumulated productivity gains. It is however to be noted that in the consumer goods sub-sectors[17], the ULC variation remained above the average for manufacturing, while only food and furniture industries showed poor performance in terms of ULC.

The statistical data for July and August 2006 illustrate a setback in the performance of this indicator in mining and manufacturing sectors, but this development does not change drastically the expectations for 2006 Q2. The energy sector painted a much brighter picture as the ULC index showed below-par values for the first time over the past three years (98.5 percent).

[17] Tobacco products, light industry, printing, TV and radio sets, where ULC index climbed to 131.9 percent.

Net Real Wage*

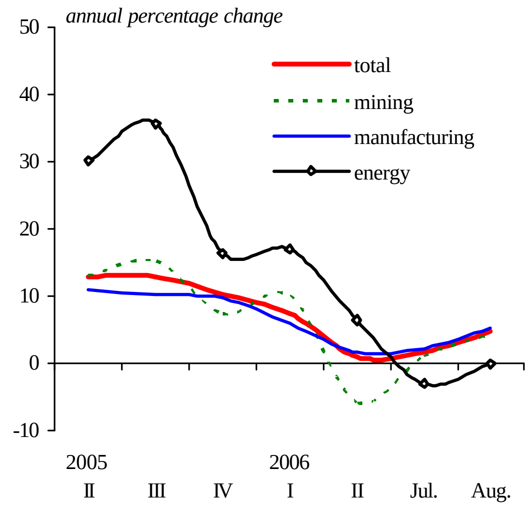


*) deflated by CPI

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

Source: NIS, NBR calculations

Unit Labour Costs in Industry



Source: NIS, NBR calculations

Labour Productivity and Real Gross Wage in Industry

annual percentage change

	2005			2006			
	II	III	IV	I	II	Jul.	Aug.
Labour productivity	3.2	3.7	7.0	8.6	13.2	13.5	10.0
Real gross average wage*	2.3	5.4	6.6	4.4	2.0	1.8	2.0
Real gross average wage**	13.8	16.5	15.9	7.8	4.0	3.9	1.8

*) deflated by industrial producer price index for domestic market

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

Source: NIS, NBR calculations

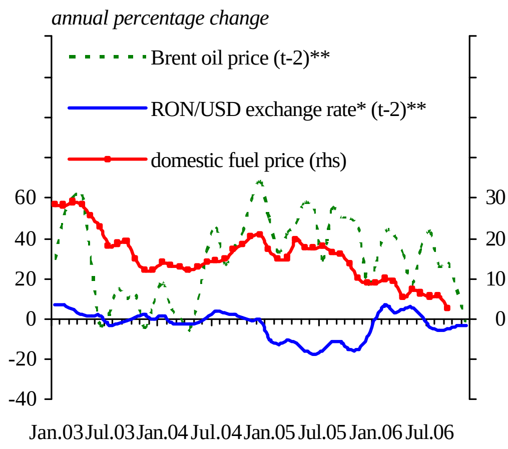
On the demand-side, although the real disposable income [18] of households (2.5 percent) saw the lowest annual growth rate in the last four years, it does not actually indicate the easing of pressures on the consumption of goods and services given that: (i) the annual dynamics of real wages stood high (8 percent) and (ii) the sharp fall in remittances from abroad (-13.4 percent) was induced by the presence of a base effect[19], current developments pointing to a 14.3 percent rate of increase in real terms from the previous quarter. A similar situation is also foreseeable for 2006 Q3 – statistical data for July-August indicate the considerable speeding-up of the annual growth rate of real disposable income (12.3 percent), bolstered by both wages and social transfers (7.9 percent) and the discontinuation of the negative trend recorded in 2006 Q1 and Q2 by the annual dynamics of remittances from abroad (+56 percent in real terms, provisional data).

3. Import prices and producer prices

Pressures brought about by both industrial and agricultural producer prices in the previous quarter dragged on into 2006 Q2; however, import prices showed favourable developments. The current trends appear to continue in Q3, except possibly for EU prices, which are expected to post swifter growth rates, and domestic agricultural prices, due to the favourable impact of bumper vegetal crops.

3.1. Import prices

Oil and Fuel Prices



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

Source: NIS, EIA

The pressures put by import prices on domestic prices eased markedly in Q2 compared with Q1, the deflator of imports of goods and services dropping 2 percentage points to 100.9 percent. Behind this development stood not only the strong deceleration in the growth rate of external prices (the unit value index of imports saw a virtual twofold decrease), but also the further strengthening of the domestic currency against the euro as compared with the same year-ago period.

In the period under review, the import prices[20] for most goods either declined markedly (prices for livestock and animal products) or posted annual growth rates slower than those in the

[18] Estimates based on the sum of total incomes from wages (net wages weighted by the number of employees), from budgetary and extra-budgetary funds (state social security, unemployment benefits and health insurance), remittances from Romanians working abroad and private current transfers by non-residents.

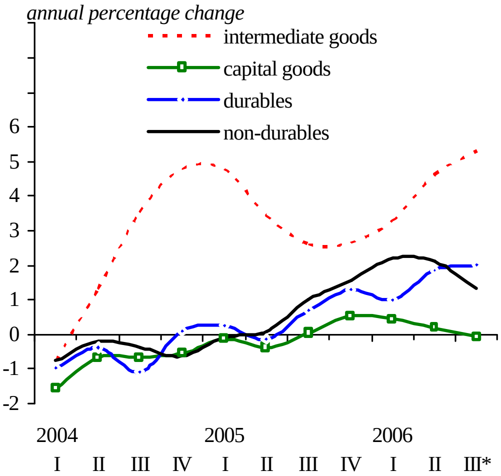
[19] Heavy floods in the spring of 2005 caused high financial inflows to Romania in the form of workers' remittances from abroad.

[20] Expressed in euro.

previous quarter (prices for mineral products[21], vegetal products, agrifood items, footwear).

The trends followed by external prices in 2006 Q2 seem to continue in the period ahead, due to the following: (i) the sudden drop in the oil price on world markets in September 2006[22], which offset the record highs in August so that the average for July-September remained similar to that for April-June, whilst the annual growth rate of the oil price decelerated to less than half and (ii) the further downtrend in the growth rate of the natural gas price. The aggregate price index of commodities calculated by the IMF also showed positive developments, as the Q3 figure (18.9 percent) was 13.1 percentage points below that seen in Q2. Upward pressures might be put on import prices for goods originating in EU Member States, as the annual growth rate of EU industrial producer prices for exports in July-August (2.3 percent)[23] stood 0.2 percentage points higher than the average for Q2.

EU-25 Industrial Producer Prices for Exports



Source: EUROSTAT *) July - August

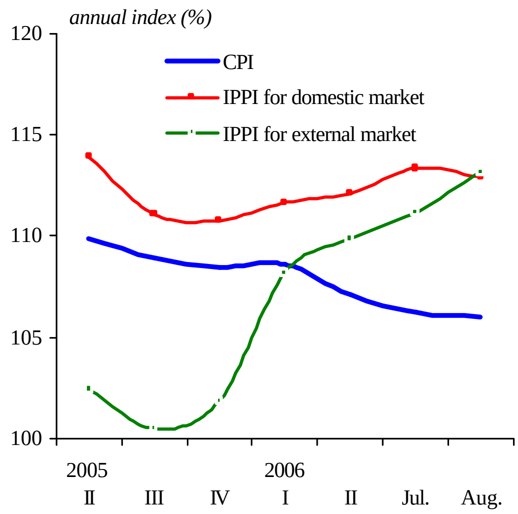
In July-September 2006, the favourable price movements on external markets were accompanied by the strengthening of the domestic currency against the US dollar (in both annual and quarterly terms). As concerns the RON/EUR exchange rate, domestic currency depreciated marginally in both quarter-on-quarter and year-on-year comparisons.

3.2. Producer prices

3.2.1. Industrial producer prices

In 2006 Q2, the annual growth rate of industrial producer prices for the domestic market advanced further to reach 12.1 percent; however, unlike the previous quarter, the 0.5 percentage point increase was due solely to developments in manufacturing, where prices added 1.7 percentage points to 11.5 percent. Under the circumstances, the gap between the annual growth rate of industrial producer prices for the domestic market in manufacturing and that of consumer prices widened more than three times compared with Q1 to 4.4 percentage points.

Consumer Prices and Industrial Producer Prices



Source: NIS

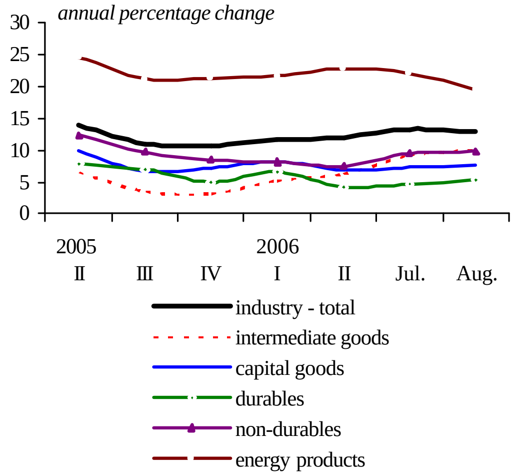
Producer prices for energy products saw the fastest annual growth rate (1.1 percentage points to 22.9 percent), solely on the back of price developments in the oil processing sub-sector

[21] Despite the heightened tensions in the oil market in 2006 Q2, prices for mineral products posted favourable developments due to the decelerating growth rate of the natural gas price and the weakening of the US dollar against the euro.

[22] To USD 58 per barrel (Brent oil).

[23] Based on the EU industrial producer price index for the external market (excluding construction and energy).

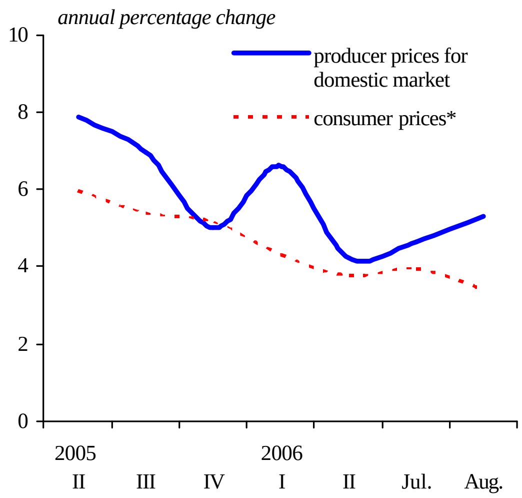
Industrial Producer Prices* by Main Group



* for domestic market

Source: NIS

Durables Prices



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

Source: NIS, NBR calculations

(up 13.4 percentage points); this hike was attributed mainly to: (i) the spike-up in world oil prices and the decision to bring domestic prices into line with international ones, owing to the decline in production and the expansion abroad of the distribution networks of the main domestic producers; (ii) the feeding through into prices of higher capital expenditures. The same as in the previous quarter, pressures were not generated by electricity and heating sub-sector, where the annual growth rate of industrial producer prices for the domestic market remained unchanged at 9.3 percent. In this latter case, the favourable developments of both prices and production might be interpreted as the first effect of the measures implemented in the past few years with a view to improving the activity of the sector.

In 2006 Q2, the annual growth rate of producer prices for intermediate goods added 1.1 percentage points to 6.2 percent as compared with Q1. This increase may be associated with price movements in metallurgy (up 5.3 percentage points), entailed by the expansion of external prices for base metals, which was only partly offset by the alleviation of pressures in the iron-and-steel sector.

Despite these circumstances, the growth rate of producer prices for durables decelerated by 2.4 percentage points against the previous quarter to 4.2 percent, owing to steel price developments and to lower domestic demand[24] in particular. Moreover, the demand for durables from external markets with high potential (Russia and the Baltic countries) allows the main domestic producers of household appliances to obtain higher profit margins from sales on these markets and pursue a looser pricing policy on the domestic market.

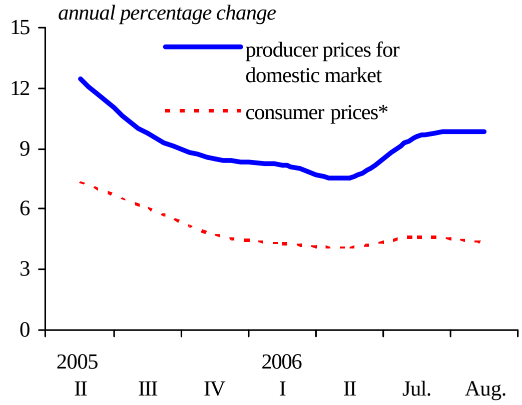
In 2006 Q2, although price developments on the external market remained unchanged, the growth rate of producer prices for capital goods decelerated by 1.5 percentage points, in contrast with the prior quarter, when it had accelerated as a result of the expansion in external prices for metals. This was possibly due to: (i) changes in the supply policy, including the raw material stock-building at lower prices in early 2006; this decision was also influenced by the difficulty in meeting the requirements of the external market; (ii) hedging against price fluctuations; (iii) moderate rise in domestic demand, as the volume of turnover for the domestic market continued to decrease compared with the same year-ago periods.

[24] The average annual growth rate of durables turnover for the domestic market slowed down 5.1 percentage points versus 2006 Q1 to 4.5 percent.

The growth rate of producer prices for non-durables – which hold a large share in the CPI basket – slowed down 0.7 percentage points versus the previous quarter, so that the gap between the growth rate of producer prices and that of consumer prices for non-durables narrowed by 0.4 percentage points to 3.5 percentage points. This trend, albeit generated by different factors, was largely accounted for by developments in food and textiles industries. While the impact of raw material costs (grains, meat) and labour costs was generally favourable in food industry, in textiles, this movement is mainly associated with strong competition on the domestic market and with producers' efforts to preserve their market shares, especially in the context of production restructuring following the liberalisation of international trade in textiles.

In July-September 2006, the current trends seen in the case of industrial producer prices for the domestic market are likely to remain unchanged, as the main pressure-inducing factors are not expected to undergo significant changes.

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, furniture, cultural and leisure products, fuels, electricity, gas and central heating, and other non-food items.

Source: NIS, NBR calculations

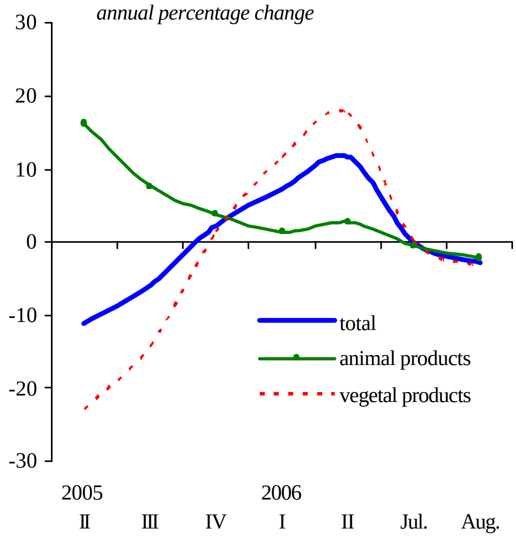
3.2.2. Agricultural producer prices

In line with expectations, the growth rate of prices for agricultural products accelerated further in 2006 Q2 (up 4.4 percentage points), particularly in the case of prices for vegetal products (up 5.8 percentage points to 17.5 percent). This development was accounted for by the slower growth rate of prices for grains, on the one hand, and by the fast-paced increase in prices for vegetables, on the other.

The annual growth rate of prices for animal products was further moderate in 2006 Q2 (2.8 percent), although it posted a twofold increase in quarter-on-quarter comparison. This development was largely driven by price movements in the poultry sub-sector amid the revival of demand, concomitantly with the gradual elimination of bird flu outbreaks (the growth rate of prices accelerated by more than 10 percentage points in June only). Nevertheless, no major inflationary pressures were caused, the more so as prices for animal products as a whole declined by 6.5 percent in quarterly terms.

In 2006 Q3, the growth rate of prices for agricultural products might record a trend reversal, associated mainly with the favourable developments in the vegetal sector, which might be supported by the performance in the grains and fruit and vegetables sub-sectors. As concerns animal products, heightened pressures in the poultry sub-sector might be further offset by favourable price movements in the other categories of the group.

Agricultural Producer Prices



Source: NIS

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

Implementation of the measures adopted by the NBR Board at end-June 2006, i.e., to raise the monetary policy rate by 0.25 percentage points and to increase the minimum reserve requirements on RON-denominated liabilities by 4 percentage points, enhanced the monetary policy restrictiveness in Q3. However, during this period, tightening of real monetary conditions induced by movements in the effective exchange rate of the RON subsided temporarily given that the domestic currency depreciated slightly in real terms compared with the previous quarter[25].

Following the decisions of the NBR Board taken in its meeting of June 27, 2006, i.e. to tighten the interest rate policy and liquidity policy, the monetary policy stance grew firmer in Q3. Thus, starting with July 3, 2006, the bids for one-month deposits submitted to weekly auctions were carried out at a fixed interest rate of 8.75 percent. Moreover, starting with the 24 July – 23 August 2006 maintenance period, credit institutions raised by about 25 percent the amount of reserves kept with the central bank following the increase in minimum reserve requirements on RON-denominated liabilities to 20 percent. In addition, the NBR maintained firm control over money market liquidity by sterilizing excess liquidity via open-market operations.

The monetary policy rate was left unchanged during Q3, as the NBR Board considered that monetary conditions were adequate for keeping disinflation on a trajectory compatible with achieving the medium-term target. Behind this decision stood the anticipation of a lower-than-expected inflation rate for end-2006, mainly as a result of significant deceleration in the growth rate of volatile food prices. In addition, considering that the impact of monetary policy tightening (decided at end-June) became manifest with a lag – during the period, the effects fed fully through into the interbank money market only –, the NBR Board decided to vigilantly monitor macroeconomic developments and, implicitly, the effectiveness of its recent steps in order to identify immediately a prospective significant increase in demand-side inflationary pressures which would call for the recalibration of monetary policy parameters. Another

[25] Calculation based on average quarterly exchange rate of the RON.

argument in favour of keeping the monetary policy rate at 8.75 percent was the assumption of a possible increase in potential GDP during 2006; the NBR Board took into consideration this assumption given that in the last few quarters the development of headline inflation and CORE2 inflation respectively differed from that of the positive output gap forecasted by the central bank. This assumption has been recently confirmed by the results of quantitative assessments and by the new analyses performed by the central bank (see the Box "Growth rate of potential GDP" in Chapter V. *Inflation outlook)*.

However, the primary concern of the NBR Board was further the persistency in the period ahead of too fast a pace of economic growth – also fostered by the easing of fiscal policy expected for the end of 2006 –, as indicated by the projection of medium-term macroeconomic developments updated in Q3. The risk of persistency or even of an increase in excess demand over the short term and, implicitly, of the inflationary potential of economic growth has become even more conspicuous following the release of statistical data for Q2, which reflected a faster-than-expected GDP growth during this period (from 6.9 percent to 7.8 percent – see Chapter III. *Economic developments).*

Statistical data enhanced the NBR concern for the dynamics of household consumption whose faster-than-anticipated growth (annual growth rate of 12.7 percent, up 1.8 percentage points from the previous quarter) was the result of the rise in purchases of goods and services[26] – the domestic demand component with the greatest inflationary potential. The growth of this component dragged on into July and August; statistical data released subsequently pointed out faster annual growth rates of turnover of retail trade and services during this period. An additional matter of concern for the central bank was the fact that the increase in consumption kept up with the continuous uptrend in real annual growth rate of net average wage and with the expansion of loans granted by non-bank financial institutions, as well as with sharper decline in household net saving.

Thus, the dynamics of total loans granted by credit institutions to households remained high during July and August, with their average balance picking up 78.3 percent in real terms against the same year-earlier period (up 3.6 percentage points compared with the average annual growth rate recorded in Q2). However, the real annual growth of new loans to individuals decelerated in this period to 50.6 percent, down 14.6 percentage points from

[26] Annual change in purchases of goods and services increased by 3.8 percentage points in Q2 compared with Q1.

Q2, due solely to slower growth of RON-denominated loans. The development of RON-denominated loans was mainly influenced by a base effect (see Sub-section *2.3. Money and credit)* and also by the slight constraints imposed on lending, as certain interest rates and other lending rates on loans were raised due to the recent decisions to increase monetary policy restrictiveness. However, the size of these adjustments was relatively low given the short time-span that elapsed from the moment of adoption of measures, on the one hand, and the increased competition in the banking sector, on the other. Moreover, tighter constraints imposed by banks on lending appeared less likely to entail a significant slowdown in the speed of growth of RON-denominated loans to households over the short term; thus, this dynamics could be boosted temporarily by the new loans to households given that the steady increase in their wages make them somewhat more eligible for loans according to the creditworthiness assessment criteria[27] and that household demand for loans is less resilient to interest rates. Conversely, new foreign currency-denominated loans to households picked up strongly in July and August given that amid fierce competition on this market segment the average interest rate on new EUR-denominated loans has declined almost steadily during the last few months – reaching levels similar to those recorded at the end of 2005 –, despite the upward trend in interest rates on the international markets; the demand for foreign currency-denominated loans was spurred by active campaigns promoting loans granted in “non-traditional” currencies (Swiss franc, yen), at lower interest rates.

The average annual growth rate of RON-denominated time deposits of households was relatively moderate in July and August (11.5 percent compared with 19.4 percent in the same year-earlier period), albeit on a slightly upward trend compared with Q2; this behaviour was attributed mainly to the fast increase in wages and also to the rise in interest rates applied by some banks, as well as to the promotional campaigns aimed at raising longer term funds. However, the propensity for saving in foreign currency increased, with the balance of foreign currency-denominated deposits of households expanding at a faster annual pace in July and August (30.5 percent compared with 26.7 percent in Q2, when expressed in euro).

Behind the decisions adopted by the NBR Board during this period stood also the impact of RON exchange rate movements on monetary conditions, which became again restrictive in the latter half of the quarter under review (see Sub-section *2.2. Exchange rate and capital flows)*; thus, after registering a slower nominal depreciation against the euro in July, the RON

[27] Established in accordance with NBR Norm No. 10/2005.

appreciated by 0.6 percent in July-September (compared with a nominal depreciation of 1.2 percent in 2006 Q2). The trajectory of the RON/EUR rate was decisively influenced by market operators' expectations and by the increase in capital inflows of direct investment and borrowings, whose effect offset the impact of the widening of trade deficit.

Unlike the previous quarters, the inflationary impact of supply-side factors made the central bank focus on disinflation over a longer horizon, given that administered prices and volatile prices were set to increase slightly in the last part of the year after posting lower quarter-on-quarter growth rates[28] and, partly, lower-than-projected growth rates. Consequently, in September, the 12-month inflation rate decelerated to 5.48 percent, down 1.6 percentage points against June and 1 percentage point lower than forecast in the August 2006 Inflation Report. Faster deceleration in inflation contributed to the relative improvement of inflation expectations as reflected by the opinions expressed in business and bank market surveys. However, the improvement of inflation expectations was more visible over the near term while over the medium term the downward trend of inflation expectations compared with the NBR target was less salient.

Monetary policy restrictiveness increased at the beginning of Q3, the one-month deposit auctions – the main monetary policy instrument of the central bank – being conducted at a fixed interest rate of 8.75 percent starting with July (0.25 percentage points above the previus level). Simultaneously, credit institutions had to adjust their manner of managing resources in order to comply with the increase in minimum reserve requirements to 20 percent starting with the 23 July- 24 August maintenance period. Implementation of these measures coincided with a period when the autonomous factors of liquidity posted large seasonal fluctuations. As a result, interest rates on interbank operations were fairly volatile July through August, the average daily interest rates reaching as late as September levels close to that of the monetary policy rate. Strong increase in demand for reserves and the contractionary impact of the autonomous factors of liquidity resulted in the significant quarter-on-quarter drop in the average daily volume of liquidity-absorbing operations, the central bank continuing to mop up entirely the credit institutions' amounts bid at the weekly auctions for one-month deposits.

[28] During July-September, telephony services recorded the most significant price adjustments.

2. Financial markets and monetary developments

Interbank rates posted higher volatility in Q3, the rise in monetary policy rate at end-June feeding through into these rates at the beginning of July. However, the exchange rate movements were more even, the RON re-entering the nominal appreciation trend against the EUR starting with the mid-quarter. Liquidity across the economy expanded at a slightly faster pace, due mainly to further high growth rate of RON-denominated non-government credit.

2.1. Interest rates

Large fluctuations of liquidity on the interbank market – entailed by the raise of minimum reserve requirements on RON-denominated liabilities, on the one hand, and by the strong seasonal contractionary impact of the autonomous factors of liquidity and by overly cautious approach taken by credit institutions in managing their reserves during the period, on the other – contributed to an increase in volatility of interest rates on interbank deposits in the first part of Q3. Therefore, the effect of the rise in monetary policy rate at the end of June fed through into the interbank deposit rates at the beginning of July; the upward trend of the quarterly average rate which had been manifest in the first half of the year came to an end, and even declined by 0.3 percentage points to 7.7 percent.

Overnight rates declined markedly and relatively persistently at the beginning of the period under review, amid increased cautiousness of credit institutions in managing their liquidity in July. Banks chose to hold excess reserves in order to comply with the increased minimum reserve requirements[29] and to make significant quarterly payments to the Treasury. The substantial excess liquidity entailed the steady decline in overnight rates, which reached the level of the deposit facility rate at the end of the maintenance period[30]. Larger-than-expected absorptions of liquidity performed by the Treasury in July and the increase in credit institutions' demand for reserves in order to meet their minimum reserve requirements put the interest rates on interbank deposits on an upward course and thereafter made them remain significantly higher than the monetary policy rate. Against this background, credit

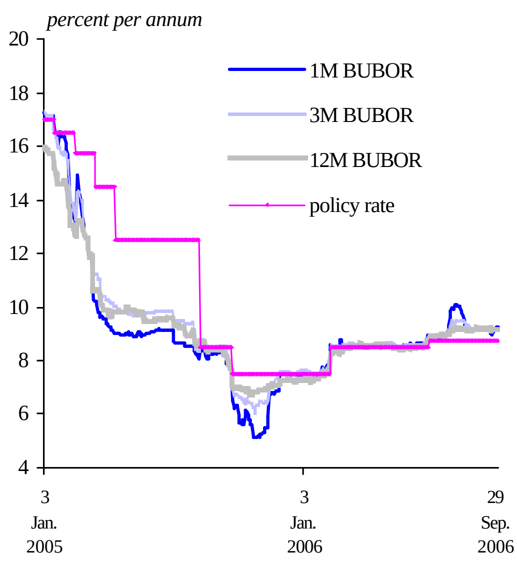
[29] An increase of 25 percent starting with 24 July-23 August 2006 maintenance period, as a result of the rise to 20 percent in minimum reserve requirements.

[30] Liquidity surplus was mopped up through the deposit facility, the amounts thus placed with the central bank reaching a 6-month high.

institutions' cautiousness in placing time deposits with the central bank had as a result the fast decline in the reserve deficit in the latter part of August and the opportunity for placing interbank overnight deposits; thus, overnight rates resumed their steep downtrend, coming close to the deposit facility rate[31] in the last few days of the maintenance period. In September, the fading effect of the shocks on liquidity across the banking system as well as the implicit change in the banks' behaviour triggered a relative stability of interbank deposit rates, which stood close to the monetary policy rate.

Consequently, overnight rates posted a significantly higher volatility during the period under review than in the previous quarter, although the band within which the average daily rates fluctuated narrowed slightly from 2.2-14.6 percent to 1.3-13.4 percent; against the backdrop of a temporarily higher uncertainty surrounding this context, the average spread between bid and ask rates for very short maturities increased.

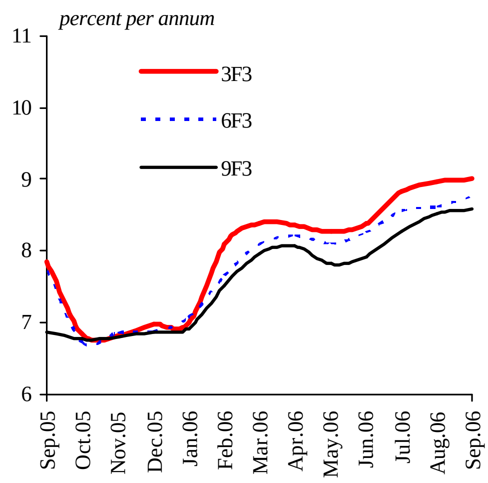
Policy Rate and BUBOR Rates



The increase in the policy rate impacted the (1M-12M) BUBOR yield curve, whose uptrend sharpened, as the average of these rates was 0.5 percentage points higher in September than at the end of the previous quarter. Longer maturities posted the most significant rises (+0.6 percentage points for 12M BUBOR rate), with the relative flattening out of the downward slope of the yield curve suggesting expectations of a slower decline in interbank rates in the next 12 months. Conversely, interest rates for shorter maturities, i.e. ON and 1W, dropped on average by 0.6 percentage points, as this downward adjustment may be viewed rather as a return to normalcy following the steep rise recorded in June.

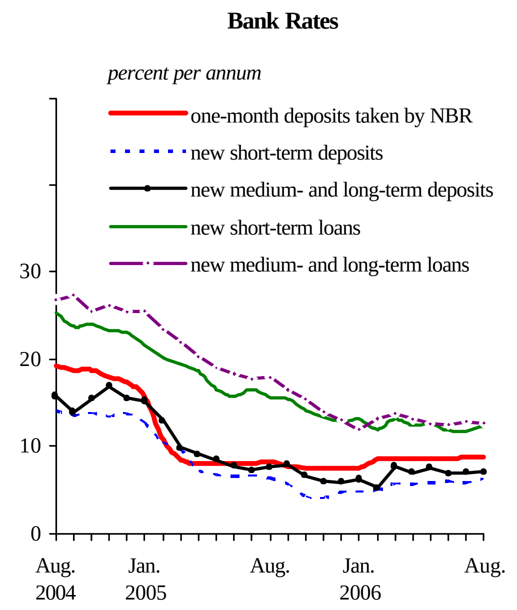
The implicit forward rates (calculated on the basis of September interest rates) hint at a relative softening of the forecasted downtrend in interbank rates. The 3M BUBOR rate is expected to stand at 9 percent at year-end (down 0.2 percentage points from the current level) and to decline further to 8.8 percent in March 2007 and to 8.6 percent at mid-2007.

Implicit Forward Rates



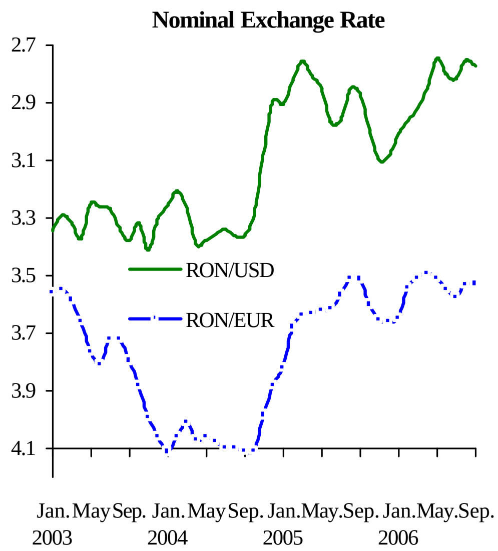
The same as in the previous quarter, the Ministry of Public Finance refrained from issuing any new government securities in Q3 too. The auctions for treasury certificates and T-bills scheduled for the reported period were cancelled, given that budget execution provided a comfortable level of holdings in the General Account of the Treasury and the value of government securities falling due was fairly low, i.e. approximately RON 29.3 million.

[31] The deposit facility was less resorted to by banks in August than in July 2006.



Banks' average interest rates on new deposits and loans to non-bank clients continued to exhibit divergent trends, reflecting the impact of tighter monetary policy measures, on the one hand, and the keener competition among banks, on the other. Thus, after declining for three consecutive months, the average interest rate on new loans posted a slight upturn during July-August; developments in lending rates followed the same direction for both categories of customers, yet the adjustment was more sizeable in the case of corporate loans. Bucking the trend were interest costs attached to new long-term household loans[32], which saw an overall downward drift, given that banks further promoted this product through all available means. Hence, the average interest rate on new household loans reached 12.97 percent in August, 0.3 percentage points lower than the May reading. Conversely, the average interest rate on new time deposits was rather volatile June through August, posting relatively frequent trend reversals; nonetheless, at the end of the reported period, it still exceeded the May figure by 0.4 percentage points. As far as the two categories are concerned, interest rates on time deposits followed the same direction, although deposit rates for companies witnessed the most significant changes; thus, their average level picked up 0.7 percentage points in August compared to May, while the average interest rate on time deposits for households inched up slightly (0.2 percentage points), reaching 6.13 percent at end-August.

2.2. Exchange rate and capital flows



In 2006 Q3, the exchange rate trajectory reached a turning point, with the domestic currency re-entering a nominal appreciation trend against the euro. The relative strengthening of the RON occurred against the backdrop of improved performance of the current account deficit, partly due to some seasonal and incidental factors, and its financing manner. The appreciation was bolstered afterwards by the favourable expectations of domestic forex market participants and of non-resident financial investors. During the period under review, exchange rate volatility diminished significantly[33], in spite of the last stage of capital account liberalisation on 1 September 2006, which failed to produce any noticeable effects on the forex market and implicitly on the exchange rates ruling in the market.

[32] Accounting for over 62 percent of new RON-denominated household loans.

[33] Although most currencies in the region saw a slowdown in their depreciation rate versus the euro in Q3, the Czech *koruna* posted the lowest exchange rate volatility, followed by the Romanian *leu*, the Polish *zloty*, the Slovak *koruna* and the Hungarian *forint*.

The upward trend of the RON/EUR exchange rate, which had started in the previous quarter, persisted only until July, when the domestic currency entered a somewhat abrupt strengthening, which slowed towards the end of the reported period. Thus, the nominal appreciation of the RON in the first nine months of 2006 exceeded slightly the level recorded in June, i.e. 3.7 percent (or 6.6 percent in real terms) against the euro and 11.3 percent (or 14.4 percent in real terms) against the US dollar. Calculated as an average annual change for 2006 Q3, the domestic currency witnessed the first nominal depreciation versus the euro for the last seven quarters (0.4 percent), leading to a further downward trend of real RON appreciation (5.4 percent). Conversely, the RON continued to strengthen versus the USD both in nominal and real terms (4 percent and 10.2 percent respectively).

The depreciation of the domestic currency against the euro continued into July, for the third successive month, albeit at a slower pace than in the previous month (0.7 percent compared to 1.2 percent in June). Although the trade deficit widened, the slowing depreciation occurred amid the considerable narrowing of the current account deficit[34] (thanks to favourable developments in the income and services balance) and the improved coverage of current account deficit through direct investments[35]. Although to a very low extent, another driver behind the deceleration in RON depreciation might also have been the favourable shift in investor sentiment towards emerging markets in the region, amid expectations of a likely pause in the series of hikes in the Fed funds rate and higher policy rates announced by most central banks in the area.

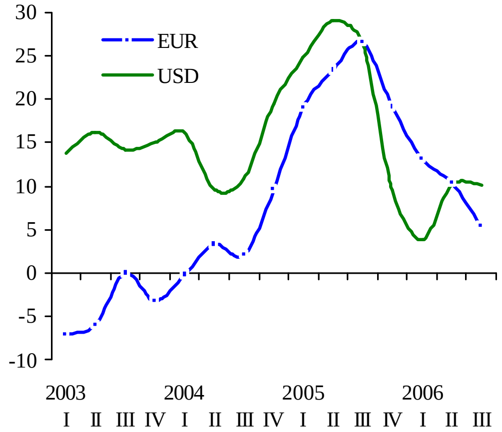
Against this backdrop, the trend reversal of the RON/EUR exchange rate became even more pronounced in August, when the domestic currency entered a relatively sharp appreciation path against the euro; this development was accompanied by a significant slowdown in the volatility of the RON/EUR rate, which dropped to its lowest level in the past thirteen months. The downward trajectory of the exchange rate was driven both by forex market operators' expectations – which improved further amid the anticipated seasonal rise in remittances from abroad and tourism receipts – and by the larger foreign currency-denominated liquidity held with credit institutions. The increase in liquidity might derive from direct investments and financial loans for short, medium and long term taken by

[34] Current account deficit hit its lowest reading since March.

[35] Over the first seven months, direct investments (current transfers included) covered 74.9 percent of the current account deficit (68.3 percent in the first six months). In July, the net balance of foreign direct investment reached its highest level for the past four months; hence, FDI surged 52 percent in the first seven months of 2006 compared to the same year-ago period.

Developments of RON Exchange Rate*)

annual percentage change



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

Source: NIS, NBR

Key Financial Account Items (balances)

EUR million

	2005 8 mos	2006 8 mos
Financial account	**3,336**	**5,617**
Direct investments	**2,762**	**4,333**
residents abroad	4	3
non-residents in Romania	2,758	4,330
Portfolio investments	**841**	**181**
residents abroad	273	91
non-residents in Romania	568	90
Other capital investments	**4,907**	**3,388**
of which:		
medium- and long-term investments	2,308	1,044
short-term investments	828	1,727
currency in circulation and short-term deposits	735	847

domestic banks. In these conditions, pressures exerted by the record trade deficit in August only led to a slackening of the RON appreciation pace, with the average RON/EUR exchange rate diminishing 1.3 percent from July.

The movements in the RON exchange rate were considerably influenced in September by the positive signals on the outlook for the Romanian economy[36] and by the favourable expectations of market participants. Against this background, but also due to the possible narrowing of the trade gap, the appreciation trend of the RON versus the EUR persisted into the early decades of September. As a confirmation of the higher correlation between the domestic forex market and its peers in the region, the abrupt change in investor sentiment towards these markets[37] temporarily fed through into the RON/EUR exchange rate in the last decade of the month; thus, the domestic currency eased 1.4 percent against the euro throughout 19-22 September. The ensuing swift recovery of non-residents' positions, also as a result of unexpectedly aggressive monetary policy measures adopted by some central banks in the area, had an impact on the RON/EUR exchange rate. Given this backdrop, the domestic currency regained some of the lost ground, the average RON/EUR exchange rate being similar to the figure recorded in August. According to expectations, the impact of completing the capital account liberalisation in early September was marginal, mainly due to the quasi-absence of short-term securities and the substantial drop in the differential between domestic and external interest rates.

In this context, it is very much likely that the influence of economic fundamentals and market participants' expectations on the RON exchange rate will prevail. Hence, in the short run, the potential influence exerted by the wider current account deficit in the period ahead is expected to be at least partly offset by the impact of still large flows from direct investments and financial loans[38]. However, given the increasingly obvious correlation between the domestic forex market and the ones in the region, the possibility of the RON exchange rate being impacted by a sudden shift in investor sentiment towards one or several markets in the region should not be ruled out.

[36] In early September, Standard & Poor's upgraded Romania's rating outlook to "positive" and the optimistic expectations that the European Commission would set 1 January 2007 as the date for Romania's joining the European Union were confirmed on 26 September.

[37] Amid political woes in Hungary and Poland and a possible risk of a slower pace of reforms in these countries.

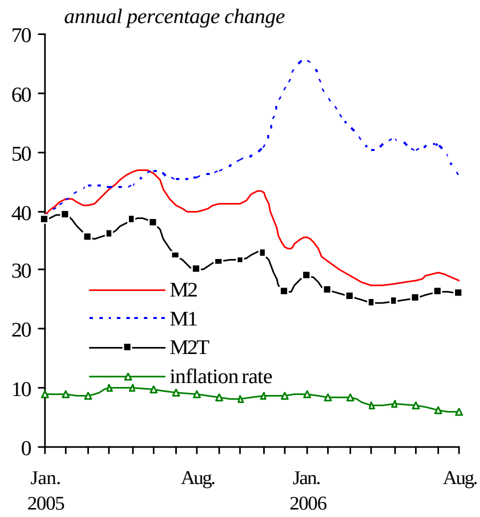
[38] Moody's announced on 6 October that it had upgraded Romania's sovereign risk to investment grade.

2.3. Money and credit

Money

In June-August 2006, the pace of increase[39] of broad money (M2) slightly gained momentum (20.8 percent compared to 19 percent in the previous quarter), reflecting mainly the upturn in economic activity in the first part of the year and the implicit rise in corporate and household incomes. Non-government credit remained on the increase, fuelled by relatively steady and low interest rates. The contractionary impact of net government credit on liquidity in the economy diminished, due mainly to the waning base effect induced by the municipal Eurobond issue launched in June 2005[40]. Conversely, the contribution of net foreign assets of the banking system to M2 expansion dwindled further (largely on the back of the slower rise in NBR's foreign investments), while "other net domestic assets" had a stronger contractionary effect on broad money. Behind the relative rebound in M2 dynamics stood the sharp upturn in household savings and corporate demand deposits.

Broad Money and Inflation Rate



Source: NIS, NBR

The growth rate of narrow money (M1) continued its downward path, albeit still above the relative increase in household and corporate deposits; thus, the share of M1 in broad money hit a 9½-year high of 29.9 percent, on average. In addition, the pace of increase of quasi-money accelerated for the first time after four quarters, amid a relative rebound in RON-denominated household savings; on the other hand, the dynamics of time deposits came to a relative standstill, while the growth rate of forex deposits lost momentum. Against this background, the composition of broad money improved, with the average share of forex deposits in M2 hitting a 7½-year low.

Annual Growth Rates of M2 and Its Components

real percentage change

	2005		2006			
	III	IV	I	II	Jul.	Aug.
	monthly average					
M2	29.3	28.6	21.5	19.2	21.9	20.8
M1	34.0	41.4	46.9	40.8	42.1	37.3
Currency in circulation	22.7	30.9	36.5	33.5	33.9	31.9
Demand deposits	47.3	53.0	57.8	48.8	50.7	42.4
Household savings	19.3	15.6	9.2	8.9	11.8	11.2
Time deposits	55.9	50.1	35.4	28.2	24.7	21.9
Foreign currency deposits	50.7	37.4	19.5	15.3	16.7	18.7

The pace of increase of household deposits accelerated considerably, as a result of the slightly faster rise in RON-denominated time deposits and the significant step-up in forex deposits; conversely, the rate of expansion of personal current accounts decelerated. Thus, demand for domestic currency for saving purposes remained relatively modest over the period; the annual growth rate of household deposits even witnessed a slowdown in August, after accelerating for three consecutive months, whilst the annual dynamics of household forex deposits touched a four-year high. During the period under review, the advance in household deposits was spurred by: (i) larger wage

[39] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2006.

[40] In June 2005, the Bucharest Mayoralty launched a Eurobond issue worth EUR 500 million, the funds thus raised being placed in the Romanian banking system.

earnings[41], (ii) the slight increase in interest rates on household deposits, (iii) the relative rise in remittances from abroad and (iv) the steady contraction of household holdings with the State Treasury. However, the increase in household indebtedness acted in the opposite direction, with the ratio between household deposits and household loans accelerating its decline.

The dynamics of corporate deposits remained unchanged from the previous quarter. Thus, the stimulative effect of (i) the step-up in economic activity, (ii) expansion of non-government credit, (iii) the hike in interest rates on corporate deposits and (iv) change in financial investment portfolio to the detriment of government securities holdings was alleviated by the effects of the uplift in imports, as legal entities resorted to significant net purchases of foreign currency during the reported period. Amid these developments, despite the step-up in the annual growth rate of corporate demand deposits, the pace of increase of time deposits[42] remained relatively steady. Conversely, the annual rate of increase of corporate forex deposits was halved also as a result of the base effect induced by privatisation operations performed in June 2005[43] (when corporate forex deposits posted a record annual growth).

Non-government credit

June through August 2006, non-government credit continued to post a strong increase, recording the highest growth rate[44] (47.2 percent) in the past two and a half years, amid opposite trends in RON-denominated loans (all-time record) and foreign currency-denominated loans (a 3-year low). Nonetheless, at the end of the reported period, the acceleration in the annual pace of increase of non-government credit came to a halt, on the back of the slower rise in its RON-denominated component (for the first time in the last 19 months); conversely, the annual growth rate of forex loans picked up slightly in August, for the first time over the last 15 months. By borrower, August saw a deceleration in the year-on-year rate of increase of household loans – mainly on account of a base effect induced by the tighter lending requirements on household lending imposed by the NBR as of September 2005 – and a relative standstill in the dynamics of corporate loans.

[41] The average growth rate of net real wage earnings came in at 8.2 percent June through August 2006, compared to 7.1 percent March through May 2006.

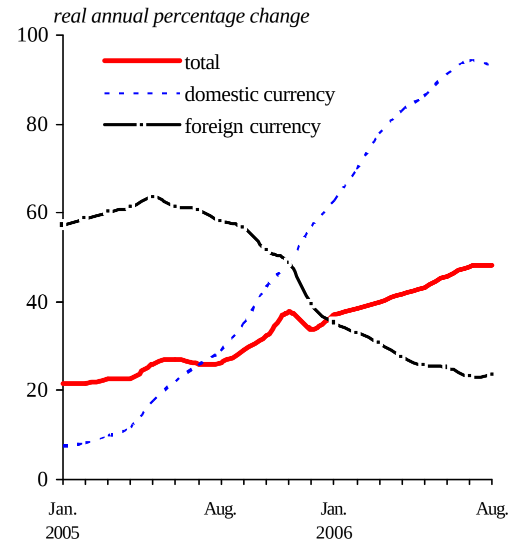
[42] Including restricted deposits, bonds and certificates of deposit issued.

[43] According to a press release issued by the Ministry of Economy and Commerce, revenues from the privatisation of Distrigaz Nord in June 2005 consisted of EUR 178 million for capital increase and EUR 125 million for the share package.

[44] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2006.

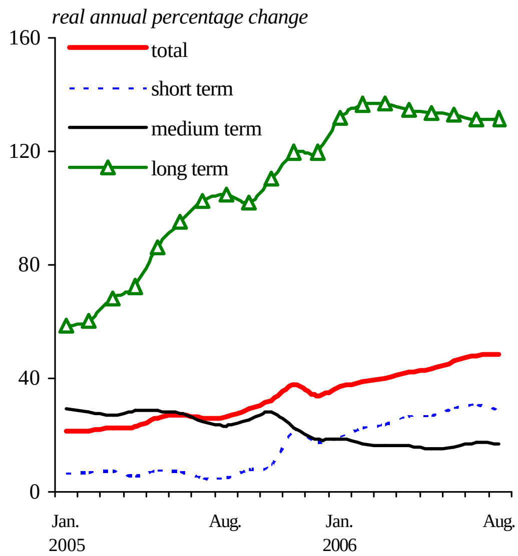
On the supply side, non-government credit was further spurred mainly by banks' increasingly favourable outlook on their clients' financial standing, the dwindling risk of adverse selection, fiercer competition among commercial banks, and the larger funds raised by credit institutions from foreign markets. In addition, given the restrictions imposed by the NBR in 2005 and with a view to boosting their supply of forex loans, some of the domestic credit institutions further resorted to capital increases largely on account of funds raised from parent undertakings[45]. Demand for non-government credit was fuelled by the still readily available loans, the speed-up in economic activity – particularly retail trade and industry – and further favourable expectations of clients concerning their future incomes. Residents' increased access to external financing is likely to have cooled down somewhat the demand for loans, especially foreign currency-denominated ones.

Non-Government Credit by Currency



Credit composition by currency continued to improve, with the average share of forex loans in total non-government credit hitting a 9½-year low. The slowdown in the growth rate of foreign currency-denominated loans during the period under review may also be explained by some credit institutions' increased propensity for transferring loans from their own balance sheets into those of non-resident banks, with a view to circumventing the constraints imposed by last year's NBR norms on forex loans.

Non-Government Credit by Maturity



Over the period, the upward course in non-government credit dynamics mirrored similar developments posted by both categories of borrowers. In case of households, RON-denominated long-term loans further recorded the fastest growth rate, thus holding the largest share in total household loans. However, the dynamics of this component tended to decelerate during the reported period, being offset by the brisker pace of increase of RON-denominated short-term loans. Similarly, the rate of expansion of long-term loans denominated in domestic currency remained the highest in case of corporate loans, despite a certain deceleration from the previous quarter in favour of RON-denominated loans with an agreed maturity of up to five years.

[45] According to balance of payments data, non-residents' net direct investment in domestic banks accounted for almost 80 percent of the total capital flow, compared to only 54 percent in the first five months of the year.

V. INFLATION OUTLOOK

The baseline scenario of the projection places the 12-month inflation rate at 4.7 percent for end-2006, close to the announced target. The 1.4 percentage point downward revision of the August projection (6.1 percent) is mainly due to the favourable and sizeable shock related to food price dynamics, with volatile food prices posting a marked deflation (down 12 percent) during Q3.

According to the projection, the significant acceleration of disinflation during 2006 will cause inflation expectations to decline compared with the previous forecast. This will contribute to keeping inflation during the first three quarters of 2007 below the previously projected trajectory. At end-2007 and in the first half of 2008, the projected inflation rate will be higher than previously forecasted under the impact of several adverse factors. These include: initially higher and more persistent excess demand pressures compared with the previous forecast and a stronger inflationary impact of administered price adjustments and of increased excise duties on tobacco products (in 2008).

In order to avoid a reversal of the disinflation trend during the projection horizon, the influence of the aforementioned factors have to be counteracted by eliminating excess demand and inducing a temporary demand deficit starting with the latter half of 2007. According to the projection, maintaining this equilibrium requires a tight monetary policy stance during the entire period. Both the highly positive real interest rates and the continuing real appreciation path of the domestic currency will ensure the restrictiveness of monetary conditions.

The main risks of deviation from the projected inflation path are generated by substantial uncertainties regarding the future stance of income and fiscal policies (these risks might be significantly augmented in the event of early elections), the critical level of the current account deficit, beyond which a possibly emerging shortage of capital inflows from non-resident investors may induce depreciation pressures on the RON, the calendar as well as the first and second-round effects of adjustments in administered prices and indirect taxes with significant impact on inflation, the fluctuations of international prices of oil and natural gas and the way they are incorporated into the domestic prices of fuels and energy as well as the shocks that may affect highly volatile food prices.

1. The baseline scenario of the forecast

1.1. Inflation projection

According to the baseline scenario, the annual consumer price inflation is projected to stay within the target band over the forecast horizon, reaching 4.7 percent at both the end of 2006 and the end of 2007. Under the working hypothesis of an average agricultural year in 2007, temporary acceleration in inflation during 2007 Q3 is due to a higher base effect induced by the decline in volatile food prices during 2006 Q3.

Table 5.1. Annual inflation rate (end of period)

Period	Q4 2006	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008
Target	5.0				4.0			
Forecast	4.7	4.5	4.3	4.8	4.7	4.6	4.2	4.2

The inflation rate projected for the end-2006 is approximately 1.4 percentage points lower than anticipated in the August Inflation Report. This is primarily due to the discrepancy between forecasted[46] and actual inflation for the third quarter of 2006, which in turn was broadly explained by lower-than-expected dynamics of food prices, especially vegetables, fruit and eggs (termed as volatile food prices). Had it been possible to most accurately predict the July-September development of these volatile food prices, the end-2006 inflation rate forecasted in the August Inflation Report would have been approximately 0.8 percentage points lower.

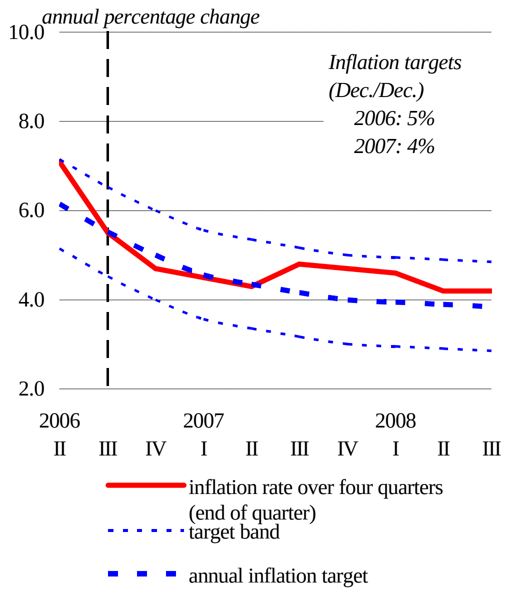
The recent drop in inflation to close-to-target levels should contribute, at least temporarily, to a faster decline in inflation expectations than in the previous projection. Additional inflationary factors are nevertheless leading to comparatively higher forecasts of the growth rate of consumer prices for the end of 2007 and the first three quarters of 2008. These factors include:

– faster economic growth in 2006 Q2, entailing a relatively higher projected output gap in 2006 Q3 and Q4, even though the growth rate of potential GDP has been revised upwards;

– a larger increase in the government's wage and pension bill within the projection horizon;

– faster inflation of administered prices than previously projected;

Inflation Forecast



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

[46] Considering the cut-off date for the forecast published in the August Inflation Report, the latest available inflation data was for June.

– higher anticipated changes in excise duties on tobacco products in 2008.

Annual CORE2 inflation at end-2006 is expected to be below that forecasted in the previous report. The main reason is faster disinflation in the third quarter of the year, which, besides showing the effects of prudent monetary and fiscal policy, can be attributed to the unexpected deflation recorded by food items other than fruit, vegetables and eggs. Over the projection horizon, the CORE2 inflation rate will loosely follow the output gap on its descending path, until mid-2008, when both indicators are projected to reverse course. In the case of the CORE2 price index, the temporary acceleration in 2008 Q3 is due to the anticipated sizeable hike in excise duties on tobacco products.

The decline of the output gap, starting from the forecasted positive level in 2006 Q4, is expected to be the result of higher real interest rates, a continuing real appreciation path of the RON, the administrative measures aimed at moderating non-government credit growth, as well as the temporarily restrictive impact exerted by the budget surpluses anticipated for the first three quarters of 2007. However, in the current baseline scenario, the trajectory of the output gap lies above what had been previously projected. This should be ascribed, on one hand, to the current year's faster economic growth compared to both the previous forecast and the estimated potential GDP growth, and, on the other hand, to the fiscal easing foreseen for the next year taken as a whole.

Administered prices are expected to exert the strongest inflationary impact among all exogenous factors. Under the current scenario, their projected annual growth rate is higher than previously anticipated throughout the projection horizon. The most substantial bouts of inflation stem from energy price adjustments against the background of the ongoing alignment of prices for gas from domestic production to import prices, on the one hand, and the incurrence of some important investment costs related to the modernization of the heating and the electricity distribution sectors, on the other hand.

Despite a projected increase in the November-December period, volatile food prices will most likely witness deflation in 2006. According to the baseline scenario, which assumes agricultural years ahead to rank as average, price growth for vegetables, fruit and eggs will resume over the next two years, at monthly levels slightly lower than those previously projected. Nonetheless, as the experience of this year shows, the uncertainties surrounding the evolution of such prices remain relatively high and they could negatively affect the predictability of disinflation.

According to the projection, the dynamics of fuel and import prices is anticipated to have a favourable impact on disinflation. Based on the assumption of no change in the price of oil from the average level for 2006 Q3 (USD 65.6 per barrel of Brent oil) and on the expected developments in RON/EUR and RON/USD exchange rates, the baseline scenario points towards moderate growth of fuel prices over the projection horizon, with a stronger disinflationary impact in 2007. Nevertheless, high volatility in the world oil market means that risks associated to any oil price scenario will remain high, which calls for continued vigilance on the part of monetary policy. As for euro area inflation, the projections published in the Consensus Forecasts have been revised upwards. The anticipated impact on import prices is however moderate, mindful of the small magnitude of such revisions and the offsetting influence of the continuing real appreciation of the domestic currency.

1.2. Exogenous inflationary pressures

The scenario used in the previous Inflation Report for projecting the future developments in administered prices was updated with the latest information provided by the representatives of the regulatory authorities in the field. Based on this information, administered prices are expected to post an annual increase of 9.3 percent in 2006 (compared to 7.4 percent in the previous projection), 7.4 percent in 2007 (compared to 7.1 percent) and 6.7 percent in 2008 (compared to 6 percent). These upward revisions originated in changes of magnitude and quarterly distribution of energy price adjustments. For 2006 Q4, the 3.23 percentage point difference between the growth rates of administered prices used in the scenarios underlying the November and August projections is primarily driven by the following:

– part of the 8.5 percent correction previously foreseen for the natural gas price will be applied in November 2006 instead of January 2007. Under the circumstances, the annual growth rate envisaged (December/December) changes from 23.2 percent to 33.5 percent, with its contribution to CPI inflation rising from 0.61 percentage points to 0.89 percentage points;

– earlier implementation of the 4.72 percent hike announced for the electricity price (in December 2006 instead of January 2007). As a result, the annual change in the price of electricity (December/December) is up from 1.91 percent to 6.72 percent, while its contribution to CPI inflation will probably rise from 0.1 percentage point to 0.35 percentage points;

– the unexpected 8.6 percent rise of Romtelecom subscriptions in August. Thus, the annual growth rate (December/ December) is expected at 6.62 percent (from -0.74 percent) whilst the contribution to CPI inflation should reach 0.21 percentage points (from -0.02 percentage points).

While the new scenario with respect to the price for natural gas basically assumes passing some of the price increases planned for 2007 on to the last months of the current year, the annual growth rates of electricity and heating prices were also subject to upward revisions[47]. The additional hikes in the electricity price are driven by some increases in the costs related to the amortization of investments foreseen by the privatised electricity distribution companies. Changes of higher magnitude expected in the heating prices are also prompted by the carrying out of rehabilitation works of coal-fired power plants and distribution networks.

Table 5.2. The scenario for developments in administered prices (percent)

	Natural gas			Heating			Electricity		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Previous scenario	23.2	23.4	17.9	5.0	5.0	5.0	1.9	5.6	5.6
Current scenario	33.5	10.3	17.9	6.0	10.0	8.0	6.7	7.1	7.1

Prices of vegetables, fruit and eggs are expected to follow a more favourable trend than in the previous projection, particularly for the current year. Despite the projected price increases over the following two months, volatile food prices are expected to record a decline in 2006 as a whole (December/December), following their prevailing downward trend for this year (prices of vegetables, fruit and eggs increased only in two out of the ten months to October 2006 for which data are available). Considering normal weather conditions, the outlook for 2007 points to a reversal of dynamics in the prices of vegetables, fruit and eggs, without however generating significant inflationary pressures, as the 12-month inflation rate for this category of prices is not expected to surpass the forecasted annual headline inflation. In 2008, volatile food prices are projected to post a moderate annual increase, as a result of the complete fading of the base effect of the 2006 deflation.

Similarly to the August Inflation Report, the oil price is assumed to remain unchanged over the entire projection horizon

[47] The aggregated hikes in electricity and heating prices aggregated for 2006, 2007 and 2008 run at 22.4 percent (compared to 13.6 percent in the previous projection) and 25.9 percent (compared to 15.8 percent).

at its average level recorded in Q3. For 2006 and 2007, the baseline scenario encompasses increases of the **fuel price** at rates similar to those of the previous projection. For 2008, against the backdrop of a forecasted real exchange rate lower than in the preceding Inflation Report, fuel price inflation will accordingly record a relatively lower inflation rate[48].

Compared to the previous projection, the inflationary impact exerted by the **increases in excise duties on prices of cigarettes and tobacco products** was reassessed based on the following:

– recent evidence of a protracted impact on the cigarette and tobacco price index released by the NIS of the latest increase in excise duties (comprising also the vice tax);

– taking into account the changes in excise duties up to 2010 (as compared to 2007 in the previous projection); by that time, total excise duties must be brought into line with the excise duties set forth by the European Commission Directives[49], i.e. EUR 64 per 1,000 cigarettes.

Despite the fact that in 2006 excise duties on tobacco products (including here the newly introduced vice tax) were raised in excess of the respective entry in the official calendar of the alignment process, the remaining adjustments (from a total excise tax of EUR 29.31 per 1,000 cigarettes at present to EUR 64 per 1,000 cigarettes) were forecasted in accordance with their previous 2007-2010 schedule used by the Ministry of Public Finance. Thus, the highest price hikes generated by changes in excise duties are envisaged to be implemented in 2008 and 2009[50]. Building upon the experience of the current year, it is projected that the effects on prices due to each excise duty adjustment are spread over a period of several months, before and after the enactment effective date. The direct impact of these adjustments is projected to fractionally feed through into prices, similarly to the effects which were observed in April-September 2006 and taking into account the likelihood of

[48] The current projection also assumes increases in the fuel price owing to the pick-up in excise duties on leaded petrol and diesel oil in 2007 and 2008 respectively. Nevertheless, this is not expected to put too much pressure on inflation.

[49] Directive 59/1995, as subsequently supplemented by Directive 10/2002.

[50] The final rise in excise duties must equal EUR 64 per 1,000 cigarettes, the minimum level established by EU directives, until 1 January 2010 at the latest. Thus, the difference from the total excise duty level of EUR 51.20 per 1,000 cigarettes, to be implemented on 1 July 2009, would be covered by a hike which is to become effective either in the course of 2009 Q4 or exactly on 1 January 2010. The baseline scenario envisaged the latter of the two options to be more plausible, so that the statistical impact of the measure would affect the inflation rate in 2010.

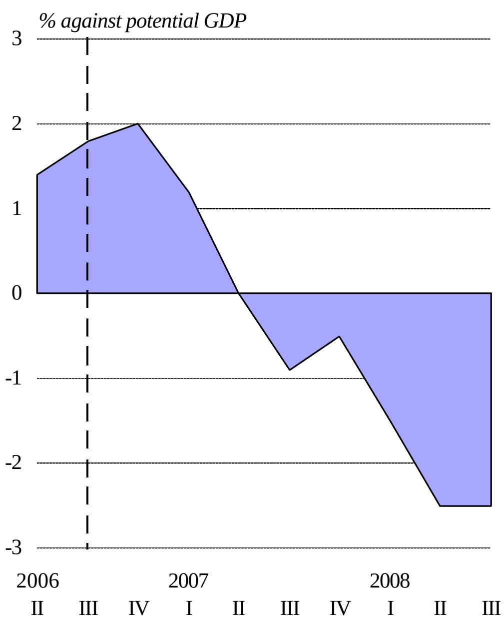
increasing price elasticity of the demand for these products as prices go up.

The forecasted inflation rate in the eurozone is slightly higher than that considered in the previous report, exerting an impact of rising import prices throughout the projection horizon. Compared with the survey made three months earlier, the analysts polled by Consensus Forecasts in September pointed to an inflation rate nearly 0.1 percentage points higher at the end of both 2006 and 2007. According to the assessments made by the European Central Bank's experts in the latest Monthly Bulletin[51], the rise in inflationary pressures in the current and the forecast periods is due to higher-than-expected commodity prices (energy products in particular), stronger-than-expected adjustments of administered prices and indirect taxes, higher volatility of unprocessed food prices and, last but not least, to stronger wage pressures.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

GDP Deviation



The officially released statistical data for 2006 Q2 show a significantly higher-than-forecasted growth rate of real GDP. NBR research results suggest that the recent acceleration of economic growth does not generate a similar increase in inflationary pressures, being accompanied by a temporary acceleration of the potential GDP growth rate[52]. Due to lags inherent to the monetary policy transmission mechanism, the excess demand mainly reflects the cumulated effect of the commercial banks' interest rates and the exchange rate in the previous quarters. The assessment of the impact of past interest rates and exchange rate developments remains unchanged compared to previous forecasting rounds. Consequently, the estimated value of the excess demand in the second quarter has not been revised compared to the August 2006 forecast.

In 2006 Q3, the economic growth rate[53] is expected to stay high, close to the levels recorded in the first half of the year. According to estimates, in 2006 Q3 excess demand increases only moderately compared to the previous quarter, contributing to the persistence of aggregate demand-induced inflationary pressures in the short run.

---

[51] ECB Monthly Bulletin No. 10/October 2006.

[52] See the Box on "Potential GDP growth rate", on page 44.

[53] Data on real GDP are seasonally adjusted.

As concerns real GDP components, in 2006 Q3 final consumption is estimated to remain above the last years' trend. The high level of final consumption is sustained by the past quarters' strong growth rate of households' final consumption. This is backed by increasing real disposable income, fostered by tight labour market conditions, visible in above-trend dynamics both in the case of number of employees and real net wages. The stimulating impact on aggregate demand is also sustained by the rapid increase of short and medium term credit to households. Additionally, the high growth rate of turnover volume indices of retail trade (excepting motor vehicles and motorcycles trade) is maintained over the first two months of Q3. On the other hand, the 1.7 percent of GDP budgetary surplus registered in the first 9 months of 2006[54], acted, *ceteris paribus*, in the direction of reducing aggregate demand-related inflationary pressures.

Gross fixed capital formation appears to stay above the medium term trend in Q3, being fuelled by, among other factors, rather easily accessible credit for economic agents. A sustained high growth rate of gross fixed capital formation is also indicated by the increased growth rate of economic agents' demand deposits and by the slightly higher share of capital goods in total imports.

Imports continue to grow at a fast pace, given the support provided by labour market conditions favouring increasing disposable income and rapid non-government credit growth. Meanwhile, although exports also display accelerated growth rates, they are still below the medium term trend. Thus, net exports contribute to reducing excess demand and, implicitly, ease inflationary pressures.

[54] According to Ministry of Public Finance data.

Box

Growth rate of potential GDP

The Potential Gross Domestic Product (GDP) is defined, according to Box 2 in the August 2005 Inflation Report, as the level of GDP that does not generate inflationary pressures. Excess demand, i.e. the difference between actual GDP and potential GDP, generates inflationary pressures because, ultimately, the response of aggregate supply translates partly into higher output and partly into aggregate price level increases.

As the measure of excess demand in the economy, the gap between actual and potential GDP is relevant for setting the monetary policy stance. Over the projection horizon, monetary policy aims to direct inflation towards the target by managing aggregate demand. In addition, the GDP forecasts throughout the projection horizon are based on the output gap resulting from the projection and on the medium-term potential GDP level.

The specifics of the potential GDP concept may vary with the time horizon considered. In the long run, potential GDP is determined by the institutional and structural features of the economy, i.e. demographic factors affecting the labour force, investment, total factor productivity, etc. This interpretation corresponds to the steady-state rate of economic growth in neoclassical models. This value usually changes over relatively long periods of time, and only as a result of significant lasting changes in the fundamental conditions of the economy.

In the medium term, the growth rate of potential GDP may deviate from its long run equilibrium level, to which it tends to revert after the effects of various temporary factors have faded. Inflows of foreign direct investment (including, in the case of Romania, the flows generated by structural funds that will be granted by European Union starting 2007), temporary labour force migration, variation in agriculture potential due to weather conditions[55] are among the factors that influence the medium term growth rate of potential GDP.

Potential GDP is not directly observable in actual real GDP data. Its measurement is a difficult task for any economy, and especially so for emerging economies, which are characterised by relatively frequent structural adjustments. Its value is inferred based on data regarding the developments in other observable macroeconomic variables, such as the inflation rate, the interest rate, the exchange rate, the unemployment rate, etc. Therefore, any potential GDP estimate is accompanied by a degree of uncertainty. This uncertainty has the strongest impact on recent periods, for which more accurate estimates can be obtained only after the revision of the initially released GDP figures and by incorporating information that is released with delay. Moreover, there are measurement issues specific to Romania, which only add to the existing uncertainties: the short sample of available data covers a period with frequent and distinct structural changes, and, also, it does not extend over a full business cycle.

Estimates regarding the level of potential GDP using several methods (production function, unobserved components filter, structural vector auto regressions) were carried out within the NBR[56]. The results show an accelerated annual potential GDP growth rate from 2000 onwards. During 2003-2006 Q2, the estimates point to a growth rate of potential GDP in the range of 5.5-6.4 percent per annum. These results suggest that the potential GDP growth rate for the period 2006-2008 will remain at around 6 percent.

[55] CORE2 inflation, i.e. the CPI component that is directly determined by excess demand, is defined by excluding volatile prices for foodstuffs – fresh fruit and vegetables, eggs (see Box 1 in the August 2005 Inflation Report).

[56] Forthcoming in NBR's Occasional Paper Series.

1.3.2. Implications of recent exchange rate and interest rate developments

The domestic currency depreciated in both nominal and real terms in Q3 against the average levels recorded in the previous quarter. The significant, yet short-lived, nominal depreciation which occurred at the end of Q2 due to the temporary shift in investor sentiment towards emerging markets had the strongest impact on the average exchange rate in the third quarter of 2006. Thus, although the exchange rate appreciated during the reported period, its average level remained above the previous quarter's reading.

The real depreciation recorded in 2006 Q3 led to a decrease of the restrictive effect exerted by the real exchange rate on the aggregate demand through the net export channel. On the other hand, given the wealth and balance sheet effects[57], RON depreciation entails higher foreign currency borrowing costs in local currency, which has a contractionary impact on aggregate demand in the following period. Thus, the cumulative effect of the real exchange rate through the two channels is restrictive and has an indirect contribution to the compression of demand-pull inflationary pressures. Exchange rate movements also influence domestic prices directly, as the nominal depreciation of the domestic currency boosts inflation via import prices.

Over the medium term, the exchange rate is expected to fluctuate around an appreciation path determined by fundamentals (the productivity differential against the major trade partners, medium- and long-term capital inflows). Taking into consideration the process of real economic convergence with the euro area, the RON undergoes a normal appreciation trend, manifest mostly in real terms. Hitherto, the last stage of capital account liberalisation, completed in September 2006, did not appear to have a noticeable impact on the foreign exchange market.

In order to offset inflationary pressures and bring inflation to the target within the forecast horizon, the NBR raised the policy rate in Q3[58] by 0.25 percentage points to 8.75 percent and continued the policy of substantial sterilisation of excess liquidity. Amid these developments, both the policy rate and the excess liquidity management policy have a restrictive effect on aggregate demand and hence on inflation.

---

[57] See the Box on "Wealth and balance sheet effects" in the November 2005 Inflation Report.

[58] The decision to raise the policy rate was taken on 27 June 2006, effective starting with 2006 Q3.

The NBR's policy rate affects the real economy mainly indirectly, through commercial banks' deposit and lending rates, as well as by the signalling effect on inflationary expectations. Lending rates continued to decrease despite the NBR's increase in the policy rate, due to the strong competition in the banking sector, as suggested by the decreasing spread between the deposit and lending interest rates. Conversely, nominal deposit rates increased, while real deposit rates inched further above zero, mainly as a consequence of decreasing inflation. Overall, the stimulating impact of commercial banks' interest rates on the real economy diminished significantly in Q3, as their current influence on aggregate demand is roughly neutral.

The third quarter of 2006 saw a more restrictive impact of interest rates (foreign currency borrowing costs in local currency included), affecting excess demand in the quarters ahead. The real exchange rate moved in the opposite direction, as its restrictive effect on economic activity via the net exports channel was relatively lower. The two opposite developments largely offset each other, so that the slightly restrictive impact of commercial banks' interest rates and of the exchange rate on excess demand over the following quarters remains virtually unchanged in Q3, given the circumstances of a restrictive stance of the real policy rate.

1.3.3. Demand pressures within the projection horizon

According to the baseline scenario, excess demand will be gradually eliminated by mid-2007 and the negative output gap will persist over the entire projection horizon. The drivers behind the forecasted deceleration in the growth rate of demand will be tight real monetary conditions, on the one hand, reflected by the positive real interest rates and the real appreciation of the domestic currency and the administrative measures adopted by the NBR to contain non-government credit expansion, on the other hand. In comparison with the previous Inflation Report, the increased likelihood of expansionary fiscal policy in 2007 and the upward revision of excess demand in 2006 Q3 cause output gap to be projected on a higher trajectory, despite the upward revision of potential GDP growth over the medium-term.

A temporary rise in excess demand is projected for 2006 Q4, following the likely substantial increase in government spending. Subsequently, output gap is expected to follow a downward drift, entering negative territory as of 2007 Q3. The accelerated elimination of excess demand is mainly attributable to more restrictive real interest rates in the following three quarters against the backdrop of faster-than-forecasted disinflation. Furthermore, a fiscal policy stance aimed at building up significant budget surpluses in the first part of 2007 – following the same pattern as in the previous years – should magnify the effects of suppressing aggregate demand. Moreover, the expansionary effects of projected government spending exceeding budget revenues in 2006 Q4 by more than 3 percent of GDP are expected to fade away until 2007 Q2. Throughout the projection horizon, the RON real appreciation tendency will increase the restrictiveness of real monetary conditions.

Meanwhile, the administrative measures adopted by the NBR in 2006 are expected to continue to exert restrictive effects on aggregate demand during the quarters ahead. On the banking market, maintaining minimum reserve requirements at high levels will probably put a temporary dent on commercial banks' credit expansion. On the retail banking market, the NBR norms on containing credit risk for all financial institutions are expected to slow down the growth rate of consumer credit. The restrictive effectiveness of these administrative measures is expected to fade gradually as the supply of banking products is diversifying and the domestic banking market is integrated into the EU financial market.

As regards the fiscal component of the economic policy mix, given the consolidated budget balance in the first 10 months of 2006, the achievement of the Government's year-end deficit target, i.e. 2.5 percent of GDP, has become unlikely. Hence, the current baseline scenario assumes a 1.5 percent deficit-to-GDP figure for end-2006. The fiscal policy assessment for 2007 and 2008 was based on the deficits set forth in the draft budget law and the Report on the Macroeconomic Context[59] submitted to Parliament by the Government, namely 2.8 percent and 2.7 percent of GDP respectively. Similarly to the previous projection, the quarterly distribution of the fiscal policy effect took into consideration the fact that a considerable share of budget expenditures is usually carried out in the final months of the year, partially feeding through into aggregate demand in the first quarter of the following year.

The assessment of the fiscal policy impact also incorporates the effect of the flow of funds between Romania and the EU. Thus, given Romania's rather safely predictable contribution to the EU budget (estimated by the Ministry of Public Finance at approximately 1 percent of GDP in 2007 and 2008 respectively), a slower (faster) absorption of post-accession funds may induce a negative (positive) net balance, making

[59] Ministry of Public Finance – "Report on the macroeconomic context for 2007 and its projection for 2008-2010".

Romania a net contributor (beneficiary) in its relationship with the EU. In the first year of membership, most of the states that joined the EU in 2004 encountered difficulties in completing all procedures concerning the absorption of post-accession funds. It is quite likely, therefore, that the payments made by Romania into the EU account might exceed next year the amounts received from the EU budget. Romania is expected to become a net beneficiary starting in 2008. As for the implications on aggregate demand developments, the forecasted impact of these funds helps ease, *ceteris paribus*, demand-side pressures in 2007 and amplify them in 2008. Controlling for the effects of GDP dynamics on budget expenditures and revenues, the current projection assumes an overall expansionary effect of the fiscal policy in 2007 followed by a restrictive one in 2008.

According to the baseline scenario, economic growth will exceed its previous projection over the entire projection horizon. The large inflows of foreign direct investment will most likely benefit all sectors of the economy in terms of productivity, resulting in a temporary speed-up in the growth pace of potential GDP forecasted for 2006-2008.

Similar to the GDP projection, both components of consumption are expected to rise in 2006 Q4: private consumption posts seasonal highs in the fourth quarter of each year, while budget expenditures probably exceeding revenues by around 3 percent of GDP will give a boost to public consumption. The growth rate of consumption is expected to decline subsequently, yet outstripping the rate of increase of GDP, mainly as a result of private consumption-boosting anticipated wage and pension hikes. In this respect, the draft budget for 2007 envisages a real increase in public sector staff costs and pensions by about 19 percent and 15 percent respectively. The growth rate of gross fixed capital formation is expected to stay high, fuelled by the announced rise in public expenditures earmarked chiefly for investment in infrastructure and by the perception of a more attractive business environment, bolstered by Romania’s joining of the EU on 1 January 2007. Besides the direct impact on economic activity, the expansion of public investment will foster consumer demand via larger disposable income of households. Exports are also seen growing, given the upbeat expectations on demand dynamics in the EU, Romania’s main trade partner. Along with the larger value of exports, the reshuffle of the export structure is expected to continue, with the share of highly-processed goods increasing further. The future rise in imports of goods and services could be underpinned by the persistent gap between domestic demand and supply of goods and services.

1.4. Risks and uncertainties surrounding the projection

The baseline scenario of the current forecast is built around assumptions which are naturally fraught with uncertainties. The assessment of these uncertainties allows the identification of several significant risks regarding the projected inflation path. At present, these risks include the following hypothetical situations:

– persistence of inflationary pressures induced by aggregate demand over a longer-than-forecasted time period, possibly caused by the following: (i) a more stimulative fiscal policy; (ii) heftier increases in wages of employees in both public and private sectors, and (iii) the maintenance in the periods ahead of a fast rise in non-government credit;

– a different path for the RON/EUR exchange rate from the one assumed under the baseline scenario, the main risk residing in the possible future widening of the current account deficit beyond the level compatible with sustainable capital inflows;

– a new possible surge in the oil price, leading to the fast-paced growth of fuel prices;

– deviations from the currently most plausible scenarios on timing and magnitude of the adjustments in administered prices and excise duties on tobacco products;

– shocks that may affect agricultural production and volatile food prices.

The forecast for the consolidated general government budget proposed by the Government in the draft budget submitted to the Parliament implies several uncertainties regarding both the magnitude of the budget balance and the budget structure. On the one hand, the budget revenues forecasted by the Government for 2007 rely on the assumption that in the coming year excess demand will still be manifest. If the output gap followed a downward course comparable with the one forecasted in the baseline scenario presented in this chapter, the resulting budget revenues would be, *ceteris paribus*, relatively smaller. In such a context, a certain recalibration of public spending would be needed to attain the deficit target. Carrying out a downward revision of these expenditures may prove to be difficult, given its potential as a trigger for social and political pressures, especially in conjunction with the perspective of early elections. If expenditures remained unchanged, and revenues were lower than projected, the result would be a deficit wider than the target set by the Government and accounted for in the baseline scenario, entailing the resurgence of inflationary pressures. The second risk scenario relating to fiscal policy could focus on the change in the structure of consolidated general government budget expenditures as compared with the current projection. Thus, given the relatively low capacity of spending the investment funds[60], some budgetary resources initially assigned to viable projects could run the risk of being redirected towards consumption and government transfers to households. The redistribution of expenditures would cause fiscal policy to have a stronger impact on inflation, as compared to the impact projected in the baseline scenario.

A more substantial hike in wages of employees in both public and private sectors could give additional impetus to demand-driven inflationary pressures. The budgeted wage increases projected by the Government for 2007, along with a sharp rise in the minimum wage (the Parliament had proposed an 18 percent increase) could lead to a spill over of pressures on salaries to the private sector. Larger staff costs incurred by companies could finally entail higher prices if these hikes could not be matched by productivity gains (a fact consistent with the existence of excess demand). Additional pressure on wages could arise from the potentially tight labour market where, amid a low unemployment rate, labour supply is also constrained by the significant number of people working abroad.

The currently fast growth of aggregate demand may trigger not only domestic inflationary pressures, but also the sharper rise in demand for imports of goods and services. If this might bring about the widening of trade and current account deficits at a much faster pace than that of capital inflows, the external imbalance may require a correction. A possible solution would be the adjustment of the fiscal policy stance by compressing government consumption. For lack of such a response, the correction could manifest as a build-up of pressure on the local currency, stemming especially from foreign investors' transactions, which could lead to a less restrictive influence of the real exchange rate on aggregate demand, compared to the case of the baseline scenario. The need to counter such pressures would require a tougher monetary policy stance in order to keep inflation within the target band.

The risks pertaining to the dilution of the disinflationary potential of the real exchange rate could be mitigated by the action of factors having a strengthening impact on the domestic currency, such as further capital inflows in the form of foreign direct investment, including pre-accession and structural funds, or the larger volume of portfolio investments, partly as a result of completing capital account liberalisation in September 2006.

As in every projection, the calendar of administered price adjustments features a high degree of uncertainty. The subsequent adoption of a calendar different from the one

[60] January through September, only 38.2 percent of the capital expenditures projected for 2006 were made.

envisaged in the baseline scenario could lead to sizable deviations from the projection. Such a significant risk is the possible concentration of large price adjustments over relatively short time spans[61]. For instance, if early elections are organised in 2007, the risk of delaying the projected increases in administered prices for that year might become manifest along with the risk of a more expansionary fiscal policy. Under such conditions, in 2008, disinflation would be most likely burdened by administered price hikes higher than those forecasted in the baseline scenario, on the one side, and by the delayed elimination of excess demand, on the other.

With similar implications as for administered prices, the uncertainties surrounding the calendar of adjusting excise duties on tobacco products might cause a disconnection between the monetary policy response and the emergence of the most significant shocks. An alternative scenario could be built on the assumption of a heftier rise in total excise duty in 2007 and of a more moderate rise in 2008-2010, which is equivalent to a more evenly distributed tax burden over the next three years. Such circumstances would generate higher inflationary pressures in the first part of the projection horizon, which, in the absence of an appropriate monetary policy response, could result in significant deviations from the inflation target.

As illustrated by recent developments, the dynamics of volatile food prices is highly uncertain as a result of the low predictability of weather conditions that have a direct impact on agricultural production, thereby weighing heavily on the inflation trajectory for this group of products. The main risk consists in the sharper reversal of the recent downward trend in inflation for vegetables, fruit and eggs as compared to the baseline scenario of the projection, potentially fuelling headline inflation and causing delays in its convergence towards the inflation target.

Overall, the assessment of the uncertainties taken into consideration indicates significant risks of higher-than-expected inflationary pressures, especially in the latter half of the period covered by the current forecast. In the short run, the main risks might be generated by the revision of the scenario for administered price adjustments, as well as by the higher inflation rate of volatile food prices starting with 2006 Q4. Nevertheless, for 2006, the likelihood that inflation rate should go beyond the target band is deemed low. In the medium run, the risk that inflation rate should go beyond the target band is higher, especially if the output gap projection for 2007 and 2008 may turn out lower than currently projected.

[61] Given the agreements negotiated with the EU on the need to attain some reference prices in a pre-determined transition period.

2. Policy assessment

According to recent economic developments and the results of the current medium- and short-term forecasting round, annual inflation rate in December is expected to fall close to the mid-point of the 2006 inflation target. The explanation for this performance lies with the faster-than-expected disinflation in the latter half of 2006, largely a result of the considerable decrease in the annual growth rate of volatile prices. Tightening of monetary policy along with austere fiscal policy for most of the year contributed to disinflation, which helped prevent an excessive rise in the inflationary potential of demand and was supportive of anchoring inflation expectations.

As for the medium-term disinflation outlook, however, the assumptions and the results of the updated projection of macroeconomic developments highlight, over the coming quarters, the stronger impact of some potentially inflation-generating factors on both supply side and demand side; such an impact makes it more difficult for the National Bank of Romania to attain its medium-term inflation targets. The major risk to disinflation, as it arises from the assessment of implications of the new projection, is the increase – compared with the level projected in the preceding forecasting round – of excess demand expected over the next three quarters, even though potential GDP for the next few years was revised upwards.

The projected rise in the positive output gap is ascribed to faster-than-expected economic growth in the previous quarter, on the one hand, and to the fiscal easing anticipated for the end of 2006 and 2007 at least, on the other. In this context, there is a significant risk of an increase in inflationary potential on the demand side given that household consumption dynamics is expected to stay overly high.

Consumer demand of households will be additionally fostered by a larger fiscal easing projected for 2007. Apart from its direct impact via wage hikes and social security transfers envisaged in the budgetary programme, fiscal easing will have indirect effects on consumer behaviour through deterioration of inflation expectations and implicitly a possible excess increase in private sector wages, as well as the multiplication effect still arising from larger capital expenditures, until aggregate supply will react positively.

Against this background, the reduction of aggregate demand to a level compatible with attaining the inflation targets for 2007 and 2008 calls for offsetting the expansionary effects of the implementation of fiscal and income policies as planned by keeping the tight monetary policy in place, although in such a context the burden of avoiding deterioration of the macroeconomic environment will almost entirely be borne by monetary policy.

The need to preserve a cautious monetary policy stance and a vigilant monitoring by the monetary authority also arises from the relatively high correlation between the increase in household consumption and the overly high dynamics of non-government credit to individuals, as well as the persistently modest household savings with banks. This is indicative, on the one hand, of the fact that the burden of debts associated with repayment of bank and non-bank loans has not yet reached the level that might entail a slowdown in consumer growth given that individuals still resort, *inter alia*, to the relative curtailment of their savings. On the other hand, the correlation hints at a relative increase in consumption elasticity to certain shocks that may affect the debt parameters of individuals, low-income households in particular.

Nevertheless, considering the recent introduction of tougher conditions for bank and non-bank[62] loans to households, which could bring about a relative deceleration in consumption growth over the short term by putting liquidity strains on individuals, o possible option for the time being is to maintain the current level of the nominal policy rate given the sizeable increase in real interest rate and the vigilant monitoring of the effects produced by the measures taken by the NBR. This solution also takes into account the effect on consumption likely to be exerted by the possible decline in net incomes or indebtedness capacity of households as a result of larger debts associated with repayment of long-term loans – for housing in particular –, the share of which widened over the past few years.

From the perspective of medium-term disinflation, another major source of uncertainty surrounding the current projection is the expansion of the inflationary potential of cost and supply factors. Given the persistence of excess demand, the possibly significant hike in private sector wages (above that warranted by productivity gains) could boost prices. Furthermore, the potential loss of external competitiveness triggered by higher ULC could result in an unsustainably wide trade deficit. Such risks are heightened by the increased likelihood of considerable wage hikes in the period ahead following the emerging trend of

[62] Following the entry into force, on 23 October, of tighter NBR measures (Norms No. 20 of 13 September 2006) aimed at containing credit risk for households; the Norms are applicable to non-bank financial institutions as well.

a tighter labour market, especially in terms of skilled staff, a phenomenon that could become more salient in the future.

Meanwhile, in view of the need to make further large-scale adjustments of administered prices and the relatively little likelihood of this year's good harvest to repeat itself, the increases in regulated prices and the dynamics of volatile food prices will be key inflation-boosting factors throughout the projection horizon. Adding to these factors will be the gradual rise – according to the calendar of harmonising domestic tax legislation with that in the EU – in excise duties on tobacco and cigarettes; the inflationary effect of these measures is expected to be significant as long as the EU demand for such products would be relatively destitute of elasticity. The inflationary potential of factors outside the central bank's authority may only be contained via firm anchoring of the public's expectations and minimizing the second-round effects of the direct shocks generated by these factors, which calls for maintaining a cautious monetary policy stance for a longer period.

In light of the recent developments, the risk of resurgent volatile capital inflows assuming a tighter interest rate policy continues to be relatively low. Thus, in the short time-span after the completion of capital account liberalisation and the formal announcement of Romania's joining the EU in 2007 there was no evidence of an abrupt shift in investor sentiment concerning the investment opportunities on the domestic market or the expected margin of appreciation of the domestic currency versus the euro. By contrast, there is increased evidence of the correlation between short-term movements of the exchange rate of the RON on the domestic forex market and those of other currencies in the region. This heightens the sensitivity of the exchange rate of the RON to the abrupt shifts in investor sentiment towards one or more financial markets in the region.

The assessment by the National Bank of Romania Board of the assumptions and results of the updated projection of macroeconomic developments has underscored a stronger effect of the action of some potentially inflation-generating factors, on both demand side and supply side, in the upcoming quarters; such an impact makes it even more difficult for the National Bank of Romania to attain its medium-term inflation targets. From this perspective, the National Bank of Romania Board shows concern over the major inflationary risks induced by the increase in projected excess demand in the near term – due largely to the envisaged fiscal policy easing in the period ahead – and by the further significant adjustments in some administered prices and hikes in some indirect taxes during the projection horizon. In this context, the National Bank of

Romania Board has decided to maintain the monetary policy rate at 8.75 percent per annum and continue to pursue a firm control over money market liquidity. Moreover, the Board has decided to maintain a restrictive monetary policy stance for a longer time-span, also as a measure aimed at offsetting some unexpected slippages of wage and fiscal policies. In addition, the National Bank of Romania 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 pose risks to disinflation.