NATIONAL BANK OF ROMANIA

INFLATION REPORT

February 2007

Year III, No. 7

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.

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Foreword

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

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

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

Inflation Report was completed on 1 February 2007 and approved by the NBR Board in its meeting of 9 February 2007.

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
COICOP	Classification of individual consumption by purpose
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

Continued disinflation during 2006 Q4 led to the undershooting of the target of 5 percent ±1 percentage point for 2006, with the 12-month inflation rate falling to 4.87 percent in December 2006. During 2006, the deceleration of core inflation (adjusted for the impact of indirect taxes) had a significant contribution to the 3.7 percentage point decrease in the annual CPI, reflecting the favourable influence – including via inflation expectations – of increased monetary policy restrictiveness and maintenance, for most of the year, of a tight fiscal policy stance, alongside the effects of stronger competition on the retail market. Faster disinflation was also the result of volatile price deflation and slower annual administrative price inflation, which were mostly due to a favourable shock from fruit and vegetable supply in 2006, the lowering of the world market price of oil in the second part of 2006, and the strong appreciation of the RON against the major currencies.

The decision to prolong the trend of higher monetary policy restrictiveness in 2006 Q4 was substantiated primarily by the maintenance of the inflationary potential of aggregate demand and the prospect of its persistence in the absence of tighter monetary conditions. In 2006 Q3, economic growth gathered momentum (annual rate of increase of 8.3 percent compared with 7.8 percent in Q2) and the positive output gap widened, albeit below expectations. In the period under review, the fastest-expanding component of aggregate demand was gross fixed capital formation, whose annual growth rate accelerated to 15.6 percent, from 12.2 percent in Q2, reflecting especially the buoyant activity in the construction sector. Household consumption growth remained very rapid, at an annual pace of 12.4 percent, given that the annual growth rate of its major component, i.e. goods purchases, hit a historical high in 2006 Q3.

For most of 2006 Q4, monetary policy restrictiveness increased, as reflected by the rise in the real monetary policy rate spread and faster real appreciation of the RON versus the major currencies. The rise in the real monetary policy rate was the result of the National Bank of Romania Board decision to keep the nominal monetary policy rate at 8.75 percent, despite the substantial acceleration of disinflation in Q3 and expectations of an annual inflation rate for December 2006 falling below the mid-point of the inflation target for 2006. In October and November, the National Bank of Romania continued to exercise firm control over liquidity by systematically sterilizing excess liquidity via open-market operations, thus contributing to the increased interest rate policy restrictiveness. Adding to the restrictiveness of broad monetary conditions was the implementation in late October of the additional measures aimed at containing the credit risk associated with loans to households by rendering access to bank and non-bank lending more difficult. Towards the end of 2006 Q4, the strengthening of the RON gathered pace, under the impact of the resurgence of potentially-volatile capital inflows, also as a result of the convergence play fostered by the substantial improvement of investor sentiment on sovereign risk (extended to the corporate segment as well) ahead of Romania becoming an EU Member State; the need to counter the risk of an unsustainable appreciation of the domestic currency given the new context made the National Bank of Romania move towards partial sterilization of excess liquidity via open-market operations.

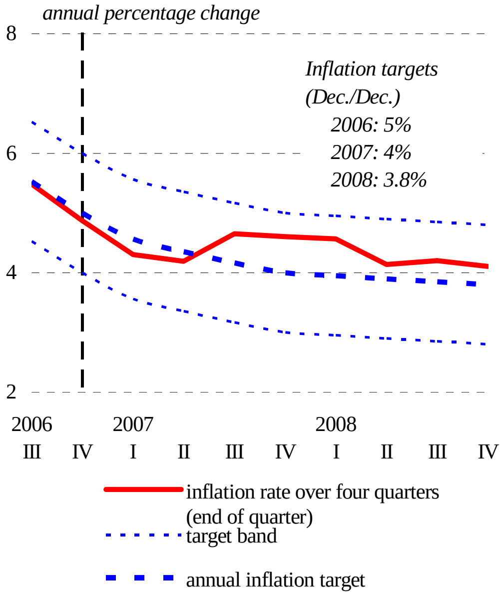
The baseline scenario of the current forecast of medium-term macroeconomic developments shows a relative improvement of the outlook for inflation over the forecast horizon, with annual inflation rate being projected to fall to 4.6 percent and 4.1 percent in December 2007 and December 2008 respectively. Annual inflation follows a trajectory broadly similar to that projected in November 2006 Inflation Report, although slightly lower during 2007, with more favourable effects in the current projection being expected from the developments in the RON exchange rate, fuel prices and other import prices, as well as from lower magnitude of administered price adjustment than in the previous projection. The size of these effects exceeds slightly that of the adverse impact on the inflation trajectory of a sharper increase in volatile food prices than in the previous forecast and of greater persistence of excess demand incorporated in the current projection, as a result of faster GDP growth than in the preceding forecast amid stronger dynamics of public and private investment. The projected trajectory of annual inflation rate is in line with the gradual reduction in anticipated excess demand and with the decline in GDP below its potential level starting with 2008 Q1. The suitability of broad monetary conditions to the new context is the result of the restrictiveness of the real interest rates in relation to excess demand and of higher restrictiveness than in the previous forecast induced by the projected dynamics of the real exchange rate of the RON.

The risks and uncertainties associated with the current projection of medium-term macroeconomic developments are relatively similar to those associated with the quarterly forecast presented in November 2006. In this context, the most significant risk is posed by excessive wage increases uncorrelated with productivity gains, which would fuel both demand-pull and cost-push inflationary pressures. The possible deviation of budget execution from its projected parameters poses another risk to aggregate demand and implicitly to inflation. Thus, a possible revenue undershooting and a change in the structure of public spending by raising current (consumption-related) expenditures to the detriment of capital (investment-related) expenditures might enhance the inflationary potential of the fiscal policy. By contrast, the fiscal policy easing could be smaller than currently projected assuming that the Ministry of Public Finance retains the prudent approach to expenditures taken over the last few years. Demand-pull and cost-push inflationary risks could be alleviated over the medium term by the possible persistence – including as a result of continuing high growth in public and private investment – of fast dynamics of productivity in industry in the recent quarters and hence by the more elastic response of domestic supply, already reflected in the higher growth of potential GDP.

A major source of uncertainty for the inflation forecast continues to be the evolution of food prices, volatile food prices in particular, as well as oil and natural gas prices on world markets; the risk of unexpected changes in such prices to occur is more skewed, in this context, towards higher inflationary pressures. Given that the Romanian currency has recently become an international asset, the future developments in the RON exchange rate are fraught with uncertainties, as it may run the risk of a diluted correlation with economic fundamentals and of higher volatility and unpredictability. In this context, these risks are heightened by fast financial integration of the Romanian economy, persistently high global liquidity, improved investor sentiment towards domestic market investments – including after Romania's accession to the EU – and by a still relatively large interest rate differential on the domestic market. In addition, there is a risk of a boom in domestic demand amid a resurgence in external debt-creating capital inflows, which might have an adverse impact on the domestic and external equilibria of the economy.

The assessment by the National Bank of Romania Board of the current macroeconomic context and of its medium-term projection has underscored some improvement, compared to the previous projection, of the outlook for inflation over the monetary policy transmission horizon. However, it is assumed that, at least in the first part of the projection period, the action of some factors which could jeopardise the domestic and external equilibria of the economy and thus pose risks to the sustainability of disinflation will persist. Taking into account the directions in which these factors may evolve and evaluating their aggregate impact, in its meeting of 9 February 2007, the National Bank of Romania Board has decided to lower the monetary policy rate by 0.75 percentage points to 8 percent, to leave unchanged the minimum reserve ratios and to pursue an adequate control of liquidity via open-market operations in line with financial market conditions. Thus, the recalibration of broad monetary conditions – including the assumption of an ongoing real appreciation trend of the domestic currency – is aimed at ensuring the maintenance of the inflation rate on a path compatible with achieving the inflation targets over the medium term. Moreover, the Board has reaffirmed that it will continue to vigilantly monitor non-government credit expansion and the prices of main asset categories, in order to identify and take prompt monetary policy measures against unfavourable developments that might pose risks to disinflation.

Inflation Forecast



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

II. INFLATION DEVELOPMENTS

During the fourth quarter of 2006, disinflation continued, with the 12-month inflation rate standing at 4.87 percent at end-December, slightly below the 5 percent target established by the NBR and 0.61 percentage points beneath the end-September level. The chief driver was the pronounced drop in prices for fruit and vegetables, as a result of bountiful crops in 2006 and of the base effect induced by the unfavourable supply-side shock on this market segment in 2005; nonetheless, adjusted CORE2 inflation also contributed to the good performance in terms of disinflation.

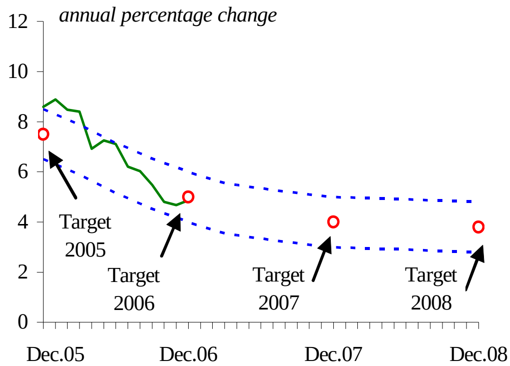
In 2006 Q4, inflation moved steadily in the lower half of the target band. At the end of December, the annual CPI was 0.1 percentage points below the target assumed by the National Bank of Romania in August 2005, at the time inflation targeting was adopted.

Over the period, the main driving force of disinflation was the performance of volatile prices, whose annual rate of increase further slowed (-2.5 percent in December) from already modest levels in September (3.1 percent). This was largely the result of decreases in annual terms of prices for fruit and vegetables (-6.5 percent in December thanks to the bountiful crops recorded in 2006 and to the base effect associated with the tensions that gripped this market segment in 2005). Another favourable development was represented by the successive cuts in fuel prices October through December 2006; given the weaker tensions on the international oil market, operators proceeded to price adjustments larger than those applied a year earlier (between -0.3 percent and -1.3 percent).

The adjusted CORE2 inflation also posted increasingly slower annual growth rates; in fact, the use of the adjusted indicator is justified by the need to ensure temporal comparability, since its third-quarter levels were still influenced by the vice tax introduction. Against the background of the persistence of excess demand, mirrored by the still positive output gap, the reduction in adjusted CORE2 inflation – from 3.34 percent in September to 3.04 percent in December – could be attributed rather to (i) stronger domestic currency, (ii) keener competition in the retail sector (driven by the fast development of modern outlet types for consumer goods[1]), and (iii) weakening inflation

[1] According to a GfK-led study released in December 2006, the share of chain stores in total retail trade widened to 31 percent January to September 2006, from 27 percent in 2005, being anticipated to reach about 50 percent by 2010.

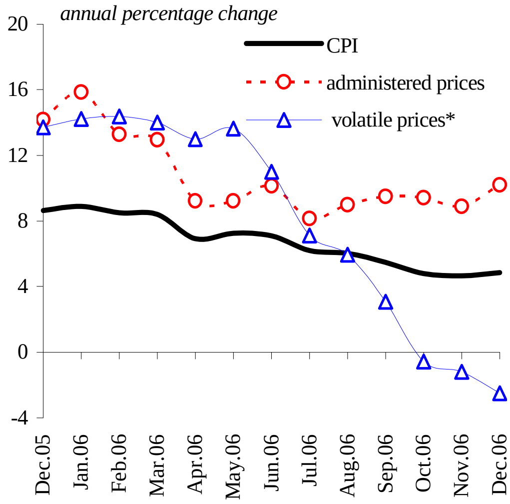
Inflation Developments



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

Source: NIS, NBR calculations

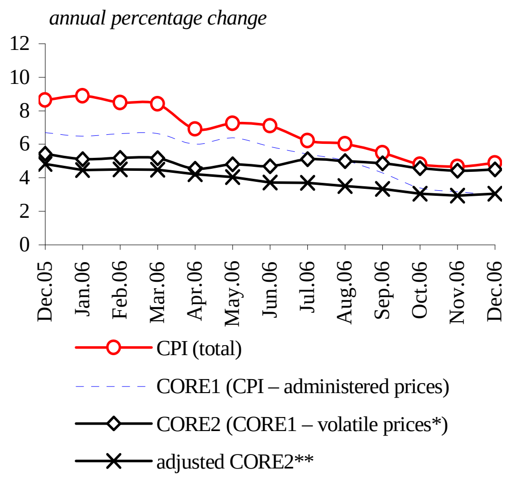
Inflation Rate



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

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation



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

**) the influence of vice tax is removed

Source: NIS, NBR calculations

expectations (the NBR-conducted bank survey pinpoints a considerable narrowing of the spread between expected inflation and the central bank's interpolated target for both time horizons, i.e. 12 months and 24 months).

CPI by Category of Products

annual percentage change; end of period

	2005	2006			
	IV	I	II	III	IV
Food, alcohol, tobacco	7.6	6.9	6.3	4.7	3.7
Wearing apparel and footwear	3.9	3.8	3.8	3.8	3.3
Household appliances, furniture	3.6	2.8	2.1	1.9	1.7
Fuels	9.0	9.4	6.3	2.6	1.4
Utility expenses*	20.8	23.0	17.9	13.4	17.9
Healthcare	0.9	0.1	-0.2	0.0	0.9
Transport	19.8	16.6	11.7	7.0	5.3
Post and telecoms	6.8	0.6	-2.1	4.2	-3.0
Leisure and culture	7.8	7.0	7.1	5.8	4.5
Other goods and services	4.0	6.3	6.6	5.7	4.1

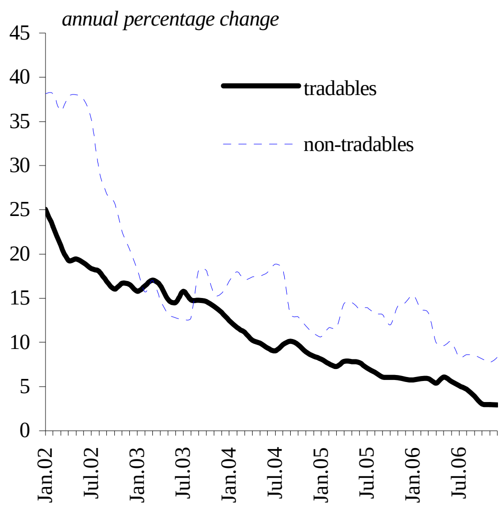
* rent, water, sewerage, sanitation, electricity, heating, natural gas

Source: NIS, NBR calculations

Structural analysis shows that the downturn in core inflation was ascribable to the developments in services and non-food prices. Food prices saw opposite developments, the only noteworthy favourable influence was the steep decline in sugar price, as a result of the need to bring the existing stocks with the producers down to the highest level accepted by the European Commission at the time of Romania's accession to the EU.

From another perspective, the prices for tradables[2] (a sector opened up to foreign competition) had the largest contribution to the progress in disinflation, their annual rate of increase falling from 3.9 percent in September to 2.9 percent in December 2006. Prices for non-tradables saw much slower downward movements (from 8.5 percent to 8.3 percent). Over the past five years however, the annual dynamics of the two price categories exhibit different behaviours, with non-tradables prices posting a much larger volatility; the major explanation for the increased volatility and the far higher rate of growth lies with the group's components, namely most administered prices, including the energy price.

Tradables and Non-tradables Prices



Source: EUROSTAT, NBR calculations

Unlike the previous two quarters, in the period under review, the developments in administered prices impeded somewhat the disinflation process, their annual growth rate quickening to 10.2 percent in December, from 9.5 percent in September. Behind this development stood the authorities' decision to raise natural gas and electricity prices ahead of schedule (1 January 2007) by 8.5 percent and 4.63 percent respectively. The increase in heating price (by around 18 percent) should not be viewed as a culprit for the slowing disinflation, as such a move is usually implemented at this time of year, its magnitude being comparable to that of a year earlier. However, the significant cut in telephony rates (3.28 percent in Q4) due to the stronger RON versus the euro mitigated the effects of the above-mentioned measures.

The disinflation performance during 2006 notwithstanding, the change in domestic consumer prices is still above the EU average. In December 2006, the difference between the harmonised indices in Romania and the EU ran at 2.8 percentage points. Similarly, by comparing the consumer price

[2] The segregation between tradables and non-tradables was made according to COICOP. The latter category includes basically products with administered prices and services, holding 34 percent of the consumption basket, the other components being include under tradables.

index based on the national definition with that resulting from applying the EU-wide definition, the differences are generally insignificant (nil in the reference period). Moreover, the comparison to the corresponding nominal convergence criterion, i.e. the average inflation rate for the best performing three EU Member States, shows that the gap widens to 3.77 percentage points, well above the 1.5 percentage point level laid down in the Maastricht Treaty.

At end-December 2006, 12-month inflation rate was 0.2 percentage points above the forecast in the November 2006 Inflation Report. The deviation was generated mostly by (i) larger-than-expected hike in heating prices, the impact of this move being hard to estimate after the prerogatives for price adjustments were transferred to local governments and (ii) the increase in the bread price in the final two months of 2006 as a result of the scant wheat supplies because of the poor quality grain crops of 2006.

Administered Prices versus Market Prices

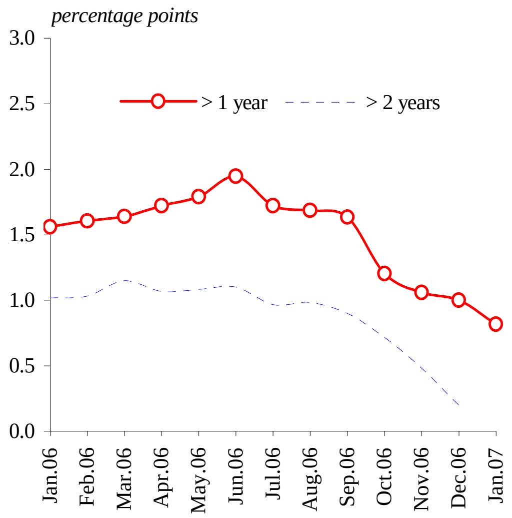
annual percentage change; end of period

	2005	2006			
	IV	I	II	III	IV
Inflation Rate	**8.6**	**8.4**	**7.1**	**5.5**	**4.9**
Administered prices*	**14.2**	**13.0**	**10.1**	**9.5**	**10.2**
1. Non-food items*:	**14.1**	**15.9**	**11.4**	**8.4**	**11.4**
electricity	9.6	7.0	7.0	1.9	6.6
heating	20.0	20.0	20.0	20.0	18.4
natural gas	36.4	52.2	28.5	21.4	33.6
medicines	–5.1	–5.5	–5.3	–4.0	–1.9
2. Services*, of which:	**14.1**	**8.2**	**8.0**	**11.3**	**8.1**
water, sewerage, sanitation	25.8	24.8	24.9	20.3	21.4
telephony	8.5	–3.4	–2.0	10.5	2.5
passenger railway transport	8.7	8.7	11.6	5.1	13.2
(passenger) city transport	23.2	20.5	12.1	7.1	4.1
Market prices (CORE1)	**6.7**	**6.6**	**5.8**	**4.3**	**3.0**
CORE2**	**5.4**	**5.2**	**4.7**	**4.9**	**4.5**

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

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

Spread between Expected Inflation and Annual Inflation Target



Box 1

Comparing the Harmonised Index of Consumer Prices and national consumer price index

Romania's accession to the European Union heightens the importance attached to the harmonised index of consumer prices (HICP), as the nominal convergence criterion on inflation for joining the euro zone is expressed in terms of HICP, and the European Central Bank defines price stability as a year-on-year increase in the HICP of below, but close to, 2 percent. Thus, a brief analysis of this concept and the differences between HICP and national consumer price index (CPI) is required.

The HICP measures changes in the level of retail prices of goods and services on the territory of Romania, with the weights for calculating the index being drawn from the structure of residents' and non-residents' consumption expenditure. Hence, the harmonised index is based on the 'domestic' concept, covering all private households in the country concerned, regardless of income, nationality, and social or residential status (foreign embassies in Romania are not considered). In fact, the definition of this index requires taking into account not only the consumption by residents, but also the expenditure by foreign visitors in Romania.

This is a main conceptual difference in comparison to the CPI which applies the 'national' concept of consumption, covering all consumption expenditure by residents, regardless of the fact that it was incurred within or outside the country concerned. Inclusion of purchases by households outside the country is based on balance-of-payments data and refers actually to consumption of tourist and transport services abroad (IT systems cannot elicit other expenditure incurred abroad).

As a rule, the HICP covers only the prices paid for goods and services in monetary transactions. Some practical consequences of using such a concept are as follows:

(i) exclusion of some special fees and taxes paid to the government (when there is no equivalent good or service receive din return);

(ii) exclusion of interest and credit charges (which are regarded as financing costs rather than consumption expenditure);

(iii) the prices measured are those actually faced by consumers (for example, they include value added tax and reflect end-of-season sales prices).

Essentially, the same concept governs the national CPI which excludes: consumption from own resources, expenditure for investment and accumulation, interest paid on loans, insurance instalments, fines, taxes, etc., as well as expenditure to pay the work for farming output of individual households. The only difference is that the HICP includes insurance expenditure for transport means; weights for the other insurance types (house insurance, health insurance, etc.) are still nil.

Another difference between the HICP and national CPIs is that the former uses 'expenditure net of reimbursement' in case of health and insurance, excluding subsidies for pharmaceutical products and compensation for damages respectively.

As for the calculation method, both the HICP and the CPI are annually chain-linked, Laspèyres-type indices, which differ however in terms of weighing systems. They derive from the aforementioned domestic/national distinction, on the one hand, and from different aggregation formulae in groups and subgroups, on the other.

Thus, the HICP covers all categories and subcategories of COICOP (classification of individual consumption by purpose), as agreed by EEC/Eurostat/OCDE to ensure comparability of indices at European level, and includes 12 divisions, detailed in 39 groups and 93 classes of goods and services. It should be pointed out that the respective weights should not be regarded as an average 'euro-basket', as they are representative for Romania and comply with the principle of ensuring representativity of expenditure for each economy.

The nomenclature used in case of CPI is divided into 3 aggregation levels, i.e. groups, positions and items, as follows: (i) group of food goods, which includes 54 positions with 360 items, (ii) group of non-food goods, which encompasses 112 positions with 947 items, and (iii) group of services, comprised of 56 positions with 423 items.

In both cases, the weighting systems used for year *t* rely chiefly on the results of the Household Budget Survey recorded in year *t-2* and are updated on a yearly basis. For computing the HICP, adding to the results is the information on the consumption of foreign tourists in Romania, as provided by the National Institute for Research and Development in Tourism. As mentioned above, the additional data on residents' expenditure outside Romania that are needed for computing the CPI are drawn from the balance of payments (services).

Data regarding the HICP are compiled by the National Institute of Statistics and sent to Eurostat in accordance with the methodology agreed by this institute in 2001; data for previous periods are estimations based on the national CPI.

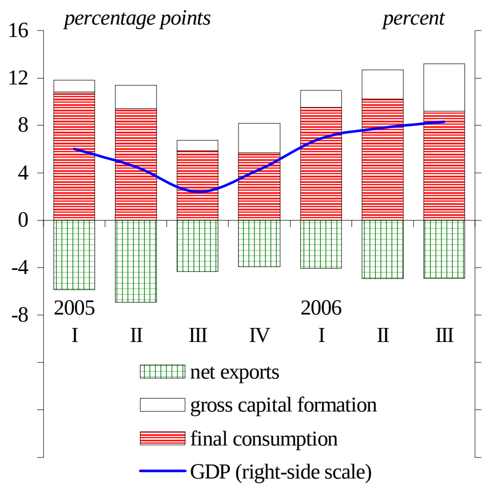
The status of both indices has not changed basically after Romania's accession to the EU, excepting most likely the increased resort to HICP in making economic analyses, especially for comparing inflation performances with the other Member States. The HICP is not aimed at replacing the national CPI, but at ensuring comparability at European level.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2006 Q3, the growth rate of real GDP accelerated for the fourth time running to 8.3 percent from 7.8 percent[3], falling short of the September's benchmark projection by 0.7 percentage points. For the first time in 2006, the economic growth pattern showed investment becoming the engine of GDP growth; the growth rates of consumer demand and exports recorded insignificant changes quarter on quarter. On the supply side, all economic sectors posted higher paces of increase.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

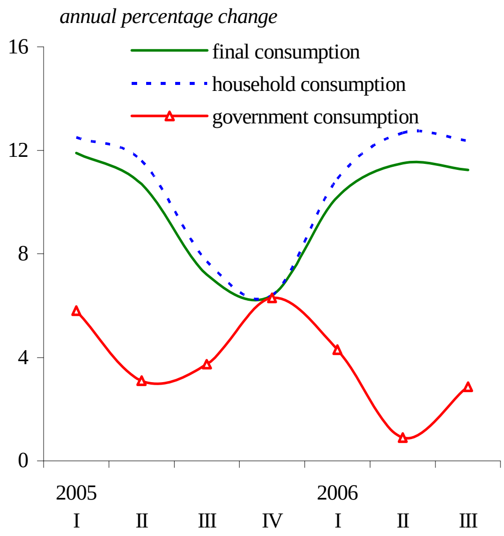
1.1. Demand

The same as in the previous quarter, GDP acceleration was propelled by domestic demand (13.2 percentage points), due mainly to the rise in capital investment and, to a lesser extent, to the faster increase in government final consumption. Nevertheless, the positive impact of these two components was overshadowed by the slight slowdown in household final consumption and the maintenance of the negative contribution of net external demand.

1.1.1. Consumer demand

Behind the marginal deceleration in the growth rate of final consumption versus Q2 (by 0.3 percentage points to 11.2 percent) stood solely its private component. However, this deceleration failed to mitigate the inflationary pressure exerted by consumer demand amid the new increase recorded by the growth rate of retail purchases of goods (particularly non-durables, which account for the largest part of the CPI basket) and services.

Actual Final Consumption



Source: NIS

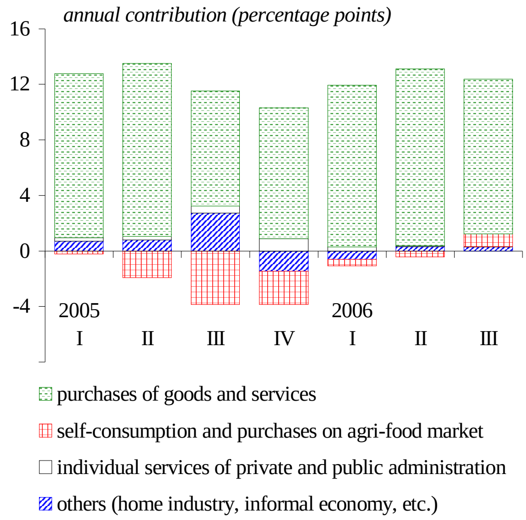
Household consumer demand

Although slightly below the previous quarter's reading, the annual growth rate of household final consumption was further high (12.4 percent), a trend bolstered by both the pick-up in "purchases of goods and services" (the growth rate of which added 2.2 percentage points from Q2 to 21.5 percent) and the rebound in "self-consumption and purchases on the agri-food market" (4.9 percent). Behind the latter development stood the

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

base effect induced by natural disasters in 2005, on the one hand, and the good crop of fruit and vegetables in 2006, on the other. However, the uptrend in private consumer demand was alleviated by the slowdown by 0.6 percentage points in the growth rate of "others" (2.1 percent)[4] and by the expenditures on households incurred by public and private administration, the volume of which remained unchanged from that recorded in 2005 Q3, mainly as a result of the base effect associated with the efforts to help the flood-hit households.

Household Final Consumption Growth



Source: NIS, NBR calculations

Against this background, the inflationary potential of consumer demand persisted into 2006 Q3 as well, as illustrated by the still fast-paced turnover of non-durables (around 23 percent), durables (around 28 percent) and market services to households (14 percent); the influence of the last two categories on inflation rate was relatively low due to their small weights in the CPI basket. Household outlays on utilities also recorded a slight increase over the previous quarter in terms of volume, yet, in this case, inflationary pressures generated by demand were insignificant, price movements being generally induced by supply.

The same as in the previous quarter, the increase in purchases of goods and services was not accompanied by a rise in the real dynamics of household disposable income[5]; on the contrary, household disposable income witnessed a decline from 4.2 percent in Q2 to 2.6 percent as a result of: (i) further decrease in inflows from abroad (-4.1 percent) owing chiefly to the base effect arising from residents' remittances in support of their relatives afflicted by floods[6] and (ii) the slowdown in the growth rate of domestic incomes, following the plunge in insurance and social security payments in the form of pensions (owing possibly to the base effect arising from the completion of the third stage of pension realignment) and unemployment benefits (amid the sharp decline in the average number of the unemployed across the economy).

In Q3, bank loans did not foster the acceleration in the growth rate of retail purchases from the commercial network as new

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

[5] Estimated 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] Mention should be made that the downtrend posted by the incomes from abroad is not indicative of an easing of the pressure from the disposable income on private consumption, given that, at the respective moment, those funds were primarily used for investments (works to rebuild damaged houses).

short-and medium-term loans[7] continued to drop in real terms (by almost 15 percent), confirming the market saturation as regards consumer credit pointed out by the November Inflation Report as well. Nevertheless, this trend was offset by the expansion and diversification of alternative financing instruments launched by both commercial banks (particularly the credit card) and non-bank financial companies (especially specialised consumer credit companies and leasing companies) and last but not least by the expansion of commercial networks and the strong resort to promotional and discount techniques by providers.

As for the origin market of consumer goods, in Q3, households continued to show keen interest in buying imported goods[8] (both non-durables and durables[9]). However, the following deserve mention: (i) the improvement in domestic supply of "food and beverages" (in spite of its remaining positive, the spread between the physical volume of imports and the turnover of domestic-market-oriented output dropped to 2.4 percentage points only from 22.8 percentage points in Q2) and (ii) the 44.8 percent share held by sales of domestically-produced motorcars in total motorcar sales in Q3[10].

Government consumer demand

The annual growth rate of government final consumption trebled to 2.9 versus the previous three-month period, against the background of a faster dynamics of job creation in the public sector.

[7] 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).

[8] The changes in the physical volume of imports/exports were calculated based on the balance-of-payments data, by deflating by unit value indices.

[9] In Q3, domestic sales of non-durables recorded the slowest real growth rate year to date (-0.8 percent), whereas imports were further on the uptrend in spite of the slowdown in their growth rate compared to the previous quarter (around 8 percent). Although the growth rate of durables sold on the domestic market accelerated (reaching +20.9 percent for motorcar purchases and +15.9 percent for purchases of other goods), it was surpassed by that of imports – the groups of durables identified on the basis of the Combined Nomenclature include: electrical machinery and apparatus, precision and optical instruments, etc. and various merchandise (where furniture holds the largest share), with real growth rates ranging from 18.9 percent to 36.6 percent, as well as motor vehicles (+35.2 percent).

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

Budgetary developments

In Q3, the implementation of the consolidated general budget ended with a surplus higher than that recorded in the previous quarter (up 0.2 percentage points, 0.6 percent of GDP), which reflected mainly the relatively slow pace of government investment spending. Consequently, the 9-month budget surplus rose to 1.7 percent of GDP (twofold increase as compared with the same year-ago period[11]).

The budget surplus in Q3 rose on account of both revenues and expenditures whose annual growth rates in real terms[12] were twice as high as those recorded in the prior quarter (20.6 percent and 17.8 percent respectively).

Staff costs continued to be the fastest-growing component of budgetary funds, moving up 24.4 percent (the highest level in the past years), 6 percentage point higher than that recorded in the previous quarter; this was largely due to the faster increase in the reviewed period of wages of civil servants as well as to the larger number of this sector's payrolls. As compared with the prior quarters, significant rises were also reported by subsidy expenditures (25.2 percent) and transfer expenditures (19.3 percent), despite the considerable deceleration to 4.4 percent in the growth rate of the latter's major component, i.e. social security transfers. Public investment spending increased as well (68.7 percent), owing largely to a base effect, given that their cumulative volume for the first nine months accounted for less than 50 percent of the projected level in early 2006 and a little more than one third of that projected in the August budget revision.

The same as in the previous quarter, the rise in budget revenues was bolstered by the significantly high collections from wage and income tax which reached a 9-year high of 40.4 percent. This is partly attributable to: (1) the step-up in wages and in the number of employees and (ii) the rise[13] to 16 percent in the tax rate on investment income, due possibly to the significant contribution made by the improved collection of budget revenues. Likewise, revenues from social security contributions picked up 15.3 percent versus 9.5 percent in the previous quarter, whilst VAT revenues advanced by 16.2 percent (up 4.8 percentage points versus Q2).

[11] The comparison takes account of the budget variables for 2005 Q1, Q2 and Q3, which were reclassified according to the new classification supplied by the Ministry of Public Finance effective in 2006.
[12] Unless otherwise indicated, percentage changes refer to the annual growth rate in real terms.
[13] Starting with 1 January 2006.

The fourth budget revision year to date was approved in November 2006. Accordingly, the projected revenues of the consolidated general budget were raised by RON 987.8 million, as a result of higher tax collections, whilst expenditures were increased by RON 1,098 million. The largest part of additional budgetary funds was earmarked for the financing of the earlier-than-projected rise by 16.8 percent[14] of the pension point (RON 182.7 million), the payment of some social security benefits in December (RON 572 million) and subsidies to the passenger railway transport (RON 520 million). Furthermore, additional funds in amount of RON 972.8 million were channelled towards local governments, particularly for paying wages of the teaching staff in the secondary school education and balancing local budgets. Conversely, the projected level of interest expenses and that of the payments made on loans guaranteed by the Ministry of Public Finance were lowered by RON 329 million and RON 200 million respectively. However, the fiscal deficit target was kept unchanged at 2.5 percent of GDP, given the upward revision of the nominal value of this indicator.

1.1.2. Investment demand

In Q3, behind GDP acceleration stood primarily gross fixed capital formation which posted the fastest annual growth rate among aggregate demand components (15.6 percent, up 3.4 percentage points), owing, to a great extent, to overly high quarterly growth rates (more than 9 percent[15]) in both Q2 and Q3. In contrast to Q2, this development was not accompanied by a step-up in retooling; statistical data on the structure of investments in economy point to a 3.6 time decrease in the annual dynamics of equipment purchases to 5.5 percent. The acceleration of capital investment was due to faster real growth rates of both construction works (new objectives and capital repairs) and investments in agriculture (18-20 percent and 57.5 percent respectively[16]).

Underlying the step-up in investment were, on the one hand, the ever increasing recourse to own sources, given the outstanding performance of the corporate sector in 2006 and also the budget assignments for some infrastructure consolidation works[17] and, on the other, the resort to funds borrowed from both Romanian and foreign banks and to financing through leasing agreements. In 2006, resources raised domestically were increasingly

Investment

annual percentage change

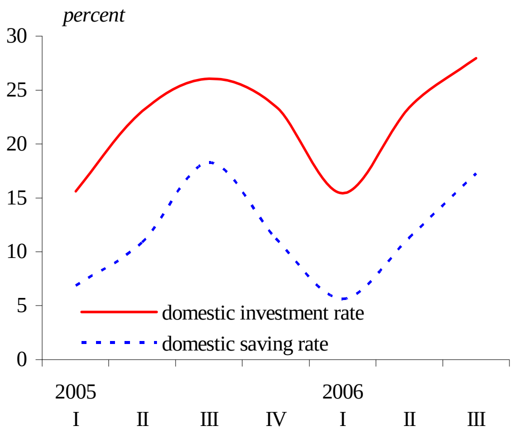
	Year	I	II	III	IV
Total	2005	5.8	10.7	13.0	17.5
	2006	10.8	14.4	15.6	
- new construction works	2005	2.2	9.4	8.8	15.3
	2006	23.5	11.6	20.0	
- equipment	2005	9.6	12.8	15.7	15.7
	2006	2.6	19.6	5.5	
- others*	2005	–4.9	1.0	27.0	48.2
	2006	4.9	–11.6	57.5	

* vineyards, orchards, afforestations, livestock purchases

Source: NIS

[14] Which became effective as of 1 December 2006 instead of 1 January 2007, as previously established.
[15] Seasonally adjusted data.
[16] Provisional data; nevertheless, mention should be made that, in the previous quarters, this heading was subject to large revisions (for instance, the provisional level of +4.3 percent related to Q2 was revised to -11.6 percent).
[17] Capital expenditures from the public budget in Q3 were 69.7 percent higher than in the same year-ago period (49.7 percent in Q2; real change).

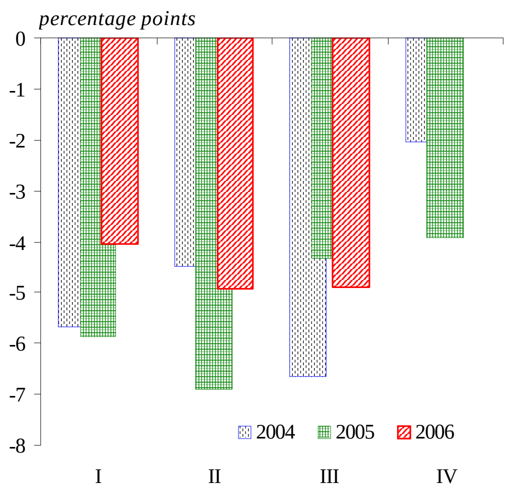
Investment Rate and Saving Rate



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

preferred, as illustrated by their persistently high growth rates concurrently with the drop in foreign loans[18]. The expansion in capital investment was also propelled by (i) foreign direct investment whose amount for the January-September period exceeded the amount for 2005 as a whole, the significant proceeds from the privatisation of four utility providers in 2005 Q2 and Q3 notwithstanding, and (ii) non-redeemable inflows (SAPARD, ISPA) ahead of Romania's joining the European Union.

In Q3, imported capital goods were further resorted to, the real growth rate of the turnover recorded by the domestic-market-oriented output of capital goods[19] being well below that of imports (26.3 percent for "mechanical and electrical machinery and apparatus" and 35 percent for "transport means") despite its reaching a positive level for the first time year to date (7.9 percent)[8].

1.1.3. Net external demand

In 2006 Q3, the negative contribution to GDP growth of net external demand remained unchanged from Q2 (-4.9 percentage points) in spite of the large volume of imports of goods and services (almost double the volume of exports thereof); in Q3, the annual growth rate of imports of goods and services came in at +21.2 percent versus +18 percent in Q2, whereas that of exports ran at +11 percent versus +10.5 percent in Q2. Behind this development stood the steeper decrease in the reviewed period in the share of imports in GDP than in that of exports, which led to a narrowing in the departure between the two. According to the balance-of-payments data, the annual expansion in exports was due solely to services (particularly communication services). As concerns goods, the volume of exports remained flat at the level seen in 2005 Q3[8], owing mainly to the annual growth rate of exports of fuels and mineral oils plunging into negative territory (-38.1 percent versus +11.2 percent in Q2) amid: (i) stronger effects of the introduction of the special tax on diesel oil and petrol exports[20] starting Q2;

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[18] In quarter-on-quarter comparison, data released by the Credit Risk Bureau point to renewed acceleration in the annual growth rates of loans for equipment and real-estate investment (by 12-13 percentage points to 64.7 percent and 54.6 percent respectively). Leasing companies also reported higher growth rates; when expressed in euro, the value of agreements concluded January through September 2006 by LCAR (Leasing Companies Association in Romania) went up by 27 percent over the same year-ago period (19.6 percent in H1). Mention should be made that loans for "industrial and agricultural equipment" accounted for more than 10 percent (9 percent in H1). On the contrary, inflows arising from medium- and long-term loans to non-banks went down in Q1-Q3 due also to the real contraction by 58.2 percent in Q3.

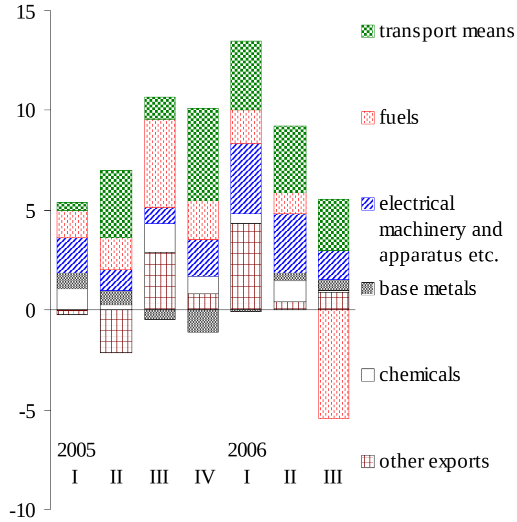
[19] Including transport means, according to the methodology for the classification of main industrial groups.

[20] USD 0.01 per litre.

(ii) the drop in the Romanian industrial output in the field of hydrocarbons extraction and, implicitly, in the field of crude oil processing (-6 percent and -11.7 percent respectively, against the background of the natural decline in mature fields and the slowdown in external demand), and (iii) a strong base effect (in 2005 Q3 the volume of fuel exports had posted an increase of 56.5 percent in annual terms). Although on a decrease versus the previous quarter, in Q3, the rates of increase of exports of "mechanical and electrical machinery and apparatus" and "transport means" continued to exceed those of exports of other goods (+16.4 percent and +37.9 percent respectively). As regards imports, services were also the main driver of the acceleration in the annual dynamics of imports, in Q3, the growth rate of the physical volume of imported goods (+18.4 percent) remaining broadly unchanged from Q2.

Dynamics of Export Physical Volume

annual contribution (percentage points)



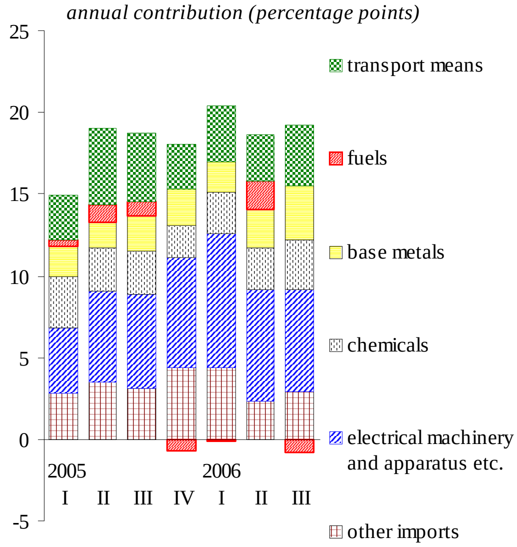
Source: NIS, NBR calculations

1.2. Supply

On the supply side, in 2006 Q3, industrial activity was further on an uptrend, the annual growth rate of gross value added accelerating slightly over Q2 to +8 percent (one of the fastest paces of increase from 1999 onwards). The development was propelled mainly by the output of intermediate goods (particularly metallurgy and chemical industry) and also by the output of durables and road transport means (amid the step-up in domestic demand). The growth rate of gross value added in the services sector accelerated as well (by one percentage point to 8.5 percent) mainly as a result of the pick-up in trade activity as concerns both wholesale trade (development matched with the acceleration recorded by all the economic sectors) and retail trade (against the background of a stronger supply – in terms of size, marketing policies and accessibility of non-bank financing).

Dynamics of Import Physical Volume

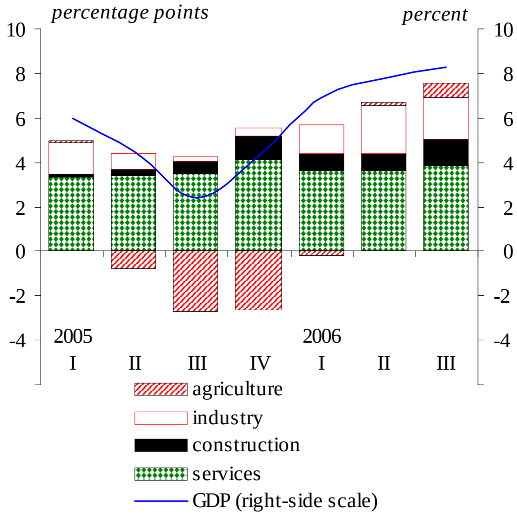
annual contribution (percentage points)



Source: NIS, NBR calculations

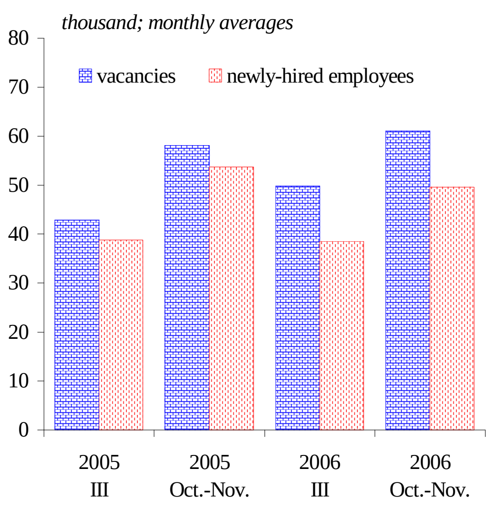
The annual growth rate of gross value added in agriculture increased more than two times (5.2 percent); unlike the previous quarter, this development was due to a hike in the output volume. In Q3, the acceleration in the pace of increase of gross value added was accounted for particularly by vegetables, fruit, sugar beet and sunflower; adverse weather conditions affected both the volume and quality of grain production in 2006 (especially wheat, rye, barley and maize). The animal breeding sector saw further decreases in the volume of meat and egg output; as concerns poultry products, this drop was chiefly caused by the massive cut in the number of fowls during the second bird flu wave (May-July 2006).

Contribution of Main Supply Components to GDP Growth



Source: NIS, NBR calculations

Number of Vacancies and Number of Filled Vacancies



Source: NEA

The annual growth rate of gross value added in construction accelerated further, adding 5 percentage points to 19.2 percent; market signals point to a 17-year high in what concerns construction activity in 2006. In Q3, construction works, whether they consisted in achieving new objectives, or in current or capital repairs, posted higher growth rates (by 4-6 percentage points) for all types of projects: residential (to almost 15 percent), non-residential (to almost 12 percent) and infrastructure (to almost 23 percent).

2. Labour market

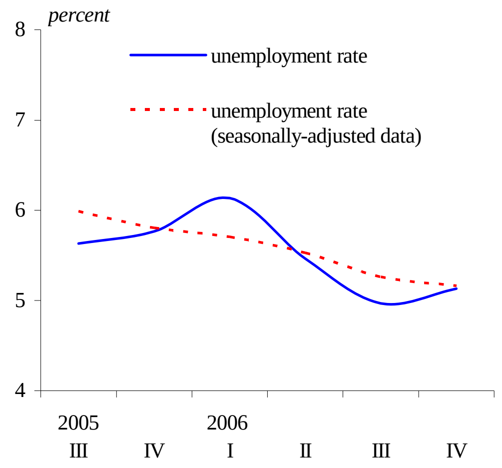
2.1. Labour force

In 2006 Q3, labour market narrowed even further as compared to the previous quarters, showing no signs of a trend reversal in the last quarter of the year. Against this backdrop, wage dynamics accelerated, which caused the worsening of ULC, particularly across manufacturing. October and November, however, saw an improvement from Q3, the ULC index in manufacturing standing again below the average industry-wide.

In line with expectations, pressures in the labour market kept building up in 2006 Q3, causing both registered unemployment rate and non-adjusted unemployment rate to bottom out at 5 percent and 5.3 percent respectively. Additional signs of the narrowing of labour market were also provided by the other elements relating to labour supply: (i) unemployment outflows were 15.9 percent higher year on year (the highest annual growth rate in the last three years); similar to the prior quarter, jobseekers that relinquished to renew their applications for a job, possibly choosing to find work on their own, made the largest contribution; (ii) the number of people subject to lay-offs remained relatively low (44.6 thousand – the lowest figure in the last couple of years) and was considerably smaller that the number of hirings (2.5 times); industry reported most of the redundancies, whereas employment rate went up year on year in construction and services (the former even witnessed a trend reversal). Actually, similar to the previous quarter, unemployment outflows as a result of hiring showed a positive annual growth rate (5.2 percent) that has been moving up slightly. These developments were backed by the step-up in excess labour demand, the number of vacancies disclosed by the NEA stepping up 16.3 percent from the year-ago period.

The statistical data available for 2006 Q4 illustrate ongoing tensions in the labour market, although the evolution of relevant indicators in October and November sent mixed signals: (i) the number of vacancies identified by the NEA kept rising, while hirings posted a negative annual growth rate; (ii) the number of the unemployed that had entered the NEA records exceeded 100 thousand in both months (for the first time since January), possibly on account of the formal procedures for being granted the minimum guaranteed income[21]. The unemployment rate showed no signs of reversing its trend; this indicator stuck to levels similar to the third-quarter as regards both the gross series and the non-adjusted series, thereby illustrating the persistence of tensions in the labour market.

Unemployment Rate

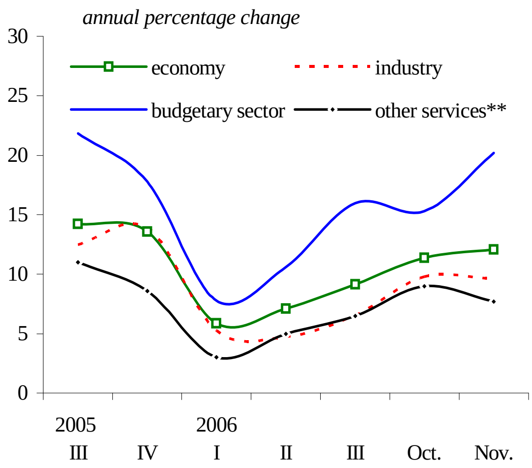


Source: NEA, NBR calculations

2.2. Incomes

Amid the build-up of tensions in the labour market, in 2006 Q3, the annual growth rate of gross average wage economy-wide remained high (17.6 percent in nominal terms, up 0.7 percentage points against 2006 Q2) due mainly to developments in mining (on the back of one-off factors[22] and in the public sector (which witnessed the final stage of annual wage increases). Additionally, the fast dynamics of wages in 2006 could not be separated from the performance of the economy, given that the share of bonuses for good results increased over the past years, accounting for about 20 percent of the wage package[23].

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

In industry, the wage dynamics, accompanied by a slower growth rate of labour productivity, entailed the 2.6 percentage point rise, compared to the prior quarter, in the nominal ULC index (to 103.6 percent). The driver of this development consisted in the poor performance of manufacturing where the annual change in nominal ULC reached 4.2 percent (+2.6 percentage points, quarter on quarter) and stood above the average for industry for the second quarter in a row. Mining also witnessed fast-paced growth, but the annual rate of increase in nominal ULC (+1.1 percent) remained below the average for industry. Although in 2006 Q3 the energy sector fared better than other sectors (-3.7 percentage points, at 102.8 percent), it is worth noting that the developments in September (labour productivity stuck to the level of the year-earlier period after recording an average annual growth of 15.4 percent in July-August) caused the sizeable change to the broad picture in the

[21] According to the regulations in force, the recipients of welfare allowances in compliance with Law No. 416/2001 on the minimum guaranteed income are also entitled to receive heating allowances. In 2006, the income ceiling per family member that was used for the calculation of heating allowances was raised from RON 310 to RON 500 and the payment mechanism was altered.
[22] Bonuses and benefits.
[23] According to a study published by PricewaterhouseCoopers in December 2006 (PayWell Romania 2006 – Salary and Benefits Survey).

Labour Productivity and Real Gross Wage in Industry

annual percentage change

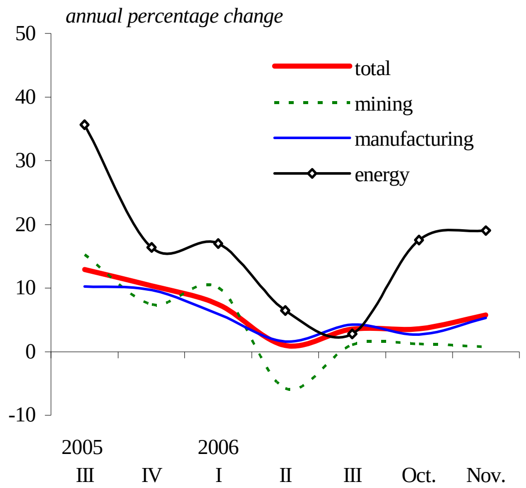
	2005		2006				
	III	IV	I	II	III	Oct.	Nov.
Labour productivity	3.7	7.0	8.6	13.2	11.1	13.3	10.6
Real gross average wage*	5.4	6.6	4.4	2.0	1.9	5.9	5.4
Real gross average wage**	16.5	15.9	7.8	4.0	3.0	6.9	5.5

*) deflated by industrial producer price index for domestic market

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

Source: NIS, NBR calculations

Unit Labour Costs in Industry



Source: NIS, NBR calculations

first part of the period, when the nominal ULC index was below par (averaging at 98.5 percent).

Statistical data for Q3 indicate a weak performance in consumer goods sub-sectors, mainly as a result of substantial productivity losses. The annual dynamics of nominal ULC index exceeded 35 percent in the following sub-sectors: tobacco products, textiles, printing, radio and TV sets. It is to be noted that despite the contraction of activity in these sub-sectors, the rates of increase in wages stood close to or even surpassed the average for manufacturing, thereby pinpointing the tensions in the labour market. The same as in the last two quarters, food and furniture industries posted below-average values.

The unit labour cost continued to exhibit a positive annual growth rate in October and November as well. The worsening which had become manifest in the energy sector deepened even further due to soaring wages. Manufacturing, where the ULC index dropped below the average for industry and the value for 2006 Q3, witnessed improved performance.

On the demand side, there are also indications of persistent pressures on the consumption of goods and services, even though statistical data illustrate a slowdown in the annual growth rate of real disposable income[5] of households (down 1.6 percentage points to +2.6 percent). This was attributable to the following: (i) the annual dynamics of real wages remained high and rising as compared to the previous quarter (to +10.4 percent); (ii) the negative annual rate of increase of remittances from abroad (-4.1 percent) should not be associated with the current developments, given that third-quarter remittances were higher than the average for the first half of 2006 (by 6.4 percent in real terms). In the latter half of 2006, the rise in disposable income is expected to boost private consumption on account of the trend reversal in the case of transfers from budgetary and extra-budgetary funds (due chiefly to early indexation of pensions) and the large volume of remittances from abroad.

3. Import prices and producer prices

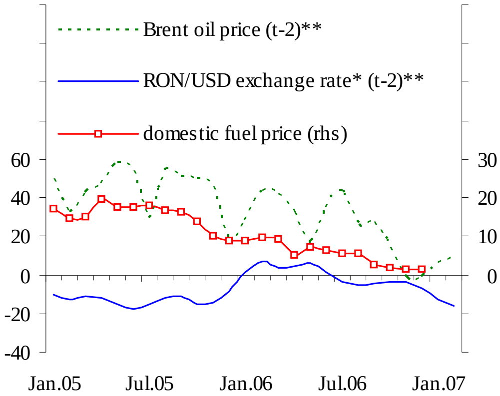
In the considered period, inflationary pressures exerted by producer prices for industrial goods remained high, whilst those brought about by import prices were on the upside; in both cases, prices for non-durables posted unfavourable developments. Prices for agricultural products improved significantly, owing to developments in both vegetal and animal products. In 2006 Q4, trend reversals are expected in the case of both industrial and agricultural producer prices, following the easing of conditions on the energy market and the decline in the grain output throughout the year.

3.1. Import prices

Import prices put larger pressures on domestic prices in 2006 Q3 versus Q2, the deflator of imports of goods and services increasing from 100.9 percent to 103.1 percent in annual terms. This deterioration was caused by the halt in the appreciation trend of the domestic currency against the euro (down 0.4 percent as compared with the same year-ago period) and the further upward path of external prices, even though their annual growth rate (3.2 percent) was slightly slower than that recorded in 2006 Q2.

Oil and Fuel Prices

annual percentage change



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

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

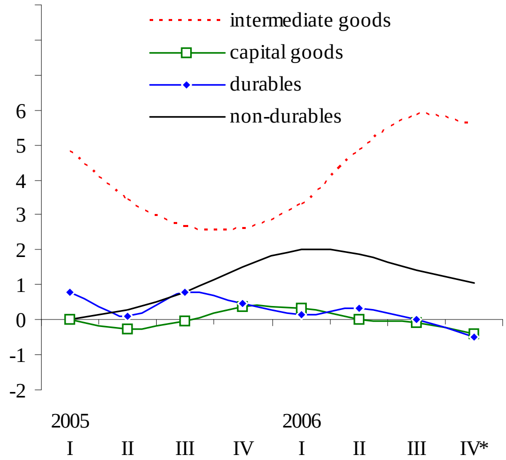
Source: NIS, EIA

In terms of structure, significant pressures were generated by prices for foodstuffs, chemicals (pharmaceuticals in particular) and base metals[24], which posted above-average growth rates (expressed in euro); given that most of the respective commodities originate in the European Union, the dynamics of import prices for such goods was higher than in Q2 (2.3 percent versus 0.5 percent). Favourable developments were reported by fuel prices, owing to the easing of tensions on the world oil market, and prices for footwear, transport means, as well as for optical, cinematographic, medical instruments and apparatus.

In October-December 2006, no additional pressures were generated by external prices given that: (i) the world oil price hovered around much lower levels than the Q3[25] average, its annual growth rate decelerating from 13.3 percent to 5.2 percent; (ii) the growth rate of the natural gas price stayed on a downtrend, and (iii) the aggregate price index of commodities calculated by the IMF points to a slowdown in their growth rate in October-November 2006 as compared with Q3 (by 7.8 percentage points to an average annual pace of 11 percent). The same holds true for prices of goods originating in the European Union, as the annual growth rate of EU industrial producer prices for exports stood in October at the Q3 average, i.e. 2.6 percent.

EU-25 Industrial Producer Prices for Exports

annual percentage change



Source: EUROSTAT *) October - November

The nominal appreciation of the domestic currency against the euro and the US dollar (by 4.6 percent and 13.4 percent respectively in annual terms) during October-December 2006 also had a favourable impact on imported inflation.

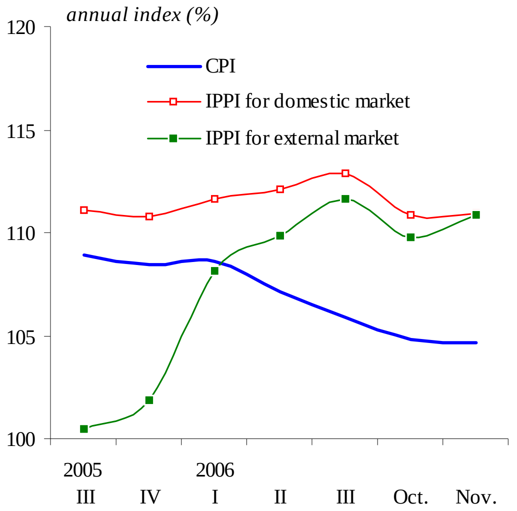
[24] In the context of strong world demand, particularly from China.

[25] The average price for Brent oil in 2006 Q4 was USD 59.9 per barrel compared with an average of USD 69.6 per barrel in the previous quarter.

3.2. Producer prices

3.2.1. Industrial producer prices

Consumer Prices and Industrial Producer Prices

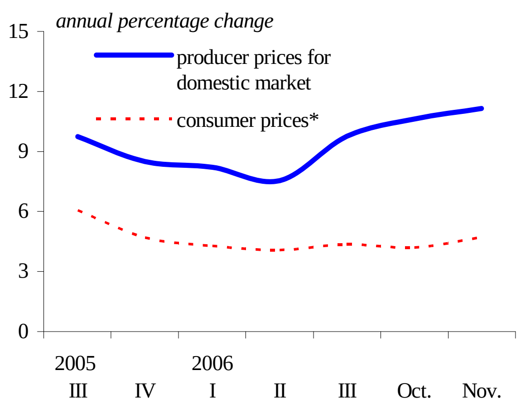


Source: NIS

In 2006 Q3, the annual growth rate of industrial producer prices for the domestic market advanced further at a fast pace (0.8 percentage points to 12.9 percent) as compared with Q2, mainly on account of developments in manufacturing, where prices added 1.6 percentage points to 13.1 percent. Thus, the annual rate of increase of industrial producer prices for the domestic market in manufacturing exceeded the average industry-wide for the first time in the past seven quarters, whilst the gap between the annual growth rate of industrial producer prices for the domestic market in manufacturing and that of consumer prices widened to 7.2 percentage points.

Unlike the previous quarter, positive and increasing price changes were recorded by most industrial groups, the only favourable development being posted by prices for energy products (down 3.1 percentage points to 19.8 percent) in both hydrocarbon extraction and processing[26] and electricity sub-sectors. This can be attributed to the alleviating tensions on world oil market and to this movement feeding through into domestic prices, as well as to the higher resort to hydroelectric power in order to meet household demand and to lower administered prices charged by the main electricity producer.

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

Producer prices for intermediate goods posted the swiftest annual growth rate (up 3.5 percentage points to 9.8 percent). Behind this increase stood the developments in the metalliferous ores extraction and processing sub-sector and in metallurgy and was associated in both cases with the hike in external prices for metals. Accordingly, this movement fed through into sub-sectors where metal is the main raw material, causing industrial producer prices for the domestic market in both capital goods and durables sub-sectors to post annual growth rates higher than in the prior quarter (up 0.8 percentage points to 7.6 percent and 5 percent respectively); in either case, the step-up in demand was an additional pressure-inducing factor.

Producer prices for non-durables on the domestic market made a negative contribution to disinflation, as their annual growth rate accelerated by 2.2 percentage points versus the previous quarter, so that the gap between their growth rate and that of consumer prices for non-durables widened to 5.4 percentage points. This trend was accounted for by faster growth rate of

[26] In 2006 Q3, the average annual growth rate of industrial producer prices for the domestic market slowed down 1.9 percentage points in hydrocarbon extraction and 7.2 percentage points in the oil processing sub-sector.

prices in food industry (up 2.4 percentage points to 7.3 percent), which, in the absence of significant pressures from raw materials and labour costs[27], may be associated with the recovery of investment required by the alignment to EU standards and the use of higher profit margins, given the strong domestic demand.

In 2006 Q4, disinflation of industrial producer prices for the domestic market may have been resumed, owing largely to developments in prices for energy products.

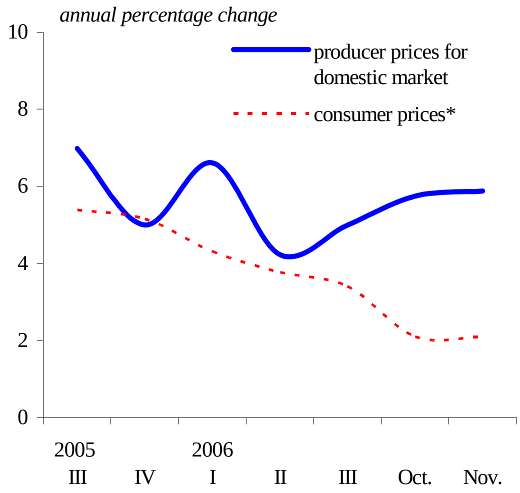
3.2.2. Agricultural producer prices

July through September, the annual growth rate of prices for agricultural products resumed the downtrend (down 1.9 percent), with prices for animal products (down 3.3 percent) making a significant contribution for the first time in two years. The same as in the previous quarter, pressures were generated by price movements in the poultry sub-sector, yet their magnitude lowered by 6.4 percentage points to 18.2 percent, being countered by the decreases in annual terms in prices for pork and mutton.

In 2006 Q3, the annual growth rate of prices for vegetal products stayed on a downtrend (down 0.9 percent), as the main categories of products subject to monitoring recorded diverging price developments: (i) considerable deceleration in the growth rate of prices for vegetables, due to plentiful supply; (ii) positive annual growth rates of prices for some grains (for the first time in two years), because of poor crops in 2006.

In the latter case, tensions are likely to have increased in the final quarter of 2006, leading to a new trend reversal in prices for agricultural products (weaker grain crops have a direct impact on prices for fodder and implicitly on meat prices).

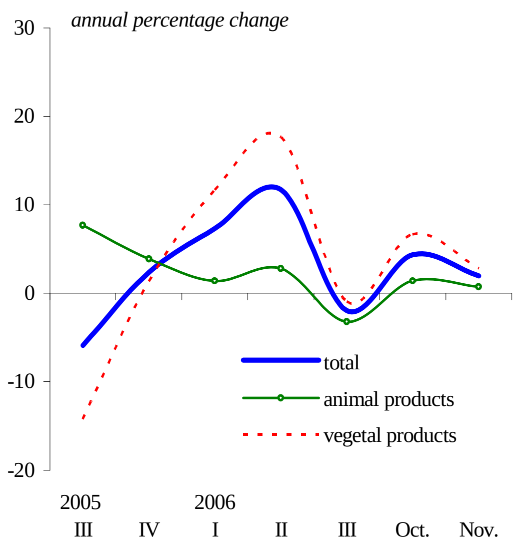
Durables Prices



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

Source: NIS, NBR calculations

Agricultural Producer Prices



Source: NIS

[27] Even though unit labour cost posted a positive annual nominal change, in 2006 its level (2.9 percent on average) was below the average across manufacturing and much lower than the averages for the past two years. Furthermore, its 2006 figure was lower than the growth rate of industrial producer prices for the domestic market, while in 2004 and 2005 the ratio of the two indicators was significantly above par.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

For the most part of 2006 Q4, restrictiveness of monetary policy increased, as reflected by the rise in the real monetary policy rate spread and strong real appreciation of the RON versus the euro. Towards the end of the final quarter of 2006, restrictiveness of monetary conditions alleviated following the National Bank of Romania's move to ease gradually its control over liquidity in response to the excessive increase in pressure that the speculative capital inflows put on the exchange rate of the RON.

The National Bank of Romania Board decided, in both its meetings addressing monetary policy issues during the last quarter of 2006, to leave the monetary policy rate unchanged at 8.75 percent, despite the considerably fast disinflation in Q3 and the anticipated decline in annual inflation rate for December below the midpoint of the year-end target. The increased restrictiveness of interest rate policy was supported by further firm control over liquidity during October and November, the central bank sterilizing excess liquidity via open-market operations. The implementation of additional steps to contain credit risk associated with household loans in late October enhanced the restrictiveness of broad monetary conditions. These steps were aimed at tightening lending conditions for both bank and non-bank customers. However, towards the end of the quarter under review, the monetary authority resumed the pattern of partial sterilization of excess liquidity via open-market operations. The aim of this move was to annihilate the risk of an unsustainable appreciation of the domestic currency triggered by the substantial increase in speculative capital inflows fuelled by favorable conditions on most emerging markets in the region and expectations of a stronger RON ahead of Romania's accession to the EU. Restrictiveness of monetary conditions remained adequate for ensuring sustainable disinflation, including as a result of sharper-than-expected drop in the real effective exchange rate of the RON.

The decisions to leave the monetary policy rate unchanged (at 8.75 percent), the significant improvement in short-term outlook for inflation notwithstanding, hinged mainly on the risk of a possible veering off of disinflation from the projected trajectory over the medium term given that during the monetary policy transmission horizon the action of some factors likely to generate inflation was still manifest. The major threat to sustainability of disinflation which the quarterly projection of macroeconomic developments identified was the near-term upsurge of the projected excess demand, in spite of the upward adjustment of potential GDP in the current forecasting round; the projected widening of the positive output gap stemmed from the faster-than-expected economic growth in Q3 and from the anticipated easing of the fiscal policy stance towards end-2006.

Analysis of statistical data for Q3 released subsequently confirmed to a large extent the central bank's projections and concerns. Even though the acceleration of economic growth in Q3 was somewhat falling short of expectations (from 7.8 percent to 8.3 percent – see Chapter III. Economic developments), it boosted excess demand, its inflationary potential in particular, with household consumption further expanding at a fairly swift pace and the annual growth rate of its major component, i.e. goods purchase, hitting a historical high in Q3. Under the circumstances, the likelihood that fast-paced consumption should persist over the next three-month periods was high, being also fuelled by the multiplication effect expected to be generated by the booming investment in Q3.

The assumption of persistently robust household consumption and the related inflationary pressure relies also on the statistical data for the first half of Q4; thus, average annual growth rates of turnover reported by retail trade and services in October and November shot up to levels close to those seen in Q3. Behind the fast-growing household consumption stood further the strong pay rises (average real growth rate of net average wage came in at 11.7 percent in October-November, up 2.5 percentage points against the third-quarter figure) and the remittances from abroad, along with net household savings with banks, the downtrend of which has slowed noticeably.

According to data available for October and November 2006, the real annual growth rate of the balance on loans granted by credit institutions to households decelerated slightly, with the average annual real growth rate slowing 3.7 percentage points against the third-quarter reading to 73.6 percent. A sharper downturn displayed the average level of new loans to individuals, whose real average annual growth declined over the period to 47.4 percent, down 5.8 percentage points from Q3, due solely to weaker growth of RON-denominated loans, whose real average annual rate of increase slowed to merely 0.5 percent in October and November, compared with 85 percent in Q3, whereas the real average annual dynamics of foreign currency-denominated loans sped up markedly (largely as a result of fading base effect – see Sub-section 2.3. Money and credit). Slower dynamics of RON-denominated loans to households was chiefly attributed to tougher bank lending requirements, on account of higher interest rates applied by credit institutions (following the decisions to raise monetary policy rate in the past few quarters) and as a result of additional steps adopted by the National Bank of Romania with a view to containing credit risk associated with loans to households[28].

The real growth of RON-denominated time deposits of households accelerated – the average annual rate recorded in October and November (15 percent) exceeding by 3.9 percentage points that of Q3, owing widely to swift rise in wages and upward adjustment of interest rates applied by banks on RON-denominated time deposits. The latter development notwithstanding, the propensity for saving in foreign currency increased further, with the balance of foreign currency-denominated deposits of households (when expressed in euro) surging to a 4½ year record high in October and November (an average annual increase of 37.9 percent compared with 32.4 percent in Q3), amid strong expansion of remittances from Romanians working abroad (average growth rate of 35.8 percent in October and November against 15.8 percent in Q3).

In this setup, the National Bank of Romania took into account the likelihood that a slower deterioration of households' net savings with banks (due to both weaker dynamics of lending and increase in the pace of growth of household deposits) could reflect less a long-lasting behaviour change – a possible result of reaching the ceiling of bearable indebtedness to banks, for people on relatively low income at least – rather than a short-lived delay of some household expenses in anticipation of better conditions on the consumer goods market, real-estate market, and the credit market ahead of Romania's accession to the EU.

From the perspective of developments in excess demand too, the National Bank of Romania was seriously concerned about the impact of the fiscal easing over the last two months of 2006, which was expected to be significant, given the maintenance at 2.5 percent deficit-to-GDP of the consolidated general government target at the fourth budget revision in 2006[29], in spite of the building-up of a surplus equalling 2 percent of GDP in the January-October period. These expectations were confirmed in December, when the balance of

[28] Additional steps to contain credit risk associated with household loans, effective 22 October 2006, were aimed at assessing the applicant's creditworthiness by considering all costs related to loan agreements (principal, interest, and any other costs such as insurance policies and fees) and including the non-bank financial institutions in the scope of these regulations.
[29] Which took place in November.

the General Account of the Treasury saw a noticeable change, with the record-high liquidity injections by the Ministry of Public Finance making the central bank's monetary control increasingly difficult. Adding to the undesirable effects of such behavior was the strong increase in broad money towards year-end, which could have entailed a bout of inflation.

Moreover, the decisions to leave the policy rate unchanged at 8.75 percent also took account of the need to counter the second-round effects of the ongoing adjustment of administered prices. A matter of concern for the central bank was the increased risk of these effects to materialize, given that the updated administered price adjustment programme envisages larger corrections in 2006 and 2007 than previously projected; the ampler-than-announced movements in 2006 were due to earlier implementation of some price adjustments due for 2007 (the 8.5 percent increase in the natural gas price and the 4.63 percent hike in the electricity price in December). Therefore, in 2006 Q4, supply-side factors, i.e. administered prices, had a heavier impact on inflation than in the previous quarter; nonetheless, their effect was offset by the decelerating annual pace of growth of volatile prices, paving the way for the 12-month inflation rate to plunge to 4.87 percent in December, down 0.61 percentage points against the end-September figure and 0.13 percentage points below the year-end midpoint of the target (0.17 percentage points above the forecast presented in the November 2006 Inflation Report). The slowdown in inflation also caused a relative alleviation of inflation expectations expressed by the respondents participating in the business and bank surveys; the same as in Q3, the alleviation was more pronounced over the near term (end of 2006) rather than over the medium term.

In order to increase the contractionary impact of the rise in the real monetary policy rate spread on monetary conditions, the National Bank of Romania kept in place the firm control over money market liquidity in October and November. Thus, it resorted heavily to sterilization operations to drain the excess liquidity during the reviewed quarter, accepted all the bids submitted by credit institutions to the deposit auctions and maintained the volume of CDs launched at the monthly auctions at levels similar to those on offer in the past.

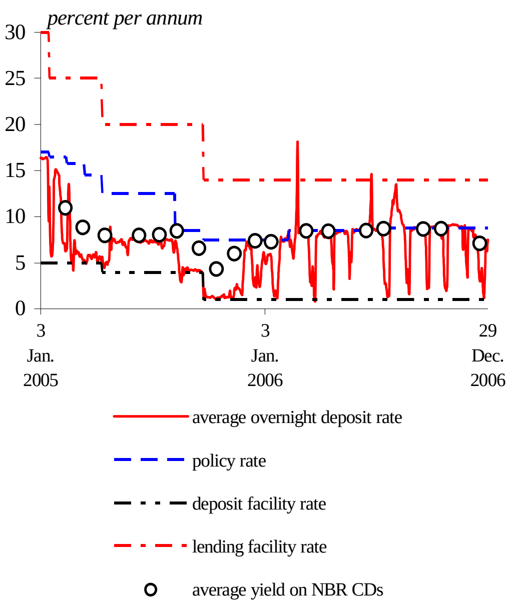
Unlike the previous quarter, tightening of monetary conditions was also prompted by the developments in the RON/EUR exchange rate, given that in the last three months of 2006 the domestic currency posted the strongest real appreciation in the past five quarters (3.1 percent). The drop in the RON/EUR exchange rate was smoother in the first half of Q4, reflecting (i) favorable investor sentiment towards financial markets in the region, (ii) improved current-account deficit financing via direct investment and capital transfers and (iii) increase in foreign financial borrowings. Strengthening of the RON gathered momentum in late November, amid the surge in speculative capital inflows fuelled by the approaching accession of Romania to the EU; such inflows put pressure on the RON/EUR exchange rate and implicitly heightened the risk of a subsequent abrupt adjustment that could jeopardize disinflation sustainability. The need to tackle this risk made the central bank resume the partial sterilization of excess liquidity via open-market operations. Hence, starting in December, the National Bank of Romania reduced gradually the mopped-up liquidity volumes and accepted only part of the bids submitted by credit institutions at the weekly deposit auctions.

2. Financial markets and monetary developments

The interbank rates monthly average was slightly lower than the monetary policy rate in Q4, except for December, when the former dropped considerably, following the loosening of the NBR's control over liquidity. The RON exchange rate posted a faster downtrend, with the domestic currency witnessing a stronger appreciation both in relation to the euro and to the US dollar. At the same time, monetary expansion slowed down, also as a result of the halt in the upward trend seen by the annual growth rate of non-government credit.

2.1. Interest rates

Interbank Money Market Rates



Interbank rates witnessed a relative stability in the first two months of the period under review, with their daily averages staying close to the monetary policy rate, except for the closing days of the minimum reserve requirements maintenance periods. However, this pattern changed in December, when the central bank pursued a partial sterilization policy of the liquidity surplus via open-market operations, leading to a swift drop in interest rates on interbank deposits; consequently, the quarterly average of these interest rates (6.9 percent) lost 0.7 percentage points from the previous quarter.

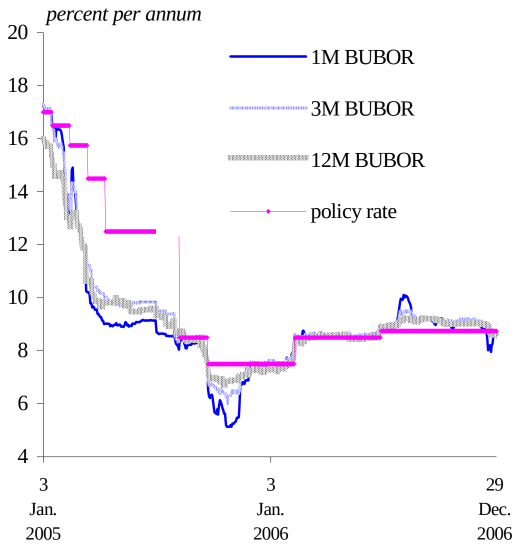
Early Q4 brought no significant changes in the trajectory of interest rates on the interbank market. Thus, in early October and in November, they stayed close to the interest rate on one-month deposits, i.e. the NBR's main monetary policy instrument. The two categories of interest rates posted different developments only in the closing weeks of the minimum reserve requirements maintenance periods, when the daily averages of overnight rates fell to the level of the deposit facility rate. This temporary decline was more broad-based in October, owing to more substantial liquidity injections by the Treasury and to increased cautiousness of credit institutions, which materialised in the expected hike in reserve holdings for making quarterly payments to the government budget. However, the decrease in overnight rates was less pronounced 16 through 23 November; besides, it came to a temporary halt, amid a sudden, atypical upturn in some credit institutions' demand for reserves and the preference of operators holding a liquidity surplus either for one-month deposits with the NBR or for maintaining their excess reserves. Against this background, the interbank rates monthly average inched up 0.3 percentage points in November, to 7.8 percent.

In December, however, average interest rates on interbank deposits were lowered by 2 percentage points, with daily average rates reflecting the impact of the gradual easing of liquidity conditions following the partial acceptance by the NBR of the bids submitted by banks at the deposit auctions. The effect of this measure was underpinned by the massive liquidity injections by the Treasury during the reported period, accounting for over 2 percent of the projected GDP, resulting in a vigorous upsurge in credit institutions' resort to the deposit facility, with the volume of placements peaking at the highest value since November 2005).

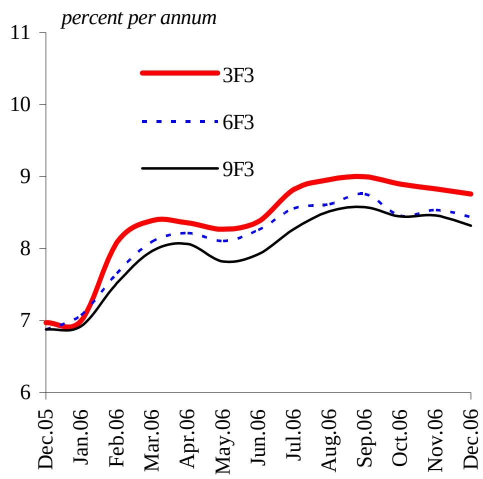
Nonetheless, throughout the period under review, overnight rates were less volatile than in the previous quarter, while the band within which average daily rates fluctuated narrowed slightly from 1.3-13.4 percent to 1.2-9.2 percent. In addition, the average spread between bid and ask rates for very short maturities narrowed by 0.2 percentage points versus Q3, although widening towards the end of the reported period.

The loosening of control over liquidity in December impacted the (1M-12M) BUBOR yield curve, which fell below the September reading; thus, after increasing for three consecutive quarters, average rates crept down 0.4 percentage points in the last three months of 2006. The downward adjustment of daily rates was faster than that recorded in the early stages of NBR's looser control over liquidity in 2005 Q3; conversely, interest rates for shorter maturities posted a sharper decline in the first stage, hinting at the fact that market operators considered (initially, at least) the easing of liquidity conditions to be temporary. Amid these developments, the yield curve entered positive territory for the first time since November 2005, with a 0.3 percentage point spread between the monthly averages of the 12M and 1M BUBOR rates.

Policy Rate and BUBOR Rates



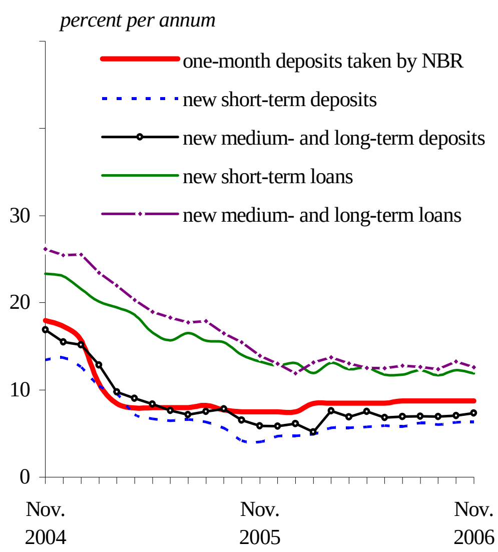
Implicit Forward Rates



The same outlook is confirmed by developments in forward rates, calculated on the basis of December average interest rates. Thus, the 3M BUBOR rate is expected to stand at 8.8 percent in March 2007, similar to the current level, but also to the level forecasted in 2006 Q3, and to decline to 8.4 percent in June 2007 (0.2 percentage points below the level calculated on the basis of interest rates recorded in September 2006) and to 8.3 percent at end-Q3.

The same as in the previous four quarters, the Ministry of Public Finance refrained from performing any operations on the primary market for government securities in Q4 too. The auctions for treasury certificates and T-bills scheduled for the reported period were cancelled, given that the value of government securities falling due was fairly low, i.e. RON 150 million, and budget execution provided a comfortable level of holdings in the General Account of the Treasury. However, in late December, amid the sharp rise in budgetary expenditures, the Ministry of Public Finance had to resort to money market deposit taking operations[30], for the first time in the past 11 months.

Bank Rates



September through November, banks' average interest rates on new deposits and loans generally stuck to their trajectories from the previous quarter, although monthly averages often posted opposing developments, particularly with regard to loans. Thus, interest rates on new time deposits continued their upward course, yet the adjustment for the reported period stood below the June-August level, especially on the back of the much slower rise in deposit rates for companies (by 0.07 percentage points, to 6.41 percent); the average interest rate on new household time deposits advanced 0.13 percentage points in November against August, thus reaching 6.25 percent. The average interest rate on new loans witnessed a steeper drop, owing solely to looser corporate lending conditions; conversely, the average lending rate on new household loans was 0.19 percentage points higher in November than in August, mainly as a result of the significant upper adjustment (by 0.73 percentage points, to 14.91 percent) of interest costs attached to new medium-term household loans.

[30] On 29 December, the Ministry of Public Finance took deposits worth RON 950 million, with two-week maturity, at an average interest rate of 8.38 percent.

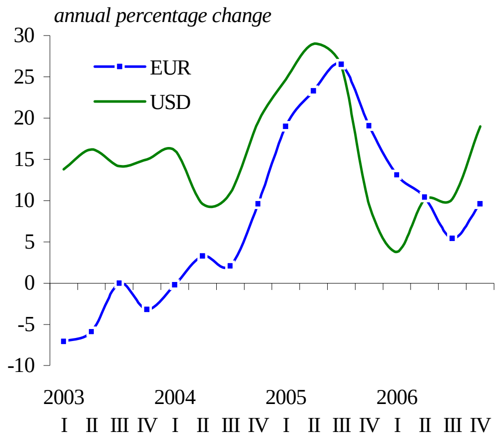
2.2. Exchange rate and capital flows

In 2006 Q4, the appreciation of the RON against the EUR accelerated. The driving forces behind the strengthening of the domestic currency were somewhat moderate in the first half of the period under review; afterwards, they gathered momentum on the back of larger and more diversified capital inflows, triggered by favourable conditions on the domestic market and expectations of a steeper downward trend of the RON/EUR exchange rate. As a consequence, the RON/EUR exchange rate entered a sharp descending path, thus exhibiting a diverging trend from most currencies in the region.

Against this backdrop, the appreciation of the RON versus the EUR for the past twelve months (compared to the same year-ago period) practically doubled from the level recorded in the first nine months of 2006 (7.2 percent in nominal terms and 12.4 percent in real terms). The domestic currency posted relatively similar developments in relation to the US dollar (19.4 percent nominal appreciation and 25.2 percent real appreciation). Calculated as an average annual change for 2006 Q4, the domestic currency re-entered a nominal appreciation path versus the euro (4.6 percent) and implicitly consolidated its real appreciation trend; the RON strengthened at a faster pace versus the USD both in nominal and real terms (13.6 percent and 19 percent respectively).

The appreciation of the RON against the EUR, which had started in the latter half of September, persisted into October as well, when the domestic currency strengthened 0.2 percent against the euro. This development was ascribable to the fact that, although the current account deficit widened considerably from the previous month (mainly due to the record-high trade shortfall[31]), its coverage through direct investments and capital transfers[32] witnessed a substantial improvement. Developments in the RON/EUR exchange rate were also bolstered by capital inflows of borrowings (especially of the banking sector) and portfolio investments[33], which were given an impetus by the increased attractiveness of the domestic financial market, as a result of still high interest rates, the upcoming EU accession and

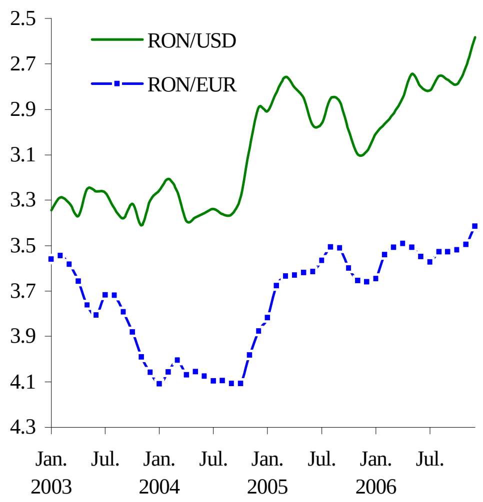
Developments of RON Exchange Rate*)



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

Source: NIS, NBR

Nominal Exchange Rate

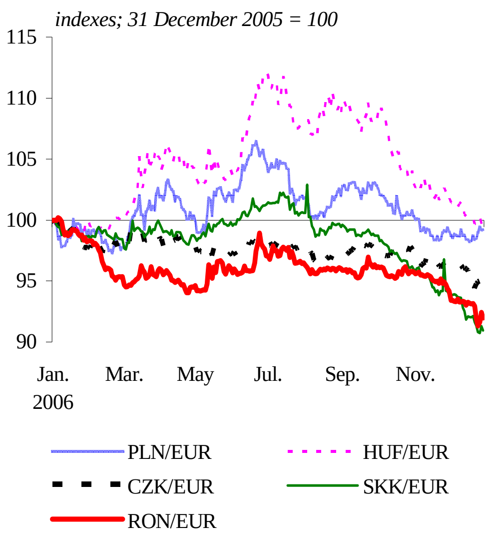


[31] Up 44.7 percent from the previous month and 48 percent versus October 2005.
[32] Over the first ten months, direct investments (including the proceeds from the privatisation of BCR, settled in October 2006) and current transfers fully covered the current account deficit (compared to 67.9 percent in the first nine months and 88 percent in the first ten months of 2005).
[33] According to data released by the BSE, non-residents' net purchases of government securities were almost 20 times higher in October than a month before.

Key Financial Account Items (balances)

	2005 11 mos	2006 11 mos
		EUR million
Financial account	**4,777**	**9,354**
Direct investments	**4,502**	**8,273**
residents abroad	-21	-30
non-residents in Romania	4,523	8,303
Portfolio investments	**228**	**0**
residents abroad	-247	-157
non-residents in Romania	475	157
Other capital investments	**5,338**	**6,210**
of which:		
medium- and long-term investments	3,000	1,755
short-term investments	916	3,173
currency in circulation and short-term deposits	439	1,410

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

the upgrading of Romania's rating by international rating agencies[34].

Amid the faster uptrend of these capital inflows[35], the strengthening of the domestic currency versus the euro accelerated in November by 0.7 percent in nominal terms; the November issue of RON-denominated bonds continued to have a relatively low influence on the exchange rate, given that most securities were purchased by residents. However, the pace of domestic currency appreciation was partly slowed down in early November by pressures exerted by the wide trade deficit, to values below those of other currencies in the region. Subsequently, the strengthening pace of the RON versus the EUR quickened amid the substantial rise in speculative capital inflows[36], due to the obvious rebound in investor sentiment towards placements on the financial markets in the region[37], on the one hand, and to expectations of a swifter downtrend of the RON/EUR exchange rate ahead of Romania's joining the European Union on 1 January 2007, on the other. As a consequence, the RON/EUR rate witnessed an abrupt decline, hitting on 30 November its lowest value since December 2002, thus posting a diverging trajectory from that of most currencies in the region.

In December, there were increased investor expectations of the RON/EUR exchange rate sticking to its downward trend over the short run; hence, despite the somewhat abrupt drop in the domestic money market interest rates[38], the share of speculative operations in total interbank forex market trading advanced, with the volume of non-residents' forex operations reaching a historic high[39]. These pressures on the domestic currency were doubled by those generated by the seasonal increase in remittances from abroad and, possibly, by those associated with the surge in capital inflows similar in nature to direct investments and financial borrowings. The influence of these factors was sporadically amplified by some forex market operators' attempts to determine the central bank to

[34] Moody's announced on 6 October that it had upgraded Romania's sovereign risk to investment grade.
[35] Banking sector lending might have been fostered by the NBR Board decision of 10 November to remove the limit on the exposure of credit institutions to unhedged borrowers in terms of foreign-currency denominated credits starting from 1 January 2007.
[36] The share of swap transactions in the total interbank forex market trading peaked at 50.2 percent in November.
[37] Amid latest positive developments in these countries and expectations of a likely drop in the Fed funds rate as of 2007.
[38] Especially as a result of partial sterilization by the NBR of excess liquidity via open-market operations.
[39] Non-residents' keener interest in placements on the domestic financial market might have also been spurred by the sudden weakening of the US dollar and expectations of maintaining policy rates unchanged by central banks in the region.

recommence its interventions on the interbank forex market. The joint action of these driving forces pushed the RON/EUR exchange rate on a brisk downward path, hitting a four-year low on 22 December. Although these pressures eventually alleviated somewhat, the domestic currency witnessed a substantial nominal appreciation over the final month of the year, i.e. 2.4 percent, coming in second in the region after the Slovak *koruna*[40].

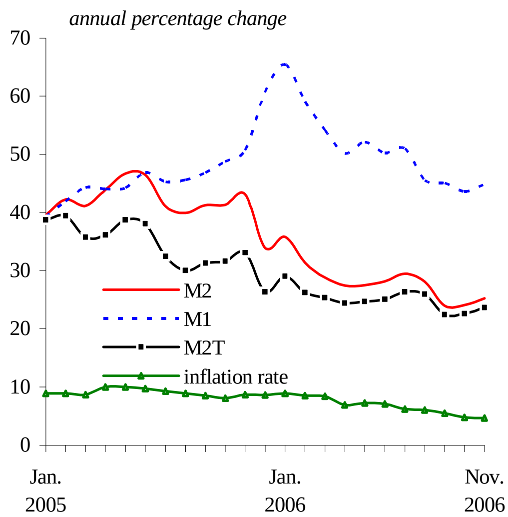
Judging by the experience of other countries that previously joined the European Union, both the magnitude and the persistence of RON strengthening expectations are likely to become less salient in the upcoming quarters. Against this backdrop, it is increasingly likely that short-term movements in the RON exchange rate will more accurately reflect the influence of economic fundamentals and of the ensuing participant expectations. However, the impact of these factors on the exchange rate might still be offset by the potential shift in investor sentiment towards the risk associated with placements on emerging markets in Central and Eastern Europe.

2.3. Money and credit

Money

In September-November 2006, the pace of increase of broad money (M2)[41] slightly lost momentum (18.5 percent compared to 20.8 percent on average in the previous quarters of 2006), reflecting mainly (i) the record widening of the trade deficit in October and November and the rise in payments on external debt, (ii) the still tight fiscal policy, and (iii) the monetary impact of changes in non-bank portfolios and of the nominal appreciation of the domestic currency. From the perspective of M2 counterparties[42], the slower dynamics of liquidity in the economy during the period under review was due to the dwindling expansionary effect of net foreign assets and, to a lesser extent, to the diminishing impact of non-government credit (given that the annual growth rate of the former slackened and that of the latter came to a standstill), amid an ampler contractionary impact of net government credit.

Broad Money and Inflation Rate



Source: NIS, NBR

[40] In December, the Slovak koruna strengthened by 2.8 percent against the euro, the Hungarian forint by 1.9 percent and the Czech koruna by 0.9 percent, while the Polish złoty softened by 2.1 percent.
[41] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September – November 2006.
[42] By removing the impact of settling the BCR privatisation proceeds on net foreign assets and net government credit (EUR 2.2 billion, transferred to the MPF account held with the NBR in October 2006).

Annual Growth Rates of M2 and Its Components

real percentage change

	2005	2006				
	IV	I	II	III	Oct.	Nov.
	monthly average					
M2	28.6	21.5	19.2	20.1	18.4	19.7
M1	41.4	46.9	40.8	39.0	37.0	38.4
Currency in circulation	30.9	36.5	33.5	32.7	29.8	28.6
Demand deposits	53.0	57.8	48.8	45.3	43.8	47.8
Household savings	15.6	9.2	8.9	11.1	13.2	16.9
Time deposits	50.1	35.4	28.2	21.1	17.0	17.9
Foreign currency deposits	37.4	19.5	15.3	16.1	16.7	19.6

Source: NIS, NBR

Developments in M1 and quasi-money contributed to the deceleration in the expansion pace of broad money. In the case of narrow money, there was a decline in the rate of increase of currency in circulation (likely due to the withdrawal from circulation of old banknotes and coins) and of demand deposits, hinting at a possible temporary slowdown in economic activity[43]; however, the M1 percentage change continued to be approximately three times higher than that of quasi-money, so that the share of narrow money in M2 hit a 10-year high of 30.3 percent, on average. In addition, the stronger nominal appreciation of the RON fed through into a relative improvement of the composition of broad money by currency, with the average share of forex deposits in M2 sticking to its downtrend and hitting an 8-year low of 29.1 percent.

By contrast to M2 developments, the pace of increase of household deposits accelerated for the second consecutive quarter, with all components posting faster dynamics. During the period under review, the advance in household deposits was spurred by: (i) higher household incomes (both in terms of larger wage earnings[44] and from remittances), (ii) the increase in interest rates on time deposits, (iii) the withdrawal of old notes from circulation, (iv) the steady contraction of household holdings with the State Treasury, and (v) the drop in the dynamics of household indebtedness to banks. Demand for domestic currency destined to saving remained on the upside, with the annual growth rate of household savings in RON reaching a 13-month high. Household deposits in foreign currency posted an even faster rate of increase, as their annual dynamics hit a 4½ year-record level in October.

Conversely, the dynamics of corporate deposits decelerated, mainly under the influence of (i) the larger volume of payments to the state budget[45], (ii) expanding external payments, including as a result of the trade deficit widening – as indicated by the drop in the growth rate of corporate forex deposits to the lowest reading since 2004 Q1 and by the still high volume of companies' net purchases of foreign currency – as well as (iii) the change in companies' portfolios in favour of purchases of RON-denominated securities issued by non-residents.

[43] The average annual index of industrial production posted a decline September through November 2006.

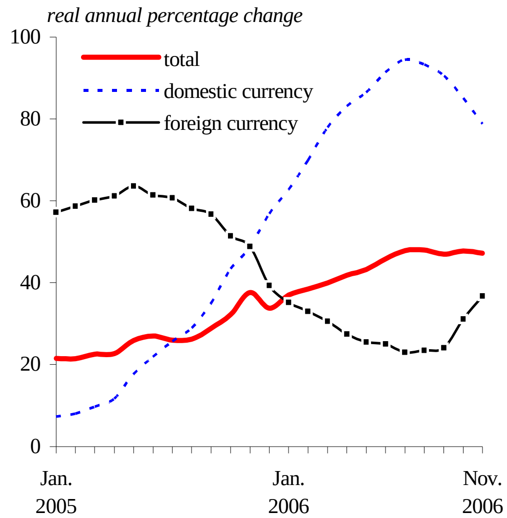
[44] The average annual growth rate of net real wage earnings peaked at 11.4 percent September through November 2006, specifically on the back of pay rises granted to some categories in the budgetary sector (the second round of increase in wages of civil servants and teaching staff).

[45] Profit tax collected September through November 2006 was 42.1 percent higher than in the same year-ago period (compared to a 26.2 percent annual rise June through August 2006).

Non-government credit

September through November 2006, the non-government credit uptrend[46] that had been manifest for the past year and a half came to a halt, with readings hovering around a historic high of 47.3 percent, following a trend reversal of its main components. Thus, after six quarters of continuous rise, the dynamics of RON-denominated loans posted a decline in the reported period, while foreign currency-denominated loans re-entered an upward path after starting to fall in 2005 Q3. Determinants of these changes, which started to emerge in August 2006, included (i) the increase in the minimum reserve requirements on RON-denominated liabilities[47], (ii) the waning base effect induced by NBR Norms No. 11/2005 on containing the concentration of exposures from forex loans, and (iii) the nominal appreciation of the domestic currency. The stronger RON was also behind the further declining share of foreign currency-denominated loans in total non-government credit, which bottomed out at 47 percent on average, i.e. a 9½-year low, despite the rebound in the value of forex non-government credit expressed in euro.

Non-Government Credit by Currency



Source: NIS, NBR

On the supply side, non-government credit was further spurred by fiercer competition among commercial banks, the relatively lower cost of credit institutions' external financing and the dwindling risk of adverse selection. On the other hand, mention should be made of the stifling effect exerted, at least temporarily, by the tighter lending requirements on household lending following the enforcement of the new NBR norms in the field[48]. Demand for non-government credit was cooled down particularly by (i) the higher lending rates on new RON-denominated medium-term loans to household and (ii) the possible decline in the indebtedness capacity of persons with relatively low income. Conversely, demand for non-government credit was fuelled by (i) the downward adjustment of lending rates on household forex loans and, especially towards the end of the reported period, of lending rates applied to corporate RON-denominated loans, (ii) the nominal appreciation of the domestic currency and expectations of even further strengthening, and, probably (iii) persistent favourable expectations of clients concerning their future incomes.

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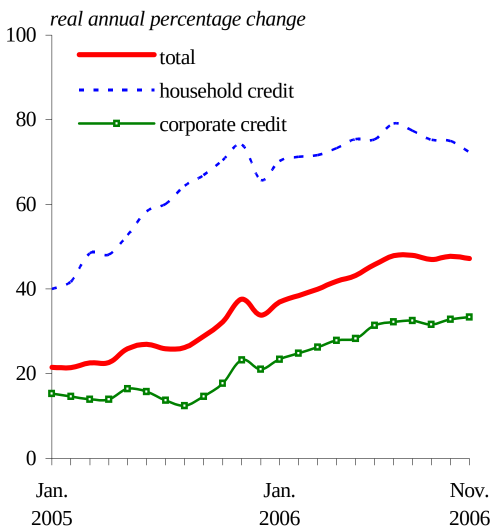
[46] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September – November 2006.

[47] Minimum reserve requirements on RON-denominated liabilities were raised from 16 percent to 20 percent starting with the 24 July – 23 August 2006 maintenance period.

[48] NBR Norms No. 20 of 13 September 2006, amending and supplementing NBR Norms No. 10/2005 on containing credit risk attached to household loans, provided inter alia for the inclusion of all costs related to a loan agreement in the calculus of the monthly payment commitments.

Non-Government Credit by Client



Source: NIS, NBR

Amid these developments, after six consecutive quarters of uninterrupted growth, the pace of household loans witnessed a decline, although remaining at a relatively high level, i.e. 74.1 percent; thus, for the first time ever, the total balance of loans to individuals almost equalled that of total household deposits in November. The trend reversal in the dynamics of household loans was ascribable exclusively to the slower rise of the RON-denominated component, last seen in 2005 Q1, while the pace of increase of foreign currency-denominated loans to households regained momentum (after five consecutive quarters of downfall) thanks to the slight reduction in related costs. Although the above-mentioned deceleration impacted household loans regardless of maturities, the available statistical data[49] pointed to a further uptrend of the growth rate of real estate and mortgage loans (thus reaching the highest reading in the existing data series) and to a continued decline in the rate of expansion of consumer loans. Consequently, long-term loans to households came to account for over two thirds of total non-government credit with an agreed maturity of more than five years.

By contrast, the growth rate of corporate loans accelerated marginally, thus hitting a new record high, with developments by currency resembling those of household loans. However, composition by maturity evolved differently, as the pace of increase of long-term corporate loans continued to slow down, amid increased propensity for short-term loans, whose upward course regained momentum.

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

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the 12-month inflation rate on a trajectory very similar, throughout the projection horizon, to that incorporated in the previous projection. The forecasted levels are 4.6 percent and 4.1 percent for end-2007 and end-2008 respectively.

Maintenance of the inflation rate on a trajectory similar to that projected in November 2006 is the result of mutual offsetting of the effects exerted by some factors whose forecasted developments differ from those in the previous forecasting round. Higher rises in volatile food prices and a more persistent excess demand than in the previous forecast are expected to have adverse effects on projected inflation. Such effects will be countered by comparatively more favourable influences of the developments in the exchange rate of the RON, fuel prices and other import prices, as well as administered prices. The baseline scenario envisages less significant changes of the previous projection in the case of inflation expectations.

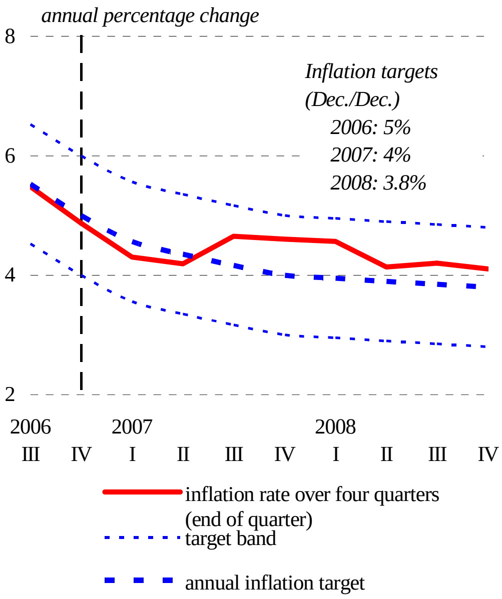
The prospect of faster economic growth than previously forecasted during the entire projection horizon implies the comparatively higher persistence of excess demand in the current projection. In order to avoid a reversal of the disinflation trend during the projection horizon, the influence of the aforementioned factors has to be counteracted by gradually eliminating excess demand and inducing a demand deficit starting with the beginning of 2008. For this purpose, a tight monetary policy stance is further required during the entire period. The suitability of broad monetary conditions with the objective of ongoing disinflation will result from the restrictiveness of real interest rates in relation to excess demand and higher restrictiveness than in the previous forecast of the projected dynamics of real exchange rate of the RON.

The main risks which, if they materialise, could cause inflation to deviate from the projected path are triggered by uncertainties regarding the rate of wage increases compared to productivity gains, the future stance of fiscal policy, the weather conditions that might adversely affect agricultural output and implicitly the developments in food prices, the developments in the current account deficit and its sustainable financing, the calendar as well as the first and second-round effects of adjustments in administered prices, 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 potentially substantial deviations of the movements in the exchange rate of the RON from the parameters considered in the baseline scenario.

1. The baseline scenario of the forecast

1.1. Inflation projection

Inflation Forecast



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

According to the baseline scenario, the annual consumer price inflation is projected to stay within the target band over the entire forecast horizon, reaching estimated levels of 4.6 percent at the end of 2007 and 4.1 percent at the end of 2008. The projected path of the annual CPI rate is broadly similar to that forecasted in the November 2006 Inflation Report, with the pace of disinflation being assumed to slow down compared to the rate seen last year.

Table 5.1. Annual inflation rate (end of period)

percent

Period	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Target				4.0				3.8
Forecast	4.3	4.2	4.7	4.6	4.6	4.1	4.2	4.1

Assuming that, during the projection period, agricultural output is unaffected by major shocks, the discrepancy seen in 2006 between the annual dynamics of food prices (1.15 percent) and the comparable rate of total CPI (4.87 percent) is expected to diminish in the coming years. For 2007 however, the low base effect of the 2006 food prices is assumed to result in a temporary acceleration of the annual growth rate of consumer prices, which will be manifest especially in the latter half of the year in case of volatile food prices (vegetables, fruit, eggs).

In the first half of 2007, additional pressure on foodstuffs could be exerted by the projection of a net inflationary impact following the implementation of the Common Agricultural Policy and of the Common Customs Policy within the European Union (see Box 2). This impact will affect particularly the prices of foodstuffs included in the CORE2 basket, thereby contributing, along with the increase in prices of tobacco products in anticipation of the excise duty raise next July, to a short-lived acceleration in core inflation in 2007 Q1. Starting with the second half of 2007, the annual growth rate of CORE2 will fall again below the annual CPI rate, reaching at end-2008 a level comparable to that incorporated in the previous projection (3.7 percent versus 3.6 percent).

Despite a similar trajectory of CORE2 inflation in the current baseline scenario compared to the scenario in November 2006 Inflation Report, its determinants are expected to have different relative contributions (except the inflation expectations having similar contributions in both projections), as follows:

– according to the current scenario, the projected output gap is higher than previously forecasted starting with 2007 Q1, which implies *ceteris paribus* a higher forecasted trajectory of CORE2 inflation;

– the changes in import prices are lower in the current projection than in the previous one, resulting *ceteris paribus* in a lower projected CORE2 inflation path;

– the increases in excise duties on tobacco products, assumed to be higher than those previously forecasted for 2007 and lower than those for 2008, induce same direction differences between the two successive projections for CORE2.

The projected output gap is higher than that referred to in the November 2006 Inflation Report, due to the upward revision of the economic growth forecast over the entire projection horizon. The explanation for this revision lies with the reconsideration of the stimulative impact of fast investment dynamics not only in the medium term on potential GDP (as assumed starting with the previous forecasting round), but also in the short term on the output gap. Throughout the projection horizon, the projected path for excess demand will remain descending (and thus fuel disinflation), while the emergence of demand deficits is expected for 2008 Q1 compared to 2007 Q3 in the preceding projection.

The latest changes to the Tax Code imply a new calendar for alignment of excise duties on tobacco products. Although the most substantial excise duty hikes are still scheduled for 2008 and 2009, the new calendar is different from the one disclosed last year in that it envisages larger increases in 2007 and lower rises in 2008.

Exchange rate developments in recent periods imply prospects for import prices dynamics. Thus, the average real appreciation of the domestic currency is expected to be stronger than previously projected, especially in the first part of the projection horizon. Its impact is regarded as more important than the contrary effect of a relative rise in euro area inflation.

The downward course in the exchange rate of the RON in 2006 Q4 also affects the inflation forecast for fuel prices in 2007, its impact being enhanced by the drop in the international price of crude oil. Fuel price dynamics is projected to have a favourable influence on disinflation of consumer prices over the entire projection horizon.

Following a smaller increase scheduled for the whole of 2007 in the price of natural gas, the projection for 2007 of administered price inflation was revised downwards; the magnitude of the revision is nevertheless a relatively small one, i.e. about 0.7 percentage points. For 2008, the baseline scenario remains unchanged relative to November 2006 Inflation Report.

Box 2
General issues regarding the impact of Romania's accession to the European Union on consumer food prices

Romania's accession to the European Union could, in the short term, bring about changes in consumer prices originating in the adoption of some mechanisms and policies specific to the Community (Common Agricultural Policy, Common Customs Policy), as well as in influences resulting from the integration into a common market.

According to NBR estimates, changes in food prices entailed by the adoption of the Common Agricultural Policy and Common Customs Policy as from 1 January 2007 will add about 0.3 percentage points to inflation rate; their impact will become manifest in the first half of 2007 alone. Moreover, in 2005, the World Bank released a research paper titled "Romanian Food and Agriculture from a European Perspective" which points to the relatively low impact that the increase in farm produce prices will have on consumer food prices after adopting the Common Agricultural Policy.

1. Adoption of the Common Agricultural Policy

The Common Agricultural Policy (CAP) is a complex system of rules and mechanisms having an economic, financial, legal and institutional nature. It regulates the production, processing and sales of farm produce in EU Member States. Nearly 90 percent of total food and farm produce are governed by this regulatory framework, with ethyl alcohol being one of the major exceptions.

The instruments used for supporting the agricultural sector are very complex, and they may have a variety of direct or indirect effects on consumer food prices. Other countries' experience suggests that the strongest impact had the adoption of the EU system for regulating producer food prices, specially the harmonisation with the intervention price (the guaranteed price below which an intervention body designated by the Member States buys in and stores the quantities produced).

For most of the agrifoodstuffs whose intervention prices are set by the EU (wheat, maize, barley, some meats), the producer price in Romania is already higher than the intervention price, so that no substantial inflationary pressures are expected in this respect. The price of sugar may go up, yet this product holds a small share in the consumption basket.

Following the adoption of CAP, the price of milk could also be subject to increases, which cannot be directly linked to the intervention price system. Thus, starting April 2007, milk can no longer be delivered to the processing units or sold to consumers unless its producer has an established quota. Since the output quota for milk negotiated with the EU is lower than the potential of Romania, a decline in domestic supply is very likely. Although the supply deficit could be covered by imports from EU countries, a favourable impact on the CPI is debatable, at least for two reasons: (i) competitiveness of imported milk[*] in terms of price is uncertain, even if customs duties were removed; (ii) UHT milk holds a very small share in the consumption basket, the more so as the calculation of CPI in 2007 will be based on the results of the household survey in 2005.

2. Integration in a common market

A country's accession to the European Union and its integration in a common market cause both producers and consumers to enjoy increased flexibility in accessing those outlets (beside domestic ones) that warrant more convenient prices and/or bigger sales.

Foreign producers drawn in by the Romanian market potential could choose to increase their deliveries to Romania, which might result in a substantial oversupply and, implicitly, drive domestic consumer prices down (as it was the case in the Czech Republic, Slovakia and Slovenia). Such an occurrence is fostered by the fact that big European chain stores gained control over a significant share of the domestic consumer market[**]. Competition on this market heated up and the players have already announced their intention to expand the product range by boosting imports and relying on more competitive prices following the removal of customs duties and thanks to their bargaining power. However, those goods are not, as a rule, staples (e.g., chocolate, natural juice, wine, cheese, beer) and they have a limited impact on the CPI.

3. Adoption of the Common Customs Policy

Once Romania has joined the EU, it shifted to the Common Customs Policy, i.e. customs duties relative to trade with other Member States are removed and the common customs regime is adopted; moreover, Romania has to withdraw from the free trade agreements it is part of and enter the preferential agreements with the Community.

In this context, some EU imports will become cheaper following the elimination of customs duties (some tinned fruit, certain meat products, tinned fish, mineral water, natural juice, alcohol). A similar performance is expected for imports from non-EU members, given that customs duties on farm produce consistent with Romania's Customs Tariff average at 29.5 percent, compared with 16.2 percent in the EU's Common Customs Tariff. By contrast, price hikes may occur for a limited number of goods (some meats) originating in the countries that were parts of preferential agreements signed by Romania prior to its joining the EU. However, in time, a portfolio restructuring by supplier of such goods is expected.

[*] Generally UHT milk, which is costlier than fresh milk.

[**] 27 percent in 2005, and likely to reach 50 percent by 2010 (according to a research published by GfK Romania in September 2006).

1.2. Exogenous inflationary pressures

Overall, and in comparison with the baseline scenario of November 2006 Inflation Report, the current projection shows that for 2007 the contribution – in absolute terms – of the exogenous components of consumer price inflation (administered prices, fuel prices and some volatile food prices) will decrease; for 2008, both the current and the previous projections point to relatively similar contributions.

Compared with the last projection, the scenario with respect to the developments in administered prices was updated by diminishing the projected price increases for 2007 as a result of the unexpected drop in natural gas prices in January 2007[50]. For 2008, the expected dynamics of administered prices is similar to that incorporated in the November 2006 projection. Table 5.2 summarizes the current scenario of the developments of energy prices, the main component of administered prices.

Table 5.2. The scenario for developments in administered prices

percent

	Electricity		Heating		Natural gas	
	2007	2008	2007	2008	2007	2008
Current projection	7.1	7.1	10.0	8.0	7.5	17.9
Previous projection	7.1	7.1	10.0	8.0	10.3	17.9

The scenario for the dynamics of some volatile food prices (vegetables, fruit, eggs) foresees growth rates higher than those in the previous projection, particularly for the current year. Assuming an average crop of fruit and vegetables, annual price changes expected for 2007 are larger, especially as a result of a base effect (prices in the current year compare to low prices in the year before, when fruit and vegetables yielded bumper crops); furthermore, this forecasting exercise reconsidered the assumptions concerning the development of the price for eggs, in accordance with an observed tendency for producers to recover the losses caused by the bird flu in 2006. Hence, in 2007, prices of vegetables, fruit and eggs are projected to rise faster than the other prices in the CPI basket, while in 2008, they are expected to post a moderate increase, comparable to that projected for total CPI. The same as in the previous projections, the change in the prices of vegetables, fruit and

[50] According to the National Authority for Regulation in the Natural Gas Sector press release of 15 December 2006, the 2.5 percent cut in the price for lock-in customers is brought about by the removal of the tax on domestically-produced natural gas, the drop by nearly USD 12/1,000 m^3 in import price, the favourable developments in the RON/USD exchange rate and the application of new distribution tariffs for 2007.

eggs is regarded as strongly seasonal, highly positive values being expected for Q1 and Q4 and negative values (deflation) for Q3 of every year.

The scenario concerning domestic prices of fuels starts from the assumption that the world market price of oil will stick to its average level forecasted for 2007 Q1. The uncertainties surrounding the level and development of output and demand for oil worldwide led to the adoption of a neutral scenario, as was the case of the previous projections. Following the drop in the world market price of oil and the considerable strengthening of the RON over the last few months, as well as in view of the real appreciation of the domestic currency forecasted for the entire projection horizon, the inflation of fuel prices is expected to be lower than the growth of consumer prices throughout the considered horizon.

As concerns the change in the prices of cigarettes and tobacco products, the main factor taken into account continues to be the calendar of aligning excise duties to the level set forth in EC Directive 59/1995, as subsequently supplemented by EC Directive 10/2002. Compared to the previous projection, the level of such excise duties that has to be reached by 2010 was raised from EUR 64/1,000 cigarettes in the previous projection to EUR 74/1,000 cigarettes by including the vice tax, i.e. EUR 10/1,000 cigarettes. According to Article 1 of Law No. 343 of 17 July 2006 amending the tax code, total excise duty is expected to increase to EUR 41.5/1,000 cigarettes in 2007, EUR 50/1,000 cigarettes in 2008 and EUR 61.2/1,000 cigarettes in 2009. For the current year, the price increase stemming from the change in total excise duty is expected to be implemented gradually in the first three quarters of 2007, considering the attempt of cigarette producers to avoid large and sudden price increases. Relative to the previous projection, the change in the official calendar of aligning excise duties leads to higher inflationary pressures in 2007 and lower inflationary pressures in 2008. The same as in the previous Inflation Report, the largest price increases are expected for 2008 and 2009.

According to the January issue of Consensus Forecasts, the projected inflation rate in the euro area is higher than previously forecasted for both the current year (by about 0.1 percentage points) and the next year (by about 0.3 percentage points). According to the European Central Bank Monthly Bulletin published in January 2007, the main reasons underlying more pessimistic inflation forecasts are the likely pick-up in energy prices and their impact on CPI inflation, expected hikes in administered prices and indirect taxes (particularly the VAT rise in Germany), as well as higher wage pressures exerted by the favourable economic dynamics and the drop in unemployment rate.

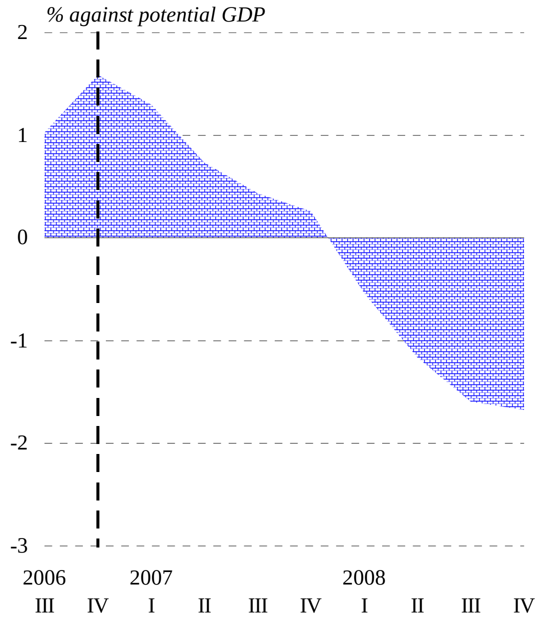
The real appreciation of the RON (higher than that assumed in the previous Inflation Report) is nevertheless expected to offset the impact of more pessimistic inflation forecasts in the euro area on the inflation of import prices.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

For 2006 Q4, the growth rate of real GDP is forecasted to remain high, similar to the growth rates recorded in the previous quarters. Short-term inflationary pressures continue in the form of a persistently positive output gap.

GDP Deviation



Owing to the time period required for the transmission of monetary policy impulses, excess demand in 2006 Q4 reflects the cumulative effect of exchange rate and commercial banks' interest rates developments in the previous quarters. Although in 2006 Q3 commercial banks' interest rates were adjusted to the monetary policy rate rise which took place in the first part of the year, their impact on excess demand in the current period is neutral. In 2006 Q3, the RON real exchange rate still exerted a restrictive influence on the current output gap. However, in 2006 Q3, the impact of the real exchange rate was lower than in 2006 H1 due to the nominal depreciation of the domestic currency at mid-year.

Statistical data show that the high quarterly growth rate of real GDP[51] continued into 2006 Q3, albeit below that anticipated in the previous forecasting round. With the estimate of the growth rate of potential GDP remaining unchanged from the previous forecast, the level of excess demand for the previous period was subject to a downward revision. The level of the output gap for Q4 is similar to the estimate for Q3 in the preceding Inflation Report.

As concerns real GDP components, in 2006 Q4, final consumption is expected to remain above the last years' trend. The high level of final consumption is backed by the fast growth rate of real disposable income of households, fostered by the existing labour market conditions. Thus, pressures on the labour market generate real net wages above recent quarters' averages, while the number of employees continues to follow the medium-term trend. Moreover, developments in real M1 supplemented by demand deposits in foreign currency, as a measure of transactions intensity, sustain the stimulating impact

[51] Data on real GDP are seasonally adjusted.

of final consumption on aggregate demand. The restrictive effect of the consolidated budget balance on aggregate demand-related inflationary pressures due to the budget surplus recorded in the first quarters was followed by a strong stimulating impact in 2006 Q4. Thus, at end-2006, the budget deficit came in at 1.68 percent of GDP[52].

Gross fixed capital formation appears to remain above the medium-term trend in Q4, being fostered, among other factors, by the readily-available credit for economic agents. The growth rate of medium- and long-term credit for economic agents will remain high, contributing to the development of gross fixed capital formation. Once the effects of new investments on aggregate supply have become manifest, in the medium and long run they will increase the potential GDP.

The growth rates of imports remain high and exceed previous average levels, being bolstered by household real income (higher than the medium-term trend) and the rapid non-government credit growth. The growth rates of exports are projected to stay close to the medium run trend amid favourable developments in industrial output and labour productivity in industry. Overall, net exports continue to contribute to reducing excess demand and, implicitly, easing inflationary pressures.

1.3.2. Implications of recent exchange rate and interest rate developments

In 2006 Q4, the domestic currency appreciated as compared to the previous quarter in both real and nominal terms, at a pace similar to that recorded in the first two quarters of 2006. The relatively fast nominal appreciation which occurred at end-December did not have a strong impact on the average exchange rate in Q4.

The real appreciation recorded in 2006 Q4 led to an increase of the restrictive effect exerted by the real exchange rate on excess demand in the quarters ahead through the net export channel. On the other hand, given the wealth and balance sheet effects[53], RON appreciation has a stimulating impact on aggregate demand. 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 in the period ahead. Exchange rate movements also influence domestic prices directly, as the appreciation of the domestic currency leads to the decline in inflation via import prices.

[52] According to Ministry of Public Finance data.
[53] See the Box on “Wealth and balance sheet effects” in November 2005 Inflation Report.

Over the medium term, the real exchange rate is driven 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. Under the influence of several relevant factors in the short term, the exchange rate may record short-run deviations from the trajectory driven by fundamentals to which it does, however, revert after the phasing-out of incidental effects. Such a temporary deviation appears to have occurred at the end of Q4 when the resurgence in speculative capital flows in the context of Romania becoming an EU Member State caused the RON to appreciate at a pace faster than that driven by fundamentals.

In 2006 Q4, the NBR maintained the monetary policy rate at 8.75 percent and continued the policy of substantial sterilisation of excess liquidity in October and November. In December, the NBR resorted to the partial sterilisation of excess liquidity in response to the fast nominal appreciation of the RON. The easing of liquidity control did not significantly influence the average nominal interest rate on commercial banks' deposits with the central bank[54]. On the other hand, the NBR's policy rate increased in real terms as a consequence of the ongoing decline in inflation. Given the circumstances, the monetary policy rate had, *ceteris paribus*, a more restrictive effect on aggregate demand and hence on inflation.

The NBR's policy rate affects the real economy indirectly, through commercial banks' deposit and lending rates. The effect of policy rate changes feeds through into commercial banks' interest rates with a time lag due to the gradual adjustment of bank rates to these moves. Thus, nominal deposit rates rose in Q4 as well, in response to monetary policy rate increases in the previous quarters, while lending rates stopped declining, reaching a nominal level close to that in Q3. These developments are associated with the narrowing of the spread between deposit and lending rates, which is indicative of the strong competition in the banking sector. Moreover, deposit and lending rates grew in real terms, having a restrictive impact on real economy and inflation starting with Q4, which reflects partially the effect of the previous level of the monetary policy rate.

The final quarter of 2006 saw a more restrictive impact of interest rates affecting excess demand in the quarters ahead, due to the rise in the real deposit and lending rates, which was partially offset by the decline in foreign currency borrowing

[54] See also Chapter IV.1. Monetary policy.

costs in local currency. Furthermore, the faster appreciation of the RON in real terms had a more restrictive effect on economic activity via the net export channel. Therefore, during 2006 Q4, the restrictive impact of the exchange rate and the real interest rates exerted larger cumulative pressures on excess demand and hence on future inflation.

1.3.3. Demand pressures within the projection horizon

According to the baseline scenario of the current projection, the output gap will follow a downward course over the entire projection horizon. The main driver behind the elimination of excess demand by early 2008 is the restrictive effect of overall real monetary conditions.

Unlike the baseline scenario in the November 2006 Inflation Report, the decrease in excess demand is, however, expected to be slower and of lower magnitude. This is due to higher forecasted economic growth, driven mainly by the reassessment of the boosting impact of the fast-paced increase in investment (including that of foreign direct investment), which affects particularly aggregate demand, while the effects on potential GDP become manifest with a time lag[55]. Under the circumstances, the time of eliminating excess demand and inducing a demand deficit is delayed by two quarters as compared with the previous projection.

The comparative contribution of the real exchange rate channel and that of the real interest rate channel in the current macroeconomic projection shows several changes compared with the previous forecasting round. Hence, the contribution of real exchange rate deviation increases, owing largely to recent developments in the exchange rate of the RON, which was substantially stronger in real terms than in the previous projection. Furthermore, the restrictiveness of projected real interest rates is lower than that anticipated in November 2006 Inflation Report. This is accounted for by the downward revision of the projected average nominal interest rates on deposits and loans. As compared to the estimated increases in the previous forecasting round, the average deposit rate is

[55] When driven by foreign capital inflows rather than by a similar increase in domestic saving, the rise in investment boosts aggregate demand economy-wide. In the medium run, the pick-up in demand is generally associated with the improvement in labour productivity and higher potential GDP. This was also one of the main reasons for the upward revision of the assumed rise in potential GDP in the previous projection. On the other hand, the fast expansion of investment in the short run generally entails swifter increase in aggregate demand than in the domestic production potential (due to the stickiness of production in the short term, as well as to the hikes in wages and expenditures on goods and services related to investment). Ceteris paribus, this state of affairs is likely to generate larger inflationary pressures over the nearer projection horizons.

expected to remain close to the current level for a relatively longer time period, given the reduction of the average interest rate on banks' deposits with the NBR in December and January. The average lending rate will stay most likely on a downtrend over the entire projection horizon, in line with the decline in inflation and persistently high competitive pressures. The effect of transposing the *acquis communautaire* into the national legislation will enhance competitive pressures, as the European financial institutions may have easier access to the domestic banking market, according to the provision on the freedom to provide services within the EU[56].

The overall restrictive effect of real monetary conditions is anticipated to offset the expected pro-cyclical stance of fiscal policy. In line with the baseline scenario, the assessment of fiscal policy impact is based on assumptions similar to those in the previous projection. According to the preliminary data on budget execution in 2006, the annual balance of the consolidated general budget stood at -1.68 percent of GDP, a level similar to that forecasted by the NBR in the November 2006 Inflation Report. The fiscal policy assessment for 2007 and 2008 relies on the deficits submitted to the Parliament by the Government, i.e. 2.8 percent and 2.7 percent of GDP[57] respectively. Based on these yearly coordinates, the anticipated quarterly distribution of the fiscal policy effects has been made according to the usual pattern of budget execution of the past years, which shows a considerable share of budget expenditures being carried out in the final months of the year. However, the intra-annual distribution of the current projection is more balanced than in the previous forecasting rounds, taking into account the carrying-out of larger budget expenditures in the first part of the year, as well as the regular occurrence of payments related to Romania's contribution to the EU budget.

The effect of fiscal policy was adjusted for the effects of the financial relations generated by Romania's EU membership. Their assessment is based on the amounts referred to in chapter "Non-redeemable external funds" of budget programmes for 2007-2008 and on the assumed level of absorption of European funds similar to that of the Central and Eastern European countries[58], as well as on the recent experience on Romania's absorption of pre-accession funds. Furthermore, the expansionary effect of the volume of European funds on

[56] See Government Emergency Ordinance No. 99 of 6 December 2006 on credit institutions and capital adequacy, Chapter IV.
[57] Ministry of Public Finance – "Report on the macroeconomic context for 2007 and its projection for 2008-2010".
[58] Statistical data on the absorption of structural funds are included in the Annex to the "16th Annual Report on Implementation of Structural Funds 2004" released by the Commission of the European Communities.

aggregate demand is offset by the contractionary effect of Romania's contribution to the EU budget (roughly 1 percent of GDP for the next two years). The estimated balance of these financial flows is negative in the first year of the projection, corresponding to Romania's position of net contributor (having a net contractionary effect on demand), which will move to the position of net beneficiary following the increase in the capacity to attract EU funds[59] and in disposable amounts to be absorbed.

According to the baseline scenario, economic growth for 2007 and 2008 will exceed its previous projection against the background of a higher output gap than forecasted in the November 2006 Inflation Report. The fast GDP growth rate was mainly boosted, among aggregate demand components, by the increase in gross fixed capital formation and private consumption. Investment is seen as the fastest growing component economy-wide, its rise being driven by:

– expectations of favourable developments in foreign direct investment and investment financed with European structural funds,

– significant public investment, according to this year's budget programme,

– domestic private investment in more dynamic sectors of the economy, such as construction, manufacturing (e.g., machinery, equipment and apparatus, transport means etc.) and services (e.g., communications, financial services, retail trade etc.), which will also be bolstered by the expansion of medium- and long-term loans.

The forecasted dynamics of private consumption will also remain high, prompted by the ongoing increase in disposable income – as a result of productivity gains and pay rises in the non-tradables sector, public sector included – and the uptrend of household loans. However, the pace of increase of this economic indicator is seen gradually slowing down, particularly in the latter part of the projection horizon, following the slower dynamics of the two above-mentioned factors. Thus, the deceleration in the growth rate of disposable income might originate in a better correlation with productivity gains, while the expansion of household loans is likely to lose momentum amid a certain market saturation becoming manifest, along with the increase in the share of debt service and debt amortization amounts in total household disposable income.

[59] Particularly due to the fact that in 2007 structural funds will actually be absorbed no sooner than the second half of the year, after the Operational Programmes on the implementation of such funds are approved by the European experts.

External sector performance is still expected to have a significantly negative net contribution to economic growth, especially on account of import upsurge. Thus, imports will continue to be fostered by robust investment demand, the stimulative level of the real effective exchange rate of the RON, and – in the first part of the projection horizon – the maintenance of consumer demand above the increase potential of domestic production. However, the influence of the latter two factors is assumed to alleviate in the second part of the projection horizon, thus contributing to the containment of the balance-of-payments current account deficit.

1.4. Risks and uncertainties surrounding the projection

The baseline scenario of the projection represents the most plausible of possible scenarios on inflation developments within the forecast horizon, given the latest available data. For a full assessment of the overall macroeconomic conditions, each projection takes into account several risks that may significantly alter the forecasted inflation path. The most important risk factors which were considered for the current projection cycle include the following:

– wage increases relative to productivity gains;

– adverse weather conditions likely to hit agricultural output and hence food developments;

– fiscal policy recalibration and implementation, and their impact on aggregate demand;

– current account deficit magnitude and dynamics;

– unexpected administered price adjustments;

– sudden and sizeable changes in world market prices of crude oil and natural gas;

– significant deviations of the RON/EUR exchange rate from the projected path.

Wages are a key component of corporate production costs, particularly in labour-intensive sectors, such as services and light industry, which hold a significant share in Romania's GDP. Hence, any wage increase insufficiently correlated with the dynamics of labour productivity would result in higher costs, putting pressure on consumer prices as well. The track record of considerable pay rises[60] and the prospects of better paid jobs abroad might fuel wage expectations and hence

[60] In the last four years, real gross average wage economy-wide has risen on average by about 8.5 percent per year.

employee pressure for sizeable wage increases. Current labour market conditions, reflected in the relatively low unemployment rate, and the impetus given by this year's substantial wage hikes in the public sector pose additional risks of a potential unsustainable increase in real household income.

Major uncertainties also surround budget execution for this year and the next, which might entail both-way deviations from the projected inflation path. On the one hand, the fast-paced public spending manifest towards end-2006 and envisaged in the 2007 budget programme could be a source of disequilibrium if this year's rise in the share of budget revenues in GDP failed to attain the scheduled parameters or if the failure to carry out infrastructure development expenditure[61] resulted in a shift towards purposes with a higher inflationary potential. On the other hand, recent years have seen an undershooting of budget execution deficits overall, hinting at a *de facto* tighter-than-expected fiscal policy stance.

The widening of the balance-of-payments current account deficit, alongside swift economic growth, reveals an increasing mismatch between saving and investment. For an open transition economy this is generally in line with the real convergence process, reflecting larger foreign investment inflows and considerable increases in capital stock and labour productivity. From this perspective, the baseline scenario assumes, over the medium term, an adjustment of the current account deficit to lower figures, as the levels of labour productivity and consumption in the Romanian economy approach EU averages. However, foreign investment dynamics is not always smooth, as it might come under the influence of several factors exogenous to the long-term growth potential of the Romanian economy, such as developments in the international financial environment, competing opportunities on emerging markets, short-term outlook on the political and social stability, etc. Since the adjustment pace of revenues economy-wide and of domestic demand is generally slower than that of international capital flows, the somewhat volatile nature of the above-mentioned exogenous factors poses a risk to the progress in real convergence amid macroeconomic stability.

The current conditions on international financial markets, developments in food prices – particularly vegetables, fruit and eggs prices – and crude oil and natural gas prices on world markets constitute permanent sources of volatility for the inflation projection. If last year's relatively favourable action of

[61] Including the co-financing expenses of certain projects alongside EU structural funds, if such expenses are incorporated in the budget, yet cannot be effectively incurred due to the lack of absorption capacity.

these factors did not last long enough to develop into a trend, the risk of unexpected changes would more likely be biased towards heightened inflationary pressures in relative terms as compared to the baseline scenario. For instance, in case of a below-average agricultural year, volatile food prices would post much higher annual increases in 2007, while a potentially above-average agricultural year would not have a symmetrical impact, because the previous year's reference prices were already low.

Accurate forecasts on administered prices are difficult to produce in the absence of a firm, pre-established schedule prepared by the regulatory authorities and of any transparent rules for administered price adjustment, based on developments in certain exogenous factors, such as international energy prices, the exchange rate of the RON, etc. Some extra volatility in the case of these prices is also generated by the likelihood of adjustments for other purposes than purely economic ones (e.g. social purposes).

In an open economy like Romania's, the exchange rate of the RON has a considerable bearing on inflation, both through the net export channel and import prices. Consequently, any major divergence in the future movements of the exchange rate from the baseline scenario might generate deviations from the projected inflation trajectory. A potential significant deceleration in capital inflows that help finance the current account deficit – for instance as a result of flagging investor sentiment towards emerging markets – might trigger a considerably slower real appreciation of the RON than projected in the baseline scenario. In this case, less favourable import price dynamics and looser restrictiveness of the exchange rate on excess demand compared to the baseline scenario would lead to higher-than-projected inflation. Symmetrically, faster real appreciation of the RON would have an opposite influence, pushing inflation lower. This favourable effect would be more persistent in case the additional real appreciation was caused by fundamental factors, such as fast-paced increase in productivity and sustainable capital inflows in the medium and long term.

2. Policy assessment

The National Bank of Romania's forecast on undershooting the 2006 inflation target (5 percent ±1 percentage point) published in November 2006 Inflation Report was confirmed by the recent statistics which show the reduction in annual inflation rate to 4.87 percent in December. Behind the 3.7 percentage point deceleration in the annual rate of increase of consumer prices throughout 2006, along with the 2.4 percentage point reduction in the average annual inflation rate – from 9 percent to 6.6

percent –, stood in particular volatile prices and administered prices, as well as CORE2 inflation. Volatile price deflation and a slowdown in the administered price dynamics were largely due to the oversupply of fruit and vegetables in 2006, the favourable movements in world oil prices and the strong nominal appreciation of the RON versus the major currencies. The latter development provided an underpinning to the disinflation recorded by CORE2 inflation which reflected more accurately the favourable impact of increased restrictiveness of monetary policy, including via inflation expectations, and the maintenance of a restrictive fiscal policy stance for most of 2006.

The updated quarterly projection of macroeconomic developments highlights some improvement, compared with the previous forecasting round, in the inflation outlook within the monetary policy transmission horizon. The chief prerequisites and determinants of this change for the better are the following: (i) substantial compression (compared with the previous forecast) of excess demand in 2006 Q3 and implicitly of excess demand estimated for 2006 Q4; (ii) tightening of monetary conditions in the final months of 2006 following the increase in the real spread of the policy rate and especially faster-than-expected strengthening of the domestic currency against the euro and the US dollar; (iii) relative drop in the projected dynamics of import prices and fuel prices; (iv) improved inflation expectations, compared with the preceding period, amid faster disinflation in the latter half of 2006 and the end-year inflation target undershooting.

The above-mentioned circumstances call for a lowering of monetary policy rate, as the newly-shaped monetary conditions – given that the strengthening of the domestic currency is expected to carry on – remain adequate for keeping disinflation on a trajectory compatible with achieving the medium-term inflation targets, concurrently with avoiding excessive swings in economic activity.

However, the persistence of risk factors threatening the pace and the trend of medium-run disinflation and of some uncertainties surrounding the assumptions of the current quarterly forecast require utmost prudence in choosing the magnitude of the policy rate cut. In this context, a significant issue is the risk generated by the possible persistence of robust economic growth and a still positive output gap over the coming quarters, largely as a result of ongoing fast-increase in domestic demand. Even though the estimated excess demand for 2006 Q4 is considerably lower than that incorporated in the preceding forecast, the ensuing decline in the output gap is foreseen to be slower and to last until 2007 Q4. The major drivers of the domestic component of aggregate demand could be the easing of the fiscal stance at end-2006 and over the next quarters, and the likely increase in wages; the far-reaching pay rises that might be implemented in the private sector could be boosted not only by the consistent increases in budgetary-sector wages, but also by the possible tightening of the labour market, due also to the persistence of labour force migration.

A substantial increase in wages could fuel cost-push inflation, whose materialization is nevertheless conditional upon the developments in labour productivity dynamics – which grew noticeably in industry starting May 2006 – and the quality of financial standings at corporate level. High profitability rates of enterprises, a possible occurrence in many sectors, would allow entrepreneurs to stop pay rises being passed through to prices; in contrast, such a behaviour might stifle a potential investment growth and implicitly economic growth. All these developments should be vigilantly monitored given the numerous uncertainties surrounding wage-setting in the currently booming economic environment and the likely risks triggered by this mechanism.

The risk of bank lending to further give a big boost to excess demand, and especially to the likely demand-pull inflationary pressures, appears to have diminished for the time being at least, given that since September 2006 the annual real growth rate of non-government credit was quasi-flat and even receded in December, due solely to the setback in the pace of increase of RON-denominated loans. In addition, the performance of household loans had a decisive contribution to the slowdown in non-government credit expansion, which gives an indication of the outlook for private consumption growth potential and demand-pull inflationary pressures; the annual growth rate of household loans followed a downward path starting August 2006, except in December, when it posted a likely seasonally-driven uptick. Since October 2006, there were signs of a rebound in household deposits with banks, also as a reflection of a slowing indebtedness rate of individuals. It is noteworthy that the accelerated growth of household deposits could have been fostered by considerable real spreads of credit institutions' interest rates.

Given the nature of factors that caused the slowdown in household loans expansion, at least some of them[62] are expected to put pressure on prices in the period ahead, but there are still uncertainties on how strong their action could be and

[62] Such as a smaller indebtedness capability of people of relatively low income, the fact that loan-funded demand for housing was relatively met, the impact of the implementation on 22 October 2006 of additional steps taken by the NBR with a view to containing credit risk for individuals.

how long will it last. Furthermore, individuals may renew the borrowing spree and therefore cause their savings to slacken again, assuming that certain consumption expenses were deliberately delayed for the period following Romania's accession to the EU and availability of real-estate loans was restricted by the National Bank of Romania through prudential measures that are to be scrapped in the forthcoming months. In this context, another risk could be the possible rebound in foreign currency-denominated, non-government credit, due largely to the removal as from 1 January 2007 of the credit institutions' ceiling exposures from forex loans; from this perspective, the reduction in monetary policy rate and the cost differential between the two major components of non-government credit may diminish the likelihood of RON-denominated loans being substituted by forex loans.

Another reason behind the cut in policy rate is the need to reduce relatively the interest rate differential between domestic and world markets which spurred volatile capital inflows and foreign currency borrowings. Against the backdrop of rapid increase in financial integration of the Romanian economy and persistent global liquidity, the high differential of domestic interest rates may pose significant risks to both macroeconomic stability and financial stability.

As for macroeconomic stability, the major threats to the increase in the two categories of capital inflows are the likely deviation of the exchange rate movement from economic fundamentals, having as a result potential unsustainable appreciation of the local currency triggered by speculative capital inflows and, in case of financial borrowings, potential severe expansion in domestic demand, with adverse impact on both the domestic and external equilibria of the economy. Behind the concern for preventing these risks from being carried into practice stood faster increase in foreign borrowings in the past few months, especially short-term borrowings and implicitly, the rise in private foreign debt as well as the likelihood of further increase in such inflows.

A prudent approach to the monetary policy rate cut is also justified by the persistence of a considerable inflationary potential of supply-side factors. Administered prices still have the largest inflationary potential, even though the magnitude of adjustments due for 2007 is slightly below that incorporated in the November forecasting scenario. By contrast, compared with the previous forecasting round, the projected inflation for highly-volatile food prices was raised for both 2007 and 2008. Adding to these factors is the gradual increase – in line with the calendar of harmonising domestic tax legislation with that of the EU – in excise duties on cigarettes and tobacco; compared with the previous forecasting round, the magnitude of anticipated hikes in such excises will be considerably higher in 2007, but lower in 2008. Moreover, considering the developments in prices recorded by the countries that became EU Member States in 2004, there are some risks and uncertainties related to the net impact of Romania's joining the EU on the short-term movements in consumer prices. Nonetheless, this impact is expected to be small, given that (i) the estimated inflationary effect of adopting the Common Agricultural Policy, of implementing the Common Customs Policy and of becoming part of a common market for foodstuffs is relatively small; (ii) the anticipated influence of implementing the Common Customs Policy in other fields affecting household consumption would translate into lower prices for some imports; (iii) stronger competition resulting from the new context could dampen the increase in some domestic prices.

The assessment by the National Bank of Romania Board of the current macroeconomic context and of its medium-term projection has underscored some improvement, compared to the previous projection, of the outlook for inflation over the monetary policy transmission horizon. However, it is assumed that, at least in the first part of the projection period, the action of some factors which could jeopardize the domestic and external equilibria of the economy and thus pose risks to the sustainability of disinflation will persist. Taking into account the directions in which these factors may evolve and evaluating their aggregate impact, in its meeting of 9 February 2007, the National Bank of Romania Board has decided to lower the monetary policy rate by 0.75 percentage points to 8 percent, to leave unchanged the minimum reserve ratios and to pursue an adequate control of liquidity via open-market operations in line with financial market conditions. The recalibration of broad monetary conditions – including the assumption of an ongoing real appreciation trend of the domestic currency – is aimed at ensuring the maintenance of the inflation rate on a path compatible with achieving the inflation targets over the medium term. Moreover, the Board has reaffirmed that it will continue to vigilantly monitor non-government credit expansion and the prices of main asset categories, in order to identify and take prompt monetary policy measures against unfavourable developments that might pose risks to disinflation.