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N O T E

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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 30 April 2007 and approved by the NBR Board in its meeting of 2 May 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
CD	certificate of deposit
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)
ERM II	Exchange Rate Mechanism II
ESA	European System of Accounts
EUROSTAT	Statistical Office of the European Communities
FED	Federal Reserve System
GCF	Gross Capital Formation
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IFS	International Financial Statistics
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MAFRD	Ministry of Agriculture, Forests and Rural Development
MLSSF	Ministry of Labour, Social Solidarity and Family
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
NSC	National Securities Commission
OCI	Organisation for Collective Investment
ON	overnight
OPEC	Organisation of Petroleum Exporting Countries
ULC	unit labour cost
1W	one week
12M	12 months

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I. SUMMARY

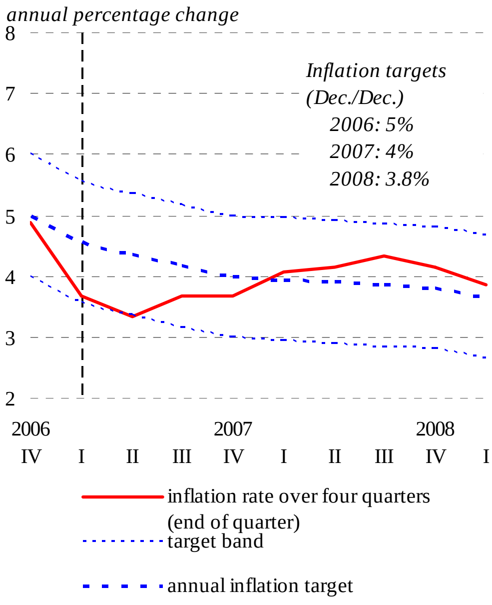
Disinflation consolidated in 2007 Q1, with the 12-month inflation rate dropping to 3.66 percent in March 2007, down 1.21 percentage points from end-2006 and 0.34 percentage points lower than the end-2007 target midpoint. The significant decline in the 12-month CPI was largely due to the slower dynamics of administered prices and the sharper deflation of volatile prices on the background of a reduction in fuel prices and a continued decline in vegetable and fruit prices compared with the same year-ago period. Adjusted CORE2 inflation contributed substantially to the slowdown in CPI inflation, the 0.2 percentage point drop in its annual rate reflecting mainly the impact on aggregate prices – including via inflation expectations – of increased restrictiveness of broad monetary conditions in the previous period, especially through strong RON appreciation versus the major currencies. Together with the strengthening of the domestic currency, the favorable effects of Romania's accession to the EU, induced by subdued inflation in the euro area that showed up in imported goods prices, as well as by increased competition on the retail market, were also captured by the adjusted CORE2 inflation rate. Thus, unfavorable expectations regarding the magnitude of the inflationary impact on food prices stemming from Romania's adoption of the Common Agricultural Policy and the Common Customs Tariff have not been confirmed so far. Nonetheless, some minor inflationary effects of EU accession on food prices may become manifest with a certain lag.

A prerequisite for continued disinflation, in the medium term as well, is the decrease of excess demand below the projected level for the second successive quarter in view of the fact that, contrary to expectations, the pace of economic growth exhibited a relative slowdown in 2006 Q4, as reflected by the reduction in annual GDP dynamics to 7.7 percent from 8.3 percent in the previous quarter. However, the year-on-year growth of domestic absorption remained very fast, the slowdown in GDP growth being solely due to the rise to a record high of the negative contribution of net exports. Conversely, investment strengthened its role as the major driver of economic growth, increasing at an annual pace of 18 percent; its acceleration is expected to lead, with a certain lag, to higher levels of aggregate supply and potential GDP. At the same time, after having accelerated for three successive quarters, private consumption – the GDP component with the heaviest inflationary potential – posted a slightly slower pace of growth (down 0.6 percentage points to 12.7 percent). The deceleration was more pronounced in what concerns retail sales, the annual growth rate of which fell to a record low in the last five quarters; nevertheless, private consumption – fuelled by fast wage increases, the brisk expansion of loans to households and larger remittances from Romanians working abroad – may further stoke up inflation and contribute to the current account deficit.

A further deceleration in inflation and the improving inflation outlook, against the background of relatively lower pressures from aggregate demand and the consolidation of significant appreciation of the RON versus the major currencies prompted the NBR Board to implement in 2007 Q1 two policy rate cuts and implicitly to readjust the settings of monetary policy instruments. The monetary policy rate was lowered in two stages – by 0.75 percentage points and 0.5 percentage points on 9 February and 26 March respectively – to 7.5 percent per annum. At the same time, in order to reduce the spread between the monetary policy rate and the effective rate of sterilization, thereby enhancing the signaling role of the policy rate and its capability to durably anchor inflation expectations, the National Bank of Romania began to gradually increase the relative volume of sterilized liquidity in the latter part of 2007 Q1. Nevertheless, the central bank continued to make a flexible use of its partial sterilization of excess liquidity via open-market operations, in an effort to deter volatile capital inflows and to counter the risk of a potentially unsustainable additional appreciation of the domestic currency. Over the period, broad monetary conditions remained restrictive, supported by the appreciation of the real effective exchange rate of the RON and the persistence of tight minimum reserve requirements.

Compared to the previous forecast, the baseline scenario of the current forecast of medium-term macroeconomic developments highlights a considerable improvement of the outlook for inflation in the first part of the monetary policy transmission horizon, with the annual inflation rate being projected to reach 3.7 percent in December 2007 (below the central target of 4.0 percent ±1 percentage point). The large downward revision (by 0.9 percentage points) of the inflation rate forecasted for end-2007 is attributed mainly to the faster-than-expected disinflation observed in the first months of the current year and to the envisaged continuation of improved inflation expectations, underpinned by more restrictive broad monetary conditions combined with a lasting impact of the brisk deceleration of inflation over the past months. The projected path of inflation over the short term also improved on the back of the relatively smaller estimated magnitude of excess demand – reflected by the anticipated decline in CORE2 inflation rate – as well as of the reduction in the magnitude of expected administered price adjustments compared to the previous forecast and the slower change in volatile prices. However, in the second part of the forecast horizon, the inflation rate is projected to resume a slightly upward trend over a few quarters and to reach a level broadly similar to that shown in the February 2007 Inflation Report (4.2 percent at end-2008); the main drivers of this trend are the administered price and indirect tax adjustments expected to take place over that period. The projected trajectory of annual inflation is in line with the gradual reduction in the output gap and its moving into negative territory starting with 2008 Q1; even though the projected levels of demand deficit are expected to be lower than in the previous forecasting round and economic growth is implicitly higher, the projected inflation rate remains at levels similar to those in the former projection in the latter part of the forecast horizon. Over the entire projection horizon, the appropriate restrictiveness of broad monetary conditions is ensured by the anticipated dynamics of the real exchange rate of the RON and of real interest rates, whose influence is more pronounced during the first part of the projection horizon. The current projection, similarly to the previous forecasting round, foresees tighter real broad monetary conditions in 2007-2008 than in 2006, which is consistent with the programmed elimination of excess demand. Nonetheless, unlike the previous projection, the necessary increase in the restrictiveness of real broad monetary conditions is lower in the current baseline scenario, owing to relatively weaker inflationary pressures over the short term.

Inflation Forecast



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

The main risks and uncertainties associated with the current projection of medium-term macroeconomic developments are relatively similar to those highlighted in the previous forecasting round, but their magnitude might be enhanced by the current domestic political situation. The most significant risk, which could place inflation on a higher-than-projected trajectory, remains the likelihood of excessive wage increases that overtake productivity gains, the likelihood of widespread growth of wages in the private sector increasing in 2007 in the context of substantial pay rises granted under the budgetary programme to public-sector employees in specific fields of activity. These wage hikes, apart from the inflationary pressures they might generate via domestic demand – along with persistently high credit dynamics – could also fuel inflation by raising costs, at least in those industries where excess demand is still manifest and which might face labor shortages. In sectors facing tougher competition, employers might, however, offset the increase in unit labor costs by narrowing corporate profit margins, a behavior which may become more widespread in line with the projected decline and eventual reversal of the positive output gap.

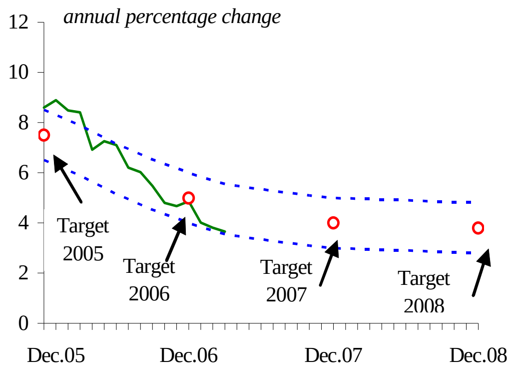
A major source of uncertainty for the current inflation forecast is the magnitude of fiscal policy easing over the entire projection horizon, namely the actual level of the consolidated general budget deficit, as well as the distribution of budgetary expenditures between capital and current expenditures. Thus, in light of developments seen at end-2006, as well as in January and February this year, the risk of a higher-than-projected expansionary stance of fiscal policy may heighten, as illustrated by the lower-than-projected budget revenues and/or the potential change in the structure of public spending by raising current (consumption-related) expenditures to the detriment of capital (investment-related) expenditures. The potential materialization of the risk of an easing of the above-mentioned macroeconomic policies, corroborated with persistently high capital inflows, including external debt-generating inflows, heightens the likelihood of a further widening of the current account deficit, which might generate risks from the perspective of sustainable disinflation and of ensuring price stability in the medium run. However, this risk is mitigated by the fact that current and future developments in the external sector are illustrative, at least in part, of the catching-up process that the Romanian economy is undergoing; once this process loses momentum, the negative balance of the current account is expected to curb its growth and then decline gradually. Furthermore, a considerable share of this deficit will continue to be financed through autonomous capital inflows, given that the potential productivity gains in the Romanian economy will remain above those in industrialized economies and will be competitive against those offered by other new EU Member States.

Given the new position as international asset of the domestic currency, a high degree of uncertainty surrounds future developments in the RON exchange rate as well. Moreover, such developments are also influenced by the volatility of capital flows to emerging markets, as confirmed in the past months by the higher degree of correlation, over short time-spans, between the movements in the RON/EUR exchange rate and the exchange rate movements of most currencies in the region. Under these circumstances, the likelihood that the exchange rate of the RON will, for certain time periods, be only partly attributable to the development of national economic fundamentals is reinforced by the persistent overall excess liquidity, as well as by investors’ volatile and unpredictable risk appetite.

A high degree of uncertainty is also associated with the future development of some exogenous factors impacting supply, the dynamics of administered prices, food prices and fuel prices ranking among the most relevant in this category.

The assessment by the NBR Board of the current macroeconomic environment and of the medium-term projection has highlighted the improvement, as compared to the prior forecasting round, of the outlook for inflation in the first part of the monetary policy transmission horizon. At the same time however, the NBR Board has pointed out that the inflationary potential of some factors that will remain manifest during the projection horizon is still high. The main risks to sustainable disinflation and to ensuring price stability in the medium run are deemed to be the persistence until end-2007 of the positive output gap and the possible future widening of the current account deficit as a result of protracted excessive dynamics of domestic absorption. In this context, the NBR Board decided in its meeting of 2 May 2007 dedicated to monetary policy issues to lower the monetary policy rate by 0.25 percentage points to 7.25 percent per annum and to further pursue an adequate control over liquidity in line with financial market conditions. Moreover, with a view to consolidating the restrictiveness of broad monetary conditions, the NBR Board has decided to maintain tight minimum reserve requirements and to continue to adjust the reserve base in line with similar practices of the ESCB. At the same time, the NBR Board has reiterated that it would continue to vigilantly monitor developments in non-government credit and prices of broad asset classes, including real estate assets, so that potentially unfavorable developments affecting disinflation could be identified and offset by taking prompt monetary policy measures, against the background of the need for consistent contribution on behalf of all components of the macroeconomic policy mix to ensuring a sustainable continuation of the disinflation process.

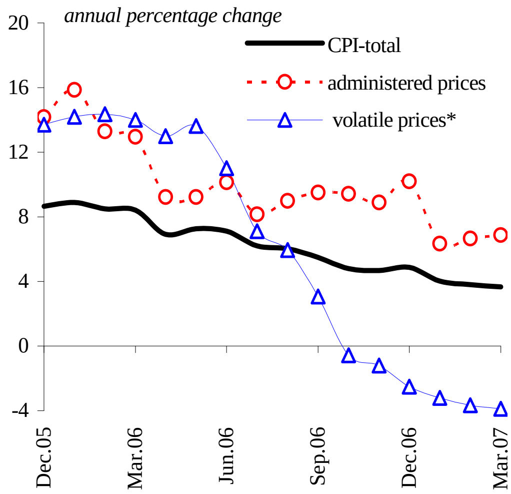
Inflation Developments



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

Source: NIS, NBR calculations

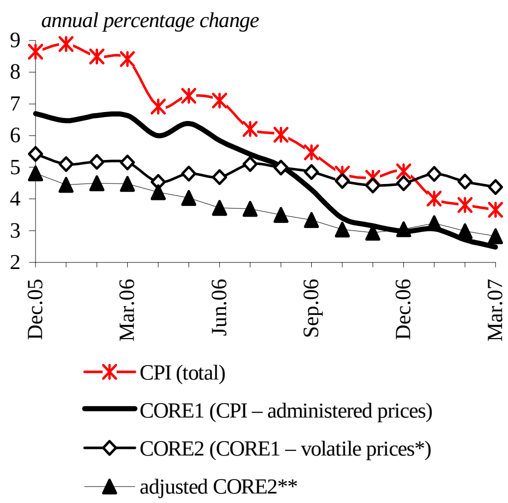
Inflation Rate



*) 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

**) excluding tobacco and alcohol

Source: NIS, NBR calculations

II. INFLATION DEVELOPMENTS

In 2007 Q1, disinflation accelerated, the 12-month inflation rate coming in at 3.66 percent at end-March, i.e. 1.21 percentage points below the figure recorded at end-December 2006. Moreover, the annual inflation rate moved steadily in the lower half of the target band of ±1 percentage point around the (dis)inflation path, nearing its lower margin at end-March. Even though deceleration was due mainly to decreases in the fuel price and some administered prices, it was also propelled by the further downward trend of adjusted CORE2.

Behind the drop in the 12-month inflation rate in 2007 Q1 stood chiefly the disinflation recorded by the products with administered prices; the growth rate of administered prices fell from 10.2 percent in December 2006 to 6.87 percent in March 2007, driven mainly by (i) the drop in the price of natural gas in January (-3.49 percent versus the previous month) as a joint result of the removal of the tax on domestically-produced natural gas, the decline in import price, favourable movements in the RON/USD exchange rate and new distribution tariffs for 2007 and also (ii) the appreciation of the domestic currency versus the euro, having a positive bearing on the prices of medicines and fixed telephony services (-2.66 percent and -1.24 percent respectively, cumulative values for the first three months of the year).

Price cuts by the important fuel providers in January-February (-1.89 percent) led to a negative annual rate of increase in fuel prices at the end of the first quarter thereby also having a favourable impact on disinflation. The comparison in annual terms shows price decreases for the other products with volatile prices as well (by 7.2 percent); however, in this case, the determinants rested not with the current developments, but with the base effect generated by the poor crops recorded by some vegetables in 2005 (adversely impacting the supply in the first part of the following year).

The same as in the previous quarters, the analysis of core inflation requires the use of the adjusted indicator in order to remove the signal distortions induced by the vice tax introduction in 2006 and the in-advance gradual incorporation in price of the increase in excise duties on tobacco products which will take effect on 1 July 2007[1]. Although the NBR

[1] As a result of producers' decision to distribute over several months the pressure exerted by the measure in point on the end-user price.

projection indicates a further positive output gap, the annual rate of adjusted CORE2 declined again, by 0.2 percentage points to 2.8 percent due further to: the strengthening of the domestic currency, increasingly stiffer competition in the commercial sector and the fall in inflation expectations on a one-year horizon[2].

Structural analysis shows that the downward trend in core inflation was attributable to developments in both food and non-food prices. Underlying the deceleration in the rate of food prices were, apart from the already mentioned drivers, the strong base effect induced by tensions on the world sugar market at the start of 2006 and also the seeming slowdown in consumption, as suggested by the nearly 6 percent drop in annual terms in the volume of food sales January through February 2007 as compared with increases of over 20 percent in the previous year. Given that the reasons behind this trend reversal are not of a methodological nature and that the base effect, associated with the change in the pattern for granting the 13th salary in December instead of January, seems rather modest[3], a possible explanation for this development is a higher allocation of incomes for purchases of durables and residential investment; furthermore, according to signals, border trade with Bulgaria and Hungary is in full swing, although the magnitude of this phenomenon is hard to assess.

As concerns non-food items, the decrease in core inflation (manifest particularly in the case of electronic and household products) may be also attributed to price cuts following the elimination of custom duties after Romania's integration into the Community market. Market-priced services posted an opposite development, mainly as a result of the more expensive insurance policies following the EU accession. Nevertheless, in 2007 Q1, non-tradable goods were the main engine of disinflation, the annual rate of increase of their prices falling from 8.3 percent in December 2006 to 6.1 percent in March 2007; the reason behind this development is the favourable growth rate of administered prices, which account for a significantly higher share than market-priced services within the non-tradables group.

The downtrend in the annual growth rate of tradables prices was by far less sizeable; however, the 2.3 percent reading in March

CPI by Category of Products

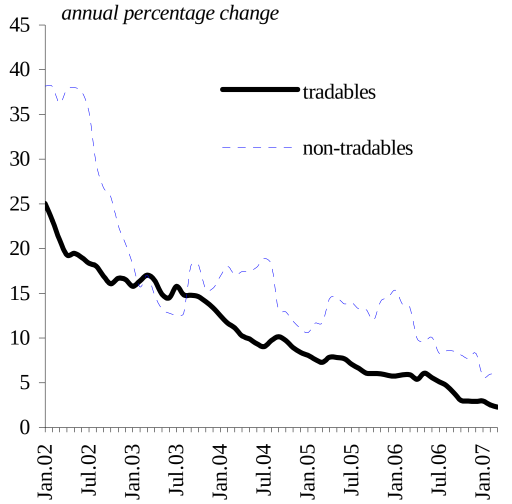
annual percentage change; end of period

	2006				2007
	I	II	III	IV	I
Food, alcohol, tobacco	6.9	6.3	4.7	3.7	3.8
Wearing apparel and footwear	3.8	3.8	3.8	3.3	3.2
Household appliances, furniture	2.8	2.1	1.9	1.7	1.7
Fuels	9.4	6.3	2.6	1.4	-0.7
Utility expenses*	23.0	17.9	13.4	17.9	11.4
Healthcare	0.1	-0.2	0.0	0.9	-0.6
Transport	16.6	11.7	7.0	5.3	6.4
Post and telecoms	0.6	-2.1	4.2	-3.0	0.0
Leisure and culture	7.0	7.1	5.8	4.5	3.9
Other goods and services	6.3	6.6	5.7	4.1	1.7

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

Source: NIS, NBR calculations

Tradables and Non-tradables Prices



Source: EUROSTAT, NBR calculations

[2] According to the NBR survey among banks, the spread between the expected inflation rate on a one-year horizon and the central bank's interpolated target narrowed to less than half the reading in December 2006.

[3] In spite of this hike in household incomes, in December 2006, the annual growth rate of the turnover recorded by food retailers was 9.5 percentage points lower than in the same year-ago period and only 3.3 percentage points higher than in the previous month.

2007 (down from 2.9 percent in December 2006) nears, at a distance of 0.7 percentage points, the readings of comparable indicators in the euro area and the European Union (the HICP change related to non-energy goods).

Administered Prices versus Market Prices

annual percentage change; end of period

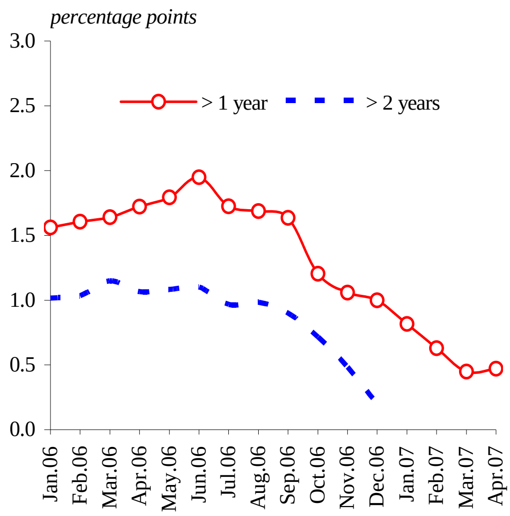
	2006				2007
	I	II	III	IV	I
Inflation Rate	**8.4**	**7.1**	**5.5**	**4.9**	**3.7**
Administered prices*	**13.0**	**10.1**	**9.5**	**10.2**	**6.9**
1. Non-food items*:	**15.9**	**11.4**	**8.4**	**11.4**	**5.4**
electricity	7.0	7.0	1.9	6.6	4.6
heating	20.0	20.0	20.0	18.4	20.8
natural gas	52.2	28.5	21.4	33.6	10.0
medicines	–5.5	–5.3	–4.0	–1.9	–4.8
2. Services*, of which:	**8.2**	**8.0**	**11.3**	**8.1**	**9.5**
water, sewerage, sanitation	24.8	24.9	20.3	21.4	20.5
telephony	–3.4	–2.0	10.5	2.5	5.6
passenger railway transport	8.7	11.6	5.1	13.2	23.7
(passenger) city transport	20.5	12.1	7.1	4.1	3.5
Market prices (CORE1)	**6.6**	**5.8**	**4.3**	**3.0**	**2.5**
CORE2**	**5.2**	**4.7**	**4.9**	**4.5**	**4.4**

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

Source: NIS

As for the convergence of consumer prices in Romania towards the EU average[4], the difference between the two harmonized indices diminished considerably versus end-2006 (from 2.7 percentage points to 1.4 percentage points in March 2007). The same development could be noticed in terms of the nominal convergence criterion; the gap between Romania's HICP and the average inflation rate for the three best performing EU state members narrowed from 3.8 percentage points in December 2006 to 2.7 percentage points in March 2007.

Spread between Expected Inflation and Annual Inflation Target



In March 2007, the effective annual rate of inflation was 0.6 percentage points below the February Inflation Report projection following: (i) the strong decline in the egg price, contrary to the initial assumptions concerning smaller cuts in view of the losses incurred by producers in 2006, (ii) the drop in the fuel tariffs, as the expected seasonal increases in the oil price failed to materialize due to high temperatures for this season and (iii) stronger appreciation of the domestic currency against the euro and the US dollar. Likewise, although the adoption of the Common Agricultural Policy and the application of the Common Customs Tariff were not expected to have an overall significantly unfavourable impact on the inflation rate, the price increases considered for some food items (particularly sugar and meat), in light of the experience undergone by the countries which became EU members in May 2004, failed to materialize.

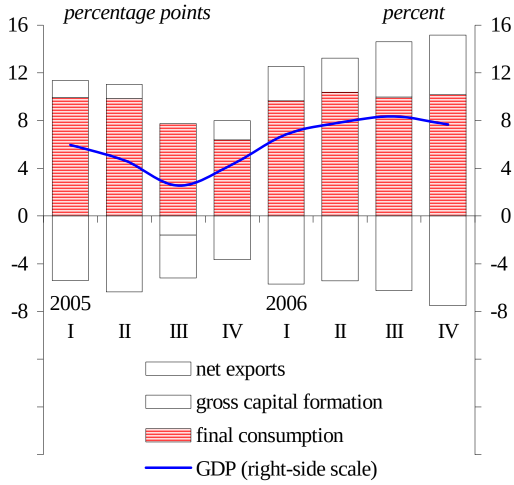
[4] EU-25 until December 2006 and EU-27 starting January 2007, after the accession of Romania and Bulgaria.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

After accelerating for four successive quarters, in 2006 Q4, the growth rate of real GDP slowed down to 7.7 percent[5], falling 0.6 percentage points both below the reading in the previous quarter and the December benchmark projection. In spite of the consolidation of the investment position as a driver of GDP dynamics starting with 2006 Q2 and of the slower growth rate of private consumption compared with the previous quarter, the still fast pace of increase of the latter remains a matter of concern, given the implications on the inflationary potential and the external imbalance. As concerns supply, the slowdown in GDP dynamics was generated by most economic sectors (except for construction).

Contribution of Demand Components to GDP Growth

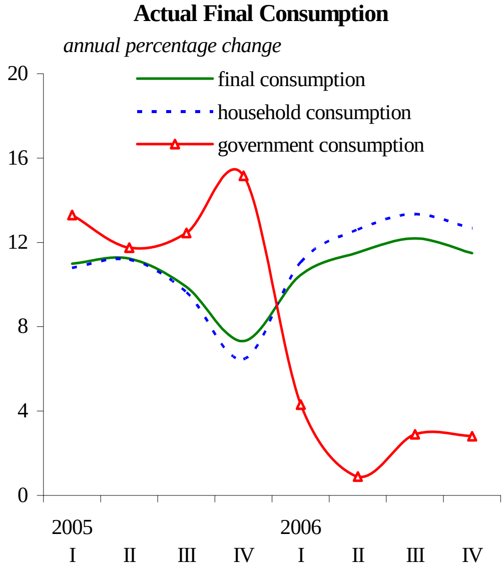


Source: NIS, NBR calculations

1.1. Demand

The acceleration in capital investment in Q4 was offset by the slight slowdown in the growth rate of total final consumption so that the pace of increase of domestic demand remained unchanged versus the previous quarter (13.5 percent). Under these circumstances, the curbing of the GDP growth was due solely to external demand, whose negative contribution (-7.5 percentage points) recorded the lowest level in the entire period for which quarterly ESA95 data are available[6].

Actual Final Consumption



Source: NIS

1.1.1. Consumer demand

The 0.7 percentage point slowdown in the growth rate of total final consumption in Q4 (to 11.5 percent) was mainly caused by private consumption, whereas government consumption rose at a pace similar to that in the previous quarter.

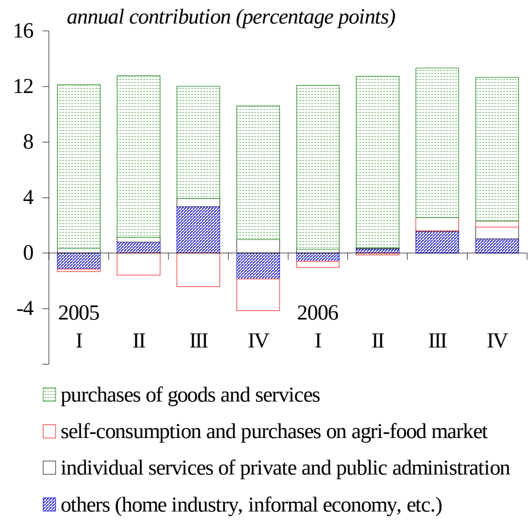
Household consumer demand

The growth rate of household final consumption continued to be fast (12.7 percent), albeit on a slight decrease versus Q3 (0.6 percentage points) owing chiefly to purchases of goods, whose dynamics slowed down from 24.8 percent to 18.9 percent. Even if this slackening was partially offset by the step-up in the provision of services to households, the expansion of the "commercial" component of private consumption (17.3 percent)

[5] Unless otherwise indicated, the growth rates in this section are annual percentage changes.
[6] 1999-2006.

was further strong, pointing to the persistence of demand-side inflationary pressures. Furthermore, the said slowdown may have been only temporary, being associated, to a great extent, with the expectations of lower prices for certain categories of products (particularly electronic and household products) after the EU accession. The maintenance of the inflationary potential of consumer demand is corroborated by the still fast growth rate of the turnover recorded by the trade in non-durables (around 20 percent) – the group of products accounting for the largest weight in the CPI basket – and, to a smaller extent, by the pick-up in the volume indices illustrating the receipts in transport and telecommunication services, the price movements of which are yet determined, to a rather large extent, by supply.

Household Final Consumption Growth



Source: NIS, NBR calculations

The other components of household final consumption saw opposite developments. On the one hand, the growth rate of self-consumption and purchases on the agri-food market slowed from 5 percent to 3.5 percent, given that, unlike the previous quarter, the period under review did not witness bumper crops for agricultural goods holding a significant seasonal weight in rural household consumption (fruit and vegetables in Q3, corn in Q4). On the other hand, provisional statistical data show an upturn in outlays incurred by public and private governments on households (5.4 percent, after the flat spending in the previous three months).

The decision to postpone the purchase of some products for the first part of 2007 may explain the seeming contradiction between the slowdown in the growth rate of purchases of goods and services and the acceleration in the growth rate of household real disposable income, pinpointed by all the components taken into consideration for the approximate calculation of this indicator (see subsection *2.2. Incomes*). The slower dynamics of household consumer demand was also illustrated by the fast narrowing in the volume of new short- and medium-term bank loans[7] (the rate of decrease was more than double that in Q3, reaching -34.2 percent), accompanied by a steeper propensity for saving – against the background of increasingly attractive deposit rates applied by commercial banks, the volume of new time deposits (the main saving/

[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 personal loans with maturities longer than 5 years. Even though banks classify the latter ones under consumer credit, they are usually destined for operations similar in nature to investments (real-estate purchases, down payment for real-estate/mortgage loans, house improvements).

investment instrument of households) expanded by 15 percent compared to 8.2 percent in the previous quarter[8].

Households' propensity for imported consumer goods consolidated further in Q4, particularly in the case of transport means and non-durables – the growth rate of the turnover of domestically-produced motor vehicles sold on the domestic market slowed by more than 6 times to 3.3 percent concurrently with a strong acceleration in the pace of increase of imports to 55.6 percent[9]. The upturn in the sales of domestically-produced non-durables (from -0.8 percent to +4.3 percent) was by far below the rise in imports (from +8 percent to +29.2 percent). Consumers showed keener interest in imports of durables, excluding transport means, as well given that the real growth rate of turnover on the domestic market continued to be outpaced in Q4 too by the growth rate of imports[10].

Government consumer demand

Government final consumption recorded a growth rate similar to that in the previous quarter, going up 2.8 percent, on the back of the job creation in the public sector.

Budgetary developments

Public spending saw a substantial rise in late 2006, particularly in December, accounting for nearly 18 percent of annual expenditures. Nonetheless, this development did not put significant pressure on the dynamics of government consumer demand, given that more than 60 percent of the increase in public spending were channelled to government investment spending and transfers. However, fiscal policy easing bolstered significantly the performance of the other domestic demand components, as the consolidated general budget's deficit-to-GDP ratio more than doubled as compared to 2005 Q4 (3.3 percent versus 1.6 percent). Therefore, financial 2006 ended on a consolidated general budget deficit of roughly 1.7 percent of GDP, over two times wider year on year, yet 0.8 percentage points lower than the figure projected for 2007.

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[8] Balances of households' time deposits expanded faster as well; their rate of increase accelerated gradually in Q2-Q4 to 12.3 percent (real change).

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

[10] The dynamics of domestic supply improved marginally (+16.4 percent), while the volume of imports of durables (other than motor vehicles) identified on the basis of the Combined Nomenclature expanded by 18 percent (electrical machinery and apparatus), by 46.8 percent (precision and optical instruments etc.) and by 22.7 percent (miscellaneous merchandise, particularly furniture).

The consolidated general budget moved from the surplus seen in the first three quarters of 2006 to a deficit for the year as a whole, against the background of opposite developments recorded by the dynamics of revenues and expenditures in 2006 Q4; hence, the annual real growth rate[11] of expenditures doubled versus the previous quarter (34.9 percent), whilst that of revenues decelerated to 16.5 percent.

Nearly all public spending components showed a faster increase in the final quarter of the year, except for domestic and external public debt-related interest payments, which saw a sharper decline[12] than in the prior quarter, owing to both the setback in government securities outstanding with the public and the strong nominal appreciation of the RON. Public investment displayed the swiftest rise (100.6 percent), about 61 percent of annual capital expenditures[13] being incurred in 2006 Q4. Considerable increases were also reported by staff costs and transfers (44.7 percent[14] and 33.6 percent respectively); the expansion in transfers may partially be attributed to the larger amounts allotted for the co-financing of projects funded from pre-accession funds and the inclusion into budget expenditures of the financial equivalent of the participating interests issued by “Proprietatea” Fund in order to grant compensations in exchange for the value of some abusively-seized buildings (about RON 1,471 million).

The slowdown in budget revenues growth in 2006 Q4 was mainly driven by the sluggish rise of non-tax revenues and capital gains; this was the result of a base effect, as in 2006 as a whole receipts under the two categories accounted for 93 percent and 120 percent respectively of the programmed figures. Nevertheless, the slowdown in the growth of non-tax revenues and capital gains was partly offset by the brisker increase in collections from wage and income tax – which hit a new record high of 50.8 percent –, and in receipts from profit tax and property taxes and fees, which rose by 38.4 percent each.

The 2007 budget programme anticipates a consolidated general budget deficit of 2.8 percent of GDP, including the effects of ensuring Romania’s contribution to the EU budget and the co-financing of non-redeemable EU funds, as well as of financing some infrastructure projects in transport and environment, and

[11] Unless otherwise indicated, percentage changes refer to the annual growth rate expressed in real terms.
[12] Extended over five quarters.
[13] In 2006 as a whole, only 92 percent of the capital expenditures envisaged by the November budget revision were made.
[14] Reflecting also a base effect, as the “13th month” wage for public-sector employees in 2005 was granted in January 2006.

investment projects in education and health. In this context, the budget programme foresees an unprecedented increase in capital expenditures (from 3.7 percent to 6.7 percent of GDP). Moreover, the 2 percentage point decrease in social security contributions to be paid by employers was considered under the 2007 budget construction.

1.1.2. Investment demand

In Q4, the growth rate of gross fixed capital formation added 0.7 percentage points versus the previous quarter to 18 percent. According to statistical data on the structure of investment, this development is mainly attributed to the step-up in retooling (the growth rate of equipment purchases doubled to 12.4 percent), and, to a lesser extent, to capital repair works, whose volume rose at a marginally faster pace of increase (almost 19 percent). In spite of a slowdown versus 2006 Q3, the dynamics of new construction works was further high (18.7 percent); thus, new construction works continued to be the main driver of the increase in capital investment.

The same as in the previous quarter, in Q4, the expansion in gross fixed capital formation was bolstered particularly by own sources, given the positive outcomes recorded by the corporate sector all through 2006, by the significant budget assignments[15], and also by the fast pace of household disposable income. To these sources added the loans granted by credit institutions: (i) as concerns domestic banks, in spite of a slower dynamics of new long-term loans than in Q3, a high growth rate was persistent both in the case of the corporate sector (55.8 percent, exceeding by far the average for 2005) and households (the volume doubled)[16]; (ii) the leasing market witnessed an expansion, 2006 recording a growing preference for equipment purchases and real-estate investment to the detriment of motor leasing operations; (iii) foreign loans taken by the non-financial sector decreased further in real terms, hinting at a stronger tendency to finance investment from domestic loans. Capital investment was spurred also by the significant inflows of foreign direct investment[17] and the recent non-redeemable inflows (under SAPARD and ISPA).

Investment

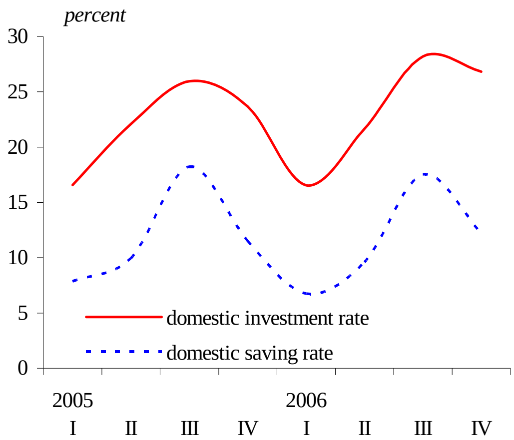
annual percentage change

	Year	I	II	III	IV
Total	2005	5.8	10.7	13.0	17.5
	2006	10.8	15.1	15.8	18.4
- new construction works	2005	2.2	9.4	8.8	15.3
	2006	23.5	11.6	20.2	18.7
- equipment	2005	9.6	12.8	15.7	15.7
	2006	2.6	20.8	6.2	12.4
- others*	2005	–4.9	1.0	27.0	48.2
	2006	4.8	–9.6	54.7	55.8

* vineyards, orchards, afforestations, livestock purchases

Source: NIS

Investment Rate and Saving Rate



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

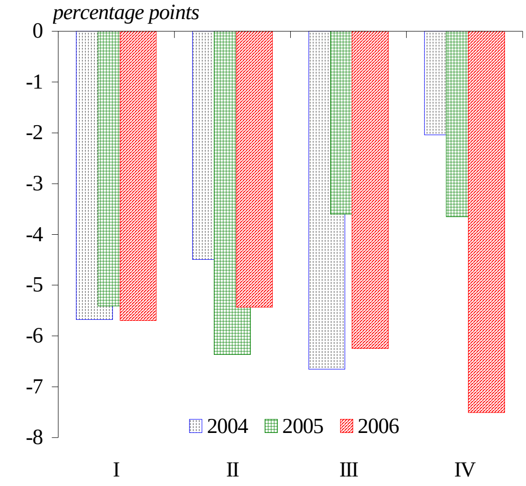
Source: NIS, NBR calculations

[15] Compared to the previous quarter, the volume of capital expenditures from the public budget rose at a significantly faster annual growth rate (118.8 percent versus 66 percent – calculations based on the government budget execution by deflation by the producer price index for capital goods for the domestic market).

[16] The analysis of data released by Credit Risk Bureau points to the same conclusion, as the high real growth rates of loans granted for equipment and real-estate investment remained broadly unchanged from the previous quarter (61.4 percent and 56.5 percent respectively).

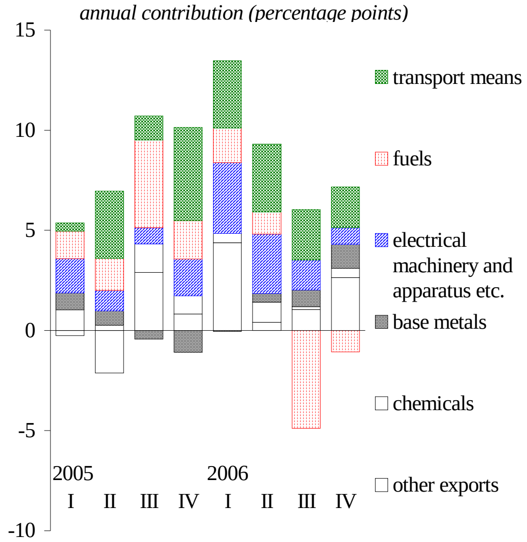
[17] The balance-of-payments data for 2006 show a 72.8 percent increase in net inflows from direct investment, with the growth rate remaining strongly positive even after excluding the EUR 2.2 billion proceeds from the privatisation of Banca Comercială Română in October 2006.

Net External Demand Contribution to GDP Growth



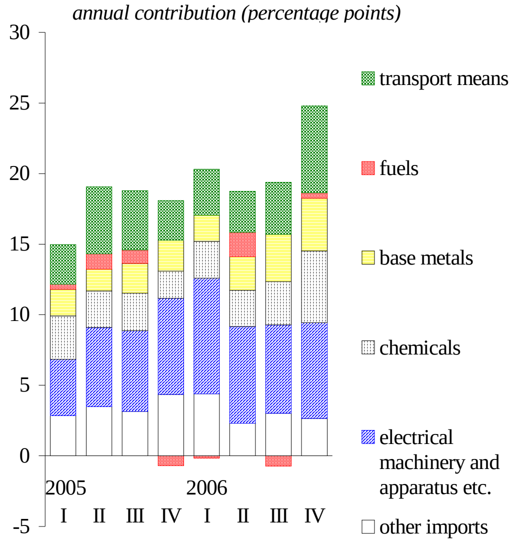
Source: NIS, NBR calculations

Dynamics of Export Physical Volume



Source: NIS, NBR calculations

Dynamics of Import Physical Volume



Source: NIS, NBR calculations

Investment in foreign capital goods continued to be increasingly preferred in the last part of the year, given that the real dynamics of the turnover recorded by specific industries following deliveries on the domestic market (8.2 percent[18]) was exceeded by that of imports (27 percent for "mechanical and electrical machinery and apparatus", 60 percent for "transport means"[9]).

1.1.3. Net external demand

Following the revision of national account data related to 2004 and 2005, the contribution of net export to GDP dynamics changed significantly over the first three quarters of 2006. Before the revision, values ranged between -4.1 percentage points and -4.9 percentage points and afterwards they ranged between -5.4 percentage points and -6.2 percentage points. In Q4, the significant negative level of net external demand worsened, its contribution to economic growth reaching an 8-year low of -7.5 percentage points. The development was due, on the one hand, to the widening to -16.7 percentage points in the growth rate disparity between exports and imports of goods and services – on the background of a weaker increase in exports (8.6 percent versus 10.6 percent in Q3) and of a faster rise in imports (from 24.4 percent to 25.3 percent), and, on the other, to the larger difference between the share in GDP of exports and imports in favour of the latter component, in the base period.

According to the balance-of-payments data, the weaker performance of exports in Q4 may be attributed to a more modest development in services (particularly transports and communications), as the annual growth rate of exports of goods accelerated versus the previous quarter (from 1.2 percent to 6.1 percent)[9]. This acceleration may be the result of (i) the fading of the base effect which was manifest in Q3 in the case of fuels and vegetal oils[19], (ii) the slower decline in the output of crude oil processing industry (from -11.7 percent in Q3 to -6.9 percent) and also of (iii) the record-high annual growth rate seen by exports of vegetal products (+113 percent) which came to account for almost one fourth of exports' growth.

As concerns imports of goods and services, the step-up in the annual growth rate was generated by purchases of goods, whose volume rose by 24.8 percent compared to 18.7 percent in Q3; chemical products and transport means posted the fastest

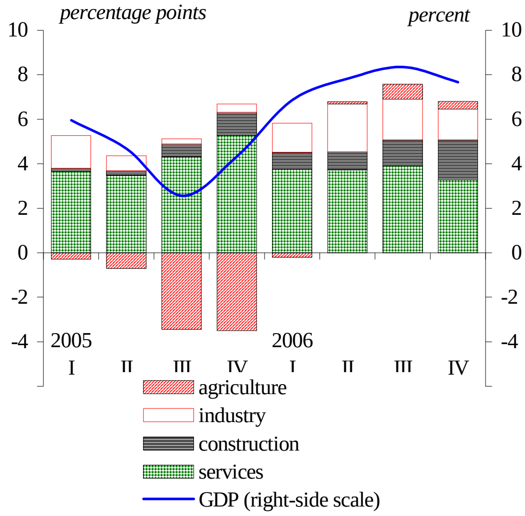
[18] The reading refers to "capital goods" heading, which includes also transport means, according to the methodology for the classification of main industrial groups.
[19] In Q3 2005, the volume of fuel exports had increased by 56.5 percent in annual terms.

growth rates. Concentration of imports was further high, the said two categories of goods contributing, together with “base metals” and “mechanical and electrical machinery and apparatus” in a proportion of 88 percent to the dynamics of this balance-oc-payments component.

1.2. Supply

Gross value added in industry posted a 1.3 percentage point lower growth rate than in the previous quarter, i.e. 6.6 percent. This deceleration may be associated mainly with (i) the decrease in the energy sector activity (given the negative impact of the unusually hot weather on heating output) and (ii) the slower growth in some industries producing intermediate goods (particularly the chemical industry). This trend was mitigated chiefly by the capital goods sub-sector, where the growth rate of the output of transport means almost doubled (up nearly 43 percent), largely due to a faster increase in external demand.

Contribution of Main Supply Components to GDP Growth



Source: NIS, NBR calculations

The growth rate of gross value added in services dropped 2 percentage points versus Q3 (to 6.5 percent). This development was entailed mainly by retail sales and receipts from transport, post, telecommunications and real-estate transactions, being partly offset by wholesale trade, whose turnover posted a higher dynamics (up 10 percentage points to 32 percent).

As concerns agriculture, the 1.4 percentage point slowdown in the annual growth rate of gross value added (to 3.7 percent) was due mainly to the negative influence of adverse weather conditions on the volume of grain production, which was only partly offset by higher outcomes recorded by production of technical plants (particularly sun flower and sugar beet).

Construction was the only sector to post a faster annual growth rate in Q4 to a record level for 1999-2006 (21.6 percent). With growth rates of gross value added staying above 14 percent in 2006, the construction sector posted, according to market signals, the most outstanding outcomes over the past 17 years. In the reviewed period, current repairs works recorded the fastest growth (almost 36 percent), ahead of capital repairs and new constructions (about 19 percent in both cases). The expansion in construction was particularly obvious in the execution of building projects (up to almost 20 percent on the residential segment and 33 percent and on the non-residential segment); meanwhile, engineering works saw a slight slowdown (to 20 percent) compared to Q3.

2. Labour market

2.1. Labour force

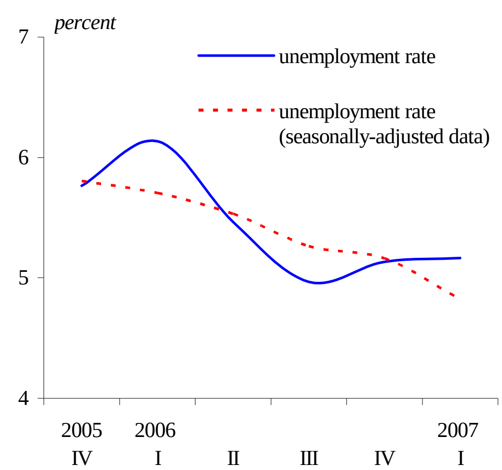
Number of Vacancies and Number of Filled Vacancies

Source: NEA

Labour demand remained robust in 2006 Q4 and the first two months of 2007, causing the further acceleration of the annual growth rate of wages. In industry, wage developments were the main factor behind the increase in ULC, but keen competition could prevent the effects of this increase to pass on to prices. However, on the demand side, the higher annual growth rate of real disposable income indicates the lingering potential risks from pressures on the consumption of goods and services.

The fast economic growth in 2006 entailed the rise in employment; in the case of working age population (15-64 years), employment rate hit a five-year high, i.e. 59.3 percent, in 2006 Q1-Q3[20] (up 1.4 percentage points from the same year-ago period). Over the same period, the larger number of vacancies attracted part of the inactive working population, but these persons appear not to have resorted to national employment agencies; thus, while the number of unemployed detected by the AMIGO survey rose slightly, the number of unemployed registered with the NEA continued to decrease[21]. The expansion of the informal market is also illustrated by the wider spread between the number of AMIGO survey respondents that have declared to be employed and the number of payrolls reported by employers[22].

Unemployment Rate



Source: NEA, NBR calculations

Taking into account the scope limitations of the available statistical data, their analysis illustrates the persistence of restrictive conditions on the labour market in 2006 Q4 and at the outset of 2007. The difficulties encountered by employers in identifying and retaining adequately skilled persons are suggested by the following: (i) the annual growth rate of the number of vacancies exceeded largely that of hirings, particularly in the first two months of 2007, when labour demand rose markedly (the number of vacancies hit a seven-year record high for this period, outstripping the number of hirings by around 40 percent) and (ii) excess workforce supply remained low – registered unemployment stood at 5.2 percent in 2007 Q1 (up 0.03 percentage points from the prior quarter), the

[20] The latest data provided by the Households Labour Force Survey (AMIGO) cover 2006 Q3.

[21] The comparison was drawn between the numbers of unemployed instead of unemployment rates due to the different methodology used in the calculation of the latter – in the case of registered unemployment, the working population taken as reporting base is that reported in the quarter under review for the ILO indicator and that reported at the outset of the year for registered unemployment.

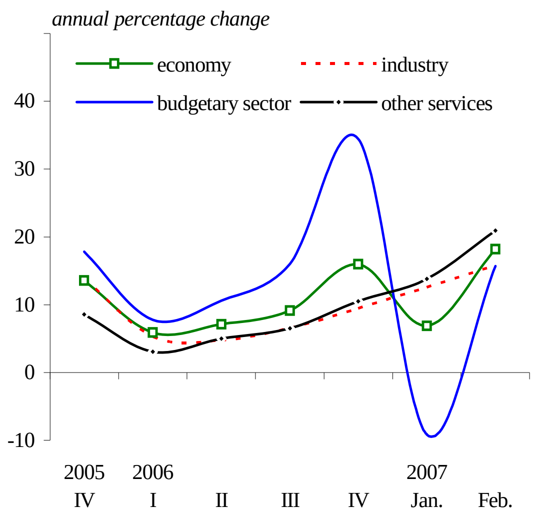
[22] The ratio of the two indicators moved up from 1.31 in Q1-Q3 to 1.35.

seasonal adjustment illustrating the persistent downtrend of this indicator. Under these conditions, a large number of companies hire staff with other skills than those required for the respective job[23], while other companies are ready, according to the recruitment agencies, to raise the wages of the newly hired so as to attract experienced staff from competing companies.

2.2. Incomes

The earlier granting of the "13th-month" wage (in December instead of January) to public sector employees influenced the annual dynamics of gross nominal wages economy-wide, which sped up strongly in 2006 Q4, to 23.7 percent and dropped to 18 percent in January-February 2007. In such a case, a sectoral analysis is needed for a meaningful interpretation of wage developments.

Net Real Wage*

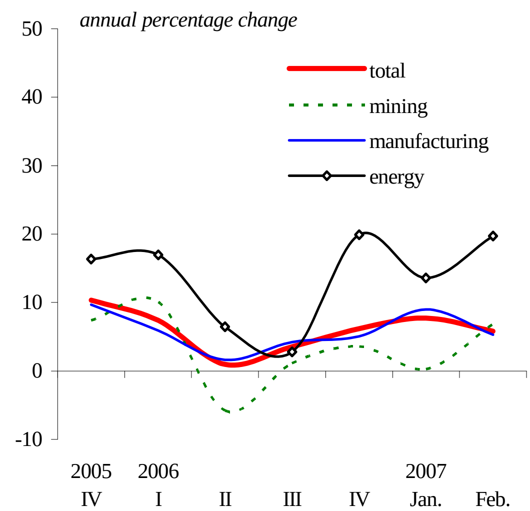


*) deflated by CPI

Source: NIS, NBR calculations

As the available data do not allow the separation of the "13th-month" wage from the other incomes and therefore the isolation of the base effect resulting from the change in seasonality, relevant for the trends of budget sector wages is only the comparison between the annual dynamics recorded in February 2007 and that recorded in the period before December 2006, i.e. July-November. Overall, the annual growth rate of gross wage decreased by 4 percentage points, its level (20.7 percent) falling below those of other economic sectors. The slowdown was due to the developments in education and healthcare, but the situation could prove temporary, given the 19-22 percent wage hikes announced for 2007. Moreover, it is noteworthy the persistently brisk pace of increase in public administration wages (around 36 percent), which might trigger additional rises in the other public sector activities.

Unit Labour Costs in Industry



Source: NIS, NBR calculations

In the other economic sectors (industry, construction, private services), the annual growth rates of gross nominal wage gathered momentum gradually in 2006 Q4 and in the first two months of 2007[24], reaching 20-26 percent. The reasons behind this development are related, on the one hand, to the accumulation of profits in those sectors that benefited from strong domestic demand[25] and the favourable prospects of a further brisk pace of economic growth and, on the other hand, to the narrowing of the labour market, which was generated by

[23] See the study *Evoluția ocupațiilor pe piața forței de muncă din România în perspectiva anului 2010*, 2006, published on the website of the Ministry of Labour, Social Solidarity and Family, www.mmssf.ro.

[24] Up 2-3 percentage points in 2006 Q4 and 4-6 percentage points in January-February 2007 from the prior quarter.

[25] Construction and industrial sectors producing building materials, trade, tourism, transports, etc.

the higher employment and the migration of labour force abroad. The pressures to close the gap separating Romania from the other EU Member States and employers' concerns to attract and retain adequately skilled staff were the reasons for setting, via the collective labour contract nation-wide, the gross minimum wage depending on the educational background of the employees, from 440 RON for unskilled workers to 880 RON for university graduates (significantly higher than the unique level of RON 370 in 2006). It should be noted that the gross minimum wage economy-wide set by the Government grew from RON 330 to RON 390 (+18.2 percent year on year), lagging behind the gross minimum wage in the private sector for the third year in succession.

Labour Productivity and Real Gross Wage in Industry

annual percentage change

	2005	2006				2007	
	IV	I	II	III	IV	Jan.	Feb.
Labour productivity	7.0	8.6	13.2	11.1	10.0	10.1	15.3
Real gross average wage*	6.6	4.4	2.0	1.9	4.8	6.5	11.4
Real gross average wage**	15.9	7.8	4.0	3.0	6.9	13.0	15.0

*) deflated by industrial producer price index for domestic market

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

Source: NIS, NBR calculations

Wage hikes in industry were not backed by attendant growth of productivity gains, so that unit labour costs entered an upward path starting with 2006 Q3 – the ULC index moved up industry-wide from 103.6 percent in 2006 Q3 to 106.7 percent in the first two months of 2007. In 2006 Q4, the increase[26] of this indicator versus the prior quarter was largely attributable to developments in the energy sector (granting of substantial bonuses along with the strong deceleration of the annual growth rate of labour productivity), while in January-February 2007, the determinant was the faster-paced wage hikes in manufacturing. At the beginning of 2007, the consumer goods industry witnessed higher ULC values in food industry, wearing apparel and furniture, but stiff competition in these sectors might prevent a pass-through of upward pressures into prices.

On the demand side, the vigorous acceleration in the annual growth rate of real disposable income in 2006 Q4 (from 5.6 percent in 2006 Q3 to 15.2 percent) illustrates the persistent potential risks associated to high consumer demand, even though, in the reviewed period, certain factors prevented these pressures from becoming manifest (see sub-section *1.1. Demand*). The rise in real disposable income was attributable to the accelerated increase in all its components: (i) real wage incomes moved up to 17.7 percent, also as a result of the early granting of the "13th-month" wage in the public sector; (ii) the real growth rate of budgetary and extra-budgetary revenues returned to positive territory (4.5 percent) following the in-advance rise in pensions; (iii) the positive dynamics of remittances and transfers from abroad accelerated by about 15 percentage points. According to provisional statistical data available for 2007 Q1, the annual pace of increase of real disposable income appears to stay at a level similar to that recorded in 2006 Q4.

[26] By 2.6 percentage points.

3. Import prices and producer prices

In 2006 Q4, inflationary pressures were significantly lower, a contribution to this trend coming from developments in import prices and industrial producer prices. Conversely, prices for agricultural products were on the rise which was more pronounced in case of prices for vegetal products, but also visible in what concerns prices for animal products. In the first part of 2007, prices appear to stay on the same trends, with a greater favourable impact of prices for energy products being noticed.

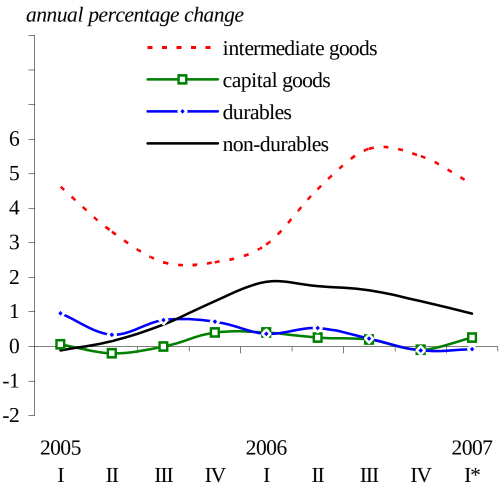
3.1. Import prices

After three quarters in which import prices kept rising, in 2006 Q4, the deflator of imports of goods and services was below par (annual index of 97.9 percent, down from 100.4 percent in Q3), which indicates an easing of pressures on domestic prices. This development was accounted for by the resumption of the appreciation trend of the domestic currency against the euro (4.6 percent as compared to a 0.4 percent depreciation in the previous quarter), as well as by the noticeable slowdown in the annual growth rate of external prices (expressed in euro), as suggested by the drop in the unit value index from 103.2 percent to 101.4 percent.

The prices for most categories of imported goods holding a significant share in the CPI basket posted favourable developments. This performance was more pronounced in case of prices for foodstuffs, fuels and pharmaceuticals (when expressed in euro, prices for such products declined or stayed flat in 2006 Q4 versus the same year-earlier period, as compared with annual growth rates ranging from 9 percent to 18 percent in 2006 Q3).

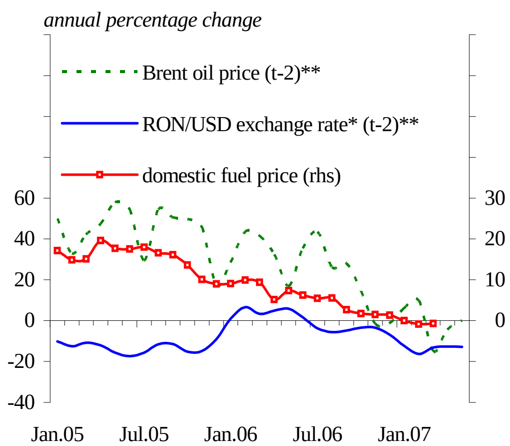
Data available for 2007 Q1 indicate that the previous quarter's trends in prices sharpened, the lowering of pressures exerted by external prices being upheld by: (i) the persistence of a downward trend in world oil price (down to an average of USD 57.8 per barrel for Brent oil in 2007 Q1, which led to an annual growth rate of -6.5 percent versus 4.8 percent in 2006 Q4); (ii) the decline in natural gas price in January-February 2007, for the first time in the past three years; (iii) the considerable slowdown in the annual growth rate of the aggregate price index of commodities calculated by the IMF (from nearly 12 percent in 2006 Q4 to 3 percent in 2007 Q1). Moreover, the average annual growth rate of prices for exported goods originating in the European Union stood at 2 percent[27] during January-

EU-25 Industrial Producer Prices for Exports



Source: EUROSTAT *) January - February

Oil and Fuel Prices



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

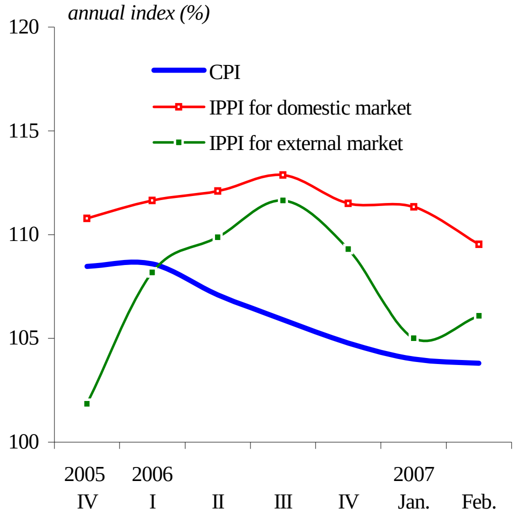
Source: NIS, EIA

[27] Across manufacturing.

February 2007, 0.2 percentage points below the average for October-December 2006, which also indicates the abating inflationary pressures on the main origin markets of imported goods.

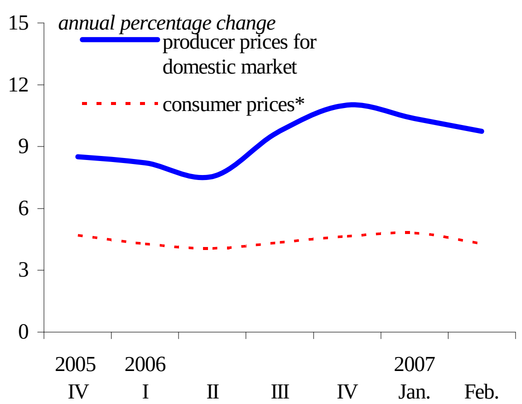
The favourable impact that the previously mentioned developments had on imported inflation was accompanied by the persistence of the nominal appreciation trend of local currency versus the major currencies. Thus, in 2007 Q1, the RON strengthened year on year against the euro and the US dollar by 5.4 percent and 14.7 percent respectively.

Consumer Prices and Industrial Producer Prices



Source: NIS

Non-durables Prices



* To identify industrial non-durables, the following food and non-food items were removed from the CPI basket:

fruit, vegetables, eggs, household appliances, furniture, cultural and leisure products, fuels, electricity, gas and central heating, and other non-food items.

Source: NIS, NBR calculations

3.2. Producer prices

3.2.1. Industrial producer prices

Against the background of ever lower pressures from energy products[28] and the emergence of the first signs of alleviating tensions on the metal exchange[29], the final quarter of 2006 saw the resumption of disinflation of industrial producer prices for the domestic market (down 1.4 percentage points to 11.5 percent). The magnitude of disinflation was lower in manufacturing, where the annual rate of increase of industrial producer prices for the domestic market exceeded further the average industry-wide, remaining 7.1 percentage points higher than that of consumer prices, the same as in 2006 Q3.

Main industrial groups further posted mixed price developments; faster rates of increase in prices were reported by durables and non-durables sub-sectors (0.9 percentage points and 1.3 percentage points respectively), which account for the largest share of the CPI basket. Price hikes in the former sub-sector were mainly attributed to food industry, where pressures emerged broadly on the supply side – costlier raw materials[30] and the need to recover the investment required by the alignment to EU standards. On the demand side, data on the volume of turnover for the domestic market in 2006 Q4[31] indicate the decrease in the market shares of specialised

[28] The gap between the annual growth rate of industrial producer prices for energy products on the domestic market and the average industry-wide narrowed from 10.8 percentage points in 2006 Q2 to 3.8 percentage points in 2006 Q4.
[29] The average annual growth rate of industrial producer prices for the domestic market in the metalliferous ores extraction sub-sector slowed by 14.1 percentage points in 2006 Q4, while the unit value index of imports under "base metals" dropped 1.04 percentage points.
[30] See subsection 3.2.2. *Agricultural producer prices*.
[31] The average annual growth rate of turnover for the domestic market in food industry halved in 2006 Q4 as compared to Q3, whereas retail purchases of foodstuffs continued to display robust annual growth rates, which slowed down only marginally as compared with Q3.

domestic producers; given that the drop in import prices for some foodstuffs following Romania's joining the EU might foster this development, the dynamics of producer prices in food industry is likely to experience a trend reversal in 2007 Q1. Steeper price rises were also seen in the leatherwear sub-sector, as the efforts of domestic producers to make their own brands popular (also by using the franchise system) brought about higher costs.

The 5.9 percent advance in the annual growth rate of industrial producer prices for durables may largely be associated with strong domestic demand[32], as no significant pressures could be identified in relation to production costs.

In correlation with the slowdown in the pace of increase of prices for metals in 2006 Q4, the annual growth rates of industrial producer prices for intermediate goods and capital goods on the domestic market decelerated versus the previous quarter (by 0.4 percentage points and 1 percentage point respectively).

In 2007 Q1, disinflation of industrial producer prices for the domestic market is expected to continue, owing to developments in prices for both energy products and non-durables.

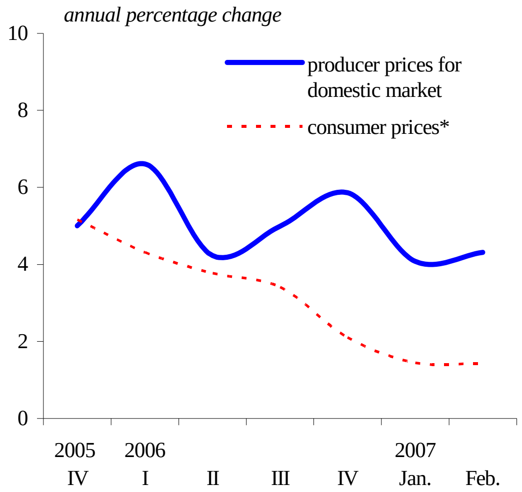
3.2.2. Agricultural producer prices

In line with expectations, in 2006 Q4, the annual growth rate of prices for agricultural products returned to positive territory, i.e. 3.2 percent, mainly on the back of developments in prices for vegetal products.

This movement occurred against the background of heightening pressures generated by prices for grains (up to 35 percentage points in case of prices for wheat), as a result of poor crops. Due to costlier fodder, the effect of this factor fed through to prices for animal products, which posted a trend reversal, their rate of increase shifting from -3.3 percent in 2006 Q3 to 0.6 percent in Q4. The rise was reflected by producer prices for beef, the growth rate of which added 7.2 percentage points to 10.4 percent as compared to the previous quarter.

The declines in prices for pork and poultry (by 9.4 percent and 4 percent respectively) were mainly caused by incidental

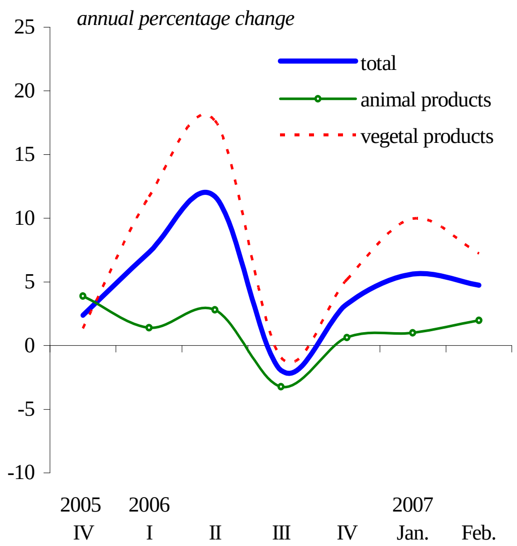
Durables Prices



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

Source: NIS, NBR calculations

Agricultural Producer Prices



Source: NIS

32 The average annual growth rate of turnover for the domestic market accelerated to 16.4 percent in 2006 Q4 as compared with Q3.

factors: (i) maintenance of the embargo Russia had imposed on meat imports from Poland at end-2005, which pushed down further prices for pork in EU Member States; (ii) the campaign for vaccination against swine fever in December 2006 and the ensuing prohibition of pork sales for a period of time; (iii) adjustment of the price for poultry following the significant hikes in the past three quarters.

In 2007 Q1, prices for both animal and vegetal products are likely to follow the same trends.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In the context of higher-than-expected appreciation of the domestic currency starting December 2006, the National Bank of Romania moved to reshape the composition of monetary conditions in 2007 Q1 by lowering the monetary policy rate in two stages (by 0.75 percentage points and 0.5 percentage points respectively) to 7.5 percent per annum. At the same time, the central bank maintained the restrictiveness of the minimum reserve requirements mechanism and increased gradually the firmness of the control over money market liquidity in the latter part of the quarter under review. Thus, the broad monetary conditions remained adequate for keeping disinflation on a path compatible with achieving the inflation targets over the medium term.

Faster-than-expected decline in inflation combined with the improvement of the outlook for inflation, also as a result of monetary conditions tightening in the prior months – both by increasing the real monetary policy rate and especially by the faster-than-anticipated strengthening of the domestic currency –, prompted the rate cuts decided by the NBR Board in the first three months of 2007. Following the two downward adjustments (on 9 February and 26 March, by 0.75 percentage points and 0.5 percentage points respectively), the monetary policy rate was lowered to 7.5 percent. At the same time, in an attempt to reduce the spread between monetary policy rate and the effective interest rate on credit institutions' placements with the central bank and thereby enhance the signalling role of the former and its capability to anchor inflation expectations, the National Bank of Romania gradually increased the firmness of monetary control in the latter part of the reported quarter. Nevertheless, the monetary authority continued to drain only part of excess liquidity via open-market operations, aiming to deter volatile capital inflows and to avoid the risk of an additional appreciation of the local currency. However, broad monetary conditions were still restrictive over the reviewed period. To this contributed, besides the drop in the real effective exchange rate of the RON[33], the keeping in place of a tight minimum reserve requirements mechanism, with the reserve

[33] The real effective exchange rate of the RON is computed based on the RON/EUR and RON/USD exchange rates by resorting to a weighing system reflecting the shares held by the EUR and the USD in Romania's foreign trade (see Chapter V. *Inflation outlook*).

ratio on RON-denominated liabilities[34] being left at 20 percent and that on foreign currency-denominated liabilities at 40 percent.

During the period, rate cut decisions were prompted particularly by the relative improvement in inflation outlook over the monetary policy transmission horizon, initially shaped in the context of updating the February projection of medium-term macroeconomic developments. The major determinants of the favourable change in the trajectory of future inflation were the faster-than-expected disinflation in the recent months and the decrease, far below the previously projected level, of excess demand in 2006 Q3 and implicitly of its estimate for 2006 Q4. Nonetheless, the National Bank of Romania Board took a cautious approach to the size of the monetary policy rate cut given the risk arising, according to the updated forecast, from the envisaged extension of robust economic growth in the period ahead – due mainly to the expected loosening of fiscal and income policies – and the slower decline of the positive output gap.

The relative mitigation of this risk, as suggested by the subsequently-released data, along with the continued improvement of recent developments and short-run outlook for disinflation were the main reasons behind the NBR Board’s decision to proceed to another rate cut. Contrary to expectations, towards the end of 2006, economic growth momentum slowed (annual GDP dynamics dropped to 7.7 percent in Q4 from 8.3 percent in Q3 – see Chapter III. *Economic developments*) and the excess demand contracted against both the previous quarter and the forecasted figure. However, domestic demand further rose at a brisk pace (13.5 percent year on year), with the deceleration in GDP expansion owing solely to the record increase in the negative contribution to growth from net exports. On the other hand, investment strengthened its role as the chief driver of GDP growth, the ensuing positive effect, in the medium term at least, being an advance in potential GDP. At the same time, after three quarters of successive rises, private consumption – the component with the largest inflationary potential – saw a slight reduction in its yearly growth rate (down 0.6 percentage points to 12.7 percent); the reduction was more visible for goods purchases, their annual dynamics shedding to a record low in the past five quarters.

Unlike the previous periods, the relative moderation of household consumer demand growth was at odds with the fast rise in household income (originating mainly in wages and remittances from abroad), being however in line with the trend

[34] With a residual maturity of up to 2 years.

in individuals' net bank saving, which showed a pronounced recovery. In addition, contrary to expectations, the slight shift in household behaviour in favour of saving, which had become manifest in 2006 Q4, persisted into January-February 2007, when the growth of private consumption further slowed down (the annual growth rate of turnover reported by companies pursuing mostly retail trade activities and that reported by service providing companies posted unexpectedly low readings), despite the still fast increase in household income.

This shift in behaviour was reflected – to a smaller extent – by the marginal slowdown[35] against the previous quarter in the real annual pace of increase of loans to households during January-February 2007 (due also to the lingering impact of administrative measures previously adopted by the central bank in order to contain credit risk attached to loans to households). Nonetheless, new credit lines granted to households saw a swifter rate of deceleration in early 2007[36]. The trend in total loans outstanding was hallmarked by the developments in RON-denominated loans, the average annual growth rate of which (78.4 percent) stayed on the downward path which had entered last August, dropping, in January-February 2007, 17 percentage points below the average figure for 2006 Q4. The effect of this moderation was partly offset by the stronger dynamics of foreign currency-denominated loans to households, owing largely to (i) persistence of a favourable cost differential, also as a result of faster RON appreciation and the anticipated continuation of domestic currency strengthening and (ii) removal, as from 1 January 2007, of the credit institutions' limit on total exposure from forex loans. From this perspective, the need to counter the upward trend in RON-denominated credit being substituted by foreign currency-denominated credit was another reason behind the lowering of the monetary policy rate.

Yet another sign of the persistence of the shift in household behaviour was the strengthening uptrend in the annual growth rate of households' time deposits with an agreed maturity of up to 2 years[37] (averaging at 7.2 percent in January-February 2007 compared with 4.1 percent in 2006 Q4). This development was underpinned by the significant rise in wages and the maintenance of attractive interest rates applied by banks since late 2006. However, a much stronger pick-up saw overnight

[35] Excluding the impact of the fading base effect of the transfer by part of credit institutions of some foreign currency-denominated loans to the portfolio of (foreign) parent undertakings in December 2005.
[36] According to data supplied by Credit Risk Bureau.
[37] Starting January 2007, the NBR calculates and publishes monetary indicators according to the ECB's methodology. Historical data were recalculated in order to ensure comparability; the resulting series may be subject to revision.

RON-denominated deposits of households (in the first two months of 2007, their annual rate of increase averaged at 110.7 percent, up 46.2 percentage points against October-December 2006), following the ongoing upsurge in the number of payment cards and the increasingly popular related products. A brisk step-up also witnessed foreign-currency denominated deposits of households (average annual growth rate of 45.1 percent in January-February 2007 compared with 38.3 percent in 2006 Q4), largely as a result of the still rising volume of remittances from abroad.

Behind the rate cut decisions stood also the faster-than-expected pace of disinflation and the prospects of this trend to consolidate. Thus, the annual inflation rate dropped in March to 3.66 percent, down 1.21 percentage points against the December figure and 0.6 percentage points against the forecast in the previous Inflation Report. At the same time, the average 12-month inflation rate shrank to 5.4 percent from 6.6 percent at end-2006 and 8.9 percent in March 2006. This performance owed to the deceleration of CORE2 inflation starting February and especially to the relative mitigation (partly above expectations) of the inflationary impact of some supply-side factors, as the annual rates of change in administered prices and volatile prices in 2007 Q1 were below those seen in 2006 Q4. The slowdown in inflation rate also entailed the further improvement of inflation expectations – of both producers and bank managers –, more visible in the near term, which was seen as supportive of the NBR Board’s decisions.

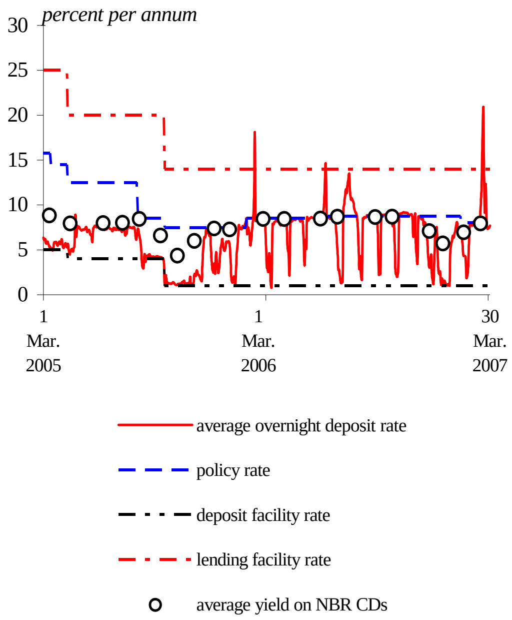
The downward revisions in the monetary policy rate were also aimed at reducing the interest rate differential between local and foreign markets and implicitly at deterring potentially volatile capital inflows and those similar in nature to financial borrowings. Thereby, the moves were meant to curb the excessive appreciation of the domestic currency, a trend which had become manifest towards the end of 2006, as well as the related risk to the sustainability of disinflation in the medium term. The National Bank of Romania took account of the fact that although faster RON appreciation was beneficial in the near term thanks to its anti-inflationary effects, in the medium term a possible deviation of the exchange rate from its equilibrium level could pose threats to both macroeconomic stability and financial stability.

In its attempt at warding off speculative capital inflows, the National Bank of Romania continued to partially sterilize excess liquidity via open-market operations in 2007 Q1 as well, rejecting part of the bids submitted by credit institutions at the weekly deposit auctions. Nonetheless, monetary control grew gradually firmer starting with the latter part of the reviewed period, also as a result of increasing the volume of CDs on offer. The average balance of open market operations rose 9.6 percent in 2007 Q1 against the fourth-quarter average. In this context, and also amid the sizeable contractionary effect temporarily induced by the autonomous factors of liquidity, credit institutions' resort to the deposit facility contracted gradually in February-March 2007, and the final month of the reported quarter even witnessed fairly heavy recourse to the lending facility after an eight-month discontinuation; hence, after falling in January, the average effective interest rate on credit institutions' placements with the central bank rebounded in the following months, causing the spread separating it from the monetary policy rate to narrow.

2. Financial markets and monetary developments

Against the background of large swings in liquidity conditions, interbank interest rates became highly volatile in 2007 Q1, with their daily averages posting sharp deviations, in both directions, from the level of the monetary policy rate. However, nominal appreciation of the domestic currency against the euro strengthened, the appreciation pace being yet far slower than that seen in December 2006. Monetary expansion regained momentum, also as a result of a looser fiscal stance and the uptrend in government credit.

Interbank Money Market Rates



2.1. Interest rates

In 2007 Q1, the large swings in liquidity conditions on the interbank market caused interbank deposit rates to post abrupt, short-dated deviations, in both directions, from the level of the monetary policy rate. During the reviewed period as a whole, the average interbank deposit rate edged up slightly to 7 percent compared with 2006 Q4.

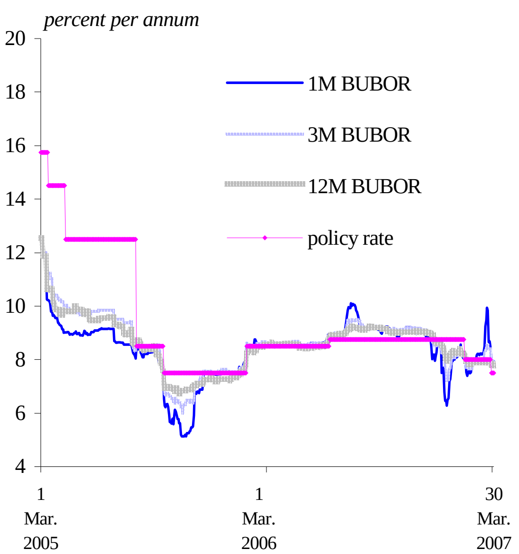
In January, the central bank continued to partially sterilize excess liquidity via open-market operations, a policy that had been pursued since the end of the previous quarter. Against this backdrop, and given the upsurge in monetary injections induced by the autonomous factors of liquidity led banks to make heavy recourse to the deposit facility. Therefore, interbank money market rates saw an abrupt fall, nearing ever since the first ten-day period of January the interest rate on overnight deposits with the central bank (their monthly average shrank 1.5 percentage points against December 2006).

In this context, the 0.75 percentage point drop in the monetary policy rate in early February was reflected by the interbank money market rates no sooner than the latter half of the month, after these rates had reverted to higher levels following the relative strengthening of monetary control[38] and the increase in the minimum reserve ratio.

Short-term interest rates stayed close to the monetary policy rate in the first half of March as well. Nonetheless, the approaching closure of the reserve maintenance period reinforced the effects of the substantial reserve deficit, which had become manifest oddly enough ever since the final week of the previous month. The shortage persisted and deepened also as a result of banks' keen interest in placing deposits with the central bank[39].

Against this background, the significantly larger demand for liquidity in the near term materialised in the unexpected strong rise of overnight rates, which climbed to levels higher than the interest rate on the lending facility[40] during 19-23 March, as some market participants that lacked sufficient eligible assets to enable them to have recourse to this facility were left with no other option but to resort to interbank borrowings[41]. Interest rates posted a relative normalisation once the new maintenance period had started, reverting to levels in line with the lower monetary policy rate set at end-March.

Policy Rate and BUBOR Rates



Under the circumstances, overnight rates were more volatile than in the previous three-month period, the range of daily averages widening from 1.2-9.2 percent to 1.0-20.9 percent. At the same time, the average spread between ask and bid rates on overnight deposits widened by half a percentage point from the previous quarter, suggesting market participants' increased uncertainties about the developments in liquidity conditions.

The two successive rate cuts, along with the improvement of inflation expectations, were largely reflected by the (1M-12M) BUBOR yield curve, which continued to display a downward trend for the second consecutive quarter (the March average of such yields was down 0.7 percentage points over December). The decrease was more pronounced for the longer-term interest rates (as much as one percentage point), hinting at the recalibration of anticipations favouring a faster decline in

[38] Open-market operations balance rose by 27.6 percent month on month.
[39] The large appetite for such placements amid uncertainties surrounding the liquidity volume drained by the NBR via open market operations (and the likelihood of some banks' expectations of further rate cuts) prompted operators to take on greater risks relating to liquidity management.
[40] Average daily overnight rates peaked at 20.9 percent on 20 March.
[41] The lending facility was first resorted to by six banks after an eight-month discontinuation, with the total of borrowed amounts rising to a historical high.

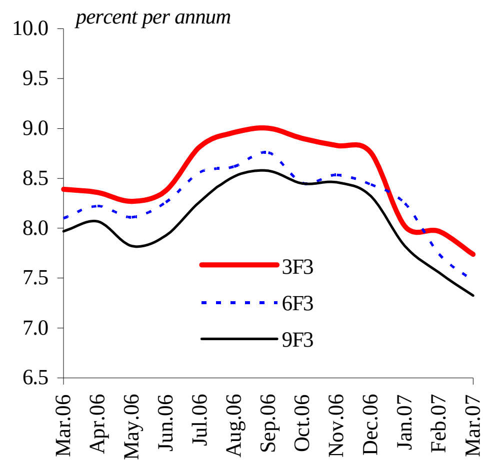
interbank market rates over the rest of the year; the average 1M BUBOR rate however continued to show a relative stability, with the seeming resistance of short-term interest rates being attributed to their increased sensitivity to liquidity shocks. Under the circumstances, the yield curve slope returned to negative territory (the spread between average monthly 12M and 1M BUBOR rates equalled -0.6 percentage points).

The developments in implicit forward rates calculated on the basis of average March rates illustrate expectations of a steeper drop in interest rates over the next three quarters. Thus, the 3M BUBOR rate is expected to stand at 7.7 percent in June 2007 (down 0.4 percentage points from the end-March figure and 0.7 percentage points lower than the level calculated based on the interest rates seen in December 2006) and to decline to 7.5 percent in September 2007 (0.9 percentage points below the level for September calculated on the basis of interest rates recorded in December 2006) and to 7.3 percent at end-2007.

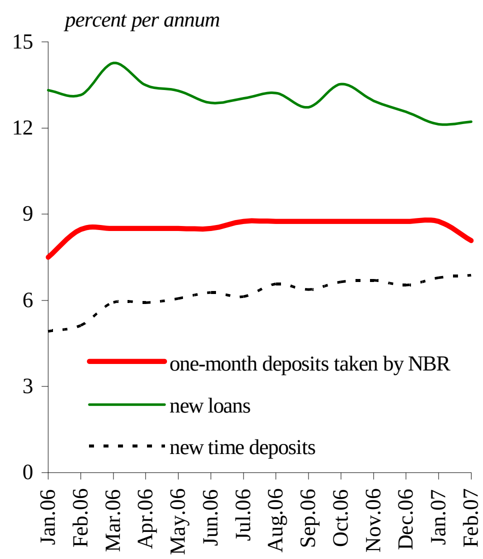
After a prolonged absence spanning approximately five quarters, the Ministry of Public Finance resumed its operations on the primary market for government securities. Given that budget execution failed to provide a comfortable level of holdings in the General Account of the Treasury, the public authority issued a record volume of government securities in 2007 Q1, amounting to RON 5,900 million. In addition, the Ministry of Public Finance resorted four times during the period under review to money market deposit-taking operations in the interbank market, supplementing its financial resources by another RON 3,958 million, with a view to meeting the Treasury's temporary requirements.

Besides reissuing the treasury certificates with maturities of up to one year, amounting to a total of RON 3,900 million, the Ministry of Public Finance issued, as a first, benchmark government bonds with maturities of three and five years respectively, worth RON 2,000 million. Treasury certificates with maturities of up to one year yielded an average interest rate ranging between 5.81 and 7.03 percent, while benchmark government bonds yielded average rates of 6.61 percent (three-year maturity) and 7.03 percent (five-year maturity).

Implicit Forward Rates



Bank Rates

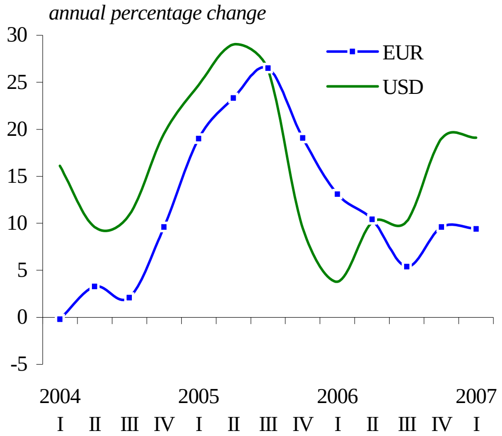


Key Financial Account Items (balances)

EUR million

	2006 2 mos	2007 2 mos
Financial account	**534**	**1,445**
Direct investments	**1,204**	**870**
residents abroad	-7	3
non-residents in Romania	1,211	868
Portfolio investments	**257**	**289**
residents abroad	157	-37
non-residents in Romania	100	326
Other capital investments	**3**	**595**
of which:		
medium- and long-term investments	-49	594
short-term investments	-179	-1,147
currency and short-term deposits	158	544

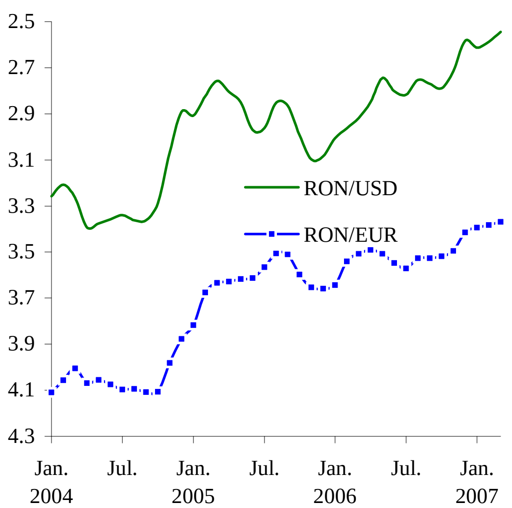
Developments of RON Exchange Rate*)



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

Source: NIS, NBR

Nominal Exchange Rate



Unlike the volatile developments seen by interbank rates, bank lending and deposit rates[42] did not witness any trend reversals December 2006 through February 2007. Thus, although displaying both-way monthly fluctuations, the interest rate on new time deposits continued its upward course, standing 0.18 percentage point higher in February against November (posting a slightly faster pace of increase compared to the previous period). Conversely, the average interest rate on new loans stuck to its downtrend, as the February reading (12.22 percent) was 0.73 percentage point lower than the November 2006 one.

The average interest rate on new time deposits from households[43] posted the steadiest development, reaching 6.86 percent at the end of February. In opposition, after hitting a record low in December, the average interest rate on new time deposits from non-financial corporations witnessed a steady rise in the following two months, to 6.88 percent. Against the backdrop of numerous promotional offers for household loans, the average lending rate on new business saw a gradual cut in each of the three months of the reported period, touching 13.13 percent in February, i.e. 0.85 percentage point lower than in November 2006. Similarly, the average lending rate on loans taken by non-financial corporations stood at 11.77 percent in February, down 74 basis points versus November 2006.

2.2. Exchange rate and capital flows

In 2007 Q1, the nominal appreciation of the RON against the EUR continued, albeit at a considerably slower pace than in December 2006. Amid the obvious fading of the anticipation effect generated by Romania's accession to the European Union, the main determinants of the RON/EUR exchange rate developments during the period under review included the high dynamics of the current account deficit and the financing manner thereof, on the one hand, and the financial investors' shifting sentiment towards emerging markets in the region and towards interest rate fluctuations on the domestic money market, on the other.

During the quarter, the RON/EUR exchange rate followed a steady, downward path, as the RON strengthened in March 2007 against December 2006 by 1.3 percent versus the EUR (1.6 percent in real terms) and 1.5 percent against the USD (1.8 percent in real terms), amid the weakening of the US currency

[42] As of January 2007, average interest rates are calculated and reported according to NBR Norms No. 14/2006; with a view to ensuring comparability, some of the historical data have been recalculated pursuant to the new methodology.
[43] The "households" institutional sector consists of households and non-profit institutions serving households.

in relation to the European one. Looking at the average annual change for January-March 2007, the domestic currency entered a faster nominal appreciation path both against the euro (5.4 percent) and against the USD (14.7 percent); however, in real terms, the RON appreciation versus the two currencies posted only minor changes compared to the previous quarter.

The fast-paced strengthening of the local currency over the euro, which had started towards end-November 2006, decelerated significantly in January 2007 (0.6 percent compared to 2.4 percent in December); furthermore, the RON/EUR exchange rate trajectory became more closely linked to that of most currencies in the region, hinting at the fact that the anticipation effect triggered by Romania's accession to the European Union had almost vanished. Against this background, developments in the RON/EUR exchange rate in January were largely influenced by: (i) the worsening of the trade deficit; (ii) the lower degree of coverage of the current account deficit through direct investment[44] and capital transfers[45]; (iii) the drop in the volume of financial borrowings of the banking sector, as well as (iv) considerable payments on short-term external debt. However, the main determinants behind RON appreciation were: (i) the non-residents' keen interest in RON-denominated government securities issued by the Ministry of Public Finance on the domestic financial market (the volume of securities purchased by non-residents accounted for approximately one quarter of the total issue); (ii) the still high volume of external financial borrowings of the corporate sector, as well as (iii) the rise, although more moderate, in the volume of non-residents' speculative transactions, partially deterred by the lower interbank deposit rates.

Nonetheless, the strengthening pace of the RON gained momentum in early February, given that investor interest in placements and transactions in the local currency was rekindled by: (i) higher yields on the domestic money market amid tighter liquidity conditions; (ii) the launch of new government bonds and the increase in the volume of RON-denominated securities issued on the international market[46], as well as (iii) higher expected returns on stock market transactions[47]. Against this

[44] Although direct investment inflows were relatively high, their volume witnessed a drop both in month-on-month comparison and against January 2006.
[45] Direct investment and capital transfers covered some 53.3 percent of the current account deficit (compared to 73.9 percent in December 2006 and 277 percent in January 2006).
[46] The value of RON-denominated bonds issued by non-resident institutions on the external financial market stood at RON 1,061 million in February.
[47] According to data released by the BSE, non-residents' net purchases of securities peaked at EUR 90.35 million in February.

backdrop, the cut in the NBR's monetary policy rate[48] had a somewhat limited impact on exchange rate developments, all the more so that market participants had anticipated this downward adjustment, albeit to a lesser extent. However, the exchange rate came under the stronger impact of the turbulence affecting emerging markets[49] as of 26 February, generated by the sudden worsening of investor sentiment towards assets perceived as having a high degree of risk. Although at a lower scale, this development sent ripple effects to the regional and local markets, as the RON witnessed a slight depreciation in the closing days of the month, which made its monthly strengthening pace versus the euro fall to merely 0.3 percent.

Investor scepticism in relation to emerging markets persisted into the first decade of March as well, leading to a prolonged depreciation trend and a higher volatility of most currencies in the region. Nevertheless, the local currency proved somewhat more resilient to these pressures, with the lower magnitude of the depreciation and of the volatility of RON/EUR exchange rate[50] reflecting mainly: (i) the lower liquidity of the domestic financial market and foreign investors' still limited exposure to RON-denominated assets; (ii) the more attractive interest rates on the domestic market, and (iii) the relatively high volume of direct investment and financial borrowings. Subsequently, against the background of the gradual revival of investor interest in placements on the regional financial market, the domestic currency resumed its strengthening trend against the euro. This trend accelerated abruptly starting with the latter half of the month, under the joint impact of the unexpectedly high appreciation of the Slovak koruna[51] and of the higher degree of correlation between the RON and SKK exchange rates, on the one hand, and as a result of the sudden increase in domestic money market interest rates[52], on the other. In this context, on 20 March, the RON/EUR exchange rate hit the lowest threshold in the past four years. In the closing days of the month, amid a relative easing of liquidity conditions on the money market and hence lower interest rates (also under the impact of the further cut in the NBR's policy rate), the domestic currency lost some of the previously gained ground so that, in March overall, the RON strengthened only marginally versus the EUR (0.4 percent).

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[48] On 9 February 2007, the NBR Board decided to lower its policy rate from 8.75 percent to 8 percent.
[49] Triggered by the sudden drop on the Chinese capital market and amplified by rising uncertainties related to developments in the US economy.
[50] During 26 February – 9 March, the volatility of the RON/EUR exchange rate was much lower than that of the Czech koruna, the Polish złoty, the Slovak koruna and the Hungarian forint.
[51] Despite the measures taken by the central bank of Slovakia, i.e. partial sterilisation of excess liquidity, forex market interventions, revaluating the central parity of the Slovak koruna and lowering the monetary policy rate, the Slovak currency posted a steady appreciation trend over the euro in March.
[52] Determined by the temporary liquidity shortage at the end of the minimum reserve maintenance period.

Given that the price of financial assets on emerging markets is highly dependant on major developments in the main world economies, it could be assumed that the volatility of the RON/EUR exchange rate will be on the upside as the potential of a significant increase in investor exposure to the local currency materialises. However, looking ahead, the impact of economic fundamentals on the exchange rate is expected to be predominant, all the more so that investor decisions regarding placements on emerging markets – domestic market included – are likely to be more and more influenced by developments in such fundamentals.

2.3. Money and credit

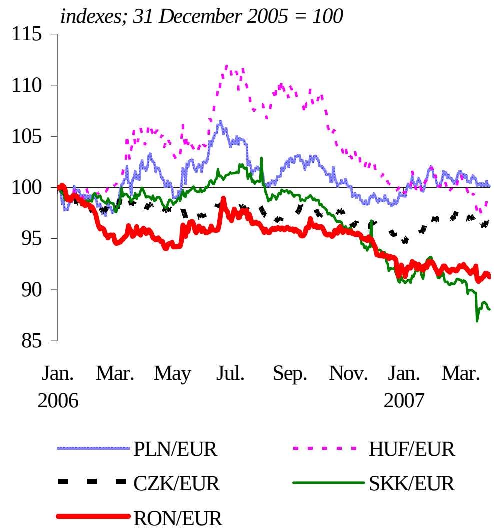
Money

In December 2006 – February 2007, the pace of increase of broad money (M3)[53] regained momentum (21.8 percent compared to 17.3 percent in the previous quarter), amid (i) the easing of government spending at end-2006, which persisted into early 2007 as well, (ii) prolonged robust economic growth, and (iii) the strong rise in household incomes. From the perspective of M3 counterparties, broad money expansion reflected largely the influence of developments in government credit[54] (which leapt 68.1 percent on average, after three consecutive quarters of decline), against the backdrop of relatively stable growth rates of private sector loans[55], i.e. the main driver of monetary expansion, and of net foreign assets; domestic long-term financial liabilities[56], whose annual change rose, had a slightly contractionary monetary impact.

The only major component[57] of M3 witnessing a step-up of its annual growth rate (+12 percentage points, to 45 percent) was narrow money (M1), with its share in M3 averaging out at 46.6 percent, a record high for the past two years. The upward path of M1 was determined exclusively by overnight deposits, whose dynamics accelerated amid a strong rise in public spending, the further buoyant economic activity (particularly in construction, fostered by the somewhat favourable weather conditions, and in

[53] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2006 – February 2007.
[54] Includes loans to the general government (central government, local government and social security funds).
[55] The private sector comprises non-financial corporations, non-monetary financial institutions and the household sector (households and non-profit institutions serving households).
[56] Long-term financial liabilities are included in the M3 counterpart. They comprise time deposits with an agreed maturity of over two years (including deposits redeemable at notice of over three months) as well as marketable instruments issued by credit institutions with a maturity of over two years.
[57] Deposits included in broad money belong to non-financial corporations, non-monetary financial institutions, local government, social security funds and households (non-profit institutions serving households included).

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

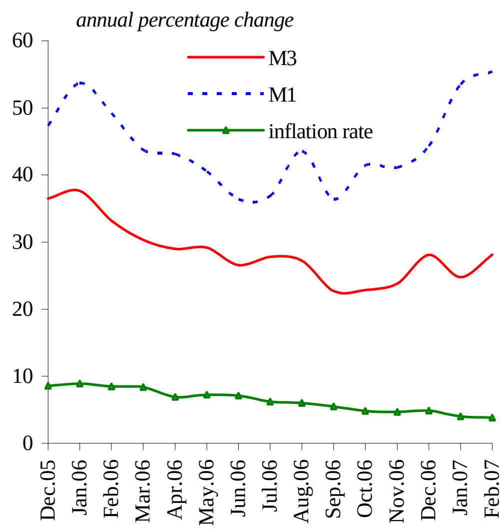
Annual Growth Rates of M3 and Its Components

real percentage change

	2006				2007	
	I	II	III	IV	Jan.	Feb.
	monthly average					
M3	21.9	19.5	20.3	20.7	21.3	24.9
M1	36.7	33.2	33.9	36.2	47.1	49.3
Currency in circulation	36.5	33.5	32.7	28.4	18.2	22.2
Overnight deposits	36.8	33.0	34.6	40.2	61.1	62.7
Time deposits (maturity of up to 2 years)	13.8	11.6	11.8	10.9	4.1	8.8

Source: NIS, NBR

Broad Money and Inflation Rate

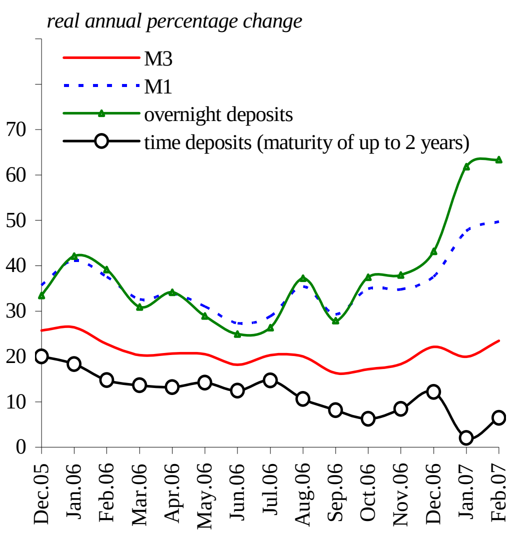


Source: NIS, NBR

industry), and the faster hike in household incomes. Conversely, the rate of increase of currency in circulation decelerated markedly, reflecting mainly the recent change in the calculation methodology for this indicator[58].

The growth rate of RON- and forex-denominated time deposits with an agreed maturity of up to two years (including deposits redeemable at notice of up to three months) continued to slow down, albeit at a more sluggish pace (6.9 percent, 0.8 percentage points below the previous quarter reading), reflecting largely a portfolio shift either towards longer-term investments (including time deposits with an agreed maturity of over two years and/or RON-denominated securities issued on international markets) or towards highly liquid placements. The relative deceleration was mainly ascribable to corporate deposits[59] sticking to their downtrend; behind this development stood chiefly this segment's higher propensity for overnight deposits (bolstered by the fact that some credit institutions offered relatively similar interest rates to those on time deposits), the partial shift towards placements with a maturity of over two years, as well as the likely repayment of a higher volume of loans, external loans included. Conversely, the rate of increase of both components (RON- and forex-denominated) of household time deposits with an agreed maturity of up to two years continued to accelerate, mainly on the back of (i) the faster dynamics of wage earnings and other related incomes (bonuses, severance payments, remittances from abroad[60]), (ii) the payment effected by Erste Bank for the shares purchased from BCR employees, and (iii) the continued uptrend of average interest rates on time deposits.

Main Broad Money Components



Source: NIS, NBR

Developments in marketable instruments also contributed to the slowdown of the M3 dynamics; the annual change in the balance of these instruments stuck to its downward path (at an average pace of increase of 16.8 percent, 0.7 percentage points below the previous quarter's level), mirroring the further deceleration in the growth rate of repos and the diminishing stock of negotiable debt securities with a maturity of up to and including two years.

[58] As of January 2007, according to Order No. 24/2006 issued by the Governor of the National Bank of Romania amending and supplementing Order No. 5/2005 issued by the NBR Governor approving the "Accounting regulations consistent with EU Directives, applicable to credit institutions", the "Cash and other values" category explicitly comprises currency in ATMs and in automated exchange teller machines.

[59] Non-financial corporations and non-monetary financial institutions.

[60] The value of current transfers hit a record high in December 2006.

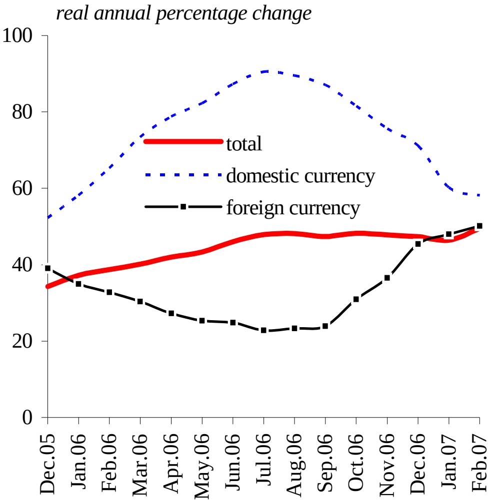
Credit

December 2006 through February 2007, the expansion rate[61] of loans to the private sector hovered around the same high level of 47.7 percent for the second consecutive quarter. The rates of increase of the main components stuck to their diverging trends, i.e. upward movement for forex loans and a downward path in case of RON-denominated loans. The determinants of these developments were the faster nominal appreciation of the domestic currency, the increase in the minimum reserve requirements on RON-denominated liabilities[62], the removal of any limits imposed on credit institutions with regard to exposures from forex loans[63], as well as the waning base effect determined by the transfer, in December 2005, of some foreign currency loans into the balance sheet of a non-resident financial institution. Against this background, the growth rate of RON-denominated loans hit the lowest reading in the past year, i.e. 63.2 percent on average, whereas the pace of increase of forex loans peaked at 47.8 percent on average, a record high for the past six quarters; furthermore, the average share of foreign currency loans in total loans to the private sector witnessed a trend reversal after an 18-month decline, jumping to 48 percent.

On the supply side, private sector loans were further spurred by the same specific factors as in the previous quarters, namely fierce competition among commercial banks, the relatively low cost of credit institutions' external financing[64], as well as banks' favourable outlook on current and future economic developments and hence the higher degree of customer eligibility. On the other hand, mention should be made of the dampening effect exerted by the tighter lending requirements on household lending following the enforcement of the relevant NBR norms[65]. Demand for loans was bolstered by (i) robust economic growth, (ii) larger volume of imports, (iii) strong rise in household earnings and persistent favourable expectations of clients concerning their future incomes, (iv) the nominal

Credit to Private Sector by Currency

real annual percentage change



Source: NIS, NBR

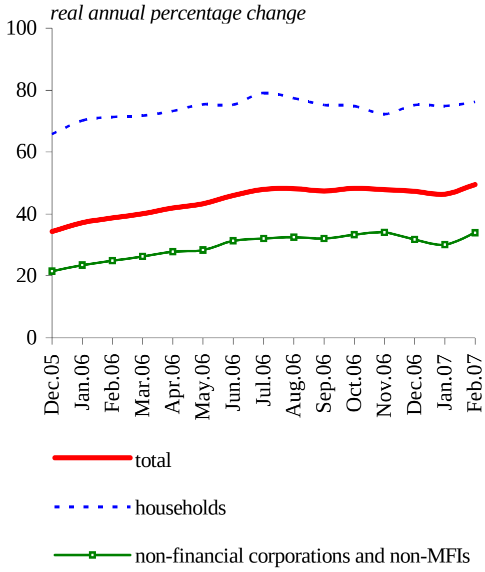
[61] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2006 – February 2007.
[62] Minimum reserve requirements on RON-denominated liabilities were raised from 16 percent to 20 percent starting with the 24 July – 23 August 2006 maintenance period.
[63] NBR Norms No. 11/2005 on containing the concentration of exposures from forex loans, which entered into force on 26 September 2005, were repealed as of January 2007.
[64] In December 2006, BRD-Société Générale issued bonds worth RON 735 million on the international capital market, destined exclusively to non-residents.
[65] Norms No. 20/2006 amending and supplementing NBR Norms No. 10/2005 on containing credit risk attached to household loans, effective as of 22 October 2006.

appreciation of the domestic currency and expectations of even further strengthening, as well as (v) the slightly downward adjustment of lending rates applied to new RON-denominated loans. Conversely, demand for loans might have been cooled down by (i) individuals postponing their decision to take loans in anticipation of looser lending conditions, (ii) the relative decline in the indebtedness capacity of persons with relatively low income, and (iii) companies' increased resort to external[66] and own resources (fuelled during the reported period by considerable inflows from the state budget) for financing current operations and investment-related expenses; at the same time, the hike in the RON equivalent of forex loans was partly offset by the accounting effect exerted by the nominal strengthening of the domestic currency.

In terms of customer categories, the growth rates of the main components posted opposite developments from the previous quarter, as that of household loans was on the upside by 1.3 percentage points, to 75.5 percent, and that of corporate loans dropped 1.2 percentage points, to 31.9 percent.

Credit to Private Sector by Institutional Sector

real annual percentage change



Source: NIS. NBR

The upward path of household loans was exclusively ascribable to the surge in forex loan growth, which averaged out at 86.4 percent, surpassing the growth rate of RON-denominated loans for the first time in the last year, notwithstanding the estimated impact of the waning base effect triggered by the transfer (in December 2005) of a volume of household forex loans into the balance sheet of certain non-resident financial institutions. Conversely, the pace of increase of the RON-denominated component decelerated considerably (to an average of 80.3 percent, 24.2 percentage points lower versus the previous period), amid somewhat downward adjustments of interest rates on new household loans and the slight rise in lending rates on bank overdrafts and credit card loans in February. Individuals continued to resort heavily to consumer loans[67], although their share in total household loans dropped marginally to 79.3 percent on average during the period, amid the further uptrend of the growth rate of real estate and mortgage loans.

[66] According to balance of payments data, December 2006 through January 2007, non-residents' net direct investment in the non-bank sector averaged out at a level close to the September-November 2006 reading.

[67] Until December 2006, according to data in NBR's "Financial Behaviour of Households and Companies by County" (except for CREDITCOOP); as of January 2007, based on the information received from credit institutions, pursuant to NBR Norms No. 14/2006.

The slower dynamics of corporate loans mirrored exclusively the deceleration in the expansion rate of the RON-denominated component (the same as for household loans), possibly due also to the repayment by companies of a larger volume of loans and/or the non-renewal of some credit lines. On the other hand, forex loans grew at a faster annual pace, boosted – among others – by the local companies' increased propensity for investments in the real estate sector.

Unlike private sector loans, credit to the general government[68] posted a trend reversal, the 68.1 percent expansion after three quarters of uninterrupted decline reflecting the surge in budget outlays and hence the higher budget deficit financing needs, both through government security issues and direct resort to bank loans.

[68] Comprises central government, local government and social security funds.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the 12-month inflation rate at 3.7 percent for end-2007, down 0.9 percentage points from the February projection. The forecasted level for end-2008 is 4.2 percent, marginally higher than the previous projection of 4.1 percent.

The downward revision of the end-2007 projection is attributed to the lower-than-expected inflation observed in 2007 Q1 and to its favourable impact on expectations, as well as to other effects exerted by some factors whose projections differed from those in the previous forecasting round. Significant differences stem from the reduction in the magnitude of expected administered price adjustments and the slower change in highly volatile food prices, as well as a more diluted excess demand than in the previous forecast. Such favourable effects will be mitigated by a somewhat slower deflation of import prices against the background of anticipations of a less sharp RON appreciation in the early part of the forecast horizon than in the February projection. For 2008, the impact of the exchange rate dynamics on import prices will be comparatively more favourable than in the preceding projection, but it will be countered by the opposite effects on inflation as a result of a comparatively lower demand deficit.

Similarly to the previous projection, the current projection foresees tighter real monetary conditions in 2007-2008 than in 2006, which is consistent with the programmed gradual elimination of excess demand. Along the projection horizon, the anticipated dynamics of the real exchange rate and the developments in real interest rates, especially in the first part of the horizon, will add to the suitable restrictiveness of monetary conditions. Unlike the previous projection, however, the necessary increase in the restrictiveness of real monetary conditions is lower under the current baseline scenario, owing to weaker inflationary pressures in the near term. This also implies narrower negative output gaps in the latter part of the forecasting round, allowing the achievement of an inflation rate similar to that forecasted in the previous exercise, along with faster economic growth in 2008.

The main risks which, if they materialise, could cause inflation to deviate from the projected path, arise from the significant uncertainties regarding the rate of wage increases compared to productivity gains, the future stance of fiscal policy, developments in the current account deficit and the pass-through effects of its potential adjustment, substantial deviations of the movements in the exchange rate from the path forecasted in the baseline scenario, as well as developments in some exogenous supply-side factors, as reflected in the growth rates of administered prices and domestic prices of food and fuels.

1. The baseline scenario of the forecast

1.1. Inflation forecast

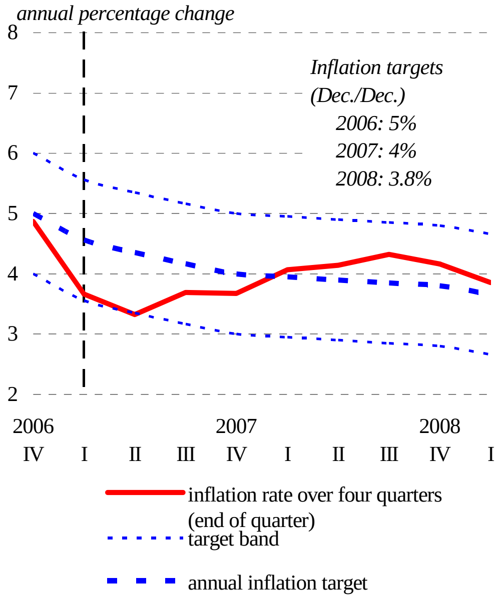
According to the baseline scenario, the annual consumer price inflation is projected to stay within the target band over the entire forecast horizon, reaching estimated levels of 3.7 percent at end-2007 and 4.2 percent at end-2008. The projected path of the annual CPI rate for 2007 is lower than that forecasted in February 2007 Inflation Report, whereas for 2008 the projection is similar to the previous one.

Table 5.1. Annual inflation rate (end of period)

percent

Period	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1
Target			4.0				3.8	
Forecast	3.3	3.7	3.7	4.1	4.1	4.3	4.2	3.9

Inflation Forecast



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

At the beginning of the forecast horizon (2007 Q2), the 12-month inflation is 0.9 percentage points lower than that projected in February 2007 Inflation Report. Behind this reassessment stood the following:

– a lower CORE2 inflation than in the previous projection in 2007 Q1;

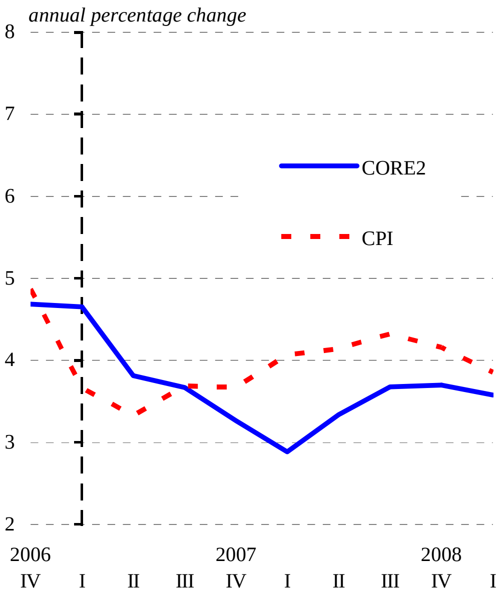
– a smaller-than-anticipated increase in the electricity price on 1 April 2007 and a delayed adjustment in consumer price of natural gas originally scheduled for April;

– a weaker-than-expected inflationary impact of the implementation of the Common Agricultural Policy and of the Common Customs Policy within the European Union on food prices, both volatile prices and those included in CORE2;

– a decline in the international oil price and in the domestic fuel price in 2007 Q1.

According to the current projection, annual total CPI inflation will remain below the midpoint by the end of 2007. In Q3 and Q4, it is expected to go up as a result of changes in excise duties on cigarettes and tobacco products as well as of hikes in several administered price, heating in particular. In Q3, a base effect will be manifest due to the leaving out of account from annual inflation calculation of sharp deflation recorded by highly volatile prices in the third quarter of 2006. Forecasted CPI is anticipated to rise in 2008 owing largely to the sizeable planned adjustments to administered prices and excise duties.

CORE2 and CPI



The current baseline scenario foresees the return of CORE2 inflation rate to a level below that of CPI inflation and its gradual reduction down to 2.9[69] percent in 2008 Q1. During the period, the disinflation recorded by the CORE2 index is fostered by: (i) restrictive real monetary conditions allowing the elimination of excess demand by the start of 2008, (ii) lower inflation expectations after headline inflation fell below the central target, (iii) favourable contribution of imported inflation amid the ongoing real appreciation of the RON. The last mentioned factor is supported by Romania's accession to the EU, which facilitates the access of retailers to cheaper imported goods or of a higher quality than domestic ones (foodstuffs are a case in point). In 2007 Q2, the nearly one percentage point decrease in the annual CORE2 inflation versus the previous quarter is due also to a base effect, since the 'vice tax' introduced in 2006 Q2 is no longer taken into account when calculating this index. Inflation-boosting factors whose magnitude is smaller than that of disinflationary factors in the above-mentioned period consist in the raise of excise duty on tobacco products scheduled for 2007 Q3 and the persistence of excess demand until the end of 2007.

Starting with 2008 Q2, the changes to excise duties envisaged for tobacco products and the second-round effects induced by administered price hikes (materialising in the temporary rise in inflation expectations) will push up CORE2 inflation to 3.7 percent at end-2008. The impact of the two exogenous factors is insufficiently offset by the projected demand deficit and the real appreciation of the RON, which is lower than that incorporated into this year's forecast.

Inflationary pressures are fuelled chiefly by administered prices in the current baseline scenario too. The annual change in such prices outpaces that of consumer prices throughout the projection horizon. In spite of delaying or reducing the adjustments scheduled for the first half of 2007, the current calendar envisages large increases for 2007 Q4, as well as 2008 Q1 and Q4, especially in energy prices.

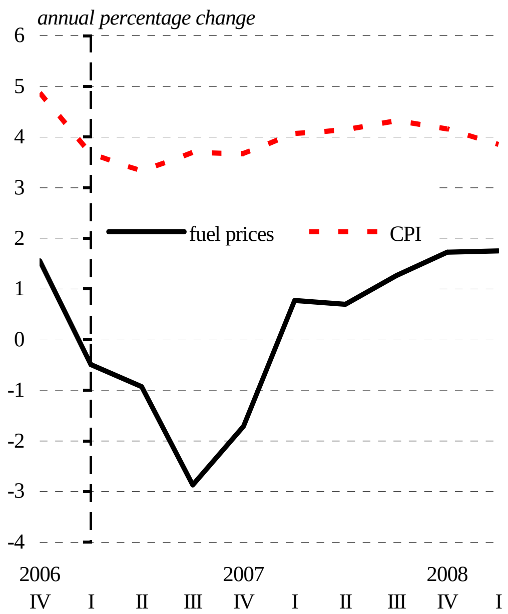
In 2007 Q1, some volatile food prices (vegetables, fruit, eggs) posted lower increases than those considered in the February 2007 Inflation Report. However, the projected trajectory of prices for vegetables, fruit and eggs is distorted by a base effect

[69] All inflation rate figures for CPI components are calculated as an average of prices for the reported quarter, which is compared to the average for the same year-ago period.

in 2007[70] (to reach 5.8 percent) but it is comparable to that of consumer prices in 2008 (3.7 percent).

The projected developments in domestic fuel prices rest on the assumption that throughout the forecast horizon the international oil price remains at the average expected for 2007 Q2, in line with the Consensus Forecasts projections released in March. Although recent figures point to an upward trend in the oil price on international markets, the choice of this neutral scenario is attributable to the uncertainties surrounding the level and the developments in the production of and global demand for oil. In case of domestic fuel prices, the projected inflation rate is lower than the change in consumer prices as a result of ongoing real appreciation of the domestic currency.

Fuel Prices and CPI

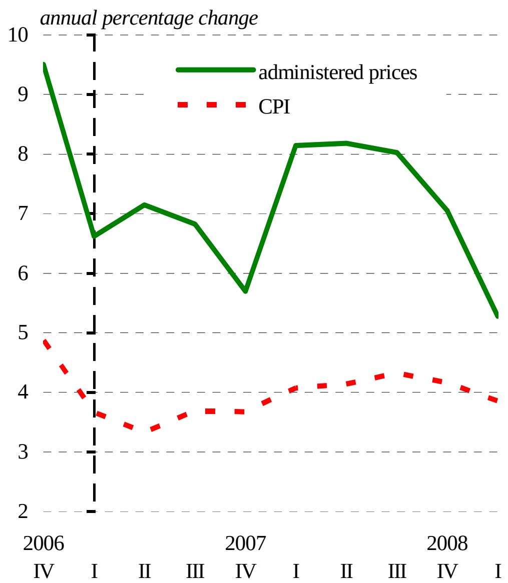


1.2. Exogenous inflationary pressures

The cumulative effect of exogenous components of consumer price inflation (administered prices, highly volatile food prices, excise duties on cigarettes and tobacco products) anticipated for 2007 is 0.5 percentage points lower in the current baseline scenario than in the prior projection, while that for 2008 is expected to be 0.1 percentage points higher.

The expected increases in administered prices for the current year are 1 percentage point smaller than projected – 5.7 percent[71] compared to 6.7 percent – and 0.3 percentage points higher for the year ahead – 7.0 percent versus 6.7 percent. The smaller price adjustments in 2007 are mainly due to the slow growth of prices of energy and natural gas. The price of energy was 1 percent lower than that announced at the beginning of the year, and the consumer price of natural gas stayed put at the level recorded in April, in line with the adjustment calendar. These developments are partly offset in 2007 by the revision of heating price increases compared with the prior forecast, increases that will continue in the 2008 as well. Table 5.2 shows the evolution of energy prices, the main component of administered prices. Despite the downward revision in 2007, administered prices continue to grow faster than the other consumer prices and to exert inflationary pressures throughout the forecast horizon.

Administered Prices and CPI



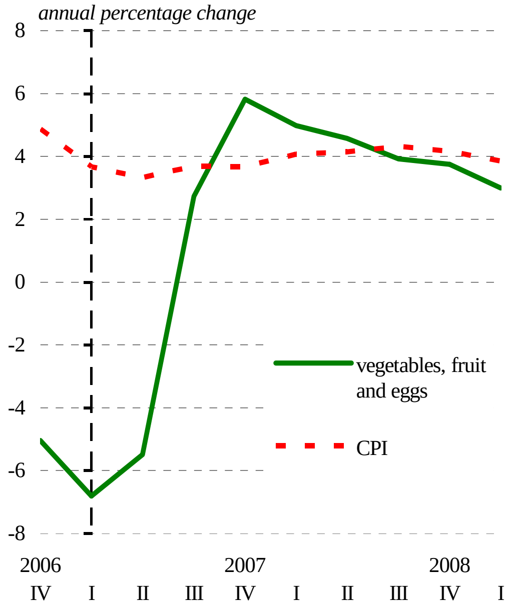
[70] The base effect originates in the reference to the sharp deflation seen by the prices for vegetables, fruit and eggs in 2006 Q3.
[71] The average of administered prices for Q4 relative to their average for the same period a year earlier.

Table 5.2. The scenario for developments in administered prices

percent

	Electricity		Heating		Natural gas	
	2007	2008	2007	2008	2007	2008
Current projection	6.1	7.1	19.1	9.3	1.3	17.9
Previous projection	7.1	7.1	10.0	8.0	7.5	17.9

Vegetables, Fruit and Eggs Prices and CPI Inflation



The scenario regarding some volatile food prices (vegetables, fruit and eggs) foresees a growth rate lower than that envisaged in the prior projection for 2007 and higher dynamics for 2008. Similarly to the previous forecast, the adjustment of prices for vegetables, fruit and eggs is highly seasonal, high positive values being expected in Q1 and Q4 and negative values (deflation) in Q3 of each year. The projected increase in prices for vegetables, fruit and eggs in the current year is higher than that of consumer prices and is the result of the base effect entailed by the steep decline of volatile prices in 2006 Q3.

The scenario relative to the adjustment of prices for cigarettes and tobacco products is built in line with the level of excise duties set forth by the European Commission[72]. For 2007, the current scenario retains the price increases envisaged in the previous baseline scenario, but foresees lower dynamics for 2008, as a result of the adjustment of the exchange rate used to calculate the RON-denominated excise duty. This will have an impact on the prices of tobacco products via the specific excise duty component, calculated in euro.

According to the survey released in March, the analysts polled by Consensus Forecasts pointed to an inflation rate for the euro area lower than that in the previous projection, both for the current year (2.0 percent as compared to 2.2 percent) and the year ahead (1.9 percent as compared to 2.9 percent). In the ECB Monthly Bulletin – March 2007, this adjustment is attributed mainly to the fall in fuel prices. However, the risks of a surge in prices in the euro area are deemed much more considerable than in the previous projections. Therefore, the EURIBOR interest rate is higher than that presented in the previous Inflation Report for the entire projection horizon.

The appreciation of domestic currency, which is expected to continue, will fully compensate the effect of the inflation projected for the euro area on the dynamics of prices in the consumption basket.

[72] Provided for by Directive 59/1995, as subsequently supplemented by Directive 10/2002 and implemented in the national legislation by Law No. 34 of 17 July 2006 amending the Tax Code.

1.3. Aggregate demand pressures

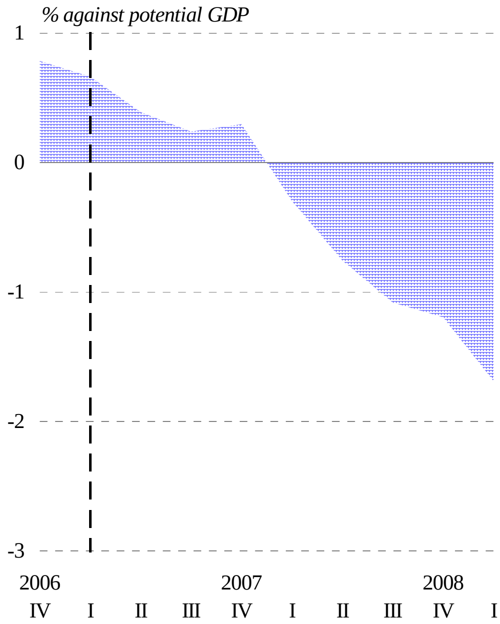
1.3.1. Current aggregate demand pressures

In 2007 Q1, the annual growth rate of real GDP is expected to stay high, albeit at a lower level than in the prior quarter. The positive output gap narrowed marginally, the short-term inflationary pressures stemming from excess demand nearing the prior quarter's level.

Due to lags inherent to the monetary policy transmission mechanism, the excess demand in Q1 reflects the effect transmitted by the commercial banks' interest rates and the exchange rate in the previous quarters. In Q4, banks' interest rates saw further adjustments to last year's policy rate increases, exerting a restrictive impact on excess demand in the current period. The real appreciation of local currency led, through the net export channel, to the strengthening of the restrictive impact on excess demand.

The officially released statistical data on real GDP[73] for 2006 Q4 indicate that the economy keeps growing fast, albeit at a lower rate than forecasted in the previous projection round. The output gap for 2006 Q4 was revised downwards. In Q1, the value of excess demand is expected to stay close to the previous quarter's revised reading, yet below the value used in the prior forecasting round.

GDP Deviation



Household final consumption is expected to post a high annual growth rate, albeit lower than the rates recorded in 2006. This is backed by the increasing real disposable income and the large net current transfers at end-2006. As in the previous quarters, the labour market still features a decreasing unemployment rate and hefty increases in wages, particularly wages in public administration. The budget surplus of 0.1 percent of GDP in the first two months of 2007 had a neutral effect on aggregate demand-related inflationary pressures.

Gross fixed capital formation appears to stay above the medium-term trend. The positive signals as to its development come from the persistently high growth rate of medium- and long-term loans to companies and lowering lending rates. Moreover, while imports grew at a faster pace, the share of capital goods in total imports increased. Data on the structure of investment in the economy shows that the good performance of gross fixed capital formation is attributable mainly to technological upgrading as illustrated by the brisk pace of

[73] Data on real GDP are seasonally adjusted.

equipment purchase, capital repairs works and new construction works.

Imports continue to rise at fast annual growth rates, given the support provided mainly by increasing disposable income, domestic currency appreciation lowering import prices and the dynamics of medium- and long-term loans to companies, as the share of capital goods in total imports is widening. Exports are still below the trend, but the rise in labour productivity in industry in 2007 Q1 may point to a rebound from the prior quarter's growth rate. Net exports contribute to reducing excess demand and inflationary pressures.

1.3.2. Implications of recent exchange rate and interest rate developments

The domestic currency continued to appreciate in both nominal and real terms in 2007 Q1, the downward evolution of the exchange rate of the RON against the EUR being more pronounced than in the prior quarters.

In 2007 Q1, the trajectory of the exchange rate was also influenced significantly by events exogenous to the Romanian economy, such as the signal towards stronger expected appreciation of the RON, as a "contagion" effect of the currency revaluation decided by a central bank in the region[74]. Among the domestic factors impacting the exchange rate in the reviewed quarter stands out the temporary low level of money market liquidity which, amid the strong external demand for Romanian government securities, led to a build-up in pressure on the exchange rate.

Given the real and nominal appreciation in 2007 Q1, the exchange rate has a restrictive effect on aggregate demand and hence on the future inflationary pressures via the net export channel. This influence is partly offset by the wealth and balance sheet effects, according to which domestic currency appreciation entails lower cost of foreign borrowings, representing the equivalent of a stimulative impulse sent to aggregate demand. Thus, the net effect of local currency appreciation in 2007 Q1 strengthens the restrictive nature of the exchange rate and, therefore, reduces the future inflationary pressures. On the other hand, domestic currency appreciation influences domestic prices by causing a drop in import prices and reducing inflation.

[74] Starting with 19 March 2007, at the request of the Central Bank of Slovakia, the central parity of the Slovak koruna/euro exchange rate in the ERM II is 35.4424, i.e. a 8.5 percent revaluation of the Slovak koruna.

The medium-term developments of the real exchange rate are determined by economic fundamentals (productivity gap between Romania and its main foreign partners, medium- and long-term capital inflows). Under the conditions of Romania's real convergence with the euro area economy, the exchange rate shows a natural tendency towards longer-term real appreciation. Under the impact of factors relevant over the short-term, the exchange rate may temporarily deviate from the trajectory set by economic fundamentals, towards which it tends to return once transitory effects have been exhausted.

In 2007 Q1, the NBR lowered, in two stages[75], the monetary policy rate to 7.5 percent and, in the first part of the quarter, continued the policy of partial sterilization of excess liquidity to which it had resorted in December 2006 in response to the fast appreciation of the RON. On the other hand, the volume of sterilization operations increased significantly over the first quarter of 2007. In this context, the NBR's policy rate decreased in real terms and, although it continues to have a restrictive effect on excess demand in the period ahead, its impact is lower than that exerted in the prior quarter.

The NBR's average policy rate affects the economic activity indirectly, through commercial banks' deposit and lending rates. Monetary policy impulses feed through into the economy with a time lag due to the gradual adjustment of bank rates to policy rate changes. As a result, the decisions taken in 2007 Q1 to lower the monetary policy rate are reflected only partially by commercial banks' interest rates in the same quarter. Thus, both deposit and lending rates declined in the quarter under review. Moreover, the sharper decline in nominal lending rates led to the narrowing of the spread between deposit and lending rates, which points to the heightening competition in the banking sector. On the other hand, due to lower inflation expectations, the real deposit and lending rates stayed at levels close to those recorded in the preceding quarter. Consequently, the impact of commercial banks' interest rates on economic activity and future inflation remains unchanged as compared with 2006 Q4 and the interest rates continue to reflect further the restrictive effect of the monetary policy rate.

Overall, in 2007 Q1, the real deposit and lending rates stayed at levels close to those recorded in 2006 Q4. Given the decline of foreign currency borrowing costs in local currency, the restrictive effect of interest rates on excess demand diminished slightly compared to previous quarters. This easing was, however, more than offset by the real appreciation of the RON

[75] The second rate cut took place on 26 March 2007 and hence it had no impact on the economy during January-March.

through the strengthening of the restrictive effect it has on excess demand via the net export channel. Therefore, during January-March 2007, the restrictive impact of the real interest rates and the exchange rate put greater cumulative pressure 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, considering the initial conditions for the output gap, the real effective exchange rate and real interest rates, the projected dynamics of real monetary conditions, as well as the assumptions on the coordinates of fiscal policy. The main driver behind the elimination of excess demand by early 2008 is the restrictive effect of real broad monetary conditions, with the projected level of the real effective exchange rate making a significant contribution in this respect.

As compared with the previous forecasting round, aggregate demand pressures are expected to be lower in 2007 and higher in 2008. At the beginning of the projection horizon, excess demand was lower than that in the previous Inflation Report, due to the slower-than-projected[76] economic growth in 2006 Q4 and the downward revision of the forecast for 2007 Q1. The current projection, similarly to the previous forecasting round, foresees tighter real monetary conditions in 2007-2008 than in 2006, which is consistent with the programmed elimination of excess demand. Nonetheless, unlike the previous projection, the prospects of a smaller increase in the restrictiveness of real monetary conditions in the current baseline scenario is generated by a considerably lower inflation in 2007 Q1 and its favourable impact on inflation expectations, as well as by weaker short-term inflationary pressures, as reflected by lower excess demand in the first quarter of 2007. As a result, demand deficits forecasted for 2008 are narrower than those in the previous Inflation Report, owing also to the more expansionary effect of fiscal policy in 2008 than that in the previous projection.

The revision of the restrictiveness of projected real monetary conditions hinges on changes in the impact of real exchange rate and real interest rates on aggregate demand. After the monetary policy rate cuts implemented in 2007 Q1, preliminary data for January and February indicate the likelihood of a decline in nominal interest rates and the narrowing of the differential between domestic and euro area deposit rates, due

[76] And to a lesser extent to the National Institute of Statistics' revision of GDP data for 2005-2006.

also to the expected rise in EURIBOR. Based on the uncovered interest rate parity condition, the projected trajectory for the real appreciation of the RON is less pronounced in the near term in case of a narrowing interest rate differential; in the medium and long run, real appreciation is further fuelled by sustainable foreign capital inflows and by the continuation of faster productivity growth than in the euro area countries. The projected restrictive impact of real appreciation of the RON via the net export channel is partially offset by wealth and balance sheet effects of the stronger domestic currency which enhance the attractiveness of foreign currency-denominated credit in relative terms.

Following the drop in inflation rate below the central target and the consolidation of low inflation, the anticipated alleviation of inflation expectations assumes the persistence of restrictive real interest rates, despite the expected decline in nominal interest rates[77].

In the first part of the forecast horizon, the restrictive effect of real monetary conditions is partially offset by the pro-cyclical stance of fiscal policy. The assessment of fiscal policy impact is based on assumptions similar to those in the previous projection, with the considered budget deficits standing at 1.7 percent for 2006[78], 2.8 percent for 2007[79] and 2.7 percent for 2008[80]. The aggregate demand impact of these deficits is estimated to be expansionary in 2007 and neutral in 2008. The analysis also included the assessment of effects of the financial relations generated by Romania’s EU membership[81], implying the equivalent of a lower fiscal deficit in 2007 and a higher one in 2008. The overall fiscal impulse on the output gap is similar

[77] The real interest rate is calculated as the difference between the nominal interest rate and the expected inflation rate. The expected inflation rate in the current period is the annual CPI inflation forecasted for the following quarter.

[78] All deficits are calculated in accordance with the Ministry of Public Finance’s current reporting methodology, which is different from the ESA95 methodology used in the Convergence Programme of Romania and taken into account by the European Commission for the regular assessments on the compliance with the Maastricht Treaty provisions (the so-called Excessive Deficit Procedure).

[79] According to the MPF 2007 budget programme.

[80] The NBR estimate is based on the “Report on the macroeconomic context for 2007 and its projection for 2008-2010”, submitted to Parliament by the minister of public finance, along with the draft law on the 2007 budget and on the value of the deficit computed according to ESA95 methodology included in the Convergence Programme.

[81] The calculation of this impact was based on the level of absorption of pre-accession funds in 2006 (almost 42 percent, computed as the ratio of paid-up funds and those budgeted in early 2007), as well as on the absorption coefficients for structural funds which the countries that joined the European Union in 2004 reported to the European Commission in the first two years of their membership.

to that projected for 2007 in the February 2007 Inflation Report, but higher in 2008[82].

The pace of economic growth is expected to remain robust, even though the current projection foresees a deceleration in 2007 as compared with the baseline scenario incorporated in the February 2007 Inflation Report, i.e. 6 percent versus 6.4 percent. The slower pace of increase in 2007 is attributed to the economic growth of 7.7 percent recorded in 2006 – below the projections in the previous Inflation Report – and to the downward revision of expectations on GDP dynamics in 2007 Q1. The economic growth forecasted for 2008 is higher than that in the previous projection (4.9 percent versus 4.2 percent). The assumption on the growth of potential GDP is maintained at the same level as in the previous forecasting round.

Taking into account the restrictive effect of real exchange rate, which is estimated to be manifest over the entire projection horizon, the net exports dynamics will further have a negative impact on economic growth. Nevertheless, the anticipated slowdown in the real appreciation of the RON over the forecast horizon and the projected elimination of excess demand imply the narrowing of the difference between the growth rates of exports and imports of goods and services by the end of the forecast horizon. The estimated growth rates of private consumption, albeit still high, will slow down slightly as compared to the previous year’s figures. The main drivers of consumption dynamics are expected to remain the foreseen increase of disposable income (including as a result of larger allocations for wages and transfers from the public budget) and fast consumer credit expansion. At the same time however, consumption dynamics is anticipated, the same as in the previous years, to lag behind that of gross capital formation, the substantial increase of the latter being further upheld by: (i) ongoing rapid growth in construction, in the context of a booming real-estate market and the initiation/continuation of budgeted infrastructure projects, (ii) significant foreign direct investment flows (including reinvested earnings of foreign companies that are already operating in Romania), and (iii) domestic companies’ allocation of their own funds for the purpose of business development. The last two trends are fostered by the high growth potential of sales and profits.

[82] This is due to estimates of a lower cyclical deficit (determined by output gap fluctuations) of the consolidated budget for 2008, as compared to the previous projection. The explanation lies with a higher output gap projection (i.e. a lower negative output gap), which implies an increase in the tax base for 2008 against the same reference period and which generates larger budget revenues and a lower-than-forecasted cyclical deficit. Considering that total deficit is the sum of cyclical and structural deficits, maintaining the total deficit target unchanged for 2008, as the baseline scenario assumes, along with a lower cyclical deficit, causes the structural deficit to widen. As the structural deficit is that particular part of total deficit which is discretionarily determined by the tax authority, a wider such deficit indicates a more expansionary effect of fiscal policy.

1.4. Risks and uncertainties surrounding the projection

The baseline scenario of the projection, which was presented in greater detail in the previous sections, 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 mismatch between wage increases and productivity gains;
- fiscal policy implementation, possibly affected also by the current political uncertainties;
- current account deficit dynamics and the way its potential adjustment will affect the economy;
- fluctuations on foreign-exchange and money markets following possible shifts in investor sentiment towards Romania’s economic outlook;
- the high degree of uncertainty associated with weather-dependent CPI components, such as vegetables, fruit and other food items;
- sudden and sizeable changes in crude oil and natural gas prices on world markets;
- deviations from the provisional calendar for administered price adjustments;
- underestimating disinflationary pressures, particularly in the case of foodstuffs, against the backdrop of keener competition following EU accession and substantial investments in the retail sector.

Over the projection horizon, any wage increase that overtakes the dynamics of labour productivity would pose a significant risk to the forecasted inflation path. The tight labour market conditions, also due to the effects of workforce migration, hint at still fast-paced wage increases in 2007 as well. Since they are a key component of corporate costs, wages can maintain a high growth without generating inflationary pressures only if such growth follows closely the developments in productivity. Thus, companies need to offset higher production costs either by improving product returns or by passing on such costs to the consumer. These constraints are not manifest in the public sector, but public-sector pay rises might fuel employee pressure for wage increases in the private sector as well. The more sizeable the wage hikes in the public sector, the higher the risk of a mismatch between wage increases in the private sector and productivity gains.

The macroeconomic projection continues to be affected by considerable uncertainties surrounding the achieved level of the consolidated general budget deficit over the two-year forecast horizon and the allocation of public spending between consumption and investment. Public authorities displayed a high degree of cautiousness in recent years, as end-year deficits usually undershoot the considered targets. However, the outcome of budget execution in the first two months of 2007 and particularly in February suggests that the pattern of accumulating budgetary surpluses for the most part of the year could be interrupted. Given that this development is not warranted only by a more balanced distribution of public spending throughout the year, but also by lower budget revenues, a possible explanation could lie with the underestimation of the projected deficit in relation to envisaged expenditures[83]. Furthermore, the current political tensions and the upcoming multiple election periods could foster a higher-than-projected easing of this year's fiscal policy stance. Even assuming strict compliance with the 2007 budget programme, the persistence of an expansionary fiscal policy against the background of ongoing excess demand might boost medium-term risks. The general picture should take into consideration the combination of the still small share of budget revenues in GDP, with limited options of raising it under the current conditions and the pressures on public spending, which are both considerable and relatively inflexible to a possible slowdown of economic growth. The latter hinge, inter alia, on implementing the second pillar of the pension system, the requirements for financing certain infrastructure projects and co-financing of EU-funded projects, continuing education and health system reforms, the mandatory contribution to the EU budget, compensations paid in relation to "Proprietatea" Fund, etc.

The significant widening of the current account deficit in 2006 hints at the uncertainties surrounding its future developments and their implications on macroeconomic variables overall. On the one hand, the persistence of the features of the main drivers behind deficit widening (i.e. excess demand, above-trend strengthening of the domestic currency and sizeable foreign

[83] Preliminary data indicate a cumulated budget surplus of 0.12 percent of GDP January through February. However, February collections – reflecting the new taxation conditions for 2007 – are more relevant to this year's budget execution forecast; changes compared to fiscal 2006 stem from the harmonisation of the Tax Code with the relevant EU practice and legislation. Operational data for February 2007 point to a deficit of approximately 0.48 percent of GDP, mainly on account of lower-than-expected indirect tax collections.

capital inflows) is indicative of a still high current account deficit projection, at least over the short term. On the other hand, the deficit is unlikely to stay at this level in the long run. Therefore, over the medium term, current account dynamics should be characterized by convergence towards a narrower negative balance. However, the pace and the magnitude of this process are harder to anticipate, as they depend on several factors beyond the influence of monetary policy, such as:

- the capability of export-oriented sectors to accommodate to single market requirements and to generate the required returns on investments;
- the degree of mobility of production factors (particularly of labour force) as well as the degree of flexibility of their prices;
- the efficient use of capital across the economy, including also remittances of Romanians working abroad;
- the financing requirements of the public sector and the structure of public spending;
- the extent to which the domestic market is attractive to foreign investors, etc.

In an open economy like Romania's, the exchange rate of the RON has a considerable bearing on inflation, both directly, through import prices, and indirectly, via the net export channel. Real and nominal appreciation in recent years was fostered by the conditions on world markets, given the investors' increased appetite for risk and market participants' steadily improving sentiment towards Romania's economic outlook, as indicated by the steady trend of the major agencies' upgrading the country's sovereign risk ratings. Looking ahead, the persistence of these two circumstances is becoming less certain. On the one hand, analysts' opinions on international markets diverge with regard to investors maintaining their upbeat sentiment towards emerging markets. The depreciation episode witnessed by these countries' currencies in the spring and summer months of 2006 is but a recent example of how fast the sentiment of a critical mass of investors can change and how this could impact exchange rate movements. On the other hand, Romania's political situation raises uncertainties in its turn, especially with regard to the pace at which structural reforms would continue in order to exploit the economy's growth potential. A display of such concerns on the part of foreign analysts was Standard&Poor's recent change in the outlook on Romania's sovereign rating from "positive" to "stable".

Despite the authorities’ tighter control over administered price developments in relation to market prices, the administered price projection is difficult to produce in the absence of a schedule prepared by the Government and of any transparent rules for administered price adjustment over the quarters ahead. Risks of slippages from the anticipated trajectory of this CPI component over the current forecasting round are more pronounced in the medium run than in the short run, given the powerful social impact that the sizeable increase in administered prices might have in the run-up to the elections.

The prices of several goods holding a major share in the consumption basket depend on developments beyond the economic field. Thus, given the influence of weather conditions on the vegetable and fruit supply, they are a constant source of risk for the inflation projection. The forecast on crude oil and natural gas prices is also plagued by uncertainties related to exogenous factors, as geopolitical events might always cause deviations from the baseline scenario.

Food prices posted surprising developments in 2006, making a significant contribution to disinflation. The slowdown in their annual pace of increase is only partly attributable to last year’s bumper crop. One of the factors that might determine the inflation path to remain considerably below the current forecast is keener competition between domestic and EU producers, also as a result of buoyant investment in the retail sector by the large outlet chains. In a certain sense, the two matters are related, given that the latter’s bargaining power may lead to stronger cost competition among producers; this reason is all the more relevant as imported products have a considerable competitive advantage if their prices reflect RON appreciation.

2. Policy assessment

In 2007 Q1, disinflation continued at a much faster pace than that expected in February 2007 Inflation Report, with the 12-month inflation rate dropping in March to 3.66 percent, down 1.21 percentage points from end-2006 and 0.34 percentage points lower than the end-2007 central target. The significant decline in the 12-month CPI was largely due to the slower dynamics of administered prices and the sharper deflation of volatile prices on the background of a reduction in fuel prices and a continued compression in vegetable and fruit prices compared with the same year-ago period. Adjusted CORE2 inflation contributed substantially to the slowdown in CPI inflation. The 0.2 percentage point drop in its annual rate reflected mainly the impact on aggregate prices – including via lower inflation expectations – of increased restrictiveness of broad monetary conditions in the previous period, especially through stronger RON appreciation versus the major currencies. Together with the strengthening of the domestic currency, the favourable effects of Romania's accession to the EU, induced by subdued inflation in the euro area that showed up in imported goods prices, as well as by increased competition on the retail market, were also captured by the adjusted CORE2 inflation rate.

Starting from these prerequisites, the updated projection of macroeconomic developments highlights a considerable improvement, compared with the previous forecasting round, in the outlook for inflation in the first part of the monetary policy transmission horizon. Other major prerequisites for the brighter picture of near-term inflation forecast are the following: (i) halving of excess demand in 2006 Q4 against the former projection and the compression, compared with the previous forecast, of the positive output gap estimated for 2007 Q1, (ii) downward revision in the projected magnitude of administered price adjustments and highly volatile food price dynamics, (iii) persistence of the improvement in inflation expectations against the background of durably fast disinflation. For the latter half of the forecast horizon however, projected inflation is expected to resume, over several quarters, a slightly upward trend, with the projected levels being relatively similar to those in the previous forecast. The chief determinants of this trend are the administered price and indirect tax adjustments foreseen for this period, as well as the temporary relative worsening of inflation expectations and imported inflation.

The assessment of assumptions and implications of the revised projection underscores the still high inflationary potential of some factors that are likely to be manifest over the entire monetary policy transmission horizon. From the perspective of the primary objective of the central bank, the most threatening risk not only in the near term, but also in the longer term is the persistence of a positive output gap until the end of 2007, even though the figures projected for the first three quarters of this year are below those forecasted previously. In addition, the excessive dynamics of domestic absorption and implicitly the current account deficit widening could persist, along with the still fast rate of increase of external debt. All these might trigger additional risks to sustainable disinflation and ensuring price stability in the medium term.

In the present context, the growth of domestic aggregate demand is expected to be fostered widely by fiscal and wage policies, the easing of which has already begun and is anticipated to become even more pronounced over the quarters ahead. This year's income policy easing is foreseen to be large since as early as February the annual growth rate of whole-economy gross nominal wages reached almost 20 percent. A reason for concern is that the substantial acceleration of wage growth was attributed not only to large pay rises in the budgetary sector but also to similar developments in private sector wages. Furthermore, such development in certain sectors, including the industry, was only partially consistent with the size of productivity gains, leading to a faster increase in unit labour cost as compared to the preceding quarter.

The companies' capability to further raise wages at a rate faster than that of productivity growth and to pass on the higher unit labour costs to prices might however be restricted by the tougher competition on the outlets where small- and medium-sized enterprises as well as export-bound companies are active. Conversely, large wage hikes in those industries where excess demand is still manifest and which might face labour shortages could ignite cost-push inflation. In these sectors too, some employers may however offset the increase in unit labour costs by narrowing corporate profit margins, a behaviour which is likely to become more widespread in line with the projected decline of the positive output gap.

From the perspective of the large wage hikes already implemented this year and of the expected impact on household consumer demand, in virtue of the previous performance and of the survey outcomes on the future developments in the trade sector, the average annual negative growth rate of retail sales in the first two months of 2007 might come as a surprise. Assuming that an explanation of a strictly statistical nature for this development is not possible, it could hint at a sudden, large-scale shift in household consumption behaviour. Such an assumption appears to have been backed by only part of monetary statistics, i.e. those regarding the pick-up in household deposit expansion; however, the data also illustrate the maintenance of a slight uptrend in the real annual dynamics of consumer credit.

Furthermore, the persistence of the potentially new aspects of household consumption is deemed to be low due to the anticipated further fast rate of increase of household disposable income, also strongly upheld by remittances of Romanians working abroad, and to the absence of an economic rationale that could substantiate against this background such a decline in consumption. This assumption relies also on the experience of other economies aiming to reach real convergence. An exception would be the marked change in household behaviour towards increasing their savings that could be channelled to real estate buying; such a trend might have taken shape considering the brisk growth in household deposits, as well as in foreign currency-denominated real estate and mortgage loans. To a certain extent, these developments could have been fostered by the relative easing of lending terms and conditions after eliminating the ceiling on credit institutions' exposure from foreign currency-denominated loans, on the one hand, and the announcement on removing in March the prudential restrictions imposed previously by the National Bank of Romania on real estate loans, on the other hand. Nevertheless, it is not certain how long is such a behaviour going to last.

Against this background, it is very likely that the future annual growth rate of private consumption could decrease only slightly. Such a performance might however be accompanied by maintenance or even slight rise in the rate of increase of gross fixed capital formation. The prospect of consolidation, against this backdrop, of the contribution from fixed capital investment to economic expansion should help ensure sustainable disinflation in the medium run, since, even if initially it entails demand pressures, they are followed with a certain lag by a favourable impact on supply, including on competition. Another positive aspect in terms of the rise in potential GDP is the recent increase and the likely future one in the share of retooling outlays in total gross fixed capital formation. However, investment in construction and infrastructure – which affects supply with a greater lag or to a smaller extent – will remain prevalent. It should be noted that a large portion of the new technologies have been and will be imported, which explains, partly at least, the widening of the trade balance, which is already under pressure from the catching-up the Romanian economy is going through. In addition, assuming that the investment in equipment is financed by foreign direct investment, it could be accompanied by a competitive management that should enhance the positive impact on supply via the stronger growth of labour productivity.

As for the future path of the exchange rate of the RON, it is considered that the likelihood of this to reflect only partly the development of economic fundamentals and the ensuing risks to disinflation has, to some extent, dwindled. This assumption relies on the prerequisite according to which during the time period that lapsed from Romania's accession to the EU the related anticipation effect on the exchange rate appears to have faded almost completely. At the same time however, the correlation between the RON/EUR rate movements over short periods and those of other currencies in the region increased, thus confirming that the Romanian currency is being influenced by volatile capital flows targeting emerging markets. The relative vulnerability of the RON exchange rate, fuelled also by the persistence of a global excess liquidity coupled with investors' volatile and unpredictable appetite for risk, calls for continuing the efforts to reduce any additional incentive offered by the domestic financial market to volatile capital.

The NBR Board's assessment of the current macroeconomic environment and of the medium-term projection has highlighted the improvement, as compared to the prior forecasting round, of the outlook for inflation in the first part of the monetary policy transmission horizon. At the same time however, the NBR Board has pointed out that the inflationary potential of some factors that will remain manifest during the projection horizon is still high. The main risks to sustainable disinflation and to ensuring price stability in the medium run are deemed to be the persistence until end-2007 of the positive output gap and the possible future widening of the current account deficit as a result of protracted excessive dynamics of domestic absorption. In this context, the NBR Board decided in its meeting of 2 May 2007 dedicated to monetary policy issues to lower the monetary policy rate by 0.25 percentage points to 7.25 percent per annum and to further pursue an adequate control over liquidity in line with financial market conditions. Moreover, with a view to consolidating the restrictiveness of broad monetary conditions, the NBR Board has decided to maintain tight minimum reserve requirements and to continue to adjust the reserve base in line with similar practices of the ESCB. At the same time, the NBR Board has reiterated that it would continue to vigilantly monitor developments in non-government credit and prices of broad asset classes, including real estate assets, so that potentially unfavourable developments affecting disinflation could be identified and offset by taking prompt monetary policy measures, against the background of the need for consistent contribution from all components of the macroeconomic policy mix to ensuring a sustainable continuation of the disinflation process.