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N O T E

*The National Institute of Statistics, Ministry of Public Finance,
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IMF, U.S. Department of Energy
and National Bank of Romania supplied data.*

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

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Foreword

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

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

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

Inflation Report was completed on 27 July 2007 and approved by the NBR Board in its meeting of 31 July 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
BSE	Bucharest Stock Exchange
CD	certificate of deposit
CCR	Central Credit Register
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
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MEF	Ministry of Economy and Finance
MLSSF	Ministry of Labour, Social Solidarity and Family
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
ULC	unit labour cost
1W	one week
12M	12 months

Contents

I. SUMMARY

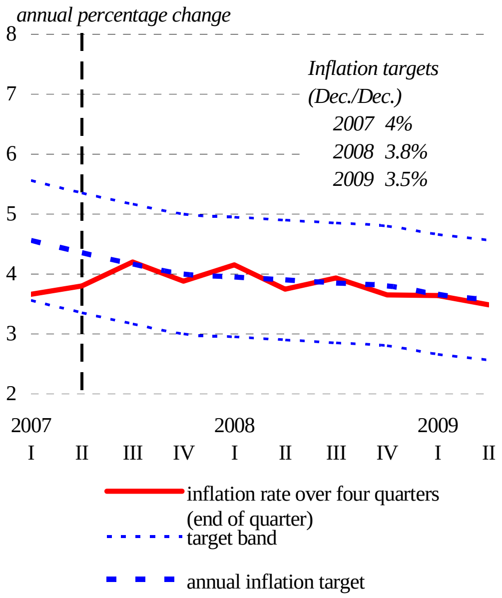
In 2007 Q2, the 12-month inflation rate remained below the end-2007 central target, although the 3.8 percent level reached in June was slightly higher (by 0.14 percentage points) than that seen at the end of Q1. Disinflation stagnated during the reported period solely due to the inflationary effects of supply-side factors, of which special mention deserve the faster annual growth rate of prices for fruit and vegetables, due to the occurrence or anticipation of a drought-induced supply shortfall, and the worsening performance of fuel price annual dynamics compared to the previous period; in May, these effects were compounded by the adverse impact on annual headline inflation of the large rent hike set by local governments. Conversely, annual CORE2 inflation rate posted a brisker decline, thereby largely offsetting the unfavorable impact of supply-side factors. The slowdown in CORE2 inflation in 2007 Q2 should be assessed against the maintained restrictiveness of broad monetary conditions, including via higher-than-expected appreciation of the *leu* versus the euro and the US dollar; at the same time, it was additionally supported by the stronger competition on the retail market as well as by wider spread price cuts following the elimination of import duties on intra-community trade after Romania joined the EU. The average annual inflation rate also remained on a downward trend, declining to 4.56 percent in June 2007 from 5.37 percent in March.

The recent alleviation in demand-pull inflationary pressures occurred along with a faster downturn in the annual pace of economic growth seen in 2007 Q1 (6.0 percent from 7.7 percent in 2006 Q4), reflected in further narrowing of the positive output gap. However, given that the decrease in GDP dynamics was attributed chiefly to the one-off adverse effect exerted by the change in the VAT payment system after Romania's accession to the EU, the effective decline in demand-pull inflationary pressures was less pronounced. Behind this stood the relative slackening of the increase in aggregate demand, but most notably the emerging changes in private consumption structure; nevertheless, the changes were less favorable from the perspective of the external imbalance, as the larger negative net exports during the first quarter of 2007 added to the decline of GDP dynamics. Investment continued to be the fastest-growing component of domestic demand, but its growth rate slowed marginally, from 18 percent to 17.2 percent. At the same time, although the dynamics of private consumption continued to fall, it remained high at 11.3 percent, given that the significant slowdown in the annual growth rate of demand for foodstuffs was considerably smaller than the surge in the dynamics of demand for non-food items, in particular that for durables (including motorcars).

The major reasons behind the NBR Board decisions to cut the monetary policy rate in 2007 Q2 were the consolidation of disinflation and the improving inflation outlook, mostly as a result of the projected reduction in demand-induced inflationary pressures, the brisker appreciation of the domestic currency against the major currencies, as well as the anticipated decrease of the inflationary impact of some supply-side factors. However, given the identified risks to disinflation, mainly those arising from the sizeable wage rises, the pro-cyclical stance of fiscal policy and the widening of the external imbalance, the monetary authority decided to lower the magnitude of the two monetary policy rate cuts to only 0.25 percentage points, down to 7 percent from 7.5 percent. Moreover, the central bank continued to exert monetary control in line with financial market conditions, which led to the removal of the negative gap between the average actual interest rate on credit institutions' deposits with the NBR and the monetary policy rate. At the same time, the National Bank of Romania kept in place the restrictive reserve requirement mechanism, i.e. the reserve ratio on RON-denominated liabilities (with residual maturity of up to 2 years) was left at 20 percent and the reserve ratio on foreign exchange-denominated liabilities of credit institutions at 40 percent. Under the circumstances, the restrictiveness of broad monetary conditions remained adequate for keeping disinflation on a trajectory compatible with the medium-term inflation targets, thus contributing to the consolidation of disinflation and the functional internalization of low inflation rates by the markets.

Against the background of the current quarterly forecasting round, the NBR Board took the necessary steps to substantiate and set the 2009 inflation target, which the Government also assumed. Following the assessment of the various projection scenarios and of their underlying key assumptions, the 2009 inflation target was set at 3.5 percent ±1 percentage point, considering the need to continue disinflation over the medium run, in a manner consistent with the timetable for euro adoption and taking into account the risks and uncertainties surrounding medium-term inflation, especially those related to factors outside the central bank's sphere of influence.

Inflation Forecast



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

Compared to the previous forecast, the baseline scenario of the current forecast of macroeconomic developments shows the annual inflation rate staying on a slightly higher trajectory during the next three quarters. The 3.9 percent level projected for end-2007 is 0.2 percentage points higher than the projection published in the May 2007 Inflation Report, but remains below the central target (4.0 percent ±1 percentage point). The chief determinants of this revision are the relatively faster projected growth rates of administered prices and of volatile prices for some food items and fuel, whose cumulated inflationary impact is however mitigated by the expected favorable evolutions in import prices.

By contrast, in the latter part of the monetary policy transmission horizon, the projected inflation pattern improves significantly as against the previous forecasting round, with the annual inflation rate being projected to drop to 3.7 percent at end-2008 (below the 3.8 percent central target and 0.5 percentage points lower than the previous projection). This revision is attributed to the favorable impact on consumer price dynamics coming from lower projected adjustment of administered prices and the relative reduction in CORE2 inflation, which is expected to prevail over the moderate contrary effects exerted by the stronger increase in fuel prices. Actually, throughout the forecast horizon, the projected CORE2 inflation rate follows a trajectory steadily below that forecasted previously, supported in the latter part of the interval by a relatively larger negative output gap than in the previous projection (the output gap is seen entering negative territory and then widening starting with 2008 Q1). The anticipated dynamics of the demand deficit are mainly the result of tighter-than-previously-projected real broad monetary conditions in 2007-2008, owing chiefly to stronger appreciation of the domestic currency in the first part of the forecast horizon.

The risks and uncertainties associated with the current projection of medium-term macroeconomic developments are relatively similar to those presented in the previous forecasting round. However, their magnitude is augmented by the possible implications of successive election rounds scheduled during the projection period. In this context, the most significant risk which, should it materialize, would place the inflation rate on a higher-than-projected trajectory is related to further rapid across-the-board wage increases in excess of productivity gains, boosted by the persistently loose income policy of the authorities. Such an increase in wage earnings could exacerbate consumer demand, including via faster credit dynamics against the background of a rise in the level and scope of borrowers' eligibility – which might delay the phasing-out of excess demand. These wage hikes could also fuel inflation by raising costs, at least in those industries where excess demand is still manifest and which might face labor shortages; there is an additional risk of these hikes feeding through to other sectors via demonstration effects.

Adding to this risk are the uncertainties surrounding the magnitude of fiscal policy easing over the projection horizon, mainly the actual level of the consolidated general budget deficit. Although the risk that the budget deficit might exceed the programmed figure is relatively low this year, its likelihood increases considerably next year, given on the one hand the projected cyclical reduction in budget revenues against the backdrop of GDP falling below its potential level and on the other hand the higher pressures on public spending specific to an election year, especially on current expenditures, as well as the likely rise in outlays to compensate for this year's drought effects. Aside from the resulting inflationary pressures, the potential materialization of the risk associated with such an easing of macroeconomic policies, corroborated with persistently high capital inflows, including external debt-generating ones, would significantly reduce the chances of a halt in the widening of the current account deficit over the projection horizon and hence those of ensuring sustainable disinflation in the medium run.

A relatively high degree of uncertainty continues to surround future developments in the RON exchange rate throughout the projection horizon. Thus, even though the recent high pressures on this variable exerted by volatile capital inflows appear to have subsided, they might be temporarily revived by the seasonal expansion in remittances from abroad in the period ahead. Nonetheless, the likelihood of downward pressures on the RON cannot be ruled out, as exchange rate volatility is determined by foreign investors' unpredictable risk appetite for emerging markets, given that RON exchange rate movements are only partly attributable to changes in national economic fundamentals.

These uncertainties are accompanied by those surrounding the future development of some exogenous factors impacting inflation, with the dynamics of food prices, administered prices and fuel prices ranking among the most relevant in this category. As for regulated prices, the persistence of uncertainties stemming from a non-definitive program for future adjustments and the apparent propensity for postponing price corrections to longer time horizons pose risks to ensuring sustainable disinflation and price stability in the medium run.

The assessment by the NBR Board of the current macroeconomic environment and of the medium-term projection has highlighted an improvement, as compared to the prior forecasting round, of the outlook for inflation in the second part of the monetary policy transmission horizon. At the same time, however, the NBR Board has pointed out the still high inflationary potential of some factors that will remain manifest during the projection horizon. The main risks to sustainable disinflation are deemed to be the persistence, until end-2007, of the positive output gap and the possible ongoing widening of the current account deficit as a result of persistently fast-growing domestic absorption. In this context, in its meeting of 31 July 2007, the NBR Board has decided to leave the monetary policy rate unchanged at 7 percent per annum. Moreover, in order to lower the magnitude of fluctuations in interbank rates and thus consolidate both their role in the monetary policy transmission mechanism and the signaling role of key monetary policy rates, the NBR Board has decided to narrow the corridor defined by the interest rates on its standing facilities; therefore, the interest rate on the deposit facility was raised to an annual 2 percent from 1 percent, while the interest rate on the lending facility was cut to an annual 12 percent from 14 percent. Furthermore, for a better harmonization of the maturity of the key monetary policy instrument (to which the monetary policy rate is associated) with, on the one hand, the maintenance period of minimum reserve requirements (one month) and, on the other hand, the prevailing maturities of interbank market transactions, and hence in order to reduce the volatility of short-term interest rates on this market, the NBR Board has decided to reduce the maturity for deposit-taking open-market operations to two weeks from one month previously. Also, with a view to consolidating the restrictiveness of broad monetary conditions, the NBR Board has decided to maintain the present levels of minimum reserve requirement ratios.

II. INFLATION DEVELOPMENTS

In 2007 Q2, the 12-month inflation rate continued to move within the target band of ±1 percentage point around the central target, even though the end-June reading (3.8 percent) was slightly higher than that seen at the end of the first quarter (by 0.14 percentage points). The trend reversal was determined by administered prices and volatile prices, whereas core inflation continued to decrease.

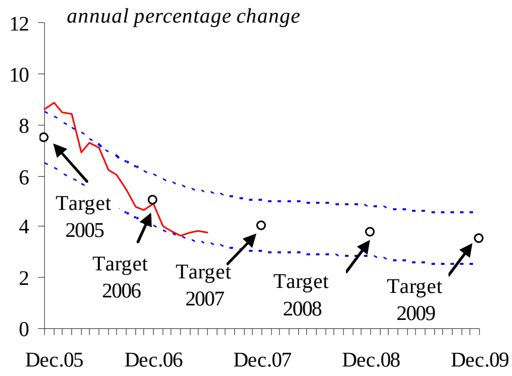
Behind the increase in the 12-month inflation rate during 2007 Q2 stood mainly goods with volatile prices; the pressures exerted on this segment in the current period (monthly growth rates steadily exceeding the average by about one percentage point) were generated by the effects of adverse weather conditions on the domestic production of fruit and vegetables and by the escalating tensions on the international oil market. In this context, the annual volatile price dynamics accelerated by 3.6 percentage points, with the still negative reading seen in June (-0.3 percent) owing solely to the steep price cuts in the previous year.

Administered prices acted in the same direction; at end-June, their annual growth rate came in at 8.7 percent, i.e. 1.8 percentage points above the March figure. Among the multiple determinants of this development the following deserve mention: the 4.2 time increase in the rents set by local governments and the adjustment by 4.16 percent of the electricity price in April.

In 2007 Q2, tobacco products had a significant favourable impact on inflation developments. However, this impact was due solely to the base effect generated by the introduction of the vice tax in the same year-ago period, which led to the deceleration in the annual dynamics of this group by more than 10 percentage points (to 15.8 percent). Price movements April through June 2007 continued to mirror the behaviour of producers who moved to incorporate in advance into prices the excise duties increase scheduled for July.

In order to eliminate such signal distortions, the analysis of core inflation further requires the use of the adjusted indicator, whose development retained the characteristics seen in the previous quarters – the annual growth rate was on the downside (from 2.82 percent in March to 2.65 percent in June), showing a slowdown in the deceleration pace, which can be explained by the persistence of excess demand and positive dynamics of ULC in industry. The downward trend in the annual rate of

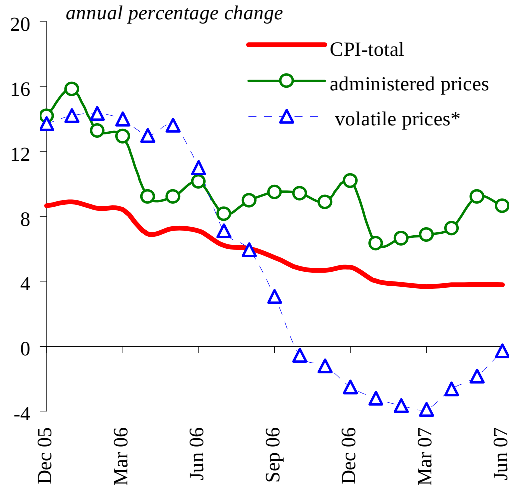
Inflation Developments



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

Source NIS, NBR calculations

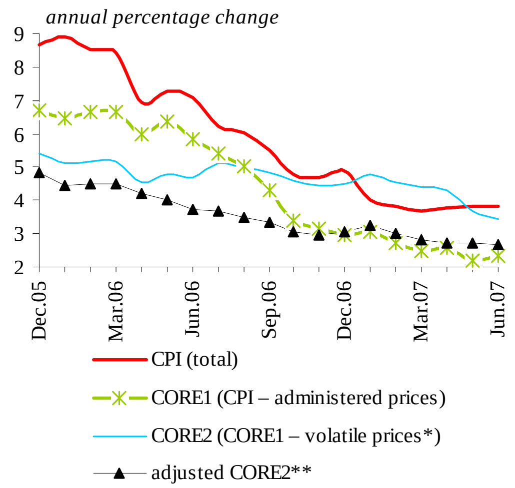
Inflation Rate



*) 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

Administered Prices versus Market Prices

annual percentage change; end of period

	2006			2007	
	II	**III**	**IV**	**I**	**II**
Inflation Rate	**7.1**	**5.5**	**4.9**	**3.7**	**3.8**
Administered prices*	**10.1**	**9.5**	**10.2**	**6.9**	**8.7**
1. Non-food items*:	**11.4**	**8.4**	**11.4**	**5.4**	**6.5**
electricity	7 0	1 9	6 6	4 6	9 0
heating	20 0	20 0	18 4	20 8	20 8
natural gas	28 5	21 4	33 6	10 0	6 3
medicines	–5 3	–4 0	–1 9	–4 8	–4 2
2. Services*, of which:	**8.0**	**11.3**	**8.1**	**9.5**	**12.5**
water, sewerage, waste disposal	24 9	20 3	21 4	20 5	14 6
fixed telephony	–2 0	10 5	2 5	5 6	0 0
passenger railway transport	11 6	5 1	13 2	23 7	29 8
(passenger) city transport	12 1	7 1	4 1	3 5	5 2
Market prices (CORE1)	**5.8**	**4.3**	**3.0**	**2.5**	**2.3**
CORE2**	**4.7**	**4.9**	**4.5**	**4.4**	**3.5**
CORE2 less tobacco, alcohol	3 7	3 3	3 0	2 8	2 7
tobacco, alcohol	15 8	22 9	21 8	22 9	12 7

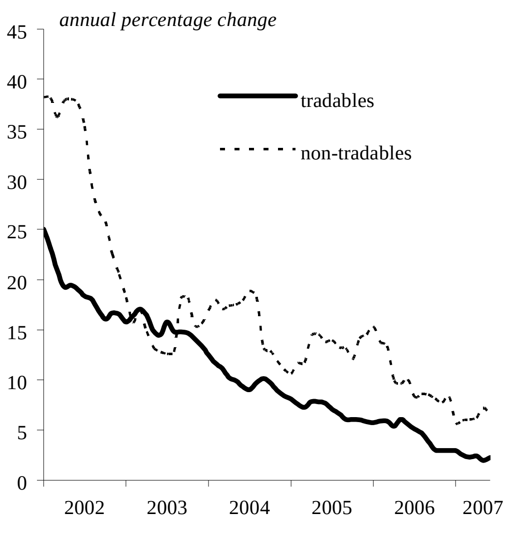
*) NBR calculations; **) CORE1 - volatile prices

Source: NIS, NBR calculations

adjusted CORE2 inflation was determined, to a similar extent, by both non-food items and market-priced services, being further supported by the stronger appreciation of the domestic currency, the increased competition in the trade sector and the expansion of price cuts as a result of the elimination of customs duties after Romania's joining the European Union. Unlike the previous quarter, when different survey results pointed doubtlessly to a favourable effect coming from the lower inflation expectations, in the period under review, this effect is less pronounced; thus, an increasing number of opinions expressed by managers in industry and trade point to slower price hikes, whereas bank managers polled by the NBR maintain their opinions expressed in March[1] concerning the expected inflation rate on a one-year horizon.

As concerns the most significant component of adjusted CORE2 inflation, i.e. food items (except for those with volatile prices), the annual dynamics remained far below the average, despite the upturn in consumption compared to the previous quarter and the presence of an adverse base effect on the poultry segment, as a result of price cuts generated by the bird flu in 2006.

Tradables and Non-tradables Prices



Source: EUROSTAT, NBR calculations

The favourable developments posted by the two categories of goods included in CORE2 inflation calculation offset the opposite influence of volatile prices on tradables prices whose annual growth rate remained relatively steady compared to the previous quarter (2.3 percent at end-June 2007); therefore, the difference from the readings of comparable indicators in the euro area and the European Union (the HICP change related to non-energy products) was close to that seen in the first quarter. By contrast, the annual dynamics of non-tradables prices remained significantly faster (6.6 percent in June, up 0.5 percentage points versus the end of the first quarter, as a result of swifter growth of administered prices).

From the viewpoint of the nominal convergence criterion relative to inflation, after the sharp contraction recorded in the previous quarter, the difference between the HICP change in Romania and the average inflation rate in the best-performing three Member States of the European Union remained almost unchanged from March 2007 (2.6 percentage points in June). However, by extending the sphere of comparison to EU-27, the difference between the two harmonised indicators increased in the period under review from 1.4 percentage points to 1.8 percentage points.

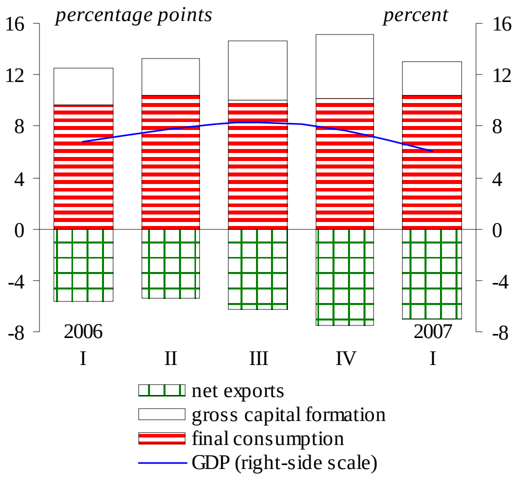
[1] According to the NBR survey, the spread between the expected inflation rate on a one-year horizon and the central bank's interpolated target stagnated at 0.4-0.5 percentage points.

In June 2007, the actual annual inflation rate stood 0.5 percentage points above the projection in the May Inflation Report, owing to (i) the rise in the rents set by local governments; (ii) the higher-than-anticipated increase in prices of fruit and vegetables, in view of the fact that the projection did not take into consideration supply shortages on this segment, but only some seasonal influences; (iii) the larger-than-expected hike in the price of fuels amid the persistent tensions on the international oil market. An opposite influence on the above-mentioned difference had the effect of the nominal appreciation of the domestic currency on the other CPI basket components, given that the forecast took into account a relative stability of the RON.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

Contribution of Demand Components to GDP Growth



Source NIS, NBR calculations

In 2007 Q1, the growth rate of real GDP continued to slow down versus the previous quarter, from 7.7 percent[2] to 6 percent, falling 0.8 percentage points below the March benchmark projection. In spite of the slight slowdown, first-quarter investment was further the fastest growing aggregate demand component. Inflationary pressures exerted by private consumption saw a decrease; however, developments in the trade sector in the first two months of Q2 hint at a temporary phenomenon. As concerns supply, the first quarter of 2007 saw an unprecedented evolution for the period for which quarterly national accounts are available[3]: the deceleration in economic growth was entirely the result of the sign reversal posted by the dynamics of net taxes on product, whereas economic sectors recorded growth rates at least as fast as those in the previous quarter.

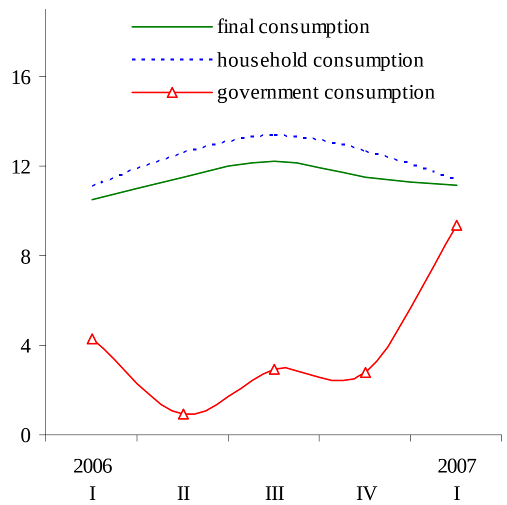
1.1. Demand

In Q1, GDP growth was dampened not only by net external demand, which continued to have a detrimental impact, but also by domestic demand, the deceleration of which was manifest on both its segments (-0.3 percentage points for actual final consumption and -5.1 percentage points for gross capital formation).

1.1.1. Consumer demand

Actual Final Consumption

annual percentage change



Source NIS

Final consumption expanded by 11.2 percent, with the annual dynamics of its components posting opposite developments. The growth rate of private consumption decelerated by 1.4 percentage points, whereas that of government consumption trebled to 9.4 percent.

Household consumer demand

The growth rate of household actual final consumption slowed down to 11.3 percent, owing to all the key components of household spending: (i) retail purchases, with foodstuffs having the largest contribution to this performance (sales on this

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

[3] 1999-2007

segment edged up only 1 percent in Q1 versus annual growth rates ranging between 23 and 33 percent in the four quarters of the previous year); (ii) services to households (up 3.4 percent versus 12.3 percent in the previous period); (iii) self-consumption and purchases on the agri-food market (whose growth rate decelerated from 3.5 percent to 1 percent), against the background of an upturn in animal production (at the beginning of each year, this category accounts for the largest share of household self-consumption) being largely offset by the drop in direct sales on the agri-food market due to restrictions arising from Romania's accession to the European Union[4].

The first quarter of 2007 saw mixed developments in the inflationary pressures exerted by consumer demand. On the one hand, the pressure generated by "food items" (holding almost 40 percent of the CPI basket) eased somewhat, as a result of:

i) the potential saturation of the market, regarded as a normal phenomenon after three consecutive years during which annual growth rates accelerated by 8-9 percentage points to reach 27.9 percent in 2006;

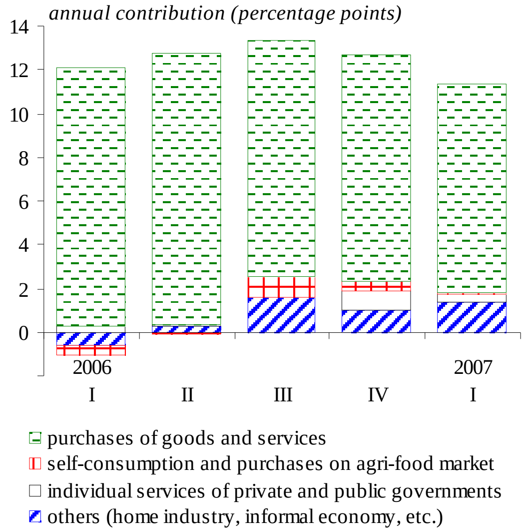
ii) the change in the income allocation options, i.e. lower propensity for buying food items, concurrently with a stronger appetite for durables purchases and residential investments;

iii) stronger saving propensity (the balance of RON- and foreign currency-denominated deposits of households went up 35.6 percent in real terms versus 20.8 percent in 2006 Q4).

The rate of increase of services witnessed a pronounced deceleration as well. However, in this case, demand-side factors generally have a limited impact on price movements, with the main influence coming from supply.

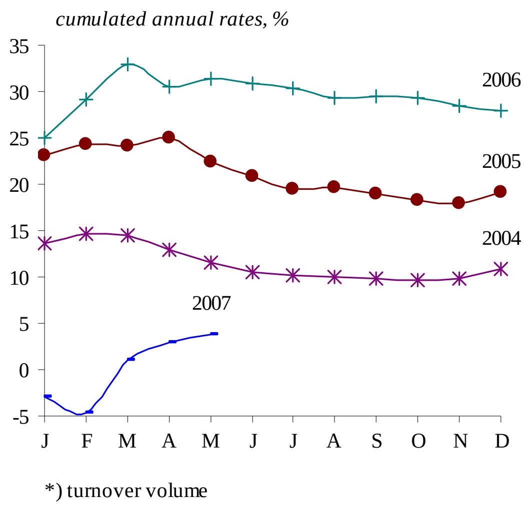
On the other hand, pressures from the non-food segment rose as illustrated by the very rapid dynamics of sales of wearing apparel and footwear, household appliances, furniture and motor vehicles (in a range between 30 percent and 57 percent, from growth rates of 16 percent at most in 2006 Q4). Behind this development stood mainly (i) the further appreciation (and even the slight acceleration thereof) of the domestic currency versus the euro (up 5.4 percent year over year); (ii) the need to

Household Final Consumption by Expenditure



Source NIS, NBR calculations

Retail Trade* of Foodstuffs, Beverages and Tobacco



*) turnover volume

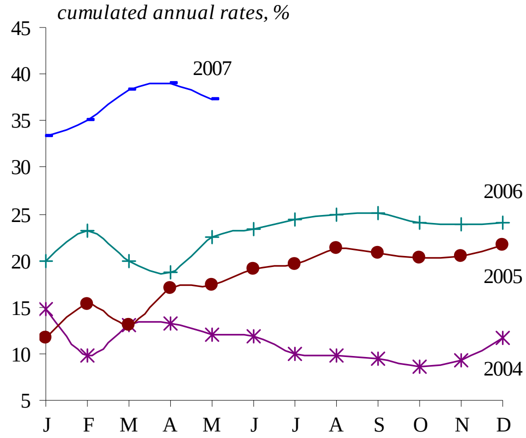
Source NIS, NBR calculations

[4] Subsequently, the authorities decided to postpone until the end of this year the enforcement of the restriction on the registration of small producers with the sanitary-veterinary agencies in every county, as well as the observance by these producers of the norms concerning the health and traceability of products put up for sale.

provide endowments to the new buildings and also the persistence of the phenomenon of replacing previously-bought household appliances; (iii) the confirmation of expectations of cheaper imports subsequent to 1 January 2007 (particularly imports of household appliances and electronic products). Nevertheless, mention should be made that the impact of prices for non-food items on the CPI is mitigated by their relatively small weight in the CPI basket (around 17 percent).

Retail Trade of Durables*

cumulated annual rates, %



*) turnover volume of retail trade in furniture, electronic devices, household appliances, IT&C and of wholesale and retail trade in motor vehicles

Source NIS, NBR calculations

The significant difference between the weight of food items and that of non-food items (excluding energy) in the CPI basket suggests the prevalence of the favourable influence on the CPI development. However, mention should be made that this phenomenon is little likely to persist, as the latest data on the dynamics of sales of food items point to its transitory nature (year-on-year acceleration from an average of 1 percent in Q1 to 8 percent in April-May).

The analysis of consumption based on the markets of origin shows a potential rebound of domestic output in meeting household needs, as reflected by the 4-6 time increase in the growth rate of sales of domestically-produced non-durables and durables (except for motor vehicles) on the domestic market to 27.3 percent and 66 percent respectively. The dynamics of the physical volume of consumer goods imports accelerated as well[5]; nonetheless, in this context, the influence coming from a methodological factor also deserves mention – the registration of imports from the EU when crossing the border and not when being put into free circulation (according to the procedure applied prior to 1 January 2007). However, the step-up of import growth rate lagged behind that of sales of domestically-produced goods, especially in the case of non-durables, the import growth rate of which slowed down 9 times to 3.1 percent[6]. Motor vehicles made an exception this time around as well, given that sales of domestically-produced transport means on the domestic market saw a renewed slackening to 1.1 percent, whereas the growth rate of import volume accelerated for the third time in a row (to 66.2 percent).

[5] Changes in physical volume were calculated based on the balance-of-payments data, by deflating by unit value indices.

[6] As concerns durables, the classification made on the basis of the Combined Nomenclature reveals opposite developments in the growth rates of the physical volume of imports for the main categories (except for motor vehicles); thus, the growth rate of electrical machinery and apparatus, and of sundry goods (particularly furniture) accelerated to 30.7 percent and 34.5 percent, whilst the dynamics of imports of optical and photographic instruments, etc. slowed from 46.8 percent to 2.5 percent.

Government consumption

Government final consumption recorded a faster growth rate (from 2.8 percent to 9.4 percent), its trajectory illustrating the vigorous increase in the number of hirings in the public sector.

Budgetary developments

The annual growth rate of government consumption accelerated as some categories of expenditures under the consolidated general budget, namely social security expenditures and transfers between public sector entities, posted a twofold or even a threefold rise in their annual real growth rates[7].

Nevertheless, the total volume of public spending and that of revenues saw their annual growth rates decelerate from the previous quarter. Yet, the declines in both categories of indicators showed atypical developments; thus, while the deceleration in the rate of increase of expenditures was by far lower from the prior figures for this timeframe, the deceleration in the growth rate of revenues was unusually large. Under these conditions, in 2007 Q1, the consolidated general budget posted a deficit of 0.1 percent of GDP, as compared to a surplus of 0.7 percent of GDP a year earlier; on the other hand, the deficit recorded at the end of 2007 Q1 was by far lower than that seen in 2006 Q4 (3.3 percent of GDP).

The annual growth rate of government spending was 16.5 percent, which is half the value for the prior quarter. The most substantial slowdowns were recorded by subsidies (-24.1 percent), capital expenditures (-19.3 percent) and staff costs (-10.3 percent); their impact was however alleviated by the increases in transfers between public sector entities (+77.3 percent), social security expenditures (+19.2 percent), as well as interest payments (+16.1 percent).

The pronounced slowdown in the dynamics of budget revenues (to 4 percent) was the result of declines in the growth rates of all categories of revenues, particularly VAT receipts (-24.5 percent) and customs duties (-65.6 percent); the fall in these revenues was due to a different method of collection, following Romania’s accession to the EU, as well as to the elimination of the custom duties previously applied to some imports from the EU Member States (meat and meat products, dairy products, alcoholic beverages). Non-fiscal revenues, whose growth rate accelerated to 19.5 percent, represented an exception.

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

The subsequent collection of some revenues from value added[8], after imported goods had reached end users, as well as the collection in April of the profit tax relative to the prior quarter caused the consolidated general budget to revert to surplus, accounting for 0.35 percent of GDP at end-April. In May, the cumulated surplus diminished to 0.16 percent of GDP as the level of monthly public spending stayed close to that recorded in April, while monthly revenues were affected by the specific fall experienced by collections from profit tax.

Investment

annual percentage change

	Year	I	II	III	IV
Total	2006	10 8	15 1	15 8	18 4
	2007	15 9			
- new construction works	2006	23 5	11 6	20 2	18 7
	2007	28 4			
- equipment	2006	2 6	20 8	6 2	12 4
	2007	1 3			
- other*	2006	4 8	–9 6	54 7	55 8
	2007	51 8			

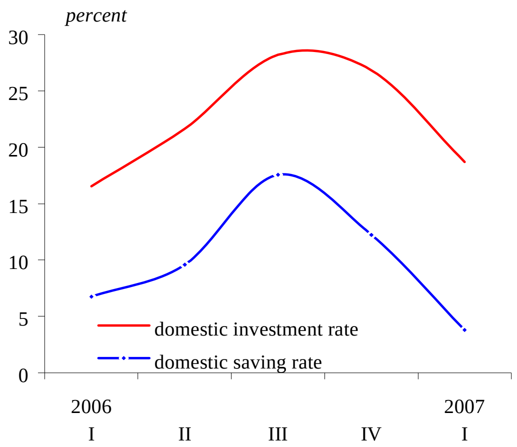
* vineyards, orchards, afforestations, livestock purchases

Source: NIS

The latter part of June saw the first budget revision in 2007 according to which the consolidated general budget's deficit for 2007 was maintained at 2.8 percent of GDP. The main beneficiary of this revision was the agricultural sector, which was earmarked an additional RON 2 billion with a view to increasing subsidies for grain crops and to paying compensations to farmers whose production was affected by drought. At the same time, additional funds were allocated for the rehabilitation of the county road infrastructure (about RON 600 million) and for the purchase of medical equipment and the modernisation of hospitals (roughly RON 335 million). Conversely, the expenditures on defence and environment were reduced.

1.1.2. Investment demand

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

Despite the 0.8 percentage point deceleration, the growth rate of gross fixed capital formation remained brisk (17.2 percent), mainly as a result of larger investment in construction – both new construction works (+28.4 percent) and capital repair works (about 33 percent) –, while the step-up in retooling was only marginal (a mere 1.3 percent compared to +12.4 percent in 2006 Q4). Although much lower compared to the contribution of the said components, it is worth noting the positive contribution of "other investment" (chiefly investment in agriculture and expenditures relative to the transfer of ownership over land and the existing fixed assets), the growth rate of which exceeded 50 percent in annual terms for the third quarter in a row.

The further positive outcomes recorded by the corporate sector, as well as the still fast pace of real disposable income of households (over 15 percent)[9] illustrate the substantial contribution of own sources to the financing of the investment

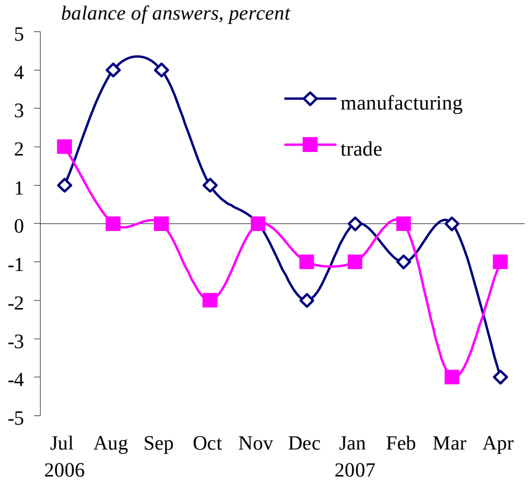
[8] Since mid-April, VAT was collected at the customs house.

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

projects implemented in 2007 Q1. Alternatively, investment from budgetary funds dropped markedly compared to the prior quarter (from 118.8 percent to 15.8 percent[10]). As regards borrowings from financial institutions, their growth rate stayed particularly high: (i) in the case of domestic banks, both loans for equipment purchase and real-estate loans[11] posted increases of more than 50 percent in real terms – the growth rate of the latter category even accelerated compared to 2006 Q4 (by 5 percentage points), real estate leasing operations witnessing a similar development, thereby consolidating their position in total portfolio of this financial market segment, to the detriment of car leasing operations; (ii) medium- and long-term foreign borrowings contracted by the non-government non-financial sector witnessed a trend reversal, moving up around 75 percent in real terms. The sustained rate of increase of investment in Q1 was also fuelled by the significant foreign financial inflows recorded recently, consisting of both foreign direct investment and non-redeemable inflows (under SAPARD and ISPA). As concerns direct investment, it is worth mentioning the favourable outlook suggested by a recent study by Ernst&Young[12], according to which Romania experienced, in 2006, the strongest dynamics in Europe in terms of the number of foreign direct investment projects.

Similar to the previous quarters, purchases of foreign capital goods grew at a faster pace than those of domestically-produced ones. Accordingly, the physical volume of imports[5] rose by 34.9 percent for "mechanical and electrical machinery and apparatus" and by 68.8 percent for "transport means", while the annual dynamics of receipts obtained by the local producers of capital goods[13], albeit 2.6 times higher than that for 2006 Q4, did not exceed 22 percent. As for the domestic/foreign ratio in investors' preferences, a clearer conclusion can be drawn when analysing the car sector, where investors' weaker propensity for Romanian goods is also revealed by the data in physical units provided by the statistical bulletin issued by the AMIA[14] – the considerable contraction of sales of locally-manufactured cars and commercial vehicles, concurrently with the higher rate of increase in imports, for both categories (up to 53.1 percent and 72 percent respectively).

Estimates* on Stocks of Finished Goods



*) a positive balance indicates higher-than-normal stocks of finished goods at the end of previous month

Source: NIS

[10] Calculations based on government budget execution, by using as deflator the producer price index for capital goods for the domestic market.

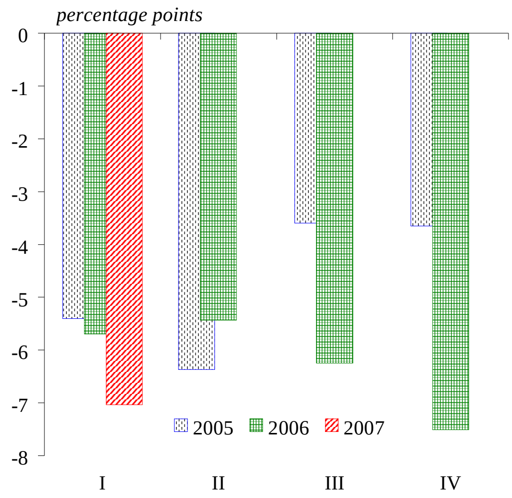
[11] CCR data.

[12] European Investor Monitor.

[13] This category also includes transport means, according to the methodology for the classification of main industrial groups.

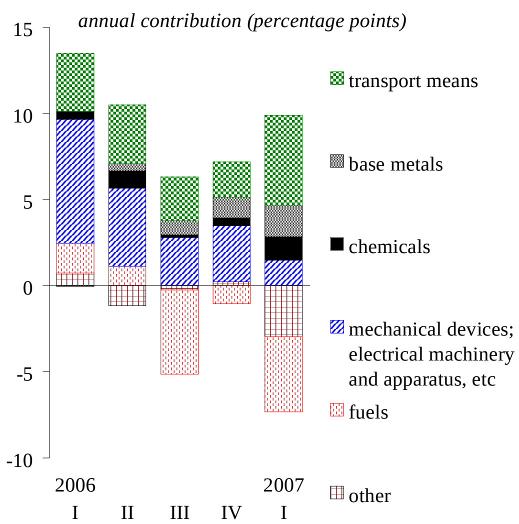
[14] Automotive Manufacturers and Importers Association; however, data only refer to total car sales (to households, as well as legal entities and public institutions).

Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

Dynamics of Export Physical Volume



Source: NIS, NBR calculations

The reduction from 21.1 percent to 16 percent in the annual growth rate of gross capital formation was also spurred by the marked fall in inventories (by 80.7 percent)[15], which induced the trend reversal in the contribution of this item to GDP dynamics (-0.2 percentage points). Yet, it is difficult to make an economic assessment of this development, given the fact that, in compiling the quarterly national accounts, the change in stocks is a residual variable, including, apart from the main features of this category, acquisitions less disposals of valuables, as well as statistical discrepancies. Nevertheless, the absorption of stocks in the economy is expected to accelerate, as the balance of answers[16] relative to the stocks of finished goods in industry and trade remained in negative territory in the first part of 2007[17]; an additional explanation is given by the poor performance of the grain production in 2006, in terms of volume, as well as the quality of wheat bread.

1.1.3. Net external demand

In 2007 Q1, the systematic negative contribution of net external demand to economic growth starting 2003 contracted slightly, but its amplitude (-7 percentage points) illustrates the persistently wide disparity between the two components of the balance of goods and services in terms of physical volume growth and share in GDP. Therefore, the 4.3 percentage point pick-up in the growth rate of exports as compared to 2006 Q4 (up to 12.9 percent) was almost entirely offset by the maintenance of the fast rate of increase of imports (23.8 percent), accompanied by their substantial contribution to GDP formation (52.8 percent in 2006 Q1).

It is noteworthy that these figures should not be taken for granted, as the preliminary version of national accounts for 2007 Q1 uses deflator estimates since the unit value indices of exports and imports – usually underlying the calculation of estimates – were not available at that particular time[18].

[15] According to the national accounts methodology, the change in inventories is calculated as a value of entries into inventories, net of the value of withdrawals from inventories and that of potential losses associated to physical deterioration, accidental losses or theft. Inventories consist of raw materials (including those at the disposal of the authorities), work-in-progress, finished goods held by producers and goods for resale.

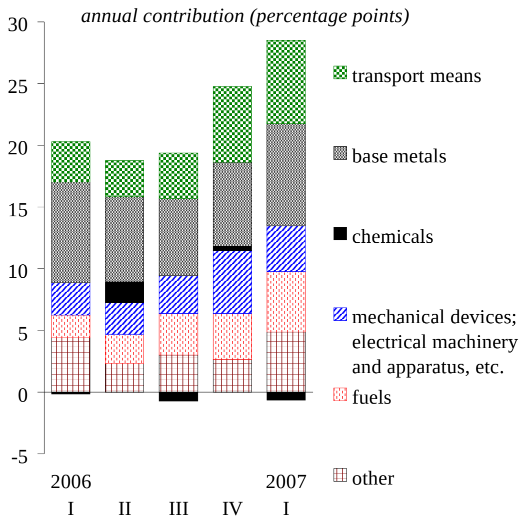
[16] The answers of company managers surveyed in relation to the stocks of finished goods at the end of the month prior to the month of the survey.

[17] According to the business survey conducted by the NIS.

[18] Until 1 January 2007, statistics on foreign trade with the EU Member States relied on data released by the National Customs Agency. Subsequent to Romania's accession to the EU, customs declarations were replaced by INTRASTAT statistical declarations submitted by foreign trade companies, which burdens the collection of data, causing a roughly 40-day delay in their publication.

Accordingly, the calculations based on balance-of-payments data show that the annual growth rate of the volume[6] of goods exports accelerated by only 2.6 percent, i.e. 3.5 percentage points below the prior quarter's figure. Behind this stood the developments recorded by several groups of goods, the strongest impact being exerted by (i) the drop in the volume of fuel exports (the scarcity of resources further affecting their exploitation and processing, whereas external demand was relatively weak due to the relatively high temperatures in the first part of the year), as well as by (ii) the steady decline recorded by "textiles" (as a result of competitiveness losses induced by wage hikes[19] and local currency appreciation, compounded by the fierce competition from Asian producers). An opposite influence had the strong pick-up in the physical volume of exports of transport means (+61 percent against +20 percent in 2006 Q4, annual growth rates).

Dynamics of Import Physical Volume



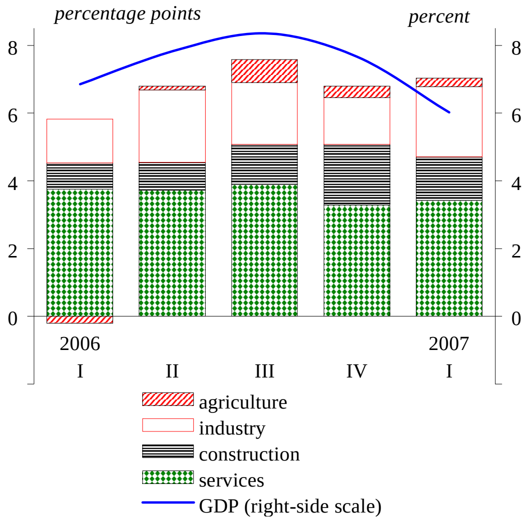
Source NIS, NBR calculations

The calculations based on balance-of-payments data also indicate that the annual growth rate of the volume of goods imports advanced to 27.9 percent in 2007 Q1, from 24.8 percent in 2006 Q4. The step-up in the annual growth rate was generated by the appreciation of local currency and the simplification of customs formalities, as well as by the statistical effect associated to the new system of registration of imports from the EU starting with 2007.

1.2. Supply

The slowdown in the growth rate of GDP in Q1 was solely attributable to the item "net taxes by product", whose trajectory reversed from +8.1 percent in 2006 Q4 to -7.8 percent, wiping out the 0.5 percentage point advance in the growth rate of gross value added (to 8.1 percent). According to official statements, this state of affairs – a breakthrough in the last eight years – was induced by the change in the tax system following Romania's accession to the EU, especially the 60-day delay allowed in the case of VAT payment for goods subject to foreign trade, until the respective goods reach end users.

Contribution of Main Supply Components to GDP Growth



Source NIS, NBR calculations

In industry, the growth of gross value added moved up 1.2 percentage points (7.8 percent), amid the similar trend of industrial output. This development was generated by manufacturing (growth rate advances were seen in intermediate goods sub-sector and, to a lesser extent, in non-durables sector), while activity in the energy industry continued to shrink under the negative impact of unusually hot weather on the heating output.

[19] Real ULC went up 25 percent in annual terms in 2007 Q1 compared to an average of about 3 percent in 2006. Wage costs account for 75 percent in the structure of production costs.

The growth rate of gross value added of the services sector stayed at a level similar to that in 2006 Q4 (6.4 percent), more significant advances being recorded by motor vehicle and fuel retail sales, wholesale trade and road transport-related activities (except railway transport), post, telecommunications, IT, real-estate transactions, urban planning.

The annual growth rate in agriculture accelerated 2.5 times (to 9.2 percent), bolstered by the rebound in the activity of the animal breeding sector (output of meat and dairy products).

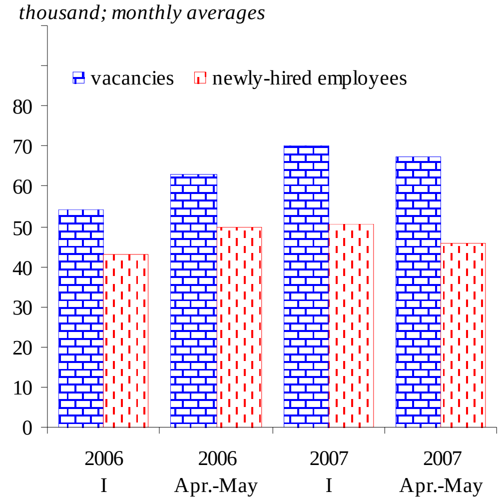
Given the favourable weather conditions, the construction sector continued to post a fast annual growth in Q1, with the rate of increase of gross value added seeing a new record high for 1999-2007 (30.7 percent). The same as in the prior quarter, the execution of building projects witnessed the fastest growth (around 42 percent, i.e. 33 percent for the residential/non-residential segments), with civil engineering following suit (roughly 26 percent).

2. Labour market

Heightened tensions on the labour market caused the annual growth rate of wages to remain strong, at a level higher than that of labour productivity. In this context, the acceleration of increase in ULC in industry, which became manifest as early as the latter half of 2006, continued; however, the sharper rise in ULC in 2007 Q2 was largely attributable to the impact of some incidental factors on the volume of output. The persistence of these unfavourable effects might put upward pressures on prices, especially if consumption potential remains high, as reflected by the steep growth in real disposable income of households and implicitly in household indebtedness capacity.

Number of Vacancies and Number of Filled Vacancies

thousand; monthly averages



Source NEA

2.1. Labour force

The contraction of excess labour supply was the main development on the labour market in the first part of 2007, as illustrated by the abrupt fall in registered unemployment rate, from 5.2 percent in 2007 Q1 to 4.3 percent in April-May (from 4.8 percent to 4.3 percent, seasonally-adjusted data). In terms of labour demand, the statistical data provided by the NEA offer only a partial explanation of this development, given that in April and May (i) the number of vacancies kept rising in annual terms, albeit at a pace slower than in Q1 and (ii) the number of hirings was lower than that in both the year-earlier period and

Q1. Additionally, there are no indications of a faster migration of unemployed labour force abroad, even though Romania's accession to the EU facilitates the access to the labour markets of some Member States.

On the other hand, part of the unemployed not claiming benefits that did not renew their applications for a job made a substantial contribution to the fall in unemployment rate. There are two possible explanations for this behaviour: either they continued to look for a job on their own (which might explain the persistence of a much higher "ILO unemployment rate" compared to "registered unemployment rate"[20]) or they found a job in the informal sector[21] – in many cases, the lack of adequate skills and/or experience representing obstacles to getting a formal contract domestically or abroad. Therefore, assuming that employers would rather hire unemployed benefit claimants[22] (short-term unemployed, which usually have at least one year experience[23]), mention should be made that their share in total registered unemployed narrowed to 33.4 percent in April-May 2007 (-2.8 percentage points year on year); apart from the contraction in the total number of unemployed, the development represents also an indication of the tightening conditions on the labour market.

2.2. Incomes

The particularly high annual growth rate of wages, seen in most economic sectors in January and February 2007, persisted in the subsequent months, given the boost in economic activity. Thus, after the abrupt fall in January (due entirely to the base effect resulting from the one month earlier granting of the "13th-month" wage to public sector employees), the annual dynamics of average net nominal wages economy-wide appears to have stabilised at around 22 percent[24].

The sectoral analysis indicates that wage earnings in predominantly private economic sectors rose on average at a pace similar to that seen in the public sector. In January-May 2007, the growth rate of net wages in predominantly private sectors ranged from about 10-11 percent (in financial

[20] This assumption is to be checked after the publication of the AMIGO surveys relative to 2007 Q1-QII, the latest data on ILO unemployment regarding 2006 Q4 (7.2 percent).

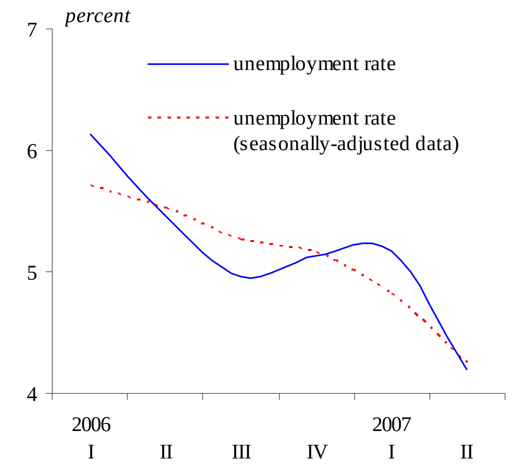
[21] The strong growth of construction activity may have caused the expansion of this sector.

[22] The NEA does not keep updated records on the share of unemployment benefit claimants in the total number of unemployed who found a job.

[23] For a clear definition of unemployment benefit claimants, see methodological notes to the Monthly Statistical Bulletin issued by the NIS, the 2007 editions.

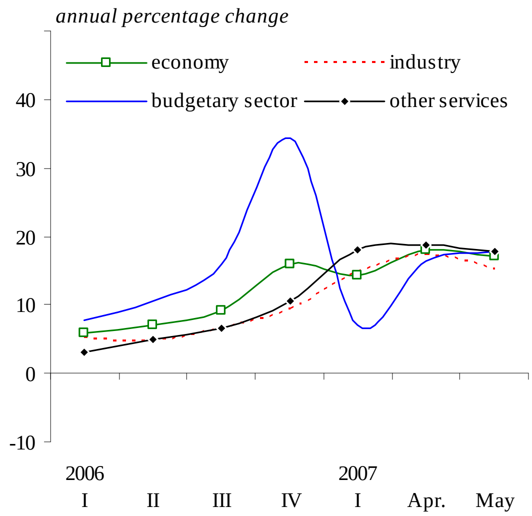
[24] Available data up to and including May.

Unemployment Rate



Source NEA, NBR calculations

Net Real Wage*



*) deflated by CPI

Source NIS, NBR calculations

Private Sector Wages

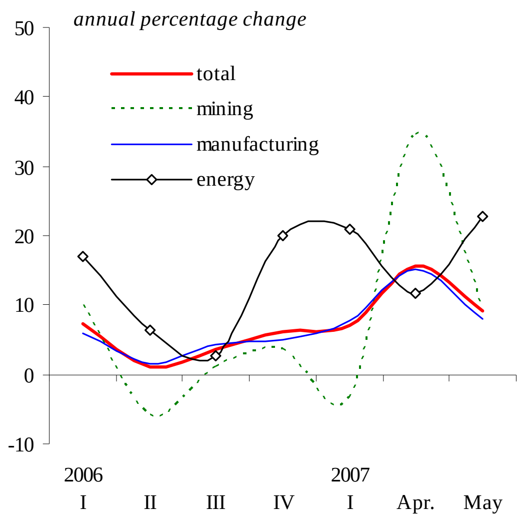
January-May 2007

	% of whole-economy average	annual change %
Tourism	63.5	22.5
Trade	83.2	29.1
Construction	83.8	24.8
Manufacturing	84.4	20.4
Communications	148.1	9.7
Financial intermediation	306.8	11.3

Source NIS, NBR calculations

intermediation and post and telecommunications) to 29 percent (in trade), a negative correlation being manifest between the latter and the level of wages. The pressure to adjust disparities in the economy emerged amid (i) the high demand for skilled staff in construction, tourism, trade, (ii) increased opportunities for getting a job in the EU, owing to sustained economic growth in this area and the legislative changes following Romania's accession to the EU[25], and (iii) the impetus given by income policy, with the 18 percent hike in the gross minimum wage economy-wide; this development and the granting of bonuses induced the 21.5 percent rise in the net average wage of public sector employees (in February-May 2007 compared to a year earlier).

Unit Labour Costs in Industry



Source NIS, NBR calculations

Industry further witnessed higher ULC growth, a trend which became manifest in the latter half of 2006. The reasons behind this development were related to wage hikes and, in some sub-sectors, to the granting of large bonuses, but especially to the emergence, in April, of some adverse incidental effects, which acted as a strong deterrent to industrial output growth and implicitly to the rise in labour productivity. Therefore, while in 2007 Q1 the rise in the annual ULC index versus the previous quarter (+0.8 percentage points, to 107 percent) was contained by substantial productivity gains, in Q2 the rise is expected to be considerable, given the April figure (+8.7 percentage points). The ULC worsening was chiefly attributable to developments in the industries affected by the entering into technical overhaul of a large refinery (oil processing, chemicals, rubber and plastic products). ULC worsening, albeit to a smaller extent, was also seen in the main consumer goods industries (food industry, textiles, wearing apparel, leather products and footwear), as well as in some capital goods sectors (machinery and equipment, electrical machinery and apparatus), but in this case it is not clear whether the most significant influence was induced by structural or incidental factors.

On the demand side, the latest data confirmed the persistently vigorous acceleration in the annual growth rate of real disposable income (15.9 percent in 2007 Q1 compared to 15.2 percent in the previous quarter). Both real wages (+17 percent) and remittances and transfers from abroad (+25.3 percent) experienced annual changes comparable with those in the prior period, whereas budgetary and extra-budgetary revenues saw a twofold increase in their real growth rate (8.8 percent).

[25] According to the Office for Labour Force Migration, starting with 1 January 2007, Bulgaria, the Czech Republic, Cyprus, Estonia, Finland, Latvia, Lithuania, Poland, Slovakia, Slovenia and Sweden fully liberalised their labour markets for Romanian workers, Belgium and Hungary simplified the procedure for granting labour permits for certain trades, and France and Italy liberalised the labour market for certain economic activities (e.g. construction, tourism, agriculture).

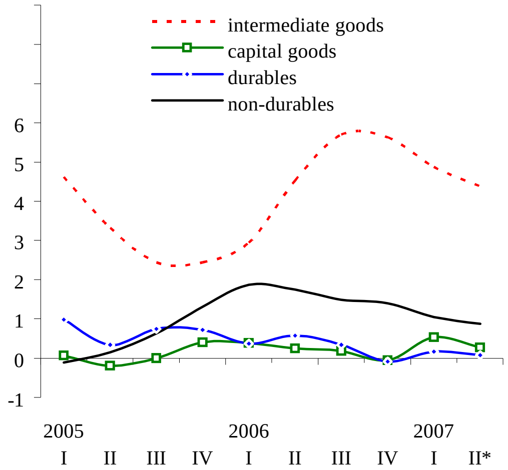
According to provisional statistical data available for 2007 Q2, the inflationary risks associated to consumer demand remained high – given the direct effect of accelerated annual growth rate of real disposable income, on the one hand, and the indirect effect induced by the fact that this development boosted credit growth, on the other hand.

3. Import prices and producer prices

In 2007 Q1, pressures exerted by producer prices lowered significantly, particularly as regards energy products and consumer goods, which hold a substantial share in the CPI basket. The same trend was seen in the case of import prices, the nominal appreciation of the domestic currency having a favourable influence which more than offset the impact generated by the faster increase in external prices. The annual growth rate of prices for agricultural products remained unchanged as compared with the prior quarter, yet it is estimated to decelerate during the second quarter of the year on the back of developments in prices for both vegetal and animal products.

EU-25 Industrial Producer Prices for Exports

annual percentage change



Source: EUROSTAT *) April

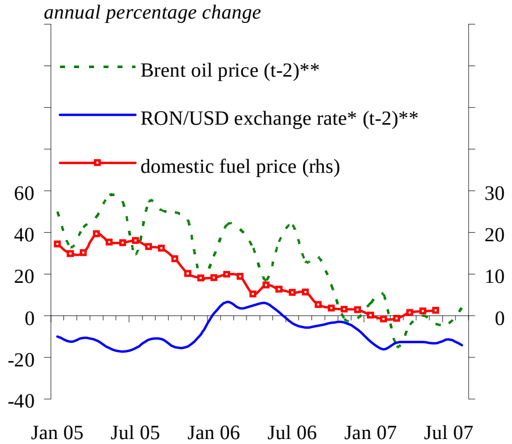
3.1. Import prices

In January-March 2007, imported inflation had a favourable impact on domestic price dynamics, the effect generated by the faster growth rate of external prices[26] (from 1.4 percent in 2006 Q4 to 2.3 percent, in annual terms) being more than offset by the strengthening of the domestic currency versus the euro (5.4 percent compared to 4.6 percent in the final quarter of 2006).

The faster annual growth rate of external prices was visible particularly as regards trade relations with the European Union, the unit value index of imports rising 4 percentage points to 5.4 percent quarter on quarter. It is worth mentioning that most groups of goods that were impacted by this increase – meat, edible fruit, pharmaceuticals, wearing apparel and electrical machinery and apparatus – are included in consumer goods. Overall, the decline in prices for oil and foodstuffs had a considerable dampening effect.

Oil and Fuel Prices

annual percentage change



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

Source: NIS, EIA

Data available for 2007 Q2 are indicative of pressures on the domestic fuel price, as the world oil prices surged from an average of USD 57.8 per barrel in Q1 to USD 68.6 per barrel. However, favourable developments were reported by the other influencing factors: (i) the domestic currency strengthened further in nominal terms against the euro and the US dollar

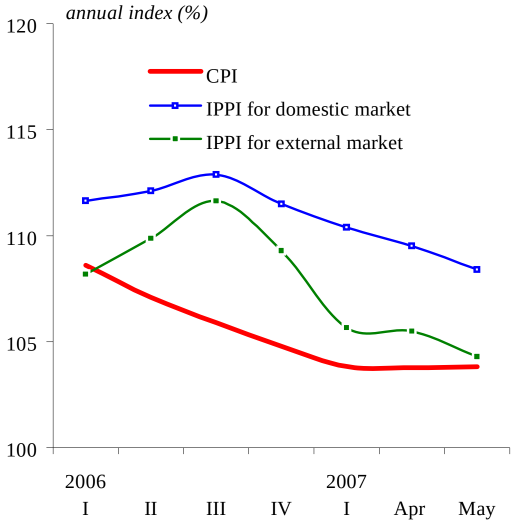
[26] Calculated based on the unit value indices of imports.

(7.1 percent and 14.9 percent respectively, in annual terms); (ii) industrial producer prices for EU25 exports (excluding construction and energy) saw an average annual growth rate of 1.9 percent in April and May, 0.4 percentage points lower than the average for the previous quarter; (iii) the price for natural gas continued its downward trend.

3.2. Producer prices

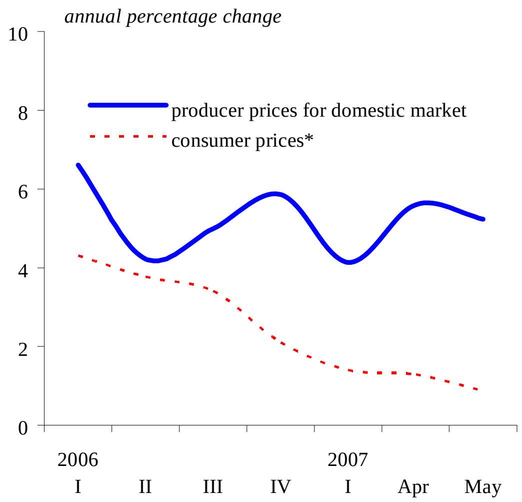
3.2.1. Industrial producer prices

Consumer Prices and Industrial Producer Prices



Source: NIS

Durables Prices



* including household appliances, furniture and cultural and leisure products

Source: NIS, NBR calculations

The annual dynamics of industrial producer prices for the domestic market continued to slow down in 2007 Q1 (by 1.1 percentage points to 10.4 percent). The main contribution to this development came from the groups of products where producer prices feed through at the fastest pace into consumer prices: (i) energy products, the prices of which posted a slower growth rate for the third quarter in a row (down 3 percentage points to 12.3 percent)[27], owing to the performance of hydrocarbon extraction and processing sub-sector and developments on the external market; (ii) consumer goods (down to 1.7 percentage points in the case of durables), due possibly to domestic producers' efforts to maintain their market shares in the context of higher imports following the EU accession.

By contrast, the growth rate of prices for intermediate goods advanced by 0.5 percentage points to 9.9 percent, largely on the back of chemicals and building materials sub-sectors, the development of which was related to the expansion of activity in construction. The rate of increase of producer prices for capital goods followed a similar trend, inching up 0.3 percentage points to 7 percent, although the main drivers of this development were some sub-sectors holding a small share in total production[28]; conversely, the sub-sectors holding a significant share in the capital goods production (electrical machinery and apparatus, road transport means and other transport means) posted slower price increases of 2.7 percentage points at most, due possibly to lower raw materials costs and the domestic currency strengthening.

The current trends may persist into 2007 Q2, as the energy products sub-sector represents further the main factor alleviating pressures generated by industrial producer prices.

[27] The differential between the annual growth rate of producer prices for energy products on the domestic market and the average industry-wide narrowed to 1.9 percentage points in 2007 Q1, the lowest level in the past nine quarters.

[28] "Metallic construction and metal products" (up 0.3 percentage points to 6.75 percent) and "medical, precision and optical instruments, watches and clocks" (up 5.4 percentage points to 15.1 percent).

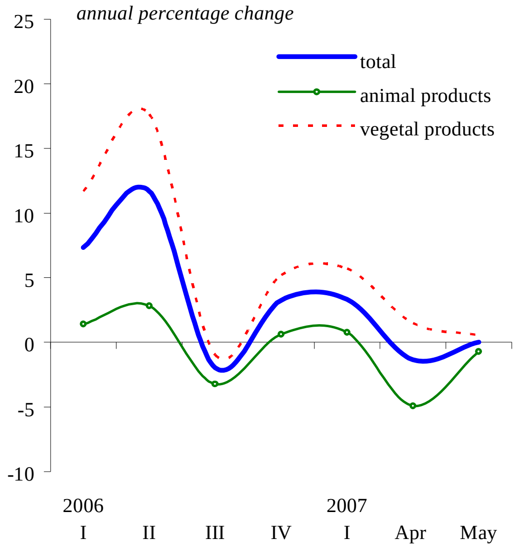
3.2.2. Agricultural producer prices

Although the annual growth rate of agricultural producer prices remained unchanged from the previous quarter (3.3 percent), tensions continued to build up in the vegetal products sub-sector, as illustrated more clearly by the quarterly change (up 11.3 percent). The same as in the prior quarter, prices for grains increased at a brisk pace, yet the developments were broadly offset by the substantial price decreases reported for some categories of vegetables.

The pace of increase of prices for animal products was similar to that recorded in the prior quarter (0.7 percent), given that the decline in prices for the main types of meat ranged between -5.1 percent for beef (a movement associated with an adjustment, as the prices for this product exhibited an increasingly fast dynamics in the past two years) and -20.6 percent for pork (owing largely to one-off factors – maintenance of the embargo Russia had imposed on meat imports from Poland and the lifting of restrictions on pork sales, following the campaign for vaccination against swine fever, during a period when demand for pork was low).

The annual growth rate of agricultural producer prices is estimated to decelerate in April-June 2007. The slowdown, although being generated by developments in both sub-sectors, is largely accounted for by the fall in prices for animal products, pork and poultry in particular. In this context, special mention deserves the persistent discrepancy between price movements at producer and consumer levels. More precisely, the significant producer price cuts for pork fed through only marginally into consumer prices, whilst the growth rates of prices for poultry posted diverging trends. The explanations may lie with the unfavourable impact of the other components of the selling price, as well as with the retailers' bias towards speculating demand developments.

Agricultural Producer Prices



Source: NIS

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

During Q2, the monetary policy rate was lowered in two stages (from 7.50 percent to 7.0 percent per annum), but the domestic currency posted a faster nominal appreciation against the euro and the US dollar. The central bank maintained the restrictiveness of the minimum reserve requirements mechanism and monetary control improved, leading to the gradual removal of the negative spread between the average effective interest rate on credit institutions' deposits with the NBR and the monetary policy rate. Consequently, the broad monetary conditions remained adequately tight for keeping disinflation on a path compatible with achieving the inflation targets over the medium term.

Consolidation of disinflation and the significant improvement in the short-term outlook for inflation, due largely to anticipations of a relative drop in aggregate demand pressures and in the inflationary impact of some supply-side factors, prompted further rate cuts, decided by the NBR Board in its meetings on 2 May and 25 June 2007. However, given the risks to disinflation revealed by recent analyses, mainly those associated with sizeable wage hikes, the pro-cyclical stance of fiscal policy and the widening of the current account deficit, the monetary authority decided to lower the magnitude of the two monetary policy rate cuts to only 0.25 percentage points. The central bank's monetary control led to the narrowing and the ensuing phasing-out of the negative spread between the average effective interest rate on credit institutions' deposits with the NBR and the monetary policy rate. At the same time, the monetary authority kept in place the restrictive reserve requirements mechanism, i.e. the reserve ratio on RON-denominated liabilities[29] was left at 20 percent and the reserve ratio on foreign exchange-denominated liabilities of credit institutions at 40 percent.

Behind the first monetary policy rate cut decision taken in 2007 Q2 stood mainly the considerably improved outlook for inflation, compared to the previous projection, in the first part of the monetary policy transmission horizon[30] shaped in the

[29] with residual maturity of up to 2 years

[30] The projected inflation rate for end-2007 was 3.7 percent, 0.3 percentage points below the central target of 4.0 percent ±1 percentage point, i.e. 0.9 percentage points below the level projected in February 2007 Inflation Report.

context of updating the projection of medium-term macroeconomic developments. The chief prerequisites for the future downtrend in the annual inflation rate were the faster-than-expected disinflation earlier this year, the near-term decrease in the foreseen impact of some supply-side factors and especially the ongoing reduction in the positive output gap in the first part of the forecast horizon. As a result of the persisting risks to domestic and external equilibriums of the economy, the most significant being the hefty pay rises in both public and private sectors as well as the predictable fiscal easing, the National Bank of Romania took a prudent approach to monetary policy rate cuts, considering also the restrictive effect exerted by the ongoing consistent appreciation of the domestic currency and the reserve requirements mechanism on broad monetary conditions.

The central bank decided to lower the monetary policy rate again after assessing the subsequently-released data, which confirmed the expectations of the continued slackening of economic expansion in 2007 Q1. The decline in the annual growth rate of GDP was even sharper than anticipated (6.0 percent against the programmed figures of 6.8 percent and 7.7 percent in 2006 Q4 respectively – see Chapter III. Economic developments), mainly due to the adverse one-off effect on GDP formation dynamics stemming from the change in VAT payment system after Romania's joining the EU, which led to a setback in the quarterly collection rate.

Nevertheless, the economic slowdown was to some extent ascribable to the reduction in domestic demand dynamics (from 13.5 percent to 11.9 percent), due also to the less sharp increase in household actual final consumption (11.3 percent against 12.7 percent in 2006 Q4). In this context, the alleviation of inflationary pressures arising from domestic absorption was boosted by the structural changes to consumer demand[31] in the early months of 2007; they were however less favourable from the perspective of the external imbalance, with the faster dynamics of net exports negative balance during the reported period fuelling the magnitude of the fall in GDP growth.

Under the circumstances, the NBR Board chose again to lower the monetary policy rate by only 0.25 percentage points. Such a cautious approach was caused by the major uncertainties surrounding the lasting nature of the economic slowdown and the prospects of the inflationary potential of aggregate demand, given that the developments in the key relevant indicators

[31] The higher growth of demand for non-food items, particularly motorcars and fuels, and the sharp fall in the pace of increase of food and services purchases.

during April-May indicated a likely step-up in the growth rates of investment demand and private consumption. Thus, the annual rate of increase of retail sales picked up versus the first-quarter average – in what regards foodstuffs, durables for refurbishment, endowment and upkeep of dwellings – and that of sales of motor vehicles and fuels remained high, although it went down somewhat. However, the performance of consumption demand continued to be in contrast with the improving trend in net savings of households, which strengthened in the first part of 2007 Q2.

From this perspective, the trajectory followed by the dynamics of loans to households in recent months was also in favour of rate cuts. The average annual rate of increase[32] in such loans decelerated markedly in the first two months of Q2 (to 65.8 percent, 9.1 percentage points below the figure seen in Q1), largely on the back of a slower growth rate of consumer credit. Average annual change of consumer credit contracted to 68.9 percent (from 82.7 percent in 2007 Q1), as interest costs remained relatively high[33]; thus, the average floating rate on new consumer loans with maturity longer than 5 years – one of the most popular products provided by credit institutions – went down marginally, whereas the average interest rate on overdraft facilities granted to households was 0.2 percentage points higher than the first-quarter reading. By contrast, the average annual growth rate of housing loans edged up somewhat (51.2 percent in April-May from 49.5 percent in January-March 2007), although the reported period experienced no major change in lending terms and conditions[34]. The faster dynamics of such loans was however less fuelled by the increase in the RON-denominated component, even though the average interest rate on new housing loans fell 1.2 percentage points[35], and more by the foreign-currency-denominated loans. The uptrend of the latter was driven by the sharper decline in costs attached thereto, owing to the decline in the interest rates on new EUR-denominated loans as well as to the steady appreciation of the domestic currency and the anticipated continuation of its strengthening. From this perspective, similarly to the previous quarter, 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.

[32] Annual rates of increase are shown in real terms.

[33] The fees charged did not witness any significant improvement either. The average annual effective interest rate on consumer credit stood at 18.3 percent in April-May from 18.8 percent in 2007 Q1.

[34] Also as a result of the fact that the NBR’s approval process of credit institutions’ own lending regulations did not lead to significant effects yet.

[35] The reduction in the average effective rate was relatively larger (1.5 percentage points), hinting at the likelihood of cuts in other costs of housing loans.

The developments in household deposits were yet another reason supportive of the monetary policy rate cut. The faster growth rate of RON-denominated households' time deposits with maturity of up to 2 years persisted into April-May (12.7 percent compared with 8.2 percent in 2007 Q1), illustrating a possible sharper propensity for saving. In addition, the trajectory of the annual change in such deposits contrasted with the slower dynamics of foreign-currency-denominated time deposits of households, as the far higher RON-denominated[36] deposit rates could have entailed a portfolio shift. At the same time, the surge in overnight RON-denominated deposits of households kept accelerating (121.0 percent), albeit at a pace considerably slower than that witnessed in Q1, especially due to the boost given by the high interest rates on certain credit institutions' demand deposits of households.

Furthermore, the NBR's decision to lower the monetary policy rate took into account the ongoing decline in annual CORE2 inflation. The somewhat faster-than-expected drop in CORE2 inflation rate helped, alongside the lower annual changes in several administered prices, annihilate the direct impact on annual headline inflation exerted by the unfavourable deviation from the projection of the rate of increase of both fruit and vegetables prices – following the scant supply that started to take shape – and the domestic fuel price. Nonetheless, at the end of Q2, the average annual inflation rate was half a percentage point higher than the projection, adding 0.14 percentage points to the March reading. However, the deviation was attributed solely to the unexpectedly large increase in rents decided by local governments in May which, given the one-off nature of the adjustment and the specific price, could not trigger second-round effects on prices, including via inflation expectations.

The rate cuts were also prompted by several reasons relating to the stronger-than-anticipated appreciation of the local currency versus the major currencies (3.0 percent against the euro compared to Q1). On the one hand, it was considered that the impact of such appreciation pace on the restrictiveness of broad monetary conditions could have paved the way for retaining the cautious approach to monetary policy rate reductions. On the other hand, it was estimated that the RON appreciation might have become unsustainable assuming that, amid the still high differential between domestic and foreign money rates, volatile capital inflows could have put greater pressure on the exchange rate.

[36] In April-May 2007, the average interest rate on RON-denominated time deposits of households with maturity of up to 2 years remained relatively close to the level seen in Q1.

Despite the considerable pressure on the exchange rate of the local currency, the National Bank of Romania fended off a plunge in money market rates, as the liquidity management policy was tailored from the perspective of ensuring a firm interbank rate, which should follow a path very close to that of the monetary policy rate. Thus, in early April, the monetary authority left unchanged its manner of exerting control over money market liquidity, but thereafter it reduced both the frequency and the volume of sterilization operations in response to the heightening tensions in liquidity conditions. This state-of-affairs was the result of the Treasury's larger-than-expected absorptions, on the one hand, and substantial increase in certain banks' demand for reserves owing to non-residents' stronger interest in making RON-denominated deposits, on the other hand. Under the circumstances, the abrupt surge in interbank rates followed by their persistence at unusually high levels prompted the National Bank of Romania to perform in May 2007 – for the first time in five years – a number of liquidity injections via four repo operations[37] with one-week maturity, at an average interest rate of 7.92 percent. The relative normalisation of market conditions led in June to the resumption of one-month deposit-taking operations, with the monetary authority accepting all the bids submitted by credit institutions at the weekly deposit auctions. Nonetheless, open-market operations aimed at mopping up liquidity were again discontinued in late June when the NBR carried out another repo operation[38] in anticipation of a sharper increase in credit institutions' demand for reserves and implicitly a renewed skewness of interbank rates.

2. Financial markets and monetary developments

Owing to a strong contractionary effect exerted by autonomous liquidity factors, interbank rates showed abrupt, short-lived increases in 2007 Q2, their average level being higher than that seen in the previous quarter. In this context, volatile capital inflows put larger pressure on the RON/EUR exchange rate, which led to the faster appreciation of the domestic currency. Albeit at a slower pace, the annual growth of broad money continued to accelerate, due solely to the consolidation of the uptrend in government credit dynamics.

[37] The average daily volume of provided liquidity amounted to RON 361.1 million in May.

[38] With 2-week maturity and an interest rate of 7.0 percent.

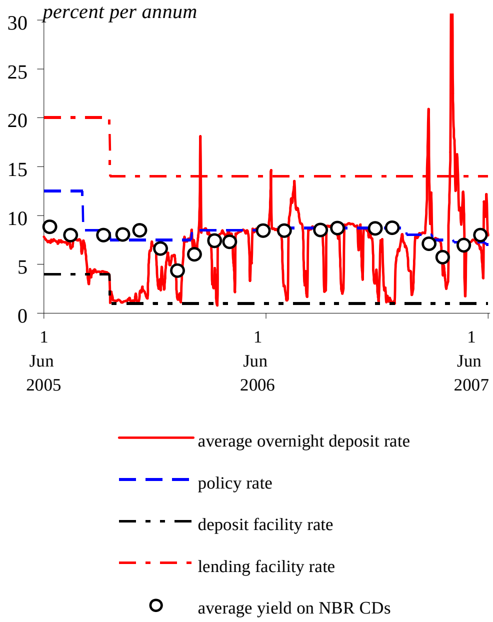
2.1. Interest rates

Interbank rates were highly volatile April through June 2007, their development being impaired by the recurrence of substantial liquidity shortages generated by a strong contractionary effect of autonomous liquidity factors. Under these conditions, the average interest rate on interbank deposits followed a path opposite from the monetary policy rate, rising 2.6 percentage points as compared with Q1 to 9.6 percent.

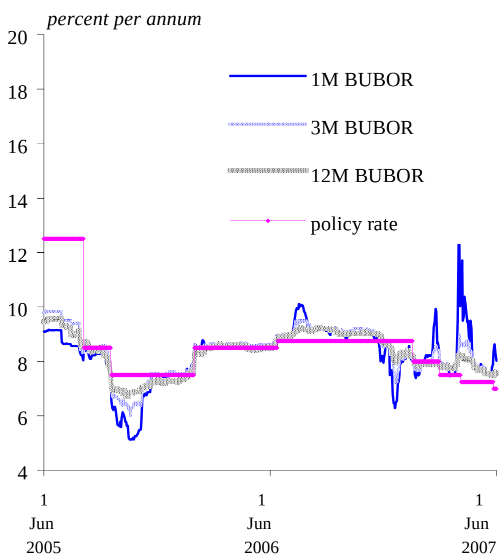
In the first 10-day period of April, interbank rates stayed close to the monetary policy rate; subsequently, they followed a downward course which persisted until the end of the reserve maintenance period. However, in the latter part of the month, the daily average interest rate on overnight deposits increased abruptly (touching a maximum level of 34.5 percent on 27 April), as a result of banks' mounting demand for liquidity; this was due to the much higher-than-expected rise in the value of payments to the Treasury, as well as to the surge in the volume of interbank settlements amid an unprecedented rise in speculative foreign currency operations performed by non-residents. In this context, the one-month maturity of deposit-taking operations – the NBR's main open-market instrument – started to exert a relatively more pronounced constraining effect on the flexibility of liquidity management by banks.

The liquidity shortfall persisted into the first part of May, which caused short-term interest rates to record high levels, given that the resort to the lending facility, albeit significant, was insufficient relative to the near-run demand for reserves, being also restricted by the lack of the necessary eligible asset volume from the portfolio of some banks; moreover, the recourse to the intraday credit facility and partially to the lending facility was further affected by some technical difficulties. Interbank money market rates were adjusted to the monetary policy rate no sooner than the last week of May – subsequent to some liquidity injections by the central bank – and they remained unchanged until mid-June. After a short period of decline, the average daily overnight rates posted a new sharp rise in the last day of the reserve maintenance period, as several banks underestimated the overall demand for reserves, and the existing liquidity surplus was not re-distributed effectively among participants. As a result, a number of credit institutions conducted deposit-taking operations on the interbank market at interest rates higher than those on lending facility[39] in order to raise necessary funds. The interest rates on overnight deposits remained high in the first days of the new reserve maintenance

Interbank Money Market Rates



Policy Rate and BUBOR Rates



[39] Similarly, the insufficient eligible assets for collateral limited the recourse of some banks to the lending facility.

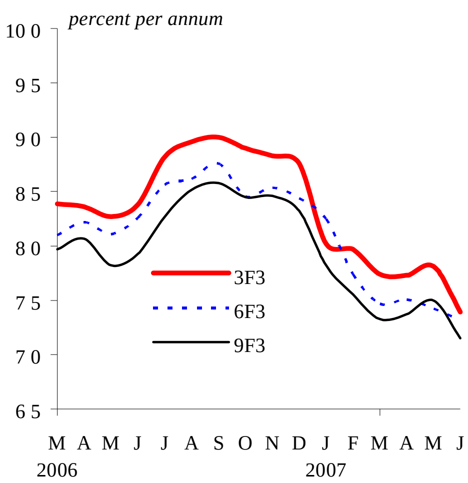
period as well and they returned to regular values only after liquidity conditions were balanced again through a new repo operation performed by the NBR.

Under the circumstances, in 2007 Q2, overnight interest rates displayed a significantly higher volatility over a longer period of time. The average spread between ask and bid rates on overnight deposits was 1.4 percentage points higher than in the first three-month period of 2007, owing mainly to the strong increase in demand for resources during April-May.

In June, (1M-12M) BUBOR yield curve was lower than in March, thus continuing its shift downwards for the third consecutive quarter. Interest rates declined by 0.4 percentage points on average across the maturity spectrum, reflecting the downward course of monetary policy rate, on the one hand, and the development in inflation expectations of market participants[40], on the other. The decline was steeper for short-term rates, so that the negative yield curve slope was less pronounced, the spread between monthly averages of 12M and 1M BUBOR rates narrowing from -0.6 percentage points to -0.2 percentage points.

Developments in implicit forward rates calculated on the basis of June average rates illustrate the lack of significant changes in the anticipated levels of interbank rates for 2007. Therefore, the average 3M BUBOR rate is expected to decrease slowly over the next three quarters and reach 7.4 percent in September (only marginally lower than the level recorded at end-March), 7.3 percent in December and 7.2 percent in March 2007.

Implicit Forward Rates



In contrast to interbank money market rates, the interest rates on government securities saw only marginal changes, hovering around 7.2 percent on almost every issue, given that the bid rates fluctuated between 6.76 percent and 12 percent. In order to cut interest costs, the Ministry of Economy and Finance rejected in whole (in two cases) or in part the bids submitted by the participants in government securities auctions, the maximum accepted interest rates being lowered gradually from 7.41 percent to 7.15 percent.

In this context, the Ministry of Economy and Finance was less present on the primary market for government securities. In 2007 Q2, the government securities issued totalled about RON 2,208 million (nearly 69 percent of which in April),

[40] As compared to the end of the previous quarter, inflation expectations for end-2007 improved in June, whilst those for December 2008 worsened somewhat.

accounting for roughly 44 percent of the pre-announced volume and less than half of that issued in the prior quarter.

In June, the public authority issued, for the first time since the resumption of government securities issues, 10-year government bonds (unlike the previous securities with maturities of one, three and five years), with an average interest rate of 6.91 percent.

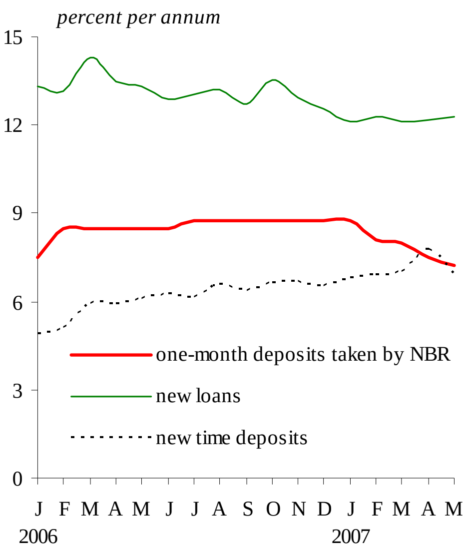
The volume of transactions on the secondary market of government securities surged in April-June, owing largely to operations conducted by the NBR. Therefore, the total trading volume on the secondary market amounted to about RON 15,653 million (as compared to RON 3,250 million in the previous quarter), almost 76 percent of which represented the counterpart of the central bank. Irreversible transactions totalled RON 2,973 million (up nearly 6 percent from the previous quarter) and involved mostly securities with residual maturities of five and three years, and up to one year; most transactions were concluded between banks and their clients.

The average interest rate on irreversible operations in government securities rose from 6.67 percent in March to 7.02 percent in June; operations in government securities with a residual maturity of up to one year recorded the highest interest rates (7.40 percent), whilst operations in government securities with a residual maturity of one year posted the lowest interest rates (6.19 percent).

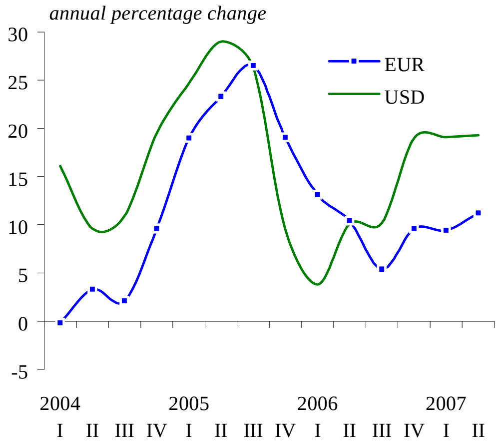
Monetary policy rate cuts and developments in interbank money market rates had an impact on lending and deposit rates, which experienced more or less significant trend changes in March-May 2007. The exception was the average interest rate on new loans, which fluctuated only marginally and reached, at the end of the period, a level similar to that seen in February (12.28 percent). By contrast, the average interest rate on new time deposits posted large swings, in both directions; however, its end-of-period level was almost similar to that recorded in February as well.

The performance of average interest rates was considerably different for the two main client categories. The average interest rate on new time deposits from households decreased slightly over the three months under review and touched 6.74 percent in May (down 0.15 percentage points from February), owing also to consecutive monetary policy rate cuts. By contrast, the interest rate on new time deposits from non-financial corporations was unusually volatile, the frequent and relatively wide swings of monthly averages being closely associated with those recorded by interbank rates. The average interest rates on

Bank Rates



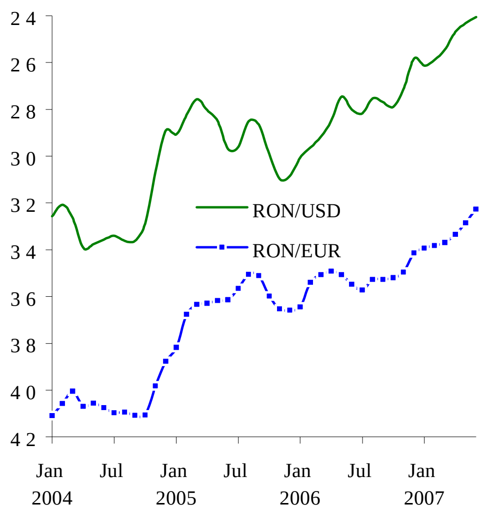
Developments of RON Exchange Rate*



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

Source: NIS, NBR

Nominal Exchange Rate



new loans to households continued its downtrend, dropping 0.89 percentage points from February, whilst the average interest rate on new loans taken by non-financial corporations increased systematically on a monthly basis to reach 12.29 percent at the end of the reviewed period.

The developments in the average interest rate on overdraft loans reflected also their increasing sensitivity to interbank rates, mainly in relation to companies (the average interest rate on overdraft loans taken by non-financial corporations standing at 13.61 percent in May – up 92 basis points from February –, after reaching a five-month high in April, i.e. 23.28 percent). Conversely, the average interest rate on overdraft loans to households was 22.36 percent at the end of the period under review, down 0.14 percentage points from February.

2.2. Exchange rate and capital flows

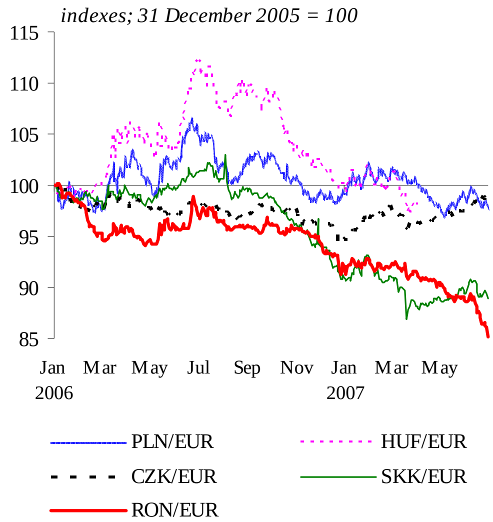
In 2007 Q2, the domestic currency posted a faster-than-expected appreciation versus the EUR. This was due to an external environment where investor appetite for risk grew higher and to increased return opportunities provided by the main segments of the domestic financial market[41], particularly by the substantial rise in interbank rates. Hence, under the impact of more sizeable capital inflows, particularly speculative ones, the RON/EUR exchange rate came under pressure and accelerated considerably its downward path starting with the latter part of April, thus temporarily exhibiting a divergent trend compared to the trajectory of other currencies in the region. Conversely, the volatility of the RON/EUR exchange rate followed a pattern similar to other currencies in the region, witnessing a slight drop.

The appreciation of the domestic currency recorded throughout 2007 H1 exceeded by far the first-quarter readings (5.8 percent in nominal terms and 7.5 percent in real terms versus the euro and 7.4 percent in nominal terms and 9.1 percent in real terms against the US dollar). Calculated as an average annual change for the reported quarter, the domestic currency strengthened further both against the euro (7.1 percent in nominal terms and 11.2 percent in real terms) and – albeit to a lesser extent – against the US dollar (14.9 percent in nominal terms and 19.3 percent in real terms).

[41] According to data supplied by the BSE, non-residents' securities purchases hit a record high of EUR 240.5 million in May.

Investor sentiment towards emerging markets in the region, the domestic market included, remained favourable in the early part of 2007 Q2, against the background of encouraging economic performance in these countries and the main central banks leaving unchanged their key interest rates. The domestic environment displayed a relative softening of the uptrend in the annual dynamics of the current account deficit, while capital inflows similar in nature to direct investments and financial borrowings, especially medium- and long-term ones, remained relatively high; amid these developments, the RON/EUR exchange rate continued its downward drift. However, the strengthening trend of the domestic currency was cushioned by larger payments on short-term external debt, basically that of banks, by the events of the domestic political scene[42] and by the changed outlook on Romania's sovereign rating by an international rating agency. Nonetheless, in the final days of the month, the downward path of the RON/EUR exchange rate steepened considerably, given that the unexpectedly brisk rise in interbank rates (see subsection 2.1. *Interest rates*) stirred non-residents' appetite for short-term placements in domestic currency. Against this backdrop, the monthly appreciation pace of the RON advanced to 1.0 percent, albeit below the readings posted by most currencies in the region[43].

Exchange Rate Developments on Emerging Markets in the Region



Source NBR, ECB

The fast-paced appreciation of the RON persisted into May as well, driven mainly by domestic incidental factors, as indicated by the occurrence and the steepening of a renewed divergent trend of the RON/EUR rate compared to the trajectories of other currencies in the region. Thus, the major determinant behind the swift strengthening of the local currency was the persistence, for an unusually long period, of high interest rates on very short-term deposits on the interbank money market, to which added investors' increased risk appetite[44]. Other possible drivers of this appreciation were (i) the upsurge in (net) foreign currency sales performed through exchange offices, hinting at a larger volume of remittances from abroad, (ii) the record-high volume of RON-denominated bonds issued on the international market and probably the purchase (at least partly) thereof by non-residents, as well as (iii) the hike in banks' short-term external liabilities. Against this background, the impact of the drop in the monetary policy rate and of the measures adopted by the central bank with a view to improving liquidity management on the money market and stabilising the corresponding interest

Key Financial Account Items (balances)

EUR million

	2006 5 mos	2007 5 mos
Financial account	**3,490**	**5,213**
Direct investments	**2,920**	**2,138**
residents abroad	-13	-18
non-residents in Romania	2,932	2,154
Portfolio investments and financial derivatives	**214**	**107**
residents abroad	123	-181
non-residents in Romania	91	288
Other capital investments	**2,294**	**3,724**
of which:		
medium- and long-term investments	182	705
short-term investments	1,012	-1,069
currency and short-term deposits	1,125	2,641
NBR's reserve assets, net ("–" increase/"+" decrease)	**-1,938**	**-755**

[42] The events related to the suspension of the President of Romania.

[43] In April, the Polish złoty, the Hungarian forint and the Turkish lira strengthened by 1.9 percent, 1.6 percent, and 1.6 percent respectively versus the euro.

[44] Investor optimism towards emerging markets was boosted by the protracted global economic upturn and by the low-cost borrowing opportunities on some financial markets.

rates fed through with a certain lag into the RON/EUR exchange rate, which hit the lowest level since October 2002 on 21 May. The decline in the RON/EUR exchange rate came to a halt as late as in the final week of the month, when liquidity conditions on the interbank money market regained their balance; in May overall, the domestic currency posted a nominal monthly appreciation of 1.5 percent.

The RON/EUR exchange rate witnessed a slightly upward movement in early June as a result of money market rates returning to normal levels and especially amid a mild correction in asset prices on emerging financial markets[45]. However, the subsequent emergence of positive signals on the robust economic growth in the major world economies and waning fears of a possible interest rate rise by the Bank of Japan[46] gave further impetus both to speculative transactions conducted by investors on emerging financial markets and to the exchange rates of the local currencies. Nonetheless, the RON/EUR exchange rate reacted more visibly than those of other currencies in the region; against this backdrop, the strengthening of the domestic currency regained momentum both as a result of domestic money market rates returning to high levels starting with 22 June and forex market operators' increased expectations of a steeper downward trend of the RON/EUR exchange rate, as the NBR retained its non-intervention strategy on the interbank forex market. Under the circumstances, the volume of non-residents' transactions on this market hit an all-time high in June, with most of these operations having a speculative nature. Consequently, in the latter half of the month, the RON/EUR exchange rate re-entered a sharply downward path, plunging on 29 June to the lowest reading since June 2002. Thus, the monthly pace of appreciation of the local currency against the euro reached a six-month high of 1.8 percent.

Over the upcoming period, the exchange rate trajectory is likely to reflect chiefly the shifts in investor appetite for risk and the high degree of attractiveness of RON-denominated placements given the still wide differential between interest rates on the domestic and world markets. However, looking further ahead, developments in economic fundamentals and the ensuing expectations might have a stronger impact on the exchange rate.

[45] The unexpected interest rate rise performed by New Zealand's central bank and the higher yields of US bonds translated into a temporary contraction of prices on emerging capital markets.

[46] In its monetary policy meeting of 15 June, the Bank of Japan decided to leave the interest rate on overnight deposits unchanged at 0.5 percent.

2.3. Money and credit

Money

In March-May 2007, although the growth rate of broad money (M3)[47] increased more slowly against the previous period (+0.6 percentage points from +4.3 percentage points), the 22.2 percent reading represented the second highest level in the past 18 months. Developments in M3 dynamics mirrored the opposing influences exerted, on the one hand, by (i) the ongoing robust economic growth and (ii) the faster rise in household incomes, and – on the other hand – by (i) the slower pace of increase of government spending, (ii) diversified financial investment alternatives for companies, (iii) higher opportunity costs of holding monetary assets included in M3[48], (iv) the wider trade deficit and (v) the accounting effects of RON appreciation. From the perspective of M3 counterparties, behind the faster broad money expansion stood only the influence of government credit[49] developments; its impact was largely offset by the effects of (i) the decelerating growth rate of private sector loans[50], (ii) the steeper decline in the balance of banks' net external assets and (iii) the brisker increase of long-term financial liabilities[51] (capital accounts excluded).

Annual Growth Rates of M3 and Its Components

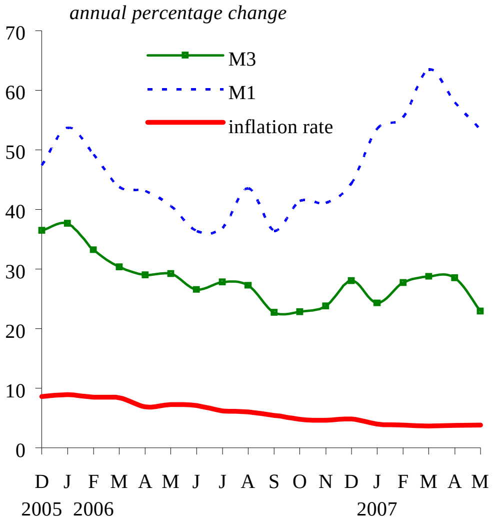
real percentage change

	2006			2007		
	II	III	IV	I	Apr.	May
	monthly average					
M3	19 8	18 9	19 2	22 6	23 9	18 5
M1	30 7	31 2	35 8	51 7	52 2	47 8
Currency in circulation	33 5	32 7	28 4	22 1	19 5	21 7
Overnight deposits	29 4	30 5	39 5	66 6	70 3	61 3
Time deposits (maturity of up to 2 years)	13 3	11 2	9 0	4 1	5 4	-1 1

Source: NIS, NBR

Except for marketable instruments[52], the annual growth rates of the key components of M3 stuck to the same trajectories as in the previous period. Thus, the pace of increase of narrow money (M1) witnessed a further step-up, with its share in M3 averaging out at 49.2 percent, a record high for the past two and a half years. The faster dynamics of overnight deposits was the sole driver of this upward path in the reported period as well; this trend was manifest for all components (RON- and forex-denominated deposits from all types of customers), underpinned

Broad Money and Inflation Rate



Source: NIS, NBR

[47] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March – May 2007.

[48] During March-May 2007, interest rates on new deposits from non-financial corporations with an agreed maturity of over two years (not included in M3) witnessed a steady rise, while those on new deposits from households further exceeded by far interest rates on new time deposits with an agreed maturity of up to and including two years.

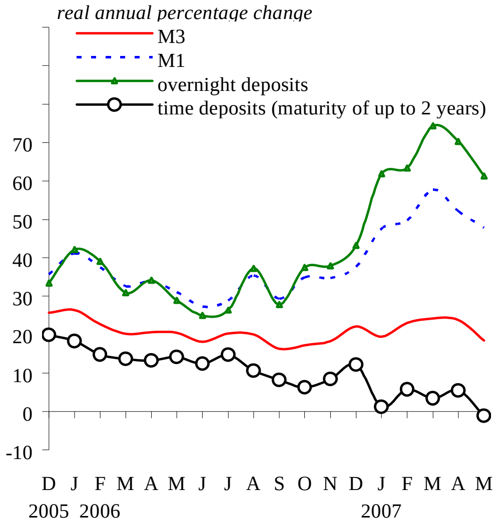
[49] Government credit (namely loans to the central government, local governments and social security funds) also includes the portfolio of government securities held by credit institutions.

[50] The private sector comprises the corporate sector (non-financial corporations and non-monetary financial institutions) and the household sector (households and non-profit institutions serving households).

[51] 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), marketable instruments issued by credit institutions with a maturity of over two years, and capital accounts.

[52] Include repurchase agreements, money market fund shares and units, and debt securities with a maturity of up to two years.

Main Broad Money Components



Source: NIS, NBR

by robust economic growth and the faster rise in household incomes. By contrast, the rate of increase of currency in circulation came to a standstill, due to the base effect generated by the change (in January 2007) in the calculation methodology for this indicator[53].

However, the growth rate of time deposits with an agreed maturity of up to two years[54] posted a steeper decline, on the back of the drop in corporate deposits and deposits from local governments and social security funds (both RON- and forex-denominated). As for the corporate sector, the development was mainly ascribable to larger payments to the government budget[55], a rise in imports volume, as well as to portfolio shifts (especially in favour of RON-denominated bonds, issued by non-residents on domestic and international markets, and government securities[56]); nonetheless, an opposite influence had the high average interest rates on new deposits from non-financial corporations. Conversely, the rate of increase 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 wages[57] and other related incomes (particularly remittances from abroad[58]), (ii) developments in banks' interest rates, (iii) the drop in household deposits with the State Treasury, and possibly (iv) the relatively slower growth of household consumption.

In its turn, the pace of increase of marketable instruments witnessed an abrupt fall, as a result of the contraction in the balance of repurchase agreements and money market fund shares[59], but also under the influence of the new statistical methodology.

[53] As of January 2007, according to Order No. 24/2006 issued by the NBR Governor 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 payment means" heading explicitly comprises currency in ATMs and automated exchange teller machines.

[54] Including deposits redeemable at notice of up to three months.

[55] During the reported period, the State Treasury balance posted exceptionally high values, reaching its second-highest level at end-May.

[56] In May 2007, the European Investment Bank launched a bond issue worth RON 300 million on the domestic capital market; furthermore, during March-May 2007, the flow of government securities held by companies re-entered positive territory, after two consecutive 3-month periods of steady decline.

[57] During March-May 2007, the average annual dynamics of net real wages hit an all-time high of 17.7 percent.

[58] Individuals' net sales of foreign currency performed through exchange offices during March-May 2007 posted the highest value since 2006 Q3.

[59] According to a press release of the National Union of Undertakings for the Collective Investment of Transferable Securities, the majority shareholder of Depfa Romania Money Market resorted to profit-taking after several years, which led to an abrupt drop in this fund's net assets at the end of the reported period.

Credit

After three consecutive 3-month periods of relative standstill, the growth rate[60] of loans to the private sector[61] slackened 1.7 percentage points during March-May 2007, posting a steeper fall in the last month of the period under review; nevertheless, the dynamics of loans to the private sector (46.0 percent) remained high from a historical perspective.

The same as in the previous 10 months, the growth rate of RON-denominated loans stuck to its downtrend (hitting an 18-month low), whereas that of forex loans kept accelerating (to an 18-month high). The determinants of these developments were the faster appreciation of the domestic currency as well as the protracted impact of the removal of any limits imposed on credit institutions with regard to exposures from forex loans[62] and of the increase in the reserve ratio on RON-denominated liabilities in the latter half of 2006. For the first time in the last six quarters, the growth rate of forex loans outpaced that of RON-denominated ones, although the share of the former in total loans to the private sector remained virtually unchanged at 48.3 percent (as period average).

On the supply side, private sector loans were further spurred by the same specific factors as in the previous quarters, namely (i) fiercer competition among commercial banks (also as a result of a larger number of credit institutions operating on the domestic market[63]), (ii) banks' favourable outlook on current and future economic developments and hence the higher degree of customer eligibility, and (iii) the relatively easy access of credit institutions to external financing[64].

Demand for loans was bolstered by (i) the still robust economic growth, (ii) stronger rise in household income, (iii) the cut in lending rates on certain categories of new household loans (particularly RON-denominated, but also EUR-denominated housing loans), and (iv) the faster appreciation of the domestic currency and expectations of further strengthening. The latter two consequences also spurred household investments in real estate assets, as indicated by the steady rise in the share of long-term loans in total loans to households (70.8 percent in May, from 67.7 percent in February) and by the stronger dynamics of

[60] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March-May 2007.

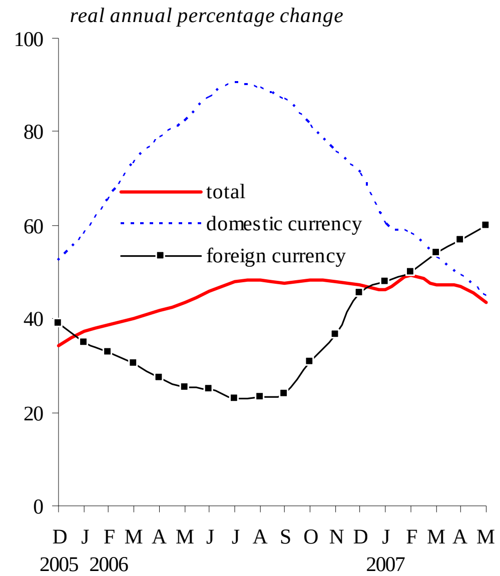
[61] The private sector comprises the corporate sector (non-financial corporations and non-monetary financial institutions) and the household sector (households and non-profit institutions serving households).

[62] Norms No. 11/2005 on containing exposure from foreign currency-denominated loans were repealed as of January 2007.

[63] Until end-May, some 52 non-resident credit institutions had notified the NBR of their intention to directly provide services in Romania.

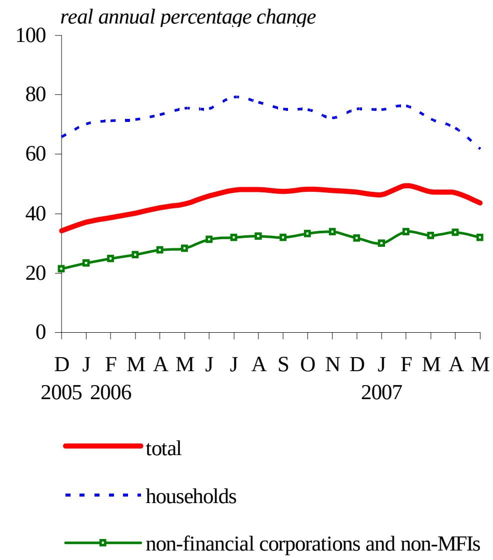
[64] The stock of credit institutions' forex-denominated external liabilities represented almost three fourths of the stock of forex loans to the private sector.

Credit to Private Sector
by Currency



Source *NIS, NBR*

Credit to Private Sector
by Institutional Sector



Source *NIS, NBR*

housing loans[65] to the detriment of consumer loans (although their pace of increase remained the fastest).

However, the impact of these factors on private sector loans was more than offset by the dampening effects of (i) companies' increased resort to foreign borrowings[66] and/or financing via sales of bonds or shares[67] (although the level of direct financing remained subdued), but especially of (ii) the stronger household propensity for saving (also mirrored by the advance to 21.2 percent – a record high for the past 18 months – in the dynamics of total household time deposits), (iii) the likely postponement of individuals' decisions to borrow in anticipation of looser lending conditions[68], as well as (iv) the potential decline in the indebtedness capacity of low-income households.

Against this backdrop, developments in household loans were the main determinant of the slower growth rate of private sector loans. The marked deceleration in the dynamics of loans to households (by 8 percentage points to 67.4 percent) was reflected solely by its RON-denominated component, whose pace of increase was affected, among others, by the high interest rates on new consumer loans and bank overdrafts during the reported period.

However, the growth rate of corporate loans slightly regained momentum, exclusively due to the acceleration in the expansion rate of its forex-denominated component, also backed by lower associated costs (at least in the case of EUR-denominated loans, the strengthening of the domestic currency offset the slight advance in lending rates on new business to non-financial corporations). In contrast, the dynamics of the stock of RON-denominated loans decelerated considerably, both as a result of higher average lending rates on new business to non-financial corporations and possibly the repayment of a larger volume of loans.

The expansion pace of credit to the public sector stayed on a sharp upward path for the second consecutive period, despite the relative reduction in budget spending dynamics.

[65] 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. 13/2006.

[66] According to balance-of-payments data, in March and April 2007, the monthly average value of non-banks' external financial borrowings was higher than the December 2006 – February 2007 reading.

[67] The growth rate of securities issued by companies (marketable securities, shares and equity stakes) and purchased by credit institutions accelerated further.

[68] According to NBR Regulation No. 3/2007 on limiting credit risk associated with loans to households, effective as of March 2007, the indebtedness ceiling and collateralisation conditions are set by credit institutions (including non-monetary financial institutions), based on their own norms, which must be approved by the NBR; at the end of the reported period, this process was still in its early stages.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the 12-month inflation rate at 3.9 percent for end-2007, 0.2 percentage points above the figure published in the May 2007 Inflation Report. The forecasted level for end-2008 is half a percentage point lower than the previous projection, i.e. 3.7 percent versus 4.2 percent.

The revision of the projection is attributed to projections differing from those in the previous scenario in respect of relevant influencing factors. For 2007, significant differences stem from faster projected growth rates of volatile prices for some food items, of administered prices and of fuels. Such adverse effects will be to some extent offset by the faster downturn in import prices amid anticipations of a substantially higher RON appreciation than in the previous forecast. For 2008, the downward revision of the inflation forecast is due to the favourable short-term influences generated by the slower projected adjustment of administered prices and the relatively larger demand deficit in the latter part of the forecast horizon. These influences prevail over the moderate adverse effects exerted by the stronger increase in fuel prices compared to the market conditions prevailing at the time the forecast was made.

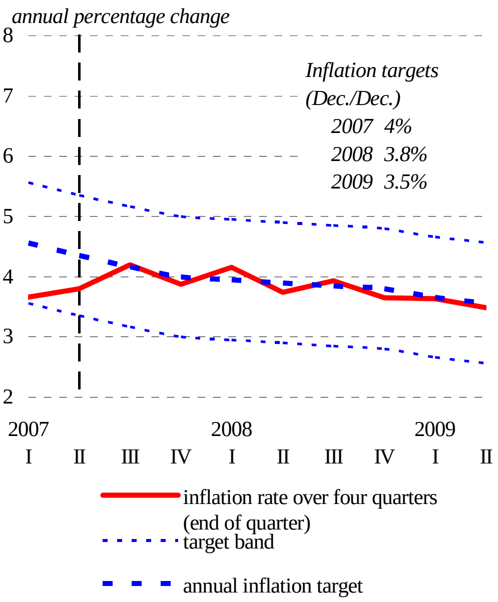
Starting from an estimate indicating a second-quarter GDP deviation similar to that incorporated in the previous forecast, the current projection foresees relatively tighter broad monetary conditions than those previously projected for 2007-2008, owing chiefly to stronger appreciation of the domestic currency in the first part of the forecast horizon. The higher restrictiveness of monetary conditions is consistent with the programmed gradual elimination of excess demand and with the downtrend of the projected annual inflation rate at end-2008 (3.7 percent) against end-2007 (3.9 percent), unlike the trajectory presented in the previous Inflation Report, which indicated a pick-up in inflation in 2008 (4.2 percent from 3.7 percent in 2007).

The main risks to the current projection which, should they materialise, would divert inflation from the projected path, arise from the significant uncertainties regarding the rate of wage increases compared to productivity gains, the fiscal policy stance over the short and medium term, future dynamics of capital flows and their impact on the current account deficit and on the RON exchange rate. Other risks, usually associated with the projections, refer to uncertainties surrounding the 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

Inflation Forecast



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

According to the baseline scenario, the annual consumer price inflation is projected to stay very close to the central target over the entire forecast horizon, reaching estimated levels of 3.9 percent at end-2007 and 3.7 percent at end-2008. The projected path of the annual CPI rate is higher for the current year and lower for next year, compared to the forecast published in May 2007 Inflation Report. The disinflation process will temporarily stagnate until the first quarter of 2008 (the estimated deviations from target will however be of low magnitude), but afterwards it will stick to the path of the decreasing annual targets.

Table 5.1. Annual inflation rate (end of period)

percent

Period	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2
Target		4.0				3.8		
Forecast	4.2	3.9	4.2	3.7	3.9	3.7	3.6	3.5

The projected annual CPI inflation rate returns close to the central target at the beginning of the forecasting period. The increase expected for 2007 Q3 originates in a base effect (as a result of dropping the sharp deflation recorded by highly volatile prices in the third quarter of 2006 from the computation of year-on-year inflation) augmented by the unfavourable impact of drought on food prices. End-of-year inflation rate is anticipated to be 0.1 percentage points below the central target. The disinflation process is forecasted to continue over the forecast horizon (until 2009 Q2).

At the beginning of the forecast horizon (2007 Q3), the estimated annual inflation is 0.5 percentage points higher than that projected in the May 2007 Inflation Report. Behind this reassessment stood the following:

– an upsurge in the volatile prices of some foodstuffs, namely fruit and vegetables, as a result of the drought;

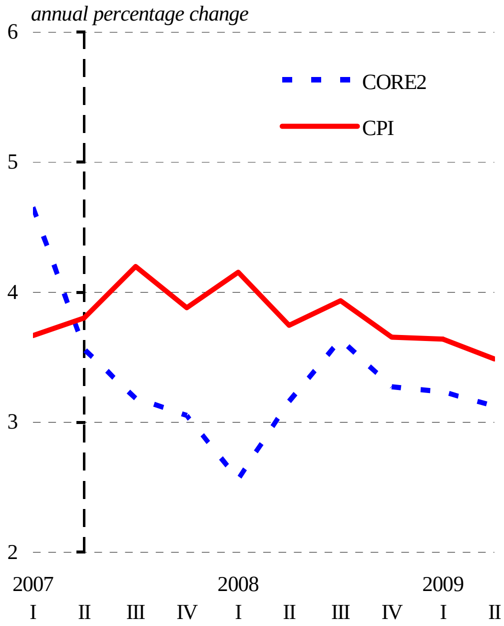
– a higher-than-previously-expected increase in administered prices, largely as a result of the hike in rents set by local governments (up 320 percent in May);

– a rise in the international oil price (by about USD 10 per barrel), which translates into a higher growth rate of the domestic fuel prices, the nominal appreciation of the RON notwithstanding.

At the same time, the projected CORE2 inflation rate is lower than in the previous forecasting round, thereby cushioning the exogenous inflation flare-up in 2007 Q3.

The current baseline scenario anticipates CORE2 inflation rate levels below those of CPI inflation over the projection horizon. The projections are lower than those published in the May 2007 Inflation Report due to the stronger-than-forecasted deflation of import prices and smaller-than-forecasted core inflation in 2007 Q2. The reduction in the annual CORE2 inflation down to 2.6 percent[69] in 2008 Q1 will primarily be the result of favourable developments in import prices following the tight real broad monetary conditions, consistent with the envisaged ongoing real appreciation of the RON against the major currencies over the longer term. Furthermore, the projected elimination of excess demand in early 2008 is seen contributing to the lowering of inflationary pressures. Following this year's drought, the anticipated price increases – especially in case of bakery products – will cause decelerating disinflation.

CORE2 and CPI



Starting with 2008 Q2, the favourable impact of import prices on disinflation will cease, bringing about a projected upturn in CORE2 inflation, despite the favourable contribution of a larger demand deficit. Moreover, the hike in excise duties on cigarettes and tobacco products, which is projected to add 0.7 percentage points to CORE2 inflation in 2008 Q2 and Q3, and the pass-through of inflationary effects stemming from the poor agricultural crops until 2008 Q2 could entail a moderate reversal in the disinflation trend at mid-2008. The increase in the favourable impact of the demand deficit, along with the base effect due to an average agricultural year in 2008 as compared to a below-average agricultural year in 2007, will lead to the expected resumption of disinflation recorded by the CORE2 index starting in 2008 Q4.

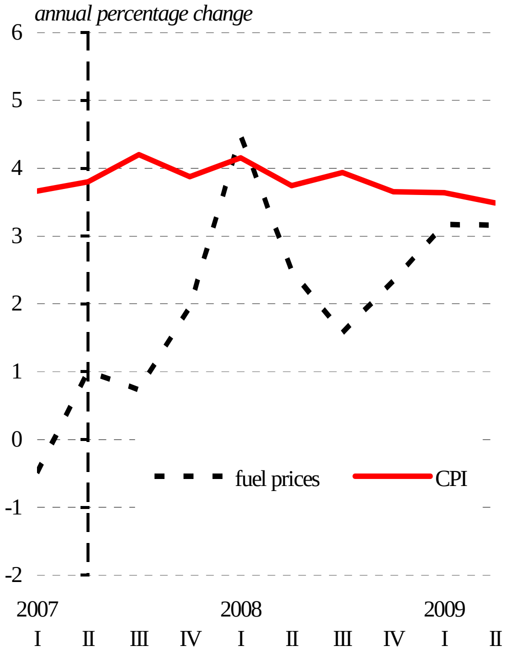
Considering the relatively low projected fluctuations of headline inflation, inflation expectations are foreseen to have a quasi-neutral impact on disinflation.

The hikes in administered prices remain the main source of inflationary pressures in the current baseline scenario. The annual change in such prices outpaces that of consumer prices throughout the projection horizon. Given that some adjustments, especially in energy prices, were rescheduled for the final quarter of 2007 and for 2008 or delayed for 2009-2010, the projected rises in administered prices will be 6.4 percent at end-2007 and 5.6 percent at end-2008.

[69] All real annual inflation rates for CPI components are calculated as a ratio of price averages in the quarter under review and their averages in the same quarter a year earlier.

The trajectory of volatile prices of some food items (vegetables, fruit and eggs) is distorted by the anticipated drought effects and a base effect in 2007 Q3[70], taking their projected annual growth rate to about 7.3 percent at end-2007. For 2008, assuming that agricultural production would not be affected by major shocks, the forecast of prices for vegetables, fruit and eggs is largely similar to that of consumer prices, i.e. 3.7 percent.

Fuel Prices and CPI



The projection for domestic fuel price movements rests on the assumption that throughout the forecast horizon the international oil price remains at its average expected for 2007 Q3. Even though the assumption is less optimistic than the figures released by Consensus Forecast in June, the insufficient rise in global supply of petroleum products substantiates a scenario under which the Brent oil price remains above USD 70 per barrel. Furthermore, the projection incorporates excise duty adjustments to certain fuel types that were envisaged by the Tax Code to be implemented at the beginning of 2008, 2009 and 2010. Nevertheless, projected inflation of domestic fuel prices is lower than the consumer price change as a result of the ongoing real appreciation of the domestic currency.

Import prices benefit in the first part of the projection horizon from the nominal appreciation of the domestic currency (5.8 percent January through June 2007); this will help mitigate inflationary pressures induced by excess demand. The strongest favourable impact of import price developments on 12-month CPI inflation is expected to become manifest in 2007 Q4. For the latter part of the projection horizon, the anticipated gradual reduction in pressures for a stronger RON, along with euro area inflation staying close to 2 percent, will steadily weaken the disinflationary potential of import price dynamics – import prices will then have a neutral impact and finally a slightly inflationary effect over the final quarters of the current projection.

[70] This base effect is generated by the reference to the sharp deflation in prices for vegetables, fruit and eggs recorded in 2006 Q3.

1.2. Exogenous inflationary pressures

The cumulative effect of exogenous components of consumer price inflation (administered prices, some volatile prices of food items, excise duties on cigarettes and tobacco products) anticipated for 2007 is 0.2 percentage points higher in the current baseline scenario than in the previous projection, whereas that for 2008 is expected to be 0.3 percentage points lower.

The expected hikes in administered prices are higher than previously projected. They exceed the previous projection by 0.7 percentage points for the current year, i.e. 6.4 percent compared to 5.7 percent[71], but are 1.4 percentage points lower in 2008, i.e. 5.6 percent compared to 7.0 percent. This year's larger-than-projected change was mainly ascribed to the 320 percent increase in rents set by local governments. Lower-than-projected price increases are expected for all energy prices over this year and, except for heating, over the next year as well. In addition, some of the rises anticipated in the May Inflation Report were postponed for 2009-2010, entailing potential inflationary effects that go even beyond the current projection horizon. Table 5.2 sets out the developments in energy prices, the key component of administered prices. Despite the lower-than-programmed adjustments, administered prices will continue to grow faster than the other components of consumer prices, triggering significant inflationary effects over the entire projection horizon.

Administered Prices and CPI

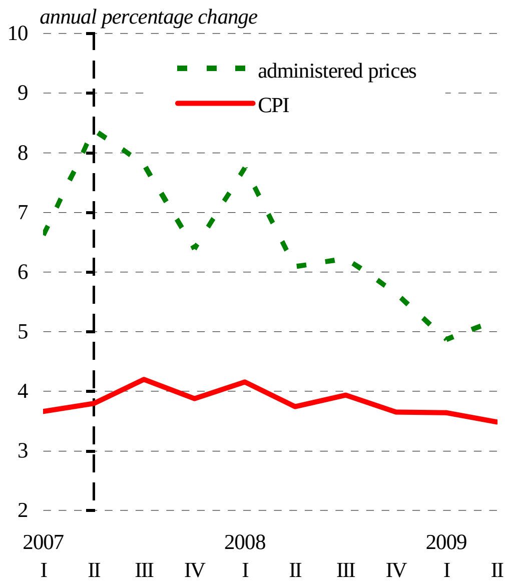
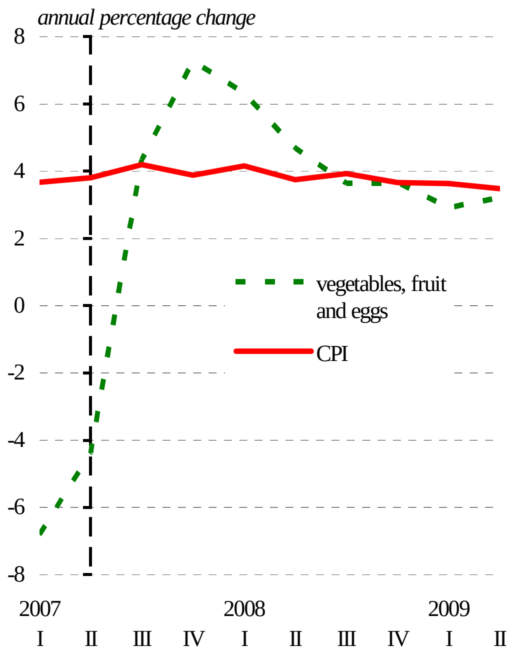


Table 5.2. The scenario for developments in key administered prices

percent

	Electricity		Heating		Natural gas	
	2007	2008	2007	2008	2007	2008
Current projection	4.2	4.2	12.3	11.4	-0.6	12.5
Previous projection	6.1	7.1	19.1	9.3	1.3	17.9

Vegetables, Fruit and Eggs Prices and CPI Inflation



The scenario regarding the volatile prices of some food items, i.e. those for vegetables, fruit and eggs, incorporates a growth rate higher than that envisaged in the previous projection for 2007 and similar to that for 2008. Similarly to the previous projections, the change in prices for vegetables, fruit and eggs displays a strong seasonal pattern, with high positive levels being expected for Q1 and Q4 and negative levels (deflation) anticipated for Q3 of each year. For 2007, the forecast of highly volatile prices exceeds that of consumer prices, being driven by the anticipated decline in agricultural production due to the

[71] The ratio of the average of administered prices for Q4 to their fourth-quarter average a year earlier.

drought and by the low base effect caused by the significant price declines recorded in 2006 Q3.

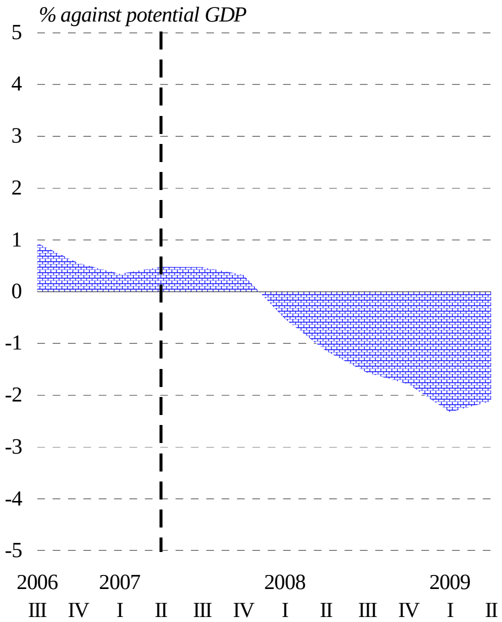
The scenario for tobacco products and cigarette price inflation is constructed in view of the calendar for bringing excise duties in line with those in the European Union[72]. Compared to the previous baseline scenario, the expected price increases are similar in 2007, higher in 2008 and lower in 2009 following the revision of the exchange rate employed for assessing the RON value of the excise duty, more precisely its specific tax component which is EUR-denominated.

According to the figures published by Consensus Forecasts in June, the anticipated inflation rate for the euro area is higher than that previously announced for both 2007 and 2008 (2.2 percent against 2.0 percent and 2.0 percent from 1.9 percent respectively). In line with the Monthly Bulletin published in July 2007, the ECB expects inflation to fluctuate around 2 percent, close to the quantitative definition of price stability[73]. Despite the benign developments in euro area inflation, the risks of an escalation of aggregate prices remain significant. The ECB cites robust economic growth, wage rises in excess of labour productivity gains and loose fiscal policy in some Member States as the major sources for inflationary pressures. As a result, the envisaged trajectory for the EURIBOR rate is higher than that published in the previous Inflation Report.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

GDP Deviation



The statistics released by NIS on real GDP for 2007 Q1[74] show a slower growth rate than in the previous quarter, at a level below the previous forecast. The slowdown was caused by a temporary reduction in net taxes on product as a result of the amended legislation on VAT (see the Box). As the impact of this measure on budget revenues is not permanent and, consequently, it does not automatically imply lower inflationary pressures induced by aggregate demand, the excess demand for the current quarter was assessed under the assumption of a neutral effect of the above-mentioned legal amendment. Even under these circumstances, the growth rate of real GDP would be lower than those seen in the previous quarters, which led to a

[72] Stipulated in Directive 59/1995/EC, as supplemented by Directive 10/2002/EC, and transposed into Romanian legislation by Law No. 343 of 17 July 2006 amending the Tax Code.

[73] The ECB's Governing Council defines price stability as the annual change in the harmonised index of consumer prices for the euro area by less than 2 percent.

[74] See Chapter III. *Economic developments*

downward revision of excess demand compared to the level considered in the previous forecasting round.

In 2007 Q2, the annual growth rate of real GDP[75] is expected to revert to readings close to those recorded in 2006, without, however, measuring up to either those levels or the previous forecasts. Weather and hydrological conditions April through June, as well as forecasts for the remainder of 2007 point to drought. From a macroeconomic point of view, drought acts as a negative aggregate supply shock, along with its direct impact on some categories of volatile prices. The drought-induced shock leads to a temporary slowdown in GDP growth owing to the poor performance of agriculture; however, given the simultaneous drop in the agricultural potential, the shock does not imply a reduction to the same extent in excess aggregate demand on account of this sector. In Q1, the interest rates applied by commercial banks and the exchange rate sent a restrictive impulse to excess demand in the following period, with the monetary conditions in the first part of 2007 leading to lower inflationary pressures in the quarters ahead. Due to the uncertainties surrounding the events that took place in Q1, the assessment of excess demand in Q2 is maintained close to the level seen in the previous quarter.

Household actual final consumption remains above its medium-term trend, notwithstanding the expectations of a slight slowdown in its quarterly dynamics versus 2007 Q1, owing to the drought. Nevertheless, this dynamics remain high, fuelled by the hefty wage hikes and the further decreasing unemployment rate. The public budget, which recorded a surplus of 0.16 percent of GDP at end-May, has an almost neutral influence on aggregate demand in the short run.

Gross fixed capital formation remains above the medium-term trend, with the forecast for 2007 Q2 pointing to a return to higher growth rates after the relative slowdown in 2007 Q1. Real medium- and long-term credit for economic agents, one of the main sources of investment financing, continued to grow at a fast pace in the first two months of Q2. The weight of capital goods imports in total imports has been increasing slightly over the recent periods, again suggesting a level of gross fixed capital formation above its medium-run trend.

The same as in the previous quarters, imports continued to grow fast, further exceeding the trend. The deviation from the medium-term trend is brought about by developments in the

[75] Data on real GDP are seasonally adjusted.

factors fostering household disposable income, such as real wage, the economy-wide number of employees and credit to households. In view of the dynamics recorded in 2007 Q1, as well as of developments expected for Q2, exports are also seen surpassing the medium-term trend, emphasizing at the same time the structural changes substantiating the long-lasting adjustment of the supply of export-oriented sectors to the new conditions on the international markets. However, overall, the persistent gap between the growth rate of imports and that of exports further causes net exports to have a downward impact on aggregate demand, despite the dilution of its restrictive nature through the wealth and balance sheet effects of both companies and households.

1.3.2. Implications of recent exchange rate and interest rate developments

In 2007 Q2, the domestic currency continued to strengthen in both nominal and real terms[76], the gains recorded in the first two quarters being considerably more pronounced than those in 2006.

The continuation of a faster appreciation rate is due to the cumulative effect of several factors manifest in the first part of the year, the most significant being: (i) the favourable outlook on economic growth and inflation developments, (ii) the liquidity deficit emerging sporadically on the interbank market during the first two quarters with spill-over effects on the foreign-exchange market, and (iii) the existing appreciation trend at regional level amid the tendencies of closer correlated movements in the exchange rates of the RON and of other currencies in the emerging economies in Central and Eastern Europe as well as of increased liquidity on local forex markets. The uncertainty surrounding the duration and the impact of these influences is high. For example, the appreciation trend of national currencies in the region is also a result of these investments being seen as an alternative to deposits in international currencies, as they are considered to provide at present a favourable trade-off between investors' yield and risk requirements.

The real appreciation of the domestic currency in 2007 Q2 causes the impulse sent to real economy to have a restrictive effect on aggregate demand and implicitly on future inflationary pressures through the net export channel. The exchange rate of the domestic currency also has a direct influence on inflation

[76] The effective exchange rate of domestic currency is based on the RON/EUR and RON/USD exchange rates, the weighing system illustrating synthetically the significance of the two currencies for Romania's foreign trade.

via import prices, which, in case of appreciation, tend to go down leading to a further decrease in inflation. On the other hand, given the significant weight of non-government credit denominated in foreign currency, the exchange rate has, through wealth and balance sheet effects, an influence contrary to those mentioned previously; in this case, appreciation brings down the costs related to foreign currency borrowing, thereby giving a boost to aggregate demand. All things considered, the net effect of domestic currency strengthening in Q2 consists in a relative consolidation of the restrictive impact of the exchange rate.

Over the medium run, the exchange rate is driven by fundamentals (productivity differential against major trade partners, medium- and long-term capital inflows). Taking into account Romania’s real economic convergence with the euro area, the RON shows a normal real appreciation trend in the longer run. Under the influence of various factors relevant for the short run, the exchange rate may deviate temporarily from the trajectory driven by fundamentals to which it tends, however, to revert after the phasing-out of incidental effects.

In 2007 Q2, the NBR lowered again the monetary policy rate, reaching 7 percent at end-June. During the quarter under review, commercial banks resorted to a less extent to the deposit facility amid the persistence of a liquidity deficit on the interbank market in April and May. The significant sterilisation of excess liquidity removed the gap between the monetary policy rate and the average interest rate on the commercial banks’ deposits with the central bank, which became manifest in 2007 Q1, the latter being slightly above its level in the previous quarter. As a result, the NBR’s real policy rate decreased solely due to the slight rise in inflation expectations, the restrictive impulse sent by the NBR’s real interest rate to the economic activity being similar in terms of magnitude to that in the previous period.

The average interest rate applied by the central bank to commercial banks’ deposits influences the economy indirectly through commercial banks’ deposit and lending rates. These rates are usually subject to gradual adjustments to the changes in the monetary policy rate. Nevertheless, in Q2, possibly owing to the liquidity conditions on the interbank market, commercial banks’ deposit and lending rates followed closely the dynamics of the central bank’s interest rate; in addition, as a response to the sporadic emergence of liquidity deficits on the interbank market and with a view to alleviating the changes in short-term interest rates on this market, the central bank made liquidity injections for the first time in the last five years during the quarter under review. Thus, both lending and deposit rates posted slight increases in the reviewed period. However, most nominal rates were offset by the modest increase in inflation expectations so that the real interest rates applied by commercial banks remained roughly unchanged from the previous quarter. Under the circumstances, the impulse sent by real interest rates had the same magnitude as in 2007 Q1, *ceteris paribus* maintaining its restrictive effect on economic activity.

Overall, in Q2, the real interest rates on RON-denominated deposits and loans remained close to the levels seen in the previous quarter, with the restrictive impulse passed through to the economy having almost the same magnitude as in Q1. The real appreciation of the domestic currency in Q2 caused the restrictive impulse sent to the economy via the net export channel to broaden. This restrictive impact of the strengthening of the RON is somewhat alleviated by the stimulating impulse due to the wealth and balance sheet effect. Overall, in the quarter under review, the cumulative effects of interest rates and the exchange rate enhance, in relative terms, the restrictive pressure exerted on aggregate demand and 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 path until 2009 Q1. The main driver behind the elimination of excess demand by early 2008 is the restrictive effect of real monetary conditions, with the projected level of the real effective exchange rate, alongside the interest rate, making a significant contribution in this respect.

As compared with the previous forecasting round, aggregate demand pressures are expected to be slightly higher in 2007 and lower in 2008 Q1 – 2009 Q2. At the beginning of the projection horizon, excess demand is forecasted to stay close to the level reported in the May 2007 Inflation Report, despite the anticipated slowdown in economic growth versus the previous projection, taking into account that this is assessed to be the result of one-off factors. Therefore, the slower economic growth reported by the National Institute of Statistics in 2007 Q1 is mainly attributable to indirect tax collection issues, without inflicting upon the dynamics of gross value added or the performance of key aggregate demand components, whose dynamics have remained buoyant (see the Box below). Another one-off factor is the drought, which *ceteris paribus* entails a slower pace of economic activity (owing to the agricultural production) as well as supply-side upward pressures on prices for agricultural products. At the same time, drought may exert demand-side effects on market prices in several ways, as follows: (i) the drought-induced negative shock on aggregate supply tends, *ceteris paribus*, to increase excess demand, thus having a potential impact on aggregate price dynamics, not only on that of volatile prices; (ii) farmers' incomes tend to decrease, but the large share of self-consumption in total agricultural output acts towards containing direct and persistent pressures on market prices; (iii) the partial compensation of farmers' income losses either via payments from the government's reserve fund or the independent allocation for consumption of a larger part of remittances from abroad. Moreover, factors pushing demand-side pressures higher are manifest in the first part of the forecast horizon, special mention deserving the surge in incomes reported by other economic sectors (see also Section 1.4 of Chapter V).

The driver behind the programmed elimination of excess demand and the gradual opening of a demand deficit in early 2008 is the restrictive effect of real monetary conditions, with the real effective exchange rate making a significant contribution in this respect. The anticipated real appreciation is stronger than in the previous projection, as shown by wider demand deficits starting with the first quarter of 2008. The output gap dynamics is also accounted for by the restrictive effect of fiscal policy in the second part of the forecast horizon, according to the currently envisaged official budget co-ordinates.

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. Despite the monetary policy rate cut, the recent RON appreciation against the major currencies entailed an increase in the restrictiveness of real monetary conditions. Besides the expected productivity gains, the still high liquidity level on international markets as well as the improvement in the sovereign risk assessment after the country's EU accession maintain Romania among the preferred destinations for emerging market foreign investment. This trend is reflected by the real exchange rate appreciation which is forecasted to continue until the end of the projection horizon, being more pronounced however in its first part.

The real interest rates projected for 2007 are less restrictive than in the previous Inflation Report, their dynamics being consistent with the monetary policy rate cuts implemented during the time period elapsed since the previous forecasting round. However, more constraining effects on aggregate demand are expected to be manifest throughout the remaining projection horizon. The decline and stabilisation of inflation and the increased competition among banks are both supportive of the projected fall in commercial bank interest rates by early 2009, as well as of a narrower spread between deposit and lending rates.

Based on similar budget deficit co-ordinates to those in the previous forecasting round, the assessment of fiscal policy impact for the projection horizon changes marginally, due to revised estimates of the cyclically-adjusted budget balance. The most significant change is in 2008, when the wider-than-previously-projected demand shortfall implies that the decline in budget deficit from 2.8 percent to 2.7 percent of GDP entails a stronger cyclically-adjusted fiscal tightening than previously forecasted. In 2008 and 2009, the impact induced by a higher forecasted cyclical deficit is however partially offset by a slightly improved projection of the European funds absorption, taking into account, as an informative term of comparison, the preliminary estimates on the absorption of structural funds in the countries that joined the EU in 2004. Similarly to the previous forecasting round, a stimulative fiscal impact on excess demand is expected for 2007, which contributes to its persistence by early 2008.

According to the current projection, economic growth is expected to be lower than in the previous Inflation Report for the current year and slightly higher in 2008. The forecasted economic growth reduction in 2007 is the result, on the supply-side, of the projected drought-induced contraction of activity in agriculture, as well as that of the slower dynamics of net taxes on products owing to Romania's joining the EU. On the demand side, the growth rate of GDP will be most significantly affected by the dynamics of net exports, given their forecasts for 2007 and particularly 2008. The main driving force behind this development will be the risk of a widening negative deviation of the real exchange rate from its level determined by medium-term fundamentals. Export dynamics, albeit lower than the forecasted boost in imports, will remain robust according to estimates, fostered by investment in retooling and the ongoing shift of export production to goods and services with higher value added, as well as by the improving demand outlook for imports from EU partners, as the share of Romania's exports in total EU trade have until now posted slight increases. Domestic demand components will continue to expand at a fast pace in the period ahead, which is however expected to slow down as compared to the previous year's high levels. Household consumption will be spurred by the substantial wage increases in 2007 as well as by the likelihood of a persistently high growth rate of household incomes throughout the current projection horizon (considering both the expected rise in pensions and further significant wage increases in the government sector). The evolution of real interest rates, particularly those on loans in both domestic and foreign currency (the latter on the account of the tighter ECB monetary policy stance), will have an opposite effect. Their restrictiveness is expected to be maintained over most of the forecast horizon, in spite of the gradual reduction in nominal interest rates. The prospects of buoyant investment dynamics is supported in the near run by the significantly favourable trend recorded by the construction sector in the first part of this year. In the medium run, a more important role can be attributed to the anticipated implementation of large-scale investment projects, including also the multiplication effects arising from the start of accessing the EU structural funds.

Box

Adjustment of GDP growth in 2007 Q1 by the impact of the change in legislation on VAT collection

According to data released by the National Institute of Statistics, the annual GDP growth for 2007 Q1 stood at 6 percent, despite the 8.1 percent advance in gross value added, the difference between the two figures being generated by the negative contribution of net taxes on product. Behind this development stood the changes in VAT collection following Romania's accession to the EU, more precisely the permission to delay by up to 60 days the VAT payment for imported goods until they are sold or re-exported. As a result, the first quarter of 2007 saw a sharp decrease in VAT receipts, which thus represents only a delay in VAT collection by the government. Starting with April 15, the legislation was amended so as to allow customs collection of VAT on non-EU imports (which nevertheless hold less than 30 percent of total import value).

Owing to the temporary impact of this measure on budget revenues (VAT collection was only delayed from the moment of customs entry of imported goods until their being re-exported or sold in Romania), the assessment of excess demand in 2007 Q1 was made on the basis of a neutral effect attributed to the above-mentioned amendment in legislation. Based on a theoretical simulation, a more regular development in the value of collected taxes and the rise in budgetary subsidies in 2007 Q1 would have induced an economic growth higher by at least one percentage point than that reported by the NIS.

Other countries in the region also experienced a drop in VAT receipts around the date of their EU accession. Table 5.3 shows the percentage change in the value of budget revenues in Romania, the Czech Republic, Poland, Slovakia, Slovenia and Hungary.

Table 5.3: Changes in budget revenues following EU accession

Country	Period	Value changes of collected taxes (%)		Annual change in real GDP (%)	
		Receipts from taxes and duties	VAT	quarter prior to accession	quarter subsequent to accession
Romania	2007 Q1/2006 Q1	5.5	-21.7	7.7	6.0
Czech Republic	2004 Q2/2003 Q2	-2.9	-26.4	4.4	4.6
Poland	2004 Q2/2003 Q2	2.3	-5.2	5.8	3.8
Slovakia	2004 Q2/2003 Q2	2.1	2.7	5.4	5.2
Slovenia	2004 Q2/2003 Q2	3.8	-8.6	4.6	5.0
Hungary	2004 Q2/2003 Q2	-7.6	-26.9	5.1	4.9

***Source**: websites of the ministries of finance of the aforementioned countries; Eurostat.*

***Note**: Data on Romania and the other countries are not entirely comparable due to the fact that the latter joined the EU on 1 May 2004, which means that their budget revenues were affected by changes in the tax legislation for only two months out of three of the first post-accession quarter. Furthermore, VAT data in Slovakia were influenced by the implementation on 1 January 2004 of a single VAT rate of 19 percent which replaced the differentiated rates of 14 percent and 20 percent respectively.*

1.4. Risks and uncertainties surrounding the projection

Aside from the baseline scenario of the projection, the quarterly review of the macroeconomic outlook also took into account the most salient risks to the current projection. Thus, the uncertainties most likely to alter the forecasted inflation path include:

– the likely maintenance of a fast-paced increase in corporate wage costs;

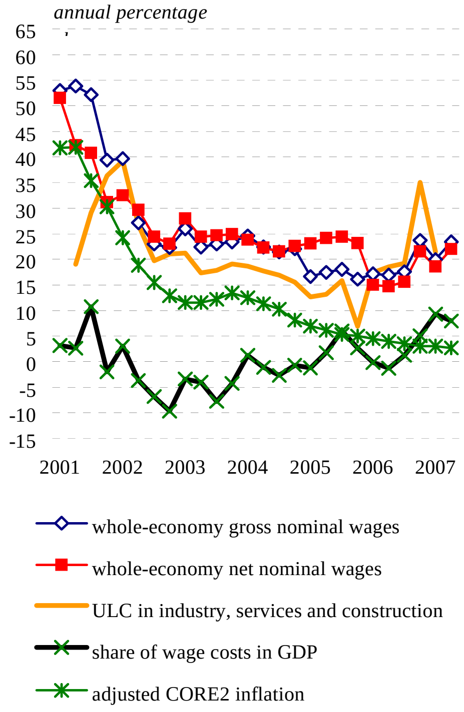
– possible changes in the fiscal policy stance and in the administered price adjustment calendar;

– future exchange rate developments, as the influence of domestic macroeconomic conditions and especially that of the international environment are fraught with uncertainties.

The recent periods have witnessed an acceleration of wage growth compared, on the one hand, with the similar periods of last year and, on the other hand, with the growth rates of aggregate prices and labour productivity. Thus, in 2007 Q1, the annual pace of increase of real ULC – approximated as the ratio between the economy-wide nominal gross average wage and nominal GDP per employee – stood at approximately 9.3 percent, compared to the 0.18 percent drop seen in 2006 Q1. This development points to rising pressure on companies in terms of labour costs. Furthermore, it reflects the persistence over the short run of demand-pull pressures on consumer prices (via stronger demand for products => higher demand for labour => higher wages => higher corporate costs overtaking the dynamics of labour productivity => heightened upward pressures on prices). However, an analysis of inflation rates in 2007 H1 (particularly adjusted CORE2 inflation rates) shows that, over the short run, the influences on aggregate prices exerted by the faster wage dynamics and by the persistence of excess demand were offset by several factors fostering disinflation, such as the significant strengthening of the RON during January-June, the still high competitive pressures induced by imported goods and services on domestic products (augmented as a result of Romania's accession to the European Union), as well as the improving inflation expectations following the low inflation rates recorded in the recent past. Nonetheless, the prospects of a persistent mismatch between wage increases and productivity gains entail inflationary risks in the medium term, because the offsetting effect of the above-mentioned factors cannot be warranted over such a long horizon, not even amid the increased restrictiveness of the monetary policy stance.

One of the likely consequences of such a risk materialising would be the delayed elimination of excess demand compared to the

Average ULC



Source NBR calculations based on NIS data; estimate or forecast for Q2.

period indicated in the baseline scenario, given that average gross wage hikes would feed through into fast dynamics of household disposable income[77]. These developments could lead to an excessive increase in household consumption, outpacing the growth potential of the economy. Such effects could occur either directly or indirectly, by spurring the demand for consumer loans, given that larger incomes make such financing sources more readily available in terms of both the eligibility of a greater number of potential debtors and higher creditworthiness of individual debtors. The persistence of excess demand into 2008 would generate, *ceteris paribus*, a significantly higher inflation than that forecasted in the baseline scenario.

Taking into consideration that the public sector accounts for approximately 20 percent of total employees registered with the National Institute of Statistics and it is the main supplier of incomes for several other social categories (pensioners, unemployed, other recipients of welfare benefits, etc.), government policies related to wages and social transfers play a direct role in shaping developments in aggregate demand economy-wide[78]. A major risk in this respect is the potential loosening of public spending, including over the election periods. This year's budget execution seems to be confronted with somewhat more benign risks, as the relatively considerable increase in staff costs and transfers could be backed by higher budget revenues generated by a cyclical broadening of the tax base (given the excess demand forecasted until the end of the year)[79]. For 2008, however, the programmed deficit cut from 2.8 percent to 2.7 percent of GDP will prove more difficult to achieve, taking into account the envisaged elimination of excess demand starting with 2008 Q1. This elimination could entail a cyclical slowdown in the dynamics of budget revenues which, linked with the planned reduction in social security contributions, assumes that the deficit target could only be attained through a smaller share of budget expenditures in GDP. On the other hand,

[77] The rise in household disposable income is attributed not only to higher net wages, but also to higher pensions, given that the latter are calculated based on the developments in the average gross wage economy-wide.

[78] According to the latest IMF study on Romania (Costas Christou, *Romania: Selected Issues – Section II: Wage Dynamics in the Romanian Economy*, June 2007, IMF Country Report No. 07/220), the public sector is all the more important in terms of wages that, in recent years, government wage increases seem to cause (in the Granger sense) private-sector wage increases. Among others, the author explains this econometric result by the fact that wage agreements in the government sector provide a signal to private-sector wages, on account of their timing (the former usually precede the latter), and the fact that the government competes with the private sector for educated and skilled staff. Both channels are given additional impetus by the tight labour market reflected by the relatively low unemployment rate.

[79] Despite the lower collection rate in 2007 Q1, preliminary data on the cumulated budget execution over the first five months of the year point to a consolidated general budget surplus of roughly 0.16 percent of GDP, mainly on account of the second-quarter rebound in collections dynamics.

upward pressure on budget expenditures is building up, as shown by the latest steps to raise pensions, which could prompt further easing of the fiscal stance in the run-up to the European Parliament, local and parliamentary elections. Against this backdrop, the significant overshooting of the projected budget deficit is by no means a marginal risk.

Apart from the effect on aggregate demand and, thus, on the output gap, any potential considerable widening of the consolidated budget deficit beyond the current targets – due to larger payments of wages and social benefits – could pose additional threats in the medium run, as follows:

(i) the possible significant overstepping of the threshold determining the European Commission to initiate the excessive deficit procedure would call for a medium-term adjustment of public deficit. As indicated by other Member States' experience (Germany and Hungary are the latest cases in point), such adjustments are difficult to bring about only by cutting budget expenditures, while more comprehensive adjustment measures might affect the aggregate price level.

(ii) wage increases in the public sector and their financing could also affect the administered price adjustment calendar, given that any increase in such prices usually entails higher budget revenues (for instance, higher heating tariffs generate additional revenues to the local budgets, while more expensive natural gas is reflected in extra revenues of national corporations).

(iii) a potential budget deficit slippage would constitute an additional source fuelling the widening of the current account deficit. Such a combination could trigger a negative signal for foreign investors, leading to a possible deceleration in the growth rate of capital inflows and hence to considerably stronger depreciation pressures on the domestic currency. In turn, a weaker RON would translate in higher import prices and implicitly higher consumer prices.

Exchange rate developments are closely linked to international capital flows dynamics. International investors' decision to continue investing in RON-denominated assets is based on a risk and return assessments related both to the outlook of the Romanian economy and the combination of risk and return such investors might obtain by investing in similar assets denominated in other currencies. In the former case, one of the pessimistic scenarios in terms of inflation projection is the potential revision of estimates on the future growth of the Romanian economy. This could be influenced, among others, by the persistent and substantial trade deficit widening, by the possible overheating of the economy (subsequently entailing slower economic growth and productivity losses, a situation similar to that experienced by Portugal starting 2000), by the Romanian authorities' delayed implementation of structural reforms as well as the possible profitability cuts in some fast-growing sectors (such as the real estate or the retail sector). In the latter case, the exchange rate risk might be associated with a changing environment on the international financial market. Although most analysts agree on the existence of a global imbalance, featuring *inter alia* a global liquidity surplus that fuels a boom in emerging markets, opinions differ greatly when it comes to the exact timing or scenario of a potential adjustment. Although the Romanian economy's monetary and real convergence with the euro area could provide an adequate anchor for foreign investors, the vulnerability of RON quotations to various global shocks remains significant, given the partial correlation between RON exchange rate swings and Romania's economic fundamentals.

Aside from the above-mentioned factors, the volatility of the inflation projection might further be caused by several other sources of uncertainty, which were repeatedly cited in the previous Inflation Reports. Thus, given their unpredictable nature, weather conditions have a bearing on developments in food prices. Nonetheless, recent quarters' experience indicates a possible asymmetry as regards the impact on food prices of a below-average and an above-average agricultural year respectively. In the former case, the impact of the temporary contraction in the domestic supply of agricultural produce on prices proved to be somewhat offset by imports which made up for the supply shortage, particularly amid the nominal appreciation of the RON. Conversely, in case of an above-average agricultural year, it is more difficult for excess supply to translate into larger exports or lower imports[80], but rather into favourable price developments. Another source of risk is the likelihood of further hikes in oil and natural gas prices on the international market feeding through into domestic fuel and energy prices. Such hikes might be determined by the maintenance of a tense political environment worldwide, particularly in the major oil-producing countries. Against the backdrop of heated debates on how to attain the formally-assumed objectives of fighting global warming, one should not ignore the potential fiscal measures that could be adopted at EU level, having a direct or indirect bearing on the prices of polluting fuels.

[80] Possible reasons for this phenomenon include the relatively low degree of penetration of Romanian agricultural produce on foreign markets and the relative lack of substitutability between domestic and imported foodstuffs (which in turn could be due to qualitative or reputational differences).

2. Policy assessment

Against the background of the current quarterly medium-term projection round and the drafting of the August 2007 Inflation Report, the NBR Board took the necessary steps to substantiate and set the 2009 inflation target, which the Government subsequently assumed. From the central bank's perspective, the joint agreement on setting the target is a key prerequisite for the inflation targeting strategy, the efficacy of which is enhanced both by the increased support lent to monetary policy by government policies, i.e. fiscal, income and structural policies, and by a better anchoring of economic agents' inflation expectations. Following the assessment of the various projection scenarios and of the major assumptions underlying them, including those referring to the government's economic policy variables, as well as the major risks and uncertainties surrounding the medium-term rate of increase of consumer prices, the 2009 inflation target was set at 3.5 percent ±1 percentage point.

In view of the analyses performed thus far, this target meets the requirements arising from both the specifics of monetary policy implementation under the inflation targeting framework and the need to carry on nominal and real convergence of the Romanian economy. On one hand, the target is in line with the requirement to consolidate disinflation and to ensure fulfilment of the inflation criterion laid down in the Maastricht Treaty in a manner consistent with the timetable for euro adoption, as well as the subsequent compliance with the European Central Bank's quantitative definition of price stability. On the other hand, the 2009 inflation target is indicative of the National Bank of Romania's ongoing concern for attaining the announced inflation objective, which is essential for enhancing the central bank's credibility – given the relatively brief history of implementing inflation targeting in Romania – and eventually for more firmly anchoring of inflation expectations over the medium run. In the present context, the National Bank of Romania's caution is substantiated by the anticipated persistence throughout 2009 of direct inflationary effects exerted by factors outside the central bank's sphere of influence, the most significant being: (i) price increases as a result of the ongoing convergence of the Romanian economy, (ii) considerable adjustments of administered prices and indirect taxes scheduled for 2009, and (iii) the persistence of some asymmetric nominal rigidities.

The assessment of the present context highlights the fact that the temporary discontinuation of disinflation in 2007 Q2, which caused the annual inflation rate to deviate marginally from the projected path included in the May 2007 Inflation Report, was ascribable to supply-side factors. The most significant inflationary effects were triggered by the worsening, compared to the previous period, of the annual dynamics of the domestic fuel price and that of the annual growth rate of fruit and vegetables prices, due to the existing or the anticipated shortage of such farming products. In addition, the large rent hike decided by local governments had an adverse impact on annual headline inflation. In contrast, the annual CORE2 inflation rate posted a faster decline, with the magnitude of the decrease offsetting noticeably the unfavourable effects of supply-side factors. Over the period, the deceleration in CORE2 inflation can be associated with the maintenance of adequately restrictive monetary conditions, especially with the faster appreciation of the domestic currency versus the euro and the US dollar. Moreover, the slowdown was also underpinned by the stronger competition on the retail market and the expansion of price cuts after Romania's accession to the EU.

The updated projection of macroeconomic developments indicates that the slightly higher path, compared with the previous forecasting round, of the annual inflation rate will persist over the next three quarters. The major determinants of the relative pick-up in projected inflation are the expected increases in the dynamics of fruit and vegetables prices, fuel price, and administered prices, with the latter already including the rent hike. By contrast, in the latter part of the monetary policy transmission horizon, the projected inflation pattern improves significantly as against the previous forecasting round, largely due to the lower foreseen magnitude of administered price adjustments and the relative deceleration of CORE2 inflation. Moreover, along the entire forecast horizon, the projected CORE2 inflation rate follows a trajectory steadily below that projected previously, even though the positive output gap, after dropping sharply in 2007 Q1, is seen resuming, over the next three quarters of the current projection, values relatively similar to the previously projected ones. Special mention deserves the fact that the positive deviation is foreseen to be phased out starting in 2008 Q1.

Maintenance of excess demand at the levels projected previously and implicitly its persistence until end-2007 are viewed as the major risk to ensuring a sustainable disinflation path. Adding to this risk are the prospects of persistently high dynamics of domestic absorption, implying the risk of a widening, to unsustainable levels, of the current account deficit and implicitly of an abrupt correction of the external imbalance that might trigger a renewed bout of inflation in the medium term. These risks stem from the sizeable easing of income policy in 2007, which resulted in substantial pay rises in both budgetary and private sectors, on the one hand, and from the likelihood of a pro-cyclical stance of fiscal policy over the next quarters, on the other.

Given the current projection, the explanation for the lingering positive output gap in the first part of the monetary policy transmission horizon lies with persistently robust domestic demand and the short-lived downward revision in potential GDP following the adverse supply-side shock to be induced by the likely decline in agricultural output and possibly in electricity output in 2007. Although the magnitude of drought-induced losses in agriculture and industry is yet uncertain, research outcomes point to the fact that the grain crops are most badly hit. Nevertheless, it is very likely that, at least in part, excess demand for goods produced in the above-mentioned sectors should be met by larger imports, which could cause anti-inflationary effects in the near run, including via favourable exchange rate movements, on the one hand, and an additional widening of the current account deficit, possibly associated with an increase in foreign debt, and greater potential risks to medium-term disinflation, on the other hand. Agricultural produce imports could however generate inflationary effects even in the near run given that prices for some of these products on international markets have already risen.

Some alleviation in the inflationary potential of economic growth could come from the likelihood of certain recent features and structural changes of domestic demand becoming more pronounced. Thus, in view of the first-quarter developments, the positive spread between the growth rate of gross fixed capital formation and that of private consumption could widen over the next quarters. This assumption is advocated by the persistence of a fairly fast-paced expansion in construction works in April and May 2007, the favourable expectations of construction activity and the increased likelihood of investment growth regaining some of the ground lost in 2007 Q1 (possibly as a result of a build-up in direct investment from third countries ahead of Romania’s accession to the European Union). Moreover, a reason for the looser public spending in 2007 H2 may well be the making up for the delay in the execution of public investment works, including Community funded projects.

Signs of a possible acceleration in retooling investment over the next quarters could be the large value of capital goods imports seen in Q1[81], which were not mirrored by the dynamics of equipment investment within gross fixed capital formation over

[81] In 2007 Q1, the growth rate of capital goods imports was much faster than those of the other two basic classes in the National Accounts System.

the aforementioned period, and the high growth potential of foreign direct investment, which posted an unexpectedly low volume in the early months of 2007. They are accompanied by the recent improvement in capacity utilisation rate in industry[82], which would substantiate an increase in investment in some sectors over the coming period, and the possible notable growth of corporate profits in Q1, as suggested by the significant rise in first-quarter[83] profit tax as against the previous quarters.

It is estimated that the possible step-up in investment, particularly equipment investment, will give an impetus, albeit with a certain lag, to the potential of economic growth, including the total factor productivity and competition, thus contributing to ensuring sustainable disinflation and subsequently price stability over the medium and long term, as well as to the advance in the convergence process. In the near run however, the faster increase in investment demand implies the risk of heightening inflationary pressures, but most notably the widening of trade deficit, given the increased likelihood of large imports of new technology products. Under the circumstances, the increase in trade shortfall could be associated, at least in part, with the catching-up the Romanian economy is going through. The sustainability of such an increase is conditional upon the extent to which foreign direct investment and foreign borrowings for tradables sectors have a contribution to trade deficit financing.

From the perspective of developments in relevant indicators during Q1, the magnitude and the distribution in time of the impact exerted by the inflationary potential of future household consumption on domestic demand are viewed as a higher uncertainty. Thus, assuming that the features and changes in the structure of household consumption in early 2007 might persist over the next quarters – i.e. a significantly higher dynamics of demand for non-food items, durables (including motorcars) in particular, on the one hand, and the sharp slowdown of the annual growth rate of demand for foodstuffs, on the other hand –, the still fast-growing private consumption will further put pressure predominantly on trade balance, but possibly on domestic prices as well.

Nevertheless, the relative shift in household consumption behaviour could be a short-lived effect of the favourable alteration in the taxation regime after Romania's becoming an EU Member State, since such a phenomenon was manifest in the former new EU entrants in the months following the accession. Under the circumstances, in the months ahead, the

[82] Business Survey, NBR, June 2007.

[83] Collected by the Ministry of Economy and Finance in April 2007.

possible return to the previous structural features of household consumption and the likely renewed acceleration of this domestic demand component amid the ongoing significant pay rises might refuel the inflationary potential of GDP growth compared to the previous period. This assumption is to some extent underpinned by the slight rebound in the growth rate of foodstuffs sales in April and May 2007, alongside the still fast-paced increase in similar indicators of durables sales. Another reason underlying the assumption of higher dynamics of private consumption in the future is the foreseeable retrenchment, given the specifics of this agricultural year, of self-consumption in 2007 Q3 and Q4, and the possible ensuing rise in demand for foodstuffs – partly financed by the public funds to be granted to farmers to compensate for damaged crops. The pressures exerted by this demand component could partly be reflected by the external imbalance, with the potential inflationary risks being delayed to a longer time horizon.

Nonetheless, the faster pace of increase of household purchases of real-estate property and financial assets in the future – buttressed by steady or even stronger dynamics of households' disposable income due to higher wages and remittances from abroad – might act as a disincentive on the pick-up in private consumption growth in the short term. Such behaviour could be substantiated by a saturation of consumer demand in case of households with relatively large incomes associated with growing interest in house buying and financial investments; behind this scenario stand a relative acceleration over the recent months in the expansion of housing loans, further fast-paced advance in household deposits with banks and slower consumer credit growth.

The developments in the inflationary potential of cost and supply-side factors remain another major cause of concern about the future path of inflation. Thus, compared to the previous quarterly projection, the current context shows upside risks related to the inflationary potential of short-term developments in volatile prices, namely highly volatile food prices and fuel price. Administered price adjustments are expected to have a relatively lower direct inflationary impact in the near run. Yet, the persistence of some uncertainties stemming from a non-definitive programme for future adjustments and the apparent propensity for postponing administered price corrections to longer time horizons pose heightening risks to ensuring sustainable disinflation and price stability in the medium run.

Another risk to the outlook for inflation comes from the persistently fast-paced increase in private-sector wages and the upward course in the annual growth rate of ULC in industry. The companies' capability of passing on to consumers the increase in costs appears to be limited, in some cases, by the strong competition on markets they are active in. By contrast, in those industries where excess demand is still manifest and which might face labour shortages these wage hikes could entail cost-push inflation; there is an additional risk of these hikes feeding through to other sectors via demonstration effects.

A relatively high degree of uncertainty continues to surround the developments in the RON exchange rate throughout the projection horizon. Thus, even though the recent large pressures on this variable exerted by volatile capital inflows appear to have subsided, they might be temporarily revived by the seasonal expansion in remittances from abroad in the period ahead. Nonetheless, the likelihood of downward pressures on the RON cannot be ruled out, as exchange rate volatility is determined by foreign investors' unpredictable risk appetite for emerging markets, given that RON exchange rate movements are only partly attributable to changes in national economic fundamentals.

The assessment by the NBR Board of the current macroeconomic environment and of the medium-term projection has highlighted an improvement, as compared to the prior forecasting round, of the outlook for inflation in the second part of the monetary policy transmission horizon. At the same time, however, the NBR Board has pointed out the still high inflationary potential of some factors that will remain manifest during the projection horizon. The main risks to sustainable disinflation are deemed to be the persistence, until end-2007, of the positive output gap and the possible ongoing widening of the current account deficit as a result of persistently fast-growing domestic absorption. In this context, in its meeting of 31 July 2007, the NBR Board has decided to leave the monetary policy rate unchanged at 7 percent per annum. Moreover, in order to lower the magnitude of fluctuations in interbank rates and thus consolidate both their role in the monetary policy transmission mechanism and the signalling role of key monetary policy rates, the NBR Board has decided to narrow the corridor defined by the interest rates on its standing facilities; therefore, the interest rate on the deposit facility was raised to an annual 2 percent from 1 percent, while the interest rate on the lending facility was cut to an annual 12 percent from 14 percent. Furthermore, for a better harmonization of the maturity of the key open-market instrument (to which the monetary policy rate is associated) with, on the one hand, the maintenance period of required reserves requirements (one month) and, on the other hand, the prevailing maturities of interbank market transactions, and hence in order to reduce the volatility of short-term interest rates on this market, the NBR Board has decided to reduce the maturity for deposit-taking operations to two weeks from one month previously. Also, with a view to consolidating the restrictiveness of broad monetary conditions, the NBR Board has decided to maintain the present levels of reserve ratios.