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N O T E

The National Institute of Statistics, Ministry of Economy and Finance,
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National Employment Agency, EUROSTAT,
IMF, U.S. Department of Energy
and National Bank of Romania supplied data.

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

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Foreword

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

To this end, the National Bank of Romania revised both the structure and the frequency of Inflation Report which has become a quarterly publication in accordance with the frequency of the forecast cycle. Apart from the information on economic and monetary developments, and on the rationale behind the monetary policy decisions in the reviewed period, the quarterly report includes the NBR projection on inflation rate developments on an eight-quarter time horizon and the associated risks and uncertainties, 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 25 October 2007 and approved by the NBR Board in its meeting of 31 October 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)
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
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
OPEC	Organization of the Petroleum Exporting Countries
ULC	unit labour cost
1W	one week
12M	12 months

Contents

I. SUMMARY

In September 2007, the 12-month inflation rate reached 6.03 percent, 2.23 percentage points above the June figure and 2.04 percentage points higher than the annual inflation rate recorded in July, due to the emergence of two types of inflationary shocks in 2007 Q3. The largest inflationary impact was generated by a higher-than-expected rise in the volatile prices of some agricultural produce (up 10.8 percent from June and 8.4 percent versus July respectively) and the substantial increase of the prices of certain processed foods with significant shares in the core inflation basket and which exhibit inelastic demand, the mentioned price increases mainly being the consequences of declining agricultural output following this year's severe drought and of the negative base effect associated with the bumper harvest of 2006. The second major adverse effect on CPI inflation came from the upward correction of the RON exchange rate in the context of turbulence on world financial markets; this development confirmed the unsustainable nature of the rapid nominal appreciation of domestic currency in the previous period, which was not underpinned by similar changes in Romania's economic fundamentals, an aspect which the central bank had highlighted as one of the major risks to continued sustainable disinflation in the medium term. Under the impact of these two inflationary shocks, which were accommodated by excess demand, the annual CORE2 inflation rate adjusted for the effect of indirect taxes also saw a trend reversal, re-entering a steep upward path in August.

The impact exerted by the negative supply-side shock stemming from the poor agricultural output on core inflation was strengthened by the second-quarter pick-up in domestic demand growth, and especially by the strong increase in the demand for agri-food items in response to lower self-consumption. Investment remained the fastest-growing component of domestic absorption in 2007 Q2 – to a great extent due to the ongoing boom in construction investment – its annual pace advancing to 19.4 percent from 17.2 percent in the previous quarter. Under the circumstances, the slight drop in annual GDP dynamics (to 5.6 percent in 2007 Q2 from 6.0 percent) was largely attributable to the rise in the negative balance of net exports[1], as well as to a contraction in self-consumption, given the poor performance in agriculture.

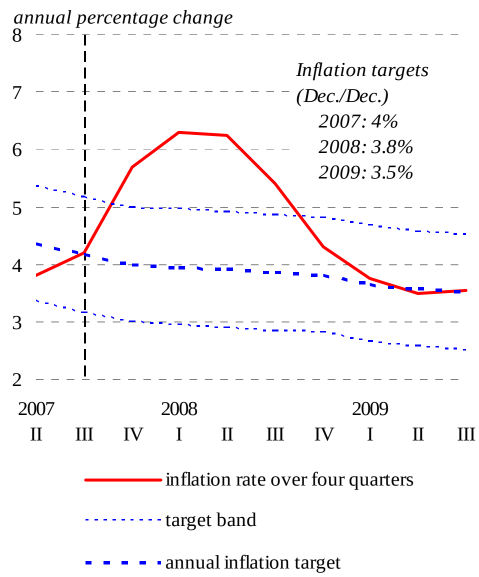
The anticipation of heightened risks to continued disinflation prompted the NBR Board to discontinue at the beginning of 2007 Q3 the downward trend in the monetary policy rate by leaving it unchanged at 7 percent per annum thereafter. The risks identified following the analyses were associated with the persistent mismatch between rapid wage increases and productivity gains, the anticipated upsurge in public spending, which is projected to outpace growth in budget revenues, and with the continued worsening of the external deficit. The interest rate policy was preemptively strengthened in the latter half of Q3 through tighter control exerted by the central bank over money market liquidity, so that average interbank rates stood about 2 percentage points higher at end-September than in the previous month.

The decision taken by the NBR Board was substantiated by the worsening near-run inflation outlook – due largely to the rise in the inflationary potential of developments in some supply-side factors (especially the influence of drought on agricultural output and food prices) and the adverse effects triggered by the upward correction in RON exchange rate – as well as the increased uncertainty surrounding future developments in these inflationary factors. In order to enhance the impact of interest rate decisions, the National Bank of Romania made several changes to the operational framework of monetary policy during the reported period, seeking to

[1] Their contribution to GDP dynamics hit a record -9.2 percentage points in 2007 Q2.

strengthen the signaling role of the key policy rate and the role played by interbank money market rates within the monetary policy transmission mechanism. Thus, the central bank moved to narrow the corridor defined by the interest rates on its standing facilities by raising the interest rate on the deposit facility to 2 percent per annum from 1 percent and by lowering the interest rate on the lending facility to 12 percent per annum from 14 percent. Moreover, the National Bank of Romania decided to reduce the maturity for deposit-taking open-market operations – the key tool for monetary policy implementation – to two weeks from one month previously. Also, with a view to consolidating the restrictiveness of broad monetary conditions, the central bank left unchanged the minimum reserve requirements ratio on RON-denominated liabilities[2] at 20 percent and the minimum reserve requirements ratio on foreign exchange-denominated liabilities of credit institutions at 40 percent; by maintaining this measure, the National Bank of Romania took into consideration the fast growth in non-government credit (by a real 43.1 percent), particularly its foreign exchange-denominated component (73.2 percent in euro terms), as well as the ongoing prospects of these trends.

Inflation Forecast



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

Compared to the previous forecast, the baseline scenario of the current projection of medium-term macroeconomic developments highlights a worsening of the inflation outlook through the majority of the monetary policy transmission horizon. The annual inflation rate is anticipated to reach 5.7 percent in December 2007 and 4.3 percent in December 2008 (1.8 percentage points and 0.6 percentage points higher than the projection published in the August 2007 Inflation Report); until 2008 Q3, its trajectory will stay above the upper limit of the target band. The upward revision of the inflation forecast stems largely from the significant deviation, starting with 2007 Q3, of the trajectory of food prices (including the volatile prices of food items) and of the RON exchange rate from the previous projection, resulting in relatively less restrictive monetary conditions in the first part of the projection horizon. The annual CORE2 inflation rate is seen following an upward path in the first part of the current projection horizon, reflecting the adverse impact of the above-mentioned factors and the expansionary effect triggered by the projected fiscal policy easing in the period ahead, expected to follow the prudent policy conduct in the first 10 months of this year. Nevertheless, CORE2 inflation is foreseen to decelerate markedly in the latter half of 2008 and to revert, over the final part of the projection horizon, to levels close to those forecasted previously. This development is underpinned by a gradual widening of the negative output gap, largely driven by real monetary conditions whose restrictiveness will be ensured by an adequate calibration of interest rate policy, along with the projected resumption of a long-run real appreciation trend of the domestic currency, reflecting ongoing realized productivity gains in the Romanian economy and the persistence of sustainable productive capital inflows.

Compared to the previous forecast, the current forecast of macroeconomic developments in the medium term underscores heightened and more complex risks and uncertainties, especially due

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

to the propagated effects of third-quarter inflationary shocks over the period ahead, concurrently with the effects stemming from approaching successive elections which are timed until 2009. Against this background, the major risk relates to further rapid across-the-board wage increases in excess of productivity gains, boosted by the persistently lax income policy of the authorities. Such an increase in wage earnings could additionally exacerbate consumer demand, including via faster credit dynamics, which might delay the phasing-out of excess demand. 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, especially in the presence of heightened inflationary expectations. In this context, there is a risk of excessive wage claims spreading across all sectors which, if agreed to, would fuel inflation via generalized higher unit labor costs, pushing them above the levels that producers can absorb by squeezing profit margins.

Adding to this risk are the uncertainties surrounding the magnitude of fiscal policy easing over the projection horizon, mainly those referring to the actual level of the consolidated general budget deficit as well as regarding the ratio of capital expenditures to current expenditures, as the latter have a greater consumption-boosting impact. While in 2007 the risk of budget deficit exceeding the projected level is relatively low, it increases considerably in 2008 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 potential overshooting of the projected level of expenditures as a result of sizeable pension increases and higher pressures on the budget that are specific to an election year. Aside from the resulting inflationary pressures, the potential materialization of the risk associated with such an easing of macroeconomic policies, corroborated with persistently fast growth of some types of 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.

Another major risk to the current forecast is the likelihood that future food price increases and the ensuing second-round effects might exceed the projection assumptions. This risk stems mostly from (i) the very large share of food prices in the CPI basket amid high volatility of the annual performance of the agricultural sector in Romania; (ii) the trend of a faster and more comprehensive increase in agri-food prices on international markets; and (iii) the magnitude and gradual nature of administered price adjustments scheduled for the coming months in the domestic market. In the near run, the recent nominal correction of the RON against the major currencies and the increase in volatility and unpredictability of RON exchange rate movements could have a stronger adverse impact on inflation expectations. Such a behavior of the exchange rate will be strengthened by the persistence, at least in the short term, of major uncertainties regarding the global effects of the crisis in the US sub-prime mortgage loan market, as well as by potential changes in investor sentiment towards the Romanian market in response to the evolutions in domestic economic fundamentals, within the broader context of possible changes in behavior towards emerging markets as an asset class.

Adding to such uncertainties are those related to the future developments in some exogenous factors impacting inflation, with the dynamics of administered prices and that of volatile prices (fuel prices included) ranking among the most relevant in this category. As for regulated prices, postponing price corrections initially due for 2007 and 2008 election years places the risk of their attending inflationary shocks emergence towards the end of the projection horizon and even beyond.

However, average annual inflation, estimated at around 4.7 percent versus 6.56 percent in 2006, shows a consolidation of the disinflation process this year. Nevertheless, the risk of a prolonged deviation of inflation from the target through part of 2008 tends to diminish the favorable impact of this consolidation and to affect the inflation expectations of corporates and households.

In view of the worsening inflation expectations, compared to the previous projection, almost throughout the monetary policy transmission horizon and amid prevailing upside risks to inflation, the NBR Board has decided to raise by 0.5 percentage points the monetary policy rate to 7.5 percent per annum and to continue to pursue prudent liquidity management via open-market operations. Also, in order to consolidate the restrictiveness of broad monetary conditions and in view of the rapid growth of all components of non-government credit, the NBR Board has decided to maintain the present levels of minimum reserve requirement ratios on both RON- and foreign currency-denominated liabilities of credit institutions.

Against this background, the NBR Board has reaffirmed that monetary policy, along with all components of the macroeconomic policy mix, should ensure a firm and sustainable anchoring of inflation expectations at the low inflation levels achieved so far, in order to bring annual price growth within the medium-term disinflation trajectory agreed with the Government and, on a broader horizon, to achieve the convergence of Romania’s aggregate price level towards price stability, as defined by the EU. Such a stance of all components of the macroeconomic policy mix is all the more necessary given that the external deficit posts levels that are difficult to sustain in the long run, in the context of heightened uncertainties that affect the world economy. This monetary policy stance is also aimed at ensuring an appropriate real interest rate level, with a view to stimulating savings and improving the savings-investment balance, resulting in an impact on the gradual reduction of the external deficit in the future.

II. INFLATION DEVELOPMENTS

In 2007 Q3, the 12-month inflation rate exceeded the upper limit of the target band of ±1 percentage point around the central target; thus, at end-September, the annual inflation rate reached 6.03 percent, 2.23 percentage points above the June figure and 2.04 percentage points higher than the annual inflation rate recorded at end-July. Unlike the previous quarter, when pressures were visible only on volatile prices, during the period under review, the short supply of agri-food items (some of them having significant shares in the CPI basket and exhibiting inelastic demand), alongside the correction in the previously fast nominal appreciation trend of the domestic currency, had an adverse impact on the trajectory of core inflation as well. The persistent excess demand facilitated the pass-through of supply-side shocks against the background of a fast rise in household incomes.

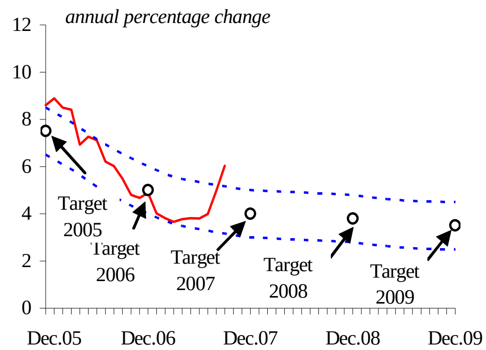
The acceleration of the 12-month inflation rate in the period under review was accounted for in a proportion of almost 70 percent by volatile prices, whose annual dynamics exceeded in September 2007 by 10.9 percentage points that at mid-year. Among the drivers of this performance were, on the one hand, the tensions generated by drought on the market of fruit and vegetables – not only domestically, but also regionally – and, on the other, the significant base effect associated with the bumper crop in 2006. Nevertheless, a favourable influence came from the deceleration by 1.9 percentage points in the annual growth rate of fuel price (to -0.7 percent), with the recent upward trend in the oil price on international markets[3] entailing no significant movements on the domestic market.

The pressures exerted by administered price developments on inflation rate diminished, as their annual dynamics slowed down to 7.3 percent in September compared to 8.7 percent at the end of the previous quarter. Behind this performance stood the absence of adjustments in energy prices, as well as the favourable base effect in case of fixed telephony, the pick-up in prices following the depreciation of the domestic currency versus the euro in the current period being far below last year's rise as a result of Romtelecom higher subscription fees.

The same as in the previous quarters, developments in the prices of tobacco products should be emphasised apart from the CORE2 measure, as movements have usually been associated

[3] In September, the Brent oil price hit a new record high (with an average of USD 77.2 per barrel compared to USD 71 per barrel in June).

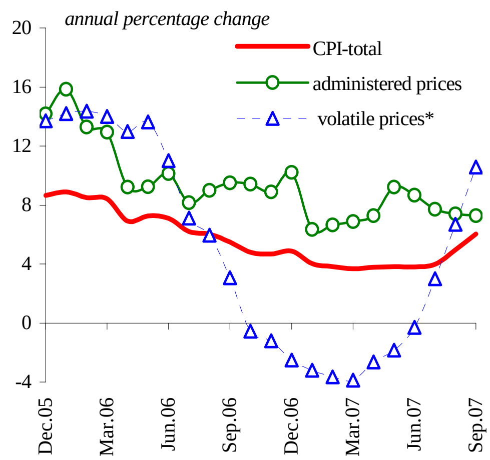
Inflation Developments



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

Source: NIS, NBR calculations

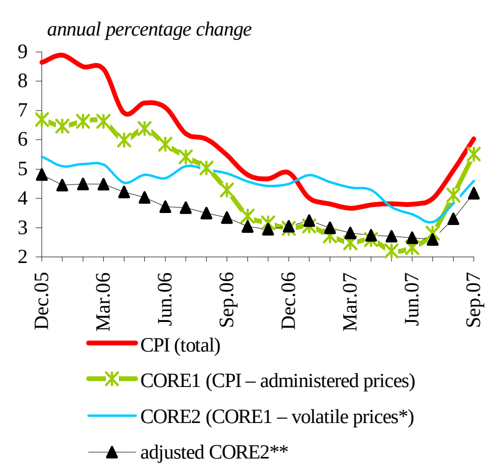
Inflation Rate



*) 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

with some changes in the tax treatment (vice tax, excise duties). The slowdown in the annual dynamics by almost 4 percentage points in September versus June 2007 was due to a favourable base effect, the impact generated by the increase in excise duties in July 2007 being weaker than that on 1 July 2006[4].

Administered Prices versus Market Prices

annual percentage change; end of period

	2006		2007		
	III	IV	I	II	III
Inflation Rate	**5.5**	**4.9**	**3.7**	**3.8**	**6.0**
Administered prices*	**9.5**	**10.2**	**6.9**	**8.7**	**7.3**
1. Non-food items*:	**8.4**	**11.4**	**5.4**	**6.5**	**5.7**
electricity	1.9	6.6	4.6	9.0	9.0
heating	20.0	18.4	20.8	20.8	20.8
natural gas	21.4	33.6	10.0	6.3	4.7
medicines	-4.0	-1.9	-4.8	-4.2	-5.7
2. Services*, of which:	**11.3**	**8.1**	**9.5**	**12.5**	**10.2**
water, sewerage, waste disposal	20.3	21.4	20.5	14.6	14.1
fixed telephony	10.5	2.5	5.6	0.0	-5.1
passenger railway transport	5.1	13.2	23.7	29.8	37.2
(passenger) city transport	7.1	4.1	3.5	5.2	6.8
Market prices (CORE1)	**4.3**	**3.0**	**2.5**	**2.3**	**5.5**
CORE2**	**4.9**	**4.5**	**4.4**	**3.5**	**4.6**
CORE2 less tobacco, alcohol	3.3	3.0	2.8	2.7	4.2
tobacco, alcohol	22.9	21.8	22.9	12.7	9.3

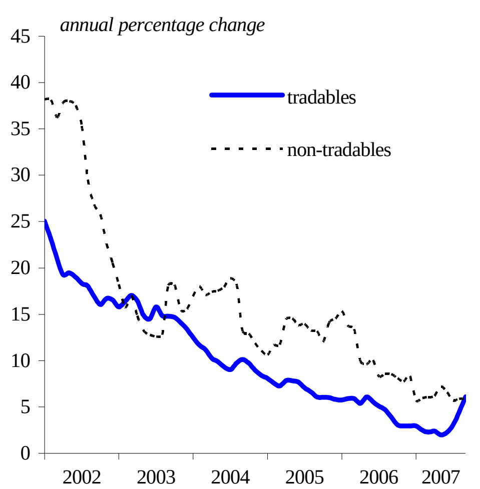
*) NBR calculations; **) CORE1 - volatile prices

Source: NIS, NBR calculations

The steadily downward trend in adjusted CORE2 inflation reversed abruptly in August. The effects of the significant vegetal output losses caused by adverse weather conditions on the domestic market and of the escalating tensions on the external agri-food markets, in the context of the global incidence of such phenomena, spread beyond products with volatile prices (bakery products and edible oil were the hardest hit). Thus, the annual growth rate of core inflation accelerated by approximately 1.5 percentage points at end-September compared to June 2007, almost entirely as a result of developments in food prices. Market-priced services also had a marginal contribution to this performance, whereas the decreasing trend in the annual dynamics of non-food prices slowed down significantly.

Behind the halt in disinflation stood also the depreciation of the domestic currency during August-September and the marked hike in wage earnings on an annual basis, which was conducive to the further fostering of excess demand, as well as to higher ULC. In this context, industrial producers, traders as well as banks adjusted their inflation expectations[5], whose worsening has acted as an additional deterrent.

Tradables and Non-tradables Prices



Source: EUROSTAT, NBR calculations

Under the impact of the shock caused by the agri-foods shortfall, the annual growth rate of tradables prices accelerated by 3.9 percentage points against June to 6.1 percent in September. In contrast, the dynamics of non-tradables prices slowed down 0.7 percentage points to 5.9 percent due primarily to the deceleration in the growth rate of administered prices, the main component of the group.

From the viewpoint of the nominal convergence criterion on inflation, the difference between the HICP change in Romania and the average inflation rate in the three best-performing Member States of the European Union (annual average for the past 12 months) remained at a level similar to that seen in June 2007 (3.3 percentage points in September). By extending the

[4] Including also the last stage of vice tax introduction.

[5] This statement is supported by (i) the results of the NBR survey among banks, which point to an unchanged annual inflation rate May through September on a one-year horizon, and (ii) the NIS survey among managers in industry and trade in August and September, which illustrates significant increases in the balance of answers related to price developments over the next three months.

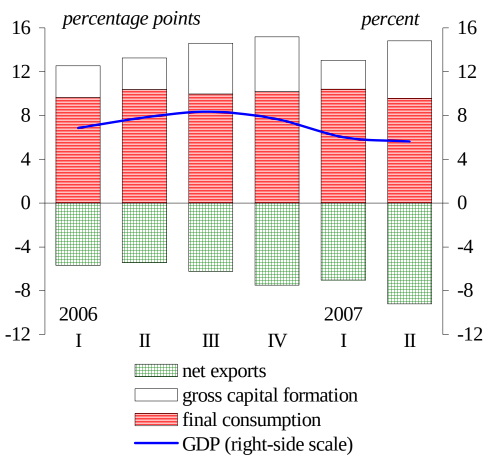
sphere of comparison to EU-27, the difference between the two harmonised indices, i.e. 2.3 percentage points, featured a steady performance as well, being only marginally below that seen in June.

In September 2007, the actual annual inflation rate was 1.8 percentage points above the projection in the August 2007 Inflation Report, owing to (i) significantly higher prices of some vegetables and fruit, given that, in spite of the projection incorporating tensions on this segment, price changes exceeded by far the anticipated level, including as a result of marked decreases in the agricultural output starting August, and (ii) the correction, in nominal terms, of the domestic currency, with changes exceeding the projection (even though there were no significant differences between the average quarterly effective exchange rate and the projected one, monthly fluctuations considered under the forecast were far below real fluctuations). The favourable developments in fuel price had an opposite impact, given that the hikes considered by the forecast failed to materialise during Q3 (except for September).

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

In 2007 Q2, the annual growth rate of real GDP slowed down slightly against the previous quarter from 6 percent to 5.6 percent[6], being 0.4 percentage points above the June benchmark projection. As concerns the economic growth pattern, investment continued to be the fastest-growing aggregate demand component for the fifth straight quarter; unlike Q1, the growth rate of exports of goods and services decelerated markedly to less than 25 percent of final consumption dynamics. As concerns supply, most economic sectors recorded weaker annual growth rates in Q2, except for construction.

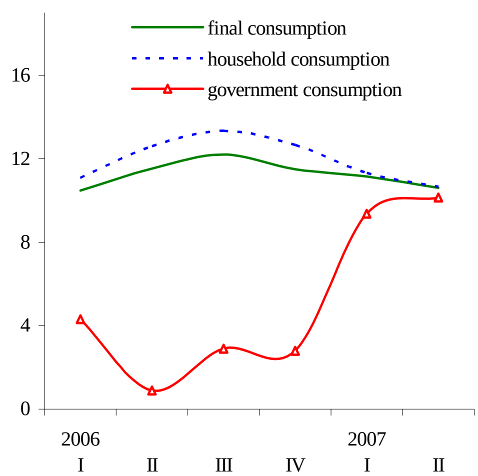
1.1. Demand

Behind the slower economic growth in Q2 stood the strong worsening of the contribution from the external component of aggregate demand to -9.2 percentage points, i.e. the lowest level in the period for which quarterly national accounts are available[7]. This trend was only partly offset by the 1.3 percentage point acceleration of domestic demand growth due to gross capital formation.

1.1.1. Consumer demand

Actual Final Consumption

annual percentage change



Source: NIS

The growth rate of final consumption decelerated further, by 0.6 percentage points to 10.6 percent, owing entirely to its private component.

Household consumer demand

The annual dynamics of household actual final consumption slowed down slightly, remaining however at a high level (10.7 percent). Structural analysis points to mixed developments. On the one hand, "self-consumption and purchases on the agri-food market" narrowed by 8.9 percent and the growth rate of "other consumption"[8] slowed 2.6 times to 5.7 percent, primarily due to the drought in the first part of 2007, which had an adverse

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

[7] 1999-2007.

[8] The main negative influence came from home industry, defined by the NIS as activity carried on by households (living either in rural or urban area) by their own means, which consists in agricultural produce from own production or purchased from the retail network.

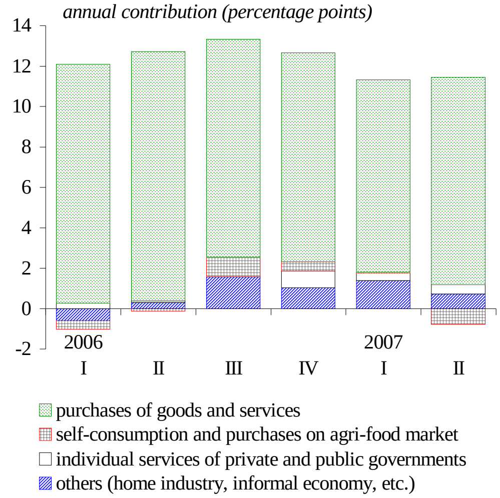
impact on the output of both fruit and vegetables and milk and dairy produce. On the other hand, the growth rate of retail purchases and service provision accelerated by 2.8 percentage points to an annual 15.2 percent; statistical data on retail sales show that food sales had the largest contribution to this performance, going up 15.1 percent compared to merely 1 percent in Q1.

The large share of foodstuffs in household consumer basket (around 40 percent) led to an expansion in the inflationary potential of consumer demand during Q2. The growth rates recorded by sales of most non-food items accelerated as well, except for sales of motor vehicles, whose annual dynamics slowed down to 23.2 percent[9], i.e. less than half the previous quarter's figure.

The advance in retail purchases of goods and services was bolstered mainly by the high growth rate of disposable income (16 percent in real terms, a level similar to that seen in Q1)[10]. However, mention should be made that the influence of this hike may have been alleviated by the higher saving propensity illustrated by the renewed acceleration in the growth rate of RON- and foreign currency-denominated deposits of households (to 38.4 percent in real terms). As for borrowed funds, bank loans seem to have had a lower contribution to the financing of consumer goods purchases, as suggested by the maintenance of a strong downward trend in the annual dynamics of short- and medium-term bank loans to households (4.6 percent in Q2 against 7.8 percent in Q1[11]). Nevertheless, the signals sent by the market point to an upward trend in alternative financing instruments launched by both commercial banks (particularly credit cards) and non-bank financial institutions (especially those specialised in granting consumer loans). The expansion of retail networks (particularly hypermarkets and supermarkets[12]), and their wide resort to promotional campaigns and discounts were yet another channel for boosting purchases of goods and services.

Household Final Consumption by Expenditure

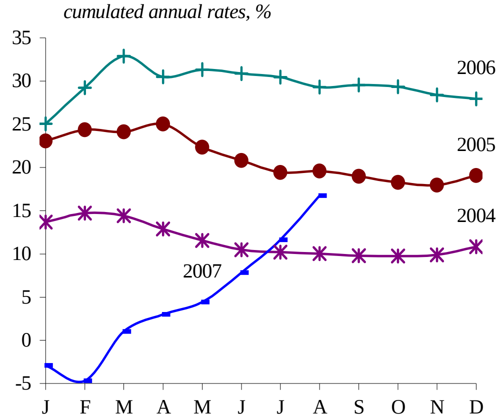
annual contribution (percentage points)



Source: NIS, NBR calculations

Retail Trade* of Foodstuffs, Beverages and Tobacco

cumulated annual rates, %



*) turnover volume

Source: NIS, NBR calculations

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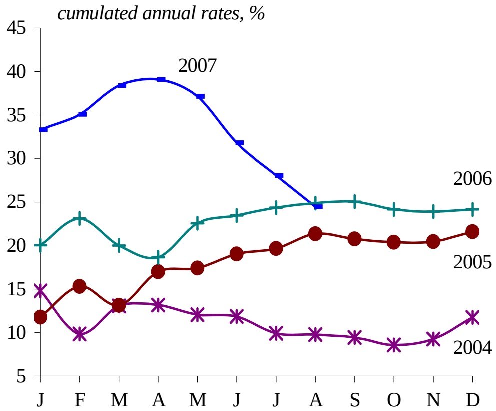
[9] According to the national accounts methodology, purchases of motorcars by households are included in the final consumption.

[10] Household disposable income is estimated by the sum of total wage earnings (net wages weighted by the number of employees), incomes from budgetary and extra-budgetary sources (state social security, unemployment benefit, health insurance), remittances from abroad and private current transfers from non-residents.

[11] The deceleration was manifest in 2006 as well; in 2006 Q4, the annual dynamics accounted for one third of the growth rate for the first three months, i.e. +11.8 percent in real terms.

[12] According to a market survey conducted by MEMRB Retail Tracking Services, at end-2007 H1, the share of supermarkets and hypermarkets in the fast-moving consumer goods market doubled versus January-June 2006 to reach 29.4 percent.

Retail Trade of Durables*



*) 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

Available statistical data on the markets of origin of goods for household consumption show a possible decline in the share of domestically-produced goods in favour of imports. Thus, the growth rate of sales of domestically-produced goods on the domestic market slowed down almost 5 times versus Q1 on both "non-durables" and "durables" segments to 12.9 percent and 5.9 percent respectively; the weak performance was partly offset by the slightly faster dynamics of road transport means in Q2, which, however, remained low, i.e. 2.7 percent. Conversely, the growth rate of the physical volume of non-durables imports[13] accelerated by 4.6 percentage points to 21.2 percent, whereas that of durables imports continued to exceed by far the dynamics of the domestic output of such goods, in spite of the slowdown recorded by most groups of imports[14].

Government consumption

Government final consumption grew at an annual rate of 10.1 percent, from 9.4 percent, in line with the increase in the number of hirings in the public sector.

Budgetary developments

At mid-year, the consolidated general budget posted a cumulated negative balance of about RON 750 million, making up approximately 0.2 percent of the projected GDP for 2007, against the background of a forecasted 2.8 percent of GDP annual deficit[15]. Almost 50 percent of the half-yearly deficit was recorded in Q2, which saw a significant pick-up in the annual dynamics of both revenues and expenditures. Thus, the growth rate[16] of quarterly revenues (22.3 percent) was the fastest in two years[17], against the background of record highs for this period under many categories of receipts (43 percent under wage and income tax, 41.2 percent under profit tax, and 15.3 percent under excise duties). The other categories of revenues, such as VAT, capital revenues, non-tax revenues and contributions to social security, also posted substantial increases in annual dynamics as compared to the previous quarter, except for transfers from property tax, whose annual dynamics decelerated from 32.8 percent to 9.7 percent.

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

[14] The annual dynamics of the physical volume of those categories of durables identified on the basis of the Combined Nomenclature ranged between 24.2 percent (electrical machinery and apparatus) and 68.8 percent (motor vehicles).

[15] The deficit remained unchanged at the latest budget revision in September.

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

[17] Period for which data comparability is ensured, due to the change in budgetary classification.

The annual growth rate of expenditures (30.6 percent) stood near the two-year high (34.9 percent recorded in 2006 Q4). Almost all categories of expenditures exhibited an acceleration of their annual dynamics against the previous quarter, except for some transfers (for social security, whose expansion in real terms slowed down from 19.2 percent to 11.1 percent). The highest annual growth rates were recorded by capital expenditures, transfers (due to those between general government entities and to those including Romania's contribution to the EU), as well as by staff costs.

Nevertheless, in July, the consolidated general budget reverted to a cumulated positive balance (0.5 percent of projected GDP). The change occurred against the background of (i) the build-up of quarterly transfers from profit tax, (ii) expenditures being relieved of some of the wages of the teaching staff (paid in advance in June for the summer months), while (iii) interest payments on public debt and subsidies stood lower than the monthly average for the first half of the year. In August, the cumulated budget surplus fell to 0.3 percent of GDP, as a result of a slight increase in expenditures, along with a decline in receipts, which is typical of the month following that during which profit tax is collected.

The first half of September witnessed the second budget revision of 2007. Both components of the consolidated balance glided upwards (by RON 1,789 million each), so that the deficit target stood flat at 2.8 percent of GDP. The increase in projected revenues was based mainly on the rise in receipts from income tax, dividends and social security contributions, while the expansion in expenditures was mostly attributed to their social component.

Moreover, several decisions were taken in the first part of October with a direct impact on the consolidated general budget deficit for the current year and the years to come. Thus, the authorities approved the early implementation (two months in advance) of part of the pension increase, by 30 percent starting 1 November 2007, followed by another 7.4 percent rise at the beginning of 2008. The Tax Code was amended as well. The changes, effective 1 January 2008, concern mainly (i) the expansion of the tax base (payment of social security contribution for incomes exceeding 5 whole-economy average gross wages, the inclusion of gambling gains into taxable incomes, the correlation of non-residents' income tax from real estate and securities transfers with the legislation on income tax for resident individuals, (ii) the easing and postponement of taxation for some categories of incomes (increase in monthly non-taxable pension income ceiling from RON 900 to RON 1,000 starting 1 January 2008, the inclusion of certain extraordinary incomes into the list of non-taxable revenues of not-for-profit organisations, trade unions, and employers' associations, the postponement until 2009 of the 2 percent tax on sales of agricultural produce to specialised centres), as well as (iii) the optimisation of VAT collection (the extension of VAT collection at customs houses until end-2011, the removal of easy payments in relation to VAT on particular construction works).

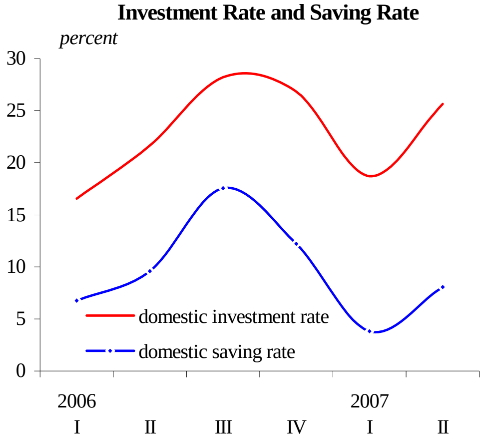
Investment

annual percentage change

	Year	I	II	III	IV
Total	2006	10.8	15.1	15.8	18.4
	2007	16.8	18.4		
- new construction works	2006	23.5	11.6	20.2	18.7
	2007	27.8	33.0		
- equipment	2006	2.6	20.8	6.2	12.4
	2007	3.0	2.8		
- other	2006	4.8	–9.6	54.7	55.8
	2007	57.4	49.4		

Source: NIS

Investment Rate and Saving Rate



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

Source: NIS, NBR calculations

1.1.2. Investment demand

In Q4, gross fixed capital formation remained the main driver of GDP dynamics, its annual growth rate adding another 2.2 percentage points from the prior quarter, to 19.4 percent. However, similar to Q1, construction investment, both new construction works (+33 percent) and capital repair works (around 30 percent) was accounted for the largest share. "Other investment"[18] also made a positive contribution, its annual growth rate hovering around 50 percent in Q2 as well. In contrast, the dynamics of retooling investment remained modest (2.8 percent), its contribution to the rise in total investment dropping to 1.4 percentage points.

In terms of financing sources, the step-up in capital accumulation was bolstered in Q2 too by the increase in own sources of the corporate sector and households, as well as by investment from the public budget (a real growth rate of 125.2 percent, eight times higher than in the prior quarter). Borrowings further stayed on an upward path as well: (i) in the case of domestic banks[19], both loans for equipment purchase and real-estate loans continued to post fast growth rates of the real balance (46.8 percent, down from the prior period and 63.5 percent, up from Q1); (ii) real estate leasing operations increased, so that their share at mid-2007 accounted for 7 percent of the total value of contracts concluded by specialised companied in Romania; leasing operations for equipment purchase saw a fast rise in their market share (up to 22 percent), these two segments expanding on the back of the contraction in the share of loans for purchases of motor vehicles. The sustained rate of increase of investment was also fostered by foreign financial inflows, either redeemable (the volume of medium- and long-term loans granted to the non-government non-financial sector went up 55 percent) or non-redeemable – foreign direct investment and financing under the pre-accession programmes.

[18] Mainly investment in agriculture and expenditures relative to the transfer of ownership over land and the existing fixed assets taken over, against payment, from other units or from the households (notary fees, commissions, transport expenditures, etc.).

[19] CCR data.

The deceleration in the annual growth rate of equipment purchase (including transport means purchases by legal entities and public institutions) impacted both markets of origin – growth rate decelerations saw both the volume of turnover relative to the production of capital goods destined to the domestic market[20] (to 12.4 percent, about half of the prior quarter's figure) and the volume of imports[13], but it is worth noting that the dynamics of foreign goods still outpaced that of domestically-produced ones (the physical volume of imports stepped up 32.9 percent for "mechanical and electrical machinery and apparatus" and 66 percent for "transport means").

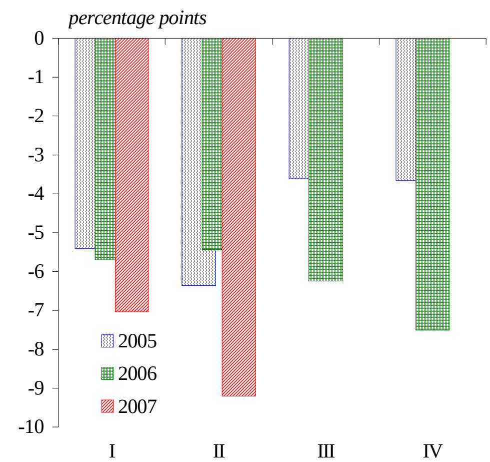
1.1.3. Net external demand

The sharp widening of the negative contribution of net external demand to GDP growth (up to 9.2 percentage points) was solely attributable to the decline by more than five times in the dynamics of exports of goods and services (to 2.4 percent, one of lowest record levels since 1999). Imports further displayed a high growth rate (20.8 percent, slightly lower from Q1).

Similar to the August 2007 Inflation Report, mention should be made that the changes in volume included in the preliminary version of the national accounts for 2007 Q2 relied on deflator estimates, with unit value indices of exports and imports – commonly used for such calculations – being unavailable at that time[21].

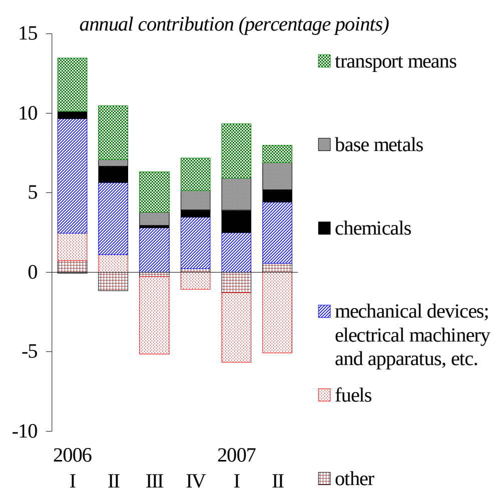
Even if to a lower extent, the poor performance of exports is also revealed by the calculations based on balance-of-payment data (dynamics of physical volume was 2.9 percent[13], down 0.8 percentage points compared to Q1), being attributable mainly to the following categories of goods: (i) light industry products (drop in the physical volume by more than 10 percent), amid competitiveness losses associated to the even stronger appreciation of domestic currency (7.1 percent compared to 5.4 percent in Q1) and the deterioration of the ULC[22]; (ii) fuels (drastic fall in exports volume by 44.2 percent), due to

Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

Dynamics of Export Physical Volume



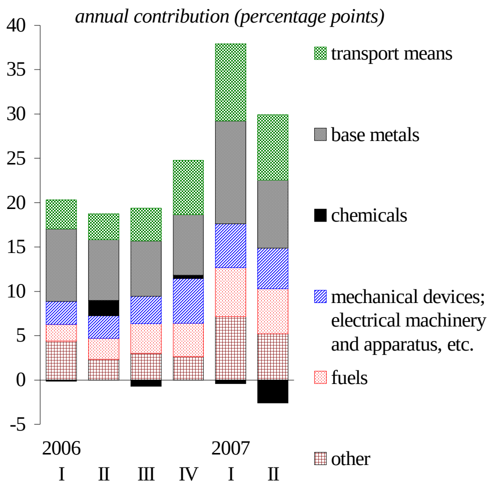
Source: NIS, NBR calculations

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

[21] 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.

[22] The nominal growth rate relative to the ULC in the wearing apparel sub-sector stayed high (33.8 percent, close to the Q1 figure); the growth rate in leather products and footwear sub-sectors posted a threefold increase, to 16.5 percent.

Dynamics of Import Physical Volume



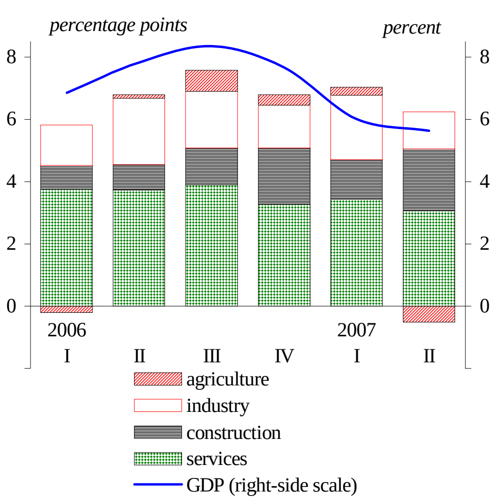
Source: NIS, NBR calculations

incidental factors – further decline in external demand as well as the discontinuation of activity of a leading domestic oil refinery for a six week period; (iii) transport means (growth rate deceleration to 10.2 percent – around one quarter of the prior quarter's figure), mainly on account of the base effect generated by the nature of the manufacturing cycle of transport means other than land vehicles[23]; (iv) electricity – containment of exports, as only orders placed by traditional partners have been honoured given the poor performance caused by drought. In this context, the stimulating impact of the simplification of customs formalities following Romania's accession to the EU, including the removal of customs tariffs for intra-community trade, was virtually annihilated.

The balance-of-payments data show a slowdown in the imports of goods as well. The magnitude of the change in the physical volume of imports (up 27.3 percent) was by far larger than that of exports, fuelled by the above-mentioned procedural changes along with the RON appreciation, the pressure put by the consumption and investment demand as well as by the statistical effect associated with the change in the registration of imports from the EU – at border crossing, not when putting them in free circulation (procedure prior to the EU accession).

1.2. Supply

Contribution of Main Supply Components to GDP Growth



Source: NIS, NBR calculations

On the supply side, the 0.4 percentage point deceleration in the annual real GDP growth in Q2 was attributable to most of the economic sectors, except construction where the annual rate of increase in gross value added gained 1.5 percentage points, a new record level for the 1999-2007 period (32.2 percent), bolstered by all segments (residential, non-residential and engineering works).

In contrast, in 2007, the performance of agriculture was modest due to protracted drought; in Q2, activity in agriculture contracted by 10.9 percent.

In industry, the growth rate of gross value added (4.4 percent) decelerated by 3.4 percentage points as compared to Q1 due solely to the performance in manufacturing, poorer results as compared to the prior quarter being mostly seen in: (i) light industry – against the background of competitiveness losses on foreign markets; (ii) chemicals and oil processing sectors, which were affected by a six-week discontinuation in the activity of one of the leading oil refineries as well as by the unfavourable external environment, in the case of the latter

[23] A long period that entails sudden surges in production and sales.

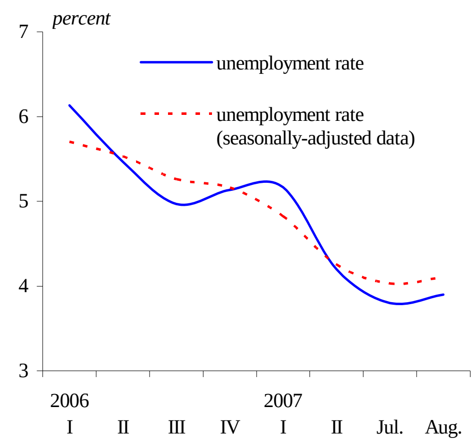
sector; (iii) electrical machinery and apparatus whose underperformance may be attributed to stock building as well as to the durables producers' wait-and-see approach, in order to analyse the market response to the step-up in imports after joining the EU. The trend was partly offset by the faster growth in some industrial sectors, the twofold rise in the growth rate of land transport means (due to the larger number of foreign orders mainly for new models) deserving particular mention.

The services sector also witnessed a deceleration in the growth rate of gross value added, yet lower compared to that in industry (by 0.2 percentage points, to 6.2 percent in Q2). The pace of increase in turnover slowed down chiefly in: (i) retail sales of motor vehicles, due to the modest sales of domestically-produced cars; (ii) wholesale trade, a possible cause consisting in the slowdown of industrial production growth rate, (iii) transport services (particularly on account of further contraction of receipts on the railway transport segment) and (iv) real estate transactions, in which case turnover outpaced, in Q2 as well, the double of the figure for the same year-earlier period.

2. Labour market

The widening of labour deficits signalled by economic agents in various sectors and the further easing of income policy (via the granting of substantial bonuses to public sector employees and the acceleration of the annual growth rate of budgetary and extra-budgetary revenues) fuelled, in 2007 Q2 and Q3, the inflationary risks associated with wage developments. The build-up of such pressures was manifest on both demand and supply sides, as reflected by the more than twofold increase in the annual growth of wages than that in labour productivity (in industry) and by the faster pace of increase in the purchases of goods and services by households.

Unemployment Rate



Source: NEA, NBR calculations

2.1. Labour force

In 2007 Q2 and Q3[24], tensions in the labour market continued to strengthen, as a result of the further contraction of excess workforce supply (unemployment rate declined to 3.9 percent in July-August 2007) as well as employers' high persistent demand. Therefore, the ratio between the number of unemployed and the number of vacancies[25] contracted markedly (16.9:1 as compared to 23:1 in April-August 2006), and the widening of the positive gap between the number of newly recorded vacancies and the number of hirings (to more

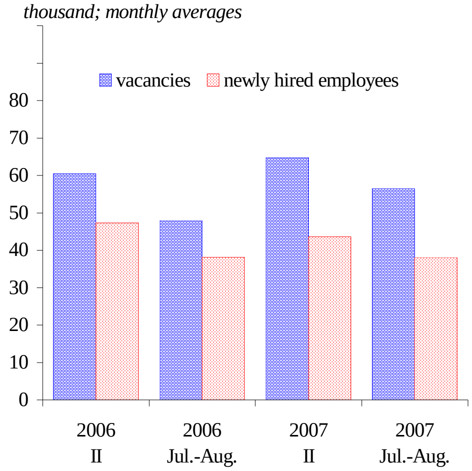
[24] Statistical data provided by the NEA up to and including August.

[25] Monthly stocks.

than 48 percent, compared to only 27 percent in the year-earlier period) suggests ever increasing discrepancies between excess workforce supply and demand.

Number of Vacancies and Number of Filled Vacancies

thousand; monthly averages



Source: NEA

Although there are no official data regarding the distribution of workforce deficit by sector or by trade, the opinions of the NEA, as well as those of recruitment agencies or employers, show that the sectors facing the biggest challenges are the following:

i) construction, which has seen large workforce fluctuations due to migration, so that employers' difficulties to find properly skilled staff extended to unskilled workers as well; additionally, the workforce deficit has been fuelled by the large workforce demand given the expansion of activity[26];

ii) trade and hotels and restaurants, on the backdrop of the sharp expansion of networks of foreign companies nationwide and of the penetration of new companies on the Romanian market (mainly in the former case) as well as of the migration of workforce abroad (in the latter case);

iii) light industry, pharmaceuticals, transport means, computers; the workforce deficit in industry has been related mainly to adequately skilled staff (except for light industry) and may be associated with several factors: workforce migration, insufficient supply of university graduates and the business development policies promoted by companies, that focused on enhancing the sale/distribution networks rather than on staff recruitment and training.

The problems associated with the workforce deficit have been amplified by:

i) low mobility of workforce. The legislation provides for the possibility of granting benefits to the unemployed claimants that accept a job in another locality[27], yet the experience of large companies which proceeded to relocating their activity illustrates the fact that employees are usually reluctant to such a change, their motivation entailing a substantial financial effort;

ii) insufficient adjustment of education curricula to labour market requirements (more manifest in the case of technical higher education) or the poor quality of staff training on some segments (hotels).

[26] According to the AMIGO survey, in 2007 Q1, the number of employed in construction was 25 percent higher year on year.

[27] Hiring bonuses representing the equivalent amount of two minimum gross wages for accepting a job in a locality situated at more than 50 km from residence and relocation bonuses consisting in the equivalent amount of seven minimum gross wages for changing residence.

2.2. Incomes

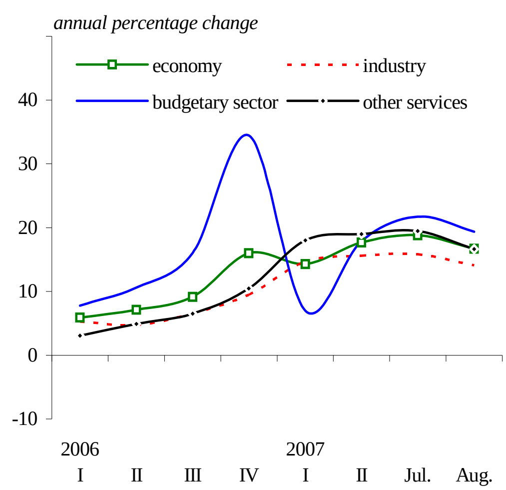
According to expectations, in June-August 2007, the annual growth rate of net wages economy wide stood above the 20 percent level that has been recorded starting with February. This was the result of persistent tensions in the labour market and the granting of bonuses[28] to public sector employees; public sector wages posted a 25.3 percent annual dynamics, around 3 percentage points higher than the average for the majority private sectors.

The sectoral analysis shows that, in 2007 Q2, above average annual growth rates (22.1 percent) were recorded by net wages in construction, trade, and particularly public administration (by more than 15 percentage points). Moreover, in July and August, the annual dynamics of net wage in public administration rose to a 42.4 percent average, representing the largest move up to the highest value among all sectoral developments under scrutiny. The loose wage policy sets the stage for fuelling wage claims during a period when labour contracts are being negotiated, putting pressures additional to those stemming from the workforce deficit in the above-mentioned sectors and, implicitly, fostering the rise in inflationary risks.

In industry, the annual dynamics of gross wages (21.7 percent in 2007 Q2, as well as in July and August) continued to outpace the annual growth rate of labour productivity, although the latter reverted to substantial levels, after the April decline (the fall to almost half of the average for 2007 Q1 being driven by the unfavourable effect that the discontinuation of activity of a leading domestic oil refinery due to technical overhaul had on the volume of production in several related industries). In Q2, the annual growth rate of the ULC index saw a 4.7 percent acceleration quarter on quarter industry wide; it is likely that the trend should reverse in Q3, yet without entailing a significant alleviation of related inflationary risks (a 1.4 percent deceleration in July-August to 10.3 percent). In fact, in some consumer goods sub-sectors (food industry, wearing apparel, leather products and footwear, furniture, which hold a large share in the consumption basket), the annual growth rate of the ULC index stood above the average for manufacturing throughout the period under review. However, there were some sub-sectors that make a large contribution to the industrial production volume (chemicals, metallurgy, transport means) which saw no cost-push pressures during May-July 2007, but they witnessed a worsening in August, most likely due to the stronger impact of holidays on production, compared to the year-earlier period.

[28] Including holiday entitlements.

Net Real Wage*



*) deflated by CPI

Source: NIS, NBR calculations

Private Sector Wages

January-August 2007

	% of whole-economy average	annual change %
Tourism	61.9	17.4
Trade	82.0	28.2
Construction	85.0	22.1
Manufacturing	85.0	19.5
Communications	155.0	17.4
Financial intermediation	295.0	23.5

Source: NIS, NBR calculations

Labour Productivity and Real Gross Wage in Industry

annual percentage change

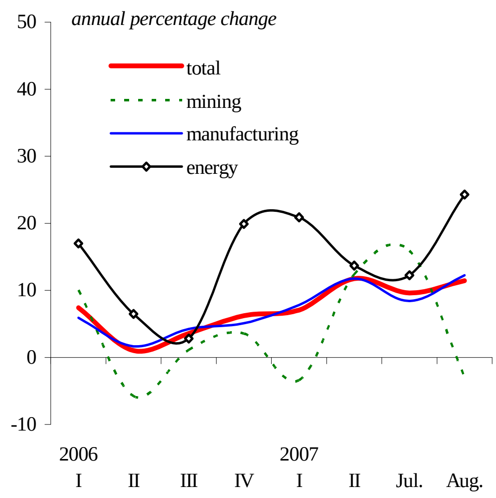
	2006				2007			
	I	II	III	IV	I	II	Jul.	Aug.
Labour productivity	8,6	13,2	11,1	10,0	12,8	8,9	11,3	9,0
Real gross average wage*	4,4	2,0	1,9	4,8	9,4	12,4	14,2	14,2
Real gross average wage**	7,8	4,0	3,0	6,9	14,3	16,5	20,6	18,6

*) deflated by industrial producer price index for domestic market

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

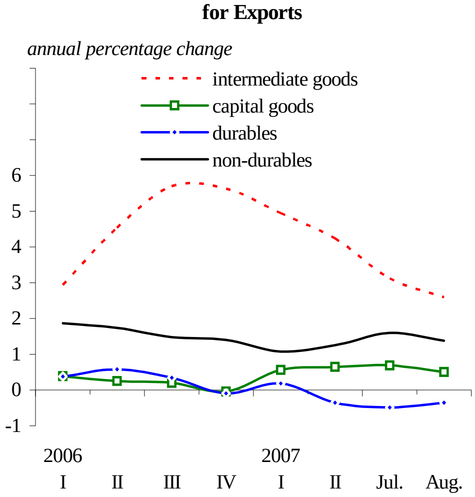
Source: NIS, NBR calculations

Unit Labour Costs in Industry



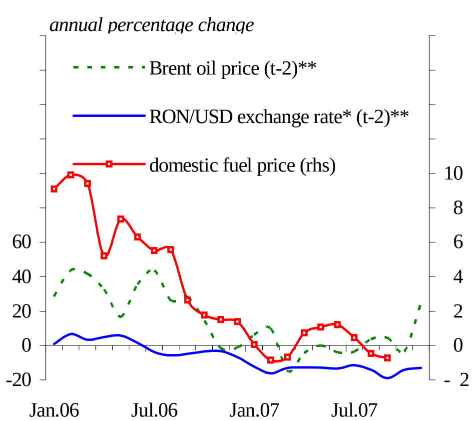
Source: NIS, NBR calculations

EU-25 Industrial Producer Prices for Exports



Source: EUROSTAT

Oil and Fuel Prices



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

Source: NIS, EIA

On the demand side, the latest data confirmed the persistent brisk growth rate of real disposable income (16 percent in 2007 Q2, the same as in the prior quarter). The annual dynamics of both real wage earnings (up 21 percent) and budgetary and extra-budgetary revenues (up 13.1 percent) accelerated by 4 percentage points, while the rise in transfers from abroad (7.9 percent) decelerated markedly, amid the sharper appreciation of domestic currency against the major currencies. According to flash estimates relative to 2007 Q3, despite a slower-paced growth in the latter two components of the analysed indicator, it will further witness a high rate of increase. Thus, developments in incomes, particularly wage earnings, may be seen as further posing inflationary risks, given that, despite households' increased propensity for saving, excess consumer demand might be fuelled both directly, through immediate purchases of goods and services, and indirectly, through the higher potential of contracting consumer loans.

3. Import prices and producer prices

In 2007 Q2, inflationary pressures continued to ease, as illustrated by imported goods as well as by industrial and agricultural goods originating in the domestic market, even though in the case of the latter group due partly to some favourable base effects. The said effects will be significantly lower in 2007 Q3, taking into account the developments on the international markets of energy and agricultural commodities and the poor domestic vegetal crops.

3.1. Import prices

In 2007 Q2, imported inflation further had a favourable impact on domestic price dynamics, given that the unit value index of imports remained below par (98.2 percent compared to 96.9 percent in 2007 Q1) and the domestic currency strengthened versus the euro at a faster pace (7.1 percent from 5.4 percent in the first three months of 2007). The unit value index of imports from the European Union declined slightly to 98.13 percent as compared with 98.54 percent in Q1.

Consumer goods posted uneven developments, the significantly faster growth rates of import prices for most food items (particularly meat, edible fruit and processed foodstuffs) being alleviated by opposite movements under pharmaceuticals, fuels, wearing apparel and electrical machinery and apparatus.

Data available for 2007 Q3 are indicative of ever higher pressures on the domestic fuel price, as oil prices on international markets rose from an average of USD 68.7 per barrel in 2007 Q2 to USD 75 per barrel, the alleviation of tensions on these markets seeming unlikely in the short run. Similar developments are expected in the case of agricultural commodities, the prices of which followed an upward course once the first estimates on production losses generated by adverse weather conditions have been released.

Nevertheless, favourable effects may be due to the appreciation of the domestic currency versus the euro and the US dollar (9.5 percent and 18.1 percent respectively, in annual terms) and the persistent downtrend in the annual growth rate of industrial producer prices for EU25 exports (excluding construction and energy), which decelerated from 1.98 percent in 2007 Q2 to 1.47 percent in July-August.

3.2. Producer prices

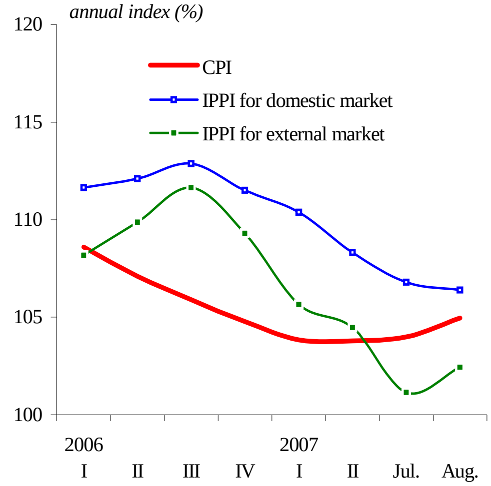
3.2.1. Industrial producer prices

In April-June 2007, the annual growth rate of industrial producer prices for the domestic market continued to slow down compared with the previous quarter (2.1 percentage points to 8.3 percent), owing to the favourable effect of the products prevailing in the CPI basket, namely non-durables (down 2.2 percentage points to 7.9 percent) and energy products (down 4.3 percentage points to 8 percent). However, a significant contribution to the deceleration of the two groups of products came from the favourable base effect which was manifest in several sub-sectors: (i) tobacco processing, owing to the introduction of the vice tax in 2006 Q2; (ii) leatherwear, which in 2006 was subject to restructuring for making domestic brands popular and expanding retail networks (both domestically and internationally), at considerable costs; and (iii) oil processing, which faced significant hikes in world oil price in April-May 2006.

Producer prices for intermediate goods also displayed slower growth rates (down 0.9 percentage points to 9 percent), although the major causes may be attributed to demand – the annual dynamics of domestic sales declined more than three times as compared with the first quarter of 2007, from 48.6 percent to 14.2 percent.

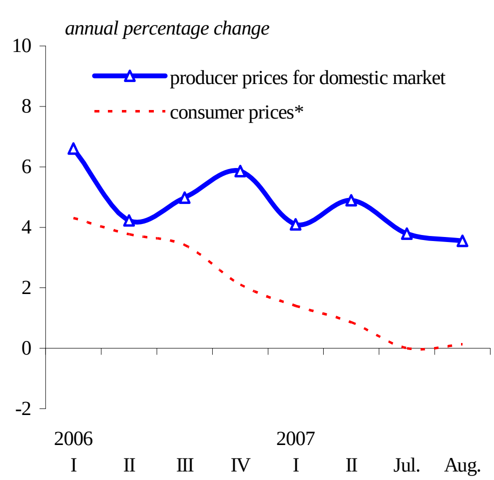
By contrast, the growth rates of producer prices for capital goods and durables advanced by 2 percentage points to 9 percent and by 0.8 percentage points to 4.9 percent respectively.

Consumer Prices and Industrial Producer Prices



Source: NIS

Durables Prices



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

Source: NIS, NBR calculations

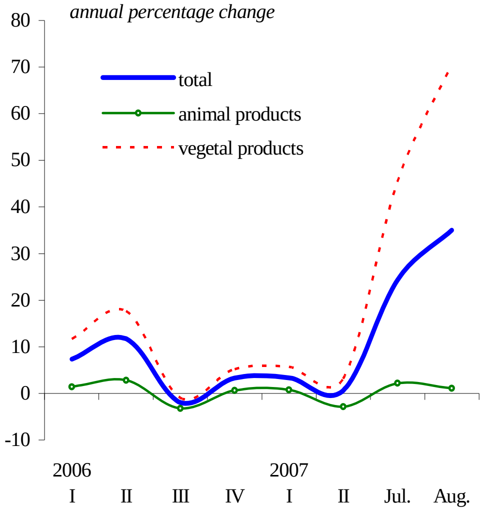
An explanation for this development could be the further costly raw materials, given the flattening of the downtrend in the dynamics of metal prices on external markets.

In 2007 Q3, disinflation of industrial producer prices is expected to continue, with a significant contribution from sub-sectors exposed to the external prices for metals, considering the latest developments.

3.2.2. Agricultural producer prices

Agricultural Producer Prices

annual percentage change



Source: NIS

In 2007 Q2, the annual growth rate of agricultural producer prices decelerated to 0.65 percent (-2.6 percentage points versus the prior quarter), owing to the favourable impact of prices for vegetal products (down 2.2 percentage points to 3.2 percent) and animal products (down 3.7 percentage points to -2.9 percent). Despite the deceleration seen in the case of vegetal products, inflationary pressures continued to build up in Q2 given that: (i) prices for grains rose further at a sustained pace compared with the same year-ago period and with the prior quarter; (ii) the slowdown in the growth rates of prices for fruit and vegetables was mainly due to a favourable base effect associated with the short supply of 2005, which had an impact on the developments in prices for such products in the first part of 2006 as well (before harvesting).

Prices for animal products painted a brighter picture, as they followed a downward course compared with the same year-ago period, with prices for all types of meat heading downwards.

For the period ahead, the annual pace of increase of agricultural producer prices is expected to revert to an upward trend, with vegetal products prices making a significant contribution in this respect, as their annual growth accelerated significantly in April-May owing to adverse weather conditions.

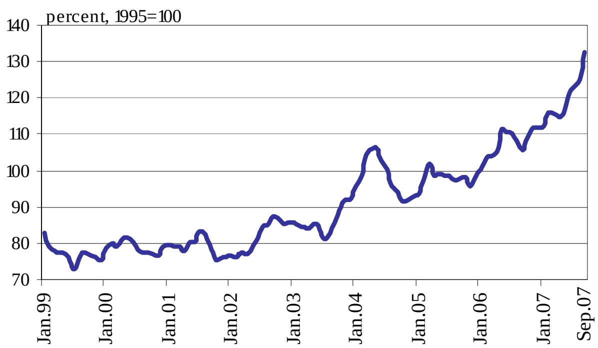
Box: Recent developments in the main commodity markets

1. Agricultural commodities

World prices of agricultural commodities have followed a steady upward path since 2001, their rate of increase accelerating significantly in 2007.

According to the ECB[29], price increases have mostly been driven by supply-side factors: higher energy and fertiliser prices, low levels of inventories and short crops caused by adverse weather conditions. However, considerable demand-side pressures have also been manifest, generated by two types of factors: (i) change in consumption behaviour in several emerging economies (e.g. China, India) through the shift in focus towards foodstuffs with high value added (dairy and meat products), which indirectly caused the increase in fodder consumption; (ii) wider use of some agricultural commodities for the production of bio-fuels (primarily ethanol), based on government programmes and incentives. Consequently, farmers were encouraged to increase the production of such plants (maize, for instance), while they decreased the supply of other agricultural products, with a subsequent indirect impact on the prices of these products.

Food price index*



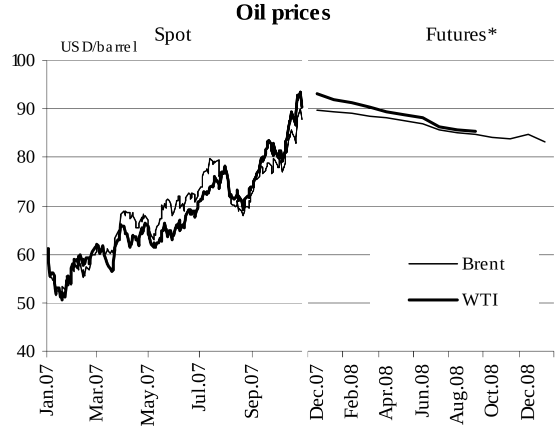
* includes prices for grains, edible oil, meat, sugar, bananas and oranges

Source: IMF

Against the background of poor grain production in 2007, the price of wheat on the main international stock exchanges hit record highs in July-October 2007. The wheat price on the European stock exchanges stood at EUR 280 per tonne (compared with an intervention price[30] of EUR 101.3 per tonne established for EU Member States), while the price for maize advanced to EUR 246.7 per tonne in September (as compared with EUR 141.3 per tonne at end-2006). In these circumstances, the traditional wheat suppliers, including for Romania (e.g. Serbia, Ukraine), decided to cease or contain deliveries in order to slow down price increases on the domestic market, while the European Commission decided to remove customs duties on wheat imports from third countries by mid-2008.

2. Oil

Oil prices



Source: Bloomberg

* 31 October 2007

Oil price hit new record highs in October 2007, the average Brent oil price rising to USD 82.9 per barrel (as compared with USD 70.8 per barrel in August, against the background of fears surrounding a slowdown in economic growth, following the US sub-prime mortgage crisis). The OPEC decision taken on 11 September 2007 to increase oil production by 500,000 barrels per day starting in November did little to alleviate fears surrounding the low levels of inventories for the approaching cold season, taking into account the weather forecasts, according to which the temperature will be lower than in the winter of 2006, and the escalating tensions between Turkey and the Kurds in northern Iraq.

According to the analyses conducted by the US Department of Energy (Energy Information Administration), the recent hike in oil prices was generated by economic fundamentals: (i) scant inventories[31], (ii) smaller spare production capacity, and (iii) greater geopolitical risks. Thus, the oil market operators were increasingly concerned with the build-up of larger prudential stocks, given the decline in surplus capacity, which may have been used in case of disruptions on some platforms or higher geopolitical risks. However, such conclusions do not rule out the role of speculators in explaining the upward trend of prices. Moreover, OPEC accused speculators of exacerbating this tendency, the analysts explaining the presence of speculators by technical investment, which is made automatically when oil prices reach certain levels, as well as by the greater attractiveness of this asset, following the depreciation of the US dollar.

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[29] Monthly Bulletin – September 2007.

[30] The intervention price is the minimum guaranteed price paid to farmers in EU Member States for the products sold on the domestic market.

[31] In October 2007, the International Energy Agency announced that the oil stocks of the main developed countries decreased below the average for the past five years.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In 2007 Q3, the monetary policy rate was left unchanged at 7.0 percent per annum and the quarterly average[32] *of the real effective exchange rate of the RON continued to drop compared to the previous quarter, in spite of the trend reversal seen in the RON/EUR rate in August. In this context, the slight increase in restrictiveness of broad monetary conditions was upheld also by a firmer control of the central bank over money market liquidity and by the further tight minimum reserve requirements mechanism.*

The decision to bring to a halt the downward trend in the monetary policy rate, which the NBR Board adopted in July, was chiefly driven by the relative increase in risks to sustainable disinflation as a result of a persistent mismatch between wage increases and productivity gains, the anticipated upsurge in public spending and the still worsening trend in the external position of the economy. The prudent stance of interest rate policy in Q3 was also warranted by worsening inflation expectations in the near run – due largely to the upsurge in the inflationary potential of some supply-side factors (with the impact of drought on agricultural output and food prices being prevalent) and to the adverse effects triggered by the upward correction in RON exchange rate in the latter part of Q3 and the increased uncertainty surrounding future developments in these inflation-boosting factors. In order to enhance the impact of interest rate decisions, the National Bank of Romania made several changes to the operational framework of monetary policy during the reported period, seeking to strengthen the signalling role of key policy rate and that of interbank rates within the monetary policy transmission mechanism. In addition, with a view to ensuring an appropriate real interest rate level for stimulating savings – as a prerequisite for the gradual reduction of the external deficit – the interest rate policy was preemptively strengthened in the latter half of Q3 through tighter control exerted by the central bank over money market liquidity; hence, average interbank rates stood about 2 percentage points higher at end-September than in the

[32] The effective exchange rate is based on the exchange rates of the RON against the EUR and the USD respectively by using a weighing formula that reflects the shares of the two currencies in Romania's foreign trade (see Chapter V. *Inflation outlook*).

previous month. Furthermore, taking into consideration the fast growth in non-government credit[33] – also underpinned by the surge in its foreign exchange-denominated component – the central bank left unchanged the minimum reserve requirements ratio on RON-denominated liabilities[34] at 20 percent and the minimum reserve requirements ratio on foreign exchange-denominated liabilities of credit institutions at 40 percent.

The decision to leave the monetary policy rate unchanged at 7.0 percent per annum – and implicitly to stop the series of cuts applied in 2007 H1 – was taken after updating in July the projection of medium-term macroeconomic developments, which underscored the increased likelihood that some major risks to sustainable disinflation should materialise. The most significant risk identified was the likely expansion in excess demand above the projected level owing to the considerable loosening of income policy in 2007 and to the pro-cyclical stance of fiscal policy in the next quarters, on the one hand, and to the short-lived reduction in potential GDP induced by the detrimental impact the poor harvest on supply, on the other hand.

The monetary policy rate was left unchanged at 7.0 percent per annum at the Board meeting of 26 September as well. This decision was taken after the balance of risks identified in the wake of analysing the new information available prompted the central bank to vigilantly monitor the movements in the main macroeconomic and financial variables both domestically and internationally so as to allow an as-realistically-as-possible assessment of their impact on the future path of inflation. The impact needs to be evaluated amid higher interbank rates, in line with the monetary policy rate, as a result of further tight liquidity control that had been pre-emptively initiated, as well as in the context of heightened uncertainties on foreign markets.

Against this background, expectations on second-quarter GDP performance were largely confirmed. Thus, economic growth slackened, but at a slower-than-anticipated pace (5.6 percent against 5.2 percent – see *Chapter III. Economic developments*), with the annual rate of increase of gross fixed capital formation accelerating to 19.4 percent from 17.2 percent in Q1 and that of private consumption dropping by merely 0.7 percentage points to 10.7 percent. As a result, the annual expansion in domestic absorption gained renewed momentum in 2007 Q2, reaching 13.2 percent – 1.4 percentage points higher than the first-quarter

[33] Given its significantly larger share in GDP.

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

reading –, and the slowdown in annual GDP growth was solely attributable to the rise in the negative balance of net exports[35].

Moreover, the poor agricultural output started to put pressure on domestic demand; thus, in Q2, demand for foodstuffs rebounded (in response to lower self-consumption), having a decisive contribution to the pick-up in the growth rate of purchases of goods and services, the chief component of household consumption (15.2 percent against 12.4 percent in 2007 Q1). Although it affected mostly the external imbalance, the pick-up generated larger demand-side inflationary pressures, which could lead to costlier domestic goods and a faster rate of increase in imported inflation amid the hike in international prices of some vegetal products and the effects of a weaker RON versus the major currencies becoming manifest. In addition, such a pattern of household consumption was very likely to persist into Q3, given that the statistics for July-August confirmed the ongoing change in the structure of household consumer demand on the back of the increase in the contribution from demand for food. Thus, the annual average growth of food purchases rose markedly[36] and was the sole driver of the sizeable advance in the dynamics of retail sales. These developments were associated with the still fast dynamics of disposable income (propelled particularly by wages and remittances from abroad) and the shaping of a worsening trend in net savings of households, which made the central bank's prudent policy stance warranted.

The explanation for this trend lies with the renewed pick-up in the annual dynamics of loans to households[37] in July and August, possibly as a result of progress in the process of approving banks' internal prudential rules on household lending. The rebound in lending was almost entirely due to faster increase in home loans, considering that the annual growth rate of consumer credit remained relatively steady. At the same time, the credit structure by currency changed at a faster pace, with foreign-currency-denominated loans gaining momentum; the annual growth rate of such loans (expressed in EUR) surged to 116 percent in August, whereas that of RON-denominated loans stayed on the downward track that had begun 11 months ago (reaching 39.2 percent in August) amid flat average rates on new loans. Developments in forex loans mirrored households' keener appetite for long-term forex-denominated loans, upheld by the protracted decline in interest

[35] Their contribution to GDP dynamics hit a record of -9.2 percentage points in 2007 Q2.

[36] The average annual growth rate of retail sales of foodstuffs in July-August more than quadrupled against the second-quarter figure.

[37] Unless stated otherwise, annual rates of increase are shown in real terms.

rates on new EUR-denominated loans and the attractive lending rates on non-traditional currencies[38]. Under the circumstances, the National Bank of Romania was of the opinion that a potential rate hike could boost demand for foreign currency-denominated loans, thereby offsetting the opposite effect which was expected to be exerted (including via altered expectations) by the recent trend reversal in the RON exchange rate and the likely increase in the cost of funds raised by credit institutions from foreign markets (a possible result of a larger risk premium).

As for household deposits, the developments in the first part of Q3 appear to suggest a steeper propensity for saving; the annual growth rate of time deposits in domestic currency with maturity of up to two years accelerated in July, but lost some momentum in August. Moreover, a portfolio shift of households' term deposits with maturity of up to two years in favour of RON-denominated instruments was manifest (against the backdrop of a continued slowdown in the pace of increase of forex deposits). The average annual growth rate of household deposits with banks increased to 40.3 percent, 1.8 percent above the second-quarter average. The dynamics of overnight deposits of households picked up sizeably, reaching 109.6 percent in August, up 15.7 percentage points from end-June 2007. Behind this development stood the rapid annual growth rate of RON-denominated deposits (135.6 percent), which reflected the banks' policy of maintaining the attractiveness of such instruments, high yields included.

Towards the end of the quarter, the central bank's concern to ensure sustainable disinflation was augmented by the sharp acceleration in inflation in August[39] and the worsening short-term outlook on the performance of the general consumer price index. The major determinants of resurgent inflation were the higher-than-expected increase in some food prices and the RON exchange rate reverting to the upward trend as a result of global market turmoil. At end-July, the domestic currency underwent an episode of nominal depreciation, prompted by the effects, due to expectations in particular, of investors' heightened risk aversion against the background of spill-over of the tensions in the US sub-prime mortgage market. The relative recovery on international markets halted only briefly the upward drift in the RON/EUR rate, which resumed in early September, given that operators' anticipations were depressed by the release of some statistical data that failed to warrant market expectations

[38] The share of loans denominated in Swiss francs in total FX loans rose to 12.2 percent in August from 10.1 percent in June.

[39] Annual inflation rate rose to 4.96 percent, 1.16 percentage points higher than in June.

(second-quarter GDP) or confirmed market fears (current account deficit for January-July 2007); subsequently however, the local currency re-entered an appreciation path.

Under the circumstances, the decision to leave the policy rate unchanged also took account of the major uncertainties arising from the impact of the recent financial market turmoil on global economic growth, particularly on the volume and cost of external financing that could be channelled to the Romanian economy and which would have an impact on its growth rate.

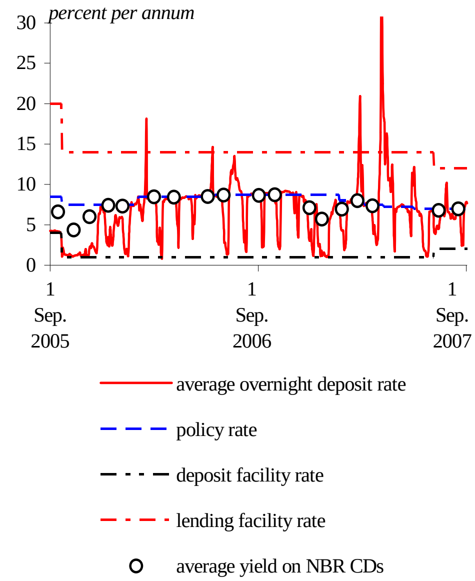
In order to increase the impact of interest rate decisions, the National Bank of Romania changed the operational framework of monetary policy. With a view to lowering the magnitude of interbank rate fluctuations and thus strengthening their role within the monetary transmission mechanism as well as the signalling role of key policy rate, the central bank moved to narrow the corridor defined by the interest rates on its standing facilities. Consequently, the interest rate on the deposit facility was raised to 2 percent per annum from 1 percent, while the interest rate on the lending facility was cut to 12 percent per annum from 14 percent. Moreover, 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 reserve requirements (one month) and, on the other hand, the prevailing maturity of interbank market transactions, and hence in order to reduce the volatility of short-term interest rates on this market, the NBR decided in July to decrease the maturity for deposit-taking operations to two weeks from one month previously.

In an attempt to consolidate the restrictiveness of monetary conditions, starting August, the central bank strengthened significantly the control over money market liquidity, while in the first part of 2007 Q3 market operations offset only partly the liquidity injections triggered by autonomous factors. The National Bank of Romania mopped up excess liquidity largely via variable-rate deposit auctions at which accepted amounts equalled the pre-announced ones; the persistent uncertainties of banks regarding the developments in autonomous factors of liquidity gave rise to a spread between the average interest rate on two-week deposits with the NBR and the monetary policy rate. For removing this gap, as of the final week of September, the central bank started to perform fixed-rate deposit-taking operations, with banks' bids being accepted in full. Under the circumstances, at end-September, the average balance on National Bank of Romania's open-market operations rose by 27.5 percent against June, with two-week maturity deposits accounting for 81.9 percent of the total balance (compared with 75.3 percent at mid-year).

2. Financial markets and monetary developments

Daily interbank rates returned to normal values during 2007 Q3 and gradually neared the policy rate, under the influence of changes to the monetary policy operational framework and of the central bank's tighter control over liquidity. The RON/EUR exchange rate saw a trend reversal, as the domestic currency – similar to other currencies of emerging economies – came under the impact of the sharp decline in investors' risk appetite given the global market turmoil. Liquidity in the economy expanded at a slower pace, while the annual growth rate of private sector credit regained momentum in the latter part of the reported quarter, spurred by the faster rise of its forex-denominated component.

Interbank Money Market Rates



2.1. Interest rates

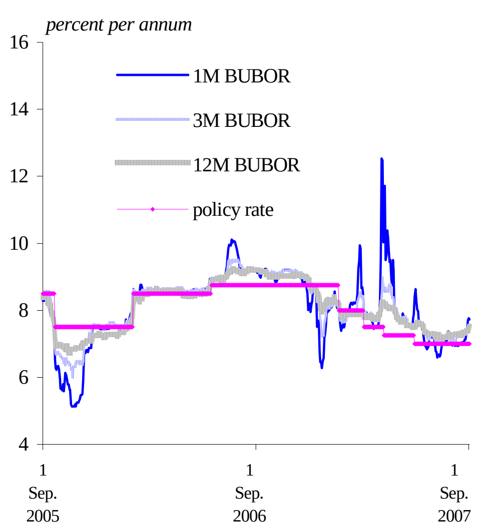
The changes brought by the central bank to the monetary policy operational framework and the tightening of the liquidity control policy made the interbank rates reduce their volatility considerably in 2007 Q3 and gradually return close to the monetary policy rate; the average interest rate on interbank deposits fell 3.7 percentage points versus the previous quarter, reaching 5.9 percent.

The magnitude of this decline reflected mainly the return of daily average rates to normal values following the extremely high levels posted in the previous quarter. Another driver of this drop was the downward course of interbank deposit rates in early July, against the backdrop of a temporary hike in excess reserves. Liquidity injections generated by developments in autonomous factors were only partly offset by the central bank's open market operations, so that the average overnight rates became significantly lower than the policy rate, nearing the interest rate on the deposit facility in the final week of the reserve maintenance period.

The subsequent rebound was followed by a further drop – albeit of a lower magnitude – in the first 10-day period of August, when average daily interbank rates posted values 2-3 percentage points lower than the policy rate, although liquidity conditions remained somewhat balanced. These developments were the result of certain credit institutions overestimating the volume of reserves within the system (including by anticipating that the NBR would stick to the same liquidity management approach as in the previous month). Increased resort to sterilisation operations led to a subsequent reshaping of these expectations, so that interbank rates overlapped again the policy rate in the latter part of the month. Liquidity conditions even became relatively tense in the final two days of the reserve maintenance period, given that excess reserves failed to be effectively redistributed among banks[40], while some participants overestimated the short-term demand for resources; on 23 August, interbank rates climbed to a daily average of 10.1 percent, the actual magnitude of their rise being limited by the NBR's liquidity injection conducted in this context via a repo operation. Starting with the last week of August, interest rates hovered around 6.0 percent, except for the temporary decline which occurred at the end of the reserve maintenance period in September. However, in the latter part of the reported quarter, interbank rates exceeded slightly the policy rate, given that the central bank reverted to its traditional manner of conducting deposit-taking auctions (at fixed-rate) and banks displayed a keener interest in this type of placements.

Against this backdrop, interbank rates fluctuated within a significantly narrower margin compared to the previous quarter, with daily average interest rates on overnight deposits ranging from 1.1 percent to 10.1 percent. In addition, the average spread between bid and ask rates for this maturity narrowed gradually during the period under review, so that its quarterly average hit a historical low.

Policy Rate and BUBOR Rates



The (1M-12M) BUBOR yield curve moved downwards in the first part of the period under review, with the overall average of such rates posting a 0.50 percentage point drop during July-August compared to the previous quarter. The decline was steeper for short-term rates (as a result of the temporary easing of liquidity conditions), so that the spread between monthly averages of 12M and 1M BUBOR rates entered positive territory. In September, however, interest rates reverted to an upward trend across the maturity spectrum, rising by approximately 0.15 percentage points on average versus the previous month. These developments mirrored a tighter monetary control by the NBR and the implicit recalibration of market operators' expectations on the interest rate trajectory over the coming quarters.

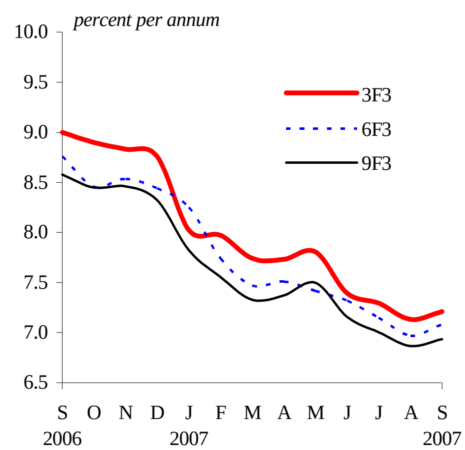
Developments in implicit forward rates illustrated similar expectations. Thus, calculated on the basis of September average rates, the 3M BUBOR rate was expected to stand at 7.2 percent at end-2007 and decline progressively to reach 6.9 percent around mid-2008. However, according to end-September readings, the 3M BUBOR rate was expected to come

[40] Inefficient market functioning – possibly stemming also from certain internal regulations of banks – is also illustrated by the recourse, on 23 August, to both standing facilities.

in at 7.3 percent in December 2007 and shrink only marginally in the first two quarters of 2008 to 7.2 percent.

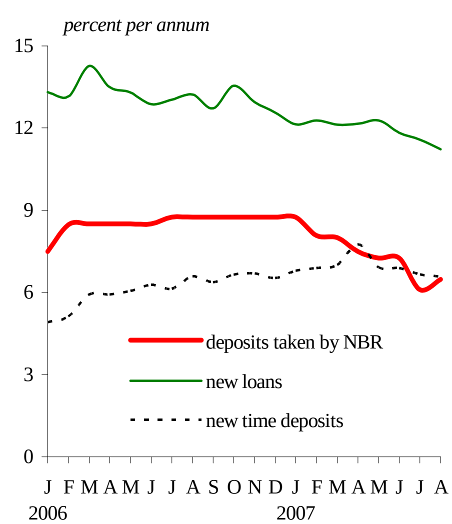
In contrast to interbank deposit rates, the interest rates on government securities witnessed an almost steady decline throughout 2007 Q3, as the policy pursued by the Ministry of Economy and Finance – namely cutting down costs associated with government borrowings – helped the primary market for government securities escape the influence of money market developments. Relying on the comfort provided by the large volume of resources in the Treasury account, at the conducted auctions the public authority has almost steadily lowered the maximum accepted interest rates (by values between 0.03 and 0.17 percentage points), which ranged between 6.71 percent (on securities with a 10-year maturity) and 7.15 percent (on securities with a 3-year maturity); in addition, during three of the twelve government securities auctions conducted July through September, the Ministry of Economy and Finance rejected all the bids submitted by participants, considering the bid rates as overly high. Against this background, the average interest rates on treasury certificates fell to 6.71 percent (6-month maturity) and 7 percent respectively (1-year maturity), while those on benchmark government bonds dropped to 7.05 percent (3-year maturity) and 6.7 percent (10-year maturity)[41] respectively. Furthermore, the value of government securities launched in 2007 Q3 (i.e. RON 1,007 million) accounted for half of the volume announced and of that issued in the previous quarter.

Implicit Forward Rates



The volume of transactions on the secondary market of government securities also halved against the previous quarter, owing solely to fewer operations conducted by the central bank. Therefore, the total trading volume (reverse + outright transactions) on the secondary market amounted to about RON 5,495 million (as compared to RON 10,253 million April through June), of which only 8 percent had the central bank as counterparty (versus 66 percent in the previous quarter). Outright transactions accounted for almost 68 percent of the total trading volume and involved mostly (76 percent) securities with residual maturities of three and five years. The average interest rates for these maturities posted opposite developments from the previous quarter: the former rose from 6.74 percent to 6.86 percent, whereas the latter dwindled from 7.1 percent to 6.93 percent. Reverse operations[42] focused particularly on one-

Bank Rates



[41] In August and September, the average interest rates on 10-year benchmark government bonds stood below the coupon rate set by the Ministry of Economy and Finance (6.75 percent).

[42] Excluding those having the NBR as counterparty.

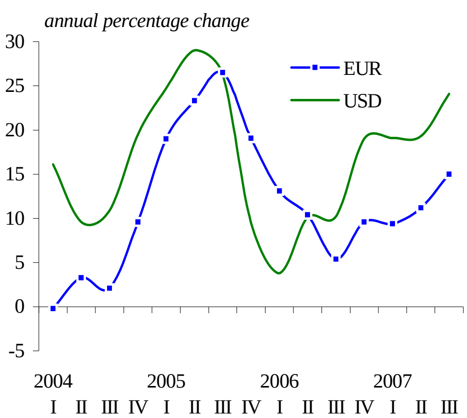
and two-month maturities, with the related average repo rates standing at 6.61 percent and 6.68 percent respectively.

Average lending and deposit rates on new business also posted a downtrend June through August 2007. However, this trend was barely perceivable in case of loans to households, whose average interest rate diminished over the reported period by a mere 0.11 percentage points[43] (12.16 percent in August). Conversely, the average lending rate on new business to non-financial corporations saw a more significant adjustment, dropping 1.75 percentage points (to 10.54 percent) on account of the considerably lower (by approximately 4 percentage points) variable interest rates on high-value loans (in excess of EUR 1 million). The downward path followed by the average interest rate on overdraft loans had a similar distribution by client (-0.37 percentage points, to 21.99 percent in case of loans to households, and -2.14 percentage points, to 11.47 percent in case of corporate loans).

Average interest rates on new time deposits posted, however, similar developments by client. Average rates on new household deposits declined over the period under review by 0.36 percentage points (down to 6.38 percent) and those on deposits from non-financial corporations shed 0.33 percentage points (down to 6.66 percent). Against this backdrop, the spread between the average interest rate on new loans and that on new deposits narrowed further, with the average for June through August posting a historical low.

2.2. Exchange rate and capital flows

Developments of RON Exchange Rate*



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

Source: NIS, NBR

In 2007 Q3, the exchange rates of the domestic currency and of other emerging-market currencies were hit by the strong decline in investor appetite for risk following the US sub-prime mortgage crisis and its spill-over effects on the international financial markets. Therefore, in late July, the RON/EUR exchange rate displayed a sudden trend reversal, with the domestic currency losing ground against the euro in August for the first time in the past 13 months. The subsequent alleviation of the effects induced by this crisis led to the short-lived discontinuation of the upward movement of the RON/EUR exchange rate, which afterwards reaccelerated temporarily. Thus, the RON exchange rate trend was disconnected from the trajectory of the main currencies in the region, as a result of worsening expectations of operators regarding domestic macroeconomic developments.

[43] Over the period, however, the average interest rate on new EUR-denominated loans to households was lowered by 0.36 percentage points, reaching 7.78 percent at end-August.

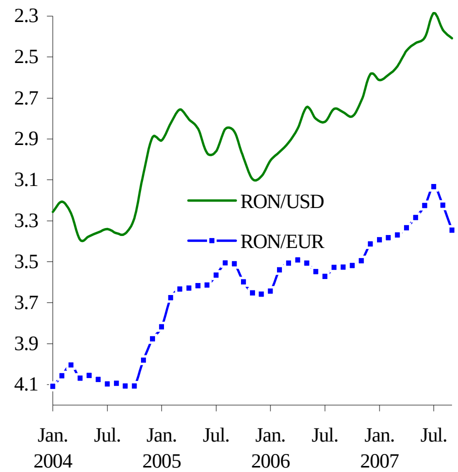
The upward correction of the RON exchange rate in Q3 confirmed the unsustainable nature of the rapid nominal appreciation of the domestic currency in the previous period, which was not underpinned by similar changes in Romania's economic fundamentals.

Against this background, the 9-month nominal appreciation of the RON versus the EUR was well below the first-half reading (2.0 percent and 6.0 percent respectively, in real terms). However, given that the US dollar weakened against the euro, the nominal appreciation pace of the RON was only marginally slower against the USD (7.2 percent), whilst the real appreciation was even higher (11.4 percent). Nevertheless, calculated as an average annual change for July-September, the local currency appreciation consolidated further both against the euro (9.6 percent in nominal terms and 15.0 percent in real terms) and the US dollar (18.2 percent in nominal terms and 24.1 percent in real terms).

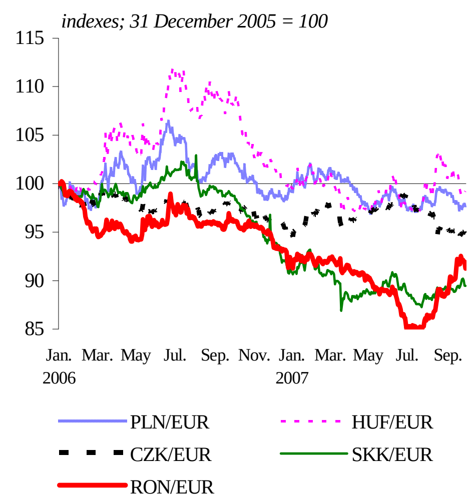
Pressures for a stronger RON persisted over most of July. They were enhanced by the maintenance of somewhat optimistic expectations on economic developments in the region and also by: (i) preservation of relatively large capital inflows similar in nature to financial borrowings, long-term deposits, portfolio and direct investments, (ii) firmer expectations of a steeper downward trend of the RON/EUR exchange rate, and (iii) higher remittances from abroad. In this context, the currency supply on the interbank forex market showed a surplus for the first time in 23 months. The turbulence on world financial markets, against the background of fears of the outlook for the US real estate and the mortgage loan markets, had a major impact on the exchange rates of currencies in the region, including the RON/EUR exchange rate, which posted a trend reversal on 27 July 2007. Nevertheless, the appreciation of the RON versus the EUR in July as a whole hit a 17-month high[44] of 3.0 percent, exceeding the readings reported by other Central and Eastern European currencies.

The RON/EUR exchange rate followed a steeper upward trend in August owing to the effect, particularly generated by expectations, of the abrupt increase in investors' risk aversion, in the context of confirmation or even worsening of fears regarding the magnitude and implications of the US sub-prime mortgage crisis[45]. Against this background and closely linked to

Nominal Exchange Rate



Exchange Rate Developments on Emerging Markets in the Region



Source: NBR. ECB

[44] The average RON/EUR exchange rate in July (3.1337) was the lowest in the past five years.

[45] Although the US sub-prime mortgage crisis occurred at mid-July (17 July 2007), fears surrounding its spill-over increased significantly starting with 9 August, when BNP-Paribas blocked the withdrawal of amounts from the three funds under its management, with exposure on the risky mortgage loan market in the USA.

the developments in the region, the RON/EUR exchange rate entered a relatively steady uptrend starting with the second ten-day period of August, peaking at 3.2772 on 21 August (the highest reading in the past three months). The upward path of the RON/EUR exchange rate also illustrated the effect of the worsening expectations of operators following the reappraisal of domestic economic fundamentals. The change in investor sentiment[46] affected only to a small extent the volume of speculative transactions performed by non-residents, as their net sales of foreign currency hit a record high in August. The measures taken by the leading central banks in order to prevent the occurrence of a major liquidity crunch, as well as the change in expectations on the decisions concerning FED and ECB key interest rates led to a short-lived alleviation of tensions on world financial markets, with effects on the regional financial markets as well. Despite the relative slowdown in the RON/EUR exchange rate uptrend in the final 10-day period of August, the nominal depreciation of the RON against the EUR over August as a whole was 2.8 percent, this figure being exceeded on the regional market only by the exchange rate of the Hungarian forint (3.3 percent).

Key Financial Account Items (balances)

EUR million

	2006 8 mos	2007 8 mos
Financial account	**6,260**	**8,812**
Direct investments	**4,642**	**4,059**
residents abroad	2	-80
non-residents in Romania	4,640	4,139
Portfolio investments and financial derivatives	**111**	**117**
residents abroad	88	-159
non-residents in Romania	23	276
Other capital investments	**3,724**	**8,161**
of which:		
medium- and long-term investments	1,104	2,126
short-term investments	1,988	-609
currency and short-term deposits	861	4,040
NBR's reserve assets, net ("–" increase/"+" decrease)	**-2,217**	**-3,525**

However, the domestic currency depreciated again at a faster pace in early September, when the developments in the RON exchange rate were no longer linked to that of regional currencies, given that the unfavourable expectations of operators were rekindled by (i) the release of some statistical indicators that invalidated the more optimistic market expectations (industrial output growth in July, GDP advance in Q2 and August inflation) or confirmed market fears (current account deficit in the first seven months of 2007), as well as by (ii) a possible domestic political turmoil[47]. The worsening of expectations was probably the main driver of residents' higher demand for foreign exchange[48] which, associated with the lower exposure of foreign investors on the regional financial market during this period[49], caused the temporary acceleration in the depreciation pace of the RON. In these circumstances, on 21 September 2007, the RON/EUR exchange rate hit the highest reading since January 2007 (3.4026). Subsequently, under the impact of the relative easing of liquidity conditions on

[46] The volume of transactions conducted by non-residents declined during this month.

[47] On 14 September, PSD, the main opposition party, announced that a motion of no confidence against the Government would be submitted to the Parliament.

[48] Net demand for foreign exchange of residents, natural and legal entities, represented the second historical high (EUR 694 million).

[49] Net sales of foreign exchange by non-residents fell to nearly one third of the previous month's reading. Moreover, according to data released by BSE, non-residents' purchases of securities in September equalled almost half of the August reading.

external financial markets – including due to the steeper-than-expected policy rate cut by FED –, of the NBR's tightening of money market liquidity control[50] and of the expected persistence of such a policy stance in the period ahead, the RON recovered part of the previous losses against the EUR. Over the period as a whole, the RON depreciated however against the EUR (3.7 percent in nominal terms), while exchange rate volatility increased.

Against the background of the potential expansion of the effects of US sub-prime mortgage crisis, the world financial markets are likely to experience high tension and volatility, which will further have an impact on the RON exchange rate. Meanwhile, investor sentiment towards emerging markets, including the Romanian financial market, is expected to be more in line with the developments in economic fundamentals.

2.3. Money and credit

Money

The growth rate[51] of broad money (M3) decelerated June through August 2007 (by 2.3 percentage points, to 19.9 percent), to reach the lowest level so far this year, reflecting prevailing influences exerted by: (i) the relative slowdown of economic growth, (ii) the slightly slower pace of increase of public spending, (iii) the wider trade deficit and (iv) the statistical effect of RON exchange rate developments. An opposite influence exerted the further acceleration in the growth rate of household incomes (albeit slower compared to the previous quarter)[52]. From the perspective of M3 counterparts, behind the slacker broad money expansion stood (i) the continued deceleration in the annual average growth rate of banks' net external assets, (ii) the downturn in the annual average rate of increase of private sector loans[53], as well as (iii) the still faster increase in long-term financial liabilities (capital accounts excluded); in contrast, government credit developments further underpinned M3 dynamics.

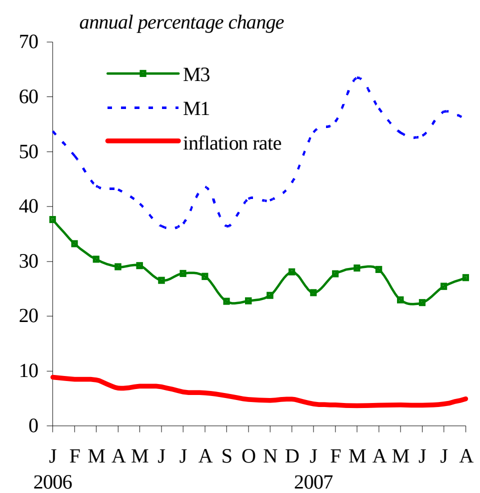
Annual Growth Rates of M3 and Its Components

real percentage change

	2006		2007			
	III	IV	I	II	Jul.	Aug.
	monthly average					
M3	18.9	19.2	22.2	20.1	20.6	21.0
M1	31.2	35.8	51.7	49.1	51.2	48.6
Currency in circulation	32.7	28.4	22.1	21.4	24.4	25.3
Overnight deposits	30.5	39.5	66.5	63.9	65.4	60.3
Time deposits (maturity of up to 2 years)	11.2	9.0	3.5	0.7	-1.2	0.9

Source: NIS, NBR

Broad Money and Inflation Rate



Source: NIS, NBR

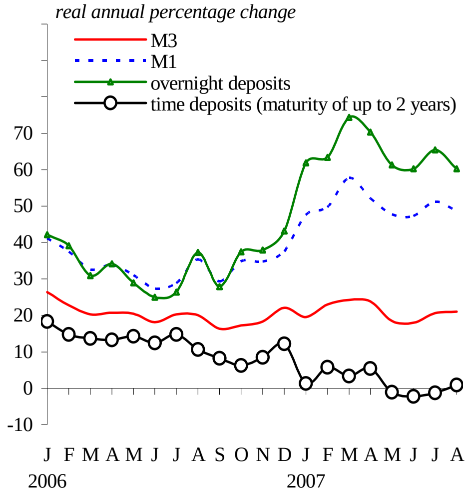
[50] In its meeting of 26 September, the NBR Board decided to tighten control over money market liquidity.

[51] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June – August 2007.

[52] The average annual rate of increase in real terms of the net average wage reached 17.8 percent, although the upward course saw a relative flattening against the previous period (from +1.5 percentage points to +0.1 percentage points).

[53] The slowdown in the annual pace of increase of private sector loans lasted only until June (see the subsection on credit).

Main Broad Money Components



Source: NIS, NBR

Both key components of M3 contributed to the slowdown in broad money expansion. In this vein, narrow money had a major contribution, with its share in M3 accounting – for the first time since comparable data series are available – for more than half[54] of total liquidity economy-wide; by contrast to previous quarters' developments, the growth rate of narrow money decelerated during the reported period, exclusively on account of the significant drop in the dynamics of overnight corporate deposits[55] (probably due also to larger payments to the government budget). Conversely, the rate of increase of currency in circulation gathered momentum for the first time in the past year and a half, possibly on the back of stronger[56] effects of seasonal factors.

The annual growth rate of time deposits with an agreed maturity of up to two years continued to fall, thus entering negative territory; this development can be ascribed to the slower dynamics of corporate deposits and deposits from local governments and social security funds, on the one hand, and to the slacker expansion of household deposits with an agreed maturity of up to two years[57], on the other. The developments in corporate deposits were mainly attributable to the larger-than-usual seasonal payments to the government budget[58], higher external payments, as well as – to a lesser extent – to companies' keener interest in investments in government securities and in deposits with an agreed maturity of over two years. As for households, only the forex-denominated component witnessed a slower pace of increase, as the expansion rate of RON-denominated time deposits with an agreed maturity of up to two years continued to accelerate; aside from the increased appetite for domestic currency placements, developments in such placements also mirrored the possible shift away from individuals' long-term placements (over two years) – despite the higher interest rates – and from deposits with the State Treasury.

The structure of broad money by currency improved during the period under review, with the share of forex deposits (26.1 percent) shrinking further, mainly on account of a slower increase in companies' foreign currency placements.

[54] 52.2 percent on average over the period under review.

[55] The corporate sector comprises non-financial corporations and non-monetary financial institutions, while the household sector includes households and non-profit institutions serving households.

[56] Including on account of the larger amounts paid to teaching staff in June and July.

[57] This development was a breakthrough during June 2006 – August 2007.

[58] During the reported period, the State Treasury balance posted the fastest annual average rate of increase in real terms in the last 12 months.

Credit

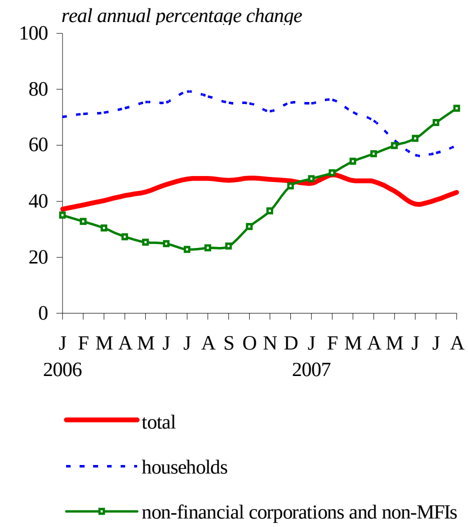
The overall growth rate[59] of loans to the private sector slackened 5.1 percentage points during June-August 2007, hitting an 18-month low of 40.9 percent. However, the monthly trajectory of annual rates reveals a faster rise of this indicator July through August (after four consecutive months of decline), attributed exclusively to the swifter increase in its forex-denominated component.

Against this background, the share of forex loans in total loans to the private sector topped out at 49.0 percent on average, a record high for July 2006 – August 2007. The wider gap between the dynamics of the two components was further driven mainly by the appreciation of the domestic currency as well as by the protracted impact of (i) the removal of any limits imposed on credit institutions with regard to exposures from forex loans[60] and (ii) the increase in the reserve ratio on RON-denominated liabilities in 2006[61].

Although costs associated with credit institutions' access to external financing are likely to have worsened somewhat over the reported period, under the impact of the global market turmoil[62], the funds raised and hence the supply of forex loans have been significant. Behind this development stood several factors, such as (i) the fierce competition among banks and their favourable outlook on future economic developments in Romania, as well as (ii) the progress in the validation of banks' own prudential norms on household loans.

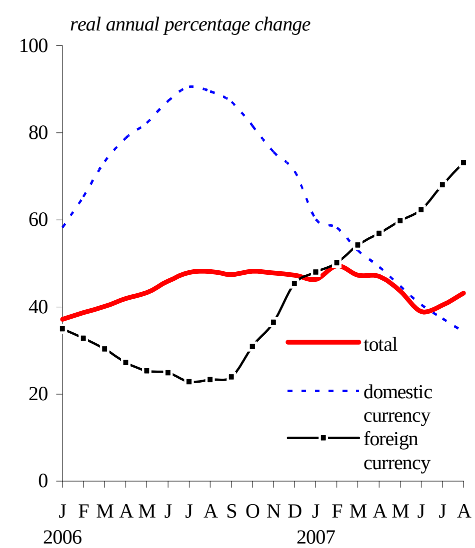
As loans became more readily-available, the latter factor bolstered household demand for loans to an increasing extent. Dampening effects on demand exerted the likelihood that the indebtedness capacity of low-income households might have reached its limit and the relative quasi-stabilisation of the expansion rate of household incomes (although it stuck to a very high reading). Against this backdrop, the downward trajectory of household credit dynamics reached a turning point in July 2007, when the annual growth rate of housing loans[63]

Credit to Private Sector by Institutional Sector



Source: NIS, NBR

Credit to Private Sector by Currency



Source: NIS, NBR

[59] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2007.

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

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

[62] Nonetheless, the growth rate of credit institutions' forex-denominated external liabilities regained momentum.

[63] 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.

re-entered an upward trend; in contrast, the annual pace of increase of consumer loans stagnated around one of the lowest readings seen since May 2005. Correlated with the continued rise in the share of long-term loans (accounting for almost three fourths of total loans to households), these developments confirm households' keener interest in real property. Driven by (i) the further decline in average costs associated with new forex loans (interest-related costs included) and by (ii) banks' aggressive promotional campaigns for lending products in non-traditional currencies (particularly Swiss francs), the annual growth rate of forex-denominated household loans picked up considerably, reaching a 21-month high in August 2007; conversely, household demand for RON-denominated loans further cooled, on account of relatively stable average interest rates on new loans to households in domestic currency.

The annual dynamics of corporate loans also gained strength somewhat in the final two months of the period under review. In this case, too, the development may be ascribed to the forex-denominated component, whose annual rate of increase saw a prolonged uptrend (despite higher lending rates on new business in EUR), backed especially by the rise in import payments[64]. Furthermore, the growth rate of RON-denominated corporate loans continued to decelerate, although banks lowered significantly the associated lending rates.

The expansion pace of credit to the public sector hit a new record high in terms of the available data series. This owed much to the further sharp increase in the stock of government securities held by credit institutions; however, the move continued to reflect the base effect induced by the absence of any government security issues in 2006.

[64] This prevailing destination of loans is suggested by the fact that the pick-up in forex-denominated corporate loans seems to have been faster in case of loans to non-financial corporations with a maturity of up to five years; data provided by the Central Credit Register may be interpreted in the same sense.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the 12-month inflation rate at 5.7 percent for end-2007, 1.8 percentage points above the figure published in the August 2007 Inflation Report. For end-2008, inflation is forecasted to reach 4.3 percent, up 0.6 of a percentage point from the previous projection of 3.7 percent.

The projection was revised due to recent developments marking substantial deviations from the previous scenario. The deviations stem from larger-than-anticipated effects of this years' drought on food prices (which made themselves felt at the end of Q3 in particular) and from the impact, starting 2007 Q3, of the RON trading at significantly higher levels than those considered in the previous forecast. Against this background, the increase in domestic prices could not be offset by the consumption of cheaper imported goods, as import price dynamics were severely affected not only by the impact of increases in the prices of agri-food items on specific foreign markets, but also by exchange rate movements. In addition, the combined effect of the nominal depreciation of the local currency and the worsening inflation expectations led to less restrictive monetary conditions in real terms, thereby reducing the pressure they had exerted on aggregate demand in the first part of the forecast horizon.

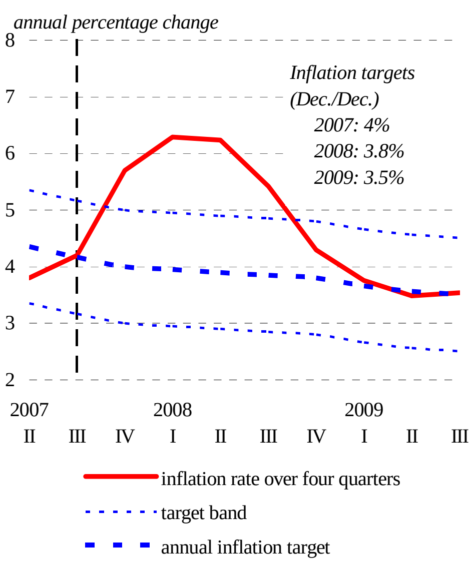
For 2008, the baseline scenario foresees a much steeper disinflation path (with the projected annual inflation rate dropping from 5.7 percent at end-2007 to 4.3 percent at end-2008) compared to the previous forecast (from 3.9 percent to 3.7 percent). During 2009, inflation is projected to revert to levels close to the central target. The decreasing inflation projection in the latter part of the forecast horizon relies on the influence exerted by restrictive monetary conditions on aggregate demand, on the forecasted favorable dynamics of import prices and on the assumption of fading after-effects from the 2007 drought following the 2008 harvest. The required restrictiveness of the real monetary conditions will be ensured by the adequate calibration of the monetary policy along with the projected resumption of the long-run real appreciation of the domestic currency, reflecting ongoing productivity gains in the Romanian economy and the persistence of sustainable productive capital inflows.

The main risks which, should they materialize, could cause inflation to deviate from its projected path arise from wage increases in excess of productivity gains, a renewed flare-up of *inflation expectations, a changed public spending pattern in favor of items with greater inflationary potential, and larger-than-anticipated budget deficits. The deviation of the inflation rate from the projected trajectory could also be generated by departures from the baseline scenario of the RON exchange rate, volatile prices of some food items, as well as fuel and administered prices. While deviations on either side of the baseline scenario are possible, the likelihood of upside inflation risks is significantly higher over the current projection horizon.*

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 exceed the upper limit of the corridor around the central target in the final quarter of 2007 and to fall back inside starting with 2008 Q4. The inflation rate is estimated to reach 5.7 percent in 2007 and 4.3 percent in 2008. Until 2009 Q1, the projected path of the annual CPI rate is higher than in the forecasts published in the August 2007 Inflation Report.

Table 5.1. Annual inflation rate (end of period)

percent

Period	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3
Target	4.0				3.8			
Forecast	5.7	6.3	6.2	5.4	4.3	3.8	3.5	3.5

At the beginning of the forecast horizon (2007 Q4), the estimated annual inflation rate is 1.8 percentage points higher than that projected in the August 2007 Inflation Report. This reassessment was caused by:

– pressures from drought-affected agricultural crops on volatile prices of some foodstuffs and the significant increase in prices of grains and oil-yielding plants[65];

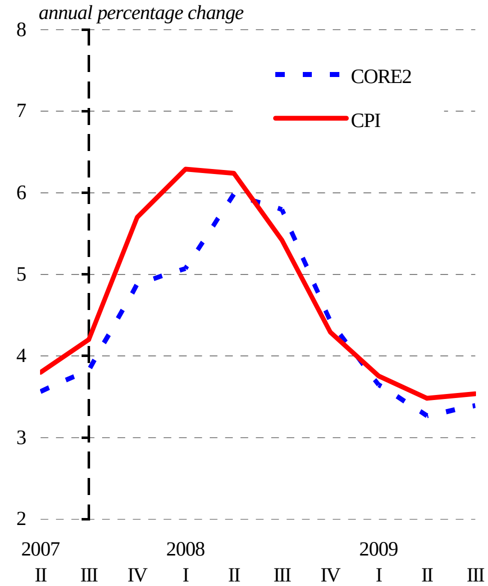
– the above-mentioned pressures are reflected in the prices of processed food items included in both CORE2 inflation and inflation expectations, which exhibit inelastic demand, given their significant shares in the core inflation basket and the validation of cost-push inflationary pressures via substantial excess demand; and

– the nominal correction of the domestic currency against the euro in August and September.

[65] See the box on page 27.

The projected CORE2 inflation rate is lower than CPI inflation, except 2008 Q3 and 4 when the rise in the aggregate consumer price index is alleviated by the effects of favorable dynamics of the RON exchange rate on domestic fuel prices and of a seasonally-induced increase in agricultural produce on the volatile prices of fruit and vegetables, resulting in a projected positive base effect. At the beginning of the forecasting round, the projected CORE2 inflation rate is higher than the figure published in the August 2007 Inflation Report due to the impact of the recent nominal correction of the RON and costlier processed food items. After peaking in 2008 Q2, CORE2 inflation is seen falling back into the target band at end-2008. The projected drop will be the result of a persistent demand shortfall over the projection horizon and the expected decline in import prices all through 2008. The projection envisages that the favorable influence of such factors will prevail over the contrariwise pressures on prices included in the CORE2 inflation basket as a result of hikes in excise duties levied on tobacco products in July 2008 and 2009 as well as of inflation expectations.

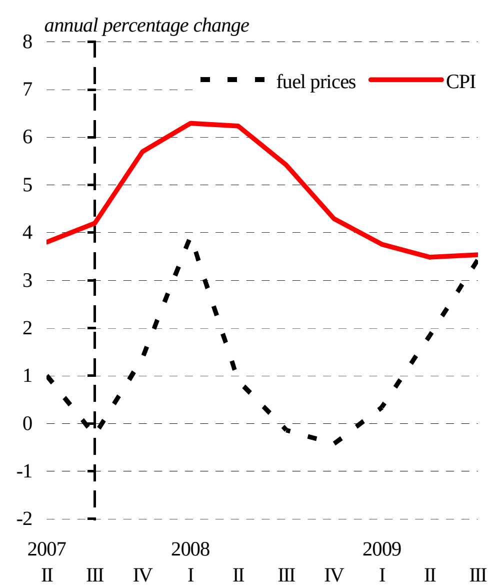
CORE2 and CPI



The recent pick-up in consumer price growth and the temporary exit of CPI inflation from the target band are seen putting persistent pressure on inflation expectations. Therefore, such anticipations are foreseen to run higher than CPI inflation over the entire projection horizon.

The dynamics of volatile prices of some food items (vegetables, fruit and eggs) are estimated to be the key inflation-boosting factor until the end of 2008 Q3, when the negative effects of this year's drought-hit supply would be cancelled by the 2008 harvest[66]. Yet again, the changes in administered prices considered in the current projection are the main source of consumer price increases starting with 2008 Q4.

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[67]. Similarly to the previous forecasting round, 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 projected continuation of a long-

[66] The current projection also relies on the assumption that 2008 and 2009 will be normal agricultural years.

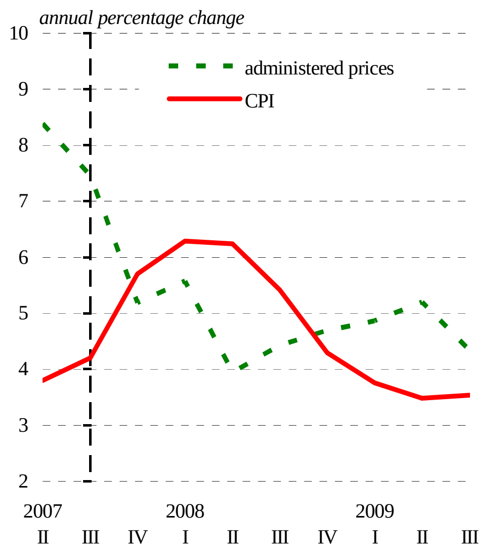
[67] This is a standard assumption frequently resorted to by the NBR and other central banks amid the heightened uncertainties surrounding future oil price movements.

run real appreciation trend of the domestic currency, reflecting ongoing realized productivity gains in the Romanian economy.

According to the baseline scenario of the current projection, import price inflation is estimated to be lower than the consumer price inflation until the end of next year. Real appreciation of the domestic currency causes the anticipated reduction in import prices during 2008. The favorable impact of exchange rate developments is expected to cease in early 2009, as compared to the previous forecast.

1.2. Exogenous inflationary pressures

Administered Prices and CPI



The cumulative effect of exogenous components of consumer price inflation[68] anticipated for 2007 and 2008 is 0.7 percentage points and 0.1 percentage points respectively higher in the current baseline scenario than in the previous projection, whereas that for 2009 Q1-Q3 is similar to the forecast in the August 2007 Inflation Report. According to the current projection, volatile prices of some food items, i.e. vegetables, fruit and eggs, are the main source of exogenous pressures on consumer prices.

Administered prices are expected to increase more slowly than consumer prices until 2008 Q3. Such hikes are seen to be lower than previously anticipated for the entire projection period; Table 5.2 shows the annualized values.

Table 5.2. The scenario for developments in administered and volatile prices

percent

	Administered prices			Volatile food prices		
	2007	2008	2009 Q1-Q3	2007	2008	2009 Q1-Q3
Current projection	5.2	4.7	4.3	26.2	5.6	3.8
Previous projection	6.4	5.6	5.2	7.3	3.7	2.2

The negative difference in the current year is chiefly attributable to the expected 12 percent cut in the prices of medicines in November and December. The current scenario for energy prices is comparable to the previous one; the only difference consists in the higher increase in natural gas prices in October 2007 than that considered in the previous projection. Table 5.3 summarizes the developments in energy prices, the main component of administered prices.

[68] Administered prices, volatile prices of some food items, the excise duty on cigarettes and tobacco products.

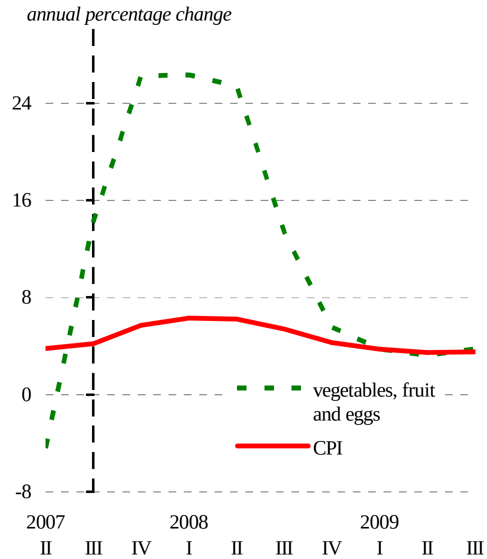
Table 5.3. The scenario for developments in energy prices

percent

	Electricity			Heating			Natural gas		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Current projection	4.2	4.2	3.5	12.3	11.4	6.0	0.1	12.5	8.2
Previous projection	4.2	4.2	3.5	12.3	11.4	6.0	-0.6	12.5	8.2

The scenario regarding the prices of vegetables, fruit and eggs incorporates a growth rate faster than that envisaged in the previous Inflation Report for the entire projection period, as shown in table 5.2. The pressures exerted on prices by the poor supply of agricultural produce in 2007 will fuel the anticipated inflation rate measured by the prices of vegetables, fruit and eggs both in 2007 and in the first part of 2008 (until the next harvest). These pressures are heightened by the steep rise in international prices of grains and technical plants following the increasing consumer demand and a higher demand for bio-fuels production worldwide.

Vegetables, Fruit and Eggs Prices and CPI Inflation



The scenario for tobacco products and cigarette price inflation is constructed consistent with the calendar for bringing excise duties in line with those in the European Union[69]. Price increases expected for 2008 and 2009 are higher than those in the previous baseline scenario, as a result of the revision of the exchange rate used for assessing the RON-denominated value of the excise duty, more precisely its specific tax component which is EUR-denominated.

According to the figures published by Consensus Forecasts in September, the anticipated inflation rate for the euro area is comparable to that previously announced for both 2007 (flat at 2.2 percent) and 2008 (1.9 percent against 2.0 percent). According to the Monthly Bulletin published in September 2007, the ECB cites the increase in indirect taxes, the wage hikes and a larger pass-through effect of producer price inflation into consumer price inflation as the major inflation risks.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

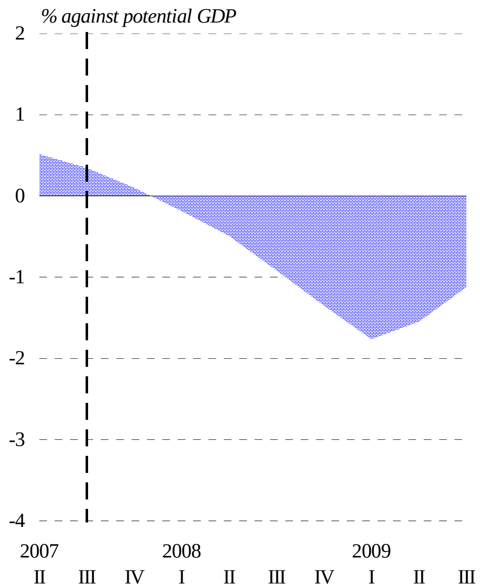
The statistics released by the NIS on real GDP[70] for 2007 Q2 indicate slower annual dynamics than in the previous quarters. As the impact of the amended VAT legislation on budgetary

[69] 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.

[70] See Chapter III. *Economic developments*

revenues[71] is only temporary, the current projection still considers the previous assumption of a neutral effect of this legal change on the assessment of excess demand in Q1. In addition, the drought gripping the country starting with Q2 acts as a supply-side shock leading to the temporary slowdown in real GDP growth due to the poor performance of agriculture. The decline in the agricultural output as a result of the drop in the agricultural potential does not entail a corresponding decrease in excess demand. The excess demand estimate for Q2 is maintained close to that of the previous projection.

GDP Deviation



In 2007 Q3, the dynamics of real GDP is expected to slow down further compared to the high readings in 2006. The estimation for excess demand in Q3 points to a slightly lower level than in the previous quarter, owing to the restrictive cumulative impulse sent by the real exchange rate of the domestic currency and the real interest rates applied by banks in the previous quarters.

The growth rate of household actual final consumption in Q3 is seen to remain as high as in the previous quarters, notwithstanding the expectations of a slight deceleration versus 2007 Q2, owing to the drought. The dynamics is fuelled by the hefty wage hikes, the further decreasing unemployment rate, as well as the fast-paced consumer credit. The consolidated general government budget ended August on a 0.19 percent surplus, producing an influence contrary to household actual final consumption on aggregate demand in the short run. Both components of consumption send a stimulative impulse to excess demand.

Gross fixed capital formation appears to stay above the medium-term trend, with the forecast for 2007 Q3 pointing to the persistence of the high growth rate seen in Q2, when it was the fastest-growing aggregate demand component; investment in construction is the main driver of the fast dynamics given that retooling saw a modest increase. Data on the real growth rate of medium- and long-term loans to economic agents, one of the major sources of investment financing point to high levels during this quarter as well. The fast growth pace of imports also suggests a level of gross fixed capital formation above its medium-run trend, with the weight of capital goods imports in total imports increasing over the recent periods.

The same as in the previous quarters, in Q3, imports continued to grow at a brisk pace, further exceeding their trend, owing to

[71] For details on the amendment of the legislation relative to VAT collection after Romania joined the EU, see the box in the August 2007 Inflation Report.

the favorable developments in financing sources and disposable income. Thus, the real growth rate of loans to the private sector continues to be as fast as in the previous quarters and the persistently fast-paced dynamics of real wages has a positive impact on disposable income. In Q3, exports are expected to remain below the medium-term trend, owing to the steep slowdown seen in Q2. Overall, the persistent gap between the growth rate of imports and that of exports causes a widening of negative net exports with a dampening impact on excess aggregate demand.

1.3.2. Implications of recent exchange rate and interest rate developments

In the latter part of Q3, a rapid correction in nominal terms caused the exchange rate to revert to levels similar to those recorded in early 2007. However, the quarterly exchange rate average indicates the appreciation of the RON in both real and nominal terms as compared with the previous quarter.

The US sub-prime mortgage crisis that started in July entailed the reassessment of investors' risk appetite, whose steep decline generated the subsequent depreciation of currencies and the increase in the volatility of asset quotations in emerging economies. In line with regional developments, the domestic currency depreciated in nominal terms during August and September as compared to previous periods. The depreciation of the RON may also be partly attributed to a less favorable perception than in the first part of the year of the domestic macroeconomic developments and their outlook, particularly with regard to prospects of the current account deficit.

Although the real appreciation of the domestic currency, calculated as a third-quarter average, causes the impulse conveyed to the real economy to have a stronger restrictive effect, the upward course followed by the RON/EUR exchange rate in the last part of the quarter implies a temporary alleviation of this restrictiveness for the following quarter. The RON strengthening leads to a decline in net external demand and implicitly in aggregate demand through the net export channel. On the other hand, given that almost one half of the non-government credit is denominated in foreign currency, the restrictive effect of the exchange rate on aggregate demand is partly offset by the stimulative impact of the wealth and balance sheet effects; thus, appreciation decreases the costs related to foreign currency borrowing, thereby giving a boost to aggregate demand. The nominal exchange rate of the domestic currency has also a direct impact on inflation via import prices, which, in case of appreciation, tend to go down, leading to a further decrease in inflation.

Apart from short-term developments influenced by one-off factors, in the medium run the exchange rate is driven by fundamentals (medium-term capital inflows or the productivity differential against major trade partners). Taking into account Romania's real economic convergence with the euro area, the RON follows a normal real appreciation trend in the longer run. In the short run, the exchange rate may deviate from the medium-term trajectory set by fundamentals to which however it tends to revert after the phasing-out of effects of temporary factors.

In 2007 Q3, the NBR kept the monetary policy rate unchanged at 7 percent, the same as at mid-year. At the beginning of the quarter under review, the gap between the nominal policy rate and the average interest rate on the commercial banks' deposits with the central bank reopened, but it narrowed in July-September; at the end of 2007 Q3, interbank rates were brought in line with the monetary policy rate as a result of a higher volume of liquidity sterilized by the central bank via open-market operations. The worsening of inflation expectations and the cut in the average nominal interest rate on deposits with the NBR as compared with the previous quarter lead to the fall in the real average rate. As a result, despite the rise seen at the end of 2007 Q3, the NBR's average real monetary policy rate during the reported period reduces the restrictive impact of the exchange rate on economic activity in the period ahead.

The NBR's policy rate influences real economy indirectly, through commercial banks' deposit and lending rates. These rates usually adjust only gradually to the changes in the monetary policy rate. Therefore, in Q3, both deposit and lending rates declined in nominal terms. The worsening of inflation expectations implies a decline in commercial banks' real deposit and lending rates. Under the circumstances, the commercial banks' interest rates have, *ceteris paribus*, a stimulative effect on real economy.

Overall, in Q3, the cumulative effects of interest rates and exchange rate enhance the restrictive pressure exerted by real monetary conditions. The impact of previous real interest rate developments and especially of the nominal depreciation of the RON in August and September will however materialize in a temporary loosening of this restrictiveness during 2007 Q4. Nonetheless, it is estimated that, starting in 2008 Q1, the adjustment of the monetary policy stance and the resumption of real appreciation of the domestic currency will contribute to more restrictive real monetary conditions, in line with the objective of gradually bringing the inflation rate close to the central target by the end of the forecast horizon.

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 in early 2008 and the maintenance of a demand deficit throughout the projection horizon is the restrictive effect of real monetary conditions, with the projected level of the real effective exchange rate making a significant contribution in this respect.

As compared to the previous forecasting round, the disinflationary effects of the aggregate demand contraction are expected to be lower starting with 2008 Q1. Demand deficit will be manifest starting with 2008 Q1, yet its magnitude is lower than in the previous Inflation Report, owing to less restrictive real monetary conditions. After touching a negative low in 2009 Q1, the output gap will begin to close due to the less restrictive effect of the exchange rate.

The revision of the restrictiveness of projected real monetary conditions hinges on changes in the impact of the real exchange rate and real interest rates on aggregate demand. The nominal depreciation of the RON in August and September caused the decline in the restrictiveness of real exchange rate. However, according to the current projection, the domestic currency will resume its appreciation in real terms at a pace faster than in the first part of the projection horizon.

The unexpected increase in inflation rate eroded the restrictiveness of commercial banks' real interest rates at the beginning of the projection horizon. Nevertheless, according to the current scenario, real interest rates are expected to revert to restrictive levels within the projection horizon. The restrictiveness of interest rates will be lower insofar as the spill-over effects of inflationary shocks in 2007 will be eliminated and the inflation rate will near again the central target in the second part of the projection horizon.

Budget deficits expected for 2007-2009 were reassessed in compliance with ESA95 methodology used by the European Union. According to said methodology, budget deficits for 2008 and 2009 will exceed 3 percent of GDP. Such values are in line with the budget deficit projections set by the Government using the cash-based accounting method[72] (2.8 percent in 2008 and 2.7 percent in 2009). As a result, the anticipated effects of a

[72] According to ESA95 methodology, revenues and expenditures are recorded when collection rights and payment obligations arise, even though the due/owed amounts are not effectively and entirely transferred at that time. In case of the cash-based accounting method, revenues and expenditures are recognised when they are transferred.

fiscal policy easing on aggregate demand are relatively higher than in the prior projection. The expansionary effects of wider deficits are offset by a projection of a gradual rise in the level of EU funds absorption in the years ahead, in view of the timely implementation of institutions and mechanisms for the efficient use of available EU funds.

According to the baseline scenario, domestic demand will continue to be the main driver of economic growth throughout the projection horizon. Moreover, the changing trend in domestic demand structure which has been manifest in recent years is forecasted to continue, with investment being expected to make a higher contribution to economic activity than consumption. The growth rate of gross fixed capital formation is projected to further exceed 10 percent in 2007-2009, fostered by the expansion of activity in construction, services and industry. At the same time, the pace of increase of private consumption will remain robust, exceeding the GDP growth rate, even though it is anticipated to be slower throughout the projection horizon. This development is expected to be mainly supported by the strong rise of corporate disposable income and by the future still swift dynamics of bank and non-bank lending. The real appreciation trend of the domestic currency is foreseen to continue in the first half of the projection horizon, which implies that imports will be relatively cheaper than domestic goods and services. Therefore, the trade deficit is anticipated to widen by the end of 2008, which will offset the impact of fast-paced domestic demand on GDP dynamics. The gap between exports and imports is expected to narrow within the projection horizon, following the gradual decline in the restrictiveness of real exchange rate.

1.4. Risks and uncertainties surrounding the projection

The main risks which, if they materialize, could cause inflation to deviate from the projected path are triggered by:

1. wage hikes overtaking productivity gains;
2. worsening inflation expectations;
3. changes in the structure of public spending in favor of components with a higher inflationary potential;
4. higher-than-projected budget deficits;
5. the significant slippage of the RON exchange rate dynamics from the forecast in the baseline scenario.

The likelihood that the aforementioned risks might materialize simultaneously has increased compared to the previous forecasting rounds. Therefore, the overall risk of a rise in the inflation rate beyond the level projected in the baseline scenario is higher than before.

The mismatch between pay rises and labor productivity gains may put pressure on corporate costs and on aggregate demand. In the private sector, wage growth reflects labor shortages, particularly in construction and services, i.e. the most dynamic economic sectors. These pressures on wages are heightened by the "demonstration effect"[73] of major hikes in the incomes of public sector employees as well as by workforce migration.

Wage pressures generated by labor market-specific factors could be augmented by the rekindling of inflation expectations. The significant pick-up in the pace of increase of consumer prices in August and September, the likelihood of protracted drought effects on food prices and uncertainties related to future developments in the RON exchange rate could impair the efficient anchoring of expectations following declining inflation targets and steady disinflation in recent years.

Higher pensions and public sector wages as well as the retroactive payment of bonuses to teaching staff are as many budget outlays with a high inflationary potential, since they are not matched by rises in the supply of goods and services. They feed through into faster dynamics of household disposable income, thus fuelling inflationary pressures induced by aggregate demand. Moreover, failure to achieve the planned budget revenues could result in the financing of the above-mentioned measures from amounts initially destined to public investment projects.

The loose fiscal policy announced for the following three years could be affected by even wider budget deficits on account of:

- optimistic expectations on budget revenue dynamics failing to materialize; and
- additional public spending during election years 2008 and 2009.

The rather optimistic dynamics forecasted for budget revenues may be slowed by the reduction of certain taxes and duties (social contributions), by the weaker-than-expected impact of some income boosting decisions (removal of the maximum tax

[73] The "demonstration effect" generally refers to the influence on the behaviour of certain individuals/social groups exerted by the actions of other individuals/social groups and by the consequences of such actions. In our case, we refer to the effects of pay rises conceded to public sector employees, which entailed similar claims in the private sector.

ceiling[74] on social security contributions) and the lower-than-anticipated increase in the tax base amid a slower-than-projected economic growth.

Recently observed trends in wage dynamics and in the configuration of short- and medium-term fiscal coordinates suggest that these sources generate a risk of overshooting the projected inflation target over the current forecast horizon. By contrast, the direction of the possible slippage of the RON exchange rate dynamics from the projected path and, hence, of the inflation rate deviation from the forecasted trajectory is more uncertain. Nonetheless, the two groups of risks are not independent, as the materialization of risks related to the income and fiscal policies increases the likelihood of higher-than-projected inflation risks on account of a comparatively weaker domestic currency.

Continued depreciation of the RON significantly beyond the levels reached at the end of 2007 Q3 could be fuelled by foreign investors' declining confidence in emerging markets, given the recent turmoil on international credit markets, and by the potential worsening of the outlook on Romania's macroeconomic standing, particularly in case of economic policy slippages, such as the fiscal and income policies. Another source of risk is derived from the wide current account deficit and the likelihood of a lower financing of this deficit via foreign direct investment. The slowdown in autonomous external financing, with consequences on the sustainability of the external deficit, could be influenced by competition among emerging markets and by domestic social and political turmoil.

On the other hand, avoiding reckless macroeconomic policies during a tight election schedule could reinforce foreign investors' confidence in the outlook of the Romanian economy. This would result in the persistence of productive capital inflows and a sustainable strengthening of the domestic currency over the longer run, which could trigger – *ceteris paribus* – a higher-than-projected disinflation.

A common risk specific to all projections so far concerns the developments in administered prices, given the repeated changes in their adjustment calendar. Postponing certain price changes initially due for election years 2007 and 2008 and the need to bring prices in line with the levels agreed with the European Union lay the groundwork for major corrections following the main election rounds. Therefore, the risks of these inflationary shocks becoming manifest are mainly relevant for

[74] Until its removal, the maximum tax ceiling was set at five average wages economy-wide.

the latter part of the projection horizon and beyond. Other risks that are regularly included in each projection and are likely to entail inflation deviations from the projected trajectory relate to the dynamics of volatile food prices and of fuel prices. Although these prices may exhibit both-way deviations from the coordinates of the baseline scenario, unfavorable slippages are more likely to occur during the current forecast horizon.

2. Policy assessment

In Q3, unfavourable changes in the economic environment came to threaten disinflation in the near run, as the shocks that unravelled both domestically and internationally caused the 12-month inflation rate to reach 6.03 percent in September 2007, a level inconsistent with this year's target. The major culprit for the pick-up in CPI growth was the drought-induced inflationary effect, the size of which exceeded significantly all expectations. It materialised not only in a higher-than-anticipated rise in the volatile prices of some agricultural produce, but also in a substantial hike in the prices of certain processed food items exhibiting inelastic demand and weighing heavily in the CPI and the adjusted CORE2 inflation baskets. The above-mentioned phenomenon was accompanied by the impact of the upward correction of the exchange rate of the RON against the EUR amid recent turbulence on world financial markets – the emergence of these tensions and their immediate after-effects took by surprise even the monetary authorities in the advanced economies.

By taking on such influences, the updated quarterly projection of macroeconomic developments reveals a clear worsening compared with the previous forecast in respect of the inflation outlook almost throughout the forecast horizon. The upward gliding of the projected annual inflation path is expected to peak in 2008 when, during three quarters, it is seen exceeding the upper limit of the target band. The upward revision of the annual inflation forecasts was also prompted by: (i) the renewed rise in domestic demand in 2007 Q2 and the anticipated persistence of a fast dynamics in 2007 Q3 as well, (ii) the ongoing upward adjustment of food prices in the months ahead, a process underpinned by price hikes on foreign markets, and (iii) the relative reduction in the restrictiveness of monetary conditions that has occurred recently following the narrowing of the real monetary policy rate margin and the correction of the exchange rate of the RON versus the EUR.

The significant deterioration in the pattern of the projected annual inflation rate over the monetary policy transmission horizon appears to be ascribable largely to supply-side factors.

However, a significant contribution is also made by demand-pull inflationary pressures, their magnitude being expected to surpass that suggested by the developments in the output gap along the projection horizon. In the near run, the risk of such pressures to grow stronger derives not only from the prospects of a persistently fast-paced domestic demand, household consumer demand included, but also from the very likely widening of the gap between the demand for and the supply of farming produce and food items. The major signs of such an evolution are the unprecedented increase of food consumption in August[75] – illustrating the sharp, drought-induced reduction in self-consumption –, on the one hand, and the outlook for a very poor performance of the agricultural sector in 2007[76], on the other. In addition, the likelihood that inflationary pressures stemming from excess demand for agri-food items might be mitigated in the current context by larger imports is relatively used up, given that world prices for such goods have been following an upward trend and the real domestic currency has recently been subjected to a nominal correction in EUR terms. By contrast, the resort to imports in the months ahead to offset the domestic demand shortfall would only cause a further widening of the current account deficit which has already reached a level difficult to finance on a longer term, thereby jeopardising the medium-term sustainability of disinflation.

A matter of concern for the National Bank of Romania is that the risk of large demand-pull inflationary pressures to linger even over a longer term is getting stronger. This risk arises, above all, from the prospects of a persistent, overly high wage dynamics in both public and privately-owned sectors – further rapid private-sector wage increases in excess of productivity gains could be boosted by the still loose income policy of the authorities and the foreseeable heightening of labour market tensions. Without overlooking the good performance of budget execution January through October 2007, the risk of persistently high demand-side pressures is augmented by the increased likelihood, at least in 2008[77], of larger-than-projected fiscal deficit and weight in public expenditure of the component fuelling both public and private consumption. An even more pronounced relaxation of fiscal policy than the budgeted one would result mainly from a potential overshooting of the projected level of expenditures following the implementation of sizeable pension increases and of other decisions amid the four run-ups to successive elections planned over the forecast

[75] The average annual growth rate of retail sales of foodstuffs in July-August more than quadrupled against the second-quarter average figure.

[76] According to the latest forecast released by the National Commission of Prognosis.

[77] For 2008, the draft budget taken into account was that approved by Government in its meeting of 10 October 2007.

horizon. Moreover, fiscal policy easing could also result from the overestimation of the projected level of public revenues induced, *inter alia*, by the possible underestimation of the impact from the cut in social security contributions paid by employers and the introduction of the 2nd pillar of the pension system in 2008. Pursuing such a fiscal and income policy stance could additionally fuel the risk of exacerbating domestic demand and, implicitly, inflationary pressures by rendering expectations of future household incomes exceedingly optimistic.

In turn, such optimistic expectations could foster credit demand of certain groups of individuals which, against the background of a rise in the level and scope of borrowers' eligibility as a result of higher incomes, might spur credit growth and hence consumer demand. From the perspective of recent developments, this risk appears however to be low, at least temporarily, given that the annual real growth rate of consumer loans almost stalled. By contrast, the recent months saw a renewed acceleration in the dynamics of housing loans. This could be attributed, at least in part, to the progress made by the NBR in approving credit institutions' own prudential norms on loans to households; moreover, the annual growth rate of household deposits with banks re-entered an upward course, both developments reflecting the maintenance of households' keen interest in purchasing dwellings and making financial investments.

Under the circumstances, the major concerns related to the recent developments in loans to the private sector are the persistence of a steep uptrend in the annual dynamics of foreign currency-denominated loans and the recent expansion in the share of this component in total loans to the private sector – these evolutions reflect the stronger substitution effect amid the further high cost differential that is not in favour of RON-denominated credit. Looking ahead, the growth of foreign currency-denominated loans might however be contained by both the recent correction of the RON exchange rate, along with the anticipated rise in its volatility, and the possible tightening by parent undertakings of terms and conditions pertaining to lending to domestic credit institutions, already reflected by a certain advance in costs attached to the financing provided via credit lines extended to local market participants; such a reaction of European banks could persist and even intensify due primarily to the liquidity squeeze they could face in the aftermath of the crisis on the US sub-prime mortgage loan market and, to a lesser extent, to the potential reassessment of risk attached to investments on the Romanian banking market.

Given the rapid growth of short-term external debt of non-banks in recent quarters, another indirect channel through which the effects of the turbulence on world financial markets might affect the Romanian economy in the near run is that of a possible tightening of the conditions for direct access to short-term external borrowings by companies; the likely impact of such developments would be the slight, short-lived weakening of demand for imports. Over the longer term, local economic activity could also be hit by the effects of the foreseeable slowdown in US economic growth, the fallout of the sub-prime mortgage loan crisis. Such effects would only be detectable if, in this context, the risk of a slowing euro-area GDP growth materialises, entailing some deceleration of Romanian exports growth. Nevertheless, the overall impact on Romania's economic expansion would be low, considering that domestic demand has been and is expected to be the major driver of GDP dynamics.

In this context, the medium-term outlook on inflation is marred by the sizeable increase in cost-push inflationary pressures and supply-side shocks. A major reason for concern is the magnitude of the inflationary impact to be exerted by the foreseeable continuation of food price increases and the ensuing second-round effects, including via inflation expectations. The direct impact is estimated to be considerable, given: (i) the very large share of food prices in the CPI basket and in its adjusted CORE2 basket, as well as the relatively inelastic demand for such products; (ii) the protracted and more broad-based increase in agri-food prices on international markets; and (iii) the magnitude and gradual nature of price adjustments scheduled for the coming months on the domestic market. Against this backdrop, the recent substantial hike in the prices of certain processed food items appears to be only partly attributable to higher producer costs with raw materials; a major role was probably played both by the still booming consumer demand – all the more so as demand for foodstuffs is highly inelastic in relation to prices – and the sizeable upsurge in ULC in food industry year so far. As regards the expected inflationary impact of these price increases, there is a major risk of excessive wage claims spreading across all sectors which, if agreed to, would fuel inflation via overly high ULC.

In the near run, the recent nominal correction of the domestic currency against the euro and the increase in volatility and unpredictability of RON exchange rate movements could also have a strong detrimental impact on inflation expectations. Such a behaviour of the exchange rate will be strengthened by the persistence, at least in the short term, of notable uncertainties regarding the global effects of the crisis in the US sub-prime mortgage loan market, as well as by potential changes in investor sentiment towards the Romanian market in response to the evolutions in domestic economic fundamentals, within the broader context of possible changes in behaviour towards emerging markets as an asset class.

In view of the worsening inflation expectations, compared to the previous projection, almost throughout the monetary policy transmission horizon and amid prevailing upside risks to inflation, the NBR Board has decided to raise by 0.5 percentage points the monetary policy rate to 7.5 percent per annum and to continue to pursue prudent liquidity management via open-market operations. Also, in order to consolidate the restrictiveness of broad monetary conditions and in view of the rapid growth of all components of non-government credit, the NBR Board has decided to maintain the current levels of minimum reserve requirement ratios on both RON- and foreign currency-denominated liabilities of credit institutions.

Against this background, the NBR Board has reaffirmed that monetary policy, along with all other components of the macroeconomic policy mix, should ensure a firm and sustainable anchoring of inflation expectations at the low inflation levels achieved so far, in order to bring annual price growth within the medium-term disinflation trajectory agreed with the Government and, on a broader horizon, to achieve the convergence of Romania's aggregate price level towards price stability, as defined by the EU. Such a stance of all components of the macroeconomic policy mix is all the more necessary given that the external deficit posts levels that are difficult to sustain in the long run, in the context of heightened uncertainties affecting world economy. This monetary policy stance is also aimed at ensuring an appropriate real interest rate level, with a view to stimulating savings and improving the savings-investment balance, resulting in an impact on the gradual reduction of the external deficit in the future.