NATIONAL BANK OF ROMANIA

INFLATION REPORT

February 2008

Year III, No. 11

New series

ISSN 1582-2931

N O T E

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

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

Phone: 40 21/312 43 75; fax: 40 21/314 97 52
25, Lipscani St., 030031 Bucharest – Romania

Foreword

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

To this end, the National Bank of Romania revised both the structure and the frequency of Inflation Report which has become a quarterly publication in accordance with the frequency of the forecast cycle. Apart from the information on economic and monetary developments, and on the rationale behind the monetary policy decisions in the reviewed period, the quarterly report includes the NBR projection on inflation rate developments on an eight-quarter time horizon and the 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 1 February 2008 and approved by the NBR Board in its meeting of 4 February 2008.

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
ULC	unit labour cost
UVI	Unitary Value Index
1W	one week
12M	12 months

Contents

I. SUMMARY

In 2007 Q4, the 12-month inflation rate remained on the temporary upward path that it had entered at mid-year, reaching 6.57 percent in December. The 1.70 percentage point increase in the annual growth rate of consumer prices as against end-2006 was mainly due to exogenous supply-side shocks – seen as factors beyond the control of monetary policy – on both domestic and external markets in 2007 H2. The magnitude and simultaneous occurrence of such shocks placed the annual inflation rate above the upper limit of the ±1 percentage point variation band associated with the annual 4 percent target at a time when higher inflation has impacted both the regional context and the international environment. Over the period, the main factor of resurgent inflation was the strong increase in prices of certain agri-food items with significant shares in the CPI basket, including the CORE2 inflation basket, and which exhibit relatively inelastic demand; this resulted both from the drought-induced decline in domestic agricultural output and the hike in prices of some agri-food commodities on external markets. Adding to these effects was the impact of substantial domestic currency depreciation compared to the strongly overappreciated level seen at mid-2007 – a correction that began in the context of turbulences on world financial markets – as well as that of the significant rise in fuel prices during 2007 Q4. The inflationary impact of exogenous supply-side factors was boosted by the persistence of excess aggregate demand fuelled largely by the persistent fast growth of household incomes, the still fast-paced increase in credit to the private sector, the steep expansion of public spending that took place at the end of the previous year, as well as by the inflation expectations arising from such developments.

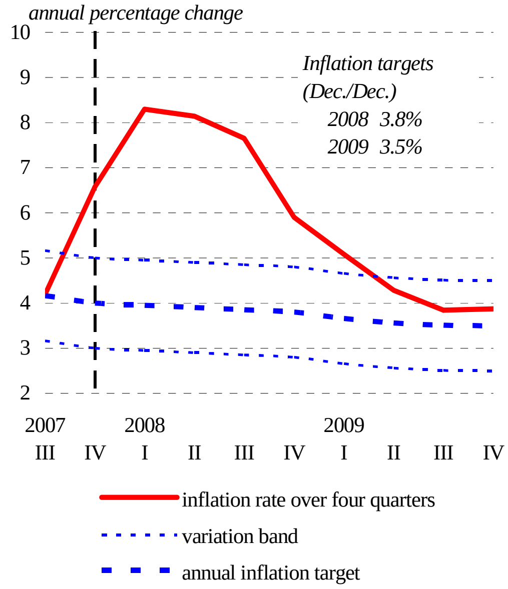
Demand-side pressures were underpinned by further sustained economic growth (5.7 percent) in 2007 Q3 and the persistent high dynamics of domestic absorption against the background of domestic supply performance being still adversely affected by the decline in agricultural output. In addition, although the pace of increase of household actual consumption slowed by 2.5 percentage points versus the second-quarter figure to 8.2 percent, this was largely attributable to the setback in self-consumption, which was however offset by a strong acceleration of the growth in goods purchases (24 percent), and especially in purchases of food items. Investment consolidated its position as the fastest-growing component of GDP dynamics, rising at a record pace of 32.2 percent year on year, given that the uptrend in construction was accompanied by a faster increase in equipment investment. Net exports further acted as a deterrent to economic expansion, while recording a smaller negative contribution to GDP growth than in the second quarter.

Further acceleration of consumer price inflation, along with a significant worsening of the short- and medium-term inflation outlook, mostly due to supply-side factors but also to persistently high demand-induced pressures, prompted the NBR Board to reinitiate the upward trend in the monetary policy rate, raising it by half of a percentage point in both October 2007 and January 2008 to 8.0 percent. The central bank's firm response was also substantiated by aggravating inflationary risks, particularly those arising from the prospects of a persistently fast increase in wages insufficiently matched by productivity gains and the risk of larger public spending in run-ups to local and general election, as well as from the possible worsening of corporate and household inflation expectations assuming the annual inflation rate will remain above its central target path during several quarters ahead. With a view to enhancing the impact of interest rate decisions, the National Bank of Romania continued to pursue firm control over domestic money market liquidity. This required additional efforts by the monetary authority given the Treasury's substantial liquidity injections towards the end of the year; the pick-up in sterilization operations resulted in the gradual reduction of the gap between the interbank money market rates and the monetary policy rate, entailing an improved transmission of the monetary policy signal. At the same time, considering the brisk dynamics of credit to the private sector and the prospects of this trend to continue, the NBR Board left the minimum reserve requirements ratio on RON-denominated liabilities[1] unchanged at 20 percent and that on foreign exchange-denominated liabilities of credit institutions at 40 percent.

Compared to the previous forecast, under the baseline scenario of the current projection of macroeconomic developments, the annual inflation rate follows a significantly higher path over the entire projection horizon. For end-2008, the inflation rate is projected to run at 5.9 percent, 1.6 percentage points above the figure released in the November 2007 Inflation Report, and for end-2009, at 3.9 percent. The projection of consumer price dynamics was revised upwards due mostly to the pick-up in inflation towards the end of the previous year and the foreseen stronger and/or longer effects of negative exogenous shocks (the drought of 2007, food and fuel price hikes on international markets, administered price increases). Under the joint action of such factors and under the impact of (i) the recent repositioning of the RON exchange rate at levels higher than those envisaged in the prior forecast and (ii) the relatively larger and more persistent positive output gap, the annual CORE2 inflation rate will also follow a higher than previously projected path.

The upward trend in the projected annual inflation rate is expected to continue in 2008 Q1 followed by the resumption of disinflation and its acceleration towards end-2008. The annual inflation rate is projected to temporarily exceed the upper limit of the variation band associated with the annual target – an evolution which is seen persisting until 2009 Q1 as a result of significant inflationary shocks and the inherent lag in the efficient transmission of the impact of increased restrictiveness of broad monetary conditions incorporated in the forecast. The projected annual dynamics of consumer prices will revert subsequently to a path compatible with achieving the medium-term inflation target, a horizon where the effectiveness of monetary policy tools becomes more apparent. The determinants of disinflation in the latter part of the projection horizon are the impact of increased real monetary conditions restrictiveness on aggregate demand, the fading after-effects of the 2007 drought after the 2008 crops are harvested, and lower inflation expectations once the disinflation process resumes and gathers strength.

Inflation Forecast



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

The nature of risks and uncertainties surrounding the current projection of medium-term macroeconomic developments is generally similar to that in the previous forecasting exercise. In the event of these risks materializing, they could however bring about more serious consequences in the current global economic and financial environment marred by major tensions and uncertainties.

The main risk to the inflation forecast materializing is the still overly-fast pace of wage

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

increases compared to that of labour productivity. Aside from the widening of the demand-supply gap on the domestic market, the possible persistence or even worsening of the wage-productivity mismatch might put additional upward pressure on corporate spending, thereby entailing the threat of a dangerous wage-inflation spiral, together with that of weaker external competitiveness. Against this background, the risk of such a development is, on the one hand, enhanced by the likely exacerbation of wage claims as a result of the possible deterioration of inflation expectations and the demonstration effects of an eventual materialization of lax public-sector income policy; on the other hand, the likelihood of employers accepting such claims and of the resultant higher unit labour costs being partly or fully factored into prices is boosted by labour market tightness and the possible worsening of companies' balance sheets, due to previous wage hikes in excess of productivity gains and to the weaker local currency.

Against this backdrop, another identified risk is the possible increase in the expansionary stance of fiscal policy compared to the projection, which is likely to boost the stimulative effect on aggregate demand and inflationary pressures. The relative easing of fiscal policy could derive from the persistence of unforeseen public spending – as seen in previous years, e.g. public-sector pay rises, bonuses – and the failure to achieve the planned increase in budget revenues. Moreover, given the successive election rounds scheduled for 2008 and 2009, a relative deterioration in public spending structure may occur by raising current (consumption-related) expenditures with a high inflationary potential to the detriment of capital (investment-related) expenditures.

In contrast, bumper crops in 2008 could help curb the annual inflation rate below the projected levels. By also incorporating the favourable base effect, the larger-than-expected increase in agricultural output, as the current projection assumes an average agricultural year for 2008, would have a sizeable impact on food prices, thus significantly reducing inflation expectations.

Inflation expectations might worsen somewhat compared to the forecast assumptions following the persistence of the depreciation trend of the domestic currency versus the major currencies seen in recent months, the increased exchange rate volatility, and the lingering uncertainties about the short-term developments in the RON exchange rate. A similar effect might have the persistence beyond 2008 of the period during which the projected annual inflation rate stays above the upper limit of the variation band. The risk that inflation expectations prove highly sensitive to such a performance is amplified by the short track record of low inflation in Romania and of monetary policy under an inflation targeting strategy.

In this context, avoiding a significant unanchoring of inflation expectations and thus allowing a return of inflation to a downward trajectory compatible with attaining the medium-term targets can only be achieved in a cost-efficient manner through increased consistency of the entire policy mix. Along with tighter monetary policy, this implies a considerable strengthening of fiscal policy and speeding-up of structural reforms – especially those concerning the labor market – which are essential in mitigating the inflationary effects of supply-side factors. By contrast, an attempt to rapidly remove the deviation of inflation from the 2008 target and preclude an overly-high increase in inflation expectations by resorting solely to an abrupt tightening of monetary policy stance would pose additional risks and costs, especially to financial stability; in addition, such a move would prove ineffective in the near run considering the lag in the transmission of monetary policy stimuli to inflation, together with the possible substantial addition to aggregate demand coming from an acceleration of foreign-currency borrowing.

The NBR reiterates that it will use all available instruments at its disposal in order to resume as fast as possible, in a sustainable manner, the announced medium-term disinflation trajectory, the risk-management strategy employed in the configuration and implementation of monetary policy requiring that inflation targets be attained over the medium run with the conservation of main macroeconomic equilibria while avoiding the worsening of existing disequilibria. In the context in which the main concern of the NBR remains the effective anchoring of economic agents' expectations to low levels of inflation, it is of the essence that the temporary overshooting of the upper limit of the variation band associated with the annual inflation target does not lead to relaxations of fiscal and wage policies.

From this perspective and given the need to pro-actively tighten broad monetary conditions in light of forecasted higher inflation in the next period, the NBR Board has decided in its meeting of 4 February 2008 to raise the monetary policy rate by 1 percentage point to 9 percent per annum and to continue to pursue a firm management of money market liquidity via open-market operations. Moreover, in view of the rapid expansion of all components of non-government credit, the NBR Board has decided to leave unchanged the present minimum reserve requirement ratios on both RON- and foreign currency-denominated liabilities of credit institutions and to adopt additional prudential measures via higher provisioning for foreign currency-denominated loans extended to unhedged borrowers, as well as broadening their scope to non-bank financial institutions.

Against this background, the NBR Board has reaffirmed its resolution to decisively direct monetary policy towards a sustainable anchoring of inflation expectations at levels compatible with attaining the announced medium-term inflation targets. At the same time, the NBR Board believes that such a stance should be underpinned by the strengthening of the other macroeconomic policy mix components and the fostering of structural reforms.

II. INFLATION DEVELOPMENTS

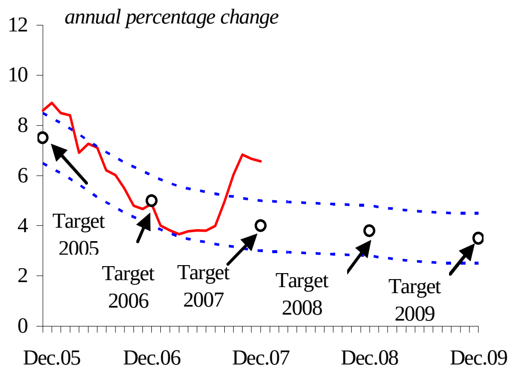
During 2007 Q4, the 12-month inflation rate deviated farther from the downward trend corresponding to the target of 4 percent ±1 percentage point; thus, at end-December, the annual inflation rate reached 6.57 percent, 0.54 percentage points above the September figure. The same as in the previous quarter, the main drivers of this development were the short supply of agri-food items (some of them having significant shares in the CPI basket and exhibiting a relative inelasticity of demand towards prices) and the depreciation trend of the domestic currency; the adverse influence exerted by higher fuel prices added to these factors. The pass-through of supply-side shocks into consumer prices was facilitated by the persistent excess demand underpinned by the further increase in wage earnings and the strong expansion in public spending. These pressures were additionally fuelled by the worsening of inflation expectations. Under the circumstances, CORE2 inflation continued its upward trend manifest since August 2007.

At end-2007, volatile prices, which were the chief pressure-exerting factor July through December, posted an annual dynamics almost twice as fast as the inflation rate, as a result of persistent adverse effects induced by the decline in output of vegetables and fruit (despite some favourable current developments October through December, the prices of fruit and vegetables recorded an annual growth rate of almost 23 percent). Nevertheless, the tensions on the market of foodstuffs with volatile prices became less pronounced[2] than at end-Q3, the acceleration of almost 2 percentage points in the growth rate for the entire group of volatile prices being accounted for by the fuel price dynamics, correlated with the hikes on the international crude oil market.

Unlike the prevailing trends shown by most groups of goods and services, administered prices diminished their contribution to the inflation rate, particularly owing to a favourable base effect caused by the stable electricity price and the smaller-sized adjustments against the same year-ago period in the prices of heating, natural gas and water, sewerage and waste collection. This effect offset the impact of the domestic currency depreciation versus the euro on the prices of fixed telephony services, so that the annual growth rate of administered prices fell to 5 percent in December 2007 (down 2.3 percentage points from end-Q3).

[2] Owing to a significant base effect in the case of eggs (the annual growth rate decelerated by almost 30 percentage points) - in an attempt to recover part of the losses generated by the bird flu, towards the end of 2006 producers raised prices significantly in several successive stages.

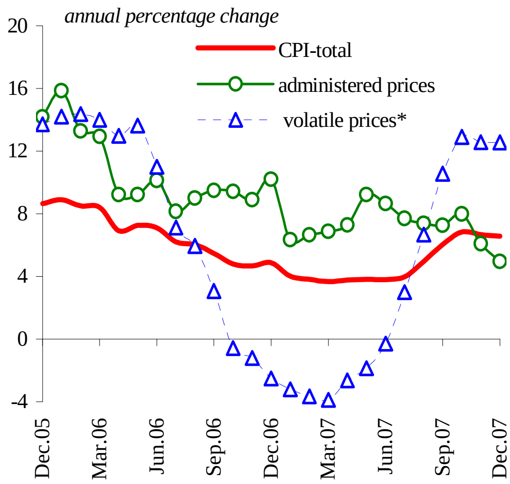
Inflation Developments



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

Source NIS, NBR calculations

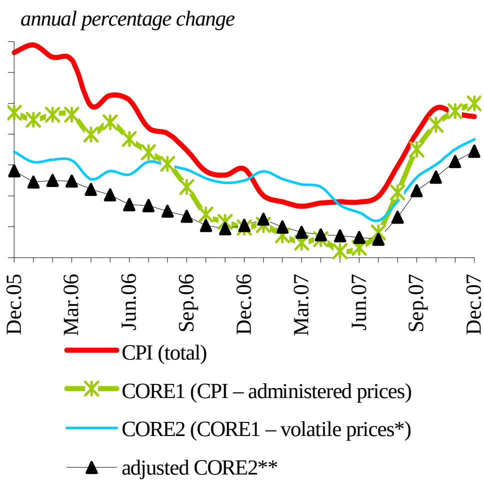
Inflation Rate



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

Source NIS, NBR calculations

Headline Inflation and CORE Inflation



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

**) excluding tobacco and alcohol

Source NIS, NBR calculations

Administered Prices versus Market Prices

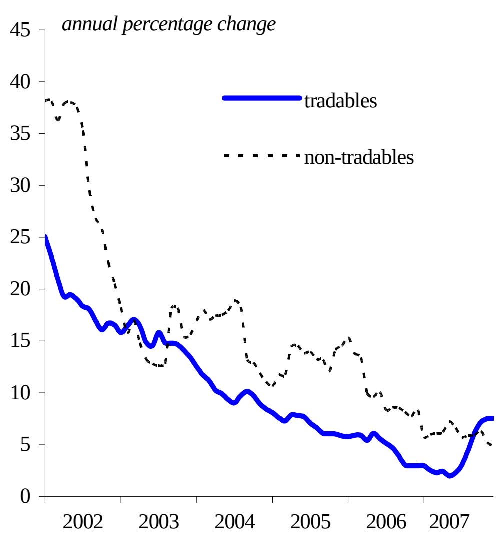
annual percentage change; end of period

	2006	2007			
	IV	I	II	III	IV
Inflation Rate	**4.9**	**3.7**	**3.8**	**6.0**	**6.6**
Administered prices*	**10.2**	**6.9**	**8.7**	**7.3**	**5.0**
1. Non-food items*:	**11.4**	**5.4**	**6.5**	**5.7**	**0 5**
electricity	6.6	4.6	9.0	9.0	4 2
heating	18.4	20.8	20.8	20.8	5.8
natural gas	33.6	10.0	6.3	4.7	0.0
medicines	-1.9	-4.8	-4.2	-5.7	-6.7
2. Services*, of which:	**8.1**	**9.5**	**12.5**	**10.2**	**13 2**
water, sewerage, waste disposal	21.4	20.5	14.6	14.1	12.0
fixed telephony	2.5	5.6	0.0	-5.1	3.4
passenger railway transport	13.2	23.7	29.8	37.2	27.4
(passenger) city transport	4.1	3.5	5.2	6.8	7 5
Market prices (CORE1)	**3.0**	**2.5**	**2.3**	**5.5**	**7.0**
CORE2**	**4.5**	**4.4**	**3.5**	**4.6**	**5 8**
CORE2 less tobacco, alcohol	3.0	2.8	2.7	4.2	5 5
tobacco, alcohol	21.8	22.9	12.7	9.3	10.0

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

Source NIS, NBR calculations

Tradables and Non-tradables Prices



Source EUROSTAT, NBR calculations

In the period under review, CORE2 inflation remained on the upward trend seen in the previous quarter; the negative supply-side shock associated with the agricultural output occurred simultaneously with the marked price increases in the main commodities on the international agri-food markets[3] feeding through into both volatile food prices and prices of some goods included in core inflation calculation (milling and bakery products, edible oil, dairy produce). An additional explanation for the rise by almost 44 percent in the price of edible oil during 2007 rests with the producers' intention to recover part of the losses incurred in the preceding years, given that the drop in external market shares was conducive to domestic oversupply and hence to consecutive price cuts.

Although less apparent than in the case of foodstuffs, unfavourable signals are also detectable in the case of non-food items included in CORE2; thus, most sub-groups recorded faster growth rates (compared to the stable developments or even the decelerations seen in Q3).

Apart from supply-side shocks (the agri-foodstuff shortfall and wage hikes in excess of productivity gains) another factor which contributed markedly to the trend changes in the prices of goods (both food items and non-food items) was the permissive climate created by excess demand, fuelled by the persistence of the fast-paced rise in household incomes and the strong expansion in public spending. In the same direction acted the worsening of inflation expectations[4] and the sharper depreciation trend of the domestic currency, even though the latter passed through only partly into consumer prices, possibly owing to the uncertainty facing market players as to the persistence of this trend. Additional factors which alleviated somewhat the pressures on prices were the expansion of promotional product sales ahead of winter holidays, against the background of fiercer competition between hypermarkets and supermarkets, and the slower dynamics of utility prices.

Owing to the same alleviating factors, disinflation continued in the case of services at market-determined prices, except for mobile telephony services, the prices of which are directly dependent on exchange rate movements. As a matter of fact, mobile telephony caused the annual dynamics of the entire group to enter an upward trend, thus contributing to the acceleration of core inflation.

[3] See Box in the November 2007 Inflation Report.

[4] According to (i) the NBR survey among banks, which indicates, October through December 2007, a doubling of the deviation of the annual inflation rate from the central target on a one-year horizon, and (ii) the NIS/DGECFIN survey among managers in industry and trade, which shows ever since August significant increases in the balances of answers related to future price developments (deseasonalised series).

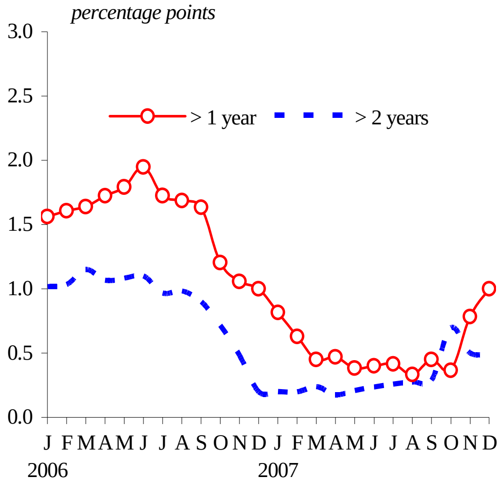
Mention should be made that the trajectory of CORE2 inflation was due, to some extent, also to the fading of the base effect caused by the significant changes in the fiscal regime in 2006 (the vice tax) which in the previous quarters called for the isolation of this type of influences by constructing an adjusted measure.

The analysis of price trends from the viewpoint of the influence exerted by international competition pressures becomes less relevant in the context of (i) the strong supply-side shock on the agri-food segment, which brought about for the second quarter in a row the acceleration of the annual dynamics of tradables prices (from 6.1 percent in September to 7.5 percent in December) and (ii) the significant base effect manifest in the case of administered prices, owing to which the growth rate of non-tradables prices[5] continued to slow down by about 1 percentage point to 4.8 percent.

Although supply-side shocks (feeding through into fuel and agri-food prices) and turbulences on financial markets affected price stability on the international markets, the adverse effects were stronger in Romania than in other European countries. Thus, from the viewpoint of the nominal convergence criterion relative to 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) widened by 0.3 percentage points during 2007 Q4 to 3.6 percentage points in December. Likewise, by comparison to the average for EU-27, the difference between the two harmonised indices increased 0.2 percentage points to 2.5 percentage points. Nevertheless, mention should be made that in some new Member States, i.e. Bulgaria, Latvia, Lithuania, Poland and Slovenia, the annual HICP inflation rate rose faster than that in Romania (up to 1.4 percentage points).

Spread between Expected Inflation and Annual Inflation Target

percentage points



At end-2007, the actual annual inflation rate was 0.9 percentage points above the projection in the November 2007 Inflation Report, owing to (i) less pronounced deceleration in the annual dynamics of administered prices, as a result of medicine price cuts failing to materialise (in August, the minister of Public Health announced a price reduction by 15 percent on average to take place in November); (ii) the downward trend of the exchange rate of the RON versus the EUR, unlike the stable exchange rate incorporated by the forecast, and (iii) higher-than-expected crude oil price on the international market, with immediate impact on fuel price.

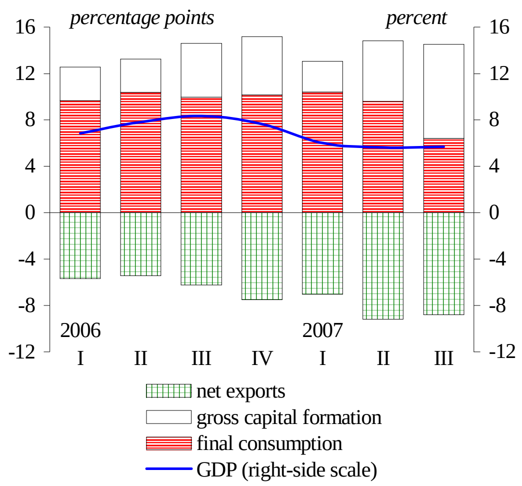
[5] Of which administered prices account for the largest share.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2007 Q3, the annual growth rate of real GDP inched up versus the previous quarter (5.7 percent[6]), exceeding by 0.4 percentage points the September benchmark projection. As concerns the economic growth pattern, the preliminary national accounts figures do not point out significant changes compared to the previous period; thus, domestic demand continued to increase at a fast pace boosted by the pick-up in capital investment, whereas the growth rate of exports recorded a new slackening. On the supply-side, GDP dynamics was propelled by most economic sectors, except again for agriculture, which saw a stronger decline, against the background of adverse weather conditions.

Contribution of Demand Components to GDP Growth



Source NIS, NBR calculations

1.1. Demand

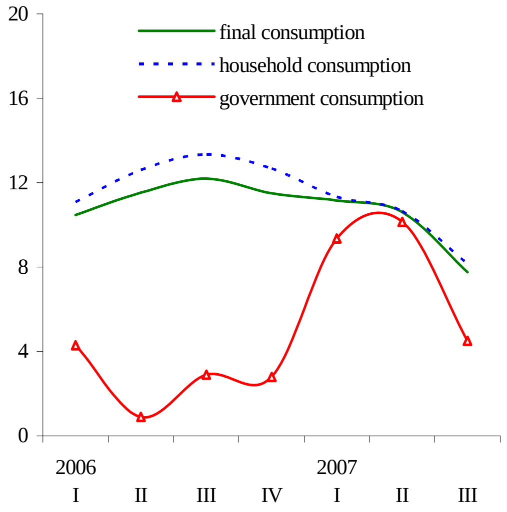
Domestic demand advanced at a pace similar to that in the previous quarter (13.1 percent), given that the new deceleration in the final consumption growth rate was offset by the unprecedented step-up[7] in investment. The decreasing performances posted by Romanian exporters were illustrated by the persistently negative contribution of net external demand to GDP growth (-8.8 percentage points).

1.1.1. Consumer demand

The slowdown by 2.8 percentage points in the growth rate of final consumption to 7.8 percent (attributable to both its private and government components) was not, however, accompanied by a decrease in the pressure exerted by consumer demand on prices.

Actual Final Consumption

annual percentage change



Source NIS

Household consumer demand

For the first time over the past two years, the annual dynamics of household actual final consumption reverted to single-digit levels, i.e. 8.2 percent. The performance is attributed mainly to the drop in "self-consumption and purchases on the agri-food market" and "other consumption"[8] (by 20.7 percent and 3.8

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

[7] Relative to the period for which quarterly national accounts are available (1999-2007).

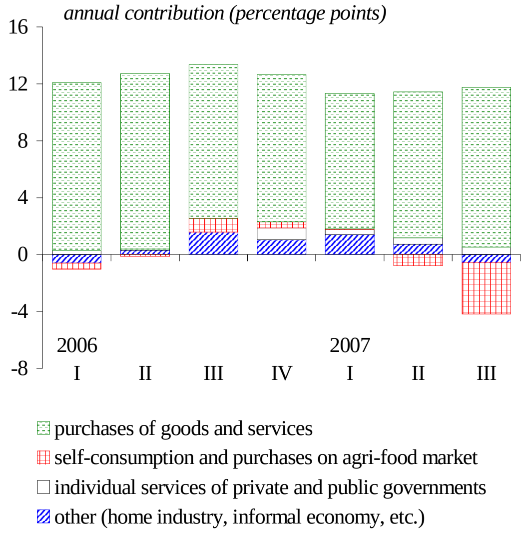
[8] The main negative influence came from home industry, defined by the NIS as activity carried on by households (living either in rural or urban area) by their own means, which consists in agricultural produce from own production or purchased from the retail network.

percent respectively), driven largely by the protracted drought which had an adverse impact on the entire agricultural output. On the contrary, expenses related to retail purchases of goods witnessed an expansion, their growth rate accelerating again (by 5.5 percentage points versus Q2 to 24 percent), owing mainly to the complementary shift shown by a large number of consumers towards goods sold by food stores, and to the higher beverage consumption against the backdrop of high summer temperatures. Statistical data on retail sales confirm the key role played by food sales, their annual dynamics expanding 3.5 times to 52.9 percent. In spite of the slowdown or even the drop in sales of most non-food items, the pick-up in purchases of foodstuffs and beverages (including tobacco) – a category accounting for a significant weight (more than 40 percent) in household consumer basket – hints at a higher inflationary potential of consumer demand during Q3 as well.

As concerns the financing sources of consumption, the available information does not allow an accurate identification of the channels via which the dynamics of household spending on retail purchases accelerated. Although still high, the annual growth rate of wage earnings and social transfers decelerated slightly versus Q2 to 17.6 percent[9], with short- and medium-term loans to households following a similar path (up 3.7 percent in real terms). Furthermore, the growth rate of bank deposits was slightly above that seen in the previous quarter, i.e. up 40.4 percent, hinting at a roughly unchanged saving propensity. The faster growth rate of retail purchases (chiefly foodstuffs) may be put down on the fact that the surge in demand, following the drought-induced low agricultural output, materialised most probably in purchases of low-cost products (households living in the rural area probably resorted to an additional financial resource, i.e. sales of home-bred livestock, determined by the same one-off factor). Another explanation could lie with the extra incomes obtained in the informal economy, in those sectors reporting significant expansion during 2007 – particularly construction works. The step-up in purchases of goods and services was also boosted by supply-side factors, such as the expansion of retail networks (especially hypermarkets and supermarkets) and the wider resort to promotional campaigns.

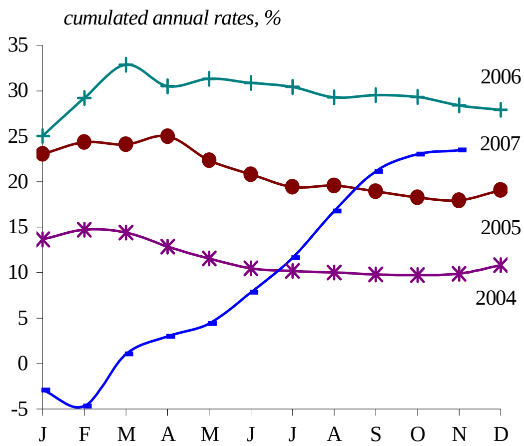
The analysis by market of origin shows a potential consolidation of the share of imports in total supply of

Household Final Consumption by Expenditure



Source NIS, NBR calculations

Retail Trade* of Foodstuffs, Beverages and Tobacco



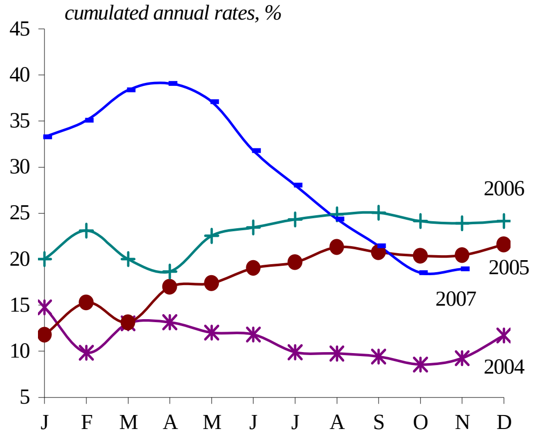
*) turnover volume

Source NIS, NBR calculations

9 A slowdown was also detected in the case of the third component used for an approximate calculation of household disposable incomes, i.e. work remittances from abroad and private current transfers from non-residents. In view of the significant corrections usually made to the concerned balance-of-payments items, it is considered that, at present, this category does not provide accurate information.

Retail Trade of Durables*

cumulated annual rates, %



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

Source NIS, NBR calculations

consumer goods. The conclusion is based, on the one hand, on the developments in the sales of domestic industrial companies on the domestic market, with "durables" and "non-durables" going up only 9.6 percent and 5.1 percent, respectively, and road transport means posting a slightly negative growth rate. On the other hand, the annual dynamics[10] of the physical volume of non-durables imports accelerated to almost 24 percent, whereas that of durables imports continued to exceed by far the growth rate of the domestic output of such goods, in spite of the slowdown versus Q2[11].

Government consumption

Provisional statistical data show a slowdown in the growth rate of the general government actual final consumption from 10.1 percent in Q2 to 4.5 percent in Q3.

Budgetary developments

At the end of the third quarter, the consolidated general budget posted a cumulated surplus of about RON 733 million, making up 0.2 percent of the projected GDP for 2007; following the latest budget revision in November 2007, the deficit target for 2007 was reduced to 2.4 percent from 2.8 percent of GDP. The surplus at end-September was solely attributable to Q3 developments; during this quarter, the consolidated general budget witnessed a surplus of roughly 0.4 percent of GDP (after displaying deficits of around 0.1 percent of GDP in 2007 Q1 and Q2). Nevertheless, during this period, the dynamics of both revenues and expenditures witnessed a slowdown, which was more manifest in the case of the latter.

Accordingly, the annual growth rate[12] of budget revenues dropped to 18.8 percent from 22.3 percent in the prior period, with almost all categories experiencing slower rates, except income tax, which saw one of the highest increases over the past quarters (45 percent).

Turning to the annual dynamics of budget expenditures, it decelerated to 23 percent from 30.6 percent in the previous quarter, on the back of the slowdown in the pace of increase of capital expenditures, transfers between public administration entities, social security contributions and subsidies. These

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

[11] The annual dynamics of the physical volume of those categories of durables identified on the basis of the Combined Nomenclature ranged between 23.4 percent (optical and photographic instruments) and 54.1 percent (motor vehicles).

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

slowdowns were partly offset by the rise in the annual dynamics of transfers that include Romania's contribution to the EU, staff costs (whose annual growth rate rose to 31.2 percent from 24.7 percent) and those relative to goods and services (their growth gained 6.8 percentage points to stand at 20.7 percent).

In the second ten-day period of November, the 2007 budget underwent a third revision, following which the consolidated general budget deficit projected for this year was reduced to 2.4 percent of GDP. The new budget revision consisted in cutting some expenditures and making a partial redistribution of funds. Therefore, on the one hand, expenditures for environment, agriculture, defence, education were diminished, while additional funds were allocated to cover expenditures incurred by the rise in pensions, the wage hikes in the health sector, the payment of some social security benefits (heating allowances, child benefits, war veteran allowances, child-raising allowances, etc.).

According to the latest official statements, the consolidated general budget remained on a surplus in October as well. Conversely, in November and December, the consolidated general budget moved into a deficit as, similar to the prior year, a large volume of budget expenditures was concentrated during this period (their volume exceeded that of revenues by more than 3 percent of GDP).

The consolidated general budget deficit approved for 2008 is nearly ROL 12,000 million, accounting for 2.7 percent of projected GDP. The shares in GDP of both revenues and expenditures of the consolidated general budget will widen to 39.3 percent and 42.0 percent respectively. Revenues will increase due mainly to receipts from social security contributions (despite the 6 percentage point cut in their rate), income tax and value added tax, while expenditures will step up on account of transfers (to social security funds and those that include Romania's contribution to the EU), and capital expenditures.

1.1.2. Investment demand

The deceleration of final consumption, on the one hand, and the record growth rate of gross fixed capital formation in the period under review (32.2 percent), on the other hand, caused investment to become the largest contributor to GDP dynamics (9.2 percentage points) for the first time[7].

Although construction investment posted the fastest growth rates – in terms of both new construction works (39.3 percent) and capital repair works (around 34 percent) – it is also worth

Investment

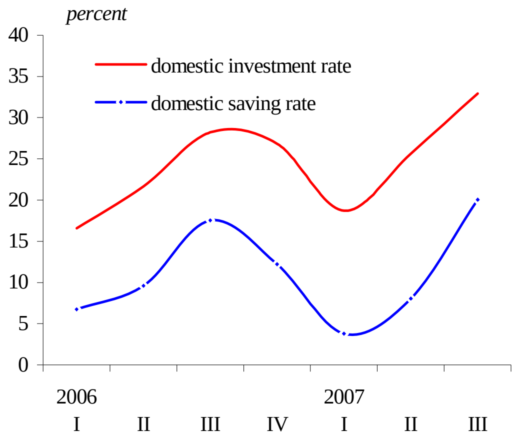
annual percentage change

	Year	I	II	III	IV
Total	2006	10.8	15.1	15.8	18.4
	2007	23.9	28.1	32.4	
- new construction works	2006	23.5	11.6	20.2	18.7
	2007	27.8	32.8	39.3	
- equipment	2006	2.6	20.8	6.2	12.4
	2007	20.2	22.8	26.6	
- other*	2006	4.8	–9.6	54.7	55.8
	2007	27.1	42.9	22.0	

* vineyards, orchards, afforestations, livestock purchases, services relative to the transfer of ownership over land and the existing fixed assets taken over, against payment, from other units or from the households

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

noting the faster pace of equipment purchase (including transport means) to 26.6 percent[13].

In terms of financing sources, in Q3, capital accumulation was largely bolstered by the further increase in own sources of the corporate sector and households, whereas the contribution of investment from the public budget declined as compared to the previous quarter (a deceleration of about 7 times in the annual real dynamics). Domestic borrowings further stayed on an upward path in the case of both loans granted by domestic banks[14] – loans for equipment purchase (the balance on such loans rose by a real 42.6 percent) and real-estate loans (66.2 percent) – and leasing purchases, where, after 9 months, the "equipment" and "real estate" segments further held the same shares as at mid-year (i.e. 21 percent and 7 percent respectively of the total value of contracts). By contrast, foreign financial inflows appear to have made a smaller contribution to the step-up in investment, given the domestic currency appreciation over the past 12 months; this development is illustrated especially by the growth rates of EUR-denominated financial inflows: the annual dynamics of medium- and long-term loans to the real sector slowed down yet again (to +42.4 percent, accounting for less than half of the Q1 figure), and financial inflows during the first three quarters in the form of direct investment by non-residents in the non-bank sector dropped 20 percent year on year.

By market of origin, the "capital goods" and "consumer goods" segments appear to exhibit similar trends, external supply increasing its contribution to meeting investment demand. The trajectory is indicated by the persistence of a substantial negative gap between the growth rate of turnover relative to the production of capital goods (transport means included) destined to the domestic market (10 percent) and that of the physical volume of imports[10] (categories of capital goods identifiable based on the Combined Nomenclature are "mechanical and electrical machinery and apparatus" and "transport means", which witnessed increases by 28.9 percent and 50.7 percent respectively).

[13] As regards the latter category, mention should be made that the volume indices relative to Q1 and Q2 underwent substantial revisions, the new growth rates exceeding 7-8 times the previously published ones (up to 20.2 percent and 22.8 percent respectively); this operation entailed the adjustment of the overall position by 7.1 percentage points and 9.7 percentage points respectively.

[14] CCR data.

1.1.3. Net external demand

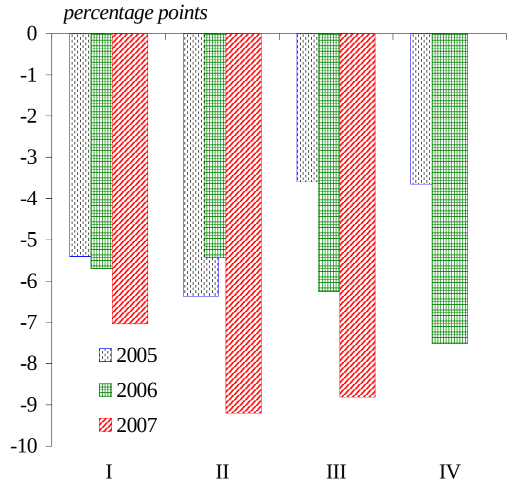
The negative contribution of net external demand to GDP growth (-8.8 percentage points), although smaller than in the prior quarter, was still worrisome, the more so as this slight improvement was not attributable to a pick-up in exports or to a slowdown in imports of goods and services.

Similar to the November 2007 Inflation Report, mention should be made that the changes in volume included in the preliminary version of the national accounts for 2007 Q3 relied on deflator estimates, with unit value indices of exports and imports – commonly used for such calculations – being unavailable at that time[15].

The growth rate of the volume of exports of goods and services lost another 0.7 percentage points, to a mere 1.7 percent. Yet, it is worth noting that the GDP revision is likely to illustrate a substantial upward adjustment of the volume index for this component, given the significant difference between the deflator used in the current version of the national accounts (100.4 percent) and that determined based on the unit value index (UVI) relative to the exports of goods (94.7 percent)[16].

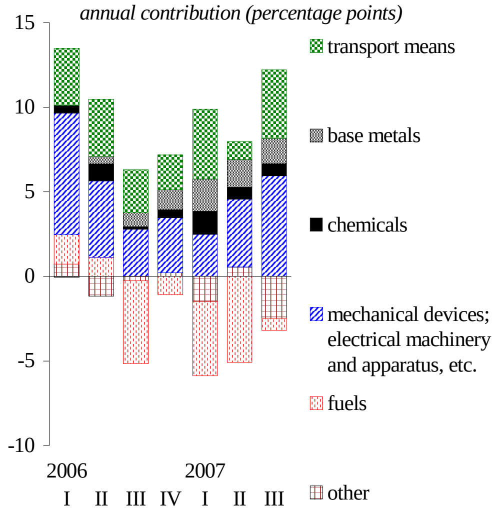
In fact, the calculations based on balance-of-payment data and the UVI show a threefold rise in the annual dynamics of the physical volume of exports of goods, to +9 percent in Q3. Exports of "machinery and equipment" and "transport means" made the largest contribution to this increase; these two categories of goods displayed growth rates faster than in Q2 (to 30.3 percent and 45.3 percent respectively) and stayed on the upward path in terms of their share in total value of exports (to 33 percent in Q3). By contrast, light industry posted a decline in the volume of exports (by roughly 14 percent) as a result of competitiveness losses amid the even stronger appreciation of domestic currency (+9.5 percent year on year compared to +7.1 percent in Q2) and the further deterioration of the ULC[17]. Electricity exports also stood on the downtrend (more than 40 percent drop in volume), due to the drought of 2007 responsible

Net External Demand Contribution to GDP Growth



Source NIS, NBR calculations

Export Physical Volume



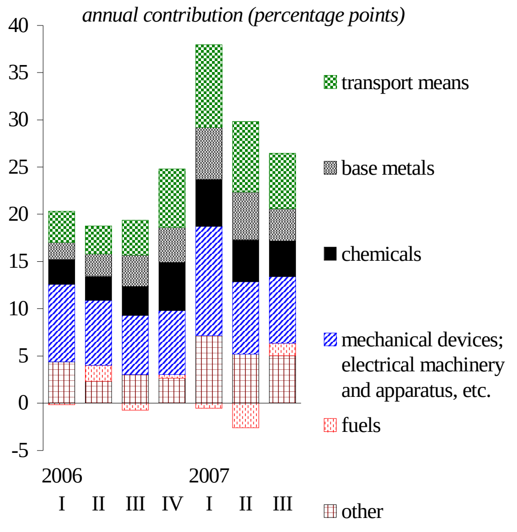
Source NIS, NBR calculations

[15] 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.

[16] The conclusion still holds even if the said difference will be somewhat affected by the influence of the movements in prices for exports of services – however, the value of this category is around 4 times smaller than that of exports of goods.

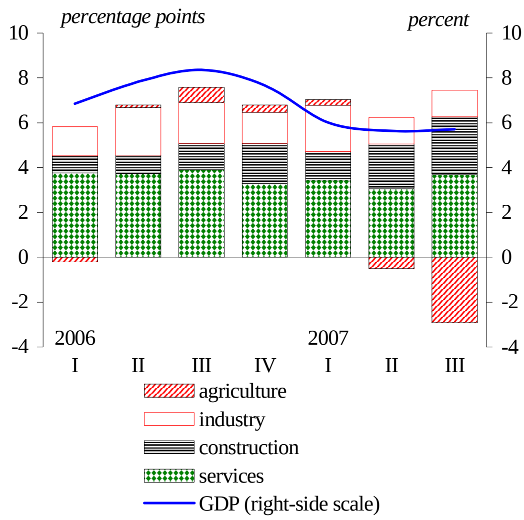
[17] Nominal ULC experienced growth in both the wearing apparel sub-sector and the leather products and footwear sub-sectors (up to 144.5 percent and 122.2 percent respectively).

Import Physical Volume



Source NIS, NBR calculations

Contribution of Main Supply Components to GDP Growth



Source NIS, NBR calculations

for the poor performance of electricity output; therefore, only orders placed by traditional partners have been honoured.

The rate of increase of imports of goods and services for Q3 further exceeded that of exports (22.4 percent, up 1.6 percentage points from the prior quarter, according to the national accounts methodology), which was also manifest when determining volume indices based on the trade balance data and the UVI. Behind this stood the simplification of customs formalities following Romania's accession to the EU, including the removal of customs tariffs for intra-community trade, the persistence of pressure put by the consumption and investment demand, the RON appreciation as well as 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

On the supply side, GDP growth was attributable to most of the economic sectors, except agriculture, the decline of which sharpened as a result of adverse weather conditions in 2007 (23.8 percent drop in gross value added). Leaving this economic sector out of account, GDP expanded by 9.8 percent (up 3.4 percentage points from the prior period).

In construction, the growth rate of gross value added stuck to the upward course, marking a new record level for the 1999-2007 period (37.4 percent), bolstered by all segments (residential, non-residential and engineering works).

In industry, the growth rate of gross value added gained 0.7 percentage points from Q2, reaching 5.1 percent, due to the good performance of manufacturing and energy sectors; outstanding results were reported in the following sub-sectors: (i) food industry, given the high potential of household consumption and the expansion of hyper- and supermarket networks; (ii) oil processing, which saw a 4.4 percent rise after posting declines for three quarters in a row, with external demand growth as the main contributor; (iii) textiles, the increased domestic demand for interior design products representing the boosting element.

The growth rate of gross value added of services saw an acceleration as well (from 6.2 percent to 8 percent in Q3), fostered particularly by retail trade (except motor vehicles and fuels), transport services other than railway transport services, telecommunications, real estate transactions, town planning.

2. Labour market

In the latter half of 2007, conditions on the labour market remained tight and nominal wages experienced particularly high annual growth rates in all economic sectors; for lack of similarly strong productivity gains, cost-push inflationary pressures and competitiveness losses incurred by domestic industry persisted. The same as in the prior quarters, the fuelling of consumer demand that had already been in excess added to the above-mentioned negative implications. The outlook for 2008 regarding the risks to price stability associated with wage developments is still worrisome, considering the negotiated increase of the minimum gross wage economywide, the run-ups to elections as well as the signals from private companies in sectors showing high development potential regarding new significant pay rises.

2.1. Labour force

According to the latest statistical data available[18], July through November 2007, tensions in the labour market did not escalate any further, yet the ratio between the number of unemployed and the number of vacancies[19] (17.6:1) was lower year on year.

Workforce demand stood high, the annual growth rate of vacancies recorded with the NEA remained in positive territory, but it started to decelerate since September 2007 (after reporting an almost 20 percent record high seen in August). Based on employers' monthly reports to the NEA, private services (trade, hotels and restaurants, telecommunications) saw the fastest annual pace of increase in the number of employees, whereas the growth rate of employees in industry and the public sector remained unchanged.

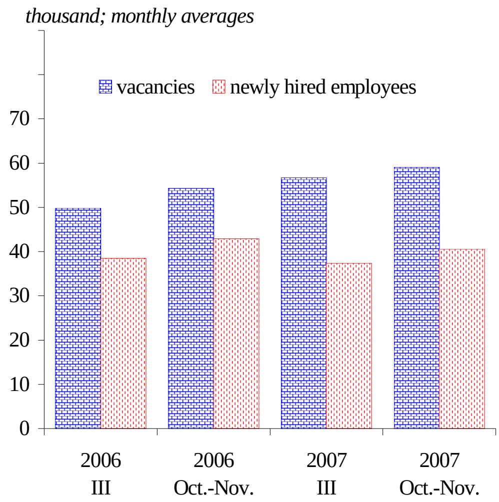
Excess labour supply was further limited and insufficiently trained – changes in registered unemployment rate[20] were of no consequence, while the share of unemployed not claiming benefits (who are not usually skilled and therefore have slim chances of finding a job) accounted for almost 70 percent of total unemployment. Moreover, similar to the previous quarters, the number of persons hired through the NEA was lower year on year, which points to potential employers' difficulties to find properly skilled staff; this is most likely the reason behind the relative slowdown of the annual rise in the number of

[18] Data provided by the NEA.

[19] Monthly stocks.

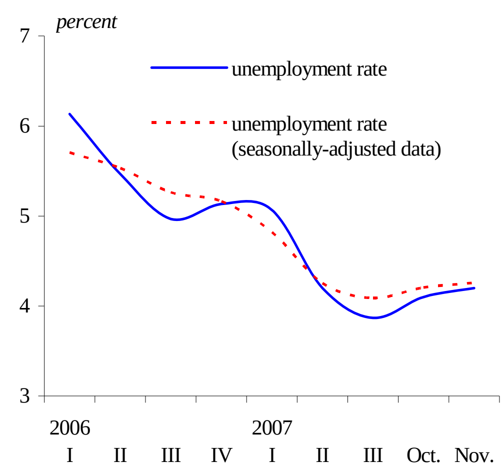
[20] According to seasonally-adjusted data, it rose marginally from 4.1 percent in Q3 to 4.2 percent in October-November 2007, standing 1 percentage point below the average for July-November 2006.

Number of Vacancies and Number of Filled Vacancies



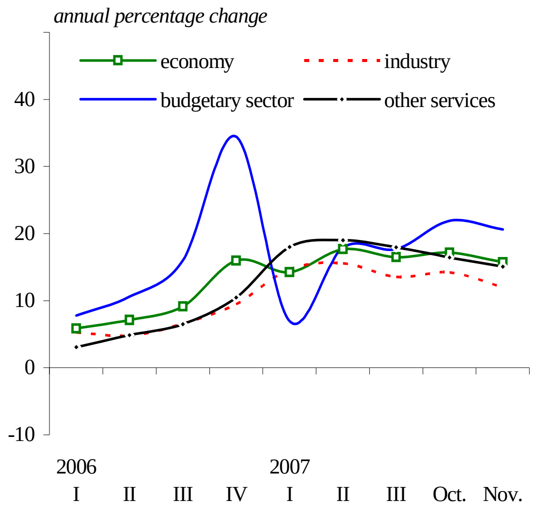
Source NEA

Unemployment Rate



Source NEA, NBR calculations

Net Real Wage*



*) deflated by CPI

Source NIS, NBR calculations

Private Sector Wages

January-November 2007

	% of whole-economy average	annual change %
Tourism	62.1	19.9
Trade	81.6	28.1
Construction	83.8	23.5
Manufacturing	83.7	19.9
Communications	146.3	13.0
Financial intermediation	288.9	17.7

Source NIS, NBR calculations

Labour Productivity and Real Gross Wage in Industry

annual percentage change

	2006				2007				
	I	II	III	IV	I	II	III	Oct.	Nov.
Labour productivity	8.6	13.2	11.1	10.0	12.8	8 9	9.4	10.4	8.7
Real gross average wage*	4.4	2.0	1.9	4.8	9.4	12.4	13.2	14.4	10.7
Real gross average wage**	7.8	4.0	3.0	6.9	14.3	16 5	17.1	15.9	11.3

*) deflated by industrial producer price index for domestic market

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

Source NIS, NBR calculations

employees in construction, despite the fast-paced development of this sector where the workforce deficit is estimated at 170,000 persons[21].

The solutions proposed by specialists with a view to covering the staff shortage are either difficult to implement in the short run (training of the under-employed in the rural area and encouraging retired persons to find a job) or are looked at reluctantly by domestic companies (resort to workforce from abroad), due to cumbersome bureaucratic procedures and difficulties to adapt to different cultures such as Asian ones. In this context, tensions will persist in the labour market in the short run.

2.2. Incomes

In the latter half of 2007, wage pressure on production costs and purchases of goods and services stood high, being fuelled, on the one hand, by quarterly financial inducements and the third stage of pay rises in the public sector[22] and, on the other hand, by the performance-linked bonuses and the wage bargaining in the private sector. Therefore, in July-October 2007, the annual growth rate of net average wage economywide reached 23 percent in nominal terms (+0.9 percentage points from 2007 Q2); however, in real terms, the step-up in the annual inflation rate caused wage dynamics to slow down (-1 percentage point).

In December, following the negotiations between government, employers and the unions the gross minimum wage economywide was set at RON 500 starting January 2008 (compared to the RON 390 wage guaranteed by the government and the RON 440 wage stipulated in the 2007 Collective labour contract nationwide); it is to be revised upwards to RON 540 at mid-2008, should macroeconomic indicators allow it. Furthermore, private economic agents, recruiting and consulting agencies warn about the highly skilled staff shortage in developing sectors (IT, banking and insurance, real estate) and expect wage hikes above 10-15 percent. The lack of staff covers both skilled and unskilled workers (construction, light industry). Taking into account the run-up to elections, in 2008, wage dynamics is further seen as the source of significant risks to price stability.

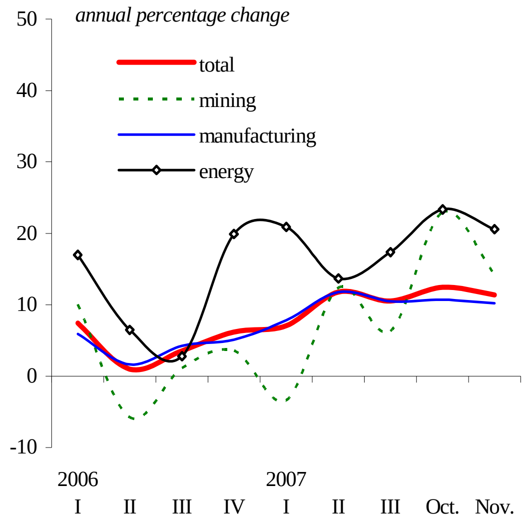
In terms of ULC, industry has been facing inflationary pressures and competitiveness losses, the growth of gross nominal wages being twice as fast as that of labour productivity. Thus, the

[21] According to the Romanian Association of Building Contractors (RABC).

[22] Up 11 percent from September, the most significant rise in 2007.

annual ULC index stood at more than 110 percent in 2007 Q3, posting a record level over the past 27 months[23] (112.3 percent) in October 2007, amid the granting of substantial bonuses, which were not warranted by productivity gains, in the mining and energy sub-sectors. Consumer goods industries also posted overall poor performance[24], the annual growth rates of the ULC exceeding by far the average for manufacturing (except tobacco and textile sub-sectors).

Unit Labour Costs in Industry



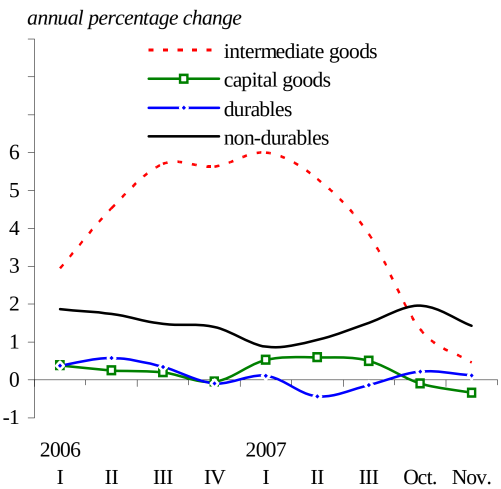
Source NIS, NBR calculations

On the demand side, the latest data on the annual dynamics of real disposable income point to a resumption of the upward trend from about 15 percent in Q3 to over 20 percent in the first two months of Q4. The trend reversal was induced by transfers from abroad[25] and budgetary and extra-budgetary revenues, whilst the annual growth of wage earnings stood at around 20 percent. Therefore, inflationary risks associated with these developments remain high and the pressures on consumer demand may be generated directly, through immediate purchases of goods and services and indirectly, through increased potential for contracting consumer loans.

3. Import prices and producer prices

In 2007 Q3, the annual growth rates of import prices and industrial producer prices continued to decelerate, despite the unfavourable developments in prices for goods holding a significant share in the CPI basket. As concerns agricultural producer prices, drought-induced tensions translated into significantly higher growth rates of prices for vegetal products. Inflationary pressures appear to have increased in late 2007, as concerns both import prices and domestic production prices.

EU-25 Industrial Producer Prices for Exports



Source EUROSTAT

3.1. Import prices

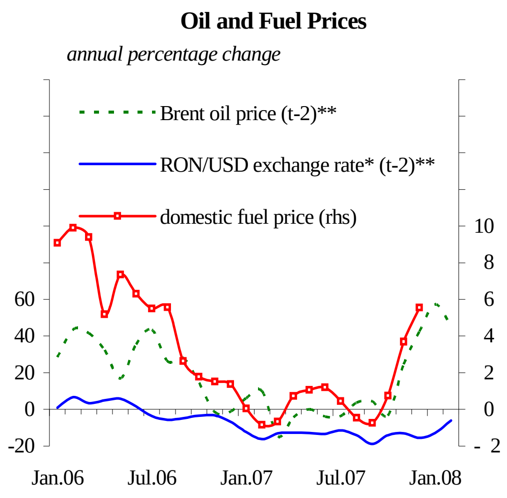
The annual growth rate of import prices slowed down further in 2007 Q3, given that the annual unit value index of imports remained below par (97.99 percent versus 98.21 percent in Q2) and the domestic currency strengthened against the euro and the US dollar at a faster pace than in the prior quarter (9.5 percent and 18.1 percent respectively).

Nevertheless, stronger pressures were seen in the case of some consumer goods (for instance, vegetal products and fats), as external prices posted significantly fast growth rates (up to 47.5

[23] Except April 2007 when ULC performance was heavily impacted by incidental factors.

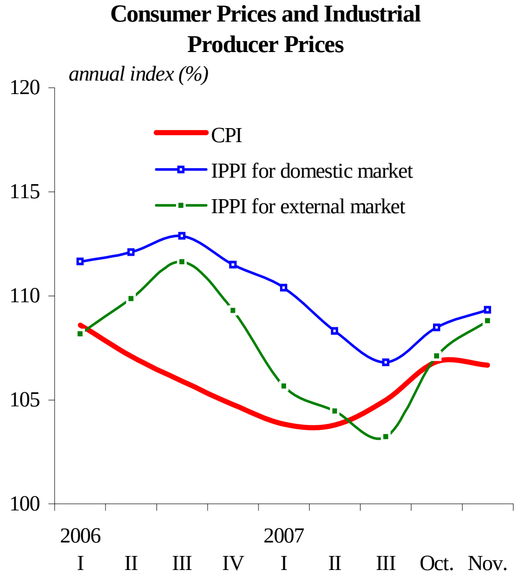
[24] Food industry, wearing apparel and leather products, publishing and printing, radio, television and communication equipment, furniture.

[25] Position that is usually subject to substantial revisions.



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

Source NIS, EIA



Source NIS

percent in the case of fruit). Prices for intermediate and capital goods (including transport means) stuck to the downward path as compared with the same year-ago period.

In 2007 Q4, imported inflation may put higher pressure on domestic prices, given that: (i) the Brent oil price hit record highs, going up 18.2 percent quarter on quarter and 48.4 percent year on year; (ii) prices for agricultural commodities remained high despite the slight deceleration in their growth rate during the final three months of the year[26]; (iii) the domestic currency weakened further, so that the previously-recorded appreciation rate (in annual terms) declined markedly (below 1 percent for the euro, from more than 9 percent in the prior quarters).

3.2. Producer prices

3.2.1. Industrial producer prices

In 2007 Q3, the annual growth rate of industrial producer prices continued to slow down (by 1.5 percentage points from Q2 to 6.8 percent), owing mainly to developments in manufacturing.

The deceleration in the annual rate of increase of producer prices was largely due to intermediate goods (down 3.1 percentage points), against the backdrop of a favourable base effect in the sub-sectors exposed to the external prices for metals. In addition, producer prices for capital goods (electrical machinery and apparatus, road transport means and transport means other than land vehicles) followed a similar trend, their annual growth rates slowing down up to 6.2 percentage points.

The annual rates of increase in prices for durables and non-durables, the groups of products which are the most indicative of pressures on consumer prices, decelerated marginally. The unfavourable developments were more visible in terms of quarterly growth rates, which accelerated from 1 percent to 1.5 percent for durables and from 0.6 percent to 2.7 percent for non-durables[27]. While the considerable advance in the quarterly dynamics of prices for non-durables may be ascribed solely to supply-side factors, the hike in prices for agricultural commodities and the deterioration of labour costs standing behind the build-up of pressures in food and wearing apparel industries, the explanation in the case of durables lies with the mounting demand[28].

[26] For instance, on the London stock exchange, futures price of wheat to be delivered in July 2008 decreased from EUR 275.55 per tonne in September to EUR 247.15 per tonne in December.

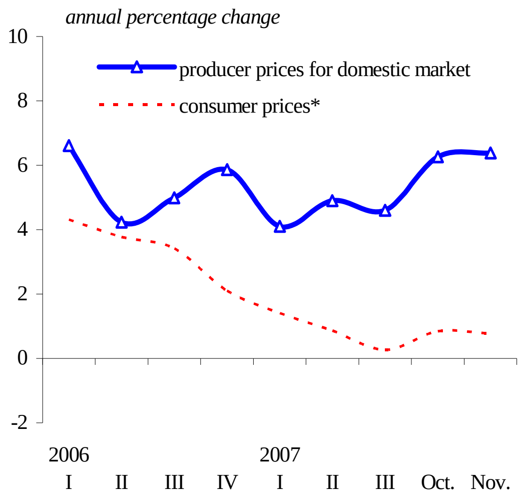
[27] Based on seasonally-adjusted data.

[28] The average quarterly growth rate of durables turnover for the domestic market advanced from -22.8 percent in Q2 to 8.7 percent in Q3.

The average annual growth rate of producer prices for energy products slowed down 1.3 percentage points from the prior quarter to 6.7 percent, staying below the average industry-wide. The oil processing sub-sector made the major contribution to this development, although tensions on the international market were manifest in the period under review (quarterly change of 0.8 percent as compared with -2.5 percent in the prior quarter). The still low magnitude of this movement may be attributed to: (i) uneven oil price developments during the considered period[29]; (ii) appropriate raw materials stocks, given that the volume of fuel exports fell sharply in the first part of 2007.

In 2007 Q4, tensions affecting producer prices for consumer goods are expected to rise, whilst the record highs in the international oil price are seen to make the growth rate of producer prices for energy products resume the upward trend.

Durables Prices



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

Source NIS, NBR calculations

3.2.2. Agricultural producer prices

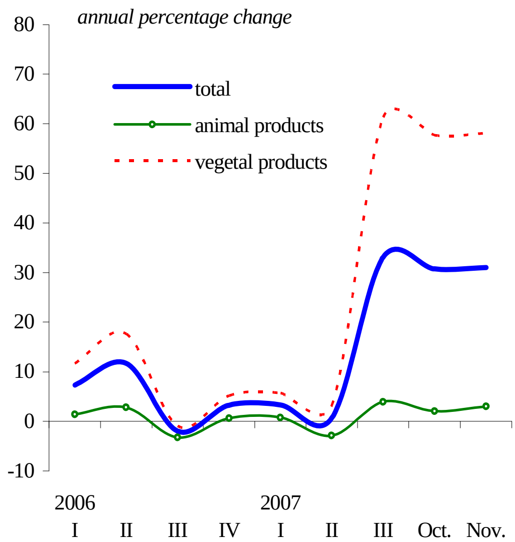
In 2007 Q3, the annual growth rate of agricultural producer prices accelerated sharply (32.4 percentage points), due to the across-the-board price hikes for vegetal products and the smaller price decreases for main types of meat.

The pressures generated by the considerable drought-induced decline in the domestic vegetable production had an impact mainly on prices for grains, which doubled in some cases as compared to the same periods a year earlier, as well as on prices for technical plants, fruit and vegetables.

The annual growth rates of prices for animal products posted a trend reversal as against Q2 (rising from -2.9 percent to 3.9 percent), owing probably to higher fodder prices. This acceleration fed through differently into the major groups of products: lower declines in prices for main types of meat and faster increases in prices for eggs and milk. The persistence of negative annual growth rates of meat prices, albeit relatively unexpected, is ascribable to: (i) competitive imports, given that the international meat price rose more slowly than in the previous quarters[30]; (ii) the larger number of slaughters in an attempt to contain costs induced by high fodder prices.

Prices for vegetal products are expected to see ever higher increases in 2007 Q4, whereas prices for animal products seem to show further uneven but moderate changes.

Agricultural Producer Prices



Source NIS

[29] In August, the Brent oil price dropped nearly 3 percent versus July, whilst in September it climbed over 10 percent against August.

[30] According to IMF statistics.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

Over the past few months, the National Bank of Romania raised the monetary policy rate twice up to 8.0 percent per annum. Moreover, the central bank continued to pursue firm control over money market liquidity and kept in place a tight minimum reserve requirements mechanism. However, broad monetary conditions became less restrictive compared to their third-quarter level as a result of a faster inflation rate and the sizeable increase in the real effective exchange rate of the RON[31].

The still fast-paced increase in consumer prices, along with a significant worsening of the short- and medium-term inflation outlook, due largely to supply-side factors but also to persistently high demand-induced pressures, prompted the NBR Board to reinitiate the upward trend in the monetary policy rate; hence, the central bank rate was raised twice, in October 2007 and January 2008, by half of a percentage point each time, to 8.0 percent. The central bank's firm response was also substantiated by aggravating inflationary risks, particularly those arising from the prospects of a persistently fast increase in wages insufficiently matched by productivity gains and the risk of larger public spending in run-ups to local and general election, as well as from the possible worsening of corporate and household inflation expectations assuming the annual inflation rate will remain above its central target path in part of 2008. With a view to enhancing the impact of interest rate decisions, the National Bank of Romania continued to pursue firm control over domestic money market liquidity, with the pick-up in sterilisation operations resulting in the gradual reduction of the gap between the interbank money market rates and the monetary policy rate. At the same time, considering the brisk dynamics of credit to the private sector and the prospects of this trend to continue, the NBR Board decided to leave unchanged the minimum reserve requirements ratio on RON-denominated liabilities[32] at 20 percent and the minimum reserve

[31] 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*).

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

requirements ratio on foreign exchange-denominated liabilities of credit institutions at 40 percent.

The decision to raise the monetary policy rate by half of a percentage point (to 7.5 percent) was taken at end-October 2007, when the updated quarterly projection of medium-term macroeconomic developments showed a worsening of the forecasted annual inflation rate pattern over most of the monetary policy transmission mechanism horizon[33]. The culprit for such a worsening was, above all, the rekindling of inflation in 2007 Q3, largely as a result of the sharp advance in food prices and the correction of the RON/EUR exchange rate against the backdrop of international financial market turmoil. The upward revision of the inflation forecast was also prompted by the relative lowering of broad monetary conditions restrictiveness and by the expected protraction, over the first part of the forecast horizon, of the uptrend in food prices (also boosted by the hike in similar prices on the international markets) and of the strength of demand-pull inflationary pressures. In addition, the analyses pinpointed the risk of such pressures being even larger in the near run – given the possible temporary widening of the positive gap between demand and domestic supply of agri-foodstuffs – and more persistent, amid the anticipated further fast wage dynamics and the increased likelihood of a higher-than-expected fiscal deficit, in 2008 at least, coupled with a bigger share of consumption-oriented expenses in public spending.

Behind the second decision of raising the monetary policy rate by another half of a percentage point (in January 2008) stood the protracted effects of supply-side shocks, especially those of costlier foodstuffs, and the emerging signs of stronger demand-side pressures. Contrary to expectations, third-quarter economic growth picked up somewhat (5.7 percent – see Chapter III. *Economic developments*), with domestic demand dynamics remaining at a level similar to that seen in the prior quarter, while domestic supply was adversely affected by the drop in agricultural production. Furthermore, although the annual growth rate of household actual consumption saw a decline[34] (8.2 percent, down 2.5 percentage points from the previous quarter), this was almost entirely due to the fall in self-consumption and the need for its offsetting entailed a robust acceleration of the rate of increase of goods purchases (24 percent), most notably food purchases. This caused demand-pull inflationary pressures to rise, possibly resulting in domestic

[33] Compared with the previous forecast (August 2007 Inflation Report).

[34] The impact of such a development on domestic demand dynamics was offset by the sharp pick-up in the annual growth rate of gross fixed capital formation (32.2 percent against 19.4 percent in 2007 Q2).

price hikes and higher imported inflation against the backdrop of dearer agri-foodstuffs on the international market and the emerging effects of a softer domestic currency. In addition, structural features of domestic demand remained unfavourable in terms of the external imbalance, as the negative balance on net exports posted a faster growth rate in the period under review.

The NBR's prompt response was also substantiated by the risk of an increase for the period ahead in the dynamics of key components of domestic absorption and therefore of the pressure it might put on macroeconomic equilibria. Specifically, public spending rose markedly (both current expenditures, most notably for goods and services and staff costs, and capital ones) in late 2007, with operational data (including the developments in the Treasury General Account) showing that the fiscal easing was similar in size to that performed a year earlier. Partly as a result of this expansionary effect, the final months of 2007 saw the emergence of the risk of a renewed pick-up in household consumer demand, in the near run at least. Thus, the annual growth rate of turnover volume in trade regained momentum in November[35], particularly on the back of motor vehicles and other non-food sales. This performance could be associated with the faster annual dynamics of household incomes and the steeper worsening trend in net financial saving of households.

From this perspective, by raising the monetary policy rate, the central bank sought to put a damper on household demand for loans, given that the annual growth rate[36] of the loan stock reaccelerated on average in the first two months of 2007 Q4 compared with the previous quarter (to 62.1 percent from 58.8 percent). Another reason for concern was the fact that, along with the persistently upward trend in the dynamics of housing loans, the end of the reviewed period saw a step-up in the annual growth pace of consumer credits (by 6.0 percentage points to 65.1 percent). Moreover, the risk of a possible reversal of the downtrend in the annual dynamics of RON-denominated loans to households, which spanned 17 months, took shape; the reinvigoration – at least temporarily – of the increase in such loans was fostered by the lower lending rates on new business (largely promotional products[37]), aggressive launch or promotion of some products to lure customers (especially 5-year consumer credits with a floating rate and an initial rate fixation period of one year), and the near-completion of the

[35] After having contracted sharply in October.

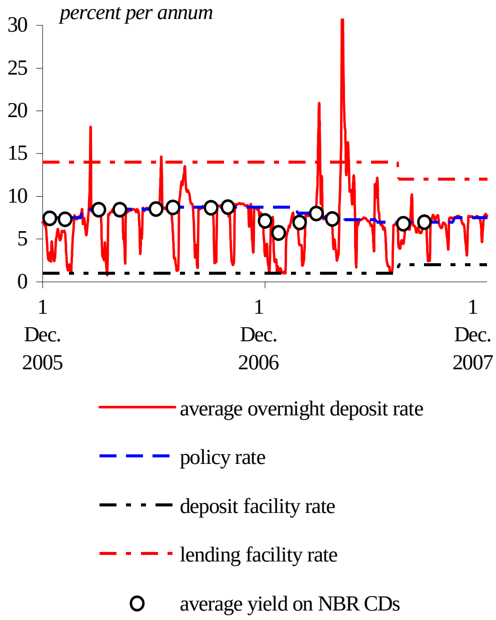
[36] Unless stated otherwise, annual rates of increase are shown in real terms.

[37] The cut in lending rates was not accompanied by a lowering of the effective annual interest rate, hinting at the short-lived nature of this measure and/or the increase in other lending costs such as commission fees.

NBR's validation of credit institutions' internal prudential norms on lending to households. At the same time, foreign currency-denominated loans further displayed a faster average annual growth rate, although its increase October through November (by 3.6 percentage points to 117.8 percent[38]) was far smaller than that seen in Q3 (15.5 percentage points); however, the growth rate was still at a 2-year high, also because of the loans denominated in exotic currencies, Swiss francs[39] in particular.

The second monetary policy rate increase was also driven by the need to counter the trend towards a weaker propensity to save manifest since the final part of Q3. Despite the deposit rate hikes applied by banks, the annual growth rate of households' time deposits in domestic currency with maturity of up to two years slowed on average to 9.9 percent in October-November from 12.3 percent July through September; the dynamics of forex deposits with maturity of up to two years (expressed in EUR) also decelerated, albeit at a slower pace (by 1.2 percentage points to 36.0 percent). Nevertheless, the total balance of FX deposits saw its annual pace of increase heading slightly forward, owing solely to the softer RON. By contrast, the year-on-year dynamics of overnight deposits of households picked up a hefty 112.1 percent, against 107.2 percent in Q3, led mainly by forex deposits (at an average annual growth rate of 94.8 percent, up 4.1 percentage points from July through September). The year-on-year expansion in households' overnight RON-denominated deposits also gathered momentum, albeit at a more moderate pace than in 2007 Q3.

Interbank Money Market Rates



The threat of second-round effects from supply-side inflationary shocks materialising, chiefly the risk of a significant worsening of corporate and household inflation expectations, which could have affected both wage bargaining and price setting, was another major reason for raising the monetary policy rate. This risk was augmented by (i) the unexpectedly high food price hikes and the anticipated persistence of supply-side shock effects in the aftermath of the 2007 drought (also boosted by the increase in similar prices on the international market), (ii) the large share of agri-food items in the CPI basket and (iii) a number of administered price adjustments in early 2008.

Yet another cause for concern was the adverse impact on consumer prices, and possibly on inflation expectations, of the continued weakening of the RON versus the EUR as well as of

[38] In EUR equivalent.

[39] In November, the loans denominated in Swiss francs accounted for 7.8 percent of total household loans against 6.4 percent and 1.8 percent in September and January 2007 respectively.

the greater volatility and unpredictability of exchange rate movements (see Section 2.2 *Exchange rate and capital flows*). The outlook for such an exchange rate behaviour to persist in the near run at least was fuelled by ever clearer signs of (i) protraction and even heightening of uncertainties surrounding the worldwide spill-over of the US sub-prime mortgage market crisis and (ii) a – possibly excessive – worsening of investor sentiment towards the changes in national economic fundamentals.

The effect of the monetary policy rate hike was boosted by the marked tightening of control over liquidity. Throughout the reported quarter, the central bank accepted all amounts bid by credit institutions at the weekly fixed-rate auctions for two-week deposits. Moreover, aside from the regular open-market operations, in October the National Bank of Romania also organised three auctions for taking 5-day deposits; in December, the central bank resorted yet again to taking deposits with very short maturities in an attempt to iron out the large liquidity fluctuations typical of a year-end and thus to avoid undesirable, sizeable swings in interest rates. Conversely, at all auction sessions for selling CDs, the National Bank of Romania rejected the credit institutions' bids in full, given that their total amount was below the acceptable threshold of 75 percent of the pre-announced volume. At end-December, the Treasury's substantial liquidity injections notwithstanding, the average balance on National Bank of Romania's open-market operations fell by about 25 percent against September. The explanation for this development lies with the relative reduction in market liquidity due to the developments in currency outside the NBR and the increase in the average balance of banks' holdings on current accounts as a result of stronger reserve demand. The monetary policy rate hike, along with the considerable retrenchment in credit institutions' resort to the deposit facility, led to an increment in the average interest rate on their placements with the National Bank of Romania. Moreover, a shift in the behaviour of interbank deposit rates took shape, as shown by their becoming increasingly stable on a path following closely that of the monetary policy rate.

2. Financial markets and monetary developments

In 2007 Q4, interbank rates headed upwards, their levels being close to the monetary policy rate, and fluctuated within a significantly narrower margin. The exchange rate of the RON remained on a sharp upward path, whilst the volatility of daily rates hit a two-year high. The expansion of liquidity in the economy accelerated again during September-November 2007, *against the background of the faster dynamics of credit to the private sector and the further strong increase in government borrowings.*

2.1. Interest rates

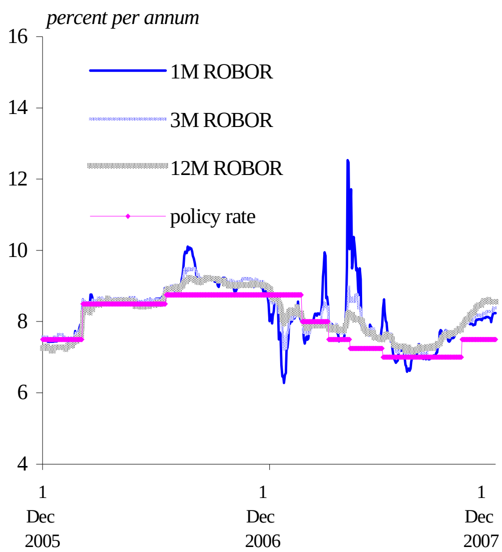
The tight liquidity control policy and the increase in the monetary policy rate pushed interbank rates higher in Q4, their average (i.e. 7.0 percent) exceeding by 1.2 percentage points the third-quarter figure. Furthermore, the volatility of average daily overnight rates declined sharply, reaching the record low of the past ten quarters.

Interbank rates neared the level of the monetary policy rate during most of the quarter, as the NBR further accepted all the bids submitted by credit institutions at the two-week deposit auctions and conducted certain open-market operations with shorter maturities, which helped cushion the effects of some temporary shocks on liquidity. Under the circumstances, both the magnitude and the duration of the traditional decline in overnight rates at the end of the reserve maintenance periods were lower versus the previous quarters; this development may indicate the potential improvement of reserve management by credit institutions, as the central bank continued to pursue a firm control over money market liquidity. The monthly average of daily interbank rates followed an upward course during the quarter under review, rising to 7.3 percent in December from 6.1 percent in September, under the impact of the policy rate increase and the narrower gap between policy rate and daily rates.

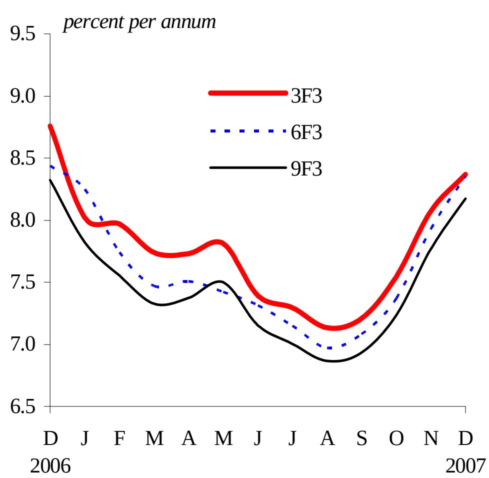
In this context, daily average overnight rates continued to fluctuate within a narrower margin (3.1-7.9 percent), while the quarterly average spread between bid and ask rates for this maturity hit a new historical low (0.7 percentage points) in the period under consideration.

The (1M-12M) ROBOR yield curve shifted upwards across the whole maturity spectrum during the reviewed quarter, which reflected market operators' expectations of higher interest rates during the first part of 2008. The average interest rates moved up 1.1 percentage points in December as compared with the level recorded three months earlier, thus putting an end to the downward trend they had followed for the past four quarters. The increase was relatively more pronounced at the longer end of the maturity spectrum, which caused the positive slope of the yield curve become steeper (the spread between 12M and 1M ROBOR rates widening to 0.4 percentage points).

Policy Rate and ROBOR Rates



Implicit Forward Rates



Developments in implicit forward rates also show the prevalence of favourable expectations of higher interbank rates during the following quarters. Accordingly, in December, the average 3M ROBOR rate was expected to stand at 8.4 percent in March and June 2008 (1.3 percentage points and 1.4 percentage points higher than the figures calculated on the basis of average rates recorded in September), while it was anticipated to drop to 8.2 percent in the latter part of the year.

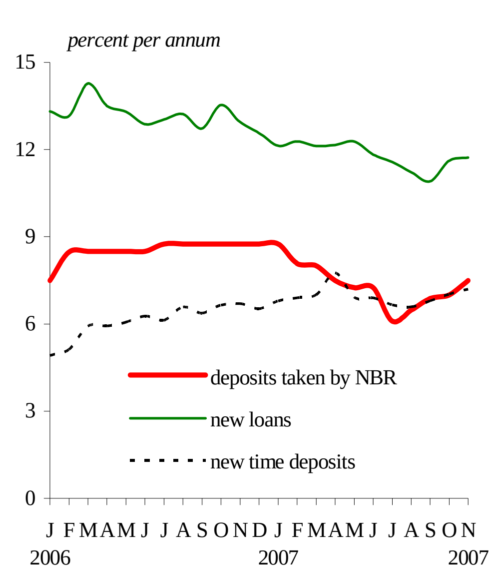
Interest rates on the primary market for government securities increased as well, although no earlier than in the latter part of Q4 (when they hit a record high year to date), as the public authority temporarily ceased to issue government securities in the first half of the reviewed quarter, in an attempt to counteract the rise in interest rates. Hence, during the period under consideration, the Ministry of Economy and Finance launched only three government securities issues (out of 11 pre-announced issues), totalling RON 503 million (while the announced figure equalled RON 2,444 million). The public authority launched 6-month Treasury certificates and 10-year government bonds, whose average interest rates stood at 7.85 percent and 7.36 percent respectively, 1.1 percentage points and 0.6 percentage points higher than the average interest rates on securities with similar maturities issued in Q3. The minimum bid rates at government securities auctions rose almost steadily, exceeding by 0.3 percentage points to 0.9 percentage points those recorded at end-September.

In October-December 2007, the volume of reverse and outright transactions on the secondary market for government securities hit a record high of RON 8,427 million[40] (considering that the NBR did not perform operations on this market during the reported period). More than half of the said transactions were carried out in December, when the monthly figure (RON 4,716 million) trebled as compared with the average for the first eleven months, owing mainly to the large-value packages of government securities being traded between banks and non-residents[41]. In 2007 Q4, securities with residual maturities of one and five years accounted for the largest part of outright transactions, the related average interest rates standing higher than those recorded in Q3 (from 6.44 percent to 6.71 percent and from 6.93 percent to 7.58 percent respectively). Repo rates on reverse operations also increased slightly as against the prior quarter, but only for transactions with maturities of one and four months (from 6.61 percent to 6.68 percent and from 6.15 percent to 6.20 percent).

[40] Outright transactions made up over 91 percent of total transactions.

[41] Nevertheless, their government securities portfolios did not undergo significant changes at the end of the period.

Average deposit rates on new business followed an uptrend during September-November 2007, against the backdrop of the increase in the monetary policy rate at end-October and the rise in ROBID and ROBOR interbank rates. Thus, the average interest rate on new household time deposits stood at 6.88 percent in November (up 0.51 percentage points from August), whilst that on deposits from non-financial corporations added 0.67 percentage points to 7.33 percent.

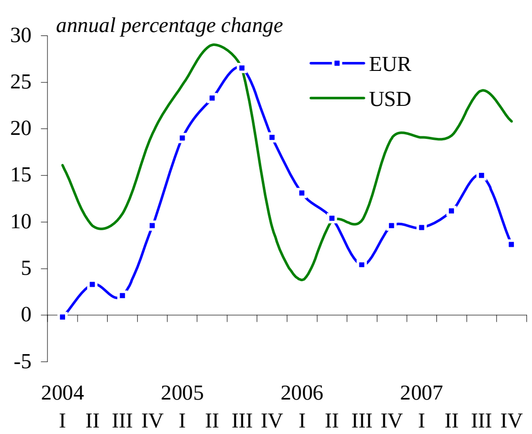


However, average lending rates on new business posted uneven developments. After the decline seen in September, the average lending rate on new business to non-financial corporations followed an upward path in October-November, the same as interbank rates, standing 0.92 percentage points higher than that recorded in August. Conversely, the average lending rate on new business to households posted opposite monthly changes in each month of the quarter, increasing only marginally by a cumulative 0.04 percentage points to 12.20 percent[42]. This development was mainly attributable to the persistently stiff competition in the banking system, which made credit institutions launch new promotional products (for instance, consumer loans with initial rate fixation for various maturities). The average interest rate on overdraft loans posted mixed developments by client, dropping 22 basis points to 21.77 percent for household loans and adding 0.71 percentage points to 12.18 percent in November for loans to non-financial corporations.

2.2. Exchange rate and capital flows

In 2007 Q4, the RON/EUR exchange rate further posted a marked upward trend, reflecting the decline in investor appetite for risk against the background of heightened concerns following the US sub-prime mortgage crisis and its spill-over effects on the international financial markets. The impact of this adverse external environment was amplified by the worsening expectations of operators with regard to the short-term outlook for the RON exchange rate, due mainly to the continued deterioration of the external position of the domestic economy and other macroeconomic indicators. Hence, during the period under review, the RON/EUR exchange rate witnessed the fastest rise since 2002 Q2; furthermore, the volatility of the daily RON/EUR rates hit a two-year high.

Developments of RON Exchange Rate*



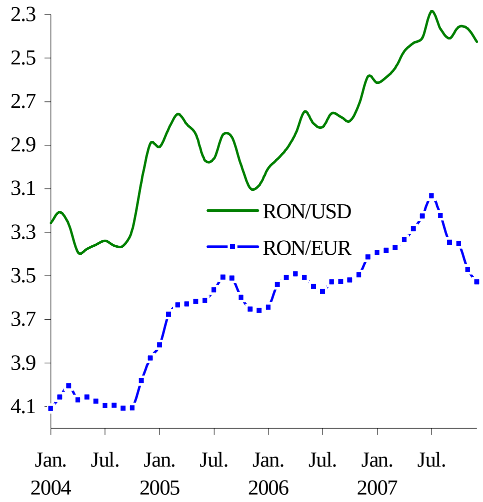
*) appreciation (+), depreciation (-) in real terms; deflated by CPI

Source NIS, NBR

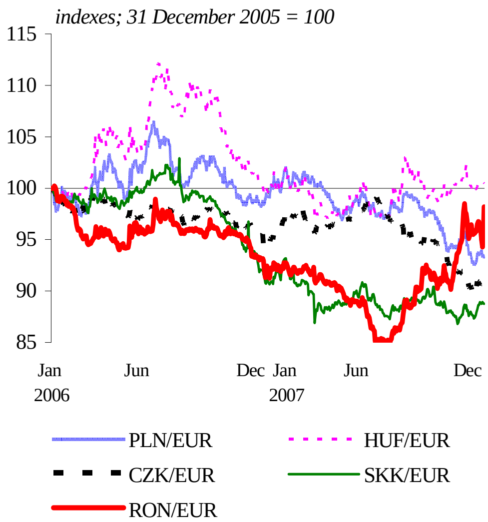
Against this backdrop, in year-on-year comparison, the domestic currency posted in December 2007 its first nominal

[42] By contrast, the average lending rate on new household loans in euro dropped 0.09 percentage points to 7.69 percent in the period under consideration.

Nominal Exchange Rate



Exchange Rate Developments on Emerging Markets in the Region



Source NBR, ECB

depreciation versus the euro (3.3 percent) in the last four years; in real terms, the RON strengthened against the EUR by 3.1 percent, compared to a cumulated appreciation of 2.0 percent and 6.0 percent in nominal and real terms respectively January through September 2007. Given that the US dollar lost ground against the European currency, the nominal appreciation of the RON versus the USD slowed down only marginally, i.e. 6.5 percent, while the real appreciation was faster, at 13.5 percent. Calculated as an average annual change for October-December 2007, there was a marked deceleration in the previously fast strengthening of the domestic currency against both the euro (0.8 percent in nominal terms and 7.6 percent in real terms) and the USD (13.2 percent in nominal terms and 20.8 percent in real terms).

Pressures for a weaker RON were considerably lower in October, amid the partial rekindling of financial investors' risk appetite, the slightly more optimistic expectations on economic developments in the region[43] and anticipations of a rate cut by the FED. Also against this background, developments in the RON/EUR exchange rate came under the impact of: (i) higher flows of direct investment and financial borrowings of non-banks; (ii) the hike in portfolio investments[44]; (iii) the preservation of a relatively high balance of non-residents' deposits, mainly due to more attractive money market rates induced by tighter NBR control over liquidity and subsequently by expectations of a policy rate hike[45]. Although the RON/EUR exchange rate posted an abrupt increase on 22 October, amid diverging signals on developments in the US economy and certain warnings on the outlook for the Romanian economy[46], the domestic currency lost only 0.2 percent against the euro in nominal terms over the month as a whole.

In November, the domestic currency came under renewed pressure for depreciation, mainly on account of a new outbreak in financial investors' risk aversion amid concerns triggered by additional losses incurred by some external financial institutions, worsening of the outlook for the US economy[47] as well as bleaker inflation expectations worldwide. To this added the increased wariness of forex market operators in relation to

[43] The main currencies in the region strengthened versus the euro in October.

[44] In October, the volume of transactions conducted by non-residents on the Bucharest Stock Exchange doubled from the previous month and their balance turned slightly positive.

[45] On 31 October 2007, the NBR Board decided to raise the monetary policy rate to 7.5 percent.

[46] On 22 October, Coface, an international credit rating agency, downgraded Romania's short-term country rating to A-.

[47] FED's FOMC minutes of 30-31 October, including the downward revision of the GDP projection for 2008, were published on 20 November.

the short-term prospects of the RON/EUR exchange rate, prompted primarily by the further deteriorating external position of the Romanian economy. As a result, the daily movements of the RON exchange rate became highly sensitive to economic events and information emerging during the reported period, particularly to those having unfavourable implications; this exchange rate behaviour was also determined by the relative decline in financial borrowings, especially those of banks, and in direct investment. Against this background, the RON/EUR exchange rate trend was connected to the trajectory of the main currencies in the region only in early November; afterwards, the RON/EUR exchange rate witnessed an episode of fast-paced increase as well as a volatility surge[48] amid (i) the downgrading of Romania's sovereign rating by Standard and Poor's from stable to negative and (ii) the release of the October inflation, which exceeded the figure anticipated in the Bloomberg poll. Reflecting the increased nervousness on the interbank forex market and the more speculative behaviour of operators, excess demand for foreign currency was on the rise, with the deficit on the interbank forex market hitting a historical high in November. The closing days of the month saw a short-lived discontinuation of the upward movement of the RON/EUR exchange rate, under the impact of (i) the publication of data on 2007 Q3 economic growth, whose pace exceeded the expectations of most analysts, and (ii) the temporary alleviation of tensions on world financial markets (also as a result of press releases issued by the ECB and the Bank of England on forecasted measures to supplement money market liquidity). Nonetheless, at a regional level, the RON posted the most significant monthly depreciation versus the EUR, i.e. 3.4 percent[49].

The behaviour of the RON exchange rate was shaped in December by the successive turmoil episodes on external money markets as well as by the rising global uncertainties related to the US sub-prime mortgage market crisis. Amid these developments, the domestic currency not only further depreciated versus the euro, but the volatility of daily rates peaked at a two-year high, thus outpacing the similar indicator of other currencies in the region. The international environment had a large impact on the RON during the period under review as well, insofar as financial investors' decisions concerning placements on the domestic market were still influenced by the possibly excessive worsening of their perception of the current and short-term developments of the Romanian economy. This

Key Financial Account Items (balances)

EUR million

	2006 11 mos	2007 11 mos
Financial account	**7,544**	**14,499**
Direct investments	**7,621**	**6,555**
residents abroad	-308	21
non-residents in Romania	7,929	6,534
Portfolio investments and financial derivatives	**-425**	**143**
residents abroad	-545	-46
non-residents in Romania	120	190
Other capital investments	**5,401**	**12,453**
of which		
medium- and long-term investments	2,321	3,172
short-term investments	2,898	388
currency and short-term deposits	928	6,082
NBR's reserve assets, net ("–" increase/"+" decrease)	**-5,053**	**-4,652**

[48] In November, the volatility of the RON/EUR exchange rate posted the highest level since August 2005.

[49] The Turkish lira and the Hungarian forint also weakened against the euro in November (2.3 percent and 1.3 percent respectively).

and the possible seasonal rise in the volume of imports, led to a new historical high of net demand for foreign currency on the interbank forex market in December. Pressures for a weaker RON were temporarily on the wane, with the domestic currency posting a short-lived appreciation versus the euro, the main determinant being the relative improvement of liquidity conditions on external money markets following the measures taken by the major central banks[50]. Nevertheless, in December as well, the RON witnessed the largest depreciation (1.6 percent) in relation to the EUR among all currencies in the region.

As uncertainties on world financial markets are likely to persist, the short-term behaviour of the RON exchange rate is expected to come under the impact of possible shifts in the attitude of investors towards the domestic financial market. These mood swings will heavily depend on the reoccurrence of turmoil on world financial markets, but also on investors' increased sensitiveness to the developments and outlook for domestic economic fundamentals.

2.3. Money and credit

Money

Annual Growth Rates of M3 and Its Components

real percentage change

	2006	2007				
	IV	I	II	III	Oct.	Nov.
	monthly average					
M3	19.2	22.2	20.1	20.8	20.6	26.2
M1	35.8	51.7	49.1	49.7	45.9	59.3
Currency in circulation	28.4	22.1	21.4	24.4	23.6	32.5
Overnight deposits	39.5	66.5	63.9	62.7	56.3	72.1
Time deposits (maturity of up to 2 years)	9.0	3 5	0.7	-0.1	1.3	2.4

Source NIS, NBR

In September – November 2007, the pace of increase of broad money (M3)[51] regained momentum (up 2.7 percentage points to 22.6 percent, one of the highest average values in the available data series). However, this trend was not uniform throughout the reported period, as the relative stabilisation of the annual dynamics in the first two months was followed by a step-up in November 2007. Over the period, the main driver behind the pick-up in M3 dynamics was the slight advance in economic growth, to which added, in November 2007, the considerable hike in public spending[52] and the significant statistical effect of a weaker RON[53]. Conversely, despite a slight slowdown, the widening of trade deficit further stymied broad money growth. From the perspective of M3 counterparties, the main drivers of

[50] On 12 December, the FED, the ECB, the Bank of England, the Bank of Switzerland and the Bank of Canada initiated a set of measures aimed at easing money market tensions.

[51] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September – November 2007 (end-of-month).

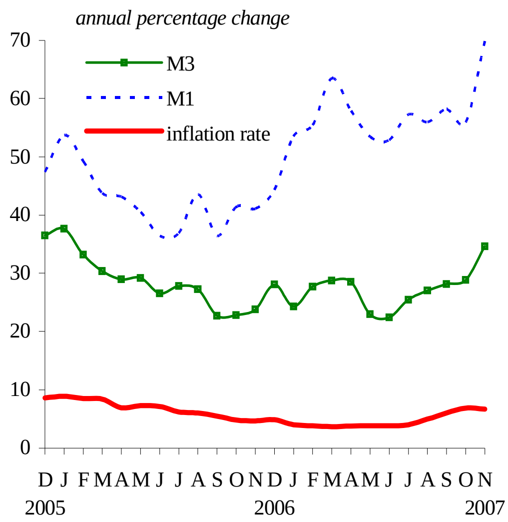
[52] In November 2007, the consolidated general budget posted a deficit, after ten months on surplus.

[53] At end-November, the domestic currency lost 4.8 percent versus the euro compared to end-October (the most noticeable monthly nominal depreciation since June 2002); hence, at end-November 2007, the RON recorded a nominal depreciation against the same year-ago period for the first time in 15 months.

monetary expansion were (i) the faster growth rate of private sector loans, (ii) the protracted uptrend in government credit dynamics, (iii) the weaker contractionary effect exerted by deposits of the central government (following the fading of the base effect generated by the BCR privatisation in October 2006 and the slacker rate of increase of the Treasury account balance with the NBR), as well as (iv) the slower rise in long-term financial liabilities, capital accounts excluded. An opposite influence exerted (i) the sharper decline in the balance of banks' net external assets and (ii) the faster growth rate of capital accounts.

The reacceleration of M3 growth was due both to narrow money and to time deposits with an agreed maturity of up to two years; in the former case, M1 expansion was more sizeable in November 2007, when its annual dynamics hit an all-time high of 59.3 percent. Conversely, marketable instruments followed a steeper downward path. Both narrow money components contributed to the average growth rate of M1 trending upwards again. However, in case of overnight deposits, only household deposits (RON as well as forex-denominated) saw a faster pace of increase, mirroring (i) higher incomes, particularly those coming from budgetary sources[54], (ii) the persistent decline in from individuals' deposits with the State Treasury, and (iii) the still high interest rate on household demand deposits. On the other hand, the annual growth rate of corporate overnight deposits continued to decelerate, despite a considerable spike-up in November 2007, most likely due to a rise in the volume of public spending.

Broad Money and Inflation Rate



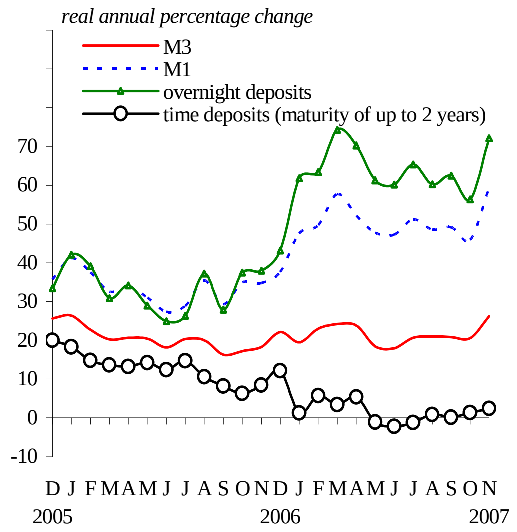
Source NIS, NBR

The annual growth rate of time deposits with an agreed maturity of up to two years followed an upward path for the first time since data series are available. Aside from the statistical effects of domestic currency depreciation, this development was also underpinned by the slower decline in the dynamics of corporate deposits and deposits from local governments and social security funds. Favourable developments in corporate deposits were mainly attributable to (i) the possible improvement in companies' financial standing, as suggested by the higher annual average index of turnover in industry[55], (ii) the diminished securities portfolio of companies once banking bonds issued in 2004 matured, and (iii) higher average interest

[54] The third gradual payrise for public sector employees, increase in pensions (30 percent rise of the pension point and the hike in farmers' pensions) as well as payments from the account of ANRP (National Authority for Property Restitution).

[55] September through November 2007, the 12-month average index of turnover in industry, for both domestic and foreign markets (108.7 percent) rose 1.3 percentage points, after a 5.5 percentage point drop in the previous period.

Main Broad Money Components

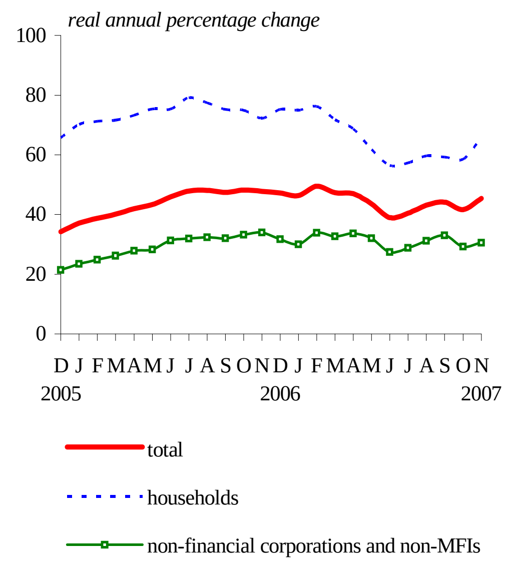


Source NIS, NBR

rates on RON- and EUR-denominated new time deposits with an agreed maturity of up to two years from non-financial corporations. By contrast, although the related average interest rates were on the rise, the growth rate of household time deposits with an agreed maturity of up to and including two years decelerated for both the RON- and the forex-denominated components. Nonetheless, the total balance of these deposits posted a relatively stable dynamics, exclusively on account of the upward movement in the exchange rate in November 2007.

After trending downwards for two years and a half, the share of forex deposits in M3 rose during the period under review (27.7 percent on average), reflecting primarily the step-up in the pace of increase of households' forex-denominated overnight deposits and the more sluggish decline in the growth rate of corporate time deposits with an agreed maturity of up to two years denominated in foreign currency.

Credit to Private Sector by Institutional Sector



Source NIS, NBR

Credit

September through November 2007, the growth rate[56] of loans to the private sector accelerated to 43.7 percent, due to further higher dynamics of its forex-denominated component, but also to the statistical effect of a weaker RON. Thus, after almost 18 months, the share of forex loans in total loans to the private sector exceeded the 50 percent mark (52.0 percent on average). The uptrend in foreign currency loans was further spurred by the removal in early 2007 of any limits imposed on credit institutions with regard to exposure from forex loans[57] and by credit institutions' still easy access to external financing[58]; another driver behind the faster increase in the RON equivalent of forex loans in November was the statistical effect of a weaker domestic currency in the reported month. In addition, credit institutions' loan supply (both in RON and in foreign currency) was further fuelled by the fierce competition among banks and especially by the quasi-completion of the validation process of banks' own prudential norms on household loans. Demand for loans in its turn was bolstered by the rise in household incomes and the fact that loans became more readily available, including through lower lending rates.

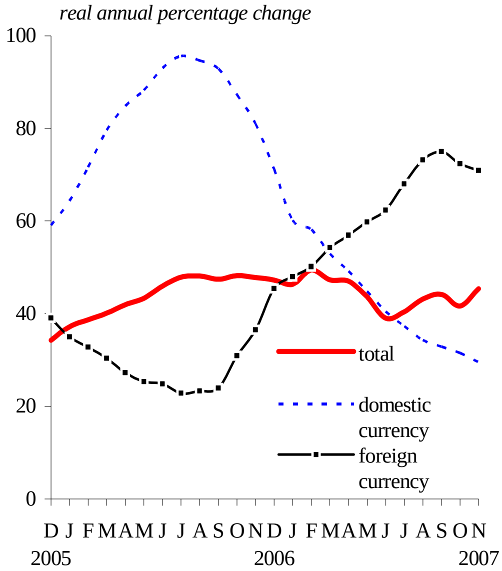
[56] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September – November 2007 (end-of-month).

[57] NBR Norms No. 11/2005 on containing the concentration of exposures from forex loans were repealed as of January 2007.

[58] The average ratio between credit institutions' forex-denominated external liabilities and the forex loans extended to the private sector was still relatively high, at 70 percent, over the period as a whole; however, this ratio dwindled in November, following the shift of some forex-denominated deposits into RON-denominated ones.

The faster dynamics of banking loans reflected primarily the upward path seen in the annual growth rate of household credit, especially its forex-denominated component (EUR-denominated loans). This development was more obvious in case of consumer loans[59]; thus, after three months of relative standstill, the annual pace of increase of forex-denominated consumer loans regained momentum in November 2007, when it hit a two-year high, also on account of increased resort to lending products in non-traditional currencies, particularly Swiss francs. Against this backdrop, the annual dynamics of consumer loans trended slightly upwards, despite the protracted slowdown in the rise of their RON-denominated component[60]. By contrast, the forex component (EUR-denominated) of housing loans picked up only marginally, given the slight rise in average lending rates on new business in euro and especially the heightened uncertainties surrounding RON exchange rate developments; the expansion rate of RON-denominated housing loans continued to decelerate, amid the upward course in the associated lending rates. The growth rate of household loans was still twice as high as that of corporate loans, so that the share of the former in total private sector loans hit a new record high over the period under review, i.e. 47.5 percent on average.

Credit to Private Sector by Currency



Source NIS, NBR

The annual dynamics of corporate loans also gathered strength somewhat, but this development can be ascribed exclusively to the accounting effects of a weaker RON. This impact left aside, statistical data reveal a slacker growth rate of corporate loans for all key maturities. The likely determinants include the depreciation of the domestic currency, the hike in average interest rates on new EUR-denominated loans to non-financial corporations, as well as companies' increased resort to external[61] and own[62] financing resources.

Conversely, the expansion pace of credit to the public sector remained robust, reflecting the local government's stronger demand for loans, but also the faster dynamics of the stock of government securities held by credit institutions.

---

59 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.

60 The share of RON-denominated loans in total consumer loans shrank to 58.3 percent in November from 62.7 percent in August 2007.

61 The actual amount of net external financial loans taken by non-banks September through November 2007 exceeded the June-August 2007 figure.

62 According to data provided by the Central Credit Register, the volume of new business to productive sectors (industry, agriculture and construction) was almost twice lower than in the previous period.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the 12-month inflation rate at 5.9 percent for end-2008, 1.6 percentage points above the figure published in the November 2007 Inflation Report and 1.1 percentage points higher than the upper limit of the variation band for the current year (3.8 percent ± one percentage point). Resumption of disinflation is expected for 2008 Q2 so that the inflation rate would fall back inside the target band starting with 2009 Q2. For end-2009, inflation is forecasted to reach 3.9 percent.

The projection was revised due to recent developments marking substantial deviations from the previous scenario. The deviations stem from the cumulative action of: (i) the shocks impacting the RON exchange rate in 2007 H2 and the persistence of their effects in early 2008, (ii) the additional excess demand induced by the increase in budget deficit and household incomes at end-2007 and in 2008 Q1; (iii) larger-than-previously-projected hikes of administered prices both in 2007 Q4 and throughout 2008; and (iv) the destabilising effects of these shocks on inflation expectations. Although the monetary policy rate was raised in response to the developments and the outlook for the economy as a whole, both the nominal depreciation of the domestic currency and the upward adjustment of inflation expectations led to less restrictive monetary conditions in real terms, thereby reducing temporarily their impact on aggregate demand in the first part of the forecast horizon.

For 2008, the baseline scenario predicts a disinflation path which is comparable to that envisaged by the previous forecast (with the projected annual inflation rate dropping from a high of 8.3 percent in 2008 Q1 to 5.9 percent at end-2008 compared to the fall from 6.3 percent to 4.3 percent projected in November 2007). The decreasing inflation projection in the second half of the forecast horizon relies on the programmed restrictive impact of real monetary conditions on aggregate demand, on the assumption of fading second round effects of the 2007 drought following the 2008 harvest, and on lower inflation expectations once the disinflation process strengthens.

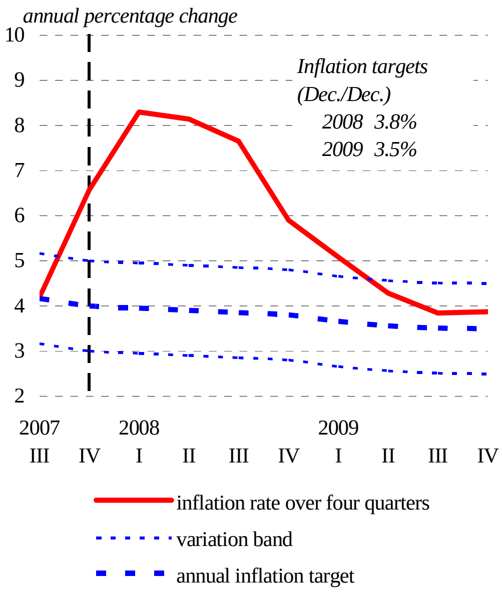
Within the current projection horizon, the major risks which, should they materialise, could cause inflation to deviate significantly from its projected path, arise from real wage increases in excess of productivity gains, sharper worsening of inflation expectations in the first part of the horizon, the possible increase in the expansionary stance of fiscal policy *compared to the projection, and the surge in fuel prices on external markets. The inflation rate could be lower than projected in the baseline scenario if the domestic supply of food items rose considerably as a result of bumper crops next summer. Deviations on either side of the baseline scenario are likely if movements in the RON exchange rate and administered prices veer off from the current scenario.*

1. The baseline scenario of the forecast

1.1. Inflation forecast

According to the baseline scenario, the surge in annual consumer price inflation is projected to continue in 2008 Q1, followed by the resumption of disinflation. The inflation rate is estimated to fall back inside the corridor around the central target starting with 2009 Q2. The inflation rate is forecasted to reach 5.9 percent in 2008 and 3.9 percent in 2009. Over the horizon, the projected path of the annual CPI rate is significantly higher than in the forecast published in the November 2007 Inflation Report.

Inflation Forecast



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

Table 5.1. Annual inflation rate (end of period)

percent

Period	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4
Target				3.8				3.5
Forecast	8.3	8.1	7.7	5.9	5.1	4.3	3.8	3.9

The anticipated inflation target miss in 2008 is attributed to several factors, as follows:

− the persistence of supply-side shocks that occurred in 2007 H2, the most relevant being the following:

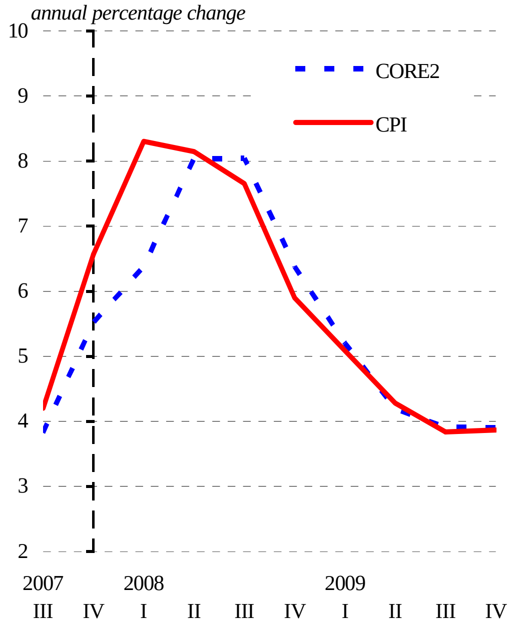
- lingering after-effects of poor agricultural crops on volatile prices of some foodstuffs, especially those included in CORE2 inflation basket;
- higher import prices following the strong nominal depreciation of the domestic currency in recent months;
- substantial hikes of administered prices, energy prices in particular;

− the fast growth of aggregate demand, underpinned by larger household incomes, credit expansion, and budget deficit widening;

− the limited efficacy of monetary policy responses to shocks within a time horizon shorter than one year because of the specific lag of these responses via the transmission mechanism.

However, the baseline scenario envisages the resumption of disinflation during the current year, after the peak in inflation rate expected for 2008 Q1. Starting with the next quarter, inflation is seen declining steadily towards the end of the forecast horizon, in line with attaining the medium-term target.

CORE2 and CPI



At the beginning of the forecast interval (2008 Q1), the estimated annual inflation rate is 2 percentage points higher than that projected in the November 2007 Inflation Report. Additional inflationary pressures stemmed from the notable supply- and demand-side shocks that have hurt the economy since 2007 H2, including:

− the depreciation of the domestic currency;

− the increase in fuel prices on international markets;

− heightened inflation expectations; and

– the higher-than-previously-projected aggregate demand growth in 2007 H2.

The pace of forecasted disinflation is slowed down by the projected sluggish reduction in CORE2 inflation rate. Thus, the prices of products included in the CORE2 inflation basket are estimated to rise faster than the other consumer prices starting with 2008 Q3. However, the projected core inflation would be lower than CPI inflation over the period if the effects of the successive hikes in excise duties on tobacco products were left aside. Over the forecast interval, core inflation prices are adversely affected by higher inflation expectations following the temporary pause in disinflation. Given the large share of processed food items in the CORE2 index basket[63], the sizable pressures induced by last year’s poor supply of agricultural produce are expected to persist in 2008 H1. It would be more difficult to remove such pressures than those impacting the volatile prices of some food items (vegetables, fruit and eggs) due to their longer processing cycle. The delayed closing of the positive output gap and the slower opening of a demand deficit would postpone CORE2 inflation’s falling back inside the corridor around the central target until 2009 H2.

At the beginning of the forecasting round, inflation expectations reflect the recent increases in prices of consumer goods, food items in particular. Starting with 2008 Q3, inflation expectations are seen falling slowly insofar as disinflation is back on track. The persistence, in 2008 H1 at least, of the effects of the above-mentioned shocks would prevent expectations from being more rapidly adjusted and the inflation

[63] Food items account for 48.92 percent of the CORE2 index basket.

rate from falling back inside the corridor around the central target by the end of 2008.

The volatile prices of some food items (vegetables, fruit and eggs) are estimated to be the key inflation-boosting factor until 2008 Q3, when the negative effects of last year's drought-hit supply are expected to be entirely cancelled by the 2008 harvest. Therefore, the changes in administered prices considered in the current projection are the main source of consumer price increases starting with 2009 Q1.

The projection for domestic fuel price movements rests on the assumption that throughout the forecast horizon the international oil price would remain at USD 100 per barrel. Similarly to the previous forecasting round, the projection incorporates excise duty adjustments to certain fuel types scheduled by the Tax Code for the beginning of 2008, 2009 and 2010. Compared to the November 2007 Inflation Report, the current projection forecasts higher inflation rates of domestic fuel prices, in line with a weaker local currency.

The forecast of the RON exchange rate weighs on import prices as well. Although the import price inflation is estimated to be lower than the consumer price inflation over the entire forecast horizon, its contribution to the disinflation process is much smaller than that envisaged in the November 2007 Inflation Report.

1.2. Exogenous inflationary pressures

The cumulative effect of exogenous CPI components anticipated for 2008 is 0.3 percentage points higher in the current baseline scenario than in the previous projection, whereas that for 2009 remains unchanged from the forecast in the November 2007 Inflation Report.

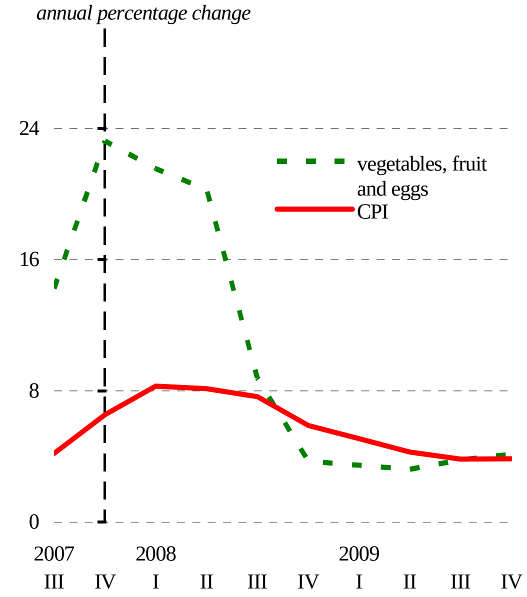
Compared to the previous projection, the faster dynamics of administered prices is expected to be alleviated during 2008 by a decrease in the anticipated inflation rate for volatile prices of vegetables, fruit and eggs. Table 5.2 shows the annualised growth rates of administered prices and volatile food prices.

Table 5.2. The scenario for growth rates of administered and volatile prices

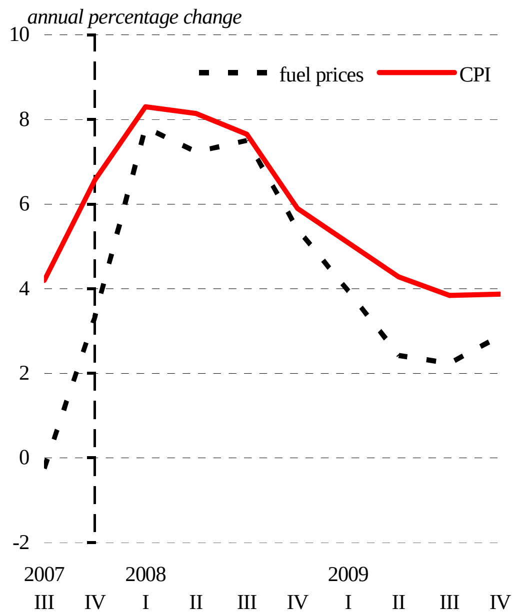
percent

	Administered prices			Volatile food prices		
	2007	2008	2009	2007	2008	2009
Current projection	6.3	6.5	4.0	23.2	3.7	4.1
Previous projection	5.2	4.7	4.3	26.2	5.6	3.8

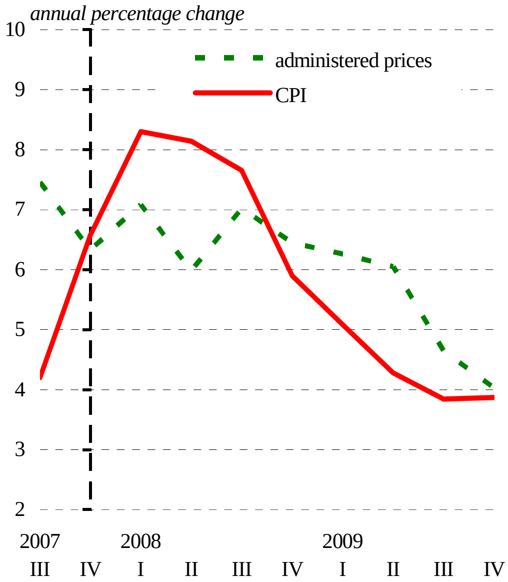
Vegetables, Fruit and Eggs Prices and CPI Inflation



Fuel Prices and CPI



Administered Prices and CPI



The current scenario anticipates that volatile food prices (vegetables, fruit and eggs) will post the fastest growth rate of all consumer prices in the first half of 2008 because of poor crops in 2007 and nominal depreciation of the RON in the second half of last year. A few years ago, the weak agricultural output would have been offset by foodstuffs imports at lower prices on the back of RON's appreciation; instead, in 2007 the insufficient agricultural supply alongside the weakening domestic currency fuelled price increases simultaneously. The inflationary effects exerted by this group of prices are predicted to diminish after the 2008 crops are harvested.

The positive difference between the current projection on administered prices inflation and the previous one is attributable to higher price increases in 2007 Q4 than those anticipated in the November 2007 Inflation Report, as well as to the revision of the calendar for adjusting energy prices following the anticipated additional rises in heating and natural gas prices. The price increases of these two components are seen exceeding by far the expected consumer price inflation, particularly in 2008. The significant price rises expected for natural gas are due to the ongoing alignment of domestic prices with prices on the European market. Table 5.3 summarises the growth rates of electricity, heating and natural gas prices.

Table 5.3. The scenario for growth rates of energy prices

percent

	Electricity			Heating			Natural gas		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Current projection	4.2	2.0	3.5	12.3	14.5	6.0	0.1	16.2	8.2
Previous projection	4.2	4.2	3.5	12.3	11.4	6.0	0.1	12.5	8.2

The anticipated price hikes for cigarettes and tobacco products are set according to the calendar for bringing excise duties at levels agreed with the European Union. For the current projection, the contribution of tobacco excise duty and vice tax was subject to upward revision, as a result of a more depreciated exchange rate used for assessing the RON-denominated value of the excise duty.

According to the figures published by Consensus Forecasts in December, the inflation rate for the euro area is anticipated at 1.8 percent both for 2008 and 2009, down from the 1.9 percent level in the previous projection for both years. The euro area interest rate is expected to decrease slightly as the inflation rate reverts close to the price stability level defined by the European Central Bank[64].

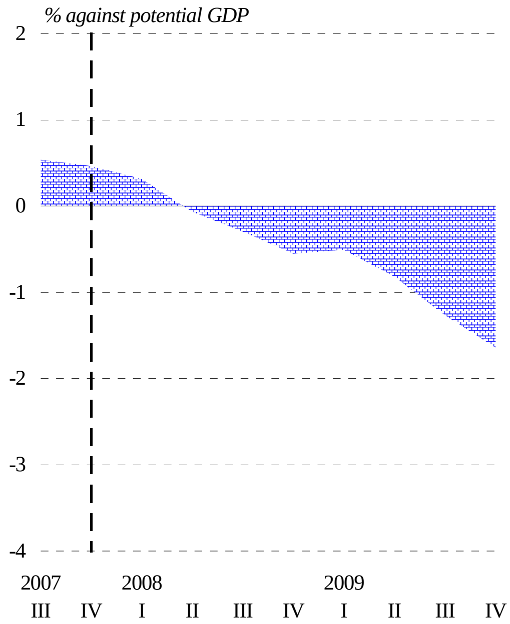
[64] The European Central Bank defines price stability as inflation rates below, but close to, 2 percent per annum.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

In 2007 Q3, real GDP posted a growth rate similar to that of the previous quarter. The statistics on real GDP and its components during the first three quarters of 2007 show a number of uncertainties surrounding mainly (i) the very large statistical discrepancy on the expenditure-side[65] which accounted for 8 to 12 percent of quarterly GDP in 2007, (ii) the significant revision by the NIS of annual investment ratios but without revising demand components; this will be corrected in March 2008 when revised quarterly data on GDP are to be published, and (iii) inconsistencies between statistical data in the consolidated general government budget and those in the national accounts relative to net taxes on products, a GDP component which was influenced by the amended legislation on VAT collection.

GDP Deviation



The assessment of excess demand in Q4 and Q3 took into account a temporary drop in potential GDP owing to negative supply-side shocks induced by the 2007 drought. This shock does not entail a similar decrease in excess demand, hence fuelling inflationary pressures. The output gap estimated for Q4 has not changed significantly from the figure used in the previous projection.

Household final consumption dynamics slowed down in Q3 as against the previous two quarters, owing particularly to the setback in self-consumption; it is expected to recover momentum in 2007 Q4. The Q3 rate of increase of more than 8 percent should not be seen as a significant deceleration in terms of inflationary pressures. Indirect evidence from variables underlying household consumption suggests faster dynamics of this consumption component. Thus, real wages continue to increase at a brisk pace and the number of employees economy-wide is also above the medium-term trend. The outcome of the consolidated general government budget execution indicates a 2.4 percent deficit-to-GDP ratio for 2007. Therefore, both components of consumption send a stimulative impulse to aggregate demand.

Gross fixed capital formation was the fastest-growing GDP component in Q3 as well, remaining above the medium-term trend. The revision of data on investment by destination released by the NIS for the first three quarters of 2007 points to greater efforts towards retooling, which fosters economic growth. Medium- and long-term loans granted to economic

[65] Data reported by Eurostat.

agents, a major financing source of investments, continued to rise at a swift pace in October-December 2007.

The dynamics of imports of goods and services is mainly attributable to the increasingly high levels of household incomes, as wages, employment and non-government credit continued to grow at a fast pace in Q4. Exports remain below the medium-term trend, but the indicators on industrial activity point to a possible acceleration in the growth rate of exports. Thus, labour productivity in industry saw a substantial increase in October and November as compared with third-quarter average, whereas ULC remained broadly unchanged at the previous quarter's level. Net exports have a dampening impact on inflationary pressures arising from aggregate demand.

1.3.2. Implications of recent exchange rate and interest rate developments

The nominal depreciation of the domestic currency, which started in August, continued in Q4, exceeding the level recorded at the beginning of 2007. Global financial markets are still under the influence of the US sub-prime mortgage crisis which is causing a liquidity squeeze and is keeping risk aversion at high levels. Apart from these factors impacting worldwide investment, the considerable domestic currency depreciation is also attributable to certain factors specific to the Romanian economy. On the one hand, the strong over-appreciation of the RON generated an exchange rate correction larger than that seen in other countries. On the other hand, the flare-up in inflation and the wider current account deficit in the latter part of 2007 led to the worsening of investors' perception of macroeconomic outlook.

The real depreciation of the RON as against the previous quarter has eliminated the domestic currency over-appreciation. Consequently, the average real exchange rate in Q4 had a considerably lower restrictive effect on aggregate demand through the net export channel. On the other hand, the wealth and balance sheet effects of the exchange rate had a restrictive impact, with the depreciation entailing a significant increase in the costs related to foreign currency borrowing. This accounts for nearly half of total non-government credit. As regards the direct impact of the exchange rate on inflation through import prices, the recent nominal depreciation implies that the RON no longer has the disinflationary impact it had in previous years.

In the medium run, the real exchange rate is driven by fundamentals (medium-term capital inflows or the productivity differential against major trade partners). In the short run, the exchange rate may deviate from the medium-term trajectory to which it tends to revert after the phasing-out of effects of one-off factors. Taking into account Romania's real economic convergence with the euro area, the RON follows a normal real appreciation trend in the longer run. However, considering the heightened risk aversion on international markets and the recent developments, a slowdown is expected in the average appreciation rate set by fundamentals within the projection horizon.

In response to the flare-up in inflation, the NBR raised the monetary policy rate by 50 basis points to 7.50 percent in 2007 Q4. The policy rate was raised again in both January and February, to 8 percent and 9 percent respectively, causing the increase in the average interest rate for 2008 Q1. Furthermore, the NBR continued to pursue a firm management of money market liquidity via open-market operations, so that the average interest rate on commercial banks' deposits with the central bank stayed at levels close to the monetary policy rate. Despite the nominal interest rate rise during October-December 2007, the strong increase in inflation and, hence, in inflation expectations led to the steep decline in real terms in NBR's policy rate.

NBR's policy rate influences the real economy indirectly, through commercial banks' deposit and lending rates. These rates usually adjust only gradually to the changes in the monetary policy rate. In response to the increase in the policy rate, the decline in both deposit and lending rates came to an end in the final months of 2007, their quarterly averages even going up slightly as compared to the prior quarter. However, the worsening of inflation expectations continued to translate into significant decreases in commercial banks' real deposit and lending rates. As a result, the commercial banks' interest rates had, *ceteris paribus*, a stronger stimulative effect on the real economy in Q4.

Overall, in 2007 Q4, both exchange rate and real interest rate developments led to the considerable alleviation of the restrictive pressure put by real monetary conditions on aggregate demand and future inflation.

1.3.3. Demand pressures within the projection horizon

According to the baseline scenario of the current projection, excess demand will persist until 2008 Q1, followed by the slow opening of a negative output gap. The one-quarter delay in the elimination of excess demand as compared to the November 2007 Inflation Report can be ascribed to the more robust economic growth and the less restrictive real monetary conditions in the latter part of 2007.

As compared to the previous forecasting round, the inflationary pressures of aggregate demand are expected to rise until 2009 Q3. Excess demand is higher at the beginning of the projection horizon, owing primarily to the more robust economic growth recorded in 2007 Q3 and anticipated for 2007 Q4. Demand deficit in 2008 is projected to widen at a pace slower than that anticipated in the previous Inflation Report, as a result of certain factors with opposite effects. Pressures generated by projected aggregate demand are underpinned by looser real monetary conditions in the early part of the horizon and by the stimulative fiscal impulse expected for election year 2008. These developments are offset by the wealth and balance sheet effects induced by the exchange rate dynamics: the recent depreciation of the domestic currency affects the debt service in case of debtors having taken forex-denominated loans. A faster opening of demand deficit is expected over the upcoming year, amid more restrictive real monetary conditions. However, the projected fiscal impulse will further have stimulative effects on aggregate demand.

The restrictiveness of real monetary conditions was considerably eroded at end-2007 by the strong depreciation of the domestic currency and the inflation flare-up eating into real interest rates. According to the current projection, the monetary policy rate is expected to revert to a trajectory compatible with attaining the medium-term inflation target. Similar developments are anticipated for commercial banks' real interest rates, which will have a significant contribution to containing aggregate demand growth in the latter part of the projection horizon. The change in interest rates is also in line with the higher risk premium associated by foreign investors with their positions on Romanian markets. The US sub-prime mortgage crisis triggered a liquidity shortage on world financial markets and led to the investors' flight to quality. The insufficient funds made available to Romanian banks by foreign banks are seen as an additional driver behind the rise in bank interest rates.

Budget deficits expected for the next two years – reassessed in compliance with ESA95 methodology used by the European Union – exceed 3 percent of GDP over the projection horizon, in line with the latest European Commission forecasts[66]. Pressures on aggregate demand stemming from the lax fiscal policy are augmented by the more robust economic growth forecasted in the current projection. The assumption regarding

[66] European Commission, Directorate-General for Economic and Financial Affairs, European Economy No. 7/2007, *Autumn economic forecasts 2007–2009*, Table 3.22.1, page 101: http://ec.europa.eu/economy_finance/publications/specpub_list9253 htm

EU funds absorption is the same as in the previous Inflation Report, providing for an increase in the absorption coefficient of funds starting with the latter part of 2007, mainly spurred by the creation of institutions managing the intake of such funds.

Domestic demand will continue to be the main driver of economic growth throughout the projection horizon. However, exports are expected to play an increasing role in supporting economic growth, given the heightened competitiveness of domestic products following the elimination of the previous years' RON over-appreciation. 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 growth than consumption. The pace of increase of private consumption will remain robust, albeit decelerating over the projection horizon. The anticipated rise in consumption will further be backed by the surge in disposable income, while the higher costs in RON attached to the repayment of companies' debts incurred in foreign currency will put a cap on aggregate demand for consumer goods. The growth rate of gross fixed capital formation is projected to be the fastest among GDP components, further exceeding 10 percent in 2008-2009, fostered by the expansion of activity in construction, services and industry. The nominal appreciation trend of the domestic currency came to an end in August 2007, entailing costlier imports compared to domestic goods and services. Therefore, trade deficit is anticipated to stabilize and then gradually narrow over the projection horizon.

1.4. Risks and uncertainties surrounding the projection

Over the projection horizon there is the risk of certain events materializing which could cause inflation to deviate from the trajectory described in this Inflation Report. The main risk scenarios relate to:

- real wage hikes overtaking productivity gains;
- faster-than-expected worsening of inflation expectations;
- implementing a looser-than-assumed budgetary policy;
- higher oil prices on international markets; and
- bumper crops.

The mismatch between pay rises in real terms and labour productivity gains could fuel inflationary pressures via the costs channel. Current and potential employees enjoy a stronger bargaining position given the labour shortage manifest in certain sectors in Romania. Pressures exerted by the scant supply on the labour market, particularly if fuelled by a lax income policy in the public sector, might force employers to concede wages they could only afford by raising the price of traded goods or services. This process could generate a wage-inflation spiral, with employees trying to maintain their real incomes via higher nominal wages and employers generating inflation by raising prices. Such behaviour is boosted by worsening inflation expectations and contributes to a wider gap between forecasted inflation and the target itself.

Failure to achieve the planned increase in budget revenues and continuing the practice of unforeseen public spending – as seen in previous years, e.g. public sector pay rises, bonuses – would have a strong stimulative effect on aggregate demand and inflationary pressures. Another risk factor consists in the financing of current expenditures from amounts destined to investment projects, a trend that has been manifest over the recent years. Due to political reasons, current expenditures are difficult to reverse and preclude any contraction in expenditures. The risk of a looser budget policy compared to the announced targets is all the more relevant given the successive election rounds scheduled for 2008 and 2009.

Fuel prices represent a major component of corporate costs. Hence, the chances of further hikes in oil prices – a plausible scenario on international markets – are also associated with a risk of inflation deviating from the NBR forecast.

As a general consideration, it is worth mentioning that, compared to recent quarters, these risks could materialize within a tense domestic and international context. The effects of the fiscal easing which, in the previous years, had allowed companies to absorb cost-related shocks without their having a major impact on inflation have faded. At least for a while, the abundant external financing provided to the Romanian economy over the past years will only be available at higher costs. Under these circumstances, any of the aforementioned risks could have major consequences.

In terms of factors that could lead to an inflation rate significantly lower than the forecasted level, the possibility of a bumper agricultural year stands out as the most relevant assumption. Underpinned by a favourable base effect, the agricultural output growth well above expectations (the current projection incorporates the assumption of an average agricultural year for 2008) would have a sizeable impact on the price level of food items, whose share in the consumption basket renders them extremely relevant for the entire price index. In addition, the favourable effect on prices would be enhanced by cushioning inflation expectations.

2. Policy assessment

In 2007 Q4, the 12-month inflation rate remained on the upward path that it had entered at mid-year, reaching 6.57 percent in December. The annual growth rate of consumer prices picked up 2.77 percentage points in H2 and 1.70 percentage points as against end-2006, largely as a result of supply-side shocks that marred the domestic and international markets in the latter half of 2007. The unexpected magnitude and simultaneous occurrence of such shocks pushed the annual inflation rate above the upper limit of the ±1 percentage point variation band associated with the 4 percent target. Over the period, the major factor of resurgent inflation was the strong increase in prices of certain agri-food items with significant shares in the CPI basket, including the CORE2 inflation basket, and which exhibit relatively inelastic demand; this resulted both from the drought-induced decline in domestic agricultural output and the hike in prices of some agri-food commodities on external markets. Adding to these effects was the impact of substantial domestic currency depreciation that began in the context of turbulences on world financial markets as well as that of the significant rise in fuel prices. The inflationary impact of supply-side factors was boosted to a certain extent by the persistence of excess demand fuelled mostly by the still fast wage growth, the steep increase in public spending towards the end of the year, and the inflation expectations arising from such developments.

Including as a result of faster-than-anticipated inflation at end-2007, the updated trajectory of the projected annual inflation rate is much higher than the previously expected path. The upturn in the projected annual inflation rate is seen persisting into 2008 Q1, with disinflation expected to gather pace in the latter part of the year. Thus, the period during which the annual inflation rate is projected to stay above the upper limit of the variation band around the central target is somewhat longer than that envisaged in the previous forecast. The period is expected to last until 2009 Q1 – including as a result of the inherent time lag in the efficient transmission of the impact of the relatively increased restrictiveness of broad monetary conditions incorporated in the medium-term forecast; thereafter the projected annual dynamics of consumer prices will revert to a path compatible with achieving the medium-term inflation target, a horizon where the effectiveness of monetary policy tools becomes more apparent. Other initial conditions that could play a role in the worsening of the projected annual inflation pattern are the following: (i) the likely persistence of higher food prices over the months ahead; (ii) the upward revision of the forecasted magnitude of administered price hikes and fuel price dynamics; (iii) brisker economic growth and continued double-digit annual expansion of domestic demand in 2007 Q3 and an expected faster GDP increase in 2007 Q4; (iv) the relatively lower restrictiveness of the existing monetary conditions following the reduction in the real margin of the monetary policy rate, despite its being raised twice (in October 2007 and January 2008) and the ongoing weakening of the RON versus the euro and the US dollar; and (v) the likely flare-up in imported inflation over the coming months due to the recent step-up in the pace of depreciation of the domestic currency.

According to the baseline scenario of the updated forecast, the pick-up in projected annual inflation during 2008 H1 and the subsequent persistence of high annual inflation rates are chiefly attributed to the stronger inflationary impact of supply-side factors that are beyond the control of monetary policy. At the same time however, the larger and to some extent more persistent positive output gap than in the previous projection hints at the risk of stronger and lingering inflationary pressures from aggregate demand over the first part of the forecast horizon (thereby posing the additional risk of supply-side shocks being passed on to consumer prices to a greater extent).

The risk of aggregate-demand inflationary potential to be stronger than that entailed by the projected excess demand is still significant, given the expected persistence of overly-high household consumption. Such a development could be fuelled mainly by the prospects of further strong wage increases – driven also by the implementation of the two-stage raise of gross minimum wage in 2008 –, the recent substantial pension rise and to some extent the possible maintenance of fast household credit expansion which might be even coupled with dis-saving. In addition, the possibility of consumer demand-driven inflationary pressures, including those of excess demand for agri-food items, being mitigated by higher imports has recently been cancelled by the sharp hikes in prices of certain consumer goods on international markets and the sizable depreciation of the domestic currency versus the major currencies in the past months. By contrast, the future resort to imports with a view to cover the domestic supply shortfall – assuming a small elasticity of demand to exchange rate movements – would further cause the current account deficit to widen. As a matter of fact, the current account deficit has already reached a level that has left the Romanian economy vulnerable to external financial shocks and, possibly, to real ones.

At the same time however, it should not be ruled out that the significant pick-up in the dynamics of food, fuel and administered prices might trigger a drop in households' real disposable income, as well as the worsening expectations on such income, which could lead to a slowdown in consumer demand growth. Moreover, the propensity for consumption might be additionally weakened by the magnitude of the depreciation of the RON versus the EUR which might weigh on the demand for foreign currency-denominated loans and entail liquidity constraints for borrowers. Similar effects could have a possible persistence of the increase in interest rates on EUR-denominated loans amid tighter terms and conditions associated with the funds lent to domestic credit institutions by parent undertakings.

The upturn in credit institutions' lending and deposits rates relative to RON-denominated funds, a move that has recently been observed in response to the two monetary policy rate increases, might also damp down the dynamics of household consumption, including by fostering saving. The impact of the monetary policy rate hikes on credit demand and implicitly on consumption and investment behaviour could be more effectively transmitted on the assumption of a gradual reduction in the share of foreign currency-denominated loans in total credit to the private sector.

Weaker domestic currency combined with higher credit costs might have a contractionary effect on the dynamics of households' consumer demand and its inflationary pressures, but also on the pace of increase in imports. Such an effect could however be to a large extent annihilated by the expansionary stance of fiscal policy over the months ahead. The ensuing concern is amplified by the risk that, given the successive election rounds scheduled for 2008 and 2009, the public deficit may exceed even the authorities' projected levels, and a relative deterioration in the structure of public spending, which could fuel demand-pull inflationary pressures, may occur. In 2008, such pressures could result from larger-than-projected rise public expenditures, especially those boosting public and private consumption, as well as from the failure to achieve the planned increase in budget revenues due to the possible underestimation of the impact from lower social security contributions payable by employers and the introduction of the second pillar pension scheme.

Against this background, another matter of concern is that the direct inflationary impact of supply-side factors, basically food price increases and administered price adjustments could trigger substantial second-round effects via worsening inflation expectations in particular. This risk is aggravated by anticipations relating to the magnitude and relative duration of the direct inflationary impact of such factors, given: (i) the very large weight of these prices in the CPI basket; and (ii) the high likelihood of a persistent uptrend in such prices on international markets in conjunction with the sizeable RON depreciation seen in the past months.

Under the circumstances, heightened inflation expectations might materialise chiefly in the exacerbation of unions' wage claims which, if accepted by employers, could well lead to a dangerous wage-inflation spiral. Such a risk is enhanced by (i) the possible conservation of the authorities' lax income policy, partly in response to the pressures ahead of the four successive election rounds scheduled for 2008 and 2009, (ii) increased labour market tightness, and (iii) the possible worsening of companies' balance sheets, owing mainly to previous wage hikes in excess of productivity gains, and to the weaker local currency, which might prompt employers to factor into prices the resultant higher ULC.

In the near run, inflation expectations could also be fuelled by the recent persistent depreciation of the RON versus the major currencies and the increase in exchange rate volatility. The future particularities of the developments in this indicator and implicitly their impact on inflation expectations will reflect not only the fluctuating uncertainties and turbulences on world financial markets, but also the response of financial investors to the potential changes in domestic economic fundamentals and in economic policy conduct.

In addition, inflation expectations might worsen as a result of the persistence beyond 2008 of the period during which the projected annual inflation rate stays above the upper limit of the variation band. The risk that inflation expectations prove highly sensitive to such developments is amplified by the short track record of low inflation in Romania and of monetary policy under an inflation targeting strategy.

In this context, avoiding a significant unanchoring of inflation expectations and thus allowing a return of inflation to a downward trajectory compatible with attaining the medium-term targets can only be achieved in a cost-efficient manner through increased consistency of the entire policy mix. Along with tighter monetary policy, this implies a considerable strengthening of fiscal policy and speeding-up of structural reforms – especially those concerning the labour market – which are essential for mitigating the inflationary effects of supply-side factors. By contrast, an attempt to rapidly remove the deviation of inflation from the 2008 target and preclude an overly-high increase in inflation expectations by resorting solely to an abrupt tightening of monetary policy stance would threaten financial stability and involve significant costs in terms of economic growth; in addition, such a move would prove ineffective in the near run considering the lag in the transmission of monetary policy stimuli to inflation.

From this perspective and given the need to pro-actively tighten broad monetary conditions in light of forecasted higher inflation in the next period, the NBR Board has decided in its meeting of 4 February 2008 to raise the monetary policy rate by 1 percentage point to 9 percent per annum and to continue to pursue a firm management of money market liquidity via open-market operations. Moreover, in view of the rapid expansion of all components of non-government credit, the NBR Board has decided to leave unchanged the current minimum reserve requirement ratios on both RON- and foreign currency-denominated liabilities of credit institutions and to adopt additional prudential measures via higher provisioning for foreign currency-denominated loans extended to unhedged borrowers, as well as broadening their scope to non-bank financial institutions.

Against this background, the NBR Board has reaffirmed its resoluteness to decisively direct monetary policy towards a sustainable anchoring of inflation expectations at levels compatible with attaining the announced medium-term inflation targets. At the same time, the NBR Board believes that such a stance should be underpinned by the strengthening of the other macroeconomic policy mix components and the fostering of structural reforms.