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INFLATION REPORT

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N O T E

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

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

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Foreword

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

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

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

Inflation Report *was completed on 2 May 2008 and approved by the NBR Board in its meeting of 6 May 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 According to Purpose
CPI	Consumer Price Index
EAR	Effective Annual Rate
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

Developments in inflation and its determinants

At the end of 2008 Q1, the 12-month inflation rate reached 8.63 percent, about 2 percentage points above the level seen in December 2007. The rise in the rate of inflation was due to the cumulative effects of persistent and larger supply-side shocks, excess demand pressures, domestic currency depreciation and worsening inflation expectations.

On the supply side, inflationary pressures worked through two major channels. The first one was through the dynamics of domestic food prices, both volatile prices and prices of goods included in the CORE2 inflation basket, which continued to be fuelled by the adverse effects of last year's poor agricultural output and by the increase in prices of agri-food items on external markets. In 2008 Q1, the faster rise in administered prices and fuel prices had an additional impact on inflation. The second channel was associated with existing labour market tensions, which brought about a further significant increase in unit labour costs in 2007 Q4, while also adding to the persistence of excess demand.

During the first quarter of 2008, the exchange rate of the domestic currency depreciated on average versus its fourth-quarter level against the background of high daily volatility. The depreciation occurred amid intensifying turbulences on the international financial markets and investors' increased risk aversion, contributing to the pick-up in inflation via the increased cost of imports.

The direct effects of the above-mentioned shocks on consumer prices fostered a further increase in inflation expectations, which may enhance the possibility of a pass-through of second-round effects on CORE2 inflation and extend the duration of the temporary increase in CPI inflation.

The inflationary impact of supply-side factors was boosted by the continued pressures from excess demand that translated into the accelerated rise in CORE2 inflation. The pick-up in economic growth (to as high as 6.6 percent) in 2007 Q4 caused the output gap to widen. Investment remained the key driver of GDP dynamics, rising at a rate of 28 percent year on year. Final consumption grew further at a brisk rate (8.9 percent), whereas net exports had a smaller negative contribution to GDP growth against the backdrop of a faster pace of rise in exports. Domestic demand expansion was underpinned by the substantial increase in public spending at end-2007, the accelerated growth rates of household income coming from wages and other sources, as well as by the continued rapid expansion of credit to the private sector.

Monetary policy since the release of the previous Inflation Report

The NBR Board decision to raise the monetary policy rate by 1 percentage point to 9 percent per annum adopted in its meeting of 4 February 2008 built on the updated inflation forecast and on the assessment of risks to that projection (described in the February 2008 Inflation Report). The new projection envisaged the inflation rate standing significantly above the levels presented in the previous forecast during the entire forecasting round. The major risks identified were the likelihood of an increase in wages insufficiently matched by productivity gains, the potential of an additional easing of income and fiscal policies in the run-ups to local and general elections, as well as a continued deterioration of inflation expectations.

The period following the February monetary policy decision reconfirmed the worsening of the short- and medium-term inflation outlook. The monitoring of risks identified in association with the February projection indicated their persistence and even the likelihood of a heightened risk of an additional deterioration of inflation expectations.

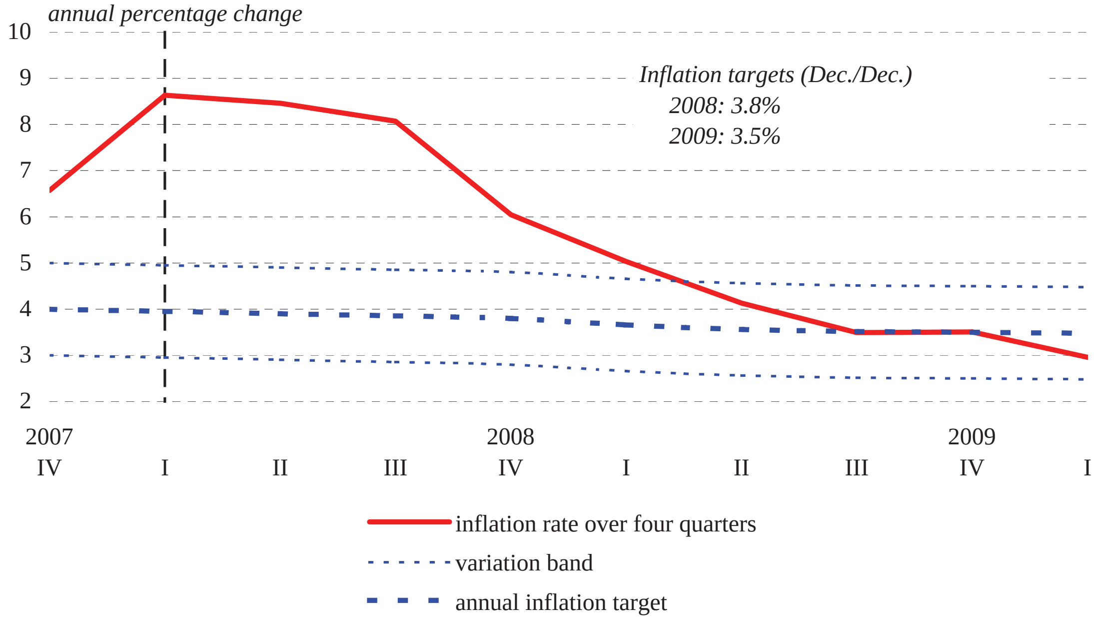
After examining these developments, the NBR Board decided in its meeting of 26 March 2008 to raise the monetary policy rate by another half of a percentage point to 9.5 percent. The decision was aimed at further tightening real monetary conditions in order to prevent an additional increase in excess demand and to counteract the potential second-round effects exerted by inflation expectations on CORE2 inflation by ensuring an effective anchoring of inflation expectations.

All through the first quarter of 2008, the impact of monetary policy rate adjustments was enhanced by the central bank's firm management of money market liquidity. Moreover, the continued rapid growth of credit to the private sector, especially that of borrowing in foreign currency, underpinned the NBR Board decision not to lower the minimum reserve requirement ratios. In addition, the National Bank of Romania took additional prudential measures, namely higher provisioning for foreign exchange-denominated loans granted to unhedged borrowers and broadening the scope of these measures to encompass non-bank financial institutions.

Inflation outlook

The baseline scenario of the current projection places the 12-month inflation rate at 6 percent for end-2008, 0.1 percentage points above the figure published in the February 2008 Inflation Report. For end-2009, inflation is forecasted to stand 0.4 percentage points below the previously projected level (3.5 percent versus 3.9 percent).

Inflation Forecast



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

For the end of this year, the slight upward revision of the prior projection reflects broadly the 0.3 percentage point overshooting of the annual inflation rate forecasted previously for 2008 Q1. The overshooting was primarily due to the aggregate demand pressures stemming from the faster-than-expected economic growth in 2007 Q4 and to the unfavourable impact of exchange rate movements on import prices throughout 2008 Q1.

In the near run, i.e. in the course of 2008, the efficacy of to-date monetary policy tightening will materialise especially in containing the impact of exogenous shocks on inflation expectations. This will help confirm the temporary nature of the current higher-inflation episode.

The effects of the recent successive monetary policy rate increases on real monetary conditions will become manifest especially during 2009. They are expected to materialise via the gradual reduction of inflationary pressures triggered by aggregate demand and the bringing of the output gap into negative territory starting with 2009 Q2. In addition, the negative effects of adverse exogenous shocks in 2007 H2 and early 2008 which fuelled the inflation expectations of economic agents are anticipated to fade in 2008 Q3. These corrections, along with keeping in place a pronounced restrictiveness of monetary policy throughout the projection horizon, will weigh heavily on inflation expectations, accounting for their faster projected decline in 2009 than in the forecast presented in the February 2008 Inflation Report.

Within the current projection horizon, the significant risks which, should they materialise, could cause inflation to deviate from its projected path, include: wage rises in excess of productivity gains, a possible depreciation of the domestic currency following the persistence of international market turmoil, the possible increase in the expansionary stance of fiscal policy compared to the projection, a larger-than-projected increase in administered prices and fuel prices. The implementation of a coherent mix of firm macroeconomic policy measures could significantly reduce the inflationary effects of some of these risks materialising. The inflation rate could be lower than projected in the baseline scenario in the event of bumper crops in the summer of 2008.

Monetary policy decision

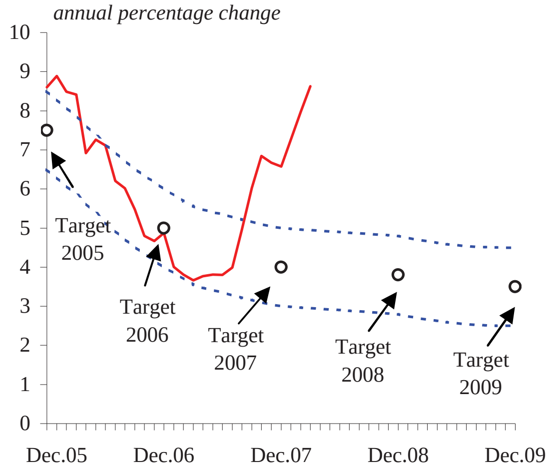
Given the unfavourable inflation outlook over the first part of this forecasting horizon, as well as the persistence and prevalence of upside risks to inflation, the NBR Board has decided to raise the monetary policy rate by 0.25 percentage points to 9.75 percent per annum and to continue to pursue a firm management of money market liquidity via open-market operations. Moreover, with a view to consolidating the restrictiveness of broad monetary conditions, the NBR Board has decided to leave unchanged the minimum reserve requirement ratio on RON-denominated liabilities at 20 percent and the minimum reserve requirement ratio on foreign exchange-denominated liabilities of credit institutions at 40 percent. In the current macroeconomic context, the NBR Board is restating that the implementation of a coherent mix of macroeconomic policies and stepped-up structural reforms are essential to bring the annual inflation rate during 2009 towards the trajectory compatible with attaining the announced medium-term target.

At the same time, in order for the central bank to strengthen the efficiency of money market liquidity management and implicitly to increase the impact of monetary policy tools on short-term interest rates on this market, the NBR Board has decided to reduce the maturity for standard deposit taking open-market operations to one week from two weeks. Furthermore, in order to consolidate the signalling role of the monetary policy rate and reduce the volatility of interbank money market rates, a symmetrical corridor of ±4 percentage points around the monetary policy rate for the interest rates on the NBR standing facilities was set up. Therefore, the interest rate on the NBR deposit facility was raised to an annual 5.75 percent from 2 percent while the rate on its lending facility (Lombard) was set at an annual 13.75 percent versus 12 percent previously. In addition, the penalty rate for deficits of RON-denominated minimum reserves was raised to an annual 20.5 percent from 18 percent. These adjustments to the monetary policy operational framework of the National Bank of Romania are part of a gradual process of alignment to that of the European Central Bank.

II. INFLATION DEVELOPMENTS

In 2008 Q1, the 12-month inflation rate continued to deviate from the ±1 percentage point variation band around the 2008 target of 3.8 percent. At end-March, the annual inflation rate reached 8.63 percent owing to the joint impact of: stronger pressures from supply-side domestic and foreign shocks, the depreciation of the domestic currency, the persistence of excess demand (fuelled by the hike in household incomes) and the existence of a pronounced unfavourable base effect. Some of these factors contributed to the deterioration of inflation expectations, facilitating the pass-through of the above-mentioned shocks into consumer prices. The same as headline inflation, core inflation continued its upward trend, adding 1.2 percentage points versus December 2007 to 7 percent.

Inflation Developments



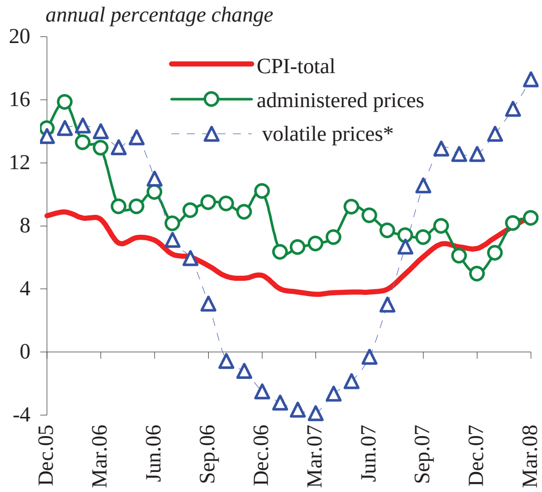
Note: ±1 percentage point around the (dis)inflation path

Source: NIS, NBR calculations

Both volatile and administered prices and prices of goods and services included in CORE2 inflation contributed to the acceleration in the annual inflation rate during 2008 Q1 (+2.06 percentage points versus end-2007).

For the second quarter in a row, the annual dynamics of volatile prices (+17.3 percent, up 4.7 percentage points versus December 2007) was boosted by the new historical highs recorded by the crude oil price on the international markets which brought about successive hikes in the domestic fuel price (an average monthly change of 1.4 percent). Furthermore, the annual growth rate of volatile food prices remained particularly high, mainly as a result of the persistence of the unfavourable base effect which had a negative bearing on their developments in the second half of 2007; on the fruit segment, adding to this was the weakening of the RON against the EUR, given that during the cold season supply comes primarily from imports.

Inflation Rate



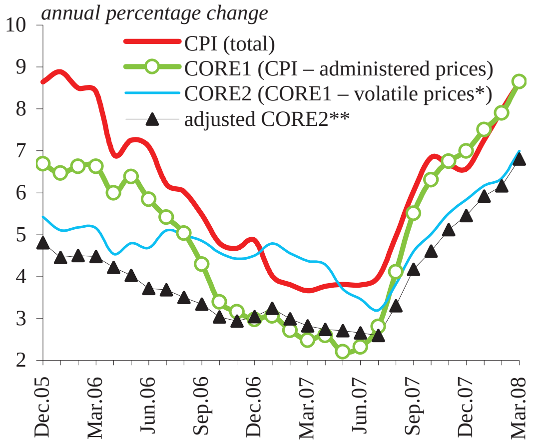
*) products with volatile prices: vegetables, fruit, eggs, fuels

Source: NIS, NBR calculations

The annual dynamics of administered prices resumed its growth, reaching 8.5 percent in March 2008 from 5 percent in December 2007. As concerns utilities, the price of natural gas posted a marked rise (8.42 percent in February versus the previous month), whereas the electricity price remained unchanged. The prices of heating, water, sewerage and waste collection posted increases similar in size to those in 2007 Q1. Significant advances were also recorded by the prices of fixed telephony services, geared to the RON/EUR exchange rate, and the city transport prices.

During the period under review, CORE2 inflation followed the upward trend manifest ever since August 2007, further owing

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

	2007				2008
	I	II	III	IV	I
Inflation Rate	**3.7**	**3.8**	**6.0**	**6.6**	**8.6**
Administered prices*	**6.9**	**8.7**	**7.3**	**5.0**	**8.5**
1. Non-food items*:	**5.4**	**6.5**	**5.7**	**0.5**	**4.2**
electricity	4.6	9.0	9.0	4.2	4.2
heating	20.8	20.8	20.8	5.8	5.9
natural gas	10.0	6.3	4.7	0.0	12.4
medicines	-4.8	-4.2	-5.7	-6.7	-4.2
2. Services*, of which:	**9.5**	**12.5**	**10.2**	**13.2**	**16.7**
water, sewerage, waste disposal	20.5	14.6	14.1	12.0	12.0
fixed telephony	5.6	0.0	-5.1	3.4	10.4
passenger railway transport	23.7	29.8	37.2	27.4	16.5
(passenger) city transport	3.5	5.2	6.8	7.5	11.1
Market prices (CORE1)	**2.5**	**2.3**	**5.5**	**7.0**	**8.6**
CORE2**	**4.4**	**3.5**	**4.6**	**5.8**	**7.0**
CORE2 less tobacco, alcohol	2.8	2.7	4.2	5.5	6.8
tobacco, alcohol	22.9	12.7	9.3	10.0	9.0

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

Source: NIS, NBR calculations

mainly to food prices, whose annual dynamics accelerated by 1.6 percentage points. Nevertheless, in quarter-on-quarter comparison, pressure sources witnessed some changes; thus, the positive effect coming from the slower growth rate of milling and bakery product prices was offset by the delayed pass-through of regional tensions into the prices of dairy produce and milk products. Likewise, the shock exerted by the decrease to almost one third in the sunflower production in 2007, albeit of a lower amplitude, continued to bear on the edible oil market, as the increase in the dependence on imports occurred simultaneously with the hike in external prices and the depreciation of the domestic currency.

The movements in the exchange rate had a significant effect on market-determined prices as well, particularly via the impact on mobile telephony prices. As concerns non-food items included in CORE2, this influence was visible only in the case of those components coming preponderantly from imports or whose prices are denominated directly in euro (household appliances, home electronics, motorcars); for the whole group of items, the 12-month inflation rate remained broadly steady (4.9 percent in March 2008).

Behind the pick-up in CORE2 inflation stood also the persistence of excess demand, fuelled by the further expansion in the annual dynamics of wages in excess of productivity gains. In the first two months of 2008, wages grew at a rate similar to that in the previous year[1], in spite of labour market signalling a slowing demand for labour force and authorities making statements on containing wage hikes in the public sector.

A negative impact on consumer prices had also short-term inflation expectations of bank managers and managers in industry and trade, all available information sources pointing to their additional deterioration, albeit at a slower pace than in 2007 Q4[2].

In spite of the international competition exerting further a downward pressure on the dynamics of non-food prices, across tradables the tensions on the international agri-food and oil markets remained the key driver of inflation. Thus, the annual

[1] Excluding the budgetary sector wage developments related to January 2008 which were affected by the existence of a base effect (see subsection 2.2. Incomes).

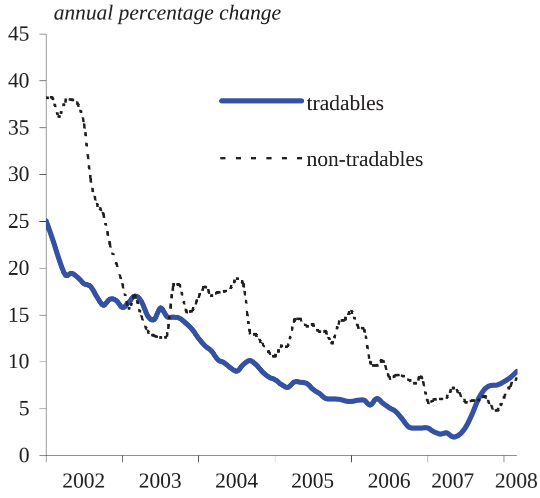
[2] According to (i) the NBR survey among banks which indicates for the period under review a larger deviation of the annual inflation rate from the end-2008 target and (ii) the NIS/DGECFIN survey among managers in industry, trade and services which shows a further rise in the balances of answers related to future price developments (deseasonalised series).

growth rate of tradables prices continued to follow an upward trend, reaching 9.0 percent in March 2008 (+1.4 percentage points versus December 2007). Across non-tradables the inflation rate came in at 8.2 percent, hinting at a 3.3 percentage point step-up following the reversal in the downward trend of administered price dynamics.

The increasing inflationary pressures were illustrated by the widening of the gap between the average annual HICP inflation rate and the average inflation rate for EU-27 to 3.2 percentage points in March 2008 from 2.5 percentage points at end-2007. Likewise, the difference between the average 12-month HICP inflation rate and the average inflation rate in the three best-performing Member States of the European Union[3] increased by 0.6 percentage points against December 2007 to 4.2 percentage points.

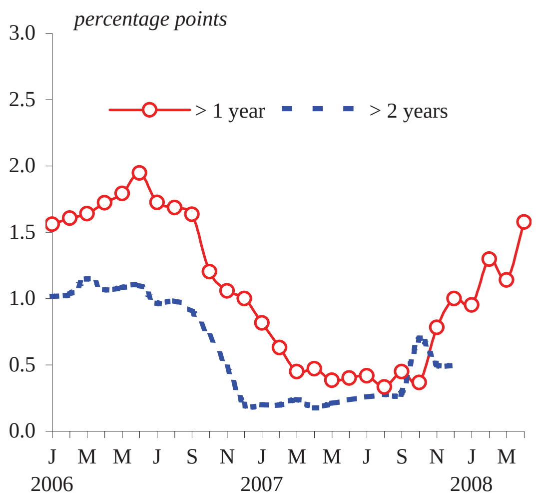
In March 2008, the actual annual inflation rate was 0.3 percentage points above the projection in the February 2008 Inflation Report, owing to (i) significantly higher-than-projected increases in fuel prices; (ii) a larger-than-anticipated depreciation of the domestic currency against the euro resulting in the rise above expectations in market-determined prices and administered prices geared to the exchange rate.

Tradables and Non-tradables Prices



Source: EUROSTAT, NBR calculations

Spread between Expected Inflation and Annual Inflation Target



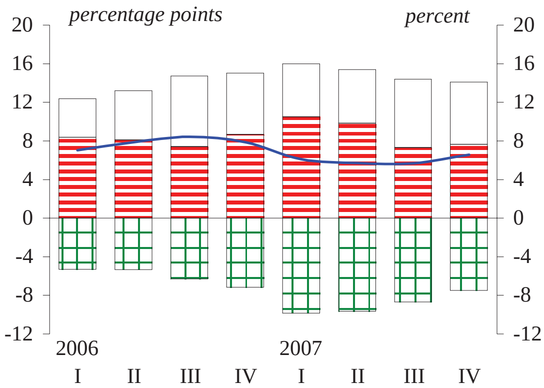
3 Calculated as an annual average for the past 12 months.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

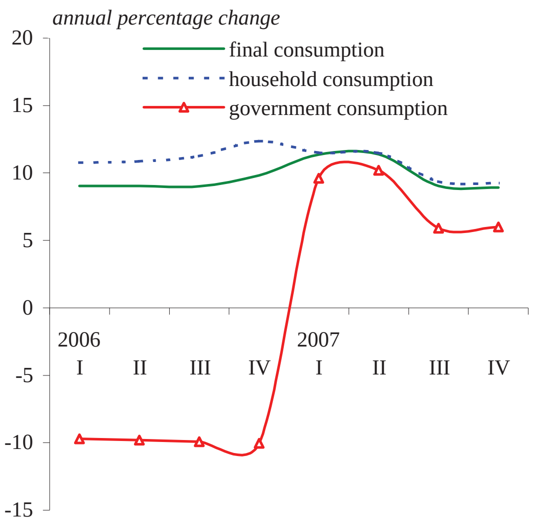
In 2007 Q4, the annual growth rate of real GDP came in at 6.6 percent[4], exceeding by 0.9 percentage points the advance in the previous quarter and by 0.7 percentage points the December benchmark projection. The same as in the previous quarter, the main contributor to GDP growth was domestic absorption, particularly investment, whereas net exports continued to have a negative contribution thereto. On the supply-side, GDP dynamics was underpinned by most economic sectors, except for agriculture, which, in Q4, was further affected by adverse weather conditions.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

Actual Final Consumption



Source: NIS

1.1. Demand

In 2007 Q4, domestic demand expanded by 12.4 percent. The same as in the previous quarter, fixed capital investment, whose annual pace of growth was approximately three times faster than that of final consumption, had the largest contribution to GDP dynamics, i.e. 7.9 percentage points. In spite of the marked acceleration in the growth rate of exports of goods and services, in 2007 Q4, the negative contribution of net external demand to GDP growth continued to be wider (-7.5 percentage points against the previous year versus an average of -6.2 percentage points in 2006).

1.1.1. Consumer demand

In Q4, final consumption expanded by 8.9 percent in year-on-year comparison, with both its private and government components posting growth rates similar to those in the previous quarter.

Household consumer demand

The still rapid growth of household final consumption (9.2 percent) was due mainly to household spending (10.3 percent), while the pick-up in the expenditures on individual consumption incurred by the public and private governments did not exceed 4 percent. The poor agricultural output caused the drop in “self-consumption and expenditures on purchases on the agri-food market” (-11.3 percent) and the spending related to “home

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

industry"[5]. The growth rate of purchases of goods and services continued to be alert (15.4 percent), slowing down, however, by 6 percentage points against the previous period. The deceleration was due to a large extent to "foodstuffs, beverages and tobacco products", as the annual dynamics of retail sales slowed 1.6 times. Nevertheless, this group of goods posted further a particular rapid growth rate of almost 32 percent, which alongside the significant share in the household consumer basket (more than 40 percent) points to a high inflationary potential exerted by consumer demand in Q4 as well.

The pick-up in private consumption was financed mainly from disposable incomes which rose by 12.8 percent in real terms[6], with the increase by almost 22 percent in domestic funds being the main contributor to this performance. Household consumption was financed to a notable extent from bank loans (whose short- and medium-term balance posted a real 4.9 percent advance) and, probably, from incomes from statistically-unrecorded activities. Supply-side factors acted in the same direction, particularly the strong territorial expansion of modern trade outlets.

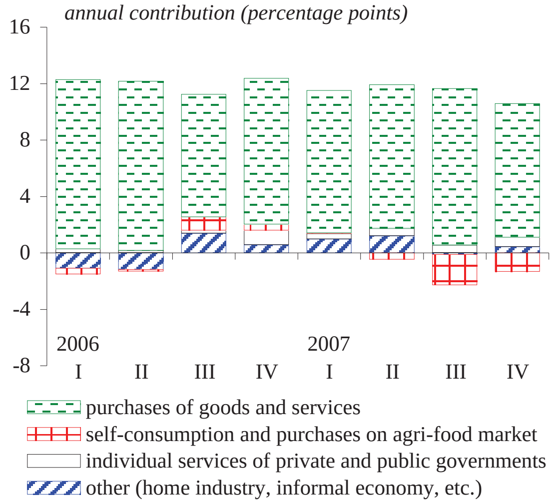
Statistical data available for the analysis of household consumption by market of origin are not indicative of an upturn in the position held by domestic supply compared to imports – both segments witnessed slower annual growth rates versus the previous quarter, the dynamics of imports[7] remaining however by far faster than that of domestic supply[8].

Government consumption

Government final consumption recorded an annual dynamics similar to that in the previous quarter (6 percent) owing to the steady growth rate of job creation in the government sector.

Household Final Consumption by Expenditure

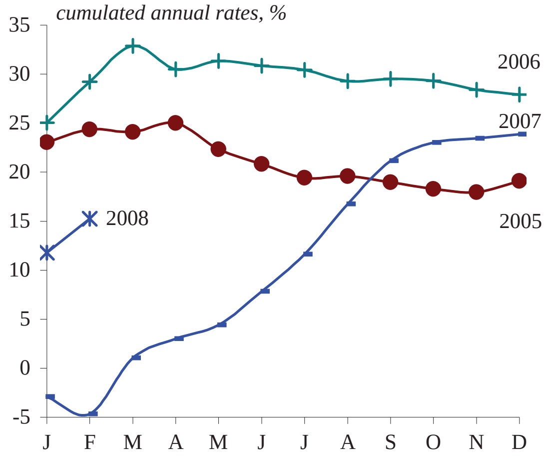
annual contribution (percentage points)



Source: NIS, NBR calculations

Retail Trade* of Foodstuffs, Beverages and Tobacco

cumulated annual rates, %



*) turnover volume
Source: NIS. NBR calculations

[5] Home industry is defined by the NIS as the 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.

[6] Household disposable income is calculated as the approximate sum of incomes from wages, social transfers (state social security, unemployment benefit and health insurance) and remittances from abroad, and current private transfers by non-residents.

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

[8] The volume of sales of domestic industrial companies on the domestic market recorded a 2-3 times slower annual dynamics, both in the case of non-durables and durables (except for motor vehicles), the annual growth rates of which slowed down to +1.6 percent and +4 percent respectively. On the contrary, the volume of imports went up by almost 6 percent in the case of non-durables and by 25.1 percent to 45.7 percent in the case of the main groups of durables identified on the basis of the Combined Nomenclature.

Budgetary developments

In 2007, the consolidated general budget posted a deficit of about RON 9,448 million, its share in GDP meeting the target established by the latest budget revision in November (2.4 percent)[9]. In Q4, the consolidated general budget showed a negative balance of approximately 2.5 percent of GDP (following a 0.4 percent surplus in Q3), distributed almost evenly in the last two months of the year. The deficit was recorded against the background of a steep fall in the annual dynamics of both revenues and expenditures in Q4 compared with the previous quarter (including as a result of some base effects).

The annual growth rate[10] of budget revenues dropped to 8.1 percent from 18.8 percent in Q3, due to an almost across-the-board contraction in the dynamics of key components. Thus, non-tax revenues, as well as property tax, posted for the first time in the last four quarters a negative dynamics, while the pace of increase of receipts from wage and income taxes, as well as from social security contributions, slowed down[11], hitting a record-low for 2007 (35 percent and 11 percent respectively).

The annual growth of budget expenditures decelerated from 23 percent in Q3 to 1.6 percent, the lowest level over the last 7 quarters, on the back of the deceleration in the pace of increase of most expenditure categories (capital, staff, goods and services, as well as other transfers). The only exception were transfers for social security, whose annual growth rate was more than double the level recorded in the prior quarter (28 percent), as a result of higher pensions in November.

The budget execution figures for the first two months of 2008 show a surplus of the consolidated general budget of about 0.2 percent of projected GDP (0.1 percentage points higher than in February 2007). The annual dynamics of government consumption might remain relatively moderate in the months ahead, given that the budget deficit target was lowered from 2.7 percent to 2.3 percent of GDP, following the budget revision in the first ten-day period of March. Moreover, the reduction of the projected budget deficit

[9] The official figure in the Government's press release made after the third budget revision. Calculated based on the actual share in GDP for 2007 published by the National Institute of Statistics, this share is 2.3 percent.

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

[11] In the case of the latter two categories of receipts, a base effect generated by the payment in advance in December 2006 of the wages due for January 2007 was manifest.

was based mainly on the cut in material expenditures, while capital expenditures remained virtually unchanged.

1.1.2. Investment demand

Although slower than in the previous period, the growth rate of gross fixed capital formation continued to be particularly alert (28 percent).

The expansion of this demand segment was attributed especially to construction works (new construction works and capital repairs) and also to equipment purchases (including transport means), as the growth rates of both components were faster than 30 percent.

In terms of financing sources, the pick-up in capital investment was bolstered mainly by the own sources of the corporate sector and households, whereas the contribution of investment from the public budget declined by 27.5 percent in real terms. Positive contributions had also domestic borrowings, either from commercial banks (the balances on loans for equipment purchase and on real estate loans advanced by 28 percent and 78.3 percent respectively[12]) or from leasing companies.

Investment was also fostered via foreign financial inflows – EUR-denominated medium- and long-term loans to the real sector posted a fast growth rate in Q4 as well (65.5 percent), while net placements of non-residents in the form of direct investment in the non-bank sector were 15.6 percent higher at end-2007 than at end-2006.

By market of origin, the data on the turnover volume relative to the production of capital goods destined to the domestic market show a slow acceleration in the annual dynamics in Q4 versus the previous period to 12.4 percent. This performance, alongside the deceleration in the growth rate of the import volume[7], are not indicative however of significant changes in the preference for purchases of domestic/imported investment goods, in Q4 the growth rate spread between the two markets[13] being further significantly negative.

Investment

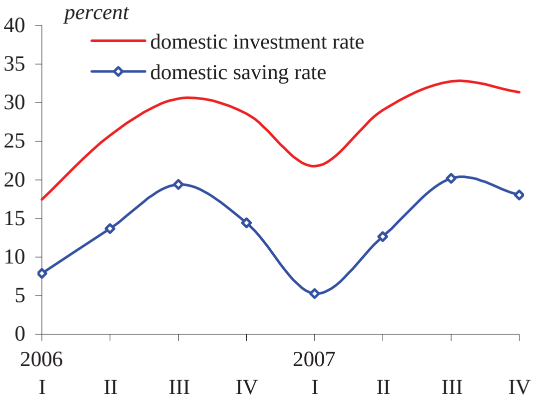
annual percentage change

	Year	I	II	III	IV
Total	2006	10.8	15.1	15.8	18.4
	2007	22.8	28.3	31.9	29.5
- new construction works	2006	23.5	11.6	20.2	18.7
	2007	27.9	32.8	38.9	26.4
- equipment	2006	2.6	20.8	6.2	12.4
	2007	19.0	22.7	25.3	32.1
- other*	2006	4.8	–9.6	54.7	55.8
	2007	20.3	48.5	24.3	29.8

* 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



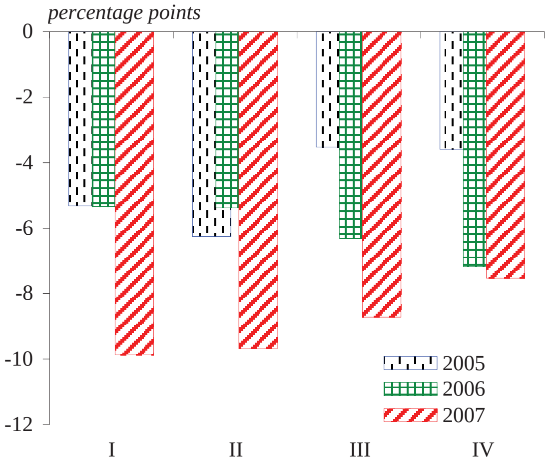
Note: Domestic investment rate is the ratio of gross capital formation to GDP; domestic saving rate is the difference between GDP and final consumption as a share of GDP.

Source: NIS, NBR calculations

[12] Changes in real terms, calculated based on the data provided by the Central Credit Register.

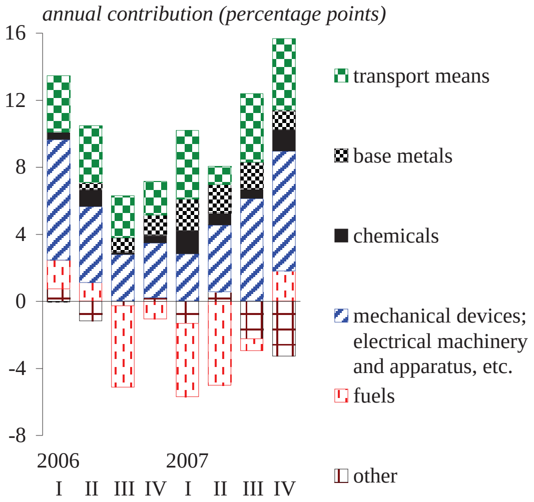
[13] The growth rates recorded by the volume of imports in the case of the main categories of capital goods identified on the basis of the Combined Nomenclature ran at 23 percent (mechanical and electrical machinery and apparatus) and 37.8 percent (transport means).

Net External Demand Contribution to GDP Growth



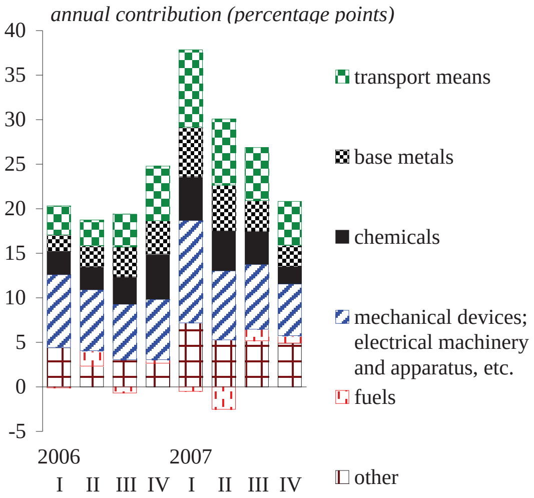
Source: NIS, NBR calculations

Export Physical Volume



Source: NIS, NBR calculations

Import Physical Volume



Source: NIS, NBR calculations

1.1.3. Net external demand

Net external demand continued to significantly erode GDP dynamics, its negative contribution declining, however, compared to the previous quarter (to -7.5 percentage points). The development was attributable to the 10 percentage point advance in the annual dynamics of exports of goods and services, which remained however well below that of imports (14.9 percent versus 28.6 percent).

It is noteworthy the rise in the physical volume of exports[7], which accelerated to 12.4 percent compared to 9.4 percent in the prior period. Exports of "transport means and materials" and "mechanical and electrical machinery and apparatus" made the largest contributions to this development. The upward trend in exports was boosted by the significant slowdown in the average nominal appreciation of domestic currency (from 9.5 percent to 0.7 percent, on an annual basis). However, the further contraction in exports of light industry exports, affected by competitiveness losses due to sharp rise in labour unit cost[14], had a dampening effect.

The annual growth rate of imports of goods and services remained vigorous, adding another 3.9 percentage points from the prior quarter. A favourable influence was exerted by the strong consumer and investment demand as well as by numerous administrative and methodological changes pertaining to Romania's joining the EU[15].

1.2. Supply

In 2007 Q4, most economic sectors provided support to GDP growth with the exception of the agricultural sector as the 2007 adverse weather conditions caused its gross value added to diminish by 16.5 percent.

The fastest pace of increase (32.4 percent) was seen once again in the construction sector whose contribution (3.4 percentage points) to the GDP dynamics was almost similar to that of the services sector.

In industry, the annual growth rate of gross value added decelerated compared to the prior quarter, from 5.1 percent to 3.5 percent,

[14] The nominal ULC index posted increases in both wearing apparel and leatherwear and footwear (to 148.9 percent and 116.7 percent respectively).

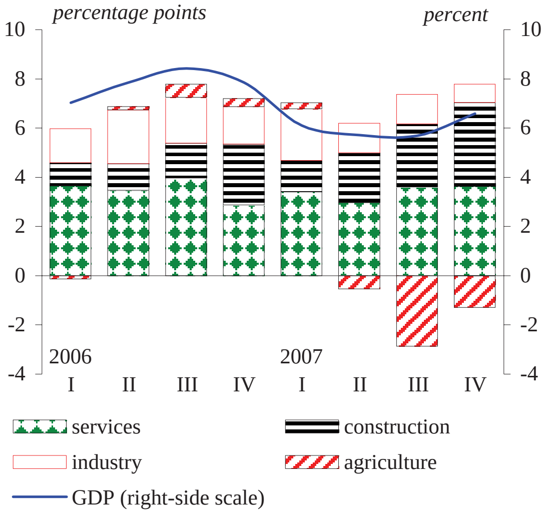
[15] The simplification of customs formalities (including the removal of customs tariffs for intra-community trade) and the statistical effect associated with the change in the registration of imports from the EU at border crossing, not when putting them in free circulation (procedure prior to the EU accession).

due mainly to the performance in the mining sector following the technical revision works in thermal power stations.

The manufacturing sector production increased by 5.6 percent, performance similar to that in the prior period; the largest changes in the annual growth rate were recorded, on the one hand, in land transport means and oil processing (in both cases, the annual dynamics of production witnessed a threefold increase, the favourable world environment playing a key role), while, on the other hand, the food and drink sector (sevenfold decline in production dynamics, turnover data showing a stalemate in sales on the domestic market and the drop by around 12 percent in exports, amid poor agricultural performance coupled with persistent competitiveness losses[16] on foreign markets).

Gross value added of services exceeded yet again 7 percent on an annual basis[17], "trade, motor car repairs, hotels and restaurants, transports and telecommunications" posting the fastest growth rate (12.2 percent) in Q4 as well. The other two components of the services sector, i.e. "financial activities, real estate, rentals and services rendered to companies" and "other services", saw annual growth rates of 3-4 percent, below the prior quarter figures.

Contribution of Main Supply Components to GDP Growth



Source: NIS, NBR calculations

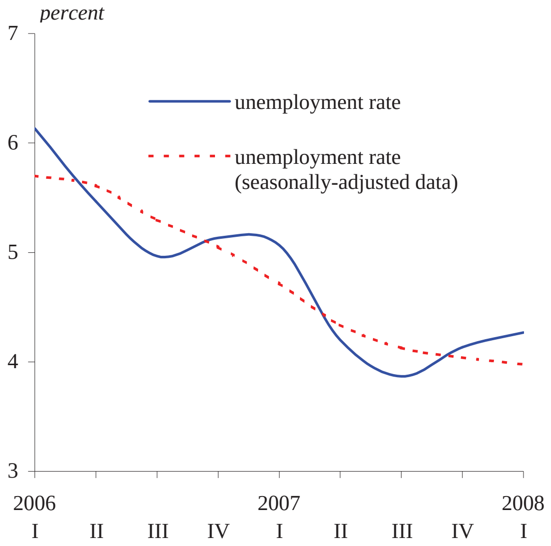
[16] The nominal ULC index stepped up to 125.6 percent from 113.1 percent.

[17] Starting with Monthly Bulletin No.1/2008, the NIS no longer releases national account data for the entire services sector as a whole, but separately, by the segment, as follows: (i) trade, motor car repairs, and household appliances, hotels and restaurants, transports and telecommunications; (ii) financial activities, real estate, rentals and services rendered to companies; (iii) other services (public administration and defence, education, health and social assistance, other services to population). Therefore, with a view to capturing economic developments, a weighted arithmetic mean of volume indices relative to the said components was calculated.

2. Labour market

Despite some indications of moderate workforce demand, the pressures from a persistent workforce deficit in some sectors (and, at aggregate level, from the low number of unemployed) remained high, pointing to the fact that private employers enjoy, in 2008, only a narrow adjustment margin relative to the growth rate of wages to match this rate with labour productivity dynamics. Across industry, this is illustrated by the statistical data at the outset of the year, which also show some progress in the consumer goods industries. In the public sector, wage hikes are still uncertain to have met the limits announced by the authorities, given the (pre)electoral rounds during 2008-2009.

Unemployment Rate



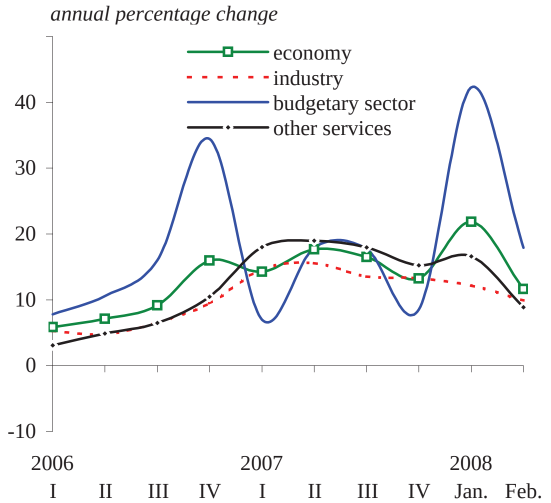
Source: NEA, NBR calculations

2.1. Labour force

The latest data released by the NEA confirmed that workforce demand exerted lower pressures. In January and February 2008, for the first time after 2006 Q1, the number of vacancies decreased and that of newly hired dropped even further (year-on-year comparisons). Nevertheless, the number of jobless following lay-offs was around 31 percent lower year on year, pointing to some stabilization rather than a decline in workforce demand.

Registered unemployment rate[18] remained relatively unchanged (about 4 percent) starting with 2007 Q3. The coexistence of a relatively low unemployment rate and shortages of staff with a certain level of education and expertise continued to raise difficulties for potential employers. The shortage of workers is still persistent in construction, textiles, hotel industry, whereas that of specialists still affects sectors such as engineering – IT, motor mechanics, construction – as well as healthcare and the finance and banking sectors.

Net Real Wage*



*) deflated by CPI
Source: NIS, NBR calculations

2.2. Incomes

Wage earnings further had a strong inflationary potential in 2007 Q4 and at the beginning of 2008. Both bonuses and financial inducements granted to employees in the private and public sectors and the rise to RON 500 in the minimum gross wage starting January 2008[19] contributed to this development. The dynamics of wages in January should be viewed considering the base effect induced by the granting of the “13-month” salary to public sector employees in December 2006 (instead of January of the following year as before), entailing the moderation of the annual dynamics of nominal wages in 2007 Q4, followed by

[18] Seasonally-adjusted data.

[19] Compared to the RON 390 guaranteed wage and the RON 440 wage established based on the 2007 collective labour contract nationwide.

its strong acceleration in January 2008. As the NBR does not have all the necessary statistical data to rule out this distortion, it can only be estimated that, (mainly) in the private sector, gross nominal wages kept rising at a particularly fast pace (above 20 percent on an annual basis), while wage hikes in the public sector could exceed the percentages announced by the authorities[20], as a result of financial inducements and pay rises.

Across industry, nominal ULC continued to put pressures on producer prices, posting annual growth rates in excess of 10 percent in the period under review. Both the contribution of gross wages and that of labour productivity to ULC formation industry-wide remained broadly unchanged. However, in the first two months of 2008, non-durable goods sectors witnessed substantial declines in the annual growth rate of the ULC index, in contrast to intermediate goods sectors[21], where the annual indices moved up in a range from 4.3 percentage points to 22.7 percentage points compared to 2007 Q4, as a result of the slowdown in labour productivity dynamics.

On the demand side, data confirmed the slower growth rate of real disposable income in 2007 Q3 (7.8 percent year on year), followed by an upturn in 2007 Q4 (12.8 percent), without reaching, however, the levels in the first two quarters of the year.

Labour Productivity and Real Gross Wage in Industry

annual percentage change

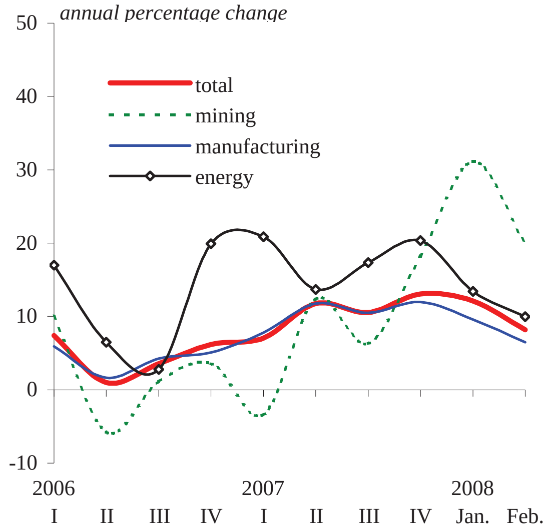
	2007				2008	
	I	**II**	**III**	**IV**	**Jan.**	**Feb.**
Labour productivity	12.8	8.9	9.4	8.6	8.8	11.1
Real gross average wage*	9.4	12.4	13.2	12.3	9.0	5.8
Real gross average wage**	14.3	16.5	17.1	12.4	3.7	1.6

*) deflated by industrial producer price index for domestic market

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

Source: NIS, NBR calculations

Unit Labour Costs in Industry



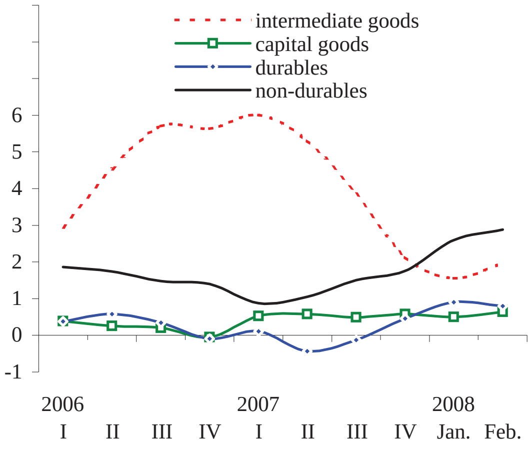
Source: NIS, NBR calculations

[20] For 2008, pay rises established in compliance with the law range between 10 percent and 12 percent.

[21] These sectors made large contributions to the industrial production value.

EU-25 Industrial Producer Prices for Exports

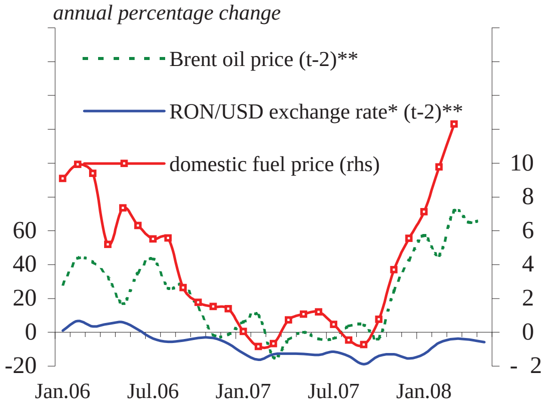
annual percentage change



Source: EUROSTAT

Oil and Fuel Prices

annual percentage change

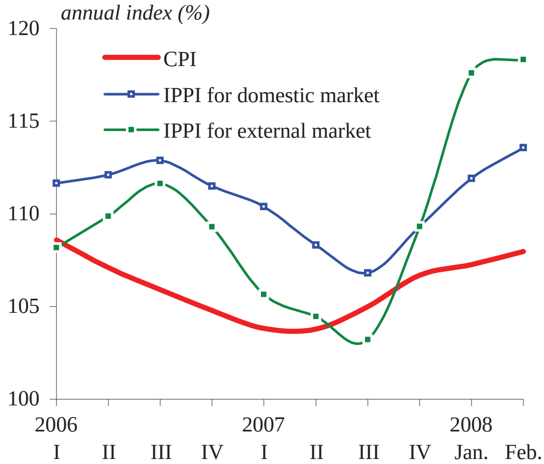


*) (-) RON appreciation, (+) RON depreciation
**) time lag attributed to the 45-day manufacturing cycle

Source: NIS, EIA

Consumer Prices and Industrial Producer Prices

annual index (%)



Source: NIS

3. Import prices and producer prices

In 2007 Q4, the inflationary pressures were ever stronger, as illustrated by developments in prices for both imported goods and domestic (industrial and agricultural) products. International market developments, which dragged on into 2008 Q1 as well, had the largest influence, their impact on domestic prices being enhanced by the RON depreciation.

3.1. Import prices

In 2007 Q4, imported inflation put higher pressure on domestic prices, given that the annual unit value index of imports rose to 99.34 percent from 98.00 percent in Q3 and the domestic currency strengthened against the euro and the US dollar at a slower pace (0.7 percent and 13.2 percent respectively).

The main categories of products contributing to this development were fuels and foodstuffs, particularly fats; in the latter case, the annual growth rate of external prices accelerated to 37.8 percent. Unlike the previous quarter, pressures induced by unprocessed food prices (for instance, vegetal products) alleviated considerably, yet the external market developments in early 2008 indicate this trend is temporary. Import prices of capital goods stayed on a downward path as compared with the same year-ago period.

Imported inflation had an impact on domestic prices in 2008 Q1 as well, considering the hikes in prices for Brent oil and agricultural commodities and the increasingly pronounced depreciation trend of the domestic currency.

3.2. Producer prices

3.2.1. Industrial producer prices

In 2007 Q4, the annual growth rate of industrial producer prices for the domestic market accelerated by 2.5 percentage points as against Q3, to 9.3 percent. This fast dynamics was mainly ascribable to costlier oil and agricultural commodities and the slower pace of the domestic currency appreciation.

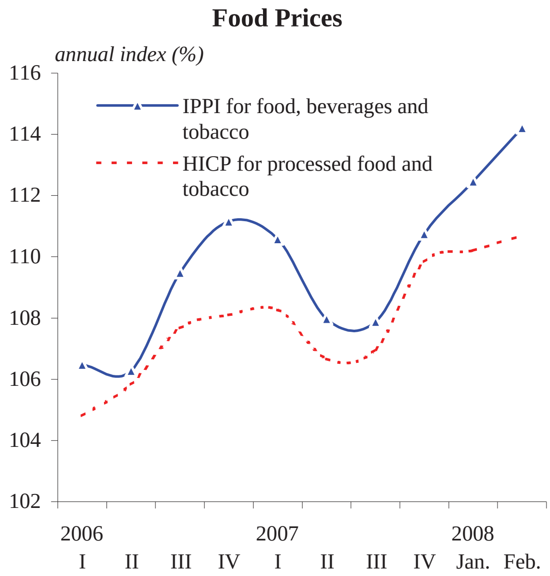
Prices for all groups of industrial goods headed upwards, yet price hikes were more visible in the case of goods holding a significant share in the CPI basket. Energy products, particularly those affected directly by oil price[22] changes, saw the highest price increases (4.2 percentage points and 8 percentage points respectively). This development is attributable to both the alignment of domestic hydrocarbon prices to those on external markets and to the costlier imports of refining oil.

[22] "Hydrocarbon extraction and processing" and "oil processing, coal coking and treatment of nuclear fuels"; source: EUROSTAT.

In 2007 Q4, industrial producer prices for consumer goods accelerated their annual pace to 9.1 percent, the largest rise (11.2 percent) being reported by the food industry. Data available for January-February 2008 indicate the persistence of relatively strong pressures (average monthly rate of 1.8 percent, slightly higher than that recorded in 2007 Q4).

Producer prices for capital goods followed a similar trend, their growth rate adding 2.7 percentage points to 10.4 percent. The major reason for this development appears to be exchange rate movements, considering that two sub-sectors, namely road transport means and metallic construction, rely on imported commodities.

In 2008 Q1, the growth rate of industrial producer prices for the domestic market seems to stay on an upward path; the changes occurred indicate only higher pressures from raw material costs.

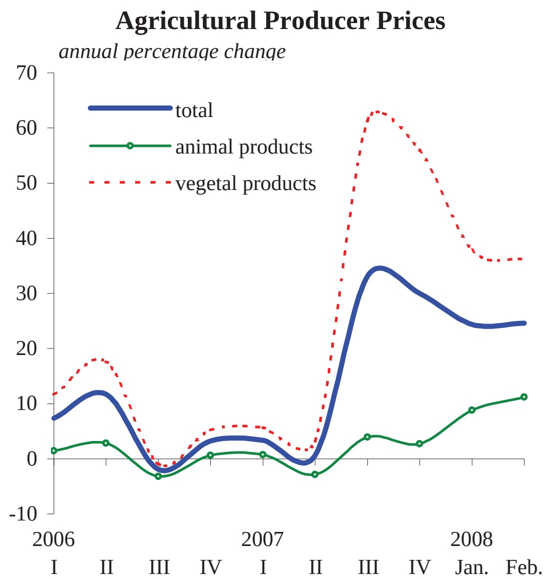


Source: EUROSTAT

3.2.2. Agricultural producer prices

Agricultural producer prices grew considerably in 2007 Q4 as well, even though at relatively slower paces (30.2 percent as against the same year-ago period).

As concerns the vegetal products, the magnitude of annual price changes was lower (55.8 percent), yet a major impact was exerted by prices for fruit and vegetables. The annual growth rate of prices for oilseeds accelerated by almost three times (to 100 percent), while that of grains remained particularly high (ranging from 94 percent to 116 percent).



Source: NIS

Pressures started to rise also in the case of animal products, as the quarterly changes of producer prices were nearly six times higher than in the prior quarter (13.2 percent), due largely to the hike in prices of milk for consumption and of some meat types; prices for pork and beef did not undergo changes, their annual and quarterly growth rates remaining in the negative territory or slightly decelerating). The swifter annual dynamics of producer prices for fodder (up 6.4 percentage points from the prior quarter to 22.8 percent) fed through differently into prices for animal products, owing possibly to the stiffer competition of imports in certain sub-sectors.

In 2008 Q1, prices for animal products might increase at an even faster pace, given the developments on international markets, while the current trends may persist in the case of prices for vegetal products.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In February and March 2008, the National Bank of Romania raised the monetary policy rate twice, up to 9.5 percent per annum. At the same time, 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 the level seen in 2007 Q4, due mostly to a further increase in the real effective exchange rate of the RON[23] *and the temporary pick-up in the annual inflation rate.*

The significant upward revision of the forecasted path in the annual inflation rate, as well as its temporary overshooting of the upper limit of the variation band around the central target – as a result of the persistence of both supply-side shocks and demand-induced pressures – led the NBR Board to sharpen the uptrend in the monetary policy rate. Hence, the key rate was raised in February and March 2008 by one percentage point and half of a percentage point respectively, to 9.5 percent. The central bank's decisions were also substantiated by the risk of a dangerous wage-inflation spiral taking shape given the persistence or worsening of the wage-productivity mismatch. Moreover, they can be attributed to the likelihood of (i) second-round effects of inflationary shocks triggered by supply-side factors, (ii) a relative fiscal easing in the election run-up and (iii) heightened volatility of the exchange rate of the RON coupled with uncertainties surrounding its near-run movements amid ongoing tensions in the international economic environment. Similarly to the previous months, the central bank continued to pursue firm control over domestic money market liquidity via open-market operations. In addition, considering the still brisk dynamics of loans to the private sector, especially their foreign currency-denominated component, the NBR Board decided to leave unchanged the minimum reserve requirement ratio on RON-denominated liabilities[24] at 20 percent and the minimum reserve requirement ratio on foreign exchange-denominated liabilities of credit institutions at 40 percent. At

[23] 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*).

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

the same time, the National Bank of Romania took additional prudential measures aimed at the financial system, i.e. higher provisioning coefficients for foreign currency-denominated loans extended to unhedged borrowers[25] and broadening of the scope of such provisions to non-bank financial institutions.

In its meeting of 4 February 2008, the NBR Board decided to lift the key rate by 1 percentage point to 9 percent per annum, given that the updated quarterly projection of medium-term macroeconomic developments showed a temporary persistence of the upward course in the forecasted annual inflation rate and its rise to a level significantly higher than that in the previous forecast[26] over the monetary policy transmission mechanism horizon. The upward shift was largely the result of an inflation flare-up at end-2007 and the projected increase in the magnitude and/or duration of the inflationary effects of negative exogenous shocks, i.e. the severe drought of 2007, the hike in food and fuel prices on international markets and higher administered prices. The forecasted trend of annual CORE2 inflation rate also moved upwards in response to the above-mentioned effects, the higher-than-previously-expected RON-EUR exchange rate and the relative rise, compared to the previous projection, in the level and duration of the positive output gap. The central bank's firm response was also substantiated by the high likelihood of even greater consequences from the potential materialisation of inflationary risks associated with the projection given the ongoing economic and financial turmoil worldwide. Therefore, the major risks identified were the possible maintenance of a fast increase in wages insufficiently matched by productivity gains and the risk of larger public spending in run-ups to local and general elections, as well as a more severe worsening of inflation expectations.

In March the central bank raised again the monetary policy rate, this time by half of a percentage point to 9.5 percent. Behind this decision stood the reconfirmed deterioration of the short- and medium-term inflation outlook, due largely to the enhanced inflationary impact in the months ahead of supply-side factors and costs (food and fuel prices, and the exchange rate of the RON) as well as to the stronger demand-induced inflationary potential given that the latest statistics showed a larger-than-expected economic growth in 2007 Q4[27] (6.6 percent from 5.7

[25] Regulation No 5/2002, as subsequently amended.

[26] November 2007 Inflation Report.

[27] GDP statistics were subject to substantial revision, which dampens to some extent the accuracy of both projections and assessments.

percent – see Chapter III. *Economic developments*). In addition, the domestic absorption annual dynamics, albeit slightly slower than in the previous quarter, remained very fast and produced, amid the steadily weakening RON, considerable inflationary effects through fostering import growth, which hit a 5-year high in annual terms. The assessments revealed that short-term pressures triggered by household consumption, the key component of domestic demand, could stay high considering the faster annual increase in turnover of trade and services in January 2008 compared to the average seen during the last months of 2007. This development could be associated with the brisker annual growth of household income, as well as with the increasingly worsening trend in net financial saving of households.

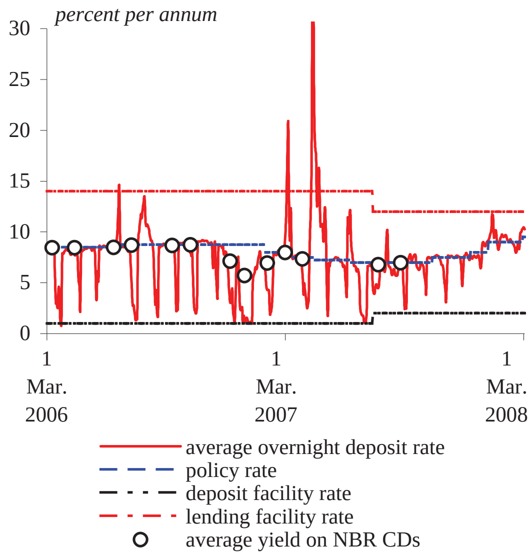
This state of affairs was driven, on the one hand, by a relative reinvigoration of household demand for loans, the annual growth rate of which picked up markedly in December 2007 and remained relatively high in the following months (71.7 percent on average versus 65.0 percent in 2007 Q4). Despite the significantly softer RON against the EUR, household demand for loans still addressed particularly foreign currency-denominated loans, whose annual dynamics continued to gather momentum (including on the back of a base effect), averaging out at 122.5 percent in the early months of 2008 from 118.4 percent October through December 2007. The explanation for this development lies with the still declining interest rates on new EUR-denominated loans to households[28], as well as with the further attractive rates on CHF-denominated credit (accounting for 9.8 percent of the loan stock in February 2008 from 8.3 percent at end-2007). The annual rate of increase of RON-denominated loans to households did not show any clear signs of a renewed downtrend either; it averaged out at 33.6 percent in February 2008, down by merely 2.4 percentage points against the 2007 Q4 figure, as the NBR interest rate hike was not yet fully passed on to the lending rates on new business. However, relatively more favourable changes saw the loan composition by destination; the annual growth pace of consumer credits slackened after peaking in December (on account of both components), whereas the year-on-year change in housing loans stayed on an upward path until January and remained relatively steady thereafter.

On the other hand, the early months of 2008 witnessed a return to the weakening propensity for saving. Thus, the annual growth rate of households' time deposits with maturity of up to two

[28] Whose average stock became almost equal to that of new loans to non-financial corporations.

years remained on the upward trend that began in November until January 2008 and subsequently declined significantly, averaging at 15.1 percent, down 0.9 percentage points from 2007 Q4. This owed much to the developments in the RON-denominated component, whose average dynamics slowed in early 2008 by 3.1 percentage points from 2007 Q4 to 6.5 percent, with credit institutions' deposit rates on new business with the above-mentioned maturity rising faster no sooner than February. The slackening dynamics was also manifest, for the first time in 7 quarters, in case of households' overnight deposits; thus, compared to the final quarter of 2007, their average annual change January through February shed 47.6 percentage points to 80.4 percent for RON-denominated deposits and 4.7 percentage points to 87.9 percent for foreign currency-denominated deposits. In turn, time deposits with maturity longer than 2 years saw their average annual rate of increase cut by half as against the last 3-month period of 2007.

Interbank Money Market Rates



Yet another major determinant of the monetary policy rate hikes was the need to counteract the risk of ever-deteriorating inflation expectations and that of second-round supply-side effects which, if they materialised, would have delayed the resumption of disinflation and would have prevented the annual CPI from re-entering the trajectory of medium-term inflation targets. Such a risk was aggravated by the anticipated persistence beyond 2008 of the period during which the annual inflation rate may stay above the upper limit of the variation band and by the magnitude and relative duration of the direct inflationary impact that food and fuel price increases, as well as further administered price adjustments, might trigger. Heightened inflation expectations could also be prompted by the persistent weakening of the RON and the still sizeable volatility and unpredictability of exchange rate movements (see Section 2.2 *Exchange rate and capital flows*). The latter features reflected the interaction of (i) the latest global financial turmoil episodes, (ii) relative delay in evidence on improving domestic economic fundamentals, which fuelled forex market operators' negative sentiment towards the short-term outlook of both the Romanian economy and the exchange rate, and (iii) stronger speculative behaviour spurred also by the liquidity surplus resulting from substantial Treasury injections at end-2007.

During the first quarter of 2008, the National Bank of Romania continued to enhance the impact of interest rate hikes by retaining a firm control over money market liquidity. The central bank resorted to deposit-taking operations to mop up excess liquidity, given that the anticipations of further policy rate increases contained somewhat the credit institutions' interest in CDs issued by the central bank. Their greater propensity for overnight deposits, including as a result of heightened uncertainty surrounding the liquidity picture, prompted the central bank to carry on increasing its regular open-market operations by taking deposits with shorter maturities[29] – all auctions featured fixed interest rates and the National Bank of Romania accepted all bids submitted by credit institutions. In January, the central bank levered up considerably its sterilization operations[30], but their outstanding balance declined noticeably in the following months, largely due to absorption operations of autonomous liquidity factors.

[29] In a range of between 3 and 7 days.

[30] When their outstanding balance rose 44.6 percent month on month, particularly due to sterilization operations performed in an attempt at soaking up the Treasury's excess liquidity injections.

2. Financial markets and monetary developments

Interbank market rates remained on a downtrend in 2008 Q1 and their volatility decreased. Nonetheless, the domestic currency kept weakening against the euro and the daily exchange rate change stayed high, following the trend seen at end-2007. Liquidity across the economy grew at a faster pace in December 2007-February 2008 against the backdrop of brisker dynamics of credit to the private sector.

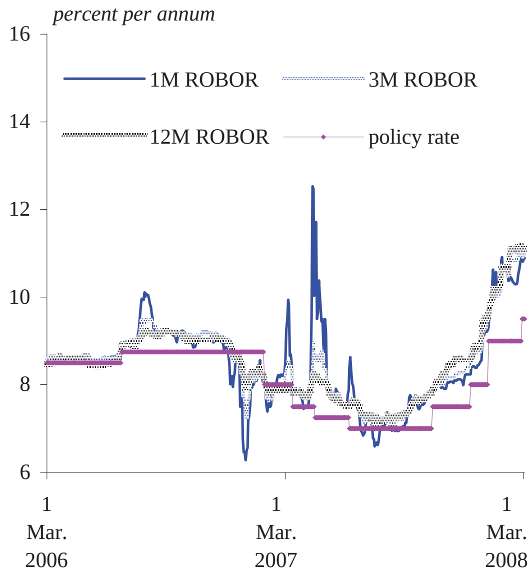
2.1. Interest rates

In 2008 Q1, the interbank rates were in line with the monetary policy rate, their quarterly average rising 2.0 percentage points to 9.0 percent as against the previous quarter, as the central bank continued to pursue a firm management of money market liquidity via open-market operations.

With a view to consistently ensuring balanced liquidity conditions, the NBR continued to perform open-market operations with maturities shorter than that of the main monetary policy instrument, along with the regular two-week deposit-taking operations. Hence, January saw a relative rise in open-market operations, which was imposed by the need to counteract massive liquidity injections by the State Treasury. The difficulty to rapidly eliminate the excess reserves in the reviewed period caused interbank rates to adjust only gradually to the rise in the NBR's monetary policy rate earlier in the month. By contrast, interbank rates recorded a relatively pronounced increase in early February (their daily average nearing the interest rate on the lending facility), as a result of a temporary liquidity shortage and particularly of stronger demand for reserves reported by some banks. Subsequently, the magnitude of fluctuations of overnight rates and the policy rate was lower. Moreover, the volatility of overnight rates decreased further to a record low of the past eleven quarters. In addition, the margin of daily average overnight rates (6.4-11.8 percent) was further similar to that of the previous quarter.

The (1M-12M) ROBOR yield curve continued to move upwards across the whole maturity spectrum, including the effects of the successive increases in the monetary policy rate and of the consolidation of market expectations towards the continued rise in interest rates until mid-2008. The average interest rates went up nearly 2.5 percentage points from the end of the prior quarter[31],

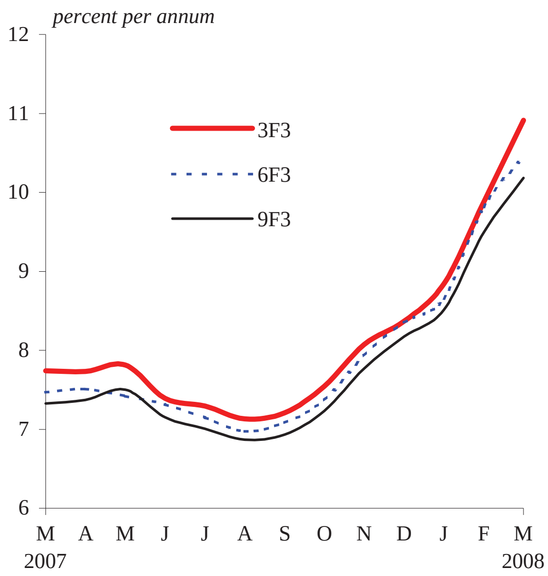
Policy Rate and ROBOR Rates



[31] On 6 March, the NBR changed the rules on establishing the ROBID and ROBOR reference rates, so that data are not fully comparable.

the adjustment being relatively uniform across the whole maturity spectrum. In February, the spread between 12M and 1M ROBOR rates entered negative territory, given the higher-than-expected rise in the monetary policy rate in early February, which triggered the repositioning of overnight rates; the yield slope returned to positive territory in March, the spread stabilising at around 0.2 percentage points at the end of the month.

Implicit Forward Rates



Developments in implicit forward rates, calculated based on March average rates, also illustrate the anticipations of the future trend of interest rates. Accordingly, the average 3M ROBOR rate was expected to peak at nearly 11.0 percent in mid-2008 and then fall to 10.5 percent in September and 10.2 percent in December.

Interest rates on the primary market for government securities followed an upward path as well. In January and February 2008[32], the Ministry of Economy and Finance agreed upon new rises in the maximum interest rates up to 9.5 percent (for Treasury certificates and 3-year benchmark government bonds) and 9 percent (for 5-year benchmark government bonds). In this context, the average interest rates on 6-month and 1-year Treasury certificates climbed to 9.4 percent (1.6 percentage points and 2.4 percentage points higher than those on the 2007 issues), while the average interest rates on 3- and 5-year benchmark government bonds rose to 9.47 percent and 8.97 percent respectively (2.4 percentage points and 1.8 percentage points higher than those on the last issues in 2007). Given the increase in costs related to public loans, the MEF temporarily ceased to issue 10-year government bonds in 2008 Q1, replacing them by securities with shorter maturities and Treasury certificates in particular (securities with maturities of up to one year held more than 62 percent of the total volume of issued securities).

The quarterly volume of reverse and outright transactions on the secondary market for government securities remained high (in excess of RON 7,000 million), due to the large volume of operations performed in January (more than 72 percent) and concluded mostly between banks and non-residents[33]. In the following two months, the value of transactions decreased considerably and, in March, hit the lowest level in the past 12 months (about RON 470 million). Outright transactions made up almost 94 percent of total operations carried out in Q1 and

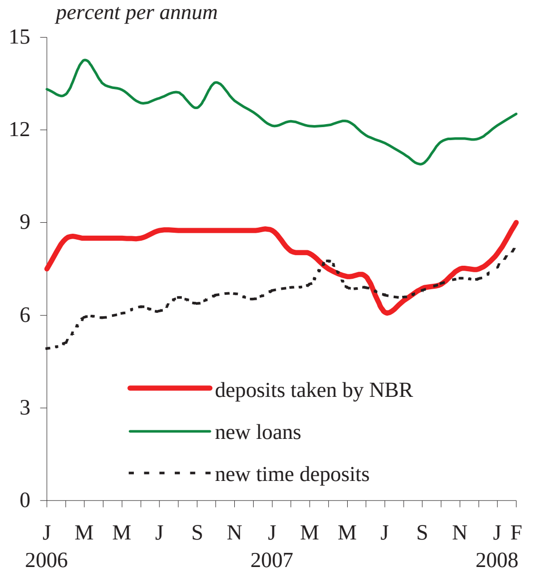
[32] Almost the whole volume of government securities outstanding came from the issues launched in January and February 2008. In March, the MEF rejected entirely the bids submitted at three out of the four government securities auctions.

[33] At end-January 2008, non-residents' portfolio exceeded the double of the figure recorded at end-December 2007.

government securities with residual maturities of up to one year, of three and five years were the most heavily traded; the related average interest rates rose in a range from 1.7 percentage points to 0.2 percentage points as compared with those recorded in the prior quarter to reach 8.90 percent, 8.93 percent and 7.77 percent respectively. The value of reverse transactions declined to half of that recorded in the previous quarter, to nearly RON 420 million, the related repo rates adding 2.3 percentage points for transactions with maturities with one month and three months to 8.94 percent and 8.49 percent respectively.

The impulse of the monetary policy rate and interbank rates fed through into average deposit and lending rates on new business, which continued to increase in December 2007 – February 2008. Interest rates applied to non-financial corporations were the most sensitive, as lending rates on new business went up 1.1 percentage points to 12.51 percent and deposit rates on new business added 1.2 percentage points to 8.55 percent in February versus November. As concerns households, the upward adjustment was less visible: the average deposit rate on new business gained 50 basis points to 7.38 percent and the average lending rate on new business inched up 0.35 percentage points to 12.55 percent. The developments in the latter included the adverse effects exerted by the upward adjustment of the lending rate on new consumer loans and real-estate loans (0.46 percentage points and 1.15 percentage points respectively), on the one hand, and by the decline in lending rates on start-up loans and credit for other purposes. The average interest rates on overdraft loans posted mixed developments by client, dropping marginally 7 basis points to 21.70 percent for household loans and adding 0.79 percentage points to 12.97 for loans to non-financial corporations.

Bank Rates

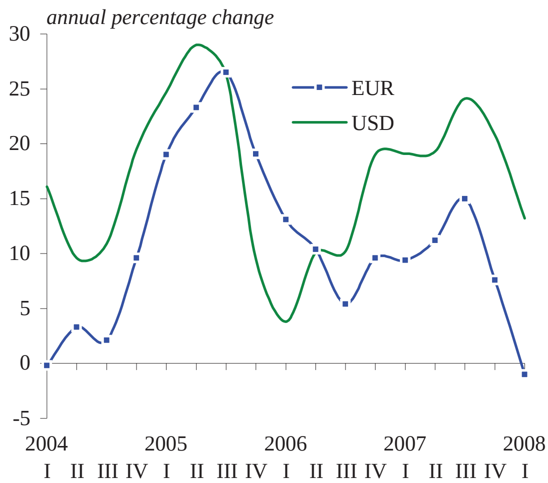


2.2. Exchange rate and capital flows

The impact of the turmoil affecting international financial markets on the domestic forex market and on the RON exchange rate was at its peak in 2008 Q1. Over the reported quarter, both the volatility of the RON/EUR exchange rate and the magnitude of the domestic currency depreciation exceeded by far the similar parameters of the main currencies in the region[34].

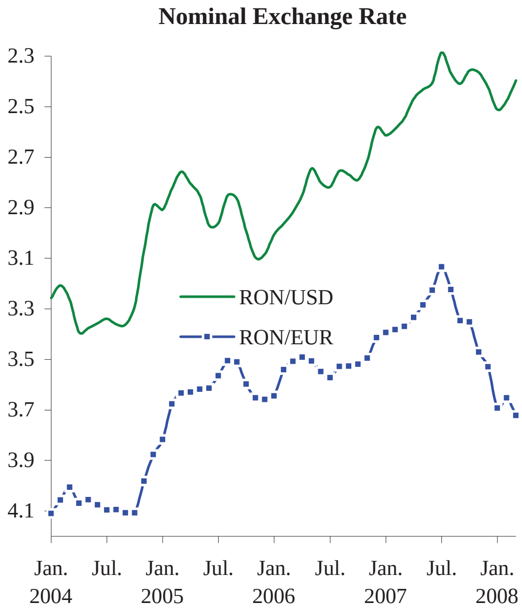
Thus, the local currency lost 5.2 percent (or 3.1 percent in real terms) versus the euro in March 2008 compared to December 2007. However, given that the US dollar weakened considerably

Developments of RON Exchange Rate*



*) appreciation (+), depreciation (-) in real terms;
Source: NIS, NBR

[34] However, developments in the RON exchange rate became increasingly correlated to those of the Polish *złoty* and of the Hungarian *forint* starting in February.



against the European currency, the RON appreciated in relation to the USD in both nominal and real terms (1.2 percent and 3.4 percent respectively). Calculated as an average annual change for January-March, the domestic currency posted its first nominal depreciation versus the euro (8.3 percent) in the last five quarters. Moreover, the RON lost 1.0 percent against the EUR in real terms for the first time in the past 17 quarters. Conversely, the quarter under review marked a continued deceleration in the previously fast strengthening of the domestic currency against the USD, i.e. 4.9 percent in nominal terms and 13.2 percent in real terms.

Pressures for a weaker RON regained momentum in January, amid financial investors' rekindled risk aversion triggered by a sequence of unfavourable external events and developments[35] as well as by their worsening expectations on RON exchange rate developments. The downbeat sentiment originated in the protracted unfavourable trend of the current account balance and of inflation, as well as in the downgrading by Fitch of the outlook on Romania's long-term foreign and local currency issuer default ratings to negative from stable. Against this backdrop, the flagging capital inflows of financial borrowings[36] and deposits, as well as the keener speculative behaviour of forex market operators (also as a result of the persistent excess liquidity following the massive injections performed by the Treasury at end-2007) positioned the domestic currency on an almost uninterrupted downward path against the euro. The volume of transactions on the interbank forex market and the net demand for foreign currency[37] peaked during the reported period. On 24 January, the RON/EUR exchange rate hit a record high of 3.7695 for January-March 2008, reflecting a nominal depreciation versus the euro by 4.2 percent[38] as against end-2007.

Although the external environment failed to paint a brighter picture and despite the persistence of a potentially overly negative outlook among forex market operators with regard to the short-term prospects of the national economy and of the exchange rate,

[35] More frequent signals regarding an impending recession in the United States and the bleaker picture on major global capital markets, given that financial investors looked upon the successive rate cuts by the FED as insufficient to help recover the American economy.

[36] Non-banks' financial borrowings posted a sharper decline, with their value diminishing to about one third of the 2007 Q4 average.

[37] Residents' excess demand for foreign currency doubled from the previous month, while that of non-residents – albeit on the wane – remained relatively high.

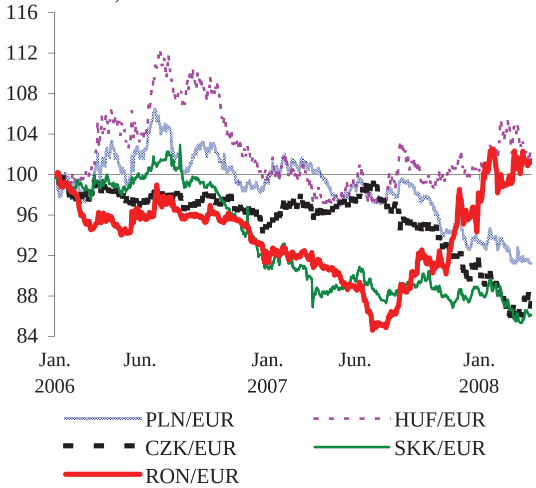
[38] The depreciation posted by the domestic currency in January (4.4 percent) was the most abrupt since May 2002, while its magnitude exceeded that of other currencies in the region.

the latter witnessed a short-lived trend reversal at end-January. This was mainly ascribable to the measures taken by the NBR, namely strengthening the control over money market liquidity and the unexpectedly large increase in the monetary policy rate in February. Another possible explanation for the trend reversal consisted in the lower pressure exerted by demand for foreign currency associated with international commercial transactions, with the annual growth in export value outpacing that of imports for the third consecutive month. Against this background, the episode of relative strengthening of the domestic currency (the average RON/EUR exchange rate posted in February the first month-on-month drop in the past six months) was accompanied by a slightly lower volatility in the RON/EUR rate. At the same time, developments in the RON exchange rate became increasingly linked to those of the Polish *złoty* and of the Hungarian *forint*.

Subsequently, however, the RON/EUR exchange rate re-entered an upward path on account of a new outbreak in financial investors' risk aversion[39] amid concerns triggered by additional losses incurred by some external financial institutions[40]. Nonetheless, the slope of this path was no longer abrupt, since the influence of unfavourable external developments[41] was alleviated by the relative improvement in market operators' sentiment on the developments of the Romanian economy, following the release of data exceeding most analysts' expectations (GDP growth in 2007 Q4, industrial output and export dynamics in January). Moreover, another mitigating factor was a further rate hike operated by the NBR. Against this backdrop, excess demand for foreign currency[42] shrank to less than half of the February figure, hitting a 7-month low. However, at a regional level, the RON posted the most significant monthly depreciation versus the EUR, i.e. 1.9 percent in nominal terms.

Exchange Rate Developments on Emerging Markets in the Region

indexes; 31 December 2005 = 100



Source: NBR, ECB

Key Financial Account Items (balances)

EUR million

	2007 2 mos	2008 2 mos
Financial account	**2,184**	**2,170**
Direct investments	**1,119**	**1,218**
residents abroad	12	80
non-residents in Romania	1,107	1,138
Portfolio investments and financial derivatives	**259**	**19**
residents abroad	-52	24
non-residents in Romania	311	-5
Other capital investments	**1,087**	**891**
of which:		
medium- and long-term investments	862	445
short-term investments	-1,113	-131
currency and short-term deposits	645	4
NBR's reserve assets, net ("–" increase/"+" decrease)	**-281**	**42**

[39] The concerted action took by the major central banks during this period with a view to improving liquidity conditions had a somewhat limited impact.

[40] Carlyle Capital investment fund, Bear Stearns, Ambac Financial Group and Deutsche Bank.

[41] The turmoil on international money markets, the sharp decline in stock market indices on the major capital markets worldwide, the US dollar hitting a record low, followed by the historical peak in raw material prices, oil included.

[42] Non-residents included.

2.3. Money and credit

Money

In December 2007 – February 2008, the pace of increase[43] of broad money (M3) accelerated further (26.9 percent), hitting a two-year high; however, this trend was uneven throughout the reported period, with broad money peaking in January. The main drivers behind the faster M3 dynamics were the protracted robust economic growth, the hike in public spending in the latter part of 2007, the slower widening of the current account deficit and the accounting effect of a weaker RON[44]. Conversely, the larger volume of government securities held by legal entities exerted an opposite influence on broad money growth. From the perspective of M3 counterparts, monetary expansion continued to reflect mainly the faster growth rate of private sector loans and the slacker increase in household time deposits with an agreed maturity of over two years. Broad money dynamics was additionally boosted by the lower negative value of net credit to central government, as a result of fewer deposits of the central public authority with the banking system. On the other hand, banks' net external assets[45], capital accounts[46] and corporate time deposits with an agreed maturity of over two years further depressed M3 growth.

Unlike the previous quarter, narrow money (M1) no longer underpinned the M3 upward trend, which was entirely supported by time deposits with an agreed maturity of up to two years. Thus, the growth rate of M1 decelerated exclusively on account of the slower increase in overnight (RON and forex-denominated) deposits from the main customer categories, whose effect was stronger than that of the uptrend in the dynamics of currency in circulation. The protracted slowdown in the pace of increase of corporate overnight deposits coincided with a spike-up in the growth rate of time deposits with an agreed maturity of up to two years, which entered positive territory for the first time in the past year. One of the possible drivers behind this step-up (irrespective of currency denomination) was the significant rise in interest rates on RON- and EUR-denominated new time deposits

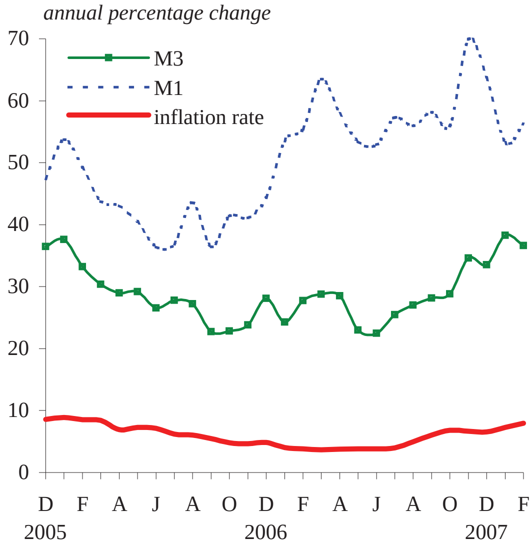
Annual Growth Rates of M3 and Its Components

real percentage change

	2007				2008	
	I	II	III	IV	Jan.	Feb.
	monthly average					
M3	22.2	20.1	20.8	24.0	28.9	26.5
M1	51.7	49.1	49.7	52.9	42.9	44.7
Currency in circulation	22.1	21.4	24.4	29.4	43.3	38.3
Overnight deposits	66.5	63.9	62.7	63.9	42.8	47.0
Time deposits (maturity of up to 2 years)	3.5	0.7	-0.1	2.4	16.4	10.6

Source: NIS, NBR

Broad Money and Inflation Rate



Source: NIS, NBR

[43] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2007 – February 2008 (end-of-month).

[44] December 2007 through February 2008, the annual change in the RON/EUR exchange rate (end of period) posted the highest values since September 2004.

[45] However, when expressed in RON, the external counterpart of M3 had a weaker contractionary impact.

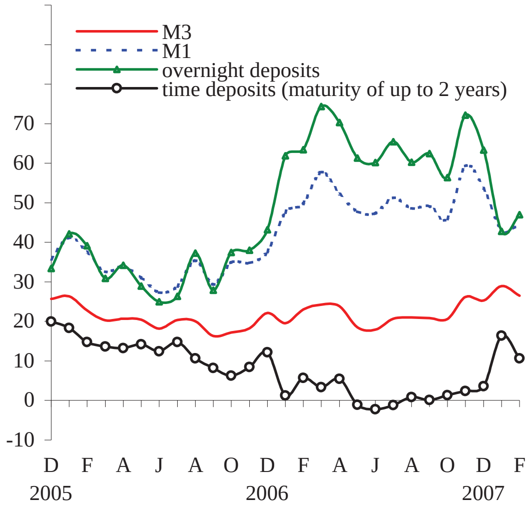
[46] The actual value of this indicator may be subject to change upon approving the credit institutions' balance sheets for 2007.

with an agreed maturity of up to two years from non-financial corporations[47]. Conversely, the deceleration seen for the first time in the last 18 months in the growth rate of household deposits seems to have been to a lower extent the result of interest rates on demand deposits becoming somewhat less attractive (although the benefits related to the taxation of such income remained in place), given that the dynamics of household time deposits with an agreed maturity of up to two years further slackened over the reported period (for the RON-denominated component, the deceleration in the average pace of increase was mainly due to the significantly slower annual dynamics in February 2008).

Turning to the structure of M3[48] by institutional sector, the pick-up in its growth rate reflected the more sizeable advance in corporate deposits and, to a lesser extent, in deposits from local governments and social security funds[49]. As far as companies are concerned, deposits from non-financial corporations continued to grow at the fastest pace, most likely due to a rise in the volume of public spending, particularly in December 2007[50]. The brisker dynamics of M3 deposits from non-bank financial institutions was of a lower magnitude, with their rise reflecting the stronger accounting effect of the RON depreciation, considering that part of these placements shifted from the domestic to the foreign currency-denominated component. After the all-time high seen in the previous quarter, the rate of increase of household deposits slowed for both RON- and forex-denominated components, possibly on account of dwindling income destined to saving, amid this segment's still robust propensity for consumption and increased debt service to banks.

Main Broad Money Components

real annual percentage change



Source: NIS, NBR

The share of forex deposits in M3 widened further during the period under review to 29.0 percent. This performance reflects the step-up in the pace of increase of corporate time deposits with an agreed maturity of up to two years as well as the accounting effects of a weaker RON.

[47] The symmetric and abrupt changes in the trajectories of the annual growth rates of corporate overnight deposits and corporate time deposits with an agreed maturity of up to two years hint at the fact that portfolio shifts reflect, aside from customer decisions, several reclassifications operated by banks according to the new statistical definitions.

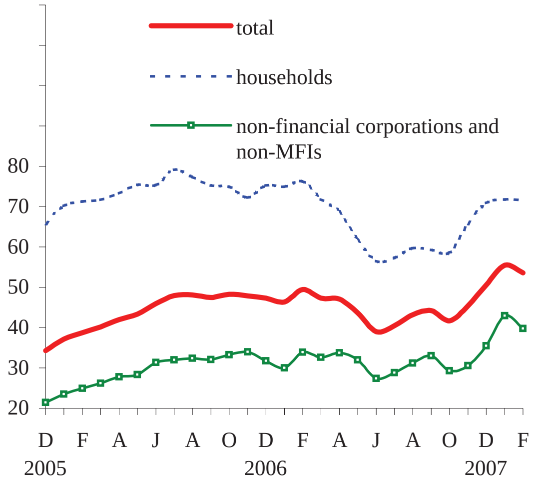
[48] M3 breakdown by institutional sector does not cover currency in circulation due to missing data.

[49] The annual dynamics of RON- and forex-denominated deposits from local governments and social security funds witnessed abrupt shifts, mainly on account of the change in the statistical methodology.

[50] In December 2007, the State Treasury balance hit a 4½-year low.

Credit to Private Sector by Institutional Sector

real annual percentage change



Source: NIS, NBR

Credit

December 2007 through February 2008, the growth rate of loans to the private sector continued to accelerate[51] and peaked at 53.2 percent. This development reflected the cumulated effect of (i) the pick-up, for the first time in the past 18 months, in the growth rate of the RON-denominated component, (ii) the pace of increase of the forex-denominated component stabilising around its historical peak[52], as well as (iii) the accounting impact of a weaker RON. The changed trajectory of the dynamics posted by the two components (RON- and forex-denominated) of private sector loans came under the influence of the partial fading, in January 2008, of the base effect generated by the removal in early 2007 of any limits on credit institutions' exposure from forex loans. The same as in the previous quarter, demand for loans was bolstered by the brisk rise in household incomes, by companies' still favourable financial standing[53] and by the possible easing of some lending requirements (other than interest rates). Loan supply was further fuelled by (i) the fierce competition among banks and the possibly keener competition between credit institutions, on one hand, and non-bank financial entities[54], on the other, as well as (ii) the quasi-completion of the validation process of banks' own prudential norms on household loans.

Both types of recipients saw faster dynamics of bank loans. While the upward path in the growth rate of corporate loans was associated with a shift away from forex- to RON-denominated loans, for household credit it reflected mainly the protracted appetite for the foreign currency-denominated component, fostered by the favourable cost differential. Against this backdrop, loans in Swiss francs witnessed a marked increase, with their average share (9.0 percent) in total household credit expanding 2 percentage points versus September – November 2007. Hence, the forex-denominated component still accounted for more than half of the household credit balance[55].

Both consumer loans and housing loans posted brisker growth rates. However, developments in the former case were largely

[51] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2007 – February 2008 (end-of-month).

[52] However, the share of foreign currency-denominated loans in total loans to the private sector was further on the rise, reaching a 2-year high of 54.7 percent.

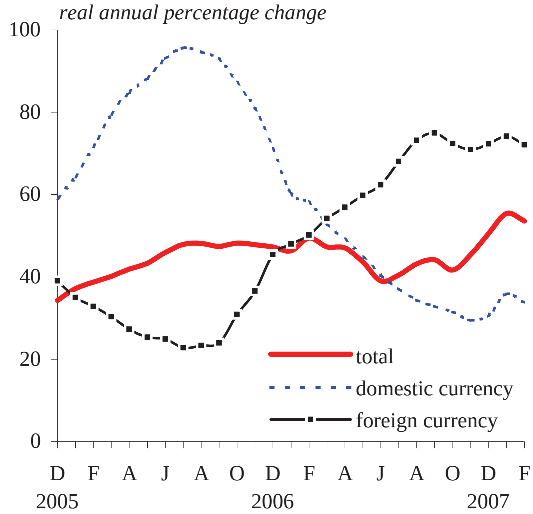
[53] As suggested by the protracted advance in the average annual growth rate of profit tax (in real terms).

[54] The General Register of Non-bank Financial Institutions included 215 entities at end-December 2007.

[55] This component holds the largest share as of November 2007.

attributable to the accounting effect of a weaker domestic currency. Thus, the pace of increase of the RON-denominated component slackened against the background of higher lending rates on new business, while the dynamics of forex loans stabilised somewhat around the last two years' high, despite lower interest rates thereon. Conversely, the faster growth rate of housing loans was manifest across all denominations. Given the considerable rise in the related lending rates, the possible explanation for this development lies with the favourable influence of easing certain lending requirements and the persistence of expectations of larger household incomes in the future. The annual growth of housing loans outpaced that of consumer loans for the first time ever, so that the share of the former in total household loans hit on average a record high over the last two years, i.e. 23.2 percent.

Credit to Private Sector by Currency



Source: NIS, NBR

The year-on-year pace of increase of corporate loans gathered strength on account of the renewed dynamics of RON-denominated loans and under the effect of a weaker domestic currency. This development was visible for both non-financial corporations and non-bank financial institutions. The pick-up in the growth rate of the RON-denominated component contrasted with the steep rise in lending rates on new business in domestic currency to non-financial corporations. It mirrored the base effect generated not only by the extremely low level of this component in January 2007, but possibly also the partial shift in demand for loans away from the forex-denominated component. Higher costs associated to this component (the hike in interest rates on new EUR-denominated loans to non-financial corporations and the depreciation of the domestic currency) as well as companies' increased resort to external[56] and local[57] financing resources stood out as the likely determinants of the slacker annual dynamics of corporate loans in foreign currency.

Despite the marked increase in the balance of loans to the central government[58], the rate of increase of credit to the public sector posted a significant slowdown, due to the fading base effects that had influenced the dynamics of direct borrowings and government securities until end-2007.

[56] According to balance of payments data, the amount of net external financial loans taken by non-banks December 2007 through February 2008 exceeded the September-November 2007 figure.

[57] The volume of net foreign currency purchases reported by the corporate sector December 2007 through February 2008 hit a 2-year high.

[58] The rise in the balance of loans to the central government was due to the issuance by the Ministry of Economy and Finance of government securities worth RON 760 million pursuant to the provisions of Emergency Ordinance No. 156/2007.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the 12-month inflation rate at 6 percent for end-2008, 0.1 percentage points above the figure published in the February 2008 Inflation Report. For end-2009, inflation is forecasted to stand 0.4 percentage points below the previously projected level (3.5 percent versus 3.9 percent).

The projection was revised due to recent and forecasted developments marking deviations from the previous scenario. For this year, the slight upward deviation of inflation is primarily attributed to aggregate demand pressures stemming from the faster than expected economic growth in 2007 Q4, the larger than previously projected hikes in administered, fuel and volatile food prices, as well as from the depreciation of the domestic currency which persisted during 2008 Q1 and entailed an adverse impact on import prices. These effects cannot be fully offset until the end of 2008 by the gradual increase so far in monetary policy restrictiveness as a result of the structural lags inherent to the transmission of monetary stimuli to the real sector.

The recent successive monetary policy rate increases will impact on real monetary conditions especially during 2009. Starting with 2009 Q2, the tighter monetary policy will bring about a negative output gap and a gradual reduction of inflationary pressures stemming from aggregate demand. In addition, the effects of adverse supply-side shocks (via food prices and a weaker RON) in 2007 H2 and early 2008 which fuelled inflation expectations of economic agents are anticipated to fade starting with 2008 Q3. These corrections, along with a pronounced restrictiveness of monetary policy throughout the projection horizon, will have a significant impact on inflation expectations, accounting for their faster projected decline in 2009 than in the forecast presented in the February 2008 Inflation Report.

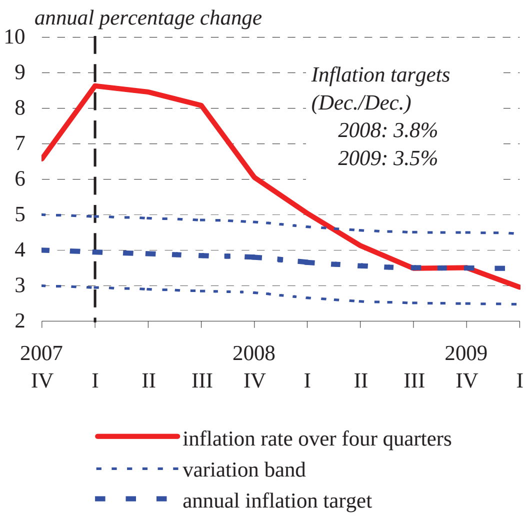
The events that might generate major risks which, should they materialise, could cause inflation to deviate from its projected path within the current projection horizon are: wage rises in excess of productivity gains, further depreciation pressures on the domestic currency following the persistence of international market turmoil, a more expansionary fiscal policy compared to the baseline scenario, a larger than projected increase in administered prices, or a faster than previously expected surge in RON-denominated fuel prices induced by persistent increases of oil price on international markets. The implementation of a *coherent mix of firm macroeconomic policy measures could significantly reduce the likelihood of some of these risks. The inflation rate could be lower than projected in the baseline scenario in the event of bumper crops in the summer of 2008.*

1. The baseline scenario of the forecast

1.1. Inflation forecast

According to the baseline scenario, after peaking in 2008 Q1, the annual consumer price inflation is projected to stay on a downward path throughout the forecast horizon, with a steeper decline starting with 2008 Q3. The inflation rate is estimated to return inside the band around the central target starting with 2009 Q2. The annual CPI inflation is forecasted to reach 6 percent in 2008 and meet the 3.5 percent target at end-2009. Compared to the projection published in the February 2008 Inflation Report, the annual inflation rate is higher this year and lower next year, by 0.1 percentage points and 0.4 percentage points respectively.

Inflation Forecast



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

Table 5.1. Annual inflation rate (end of period)

percent

Period	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1
Target			3.8				3.5	
Forecast	8.5	8.1	6.0	5.0	4.1	3.5	3.5	3.0

The revision of the projected inflation rate in 2008 primarily reflects the following:

− acceleration of fourth-quarter economic growth underpinned by larger household income, credit expansion and a widening budget deficit[59];

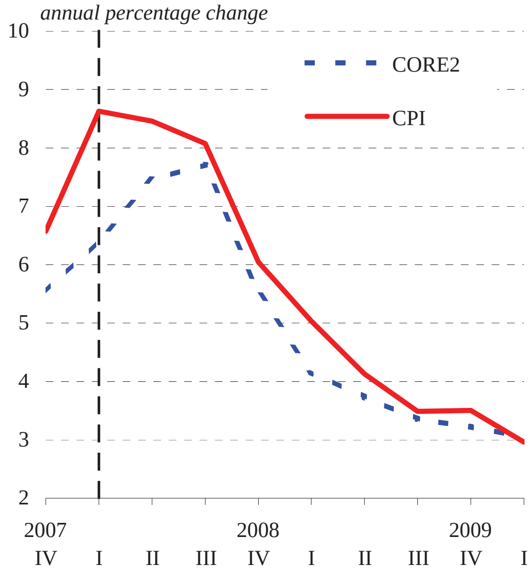
− expectations of larger administered price hikes and a less optimistic scenario for volatile prices of some food items (vegetables, fruit, eggs) compared to the projection published in the February 2008 Inflation Report;

− the persistence of tensions on international commodity markets, along with a continuation of the depreciation trend during 2008 Q1; the cumulative impact would be larger than projected fuel prices inflation and an increase in RON-denominated prices of imported foodstuffs.

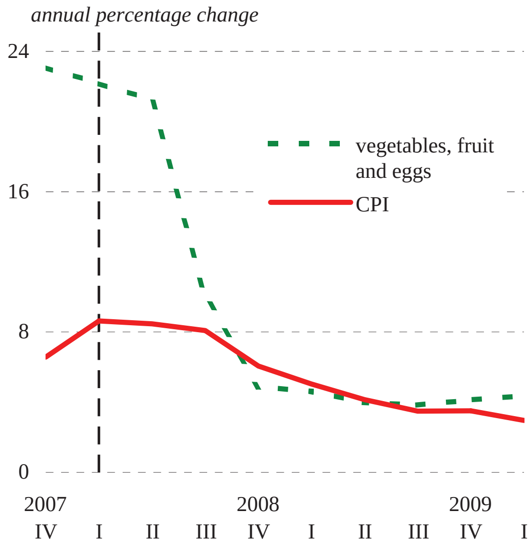
Nevertheless, consumer price disinflation will resume at a fast pace starting with 2008 Q3 against the background of restrictive

[59] The recent revision by the NIS of historical data on GDP and its components had a substantial bearing on the reassessment of the inflationary pressures triggered by the aggregate demand.

CORE2 and CPI



Vegetables, Fruit and Eggs Prices and CPI Inflation



real monetary conditions and also as a result of a favourable base effect that is anticipated to start in 2008 Q4. At the same time, the gradual pass-through of the effects of successive increases in monetary policy rate[60] into the real sector is expected to support, in the second half of the forecast horizon, a strong decrease in inflation expectations of economic agents compared to the previous projection.

Under the current scenario, the CORE2 inflation rate is expected to have a favourable influence on consumer price disinflation. CORE2 inflation is expected to remain below the level shown in the February 2008 Inflation Report on the back of the expectations of lower CORE2 inflation in 2008 Q2 and a more favourable contribution coming from inflation expectations, especially during 2009. The scheduled adjustments in excise duties on tobacco products in 2008 Q2 and Q3, on the back of still noticeable inflationary pressures due to aggregate demand, are expected to push CORE2 inflation on an upward trend in the first part of the horizon. As a result, we project CORE2 inflation to return to a downward path starting with 2008 Q4. Thereafter, despite the delayed closing of the positive output gap and the slower opening of a demand deficit and following the implementation of excise duty scheduled for 2009, the CORE2 inflation rate is projected to remain below that of the CPI.

In the first quarters of the forecast interval, food prices will grow faster than the aggregate consumer prices. The volatile prices of some food items, namely vegetables, fruit and eggs, rose sharply in 2007, but in early 2008 this move slackened somewhat. However, these prices exerted inflationary pressures that fed through (i) directly, as these prices are a component of the consumption basket, and (ii) via second-round effects and heightened inflation expectations of economic agents. Following the gradual tightening of real monetary conditions[61] and assuming the lack of major shocks in agriculture during 2008, the adverse effects of last year's poor supply of agricultural products are expected to be gradually eliminated starting with 2008 Q3. Against this backdrop, starting with 2009 Q1, the exogenous changes in administered prices are expected to remain the sole component of the consumption basket displaying a dynamics

[60] During October 2007-March 2008, the cumulative increase in the monetary policy rate totalled 250 basis points. Compared to the assumptions in the February 2008 Inflation Report, the current scenario also incorporates the 50 basis point hike announced by the NBR Board on 26 March.

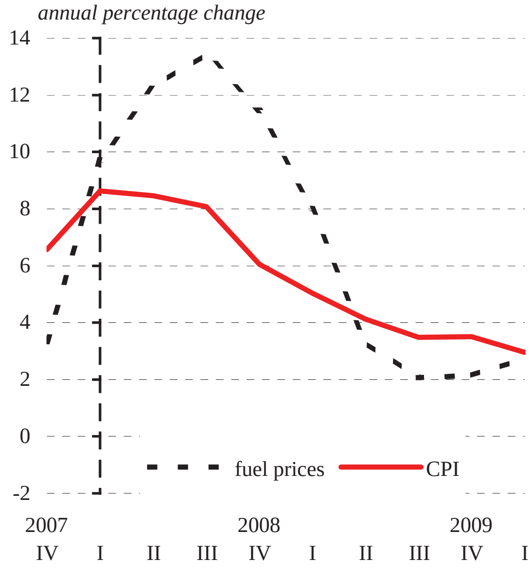
[61] Real monetary conditions act upon excess demand by reducing CORE2 inflation and prompting a gradual decline in annual CPI inflation. Considering that inflation expectations of economic agents are shaped by the dynamics of the whole consumption basket, such expectations are seen dwindling sharply starting from 2008 Q3, in line with the resumption of disinflation.

higher than the CPI inflation. According to the current baseline scenario, the projected increases of administered prices will be slightly higher than those previously forecasted, namely 7.1 percent in 2008 and 4.3 percent in 2009 respectively.

In the first part of the forecasting horizon, import prices are expected to reflect the cumulative nominal depreciation of the domestic currency versus the euro (about 15.4 percent August 2007 through March 2008), thereby having a detrimental impact on inflation outcomes in 2008. In line with our assessments, the depreciation of the RON throughout 2007 H2 contributed to a repositioning of the exchange rate on a trajectory consistent with removing the excessive overappreciation recorded in the first half of last year. As a result, we expect a subduing of RON's real exchange rate fluctuations over the forecasting horizon. Import price dynamics is thus seen fostering disinflation during 2009 in particular.

As a reflection of the assumptions on the international oil price (assumed constant at 100 USD per barrel[62]), the adjustments in excise duties levied on some fuel types[63] and the projected exchange rate movements, the baseline scenario foresees opposing effects of domestic fuel prices on inflation. At the beginning of the forecasting horizon, higher growth rates of fuel price inflation are envisaged, in line with a weaker local currency than previously projected (in 2008 Q1), and also reflecting the inertial component specific to the price-setting mechanism in the case of such products. However, in view of the expected exchange rate developments mentioned above and on the back of the data available thus far, fuel price inflation is foreseen to drop markedly during 2009. Hence, over this horizon, fuel prices are expected to support the return of the inflation rate towards the central target of 3.5 percent.

Fuel Prices and CPI



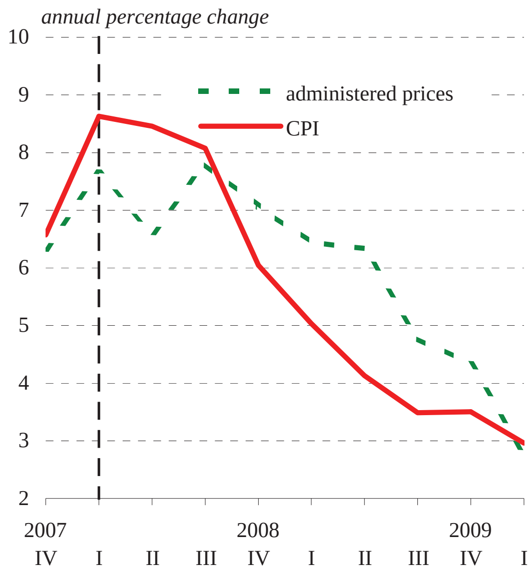
1.2. Exogenous inflationary pressures

The cumulative effect of exogenous CPI components (administered prices, volatile food prices, the excise duty on tobacco products and the vice tax) for 2008 is 0.6 percentage points higher in the current baseline scenario than in the previous projection, whereas that for 2009 is 0.1 percentage points lower than the forecast in the February 2008 Inflation Report.

[62] This assumption is at odds with the figures projected by Consensus Forecast for the coming two years. Considering the latest developments on the international oil markets, the assumption used herein is supposed to be more realistic.

[63] According to the provisions of the Tax Code, the adjustments are due for 1 January 2009 and 1 January 2010.

Administered Prices and CPI



According to the baseline scenario, in 2008, all exogenous components are expected to post faster growth rates than in the previous projection. Table 5.2 shows the annual growth rates of administered prices and volatile food prices.

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

percent

	Administered prices		Volatile food prices	
	2008	2009	2008	2009
Current projection	7.1	4.3	4.9	4.1
Previous projection	6.5	4.0	3.7	4.1

The projection of higher increases in volatile food prices (vegetables, fruit, eggs) is based on the upward trend of agri-food products prices on the international markets and on the depreciation of the domestic currency, which boost imported food prices, whilst the domestic supply of food items is still low owing to the poor crops of 2007.

The upward revision of the scenario for the administered prices growth rates is attributed to (i) the higher than previously forecasted hike in the prices of water, sewerage and waste disposal; (ii) the larger than previously expected pick-up in city transport prices; (iii) the weakening of the RON, with a direct impact on fixed telephony prices; and (iv) a larger share of natural gas in the CPI basket – under a scenario for the price for this component similar to that used in February 2008 Inflation Report. The inflationary effects exerted by such prices are anticipated to be alleviated by the expected lower increase of heating prices, according to the calendar for adjusting energy prices. Table 5.3 summarises the growth rates of electricity, heating and natural gas prices.

Table 5.3. The scenario for the energy prices growth rates

percent

	Electricity		Heating		Natural gas	
	2008	2009	2008	2009	2008	2009
Current projection	2.0	3.5	9.82	6.0	16.12	8.15
Previous projection	2.0	3.5	14.5	6.0	16.2	8.2

For the current year, the contribution of tobacco excise duty and vice tax to inflation is 0.3 percentage points larger than in the previous projection, due to the postponement for 2008 of the increase in the excise duty specified in the 2007 Tax Code and also to the expansion in the weight of tobacco products in the consumption basket.

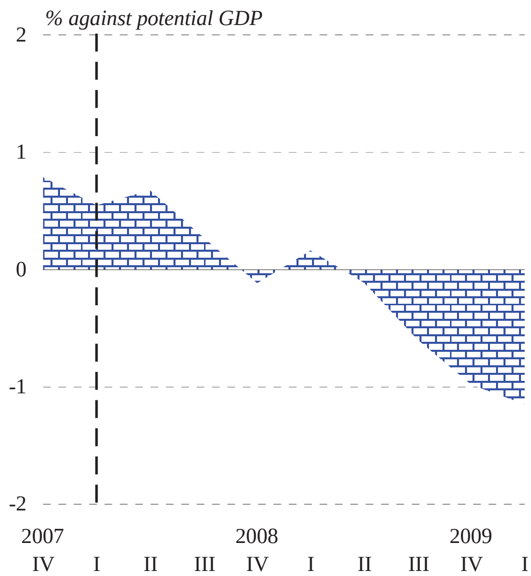
According to the figures published by Consensus Forecasts in March, the inflation rate for the euro area is anticipated at 1.9 percent for 2008 and at 2.2 percent for 2009, up from the levels used in the previous projection for both years[64]. The European Central Bank considers the possibility that euro zone inflation may exceed 2 percent at end-2008, owing to higher-than-forecasted hikes in energy and food prices, administered prices and indirect taxes. Likewise, euro area wages may be subject to larger-than-anticipated increases due to the high capacity utilisation and tight labour market conditions.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

In 2007 Q4, real GDP growth stood at 6.6 percent, i.e. above the GDP forecast in the previous projection[65]. The severe drought in 2007 entailed a negative shock on supply with effects on the growth rate of potential GDP as well. Thus, amid the temporary decrease in potential GDP and the faster increase in actual GDP (compared to the previously forecasted figure), excess demand in 2007 Q4 is subject to an upward reassessment, while in 2008 Q1 it is also higher than the estimated value of the previous forecasting exercise. The reassessment is indicative of more significant and more persistent demand-side pressures than those in the February 2008 Inflation Report.

GDP Deviation



Household final consumption and gross fixed capital formation are the main aggregate demand components contributing to a positive output gap in 2008 Q1. The assessments concerning the first component are underpinned by the persistently high household incomes and the continued expansion in non-government credit. The real net wage alongside with the number of employees and the unemployment rate show – by reference to their medium-term trend – the existence of large incomes and therefore of sizeable consumption resources. Moreover,

[64] According to the previous projections, the scenario on euro area inflation builds on the figures provided by Consensus Forecast. The predictions made by other international financial institutions may be used in the future for the baseline scenario forecast to the extent to which they turn out to be consistently higher than those currently employed.

[65] In the case of data in constant prices, the usual revision at the beginning of the year of the GDP statistical series by the National Institute of Statistics covered not only the 2005-2007 for which data were only provisional, but also the years back to 2001. The revisions of the volume indices in the case of GDP components were significant, which affects seriously the comparability with the previous projection.

consumer credit recorded a fast growth rate in the first two months of 2008 compared to the previous quarter's average. The share of household final consumption in GDP rose steadily over the past years[66], confirming the assessment of final consumption exceeding the sustainable medium-term level.

The second GDP component contributing to a positive excess demand in 2008 Q1 – gross fixed capital formation – was the fastest-growing, with an annual rate of increase of 28 percent in 2007 Q4. The high level of imports, which include a significant amount of investment goods (machinery and equipment included in this GDP component) suggests that investment might exhibit further rapid growth rates. A similar performance is suggested by the dynamics of medium- and long-term credit granted to economic agents, one of the financing sources of investment, which continued to accelerate in the first two months of 2008. While investment underpins a sustainable economic expansion, their swift growth rates contribute in the short run to the build-up of inflationary pressures.

According to the assessments, in the previous years, excess demand was largely reflected by the widening of the current account deficit; the strong appreciation of the domestic currency at that time fostered import-based consumption, relieving the pressure on domestic consumer prices. The reversal in the trend of excessive strengthening of the RON in 2007 H2 might have an adverse impact on inflation via this channel as well.

1.3.2. Implications of recent exchange rate and interest rate developments

The real depreciation of the domestic currency as against 2007 Q4 has fully eliminated the RON overappreciation in the previous years. Hence, the exchange rate had a slightly expansionary effect on aggregate demand through the net export channel, whilst the nominal depreciation of the local currency pushed import prices higher. These effects might fuel both current and future inflationary pressures. Nevertheless, through the wealth and balance sheet effects[67], the depreciation of the RON triggers an increase in the costs related to foreign exchange-denominated borrowing, has a restrictive impact on economic activity and alleviates inflationary pressures.

[66] In 2007, it stood at 96.6 percent in real terms compared to an average of around 75 percent for EU27.

[67] This assessment is based on the share of foreign exchange-denominated loans (nearly 50 percent) in total non-government credit.

In the medium run, the exchange rate is driven by fundamentals (i.e. medium-term capital inflows or the productivity differential against major trade partners). In the short run however, the exchange rate may deviate from the medium-term trajectory to which it tends to revert after the phasing-out of the effects of one-off factors. Romania's real economic convergence with the euro area contributes further to a normal real appreciation trend of the RON in the longer run. However, the relatively recent increase in investors' risk aversion on the international capital markets indicates a possible slowdown within the projection horizon in the average appreciation rate set by fundamentals.

The NBR's effective interest 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, due to the net debtor position held by the central bank towards the banking system. In 2008 Q1, the partial transmission of the increase in the NBR's effective interest rate and the rise in inflation expectations caused real commercial banks' deposit and lending rates to grow slowly. Therefore, in 2008 Q1, the real interest rates continued to have a cumulative expansionary effect on economic activity, yet of a lower magnitude than in 2007 Q4.

Overall, in 2008 Q1, real monetary conditions put less restrictive pressure on aggregate demand and future inflation. However, real monetary conditions continue to be restrictive due to the impact of the RON depreciation on foreign exchange-denominated credit – the major offsetting factor of the less restrictive impact of interest rates and exchange rate (through import prices and net export channel).

1.3.3. Demand pressures within the projection horizon

The inflationary impact generated by supply-side factors was boosted by excess demand pressures, which materialised into the rapid acceleration of CORE2 inflation. The upward revision of excess demand in this quarter, coupled with the expected above-potential economic performance in 2008 Q1 and Q2, entails a delay of four quarters of the output gap entering the negative territory as compared to the previous scenario (in 2009 Q2 versus 2008 Q2).

In the current projection, the output gap was revised upwards compared to the prior scenario as early as 2008 Q1, thus reinforcing the arguments behind the tightening of monetary policy stance over the past few months. The output gap of 0.5

percentage points in this quarter is consistent with the update of the prior assumptions regarding the deviations of the real effective exchange rate and of real interest rates, as well as of the coordinates of the fiscal stance during this quarter.

The baseline scenario envisages the gradual elimination of the expansionary effect of real deposit and lending rates and a restrictive impact starting with 2008 Q3. For the recent periods, the unfavourable contribution to the dynamics of real monetary conditions of both deposit and lending rates indicates, on the one hand, the structural lags specific to the transmission of monetary policy stimuli[68] and, on the other hand, the increase in inflation expectations of economic agents[69] at the end of 2007 and in the first part of 2008.

The new assessments on the real exchange rate restrictiveness, which incorporate the dynamics of a more depreciated domestic currency in 2007 and the first part of 2008, indicate, for 2008 Q1, a decline in the real exchange rate restrictiveness compared to the February 2008 Inflation Report. The depreciation trend of real and nominal exchange rates was also consistent with the rise in the risk premium associated by foreign investors to holdings of RON-denominated assets. Given the elimination of the prior strong overappreciation of the domestic currency, the baseline scenario further envisages a trajectory of the real exchange rate remaining relatively close to the trend for most of the relevant projection horizon. Nevertheless, the moderate deviations of the real exchange rate from its trend will further support the restrictiveness of the entire array of real monetary conditions.

Counteracting the higher inflationary pressures induced by aggregate demand requires a tight monetary policy stance throughout the eight quarters of the projection horizon. According to the baseline scenario, the entire set of real monetary conditions is projected to strengthen the disinflation process starting with 2008 Q3, and subsequently to enable the achievement of the inflation target by end-2009. The NBR's effective interest rate and implicitly commercial banks' deposit and lending rates will have the largest contribution, the latter ones being expected to gradually adjust to the changes in the NBR's effective interest

[68] Nominal deposit and lending rates rose by around 0.5 of a percentage point in 2008 Q1.

[69] According to the measure of inflation expectations determined consistent with the NBR's medium-term forecasting model, this indicator is expected to reach a peak in 2008 Q2. Inflation expectations are relevant not only as a factor impacting the dynamics of inflation but also for determining real interest rates.

rate. Real deposit rates are expected to become positive, which might steer households' behaviour towards saving rather than consumption. However, the NBR's expected shift to a net creditor position towards the banking system and, hence, commercial banks' keener interest in attracting domestic financial resources could shorten, in relative terms, the structural lags in the transmission of monetary policy stimuli to the real economy. The characteristics of the monetary policy transmission via the exchange rate channel exert mixed effects upon the output gap. Therefore, the contractionary impact of the exchange rate illustrated by the economic agents' net wealth and balance sheet effects channel in the first three quarters of 2008 is offset by the expansionary effect of the exchange rate through net exports. For 2009, the baseline scenario foresees a reversal of the impact of the two channels. The direct transmission of the exchange rate through the dynamics of imports and exports is expected to remain prevalent throughout this projection horizon too, thus helping to contain aggregate demand in the economy.

For the current projection, the fiscal component of the macroeconomic policy mix is less lax compared to the prior forecasting round, yet it is fuelling inflationary pressures in the economy. The new projections of budget deficits for the following couple of years[70], as well as the assumed trajectory of the cyclical budget component – higher than in the February forecast – envisage a fiscal incentive having *ceteris paribus* a smaller inflationary impact throughout the forecasting horizon. Budget deficit figures were adjusted with a forecast assuming the gradual increase in the level of EU funds absorption.

As regards the GDP composition by expenditure, domestic demand remains the chief driver of economic growth. However, exports have already started to experience higher rates of increase once the overappreciation of the exchange rate in previous years has been eliminated. Therefore, exports are expected to rise further as a share in GDP during the projection horizon. As for the composition of domestic demand, private consumption growth rate is forecasted to slow down primarily as a result of the expected lower resort to borrowings due to higher costs incurred by debtors (as a result of both the projected rise in interest rates on RON-denominated loans and of the wealth effect of the recent depreciation on the economic agents that had contracted foreign exchange-denominated loans). However, the main determinant of consumption is expected to remain the upsurge in disposable

[70] In compliance with ESA95 methodology agreed upon by the European Union.

income, especially wages, so that the moderation will be gradual and consumption will further display brisk growth rates. On the other hand, investment is projected to continue to expand at a fast pace during 2008-2009, thus boosting economic growth. As regards the net exports, the RON depreciation during the prior six months is expected to impact the import prices first, entailing a widening of the trade deficit over the short run. As the exchange rate movements have an impact on import demand, the volume of imports is projected to diminish considerably. This demand effect will emerge particularly in the case of consumer goods imports, the demand for investment goods being assumed to be less sensitive to exchange rate movements. The cumulative effect of the slowdown in the volume of imports and of the faster pace of increase in exports will have as a result a decline in the share of trade deficit in GDP during the projection horizon.

1.4. Risks and uncertainties surrounding the projection

Over the projection horizon there is the risk of certain events materializing, thereby causing inflation to deviate from the trajectory associated with the current baseline scenario. The main risk scenarios relate to:

– real wage hikes in excess of productivity gains;
– continued depreciation of the domestic currency as a result of persistent turmoil on international markets;
– implementing a looser than assumed budget policy; and
– better than expected agricultural output.

The mismatch between pay rises in real terms and labour productivity gains could fuel inflationary pressures via the costs channel. Current and potential employees have a stronger bargaining power given the labour shortage which exists 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[71], might force employers to concede wages they can only afford by raising the price of traded goods or services. This prolonged process might generate a wage-inflation spiral, with employees trying to preserve their real incomes by putting upward pressure on nominal wages and employers generating inflation by raising prices. Such behaviour could be boosted by worsening inflation expectations and might contribute to a wider gap between forecasted inflation and the inflation target.

[71] Likely to entail contagion effects on private sector wages.

The uncertainties affecting the international investment environment could cause exchange rate to deviate from the assumptions of the baseline projection. The potential worsening of the liquidity crunch on world markets might lead to a corresponding decline of capital inflows in Romania, putting considerable upward pressure on the exchange rate. Although a sizeable upward movement of the RON/EUR exchange rate would be unlikely to generate major imbalances in the financial system, it could prevent inflation from following its forecasted path. Also, such an exchange rate development could have adverse effects on the net wealth of economic agents whose financial liabilities comprise mostly instruments with short-term maturities denominated in foreign currencies. This would have a dampening impact on aggregate demand and would thus mitigate the inflationary effects of a weaker RON, although the magnitude of its net impact is difficult to anticipate.

The main risk associated with the budget policy stems from the non-compliance with the latest budget deficit revision, particularly through larger-than-scheduled public spending. The resort to unforeseen public spending as in previous years (e.g. public sector wage rises, bonuses) would only add to the stimulative effect on aggregate demand and trigger inflationary pressures. Another risk factor could materialize provided that the programmed capital expenditures are be reallocated to current expenditures. Due to political reasons, current expenditures are difficult to reverse and preclude any subsequent cut in spending. The risk of a looser budget policy compared to the announced targets is particularly relevant given the successive election rounds scheduled for 2008 and 2009.

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

On the other hand, the assessment of upward risks to inflation indicates that their potential materialization can be efficiently countered by implementing a mix of firm macroeconomic policies. Thus, a tight income policy in the public sector would preclude the demonstration effect on wage rises in the private sector, while limiting the budget deficit would offset the inflationary pressures from aggregate demand. In addition, avoiding reckless macroeconomic policies during a busy election schedule could reinforce foreign investors' confidence in the outlook of the Romanian economy, thus mitigating considerably the risks associated with the external position. Even assuming the persistence of the turmoil on international financial markets, viewing Romania as a relatively favourable investment alternative among the emerging economies could more than offset the risks associated with exchange rate developments. This would result in a persistence of capital inflows, particularly medium- and long-term ones, which could reposition the domestic currency on a moderate, yet sustainable appreciation trend, likely to trigger *ceteris paribus* a faster than projected disinflation.

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

A common risk specific to all projections so far concerns the developments in administered prices, given the repeated changes in their adjustment calendar. Over the current forecast horizon, the main uncertainty stems from the fact that certain price rises required for bringing administered prices in line with the levels agreed with the European Union have been postponed for various reasons, which will require significant catching-up in relation to the announced calendar. Given the share of goods with administered prices in the consumption basket, in the event of price adjustments veering off the baseline scenario assumptions, inflation would follow a higher than projected trajectory.

Fuel price dynamics are also associated with a risk of inflation deviating from the NBR forecast. Although these prices may exhibit both-way deviations from the coordinates of the baseline scenario, unfavourable developments are more likely to occur during the current forecast horizon. Thus, taking into account the anticipated strong oil demand, the persistent tensions affecting the global supply of petroleum products is likely to push oil prices even higher, thus significantly departing from the baseline scenario (USD 100 per barrel).

2. Policy assessment

Inflation continued to rise during 2008 Q1 amid the persistence of direct inflationary impact of costs and supply-side shocks, as well as the increase in spillover effects. Annual inflation rate added 2.06 percentage points to 8.63 percent in March 2008 compared to December 2007, thus overshooting noticeably the upper limit of the variation band associated with the central target set for the end of 2008. Along with the strong acceleration of the growth rate of volatile prices and the sharper weakening of the domestic currency versus the euro, the adjustment of some administered prices – which turned again into a significant determinant of inflation – weighed heavily on the increase in the consumer price index. The inflation flare-up was also fuelled by the steady rise in the annual pace of growth of CORE2 inflation which, apart from the ongoing demand-side pressures, reflected some supply-side shocks attributed mostly to the marked surge in agri-food prices. The explanation for the high sensitiveness of core inflation to the developments in such prices lies with the unusually high share of agri-foodstuffs in the CORE2 index basket.

The updated forecast of medium-term macroeconomic developments highlights the ongoing worsening trend in the inflation outlook, which is however slower and shorter than that presented in the previous forecasting round. Thus, the new upward revision in the trajectory of the projected annual inflation rate as compared to the pattern expected in February is lower than the previous revision and refers only to the first part of the forecasting interval. In addition, the deceleration in inflation is expected to be faster in the latter part of this horizon, with the levels of the annual consumer price inflation being projected to fall beneath those shown in the previous forecast; they will however fall back into the variation band associated with the central target no earlier than 2009 Q2, similarly to the previous forecast.

Against this background, a serious cause for concern is the larger-than-previously-forecasted magnitude of inflation rate in the first three quarters of this year and the persistence beyond 2008 of the period during which the projected annual inflation rate stays above the upper limit of the variation band associated with the central target. Despite its temporary nature, the inflation flare-up which is mostly due to factors beyond the control of monetary policy, i.e. food and fuel price hikes as well as administered price adjustments, implies the risk of further worsening inflation expectations and that related to the price and wage setting behaviour over the longer term. At this juncture, such risks are aggravated by (i) the likely maintenance of lax income policy and (ii) the still tight labour market, even if some companies might prove reluctant to further pay rises given the significant build-up in ULC. The need to counter these risks requires an additional monetary policy rate increase that could anchor inflation expectations at levels compatible with attaining the medium-term inflation targets via its signalling effect.

Further monetary policy tightening and the ensuing maintenance of a highly restrictive stance over the longer term is also required by the expectations of a larger and more persistent positive output gap compared to the previous projection, which entails the risk of stronger and more protracted demand-pull inflationary pressures over most of the forecast horizon. A renewed delay in the elimination of excess aggregate demand could be prompted by (i) faster-than-expected annual GDP growth in 2007 Q4; (ii) the relative reduction in the current monetary conditions restrictiveness mostly due to the ongoing increase in the real effective exchange rate of the RON, but also to the lower real margin of the key interest rate despite the NBR's rate hikes October 2007 through March 2008; and (iii) the inherent lag in the effective transmission of the impact of increased restrictiveness of the monetary policy stance incorporated in the medium-run forecast.

In view of the recent developments, the relative reduction in the negative balance of net exports over the following quarters, upheld by a combination of faster export growth and slower import dynamics, could have a significant contribution to the protraction of the positive output gap. Given the short period during which exports outpaced imports, the sustainability of a faster dynamics of the former is yet uncertain. Another uncertainty is the magnitude of the possible impact exerted by the economic slowdown in EU Member States on external demand for Romanian products; a larger-than-expected increase in such an impact, albeit less likely, might lead to a smaller and shorter positive output gap.

However, the likelihood of a good performance of exports to continue in the period ahead is higher, assuming their rebound originates in the commissioning of new industrial facilities whose production is intended largely for external markets. Such an assumption seems to be underpinned by the sizeable expansion of foreign direct investment in 2007, as illustrated by the year-on-year 23 percent rise in the number of foreign-owned companies established in Romania. Under the circumstances, an additional reason for a likely strengthening of export growth is the quasi-certain outlook for starting or completing some greenfield investments by foreign companies, including those in activities connected to the industries where foreign funds were initially channelled.

As for imports, the possible slowdown in their growth pace is expected to derive more from a relatively slacker rise in domestic demand[72], most notably in private consumption rather than from a substitution effect triggered by a softer domestic currency. The strength of the action of some factors potentially capable of slowing household consumer demand could even surpass any expectations. Such an effect might result from a more sluggish dynamics of households' real disposable income – chiefly on the back of a brisker rise in food and fuel prices as well as administered price adjustments, coupled with a lower increase in residents' remittances – and from the ensuing substantial deterioration of prospects on such an income.

The dynamics of consumer demand could also be eroded by greater household debt service to banks, in both local and foreign currencies, as a result of the noticeable depreciation of the RON versus the EUR and the gradual increment in interest rates on consumer credit in response to the successive policy rate hikes. Similar effects could have a possible persistence of the uptrend in interest rates on EUR-denominated loans amid tighter terms and conditions associated with the funds lent to domestic credit institutions by parent undertakings. A sign for the possible emergence of liquidity constraints at household level is the slowing real annual growth rate of household deposits with banks starting December 2007. This state-of-affairs, combined with the abated optimism on household future income, might also result in a cooling-off of demand for bank loans.

Credit institutions' supply of household loans could in turn be constrained by: (i) credit institutions' less readily available and costlier funding in both local and foreign currencies given the ongoing decrease in structural excess liquidity within the banking system; (ii) higher provisioning for foreign exchange-

[72] Except for the base effect, including that of a statistical nature, from Romania's joining the EU.

denominated loans granted to unhedged borrowers, a measure taken recently by the central bank, and (iii) reduction in the level and scope of potential borrowers' eligibility following the relative drop in household indebtedness capacity against the background of slower increase in real disposable income of households.

Nevertheless, given the approaching run-ups to local and general elections, there is a risk that the anticipated contractionary effect on household consumer demand growth following the joint action of the above-mentioned factors could be largely offset by the expansionary impact of a relative easing of fiscal policy. Thus, the deceleration in private consumption dynamics might be slowed by both a stronger pro-cyclical feature of such a policy – the recent upward revision of the programmed budget deficit notwithstanding – and the increase in the share of wage and social security expenditures in total public spending.

In turn, an easing of income policy in the budgetary sector might lead to the emergence of a demonstration effect on private-sector wages; against this backdrop, the effect would be enhanced by labour market tightening and the likely exacerbation of wage claims, also as a result of the possible deterioration of inflation expectations. Aside from the stimulative impact on consumer demand, the real wage growth remaining close to the levels seen in 2007 might perpetuate the wage-productivity mismatch and put additional upward pressure on corporate spending, thereby entailing a weaker external competitiveness, together with the threat of a dangerous wage-inflation spiral, assuming that the worsening of companies' balance sheets would prompt employers accept higher unit labour costs being passed on to the consumer.

By contrast, the risk that the movements and the behaviour of the RON exchange rate might further boost to a great extent both inflation and inflation expectations appears to have diminished significantly of late, yet it is uncertain how sustainable such a development would be. Assuming the appreciation of the domestic currency is triggered by the restored risk appetite of financial investors and/or their improved perception on the prospects of the Romanian economy, this trend which has become manifest recently could carry on. The continued increase in the interest rate differential as against global markets could even cause such a trend to sharpen to the extent to which investor stance towards the domestic market would not be impaired by other episodes of heightening tensions and uncertainties on international financial and money markets, or by unfavourable shifts in domestic economic fundamentals, including the economic policy conduct.

Against this backdrop, a return of inflation to a trajectory compatible with attaining the medium-term targets can only be achieved in a sustainable and cost-efficient manner through increased consistency of the entire policy mix. Along with an adequately tight monetary policy, this implies a considerable strengthening of fiscal policy, a more prudent income policy as well as 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 generate the risk of destabilizing the financial system and would come at substantial 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.

Given the unfavourable inflation outlook over the first part of this forecasting horizon, as well as the persistence and prevalence of upside risks to inflation, the NBR Board has decided to raise the monetary policy rate by 0.25 percentage points to 9.75 percent per annum and to continue to pursue a firm management of money market liquidity via open-market operations. Moreover, with a view to consolidating the restrictiveness of broad monetary conditions, the NBR Board has decided to leave unchanged the minimum reserve requirement ratio on RON-denominated liabilities at 20 percent and the minimum reserve requirement ratio on foreign exchange-denominated liabilities of credit institutions at 40 percent. In the current macroeconomic context, the NBR Board is restating that the implementation of a coherent mix of macroeconomic policies and stepped-up structural reforms are essential to bring the annual inflation rate during 2009 towards the trajectory compatible with attaining the announced medium-term target.

At the same time, in order for the central bank to strengthen the efficiency of money market liquidity management and implicitly to increase the impact of monetary policy tools on short-term interest rates on this market, the NBR Board has decided to reduce the maturity for standard deposit taking open-market operations to one week from two weeks. Furthermore, in order to consolidate the signalling role of the monetary policy rate and reduce the volatility of interbank money market rates, a symmetrical corridor of ±4 percentage points around the monetary policy rate for the interest rates on the NBR standing facilities was set up. Therefore, the interest rate on the NBR deposit facility was raised to an annual 5.75 percent from 2 percent while the rate on its lending facility (Lombard credit) was set at an annual 13.75 percent versus 12 percent previously. In addition, the penalty rate for deficits of RON-denominated minimum reserves was raised to an annual 20.5 percent from 18 percent. These adjustments to the monetary policy operational framework of the National Bank of Romania are part of a gradual process of alignment to that of the European Central Bank.