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INFLATION REPORT

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N O T E

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

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

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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 29 July 2008 and approved by the NBR Board in its meeting of 31 July 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
FOMC	Federal Open Market Committee
GFCF	Gross Fixed 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

In June 2008, the 12-month inflation rate stood at 8.61 percent, a level almost unchanged from 8.63 percent in March. This development validates the previous projections of the National Bank of Romania according to which the rise in inflation that began in 2007 Q2 would come to a halt in 2008 Q2.

While supply-side factors had diverging effects on price increases, aggregate demand pressure acted as a deterrent to disinflation, which accounts to a large extent for the CORE2 inflation rate rising further in June over March 2008.

In 2008 Q2, disinflationary effects came mainly from the significant slowdown in the growth rate of administered prices and volatile prices of some food items such as vegetables, fruit and eggs. Opposite effects were exerted by the prices of processed food making up about 38 percent of the CORE2 inflation basket, which saw faster year-on-year rates of increase than in the previous quarter, reflecting the build-up of pressures on the agri-food market. Moreover, fuel prices rose at a considerably swifter pace as a result of surging oil prices on global markets.

Unit labour cost kept rising January through May 2008 owing to labour market tensions, generating inflationary effects through both cost-push pressures and the contribution of increasing wages to excess demand.

The persistence of cumulative effects of inflationary shocks during the past four quarters resulted in a steady worsening of inflation expectations, which further induced second-round effects on CORE2 inflation in the quarter under consideration.

The strong acceleration of economic growth (up to 8.2 percent) in 2008 Q1 translated into significantly stronger excess demand pressures, thus contributing to higher CORE2 inflation in 2008 Q2. The key driver of the rapid GDP growth was the surge in both investment and final household consumption, underpinned by sizeable increases in household and corporate income and credit to the private sector, as well as by the substantial advance in public expenditures earlier this year. The widening share of imports in domestic demand caused an increase in the negative contribution of net external demand to GDP growth, despite an acceleration of export growth.

Monetary policy since the release of the previous Inflation Report

After examining the most recent macroeconomic developments, the May inflation forecast and its related risks, the NBR Board decided to raise the monetary policy rate to 9.75 percent per annum in its meeting of 6 May 2008.

Following this decision, signs of further deterioration in the short-term inflation outlook came especially from fast wage and non-government credit dynamics, oil price developments and the information regarding the anticipated increases in administered prices, for natural gas and electricity in particular, as well as in excise duties. The release of official figures on first-quarter growth confirmed that some of the risks mentioned in the previous Inflation Report, such as the additional increase and the persistence of excess demand pressures, had actually materialised.

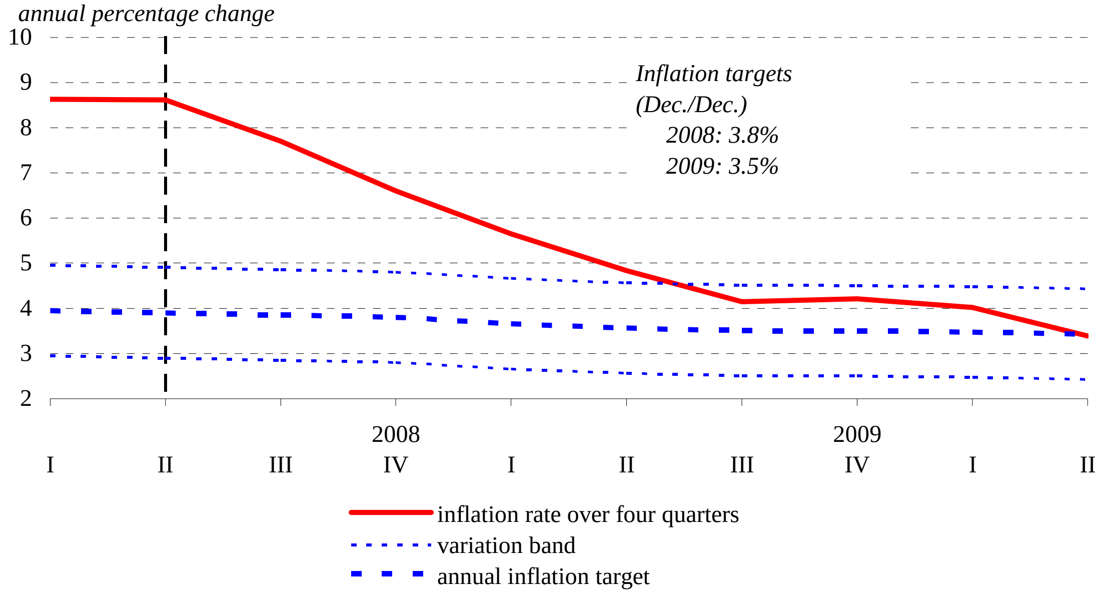
In response to these developments, the NBR Board decided in its meeting of 26 June 2008 to raise the monetary policy rate to 10 percent per annum. The decision was meant to maintain an appropriate restrictiveness of the monetary policy stance in order to avoid further worsening of inflation expectations and to contain demand-pull inflationary pressures.

Throughout the period under review, the National Bank of Romania carried out a firm management of money market liquidity, thus maintaining the average interbank rate in the immediate vicinity of the monetary policy rate.

Inflation outlook

The baseline scenario of the current projection places the 12-month inflation rate at 6.6 percent for end-2008, 0.6 percentage points above the figure published in the May 2008 Inflation Report. For end-2009, inflation is forecasted to stand 0.7 percentage points above the previously projected level (4.2 percent versus 3.5 percent).

Inflation Forecast



Note: Variation band is ±1 percentage points around the central target

Source: NIS, NBR calculations

The inflation forecast was revised upwards due to adverse effects, compared to the previous projection, coming from stronger excess demand pressures, boosted by faster-than-expected GDP growth in 2008 Q1 and underpinned by the ongoing rapid expansion of public-sector wages and the planned pension hikes. Other adverse effects include less optimistic scenarios regarding administered and fuel prices and higher inflation expectations. These influences are only partly offset by more favourable projections of the dynamics of import prices and volatile prices of some food items.

The successive monetary policy rate increases implemented since October 2007 led systematically to an adequate tightening of the real monetary conditions. This effect was partly mitigated by stronger inflation expectations against the background of some risks mentioned in the previous Inflation Reports becoming manifest, most notably the faster increase of both household disposable income and public spending in the first part of 2008. In turn, the monetary policy rate increases dampened the rise in inflation expectations. Starting with 2008 Q3, these expectations are projected to become anchored to a downward trajectory once the disinflation process resumes. Nevertheless, the resumption of disinflation is contingent upon the other components of the macroeconomic policy mix (fiscal and income policies) remaining within the coordinates envisaged in the baseline scenario. This will allow a gradual increase in the restrictiveness of real monetary conditions, growing firmer in 2009, thereby facilitating the phasing-out of excess demand during the second half of 2009. The elimination of inflationary pressures induced by aggregate demand, along with the dissipation of second-round effects from previous inflation shocks, will help consolidate disinflation towards the end of the forecasting horizon.

Compared to the previous forecasting rounds, the baseline scenario of the current projection is surrounded by increased uncertainties related to both the consistency of macroeconomic policies in the election run-up and the persistence of global market tensions. Major risks are generated by potential unfavourable developments that might entail, should they become manifest, upward deviations of inflation from its projected path. These include: ongoing wage rises in excess of productivity gains, lack of coordination of fiscal and income policies with monetary policy, renewed depreciation of the domestic currency due to shocks on global markets, and a further worsening of inflation expectations.

Other important risks to the current projection include the uncertainties about the future movements in the oil price on external markets. The oil price has a substantial impact on aggregate price dynamics given the share of petroleum products in the CPI basket and the second-round effects generated by oil price changes, inflation expectations included. While the current projection assumes a global oil price of USD 140 per barrel, uncertainties regarding the economic growth in the USA and other OECD countries over the projection horizon may cause both-way deviations from the level envisaged by the projection. The consequences of larger-than-projected hikes in administered prices are noteworthy as well. Implementing a coherent mix of firm macroeconomic policies would eliminate the risk of policy slippages and could reduce the likelihood of some of the other risks materialising.

Monetary policy decision

Given the updated forecast of the medium-term macroeconomic developments and the prevalence of upside risks to inflation, the NBR Board has decided to raise the monetary policy rate by 0.25 percentage point to 10.25 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 current minimum reserve requirement ratios on both RON- and foreign currency-denominated liabilities of credit institutions. Against this background, the NBR Board reaffirmed its resolution to firmly gear monetary policy towards countering demand-pull inflationary pressures and anchoring inflation expectations, emphasising the need for enhanced support to monetary policy from the other components of the macroeconomic policy mix, as well as from structural reforms.

II. INFLATION DEVELOPMENTS

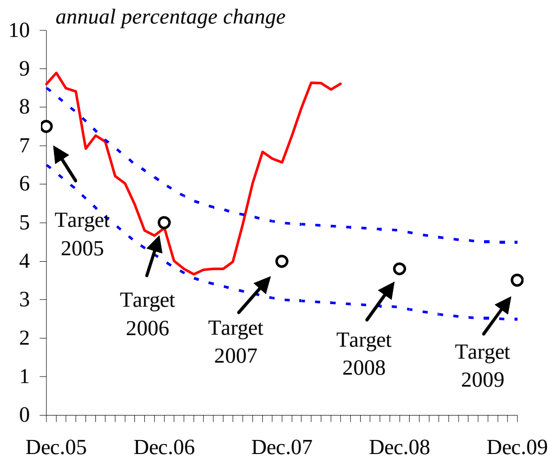
In 2008 Q2, the 12-month inflation rate continued to deviate from the ±1 percentage point variation band around the target of 3.8 percent set for end-2008. At end-June, the annual inflation rate stood at 8.61 percent, a level almost unchanged from 8.63 percent in March. Among the drivers of this performance remained the build-up of tensions on the agri-food market, the pronounced upward trend in the international oil price and the unfavourable base effect generated by low inflation in the first half of 2007. The persistence of excess demand, fuelled by the fast-paced increase in household income, and the worsening of inflation expectations paved the way for supply-side shocks to pass through into consumer prices. In this context, core inflation continued its steadily upward trend over the past four quarters, reaching 8.1 percent in June 2008.

The faster upward trend in the fuel price (up 2.1 percentage points in year-on-year terms) and the acceleration in core inflation (by 1.2 percentage points) were the main drivers behind the further high headline inflation. Unlike the past two quarters when the dynamics of volatile food prices was a major source of pressure, during the quarter under review, it decelerated by 4.6 percentage points, with the satisfactory level of the 2008 crops allowing an improvement in supply.

Given the absence of regular corrections to energy prices, the growth of administered prices moderated, their annual change falling significantly below average. The 3.1 percentage point deceleration was due mainly to the dissipation of the base effect generated by the adjustments made April through June 2007 in the rents established by the local government, to the electricity price and to the city and railway transport prices. The other components had a net positive contribution, particularly as a result of the year-on-year depreciation of the domestic currency versus the euro, illustrated by the faster dynamics of prices for fixed telephony services and, possibly, by the slower decreasing trend in medicine prices.

During the period under review, CORE2 inflation followed the upward trend manifest ever since August 2007, with food prices accounting for almost 50 percent of the CORE2 index basket (their annual dynamics accelerated by 2 percentage points). Unlike the previous quarter when the pressures on prices for milling and bakery products lost strength as a result of the favourable signals on the 2008 crops, during Q2 the prices of staple foods included in CORE2 saw faster growth rates.

Inflation Developments

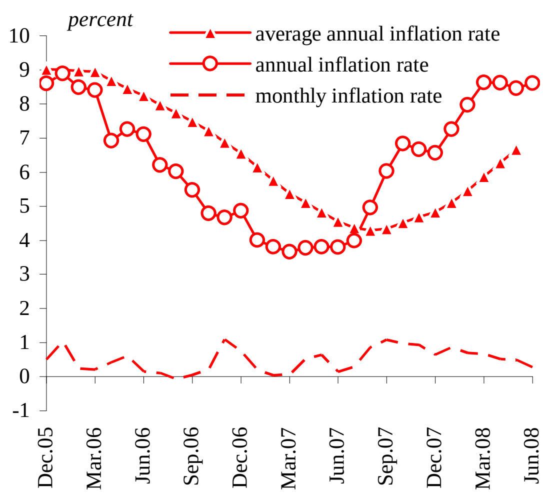


Note: ±1 percentage point around the (dis)inflation path

Source: NIS, NBR calculations

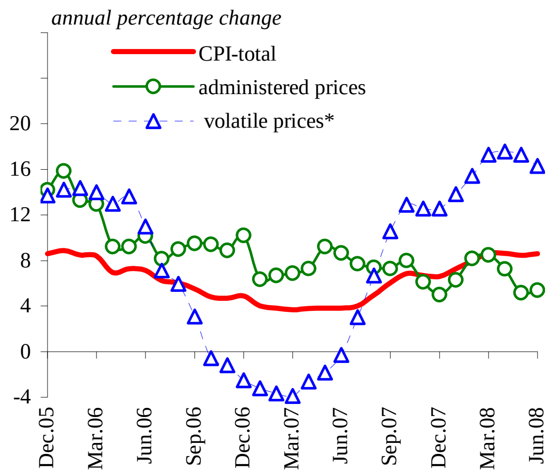
Inflation Rate

a)



Source: NIS, NBR calculations

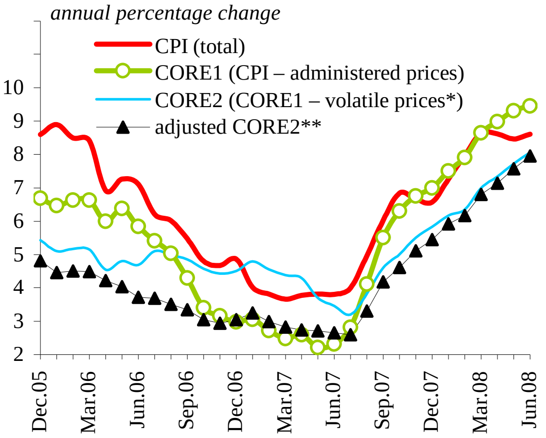
b)



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

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation



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

**) excluding tobacco and alcohol

Source: NIS, NBR calculations

The developments reveal either a base effect (milling and bakery products), or the pressures exerted by commodity prices (the costs related to edible oil, milk and meat – markedly alleviated on the last two segments by the dampening impact of competition from imports).

The upward trajectory of the annual change in the non-food prices included in core inflation was less pronounced (up 0.2 percentage points to 5.1 percent in June). Most commodity groups recorded higher growth rates, particularly durables (household appliances and motorcars) whose prices are directly anchored to the RON/EUR exchange rate (regardless of the origin market) and which were subject to mounting pressures from consumer demand in the first half of 2008[1]. By contrast, the prices of semi-durables (clothes and footwear) witnessed relatively significant decelerations in their annual changes (to 0.7 percentage points), accounting for less than half of non-food related CORE2.

Administered Prices versus Market Prices

annual percentage change; end of period

	2007			2008	
	II	**III**	**IV**	**I**	**II**
Inflation Rate	**3.8**	**6.0**	**6.6**	**8.6**	**8.6**
Administered prices*	**8.7**	**7.3**	**5.0**	**8.5**	**5.4**
1. Non-food items*:	**6.5**	**5.7**	**0.5**	**4.2**	**2.8**
electricity	9.0	9.0	4.2	4.2	0.0
heating	20.8	20.8	5.8	5.9	6.0
natural gas	6.3	4.7	0.0	12.4	12.4
medicines	-4.2	-5.7	-6.7	-4.2	-3.5
2. Services*, of which:	**12.5**	**10.2**	**13.2**	**16.7**	**10.4**
water, sewerage, waste disposal	14.6	14.1	12.0	12.0	11.1
fixed telephony	0.0	-5.1	3.4	10.4	13.3
passenger railway transport	29.8	37.2	27.4	16.5	8.1
(passenger) city transport	5.2	6.8	7.5	11.1	9.1
Market prices (CORE1)	**2.3**	**5.5**	**7.0**	**8.6**	**9.5**
CORE2**	**3.5**	**4.6**	**5.8**	**7.0**	**8.1**
CORE2 less tobacco, alcohol	2.7	4.2	5.5	6.8	8.0
tobacco, alcohol	12.7	9.3	10.0	9.0	9.2

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

Source: NIS, NBR calculations

Nevertheless, mention should be made that the acceleration in the annual CORE2 inflation of non-food prices was rather the result of a base effect, as current developments point to an alleviation of inflationary pressures (the quarterly change came in at 0.9 percent, down from 1.2 percent in Q1). The strengthening of the RON against the EUR (by 1.8 percent April through June 2008) is the main reason behind the favourable movement in prices of such commodities, given that the other pressure factors do not show any signs of easing – excess demand larger than in the previous quarter, significantly positive growth rates of the costs related to commodities and labour force, rising inflation expectations. The competition driven by the expansion of modern trade outlets continued to have a beneficial influence not only on non-food prices. In 2007, the share of modern trade outlets in fast-moving consumer goods market went up 6 percentage points to 40 percent[2], while in 2008 this trend may become broad-based in the context of opening a significant number of outlets in H1.

The upward trend in the annual growth rate of prices of market-priced services (up 1.3 percentage points to 7.6 percent) may be associated to a great extent with exchange rate changes, as most component groups are sensitive to this influence (mobile telephony, public food services, cultural and tourism services, personal care services).

[1] The volume of sales of durables recorded significant growth rates which outpaced consistently the dynamics of non-durables January through May 2008.

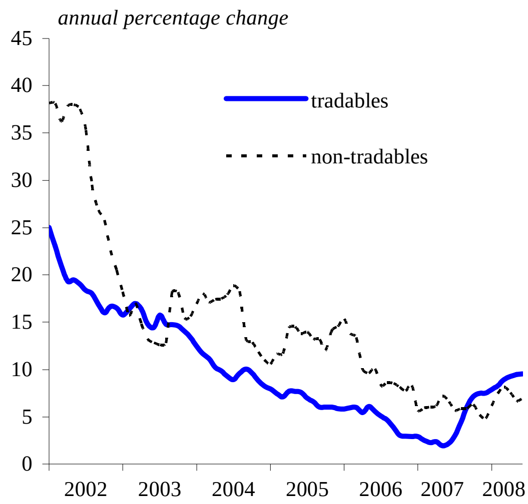
[2] According to GfK Romania (Romanian Business Digest, March 2008).

While in some sectors that are exposed to international competition domestic prices (of some food items, wearing apparel, footwear) continued to be positively influenced, across the tradables group as a whole prices were further influenced by the tensions on the global agri-food and oil markets. Thus, the annual growth rate of tradables prices remained on an upward trend, reaching 9.5 percent in June 2008 (up 0.6 percentage points versus March 2008). By contrast, prices of non-tradables witnessed a trend reversal, falling 1.2 percentage points to 7 percent, mainly as a result of the slower dynamics of administered prices.

Although the strong increase in food and energy prices had an impact on inflation in other European countries as well, the rise in the general level of prices was more pronounced in Romania than in most of them. The higher relative weight of the respective components in the consumer basket accounts largely for the varying impact; however, the negative developments in the key drivers of inflation, such as demand, wages, exchange rate, should not be overlooked. Thus, from the viewpoint of both the gap between the average annual HICP inflation rate and the average inflation rate for EU-27 (4 percentage points versus 3.2 percentage points) and the corresponding nominal convergence criterion (up 3.3 percentage points versus 2.7 percentage points at the end of 2008 Q1), the readings recorded in Q2 were above those seen in March.

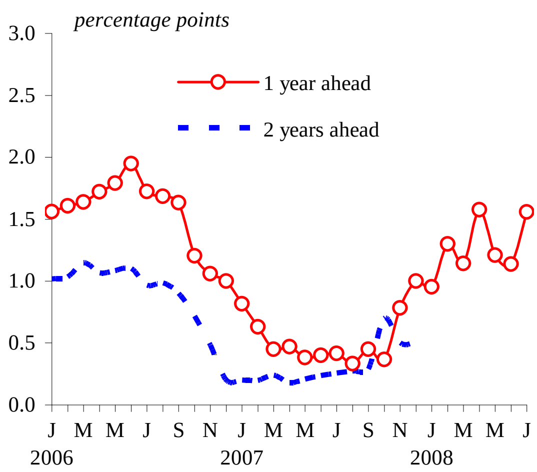
In June 2008, the actual annual inflation rate was only 0.1 percentage points above the projection in the May 2008 Inflation Report owing to the higher-than-projected increase in the fuel price.

Tradables and Non-tradables Prices



Source: EUROSTAT, NBR calculations

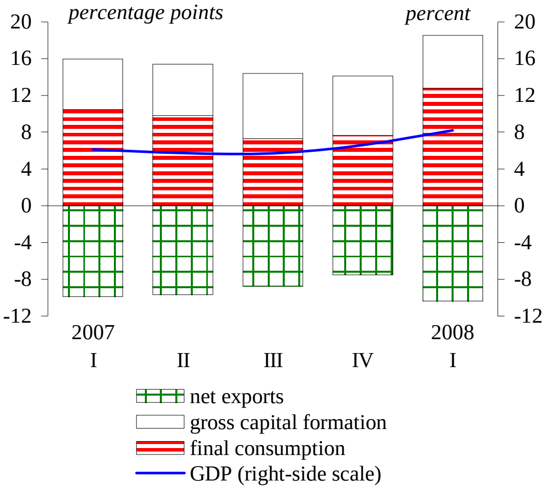
Deviation of Expected Inflation from Annual Inflation Target



III. ECONOMIC DEVELOPMENTS

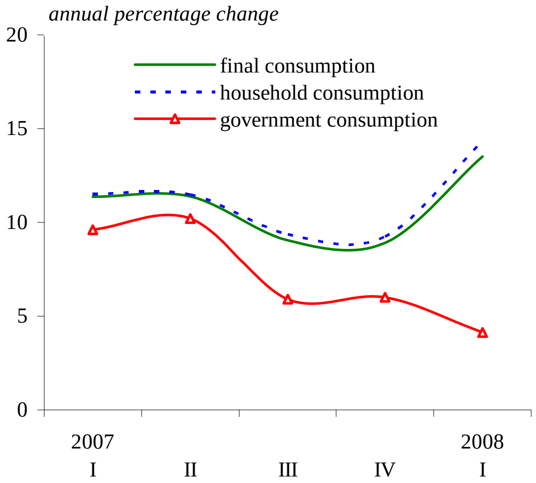
1. Demand and supply

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

Actual Final Consumption



Source: NIS

In 2008 Q1, provisional data on national accounts point to an 8.2 percent[3] increase in real GDP, i.e. one of the highest annual growth rates since 1999[4], outpacing by 1.6 percentage points the dynamics in 2007 Q4 and by 1.3 percentage points the March benchmark projection. The economic growth pattern remained broadly unchanged versus the previous quarter, featuring a fast-paced dynamics of domestic demand eroded however by the cooling-off in net external demand. On the supply side, the step-up in the GDP growth rate was underpinned by all economic sectors, given that industry and services posted faster annual dynamics, the construction sector recorded another above-30-percent expansion, and the decline in agriculture moderated significantly.

1.1. Demand

In 2008 Q1, the growth rate of domestic absorption saw a significant step-up over the previous quarter (from 12.4 percent to 15.9 percent). This performance was attributable to the fast-paced increase in final consumption and fixed capital investment. In view of the contained domestic supply, this acceleration was however accommodated by the very strong step-up in imports of goods and services (up 35.2 percent). Therefore, the contribution of net external demand to GDP growth posted an unprecedented deterioration during 1999-2008 to reach -10.4 percentage points.

1.1.1. Consumer demand

In Q1, the growth rate of final consumption accelerated to 13.5 percent, mainly owing to the private component whose dynamics surpassed markedly that in the previous quarter (up 14.3 percent); government final consumption posted a slower annual growth rate.

Household consumer demand

The acceleration by 5.1 percentage points in the dynamics of household actual final consumption was due more to the

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

[4] The annual GDP index volume series with a quarterly periodicity refers to the period starting in 1999.

expansion in purchases of goods and services (18 percent versus 15.4 percent in 2007 Q4) rather than to the trend reversal on the "self-consumption and expenditures on purchases on the agri-food market" segment, which can be attributed to the upturn in the production of meat and milk. By contrast, the dynamics of expenditures for individual consumption incurred by public and private governments slowed down to 2.3 percent.

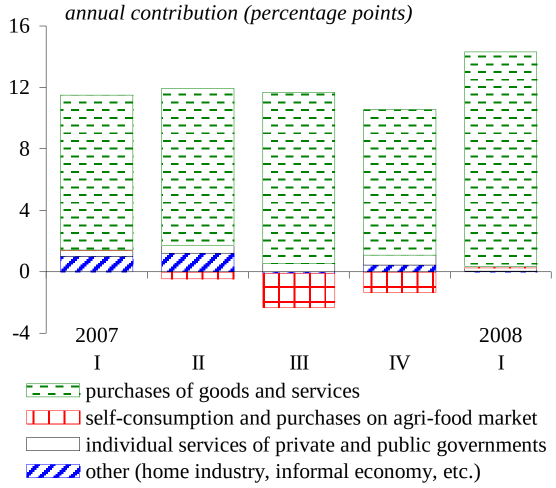
Nevertheless, from the viewpoint of the inflationary potential of consumer demand, the fast-paced increase in the annual growth rate of household spending on retail purchases of goods and services may not put a similar pressure on the consumer price index. The analysis of retail sales by group of commodities reveals that motor vehicle sales (with an average annual growth rate of about 44 percent versus 2 percent in the previous quarter) were seen as the key driver of this performance, in spite of their holding merely 1.6 percent of household consumer basket.

However, a drop in the inflationary potential exerted by consumer demand is little likely, given that, in spite of the strong deceleration, the dynamics recorded by the sales of food and beverages – accounting for the largest share of the consumer basket – was further fast (the 14.7 percent growth rate illustrated households' appetite for consumption which was large enough to facilitate the pass-through of price increases caused by costlier agricultural commodities and the worsening of producers' inflation expectations).

As concerns the financing sources of private consumption, the step-up in the annual dynamics of household expenses for goods and services was underpinned mainly by own resources – the growth rate of disposable income[5] accelerated by almost 4 percentage points in real terms versus the previous quarter to 16.7 percent, with the impact on consumer demand being amplified by the drop in the propensity to save. Likewise, the lack of official statistics notwithstanding, incomes from the informal economy may have witnessed favourable developments, in view of the significant progress in some sectors such as construction, which reported a higher incidence of this phenomenon.

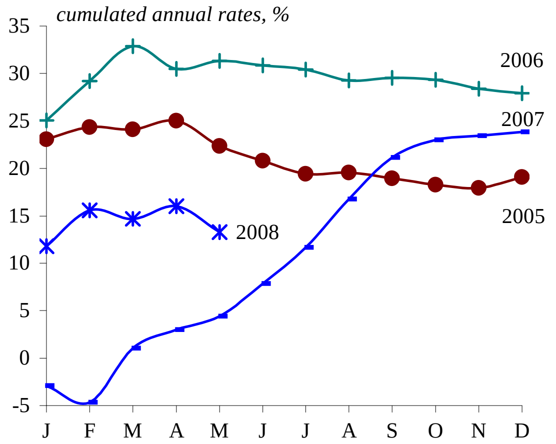
Financing via loans continued to be one of the channels fostering private consumption, consumer loans posting further a fast dynamics in real terms.

Household Final Consumption by Expenditure



Source: NIS, NBR calculations

Retail Trade* of Foodstuffs, Beverages and Tobacco



*) turnover volume
Source: NIS. NBR calculations

[5] 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.

The analysis by market of origin illustrates the increasing contribution of imports to meeting the demand for consumer goods – imports kept expanding[6], whereas the turnover volume relative to the production destined to the domestic market decreased markedly[7].

Government consumption

Compared with 2007 Q4, government final consumption recorded a decline in its annual dynamics (from 6 percent to 4.1 percent), along with a substantial slowdown in the growth rate of job creation in the government sector.

Budgetary developments

The consolidated general budget posted a surplus of about RON 79 million at the end of 2008 Q1, accounting for approximately 0.02 percent of the GDP projected for this year, as the deficit target for 2008 was lowered in the first ten-day period of March from 2.7 percent of GDP to 2.3 percent. Both components of the consolidated balance showed an uptrend versus the same year-ago period, when the consolidated general budget recorded a deficit of about 0.1 percent of GDP, the share of revenues and expenditures in GDP rising 2.3 percentage points and 2.2 percentage points respectively.

In 2008 Q1, the annual growth rates[8] of both budget revenues and budget expenditures hit a two-year high. The annual dynamics of revenues reached almost 44 percent, against the backdrop of a significantly faster pace of increase of receipts, especially from VAT[9], non-tax revenues (mainly from leasing, rentals and dividends), as well as receipts from social security contributions. The annual growth of budget expenditures ran at approximately 41 percent, on the back of the rapid dynamics of most categories, especially capital expenditures (including those resulting from the settlement in January 2008 of payments made in December 2007), subsidies, interest payments and staff costs[10].

[6] The change in the physical volume of exports and imports was calculated based on balance-of-payments data deflated by unit value indices.

[7] The volume of sales of domestic industrial companies on the local market recorded a slower dynamics in the case of both non-durables and durables (11.9 percent and 14.6 percent respectively). By contrast, the dynamics of the physical volume of non-durable imports trebled to 19 percent, while the physical volume of imports of durables increased, albeit slower, in a range from 15.5 percent to 38.3 percent in the main categories identifiable on the basis of the Combined Nomenclature.

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

[9] A base effect is still manifest, resulting from the change in the collection manner in the first part of 2007.

[10] Their developments were influenced by the base effect resulting from the change in the actual timing of the payment of the annual bonus to public sector employees.

Nevertheless, the budget execution figures for Q2 witnessed a trend reversal. Thus, the consolidated general budget for the first five months of 2008 posted a negative balance of approximately 0.4 percent of the projected GDP, compared with a surplus of 0.2 percentage point at end-May 2007. These developments, along with the estimates for June, suggest a pick-up in consumption and public investment growth.

1.1.2. Investment demand

Provisional statistical data for the period under review show an ongoing sharp uptrend in gross fixed capital formation. The 33.2 percent advance marks a Q1 high in the contribution of the investment component to GDP dynamics (almost 7 percentage points).

Massive investments were further recorded across the major segments: (i) construction works (about 32 percent), consisting of both new construction works and capital repair and (ii) equipment purchase (including transport means purchased by companies and institutions), as the growth rates of both components picked up again to 35.4 percent.

The step-up in capital investment was bolstered by the own sources of the corporate sector and households, as well as by considerable funds from the public budget for the implementation of investment projects. The consolidated general budget execution shows a 2.5 time increase in real terms of capital expenses, largely on account of the more than fourfold rise in local government expenditure. These developments were partially due to this year's election. The same as in the previous quarter, borrowings from domestic commercial banks and leasing companies recorded a fast-paced increase. Thus, bank loans for equipment purchase and real estate loans advanced by 21.6 percent and 84.9 percent respectively[11].

As for foreign financial inflows, Q1 did not see an increase in the financing of capital goods purchases, given that the annual dynamics of EUR-denominated medium- and long-term loans taken by the real sector decelerated almost ten times against the 2007 average, to 7.7 percent. Furthermore, placements of non-residents in the form of foreign direct investment contracted again by more than 30 percent when expressed in euro[12].

Investment

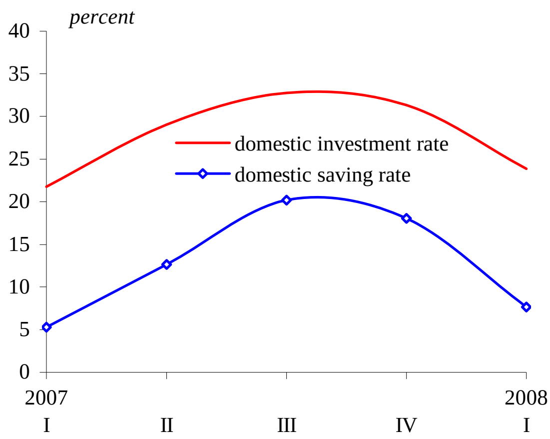
annual percentage change

	Year	I	II	III	IV
Total	2007	22.8	28.3	31.9	29.5
	2008	35.2			
- new construction works	2007	27.9	32.8	38.9	26.4
	2008	33.1			
- equipment	2007	19.0	22.7	25.3	32.1
	2008	35.4			
- other*	2007	20.3	48.5	24.3	29.8
	2008	49.9			

* 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 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

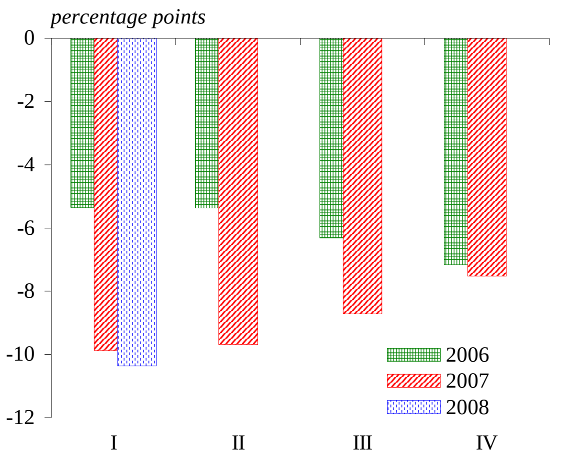
[11] Changes in real terms, calculated based on data provided by the Central Credit Register.

[12] Average dynamics for the last four quarters (rolling basis).

By market of origin, in Q1 there were no significant changes in the preference for purchases of domestic/imported capital goods[13], as both segments posted considerably slower rises.

1.1.3. Net external demand

Net External Demand Contribution to GDP Growth

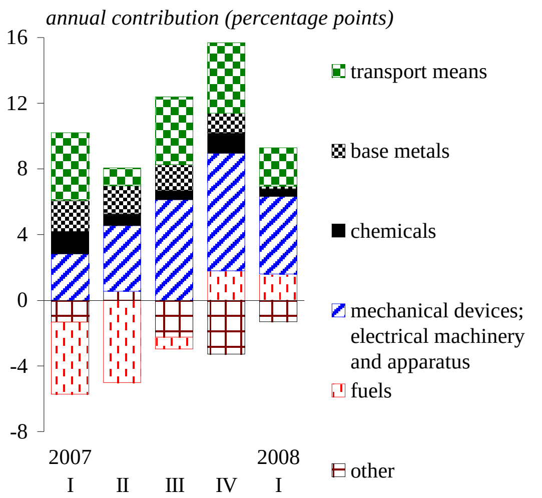


Source: NIS, NBR calculations

According to provisional national account data released by the NIS, in 2008 Q1, the negative contribution of net external demand to economic growth widened from -7.5 percentage points to -10.4 percentage points, the expansion of imports (+35.2 percent) outpacing the marked rise in exports (+24.6 percent, up around 10 percentage points, for the second time in a row).

The said volume changes should be considered under the reserve that they are based on deflator estimates, as foreign trade unit value indices (UVI) were not available upon the issue of the preliminary quarterly national accounts[14]. Caution is justified all the more so as when analysing import developments, given that for the first time since 2007 Q1[15] the trajectory of prices suggested by the estimated deflator (decrease in excess of 6 percent) is contrary to that indicated previously by the UVI and particularly to that based on the nominal depreciation of the RON.

Export Physical Volume



Source: NIS, NBR calculations

Therefore, after trade balance positions are deflated by the UVI, foreign trade developments show a completely different picture. In fact, these calculations are indicative of deceleration in the case of both exports and particularly imports of goods, up to +8 percent and +9.1 percent respectively. In addition, the recalculated level of the contribution of net external demand to GDP dynamics is around -3 percentage points, showing a substantial improvement from 2007 Q4.

Structural analysis of the physical volume of exports reveals that "mechanical and electrical machinery and apparatus" and "transport means and materials" made the largest contributions to the slowdown, although the annual growth rates for Q1 remained rather fast (22.1 percent and 19.8 percent

[13] Turnover volume relative to the manufacturing of capital goods (including transport means) destined to the domestic market and that for imports of mechanical and electrical machinery and apparatus grew by only 1 percent and 8.2 percent respectively versus the same year-ago period. Only transport means imports posted a faster dynamics (18.1 percent, i.e. half the pace recorded in 2007 Q4).

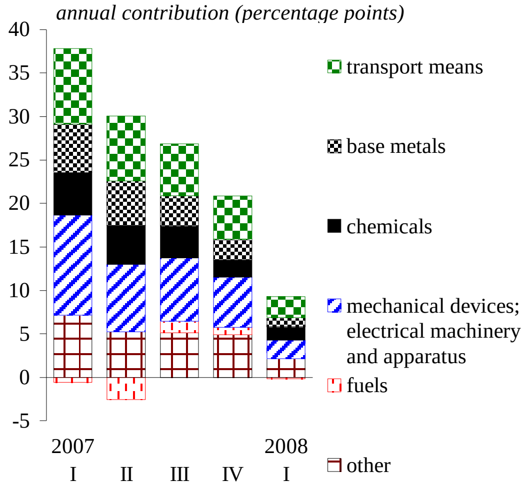
[14] By 1 January 2007, statistics on foreign trade with the EU Member States relied on data provided by the National Customs Agency. Subsequent to Romania's joining the EU, customs declarations were replaced by Intrastat statistical declarations of foreign trade companies, which burdens the collection process, causing the delay in the release of the UVI.

[15] The first quarter for which UVI estimates replaced final data.

respectively). A high rate of increase, albeit lower compared to the prior quarter, was also seen by fuel exports (+23.2 percent), amid favourable global environment. The downward trend of light industry exports in recent years continued into Q1 (over 10 percent drop in physical volume), as a result of still low competitiveness on foreign markets[16].

As regards imports, the decline to less than half in the annual dynamics of physical volume compared to 2007 Q4 was due largely to a base effect associated to Romania's accession to the EU on 1 January 2007, namely the simplification of customs formalities and the introduction of a new registration method for intra-EU imports.

Import Physical Volume



Source: NIS, NBR calculations

1.2. Supply

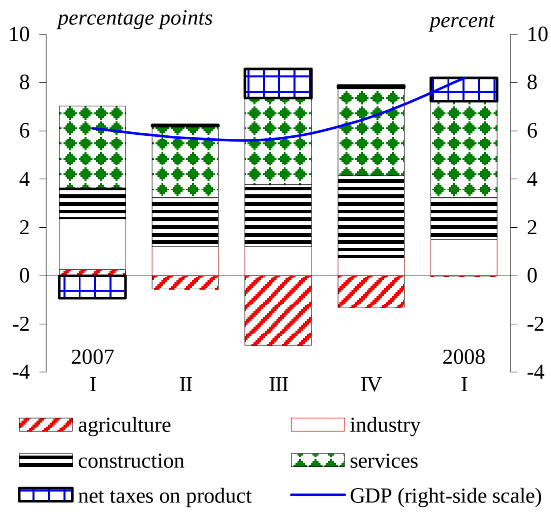
In 2008 Q1, all economic sectors provided support to GDP growth.

As for the agricultural sector, given the specific weather conditions in the first months of the year (the negligible position of the vegetable sector), the improved performance of meat and milk production entailed the substantial slowdown of the drop in gross value added for the entire sector (from -16.5 percent in 2007 Q4 to -0.5 percent in the period under review).

The increase in gross value added in the construction sector (32.4 percent) was supported by growth in all its components (residential, non-residential and engineering works).

In industry, the annual growth rate of gross value added accelerated compared to 2007 Q4 (from 3.5 percent to 5.4 percent) as a result of higher growth rates in the manufacturing and energy sectors, whereas the mining sector further experienced production shrinkage following natural decline and technological disruptions associated with the modernisation programme.

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

The manufacturing production expanded mainly on account of developments in (i) the food industry (annual growth rate trebled versus 2007 Q4 to reach 6.5 percent, associated with the expansion of production capacities, with the steady rise in demand over the past years supporting producers' investment effort) and (ii) the road transport means industry, where production stuck to a sharply upward path (+25.8 percent) despite the industrial action taken by *Automobile Dacia* company in the last week of March.

[16] Despite the substantial easing of pressures on producer prices indicated by the current development of ULC in wearing apparel and leatherwear and footwear.

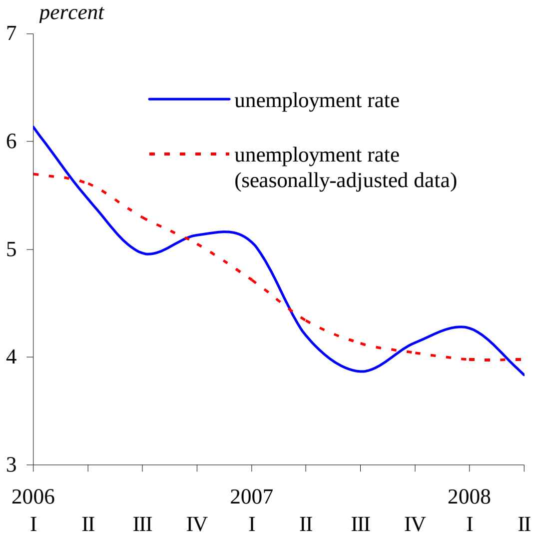
Gross value added of services exceeded yet again 7 percent on an annual basis[17], “trade, motorcar repair, hotels and restaurants, transports and telecommunications” posting the fastest growth rate (10.7 percent). The other two components of the services sector, i.e. “financial, real estate activities, rentals and services rendered to companies” and “other services” saw annual growth rates of 5.3 percent (slightly up from the prior quarter) and 3.5 percent respectively.

2. Labour market

Pressures on the labour market remained high in the first months of 2008 and the difficulties encountered by employers in recruiting staff heightened, with excess workforce supply at a low ebb. This state of affairs is further evidenced by the vigorous growth of wages but the negative gap between the annual change of ULC and that of production costs (around 5 percentage points) illustrates the strong impact of other cost elements (raw materials in particular) on price dynamics.

2.1. Labour force

Unemployment Rate



Source: NEA, NBR calculations

The registered unemployment rate (seasonally adjusted) stood at 4 percent January through May, showing that excess workforce supply reached a low ebb, and employers’ chances to recruit staff on the domestic market are getting slimmer. This inference is also confirmed by the development of ILO unemployment which, in 2008 Q1, saw the lowest quarterly rate in recent years (6.3 percent).

However, in terms of workforce demand, statistical data show different pictures. Data released by the NEA confirmed the decline in workforce demand, the number of vacancies and hirings reported in the first five months of 2008 posting a lower level year on year (by 13.1 percent and 16.1 percent respectively). For the same period, NIS data point to the rise in the number of employees economy wide by more than 100,000 which is in line with the economic expansion in Q1; the main sectors that took in workforce were construction and services, as well as some industrial sub-sectors where new production facilities were established (rubber and plastic products, metallic

[17] Starting with Monthly Bulletin No. 1/2008, the NIS no longer releases national account data for the services sector as a whole, but separately, by segment, as follows: (i) trade, motorcar repair, and household appliances, hotels and restaurants, transports and telecommunications; (ii) financial and real estate activities, 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 industry-wide developments, a weighted arithmetic mean of volume indices relative to the said components was calculated.

construction, radio and television, and communication equipment).

Employers' HR strategies relying increasingly on own efforts (they opted for direct hiring or via recruiting agencies), without resorting to the NEA, may be seen as a reason behind the said discrepancy. Such behaviour is understandable for employers in sectors facing persistent skilled staff shortages such as engineering, healthcare, finance and banking sector, hotel industry, for which the NEA job supply is limited – 80 percent of the jobless have only attended secondary or, at best, vocational education.

2.2. Incomes

During January-May 2008, the annual growth rates of net wages in the majority privately-owned sector (industry, construction and non-budgetary services) remained strong (around 20 percent in nominal terms) due to (i) the rise in minimum wage economy wide starting with January 2008 (from RON 390 to RON 500); (ii) bonuses and financial inducements; (iii) wage bargaining imposed through ample trade union movements in some key sectors[18] and implemented as of an earlier date. As regards the public sector, the annual growth rates of net wages stood at nearly 30 percent February through May[19], due to wage hikes and financial inducements as well as the implementation of the first stage of wage increases (6 percent) approved in 2008 for public servants and education and healthcare professionals.

Across industry, inflationary pressures from labour costs stayed strong (the average annual ULC index was 110.3 percent January through May 2008) and the wide discrepancy between the dynamics of ULC and that of production costs (-4.8 percentage points) showed that other cost elements, i.e. raw materials, weighed heavily on price developments.

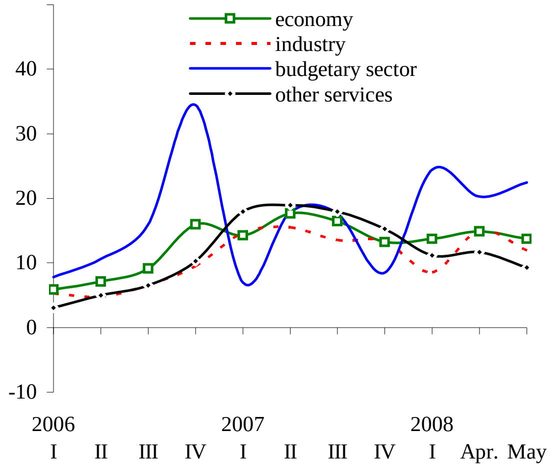
The best performance was seen in consumer goods sectors (tobacco products, wearing apparel, leatherwear, printing) where the ULC index ranged from 76.8 percent to 105 percent. While on certain segments demand developments allowed that wage costs be passed on to prices without incurring the risk of losing their market share, there are sectors (wearing apparel,

[18] The most ample trade union movements took place in metallurgy, road transport means and energy sectors, which accounted for roughly 12 percent of the number of employees in industry.

[19] January was not taken into calculation on grounds of a base effect generated by the "13th month" salary granted to public sector employees in December 2006 (instead of January the following year, as before), which moderated considerably the annual dynamics of wages in January 2007 (to -2.9 percent), but accelerated markedly to 52.6 percent in January 2008.

Net Real Wage*

annual percentage change



*) deflated by CPI

Source: NIS, NBR calculations

Labour Productivity and Real Gross Wage in Industry

annual percentage change

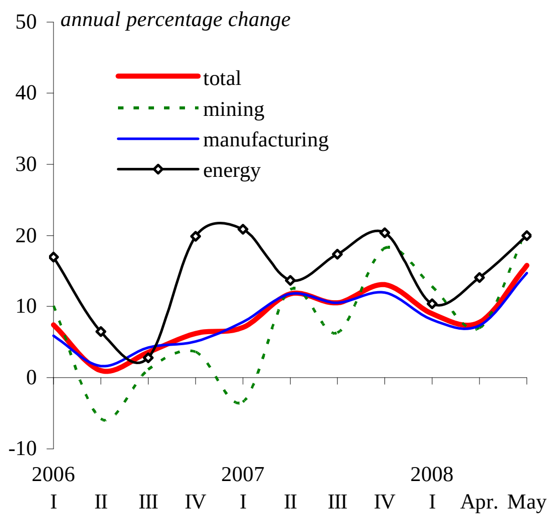
	2007			2008		
	II	**III**	**IV**	**I**	**Apr.**	**May**
Labour productivity	8.9	9.4	8.6	8.8	17.1	6.0
Real gross average wage*	12.4	13.2	12.3	4.5	10.3	6.8
Real gross average wage**	16.5	17.1	12.4	-0.02	5.3	-1.5

*) 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

leatherwear), where competition required greater efforts to boost productivity and exert tighter control over wage costs.

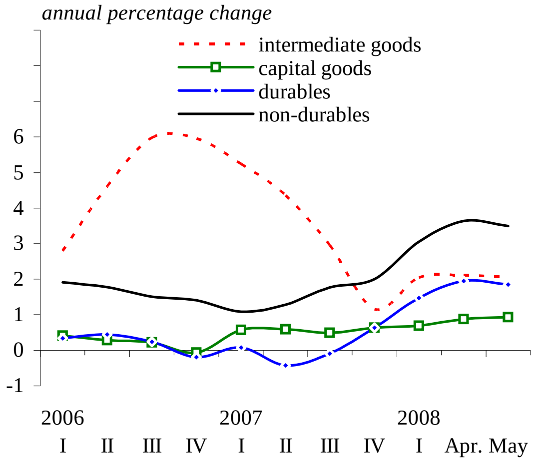
As for the food industry, the annual ULC index considerably outpaced the aggregate level (114.8 percent January through May 2008), but heavy consumption and the opportunity offered by the extensive media coverage of commodity price increases facilitated the passing of all pressure-inducing factors on to prices, without noticeable effects on demand.

A different picture could be seen in some intermediate goods sub-sectors (pulp and paper, building materials, metallurgy) and capital goods sub-sectors (electrical machinery and apparatus), which posted unfavourable developments (annual growth rates as high as 138.1 percent) and whose prospects do not look very bright. If, in some sectors, well above 1 appeared to be random (building materials, metallurgy), in others, competitiveness losses become more prevalent.

On the demand side, statistical data confirmed the faster pace of disposable income annual dynamics in 2008 Q1 (16.7 percent), given that real growth rate of incomes from domestic sources (wages and social transfers) remained in the vicinity of 20 percent, whereas remittances from abroad rebounded (+3.1 percent) after declining for two successive quarters. Therefore, the evolution of household disposable income further represents a risk to inflation.

EU-25 Industrial Producer Prices for Exports

annual percentage change



Source: EUROSTAT

3. Import prices and producer prices

In 2008 Q1, the pressures caused by prices for both domestic and imported commodities intensified. Prices for energy products and agricultural products had further a significant direct impact on industrial sectors that generated more than half of industrial producer price changes in the period under review. In April-June 2008, prices for energy resources continued to exert pressures, yet the emerging evidence pointed to the easing of agrifood market conditions.

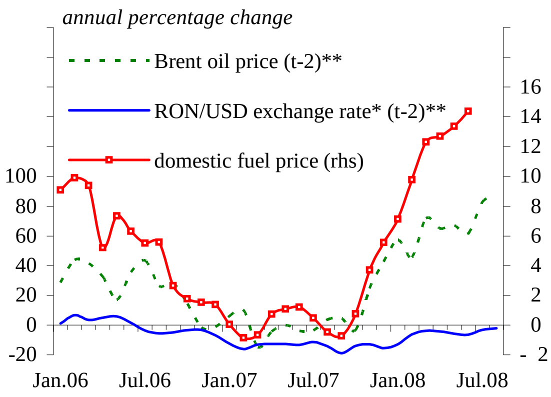
3.1. Import prices

In 2008 Q1, imported inflation had an unfavourable impact on domestic price dynamics, given that the annual unit value index of imports was significantly positive (103.49 percent versus 99.34 percent in 2007 Q4) and the domestic currency posted mixed developments (the RON depreciated by 8.3 percent versus the EUR, whereas it appreciated by merely 4.9 percent against the USD in annual terms).

Price changes were more visible in the case of goods holding a significant share in the CPI basket – vegetal products, fruit, fats, fuels, pharmaceuticals, footwear – the external prices of which recorded annual growth rates ranging from 4.9 percent to 31.2 percent. Pressures also increased, although to a smaller extent, in the case of capital goods prices, whose annual growth rates entered positive territory (machinery and mechanical devices, transport means) or recorded significantly lower negative levels.

The external price developments might continue in 2008 Q2 as well, the relative slowdown displayed by agricultural commodity prices being offset by escalating prices for energy resources (78.1 percent for Brent oil and 54.9 percent for natural gas as compared with 2007 Q2[20]). The unfavourable developments on external markets are associated with the continued weakening of the domestic currency against both the EUR and the USD.

Oil and Fuel Prices



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

Source: NIS, EIA

3.2. Producer prices

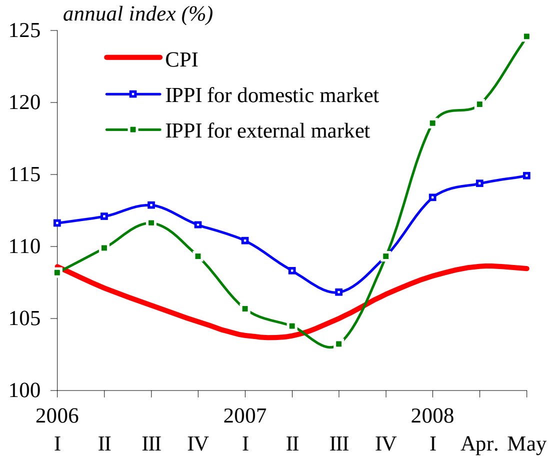
3.2.1. Industrial producer prices

The annual growth rate of industrial producer prices for the domestic market accelerated considerably in 2008 Q1, owing particularly to price hikes across the manufacturing sector (up 5.7 percentage points to 14.2 percent).

The same as in the previous quarter, energy products that were directly affected by oil price changes[21] saw the highest price increases (up 11.4 percentage points to 25.3 percent), on the back of costlier commodities and higher investment spending incurred by the main domestic manufacturers[22]. The transmission of the effects exerted on producer prices for fuels by the surging oil price on global market was further limited, which may be ascribed to the policy pursued by the main domestic producer (SNP Petrom) in an attempt at slashing oil imports, entailing a lower profit margin, as well as at expanding its recourse to domestic resources[23].

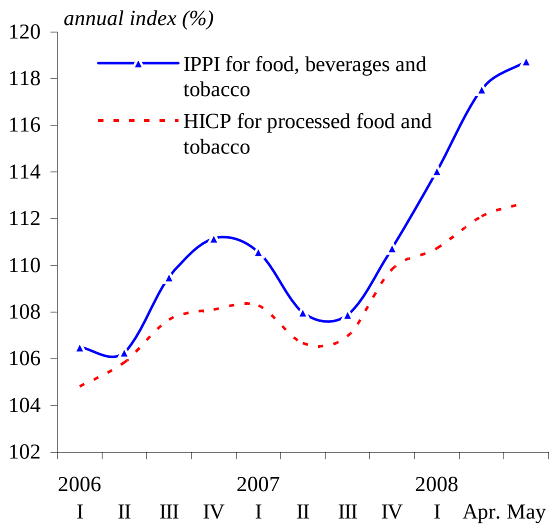
In 2008 Q1, the annual growth rate of industrial producer prices for consumer goods accelerated to 11.5 percent, due broadly to the substantial rise reported further by food industry.

Consumer Prices and Industrial Producer Prices



Source: NIS

Food Prices



Source: EUROSTAT

[20] Source: World Bank.

[21] Hydrocarbon extraction and processing (Source: EUROSTAT).

[22] In 2008 Q1, the investment made by SNP Petrom exceeded EUR 500 million, nearly three times higher than in the same year-earlier period.

[23] About 40 percent of fuel production come from refining oil from domestic sources, SNP Petrom being the only domestic producer that holds own reserves.

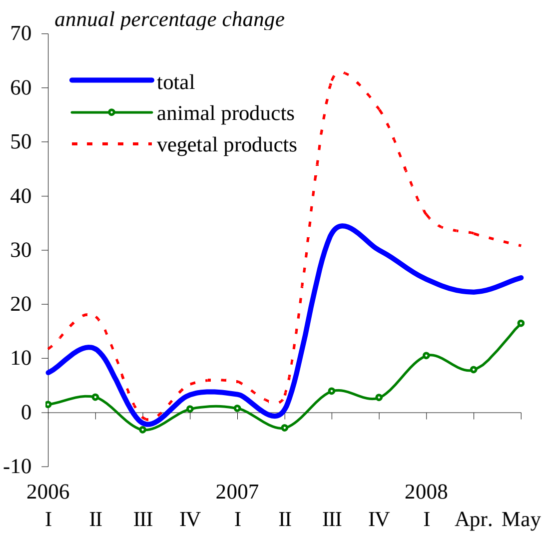
The annual dynamics of industrial producer prices for consumer goods exceeded for the third quarter in a row the average for manufacturing (up to 15.2 percent), whereas price developments in April-May (average monthly rate of increase of over 1.5 percent) indicate the relatively high likelihood of persistent pressures.

Similarly, the growth rate of producer prices for intermediate goods added 4.6 percentage points to 11.5 percent, mainly on the back of costlier metals[24], but also due to the spillover effects of escalating oil price. Accordingly, the rate of increase of producer prices for capital goods headed upwards, rising 1.9 percentage points to 12.4 percent.

In 2008 Q2, the pressures induced by commodity prices are unlikely to ease and, thus, producer prices are expected to stay on a similar trend.

3.2.2. Agricultural producer prices

Agricultural Producer Prices



Source: NIS

The annual growth rate of agricultural producer prices remained high in 2008 Q1 as well (24.6 percent), even though it slowed down slightly as against the previous quarter.

The main sub-sectors showed mixed price developments:

(i) the growth rate of prices for vegetal products decelerated significantly (by 19.3 percentage points to 36.6 percent) on the back of price movements in grains, fruit and vegetables; producer prices for oilseeds rose 113 percent versus 2007 Q1;

(ii) the annual growth rate of prices for animal products accelerated by 7.7 percentage points, due largely to price changes seen in milk and eggs components; however, the 10.5 percent level is still below the aggregate level.

As concerns the animal products, it is worth mentioning that producer prices for the main types of meat declined further in annual terms or posted increases below the average for the group, despite the considerable price hikes reported by fodder (up 56 percent as compared with the same year-ago period). Although relatively unexpected, these developments may be attributed to: (i) the larger number of slaughtered livestock at farms, considering the high costs related to stock breeding; this conclusion is substantiated by first-quarter figures on meat production, which reveal increases ranging from 8.8 percent to 48 percent in annual terms; (ii) highly competitive imports;

[24] The index on metal price developments calculated by the World Bank shows positive dynamics of 17.4 percent in 2008 Q1 versus 2007 Q4 and 22.6 percent as against the same year-ago period.

(iii) the favourable base effect in the case of beef[25], whose quarterly changes show a 10.5 percent price hike.

The positive signals related to this year's crops substantiate a further alleviation of the dynamics of agricultural producer prices, particularly as concerns the vegetal sub-sector. The pressure put by imports on the meat market will probably act further as a deterrent to the pass-through into prices of costlier fodder; the favourable impact of good crops on this item could become manifest only towards the end of the quarter.

[25] In February-May 2007, the price for beef rose 25.1 percent as against January, but subsequently producer prices for beef followed a downward trend.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In 2008 Q2, the National Bank of Romania raised the monetary policy rate twice, up to 10 percent per annum. At the same time, the central bank adjusted some features of the monetary policy operational framework with a view to enhancing its efficiency. Moreover, the minimum reserve requirement ratios were left unchanged and the firm control over money market liquidity was pursued further. Broad monetary conditions became slightly more restrictive in the period under review, due mostly to the renewed appreciation of the RON versus the EUR and the USD[26].

The continued worsening of the inflation outlook and the increased risk of additional deterioration of inflation expectations, as reflected by the updated quarterly projection of medium-term macroeconomic developments, led the NBR Board to decide in its meeting of 6 May 2008 on the fifth successive hike in the monetary policy rate. The chief drivers of the new upward revision of the inflation forecast[27] were the higher-than-expected inflation rate in 2008 Q1, but especially the anticipations related to larger magnitude of administered price adjustments and to faster dynamics of fuel prices and some highly volatile food prices. The inflationary potential of this macroeconomic environment was also fuelled by the increase, compared to the previous projection, in the scheduled scale and duration of the positive output gap as well as the likely heightening of inflationary risks associated to the projection amid the persistence of uncertainties surrounding the global economic climate. The major risks were generated by (i) wage increases overtaking productivity gains, (ii) possible implementation of a looser-than-expected budget policy, and (iii) the likelihood of further depreciation of the domestic currency and the ongoing surge in the oil price on foreign markets.

At the same time however, the upward shift in the projected annual inflation rate was slower and shorter than that presented in the previous forecasting round. Furthermore, anticipations of

[26] Broad monetary conditions include the effective exchange rate of the RON, which is based on the exchange rates 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*).

[27] Compared to the forecast in the February 2008 Inflation Report.

a relatively faster slowdown in inflation during the second part of the projection horizon took shape, with the projections of the year-on-year growth rate of consumer prices slipping below the levels in the previous projection. Under the circumstances, the NBR Board decided to contain the pace of increase of the monetary policy rate to 0.25 percentage point – therefore, the key interest rate was raised to only 9.75 percent per annum.

In June, the NBR Board decided to raise again the key rate by 0.25 percentage point to 10 percent per annum. The decision was substantiated by the further worsening of the near-run inflation outlook amid expectations of a status-quo or even strengthening of the action of supply-side and cost-push factors that might bring about higher inflation expectations. Another major reason for lifting the monetary policy rate was the high likelihood of stronger and more persistent demand-pull inflationary pressures. Thus, the latest GDP statistics for 2008 Q1 show robust growth (8.2 percent from 6.6 percent – see Chapter III. Economic developments) driven by the booming domestic demand (15.9 percent in annual terms). Stronger demand reflected the ongoing uptrend in investment dynamics and most notably the renewed pick-up in the expansion of household actual final consumption supported by brisk growth of income (wages in particular) and loans to households. The accelerated advance in domestic absorption entailed not only a record increase in the dynamics of imports of goods and services which – alongside the ongoing depreciation of the RON against the EUR – boosted contemporary inflationary pressures, but also generated most likely a larger positive output gap. It appears that this fed through only partly into demand-pull inflationary pressures, given that the faster increase in first-quarter household consumption was chiefly attributed to the higher dynamics of motorcar purchases and the return of self-consumption growth to positive territory. Nevertheless, short-term demand-pull inflationary risks remained on the upside and the partial statistics for 2008 Q2 hint at a possible protraction of sustained economic expansion and the maintenance of very fast dynamics of domestic demand; some signs of such an outlook were inter alia the substantial pay rises in April and the ongoing excessively rapid increase in credit to non-government, which slackened somewhat over the past few months.

The above-mentioned trend was underpinned by the developments in loans to households, the annual growth rate of which decelerated on average to 66 percent April through May 2008 after having risen in two successive quarters. Behind the trend reversal stood the performance of both RON-denominated and forex loans. The real average annual dynamics of the former remained on a downward drift, shedding 3.6 percentage points over the first quarter of 2008, widely as a result of higher average lending rates. At the same time, after having increased during six consecutive quarters, the annual dynamics of foreign currency-denominated loans of households stood on average at 111.8 percent, down from 120.4 percent in 2008 Q1. The downturn was manifest in both EUR-denominated loans (on which interest rates edged slightly up) and CHF-denominated loans. In addition, the favourable trends previously seen in loan composition by destination consolidated. Thus, the average annual growth pace of consumer credit eased down to 59.5 percent against 65.8 percent in 2008 Q1, dropping faster than the average annual dynamics of housing loans in real terms (down by 3.9 percentage points to 71.9 percent).

At the same time however, household saving in local currency slowed down as well. The average annual growth rate of households' time deposits with maturity of up to two years in RON declined in real terms to 2.4 percent from 5.7 percent in 2008 Q1, despite the 1.7 percentage point increase on average in deposit rates on new business compared to the first quarter of 2008. The real annual dynamics of foreign currency-denominated deposits with maturity of up to two years also cooled off, averaging 10.9 percent over 14.1 percent in 2008 Q1. In turn, households' overnight deposits and their time deposits with maturity longer than two years saw their average annual rate of increase falling slightly April through May compared to first-quarter levels.

Similarly to the previous 3-month periods, by raising the monetary policy rate, the National Bank of Romania also sought to counter the risk of ever-deteriorating inflation expectations and that of second-round supply-side shocks. Such a risk was aggravated by the reconfirmed persistence beyond 2008 of the period during which the annual inflation rate may stay above the upper limit of the variation band as well as by the magnitude and number of anticipated inflationary effects likely to stem from the projected rise in fuel prices and the planned adjustments in administered prices, particularly natural gas and electricity prices, and in excise duties. By contrast, the risk that the movements and the behaviour of the exchange rate of the RON could further fuel significantly inflation expectations was estimated to be on the downside, especially in the second part of 2008 Q2, when daily levels of the RON/EUR exchange rate tended to stabilise (see Section 2.2 Exchange rate and capital flows). It is still uncertain how sustainable such a performance would be.

During the period under review, the National Bank of Romania continued to exert firm control over money market liquidity. Thus, it engaged mainly in deposit-taking operations to mop up excess reserves given that the compression in excess liquidity and the wide seasonal swings in autonomous liquidity factors translated into a tepid interest of credit institutions in CDs issued by the central bank. At the same time, the central bank adjusted some features of the monetary policy operational framework. With a view to increasing the efficiency of money market liquidity management and implicitly the impact of monetary policy instruments on short-term interest rates, the central bank decided to shorten the maturity for its deposit-taking operations to one week from two weeks. In addition, in an attempt at improving the signalling role of the monetary policy rate and reducing 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. Eventually, the interest rate on the deposit facility was raised to an annual 5.75 percent from 2 percent while the interest rate on its lending facility was lifted to 13.75 percent per annum against 12 percent previously.

2. Financial markets and monetary developments

Interbank market rates stayed on an upward course in 2008 Q2, whereas the RON/EUR exchange rate reverted to a slightly downward trend, its volatility decreasing gradually. The annual dynamics of broad money remained high in March-May 2008, thereby reflecting the persistently fast growth pace of credit to the private sector, the rise in public spending, as well as the impact of some one-off factors.

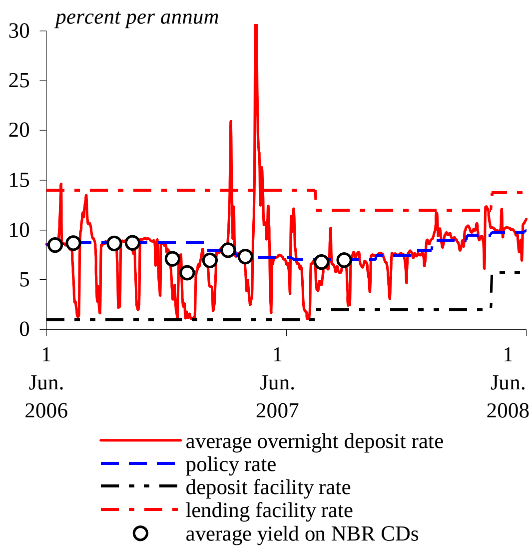
2.1. Interest rates

In 2008 Q2, interbank market rates followed an uptrend, in line with the monetary policy rate. The average interbank deposit rates added 1.1 percentage points quarter on quarter to 10.1 percent, incorporating both the successive rises of monetary policy rate and the effect of the relatively increased restrictiveness of liquidity conditions in the first part of the period under review.

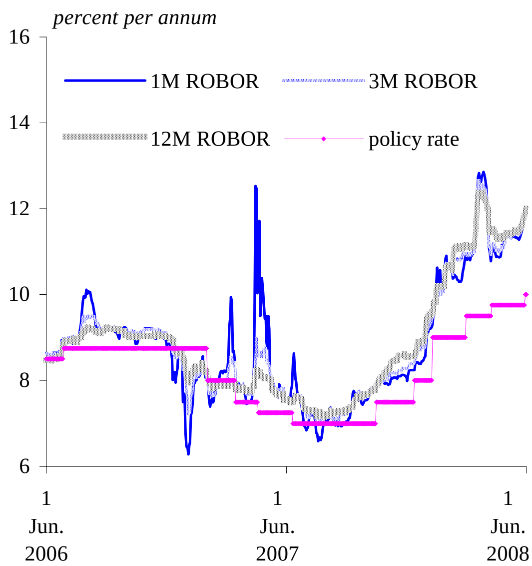
The central bank continued to pursue a firm management of money market liquidity, the efficiency of the process being strengthened starting in May by the effect of the decision to reduce the maturity for standard deposit-taking operations to one week from two weeks.

In this context, both-way deviations of overnight rates from the level of monetary policy rate, albeit relatively wider than in the prior quarter, were only short-lived. Such deviations occurred generally at the end of the reserve maintenance period or were

Interbank Money Market Rates



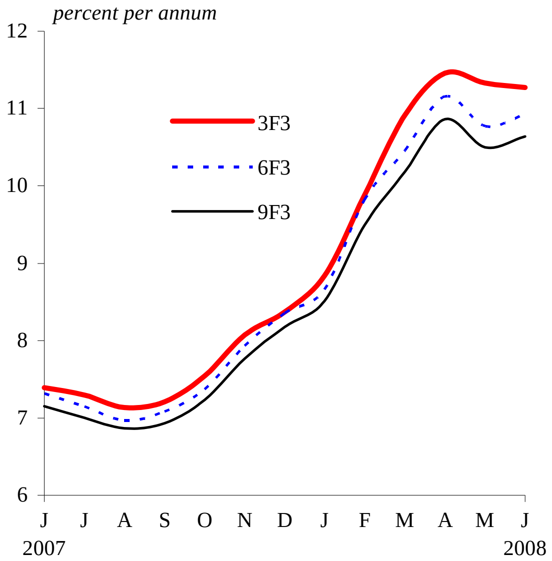
Policy Rate and ROBOR Rates



generated by seasonal factors, such as the strong increase in the liquidity-absorbing operations of the State Treasury in late April, due to the settlement of quarterly budget payments[28]. Under the circumstances, the volatility of overnight rates rose slightly, yet it stayed at a level close to the 3-year low recorded in the previous quarter.

In turn, the (1M-12M) ROBOR interest rates continued to move up under the impact of monetary policy rate increases and of market expectations on further key rate rises in the period ahead. Nevertheless, the (1M-12M) ROBOR interest rates posted uneven developments throughout the quarter, as they saw an abrupt, temporary advance in the first part of April, due to market operators' concern about the potentially immediate liquidity contraction (owing also to the predictable decline in excess liquidity in the months ahead). In June, the (1M-12M) ROBOR yield curve was higher than at the end of Q1 (by 0.65 percentage points on average); wider adjustments were reported in the case of shorter maturities, so that the trajectory of these rates was relatively flat.

Implicit Forward Rates



In addition, the anticipated trajectory of the 3M ROBOR rate as illustrated by implicit forward rates (calculated based on June average rates) was nearly 0.7-0.8 percentage point higher than that expected for Q1. Hence, the average 3M ROBOR rate projected for September stands at 11.3 percent and is estimated to go down to 10.9 percent in December 2008 and to 10.6 percent at the end of 2009 Q1.

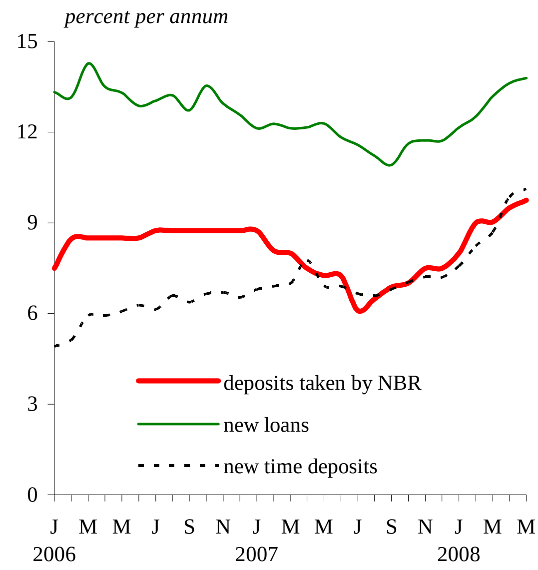
Interest rates on the primary market for government securities stayed on an upward path in Q2. In April and May 2008, the Ministry of Economy and Finance agreed upon new successive rises in the maximum interest rates, which reached at the end of the period 10.75 percent (up 1.25 percentage points for securities with maturity of up to one year) and 10.0 percent and 9.5 percent respectively (up 0.5 percentage points for both 3-year and 5-year government bonds). Average interest rates added 1.3 percentage points to 10.74 percent (for Treasury certificates) and 0.52 percentage points and 0.48 percentage points to 9.99 percent and 9.45 percent respectively (for 3-year and 5-year benchmark government bonds) as compared with those recorded at the end of the previous quarter. The securities issued in April-June amounted to nearly RON 1,814 million, given that the MEF had announced a volume of RON 5,800

[28] Amid the gradual reduction of the structural surplus in the banking system, the market operators' higher uncertainties surrounding the reserve absorption generated by liquidity autonomous factors in April-May made overnight rates reflect asymmetrically the developments in liquidity conditions (less abrupt and/or rapid decreases during episodes of excess liquidity and stronger responses to reserve deficits).

million. Non-residents did not participate in auctions held during this period.

The quarterly volume on the secondary market for government securities plunged to a six-quarter low of about RON 2,500 million; outright transactions held over 99 percent of the total volume. Government securities with residual maturity of five years were the most heavily traded, the related interest rate adding 1.4 percentage points on average to 9.11 percent as compared with the prior quarter.

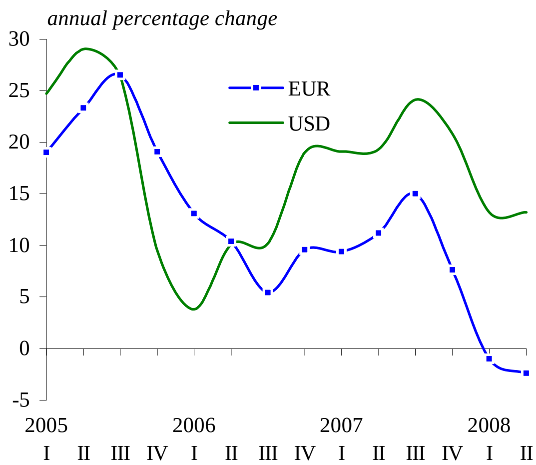
Bank Rates



The rise in the monetary policy rate and interbank rates fed through further into deposit and lending rates on new business, which saw a relatively fast increase on average in March-May 2008. Interest rates applied to non-financial corporations were increasingly sensitive to developments in interbank rates, with average lending rates on new business going up considerably (1.60 percentage points to 14.11 percent) in May versus February. As concerns households, the magnitude of the rise was lower in the case of lending rates on new business (merely 0.51 percentage points to 13.06 percent), given that: (i) average lending rates on new consumer loans and start-up loans rose only marginally in May (up 0.37 percentage points to 13.21 percent and 0.43 percentage points to 16.54 percent respectively) and (ii) average lending rates on real-estate loans climbed in March, but subsequently decreased, standing 0.9 percentage points lower in May than in February. Deposit rates on new business increased as well, even at a faster pace (1.8 percentage points to 10.37 percent in the case of non-financial corporations' placements and 1.99 percentage points to 9.37 percent for household new deposits), as the greater need for resources made banks pursue a more aggressive promotion of higher-yield saving products.

2.2. Exchange rate and capital flows

Developments of RON Exchange Rate*



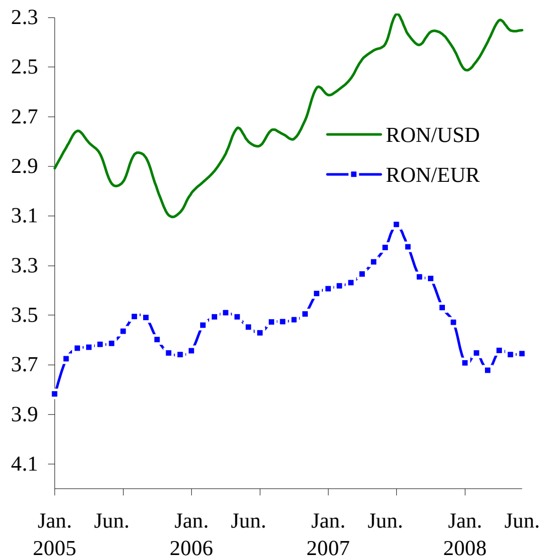
*) appreciation (+), depreciation (-) in real terms; deflated by CPI

Source: NIS, NBR

The upward movement in the RON/EUR exchange rate came to a halt in 2008 Q2, trending slightly downwards. Developments were mainly associated with the lower risk aversion and the persistence of a relatively increased wariness of financial investors towards the domestic market. Hence, the strengthening of the RON was of a lower magnitude than that of other currencies in the region.

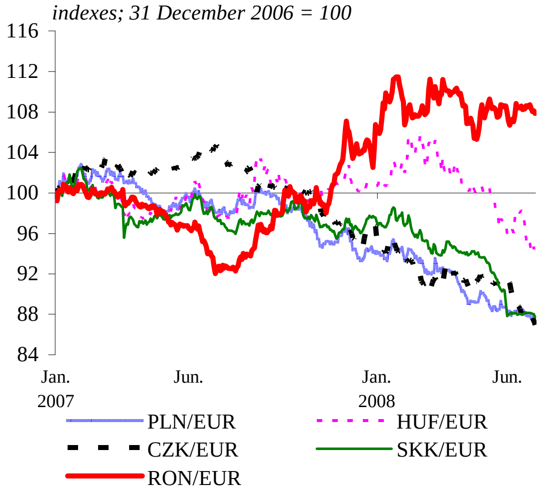
Thus, the local currency gained 1.8 percent in nominal terms and 3.1 percent in real terms versus the euro April through June. In relation to the US dollar, which weakened against the single European currency, the RON posted a faster nominal appreciation (2.0 percent) and a slightly slower real

Nominal Exchange Rate



Exchange Rate Developments on Emerging Markets in the Region

indexes; 31 December 2006 = 100



Source: NBR, ECB

strengthening (3.3 percent). However, calculated as an average annual change for 2008 Q2, the domestic currency further depreciated versus the EUR (10.1 percent in nominal terms and 2.4 percent in real terms), but saw a marginally slower strengthening against the USD.

The local currency witnessed a relatively fast appreciation trend in the first part of the quarter under review, reflecting mainly: (i) financial investors' diminished risk aversion[29], (ii) the relatively improved sentiment of forex market operators on the outlook for the Romanian economy, given that some of the data released during the reported period were above expectations (industrial output, exports, direct investment and average nominal wage), as well as (iii) higher money market yields. These developments kindled non-residents' appetite for placements on the local financial market, as confirmed by the increase in flows of long-term deposits, with their foreign exchange sales posting a surplus for the first time in the past seven months. The strengthening of the RON was also underpinned by favourable developments in inflows of financial borrowings[30] and especially by robust direct investment, including as a result of proceeds from the privatisation of Electrica Muntenia Sud. The unprecedented surge in residents' demand for foreign currency slowed only partly the decline in the RON/EUR exchange rate, which touched a record low on 23 April at 3.5614. The volatility of the RON/EUR exchange rate shrank, although remaining above that posted by the major currencies in the region. However, the exchange rate witnessed a trend reversal starting 24 April, with the domestic currency weakening about 3 percent versus the euro, mainly under the impact of heightened fears of economic slowdown in Europe.

Besides, over the following period investors became increasingly wary of the local financial market probably as a result of: (i) relatively pessimistic findings of some research papers/forecasts on the near-run outlook of the Romanian economy released in the reported period[31], (ii) the conflicting nature of some of the released statistical data[32], which could have fuelled uncertainties about the prospects of domestic economic fundamentals, and possibly (iii) the invalidation of

[29] Following the abrupt decline in the previous quarter, Dow Jones STOXX, S&P500 and Nikkei 225 rose 4.5 percent, 4.0 percent and 6.3 percent respectively in April.

[30] January through April, the value of financial borrowings and long-term deposits advanced 38.5 percent as against 2008 Q1.

[31] The EBRD lowered the forecasted level of economic growth for 2008, a survey conducted by the Economist Intelligence Unit placed Romania among the most vulnerable states, while a Moody's Investor Service report included Romania in the category of countries running a moderate risk of a possible re-evaluation of the country risk.

[32] Industrial output, current account deficit, trade and services turnover volume, gross nominal average wage and CPI.

expectations by some foreign investors concerning the size of the policy rate hike performed in early May. Against this background, non-residents' interest in investments on the local financial market diminished, with their net foreign currency sales more than halving month on month. Consequently, the RON weakened 0.5 percent versus the EUR in May, contrary to the developments in the major currencies in the region and despite the end-of-month influence exerted by the appreciation of the Slovak *koruna* and the re-evaluation of its central parity. The volatility of the RON/EUR exchange rate, albeit slightly on the wane, remained high.

The somewhat winding trajectory of the exchange rate persisted in early June, amid the release of above-expectation figures on GDP growth in Q1 and especially the financial investors' rekindled risk aversion given the more frequent unfavourable signals[33] concerning the major economies. Subsequently however, the RON/EUR exchange rate saw significantly lower daily changes, its volatility touching an 11-month low in June. In addition, in the aftermath of the policy rate hike, the exchange rate followed an almost steady downtrend, although at regional level the domestic currency recorded the lowest monthly appreciation versus the euro, i.e. 0.1 percent.

Key Financial Account Items (balances)

EUR million

	2007 5 mos	2008 5 mos
Financial account	**6,444**	**7,076**
Direct investments	**2,775**	**4,114**
residents abroad	-51	128
non-residents in Romania	2,826	3,986
Portfolio investments and financial derivatives	**104**	**-53**
residents abroad	-256	-143
non-residents in Romania	360	90
Other capital investments	**4,320**	**3,246**
of which:		
medium- and long-term investments	1,390	1,721
short-term investments	-1,056	-128
currency and short-term deposits	2,768	-491
NBR's reserve assets, net ("–" increase/"+" decrease)	**-755**	**-230**

2.3. Money and credit

Money

In March-May 2008, the pace of increase[34] of broad money (M3) stuck to the high level seen over the previous quarter, hitting the second peak in the available data series at 26.9 percent. This development was ascribable to liquidity expansion spurred by faster economic growth, the hike in public spending and the accounting effect of a weaker RON[35], but especially to the one-off effect exerted by the settlement of the privatisation of Electrica Muntenia Sud. Conversely, the temporary widening of the trade deficit in early Q2 had an opposite influence on broad money growth. Turning to M3 counterparts, monetary developments reflected the opposite influence of: (i) portfolio shifts resorted to by companies and the local government, from investments with a maturity of over two years into time deposits

Annual Growth Rates of M3 and Its Components

real percentage change

	2007			2008		
	II	III	IV	I	Apr.	May
	quarterly average growth					
M3	20.1	20.8	24.1	26.5	27.8	28.8
M1	49.1	49.7	53.0	42.2	39.6	39.6
Currency in circulation	21.4	24.4	29.7	38.0	32.6	32.5
Overnight deposits	63.9	62.7	63.9	43.9	42.4	42.3
Time deposits (maturity of up to 2 years)	0.7	-0.1	2.4	12.6	16.9	18.2

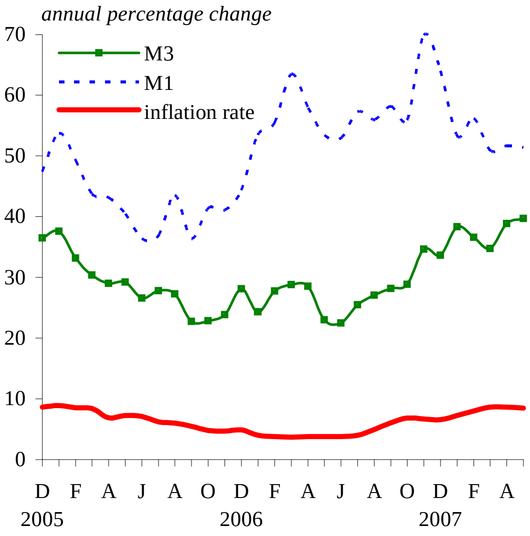
Source: NIS, NBR

[33] Standard&Poor's downgraded the ratings of major financial companies, unemployment surged in the US, more signs of an economic slowdown in Germany and France emerged, while the euro area inflation rate hit a 16-year high. Against this backdrop, price indices of foreign capital markets declined abruptly and oil price hit new all-time highs.

[34] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March-May 2008 (end-of-month).

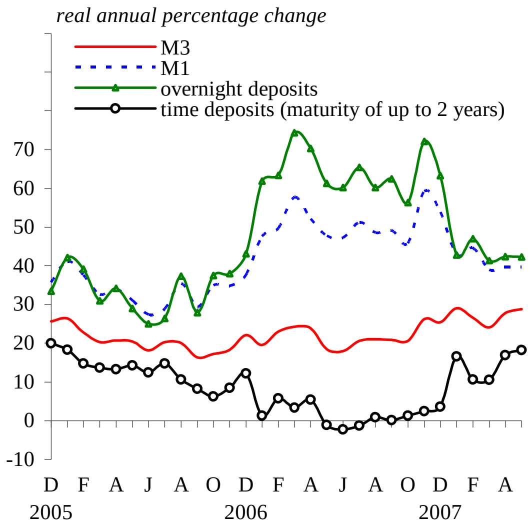
[35] Annual nominal depreciation of the RON against the EUR March through May 2008 (end-of-month) was the largest in the last four years.

Broad Money and Inflation Rate



Source: NIS, NBR

Main Broad Money Components



Source: NIS, NBR

with an agreed maturity of up to two years and (ii) the sharper decline in deposits of the central public authority. Moreover, such developments were also driven by the slacker rise in domestic credit and wider negative balance of net external assets.

The quarter under review saw a further spike-up in the growth rate[36] of time deposits with an agreed maturity of up to two years and a protracted slowdown of narrow money dynamics. The latter development was brought about by the slacker expansion of currency in circulation and the still slower increase in RON and forex-denominated overnight deposits from the main customer categories. As for companies, developments might be associated with a possible temporary rise in external payments (particularly in relation to imports[37]), but especially with a shift in these placements towards time deposits with short maturities, which became much more attractive as a result of the significantly higher interest rates on both RON- and EUR-denominated deposits.

The considerable step-up in the pace of increase of time deposits with an agreed maturity of up to two years was mainly the result of the faster rise in forex-denominated corporate placements, which peaked at 52.6 percent, the highest level in 10 quarters, amid the transfer of the amounts from the privatisation of Electrica Muntenia Sud (EUR 826.4 million). An additional boost was given by larger amounts transferred to companies from the consolidated budget[38]. On the other hand, the growth rate of household time deposits with an agreed maturity of up to two years slowed for both RON- and forex-denominated components, despite the significant expansion in related interest rates and the further swift rise in household income. Such development could be linked to this segment's increased debt service to banks.

Credit

The growth rate[39] of loans to the private sector decelerated only slightly March through May 2008 to 51.1 percent (the second peak in the past two and a half years) from the previous

[36] Changes in the main components of M3 continued to reflect the effects generated by the adoption in 2007 of a new methodology for calculating monetary indicators; thus, the growth rates of currency in circulation, time deposits with an agreed maturity of up to two years and overnight deposits returned to levels close to those seen in 2006, being faster in the first two cases and slower in the last case.

[37] The March trade deficit was the widest since December 2007, while the monthly change in forex-denominated corporate overnight deposits posted the highest negative value since November 2007.

[38] The pace of increase of consolidated budget expenditure in the period under review (32.5 percent) was nine times faster than in the previous quarter.

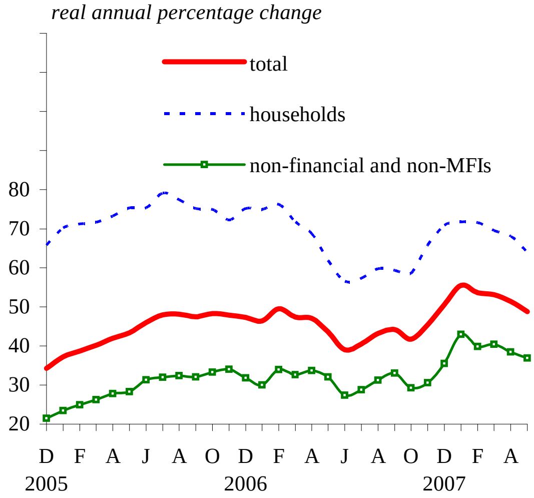
[39] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March-May 2008 (end-of-month).

quarter's record high, with both components – the forex-denominated one in particular – posting more sluggish dynamics. This development reflected the dampening impact on the supply of loans coming from: (i) the implementation of the new provisioning coefficients in relation to forex loans[40], (ii) higher costs of resources attracted from parent banks[41] and the likely slowdown in the dynamics of these flows, and (iii) banks' continued propensity for transferring abroad part of their credit portfolios. Adding to these adverse effects were the following demand-side factors: (i) companies' still significant resort to direct external financing[42], (ii) higher lending rates on most categories of new business, and (iii) low-income households potentially reaching the indebtedness ceiling. The joint impact of these factors more than offset the stimulative effect of the still keen competition among banks, the further fast advance in household income and of the potential improvement in companies' financial standing[43].

Against this background, both the growth rate of household loans and that of corporate loans (67.2 percent and 38.6 percent respectively) decelerated slightly, despite their remaining at very high levels. In the latter case, the slower dynamics was manifest for both RON- and forex-denominated loans of non-financial corporations, given the upward adjustment of lending rates on new business (in RON and EUR) to this segment. Conversely, the balance of loans to non-monetary financial institutions saw a faster rise and a continued shift away from forex- to RON-denominated loans.

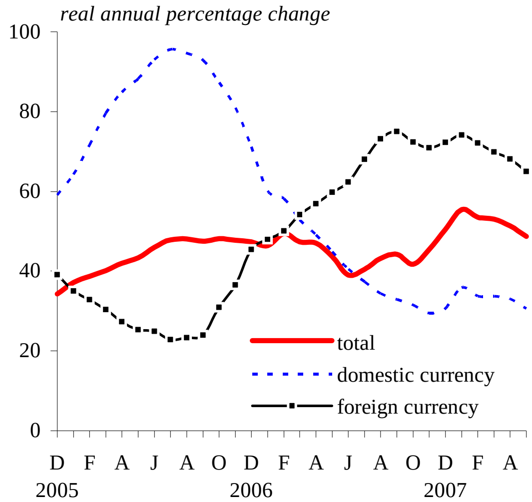
In turn, the more sluggish dynamics of household loans – after two quarters of trending upwards – was driven by the protracted slowdown in the growth rate of the RON-denominated component, but also by the decelerated pace of increase of forex loans for the first time in 18 months. However, the latter still outdid the growth rate of loans in domestic currency by more than three times[44]. Consumer loans (irrespective of denomination) also witnessed slower dynamics, amid the

Credit to Private Sector by Institutional Sector



Source: NIS, NBR

Credit to Private Sector by Currency



Source: NIS, NBR

[40] NBR Regulation No. 4/2008 amending and supplementing NBR Regulation No. 5/2002 on the classification of loans and placements as well as the setting-up, regularisation and use of specific provisions for credit risk and the methodological norms for the enforcement thereof.

[41] The ratio between external liabilities and private sector loans, albeit still high from a historical perspective, touched a three-quarter low at 47.0 percent.

[42] According to balance of payments data, the volume of financial loans taken by non-banks March through April 2008 remained high.

[43] As suggested by the advance in the growth rate of profit tax during March-May 2008.

[44] The overly fast dynamics of forex household loans mainly reflected the extremely high – albeit declining – growth rate of the CHF-denominated component, whose share in total forex loans of households advanced to 18.8 percent in May 2008 from 17.9 percent in February 2008.

slightly higher lending rates on new business in domestic currency and especially in euro. By contrast, the growth rate of housing loans posted a marginal acceleration (although their annual rates of increase decelerated gradually in April and May), since this category was actively promoted, also via significant rate cuts. The average dynamics of the RON-denominated component stuck to its upward trend (although monthly readings posted a decline over February 2008), whereas the pace of increase of the forex-denominated component came to a halt, despite reaching the second-highest level in the past two and a half years. Under the circumstances, the average share of housing loans in total household loans hit a two-year high, i.e. 24.1 percent.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the 12-month inflation rate at 6.6 percent for end-2008, 0.6 percentage points above the figure published in the May 2008 Inflation Report. For end-2009, inflation is forecasted to stand 0.7 percentage points above the previously projected level (4.2 percent versus 3.5 percent).

The projection was revised due to recent and forecasted developments indicating notable deviations from the previous scenario. The upward deviation of inflation is primarily attributed to stronger aggregate demand pressures stemming from the significantly faster than expected GDP growth in 2008 Q1, the less favourable scenario regarding administered price increases and the substantial revision of the projected hikes in fuel prices. These effects cannot be fully offset by RON exchange rate movements favouring somewhat the import price dynamics starting with Q2 and by the impact of bumper crops on food prices anticipated later this year. Although the monetary policy rate was repeatedly raised to counter the influence of multiple shocks on the economy, its efficacy in reducing inflationary pressures stemming from excess demand are contained by the structural lags inherent to the transmission of monetary stimuli to the real sector and the upward adjustment of economic agents' inflation expectations.

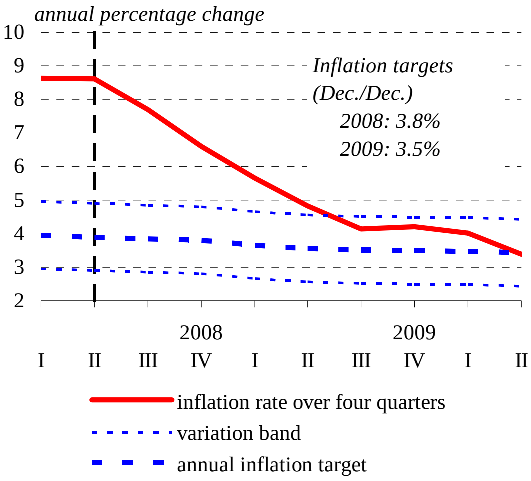
The impact of recent and projected monetary policy rate developments on real monetary conditions will become manifest especially during 2009. The restrictiveness of the exchange rate and the pass-through of monetary policy stimuli to the interest rates set by the credit institutions will increase gradually, thus favouring the offset of inflationary pressures generated by aggregate demand. According to the forecast, the progressive fading of negative effects induced by the sizeable adjustment of administered prices in July 2008 combined with the re-anchoring of inflation expectations to a downward trend as from 2008 Q3 will help annual CPI inflation return inside the variation band around the central target starting with 2009 Q3. The projection envisages CORE2 inflation to follow a trajectory lower than that of CPI inflation throughout the projection horizon.

Compared to the previous forecasting rounds, the baseline scenario of the current projection is surrounded by increased uncertainties related to both the consistency of macroeconomic policies in the election run-up and the persistence of global market tensions. Major risks are generated by the unfavourable *developments that might entail, should they become manifest, upward deviations of inflation from its projected path. These include: ongoing wage rises in excess of productivity gains, lack of coordination of fiscal and income policies with the monetary policy, renewed depreciation of the domestic currency owing to shocks on global markets, and a further worsening of inflation expectations of economic agents. Other important risks to the current projection refer to the uncertainties about the future movements in the oil price on external markets or the consequences of larger-than-projected hikes in administered prices. Implementing a coherent mix of firm macroeconomic policies would eliminate the risk of policy slippages and could reduce the likelihood of some of the other risks materialising.*

1. The baseline scenario of the forecast

1.1. Inflation forecast

Inflation Forecast



Note: Variation band is ±1 percentage points around the central target

Source: NIS, NBR calculations

After staying at 8.6 percent in 2008 Q2, the annual consumer price inflation is projected to enter a downward path starting with 2008 Q3. The inflation rate is estimated to get back inside the variation band around the central target starting with 2009 Q3 and subsequently disinflation is expected to come to a temporary halt, hovering around 4 percent. Starting with 2010 Q2, inflation is anticipated to return to a downward drift. Against this background, annual CPI inflation is forecasted to reach 6.6 percent at end-2008 and 4.2 percent at end-2009. Compared to the projection published in the May 2008 Inflation Report, the annual inflation rate is higher both this year and next year, by 0.6 percentage points and 0.7 percentage points respectively.

Table 5.1. Annual inflation rate (end of period)

percent

Period	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2
Target		3.8				3.5		
Forecast	7.7	6.6	5.7	4.8	4.1	4.2	4.0	3.4

For this year, the deviation of the projected inflation rate from the figures shown in the May 2008 Inflation Report (+0.6 percentage points) is attributed to:

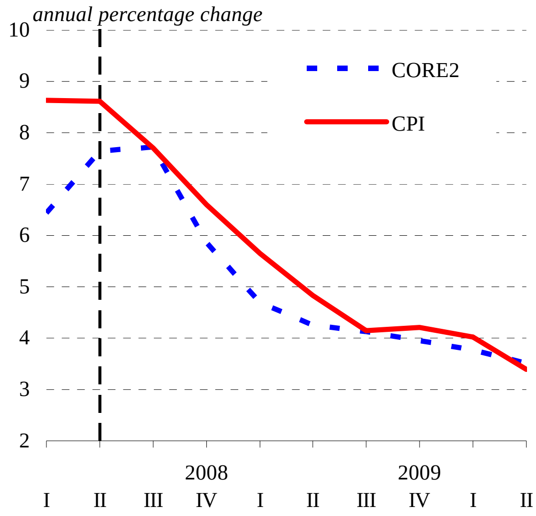
– *rising inflationary pressures from aggregate demand* in 2008 Q1 and Q2; this assessment is underpinned by the higher first-quarter growth[45] than the previously forecasted figures and expectations of robust GDP increase in Q2;

[45] According to the statistics for 2008 Q1 published by the NIS.

– *the persistence of tensions on international commodity markets in the past few months*; therefore, the current baseline scenario assumes the upward revision both in the trend of administered prices (largely as a result of costlier imports of natural gas) and the projected fuel price inflation (the assumption on the oil price diverges substantially from that incorporated into the May 2008 Inflation Report[46]);

– *the spillover of inflation shocks* that hit the economy on the supply side *by gradually incorporating* them into the inflation expectations of economic agents[47] (for more details on the importance of inflation expectations of economic agents, see Box 1); starting in the final months of 2007, these shocks were partly incorporated into CORE2 inflation, which will also contribute to higher inflationary pressures over the medium term, due to the persistent dynamics of this CPI component.

CORE2 and CPI



Source: NIS, NBR calculations

[46] See Section 1.2. *Exogenous inflationary pressures* below.

[47] Inflation perceptions of economic agents are heavily affected if the items that were repeatedly subject to price increases are more frequently purchased by households (if demand for such items is relatively inelastic), or if price hikes are of a considerable magnitude.

Box 1: The importance of inflation expectations

The credibility of central banks acting within an inflation targeting framework is extremely important, since it allows the sustainable anchoring of economic agents' expectations. As a direct consequence, their decisions and behaviour will rely to an increasing extent on the information supplied by the central bank, especially if it pursues a transparent communication with the public.

Inflation expectations are one of the most important channels whereby monetary policy influences the economic activity. They play a salient role in the process of consumer goods price formation at both producer and retailer level. Economic agents find it relatively costly to adjust prices very often, since they have to bear the costs related to promoting and advertising the new prices. However, this does not necessarily preclude them from formulating a set of inflation expectations underlying their decisions when carrying out a new price adjustment. Inflation expectations are incorporated in the model for analysis and medium-term forecasting of inflation (MAMTF) used by the NBR for its quarterly macroeconomic projections and they provide the explanation for CORE2 inflation and fuel price inflation dynamics (these components jointly account for 72 percent of the CPI basket). As for the other components of CPI basket (administered prices and volatile prices of vegetables, fruit and eggs), exogenous scenarios are used, given the manner in which such prices are formed, rather discretionary in the former case and less predictable in the latter.

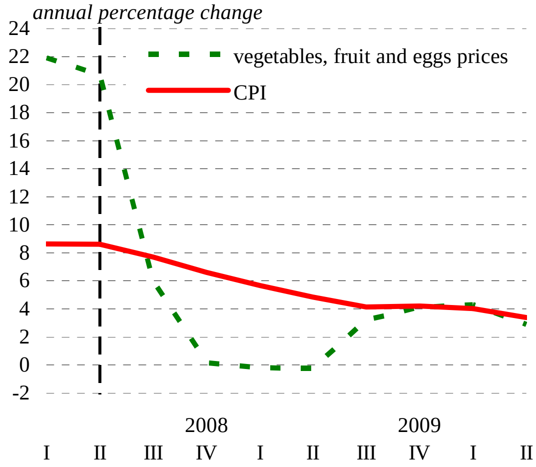
Along with the structural characteristics of the labour market, productivity developments and inflation expectations are the major landmarks in formulating wage claims. Nominal wages are eroded by inflation and, hence, employees and trade unions tend to seek compensation for *expected inflation*, given that wage bargaining is usually conducted once a year. In case of real wage dynamics overtaking productivity gains, companies will face higher unit labour costs which – if they cannot be offset by shrinking profitability margins – will feed through to consumer goods prices, thus generating inflation.

Inflation expectations have a paramount role in the transmission mechanism of interest rate stimuli to the real economy. This refers to the way in which the ratio between household saving and consumption is influenced by real interest rates, a component of real monetary conditions. *Ceteris paribus*, the lower the inflation expectations, the higher the real interest rates* on saving instruments and, hence, the higher the propensity of households to save by way of sacrificing current consumption; in addition, this would render lending products more expensive in real terms and would encourage households to reduce consumption financed through borrowings. Lower private consumption and increased saving further contribute to alleviating pressures on the growth rate of consumer prices stemming from aggregate demand.

** Real interest rate is calculated as the difference between the nominal interest rate and the expected inflation rate.*

Disinflation will accelerate starting with 2008 Q3 and is expected to be fostered by the favourable impact of bumper crops on food prices and the large share of foodstuffs in the CPI basket (37.5 percent). The progressive tightening of real monetary conditions[48] and a favourable base effect that is anticipated to become manifest in 2008 Q4 will bring annual CPI inflation rate to 6.6 percent at year-end. The monetary policy impulses generated by an adequately calibrated trajectory of the monetary policy rate and propagated through the transmission channels are expected to support during 2009 a gradual removal of inflationary pressures generated by aggregate demand, thereby ensuring the anchoring of inflation expectations of economic agents during the entire projection horizon.

Vegetables, Fruit and Eggs Prices and CPI

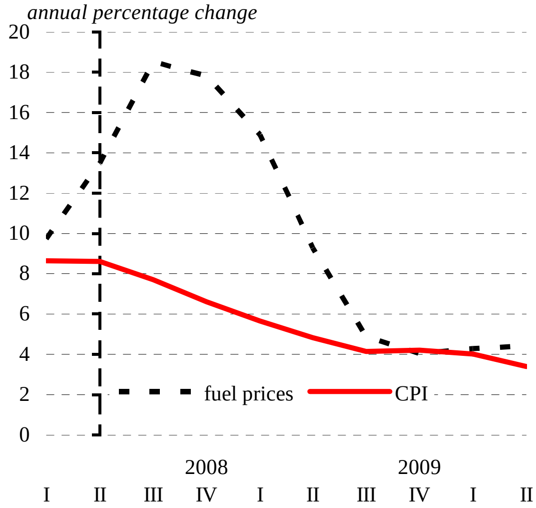


Source: NIS, NBR calculations

Under the current scenario, the CORE2 inflation rate is expected to follow a trajectory lower than that of CPI inflation throughout the eight quarters of the projection round. Compared to the figures presented in the previous Report, the CORE2 inflation path will be adversely affected by a higher starting point (actual inflation in 2008 Q2 is 0.2 percentage points higher than the previously projected figures) and a larger, more persistent excess demand throughout the forecast horizon. After gaining some momentum in Q3, annual CORE2 inflation will return to a downward path, reaching 3.9 percent towards the end of 2009, as a result of lower inflation expectations and a more favourable contribution coming from import prices. The steady downward trend in CORE2 inflation rate is set to be temporarily discontinued by the adjustments in excise duties on cigarettes and tobacco scheduled for 2009 and 2010.

The assumption envisaging bumper crops in 2008 and in turn a lower annual growth rate of food prices in 2008 H2 may translate into a more favourable exogenous scenario of volatile prices of vegetables, fruit and eggs compared to the previous Report (0.2 percent year-on-year rise in December 2008 against 4.9 percent in the previous forecast). Weakening tensions on the agri-food market will also be reflected with a lag by the dynamics of CORE2 inflation, thereby supporting a decline in prices of processed food items included in the basket. Based on such assumptions, in 2009 fuel prices and administered prices are expected to be the only components of the consumer basket displaying faster dynamics than the CPI inflation, thus slowing down the convergence of inflation towards the central target set by the National Bank of Romania.

Fuel Prices and CPI



Source: NIS, NBR calculations

[48] Restrictive monetary conditions in real terms have a bearing on excess demand, thereby curbing CORE2 inflation and translating into the gradual reduction of annual CPI inflation. Given that inflation expectations depend on the dynamics of overall CPI basket, a vigorous reduction of such expectations is estimated to start in 2008 Q3, once disinflation has resumed.

The sharp increase in the oil price since the last forecasting round led to a realised fuel price inflation that surpassed expectations for 2008 Q2 (13.5 percent versus 12.3 percent) and a higher-than-previously-projected figure in 2008 Q3. The higher starting point, the expected stronger inflationary pressures in the euro area and the unfavourable movements in the RON/USD exchange rate throughout the forecasting horizon prompt towards higher fuel price inflation – during the entire horizon – than previously projected.

1.2. Exogenous pressures on inflation

The cumulative effect of exogenous CPI components for 2008 is 0.3 percentage points lower in the current baseline scenario than in the previous projection, whereas that for 2009 is 0.1 percentage points higher than the forecast in the May 2008 Inflation Report.

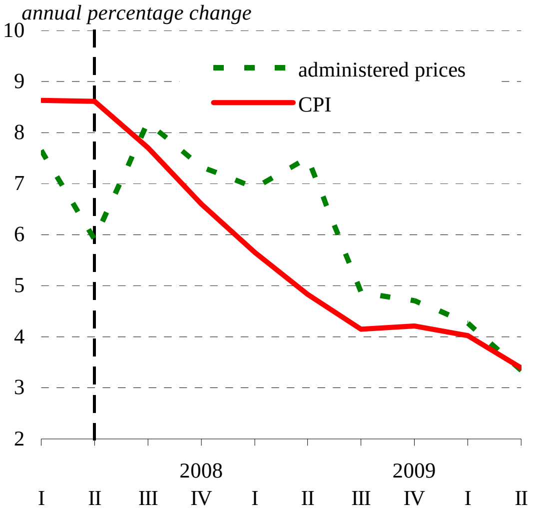
The decline in the cumulative effect of exogenous CPI components in 2008 is due to the significantly slower dynamics of volatile food prices (vegetables, fruit, eggs) than in the previous projection. In view of the recent higher-than-anticipated adjustments of energy prices, the growth rate of administered prices was subject to an upward revision by 0.2 percentage points for 2008 and by 0.4 percentage points for 2009. 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	7.3	4.7	0.2	4.1
Previous projection	7.1	4.3	4.9	4.1

Administered Prices and CPI



Source: NIS, NBR calculations

The significant revision of volatile food prices builds on the expectation of a good agricultural year and on the alleviation of tensions on the international unprocessed food market. The upward revision of administered prices is attributed to the higher-than-expected hikes in July in the prices of natural gas and electricity, as well to changes in the calendar regarding the increase in heating prices in Q4. 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	4.4	3.5	16.77	8.32	21.43	8.15
Previous projection	2.0	3.5	9.82	6.0	16.12	8.15

For 2008, the forecast on the euro area inflation rate was subject to an upward revision, owing to higher prices of oil and food items and to an expected step-up of wage increases. For 2009, the euro area inflation rate is expected to reach levels similar to those in the previous projection. According to the European Central Bank's latest forecasts[49], the annual inflation rate may even post higher levels (3.2 percent to 3.6 percent at end-2008 and 1.8 percent to 3.0 percent in 2009). In order to incorporate the expected higher restrictiveness of the monetary policy stance in the euro area, the scenario on the 3-month EURIBOR interest rate was subject to an upward revision both for 2008 and 2009. This scenario takes into account the level implicit in the FRA rates (Forward Rate Agreement[50]) recorded in early June and the European Central Bank's forecast.

Throughout the projection horizon, the oil price is assumed to remain constant at USD 140 per barrel. Table 5.4 summarises the expectations on the developments in the external variables included in the projection.

Table 5.4. Expectations on the developments in external variables

	2008	2009
3-month EURIBOR (%)	5.20*	4.50
Oil price (USD/barrel)	140	140
EUR/USD exchange rate	1.51*	1.42
Annual inflation rate in the euro area (%)	3.10**	2.10

* in 2008 Q4

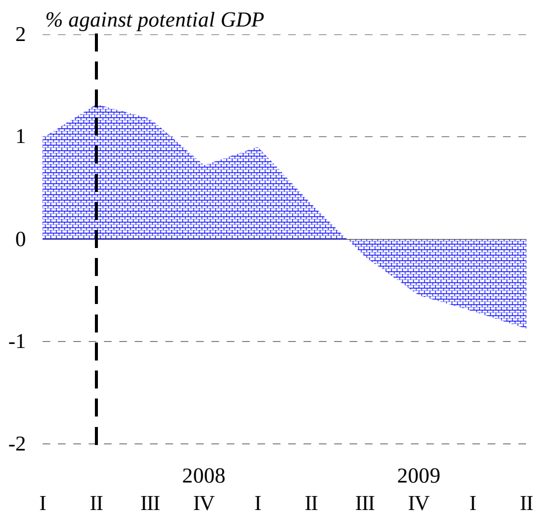
** in 2008 Q4 versus 2007 Q4

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

In 2008 Q1, the annual growth rate of real GDP stood at 8.2 percent, which is above the short-term forecast in the previous projection. We estimate that the fast-increase in the annual growth rate of the real GDP recorded in Q1 will continue in Q2, thus leading to a significant positive revaluation of the output gap. On one hand, excess demand came against the background of a faster growth rate of potential GDP, following the faster dynamics of investment across the national economy, with a favourable impact on productivity. On the other hand, excess demand was positively influenced by the strong base effect caused by the negative supply-side shock which affected agriculture in the previous year.

GDP Deviation



Source: NIS, NBR calculations

[49] "Eurosystem Staff Macroeconomic Projections", June 2008

[50] An agreement whereby the parties establish the level of the interest rate that is to be applied to the notional value of a loan at a future moment. It is used as a protection against the unexpected swings in the interest rate.

The analysis by utilisation components[51] reveals that final consumption and especially gross fixed capital formation were the main contributors to the positive GDP dynamics. Imports, regarded as a source for meeting the demand unsatisfied by domestic output, remained at high levels, confirming the existence of the excess demand.

Household final consumption is significantly above the trend level, with a markedly faster dynamics than that of gross domestic product. The existence of inflationary pressures from consumption is also suggested by the development of the latter's financing sources in the form of household incomes and credit. The real net wage exceeded the medium-term trend, while the unemployment rate fell below it, indicating the persistence of pressures on the labour market. Despite the slowdown trend in the annual growth rate, consumer credit is expected to post an increase that might lead to an expansion of excess demand. On the other hand, public consumption is above the trend, having the same impact on excess demand as household final consumption.

Gross fixed capital formation remained above the medium-term trend, its significantly fast dynamics being triggered by both investment in construction and investment in equipment with a direct impact on companies' retooling. The medium- and long-term credit to economic agents, viewed as investment financing source, continued to witness rapid real annual growth rates, albeit slower starting December 2007. The fast dynamics of imports, including the capital goods component[52], as well as the rapid increase in the industrial output of capital goods are indicative of a persistent positive gap between gross fixed capital formation and its trend level.

Exports were above the trend level, pointing to the positive developments recorded by the industrial output and the labour productivity in industry. As for imports, the persistence of

[51] The quality of the assessment of the economy's positioning within the business cycle and of the projections made on the basis of this assessment is strictly conditional upon the accuracy of the statistical data taken into consideration. *Ceteris paribus*, the revision of statistical data calls automatically for an update of both assessments and projections. For each quarterly projection, the NBR uses the latest data available (in the case of some indicators, the data used are provisional). The data released by the NIS for 2008 Q1 (related to GDP, GDP components and the corresponding deflators) may be subject to a future significant revision. This is suggested by the roughly 25 percent statistical discrepancy in the GDP calculated based on the expenditure method, as well as by the value of the imports deflator dropping below 1, which seems hard to reconcile with the depreciation of the RON and with the increasing trend in external prices manifest during the first quarter of 2008.

[52] In 2008 Q1, the share of capital goods imports came in at 24.7 percent in total imports FOB, compared to an average of 25.1 percent in 2007.

higher readings than those consistent with the medium-term trend is bolstered by the surge in household wage earnings and by the expansion in non-government credit, with the latter posting slower annual growth rates, albeit still very fast.

1.3.2. Implications of recent exchange rate and interest rate developments on economic activity

In 2008 Q2, the domestic currency appreciated in both real and nominal terms as against the previous quarter, despite the persistent deterioration, starting with 2007 Q3, of investors' perception of the risk associated with investment in Romania. Beside the unfavourable impact exerted by the international context (i.e. the lingering negative effects of the US sub-prime mortgage market crisis and the still grim inflation outlook worldwide), there are several factors specific to the Romanian economy that had an influence on exchange rate developments. On the one hand, the persistently wide current account deficit and the unfavourable short-term inflation outlook act towards the depreciation of domestic currency. On the other hand, the effects of these factors were reversed by the invalidation of expectations on economic growth deceleration in the context described above and by interest rate developments, the latter accounting for the nominal appreciation of the RON as compared with Q1.

The exchange rate had a slightly contractionary effect on aggregate demand through the net export channel, thus contributing to the alleviation of future inflationary pressures. In addition, through the wealth and balance sheet effects, the exchange rate had a neutral impact on economic activity in 2008 Q2. Moreover, the nominal appreciation had a direct impact on inflation via the decrease in import prices.

In the medium run, the exchange rate is driven by fundamentals (i.e. sustainable 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 further supports the real appreciation trend of the RON in the longer run.

Acting towards bringing inflation back on a trajectory compatible with achieving the annual objectives, the NBR Board decided in its meetings of 26 March and 6 May 2008 to raise the monetary policy rate by a cumulative value of 0.75 percentage points to 9.75 percent. (The policy rate was again raised by 0.25 percentage points in the NBR Board meeting of 26 June, a decision which would exert a significant impact starting with Q3). Given the continued firm control over liquidity, the spread between the average interest rate on credit institutions' deposits with the NBR and the monetary policy rate remains significantly low. Against the background of a slight increase in inflation expectations as compared with the (high) values recorded in the previous quarter, the rise of the nominal interest rate translated into that of the real interest rate.

The NBR's effective interest rate influences the real economy indirectly, through credit institutions' 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 Q2 however, credit institutions' nominal deposit and lending rates rose faster than the NBR's effective rate. This development illustrates two phenomena. First, the effect of the NBR's effective rate increases in the past quarters. Second, there are more restrictive conditions for banks' access to external financing; therefore, they resort to raising funds from the domestic market via the rise in the deposit rate. Against the background of the slower dynamics of inflation expectations, real interest rates picked up significantly as compared to the previous quarter. Therefore, in 2008 Q2, the cumulative expansionary effect of real interest rates on economic activity is of a significantly lower magnitude than in the prior quarter.

Overall, monetary conditions put slightly higher restrictive pressure on aggregate demand and future inflation in 2008 Q2 as compared with Q1.

1.3.3. Demand pressures within the projection horizon

The baseline scenario of the current projection envisages the upward revision of excess demand in 2008 Q2, to 1.3 percent from 0.7 percent, which is indicative of the higher inflationary pressure from aggregate demand. The revision is attributable to the faster paced economic growth in 2008 Q1 compared to that projected in *May 2008 Inflation Report*. For the remaining quarters of 2008, a brisk growth pace[53] is expected, also reinforced by the prospects of a good agricultural year, which will keep GDP above its potential level.

The elimination of excess demand will occur in 2009 Q3 (one-quarter delay as compared to the prior inflation report). During the projection horizon, the trajectory of GDP deviation from its potential is established by the dynamics of real monetary conditions, as illustrated by *the deviation of real effective exchange rate from the trend, the deviation from the trend of*

[53] See also footnote 51.

deposit and lending rates applied by credit institutions, *the wealth and balance sheet effects*[54], as well as by *the coordinates of fiscal policy*.

Overall, the projection foresees that real monetary conditions will remain tight throughout horizon, posting a gradual acceleration in the first half of the interval. The projected trajectory of real monetary conditions is the result of certain factors posting mixed developments. As compared to the prior projection, the effects on current and projected inflation of the recent additional supply-side and aggregate demand shocks have a negative impact on inflation expectations. Higher inflation expectations contribute to the loosening of real monetary conditions, by the repositioning of deposit and lending rates applied by credit institutions in relation to their trends. On the other hand, during the first part of the horizon, the projection of a higher inflation rate entails a real appreciation of domestic currency, thus contributing to a tightening of real monetary conditions[55]. During most of the projection horizon, the wealth and balance sheet effects will act towards reducing excess demand, following the higher than previously external interest rates assumption (3-month EURIBOR).

The successive rises in policy rate led to the gradual increase in nominal deposit and lending rates applied by credit institutions. Therefore, real deposit and lending rates reside in positive territory. The real levels of such interests are envisaged to move up in the first part of the projection horizon, thus acting towards a slowdown in lending to the private sector and the adjustment of households' behaviour in favour of saving rather than current consumption.

In the period since May, the persistently high volatility on the global financial markets further fostered foreign investors' risk aversion regarding investments in RON-denominated financial instruments. Nevertheless, during the projection horizon, a gradual return of the risk premium to lower values[56] is assumed, which will cause a slight real appreciation of local currency as compared to the previous projection. Given the higher projected domestic inflation rate, the quarterly real appreciation of the RON is expected to be higher throughout the projection horizon

[54] For additional details regarding the impact of the wealth and balance sheet effects on excess demand, see the Box in November 2005 Inflation Report (p. 43).

[55] In the short and medium run, a domestic inflation rate higher than that in peer foreign trade countries will result in the real appreciation of domestic currency. In the long run, inflation differential and nominal depreciation tend to post the same value (via the purchasing power parity mechanism), with a neutral effect on the real exchange rate.

[56] For example, CDS spread on domestic bonds maturing in 5 years fluctuated during July, showing no clear indications of either increase or decrease.

compared to the values in the May Inflation Report. This has a less favourable impact on net exports, thereby stimulating the reduction of excess demand.

As regards the current projection, assuming the full compliance with the fiscal coordinates in the baseline scenario, the fiscal component of the macroeconomic policy mix is seen as less stimulative compared to the prior round and is expected to tighten starting with 2009 Q3. Due to the slightly downward revision of budget deficit forecasts for 2008-2010, as well as to the outlook of a larger excess demand, the discretionary component[57] of fiscal policy has a lower inflationary impact during the projection horizon.

As for the dynamics of GDP components, domestic demand is further seen as the main driver of economic growth. However, the tight monetary conditions will dampen the pace of economic growth. Real positive interest rates will boost households' propensity to save. Moreover, the rise in lending rates applied by credit institutions will slow down the growth rate of loans to households, generating a deceleration in the growth rate of private consumption and imports of consumer goods. The strong pick-up in disposable income, attributable mainly to wage hikes as well as to larger remittances from abroad will still be supportive for the dynamics of private consumption, so that the growth rate of consumption will slow down only gradually. During the projection horizon, gross fixed capital formation is expected to post high growth rates, exceeding those of the other domestic demand components. In the first part of the projection horizon, real appreciation of domestic currency will act towards containing net exports growth, while the subsequent reversal of the RON appreciation path is seen to support the cut in external deficit.

1.4. Risks and uncertainties surrounding the projection

Over the projection horizon there is a risk of certain events materialising, thereby causing the main macroeconomic variables to deviate from the trajectory associated with the baseline scenario. The balance of risks for the current projection indicates a higher likelihood of a rise in inflation compared to the baseline scenario.

[57] The cyclical component of fiscal policy is that part of total budget deficit that can be determined directly – and automatically – depending on the position of the economy within the business cycle (i.e. larger budget revenues and smaller expenditures during expansion periods). On the other hand, the structural (discretionary) component determines the autonomous impact of budget policy on the economy, its role residing in capturing the changes in the government fiscal behaviour.

Some of the scenarios described in the May 2008 Inflation Report are deemed relevant for the current projection as well. Risk factors could be divided into two categories and relate to:

– heightened turbulence on *international* financial and commodity markets (especially those likely to put pressure on oil prices) and their implications on the Romanian economy;

– the considerable widening of *domestic* imbalances, which might impact the labour market (real wage dynamics overtaking productivity gains), the forex market (renewed depreciation of the domestic currency) or the coordination of macroeconomic policies (implementing looser fiscal and wage policies compared to the baseline scenario assumptions).

Overall, given that the current domestic and global environment is subject to various tensions, the likelihood of the aforementioned factors occurring independently is rather low, as some risk factors with complementary action might arise simultaneously.

The mismatch between real wage increases and labour productivity gains could fuel inflationary pressures via the cost channel. Over the short run, the persistence or even the widening of this gap[58] – through higher unit labour cost – will boost inflationary pressures, eventually forcing employers to concede wages they can only afford by raising the price of traded goods. *Over the medium term*, the unfavourable gap between wages and productivity in relation to trade partners could impair the external competitiveness of Romanian companies[59]. This would send ripple effects to trade deficit sustainability and would involve a divergent exchange rate trajectory from the baseline scenario. The uncertainty related to this scenario is associated with the difficulty of accurately quantifying the second-round effects of the impulse given by pay rises[60]. The chart illustrates recent macroeconomic developments signalling the relevance of this risk.

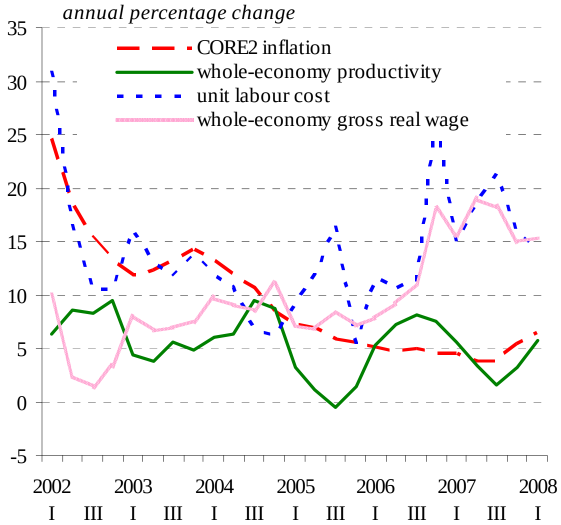
Box 2 reviews issues related to the risk assessment methodology and the quantitative assessment of the risk of higher whole-economy average wage.

[58] A wider gap might also be induced by: proposals to raise the minimum wage economy-wide to RON 540 from RON 500 as of 1 October 2008 and to RON 600 starting 1 January 2009; the scant labour supply facing private companies, likely to be aggravated by the regained momentum in central government job creation; the contagion effect on private sector wages of a looser income policy in the public sector; further migration of Romanian workers abroad.

[59] In 2007, unit labour cost rose by 15.9 percent (year on year) in Romania, by 2 percent in the euro area and by 1.2 percent in the EU.

[60] The assessment is conditional upon both the magnitude of the wage shock and the worst-hit ULC component.

Unit Labour Cost and Inflationary Pressures



Note: Whole-economy productivity: the ratio of gross value added and the number of employees economy-wide;
Unit labour cost (ULC): the ratio of total labour cost and gross value added economy-wide.
Source: NIS, EUROSTAT and NBR calculations.

The persisting uncertainties surrounding the international investment environment could cause exchange rate to deviate from the assumptions of the baseline projection. If the domestic currency were to re-enter an abrupt depreciation path, importers might try to transfer, either wholly or partially, the higher costs generated by a weaker RON to the retail prices of traded goods. As a result, the rise in import prices and hence in the prices of goods and services at end-consumers would deviate significantly from the projected trajectory in the baseline scenario. In addition, the simulations conducted using the forecasting model show that – in the event of shocks of a considerable magnitude – the multiple and opposite-sense effects[61] of a sudden fluctuation in the exchange rate would hamper an efficient monetary policy response, even in case of its prompt reaction via the recalibration of the entire array of available instruments.

The inadequate coordination of fiscal and income policies with monetary policy could lead to a significant deviation of the inflation trajectory from the coordinates of the baseline scenario. The lack of coordination of other macroeconomic policies (particularly fiscal policy and public sector income policy) with the monetary policy would be a major drag on bringing inflation back within the variation band around the central target in 2009. For instance, a slippage of the fiscal policy coordinates[62] from the assumptions of the baseline scenario would add to the stimulative effect of aggregate demand and thus trigger inflationary pressures.

This risk could not be strictly delineated from the risk of *worsening inflation expectations of economic agents*. The negative impact on projected inflation could be amplified if the central bank faced difficulties in anchoring inflation expectations and perceptions of economic agents, especially in the context of exacerbated exogenous shocks likely to hit the economy.

[61] For instance, a much stronger RON would entail favourable effects over the short term, although most likely reversible in the longer run, on the net wealth of debtors whose financial liabilities comprise mostly instruments with short-term maturities denominated in foreign currencies.

[62] There is increased likelihood of a slippage of fiscal and income policy coordinates from the baseline scenario assumptions, particularly given the successive election rounds scheduled over the projection horizon.

Box 2: Quantitative assessment of the risk of higher whole-economy average wage

Macroeconomic projections within an inflation targeting regime are a key element for the monetary policy decision-making process of the central bank. The efficiency of monetary policy in impacting economic activity is also conditional on the manner in which the central bank informs the general public about its own assessments and forecasts as well as on explaining the rationale behind the steps taken to attain the pre-announced target.

The quantitative or qualitative assessment of the impact of certain risk factors on the inflation projection in the baseline scenario is an absolute must within each forecasting cycle. For each forecasting round, the risk factors mentioned in the Inflation Report are selected from among those considered to have a reasonable likelihood of materialising in the coming period and whose evolution could diverge substantially from their coordinates envisaged by the baseline scenario. Such an approach is particularly required in the case of variables for which information is scarce or for which the intricacy of the transmission mechanism cannot be captured by the model. For reasons pertaining to the monetary policy decision-making process, every risk factor comes with at least one qualitative assessment regarding their likelihood to materialise and the direction of their impact on the relevant variables.

In the context of a persistent gap between the evolution of real average wage and that of productivity and on the back of public discussions regarding a higher whole-economy minimum wage, assessing pay rises *as a risk factor* is particularly relevant. The *direct* mechanism whereby wages come to influence consumer goods prices and other macroeconomic variables was already described in the current section. The description matches the relations transposing macroeconomic theory concepts into a mathematically formalised framework. Insofar as the temporary growth of some consumer prices lingers on – as was the case in the recent periods, it would bring about a broad-based phenomenon of stronger wage claims across the economy. The magnitude of *indirect* (second round) effects of higher wages on consumer prices – substantially stronger than those pertaining to the direct effects – is, however, difficult to appraise in terms of the formalised framework mentioned above.

The quantitative assessments set out in the table below should be viewed as the additional effects of supply-side shocks coming from higher wages. More precisely, they refer to the estimation of *direct* effects on inflation generated by further increases in the *whole-economy gross average wage*, apart from those already incorporated in the baseline scenario. Against this backdrop, given the above-mentioned difficulty in estimating *indirect* effects of a pay rise, the figures resulting from the simulations based on the macroeconomic model are indicative of the lowest effects possible, matching the macroeconomic relations that could be modelled explicitly. The impact on the annual inflation projection in the baseline scenario is shown in the table below, depending on the scale and the persistence of such a shock. *The scale of initial shocks on the rise in the average wage (the first column) is chosen for illustrative purposes and should not be interpreted as an NBR forecast for the projection horizon.*

Additional annual increase in whole-economy gross average wage (in nominal terms)	**Temporal distribution**	**Additional impact on CPI inflation at end-2008 (Dec./Dec.)**	**Additional impact on CPI inflation at end-2009 (Dec./Dec.)**
Differences in percentage points (pp)		Differences in percentage points (pp)	Differences in percentage points (pp)
+4 pp	flat in the next 4 quarters	+0.1 pp	+0.6 pp
+4 pp	flat in the next 2 quarters	+0.2 pp	+0.7 pp
+8 pp	flat in the next 4 quarters	+0.2 pp	+1.2 pp
+8 pp	flat in the next 2 quarters	+0.4 pp	+1.4 pp

Persistent turmoil on global markets having led to higher prices of oil and other essential raw materials might exceed the assumptions regarding their magnitude incorporated in the baseline scenario. Oil price has been on a steady uptrend in recent months, with heightened uncertainty as regards its future dynamics compared to the trajectory assumed in the baseline scenario. Since the prices of some broad categories of goods and services in the economy depend, either directly or indirectly, on fuel prices, any change in the latter would progressively feed through into the former, generating a chain reaction in terms of inflation developments.

A risk common to all projections so far – which has materialised to a certain extent since the completion of the projection published in May 2008[63] – concerns the *developments in administered prices*, given the repeated changes in their adjustment calendar. Over the current forecast horizon, to this adds the risk of a possible amendment of provisions regarding intra-EU harmonization of excise duties on cigarettes and tobacco products. Thus, a proposal for a Directive[64] presented by the European Commission sets forth a gradual increase in the EU minimum taxation levels on cigarettes and fine cut tobacco up to 2014. Given the share of goods with administered prices in the consumption basket and the relevance of excise duty in altering the CORE2 inflation trajectory, inflation would follow a higher than projected trajectory in the event of price adjustments veering off the baseline scenario assumptions.

[63] The increase in natural gas and electricity prices has been anticipated ever since May, but could not be accurately quantified so as to be added to the baseline scenario assumptions.

[64] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1149&format = HTML&aged=0&language=EN&guiLanguage=en

2. Policy assessment

Annual inflation rate ceased rising at the beginning of 2008 Q2, reaching 8.61 percent in June 2008. Special mention deserves the persistence of the substantial deviation from the upper limit of the variation band associated with the central target. The major determinants of the trend reversal experienced by the 12-month rate of inflation were the volatile prices of some food items and administered prices, both of which worked as catalysts for disinflation. This impact was however countered by the ongoing surge in fuel prices and the year-on-year depreciation pace of the domestic currency, as well as by the faster rise in CORE2 inflation. The latter development is indicative of not only direct and especially ripple effects from supply-side shocks and costs, including higher ULC, but also bigger demand-pull inflationary pressures and worsening inflation expectations.

The updated forecast of medium-term macroeconomic developments incorporates the most recent statistics and data available, highlighting the further deterioration of the inflation outlook. The upward shift in the trajectory of the projected annual inflation rate in the current forecasting round is significantly higher and longer than the pattern expected in May. This feature is anticipated to last throughout the projection horizon. At the same time, the deceleration in inflation is expected to be relatively slower and the levels of the annual consumer price index are seen returning inside the variation band around the central target one quarter later than envisaged in the previous forecast.

Over the near-run forecast horizon, supply-side/cost-push factors that are beyond the control of the central bank were still viewed as the chief determinants of the anticipated worsening of the inflation performance. Their inflationary impact is foreseen to be somewhat broader and longer given that the favourable effects arising from the expected persistence of the slowing dynamics of highly-volatile food prices will be offset by the stronger influence of both significant administered price adjustment and the surging oil price on global markets.

The threat that the sizeable price hikes could prompt second-round effects or heighten the effects already in place via a more persistent worsening of inflation expectations is a major cause for concern of the National Bank of Romania. The risk is aggravated by the forecasted protraction until mid-2009 of the interval during which the projected annual inflation rate stays above the upper limit of the variation band associated with the central target. The NBR is even more concerned about the fact that some consumer price increases and especially the large pay rises in Q2 might to some extent be the second-round effects of previous supply-side shocks, despite the numerous vocal interventions of the central bank and the successive monetary policy rate rises implemented in 2008 H1.

From this perspective, another central bank response is needed in order to fend off a more severe deterioration of inflation expectations and in turn of wage- and price-setting behaviours. The risk of such behaviours to worsen could be amplified by (i) the likely maintenance of lax income policy in the context of the approaching election run-up as well, (ii) the ongoing demonstration effect entailed by budgetary-sector wage policy and (iii) a still tight labour market. Such a risk materialising is dangerous if wage increases continue overtaking productivity gains, which might bring about inflationary pressures and external competitiveness losses. However, the risk of excessive wage dynamics perpetuating could be mitigated by the joint action of the recent ULC growth and costlier energy and raw materials as a result of surging global commodity prices, on the one hand, and by the possible narrowing of corporate profit margins given that stiff competition appears to prevent companies from passing the above-mentioned rises on to producer prices, on the other hand.

Another major cause for concern is the risk of stronger and more protracted demand-pull inflationary pressures over the entire forecast horizon amid expectations of a larger and longer positive output gap compared to the previous projection. The key prerequisites and reasons behind the renewed delay in the elimination of excess aggregate demand are (i) faster-than-expected GDP growth in 2008 Q1, (ii) insufficient tightening of the current monetary conditions despite the successive monetary policy rate hikes October 2007 through June 2008, and (iii) the inherent lag pertaining to the efficient transmission of the impact of tighter monetary policy stance incorporated in the projection.

Against this background, yet another key interest rate increase is all the more necessary as the forecast of medium-term macroeconomic developments is surrounded by considerable uncertainties and faster-than-previously-projected economic growth is highly likely. From this perspective, the greatest risk is the possibly larger-than-anticipated expansion of household consumption owing to the ongoing excess pick-up in pay rises, which was also fuelled by the recently announced gradual increase in the whole-economy gross minimum wage. Under these conditions, private consumption could as well be boosted by the return to an upward path of the dynamics of loans to households and/or the protracted weakening of bank saving.

The relative acceleration of final household consumption growth could also be prompted by the likely implementation of looser-than-projected fiscal policy, particularly the increase in the share of wage and social security expenditures in total public spending ahead of local and general elections. A larger-than-expected pro-cyclical feature of such policy might trigger expansionary effects through stronger final government consumption and increased outlays intended for public investment financing, which actually substantiated the budget revision of last July. Against this backdrop, the central bank seeks both to limit the scale of the fiscal easing – which is anticipated to be significant given the atypical budget deficit at mid-2008 – and to mitigate the risk of making larger current (consumption-related) expenditures in the run-up to year-end.

Household consumption has a stimulative impact on aggregate demand which could however be partly offset by the stronger action of some factors capable of dampening this behaviour. Such a potential could come from the anticipated slower dynamics of real disposable income of households given the costlier food and energy combined with the deceleration in remittances growth, as well as the likely implicit worsening of expectations pertaining to this type of income. Moreover, there is an increased likelihood of aggregate demand inflationary potential to be significantly mitigated by the expansion of self-consumption, a driver of household consumption growth, amid anticipations of good performance in the agricultural sector.

The higher bank debt service of households (in both domestic and foreign currencies) arising from the substantial depreciation of the RON versus the EUR and the gradual increase in interest rates on consumer loans might also act as a disincentive on private consumption growth. A similar impact will have the likely protraction of the uptrend in lending rates on EUR-denominated credit in response to the anticipated tightening of credit standards by parent undertakings and most notably to the recent hike in ECB key rate.

In addition, these developments could put a dent on households' demand for loans and may even entail a further or even sharper downward path in the dynamics of such loans. The deceleration in household credit growth could also be fostered by the emergence or even pick-up of contractionary effects on demand for loans as a result of (i) persistence of global market turmoil, (ii) decrease in excess liquidity across the banking system, and (iii) the central bank's recent or future prudential supervision measures. Demand for loans might also be constrained by the impact of the recent heightening of uncertainties surrounding the evolution of some fixed asset prices given that, after having recorded a long upsurge, some prices on the real-estate market have recently witnessed patchy declines.

The movements in the RON exchange rate are still affected by uncertainties, but their potential to boost inflation in the near run dwindled considerably. By contrast, assuming that the interest rate differential as against global markets increases, in step with financial investors' risk appetite, the domestic currency might strengthen further. Nevertheless, how sustainable such a development would be hinges upon the improvement in domestic economic fundamentals, which cannot be initiated or consolidated otherwise than by implementing a more consistent mix of macroeconomic policies and stepping up structural reforms.

Given the updated forecast of the medium-term macroeconomic developments and the prevailing upside risks to inflation, the NBR Board has decided to raise the monetary policy rate by 0.25 percentage point to 10.25 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 current minimum reserve requirement ratios on both RON- and foreign currency-denominated liabilities of credit institutions. Against this background, the NBR Board reaffirmed its resolution to firmly gear monetary policy towards countering demand-pull inflationary pressures and anchoring inflation expectations, emphasising the need for enhanced support to monetary policy from the other components of the macroeconomic policy mix, as well as from structural reforms.