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N O T E

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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 28 October 2008 and approved by the NBR Board in its meeting of 30 October 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)
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
OECD	Organisation for Economic Co-operation and Development
ON	overnight
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
ULC	unit labour cost
UVI	unit value index
1W	one week
12M	12 months

Contents

I. SUMMARY

Developments in inflation and its determinants

In September 2008, the 12-month inflation rate stood at 7.30 percent, down by 1.31 percentage points against June, when the reading was 8.61 percent. This development confirms the previous projections of the National Bank of Romania according to which disinflation would resume starting 2008 Q3.

Among supply-side factors, the rebound in agricultural output – in the wake of the adverse shock during 2007 – acted as the major determinant of the slowdown in inflation. This performance impacted in particular the volatile prices of some food items, with cheaper fruit and vegetables offsetting the opposite effects on inflation dynamics exerted by developments in administered prices and fuel prices.

The mismatch between payroll increases and productivity gains during June-August 2008 compared to the first five months of 2008 led to further increases in unit labour cost, generating inflationary effects through both the pressure of higher wages on excess demand and cost-push pressures on producer prices.

The uptrend in annual CORE2 inflation, which had been manifest since August 2007, came to a halt in 2008 Q3. The effects of higher aggregate demand pressure on core inflation were countered by the considerable slowdown in the growth rate of prices for processed foodstuffs included in the CORE2 basket, the favourable influence of a stronger domestic currency versus the euro on import prices and relatively lower inflation expectations. Against this background, CORE2 inflation dynamics in the third quarter of 2008 was slower than that of the overall CPI inflation, thus contributing to the latter's deceleration.

In 2008 Q2, ongoing acceleration of economic growth (to 9.3 percent) fuelled inflationary pressures from excess demand. Behind the GDP growth stood the surge, albeit slightly decelerating, in both investment and final household consumption, underpinned by sizeable increases in the incomes of economic agents and loans to the private sector, as well as by the advance in public expenditures. The slowdown in domestic demand dynamics was more than offset by the marked decrease in the negative contribution of net external demand to GDP growth. The gradual and significant narrowing of the trade deficit started in the final months of 2007. The consolidation of this tendency led to exports growth outpacing that of imports in 2008 Q2 and Q3 (until August) for the first time since 2002 Q4.

Monetary policy since the release of the previous Inflation Report

On 31 July 2008, the National Bank of Romania Board decided to raise the monetary policy rate to 10.25 percent per annum. Subsequently, global and domestic macroeconomic developments sent diverging signals regarding the medium-term inflation outlook. As a confirmation of NBR projections, the annual inflation rate re-embarked on a downward trend after reaching a peak in July. The growth of credit to the private sector began slowing gradually, whereas the exchange rate of the domestic currency posted greater volatility and a trend reversal, from appreciation to depreciation, towards the end of 2008 Q3. Inflationary pressures exerted by aggregate demand increased due to the faster second-quarter economic growth while real wages continued to overtake productivity gains. In addition, with the approaching run-up to the elections, the risk of looser fiscal and income policies became more relevant.

The deepening of the global financial crisis (especially starting September) led to a sizeable increase in uncertainties surrounding the world economic outlook, as well as concerning their implications on the Romanian economy. The broad-based global financial deleveraging process, resulting in increased risk aversion and a subsequent flight to quality of non-resident investors' capital began to gradually, but ever more strongly affect emerging economies, entailing substantial volatility of local currencies. To date, emerging market currencies have been mostly subject to downward pressure.

In this global context, the likelihood of a significant direct impact of financial deleveraging on the Romanian economy appears to be remote, given the information available thus far. A contributor to this state of affairs is the still low financial intermediation in Romania[1] and the lack of significant exposure of the financial and banking system to the financial instruments lying at the root of the crisis (subprime mortgage-backed securities)[2]. In such circumstances, the deepening of the international financial crisis is expected to affect domestic economic activity mostly indirectly, via the impact of the envisaged flagging aggregate demand in the euro area on Romania's exports dynamics. This indirect influence is enhanced by the tightening of domestic lending conditions along with the rises in external financing costs and debt service of economic agents, especially those exposed to foreign currency-denominated debt. Amid growing uncertainties, both the magnitude and duration of these processes are difficult to assess.

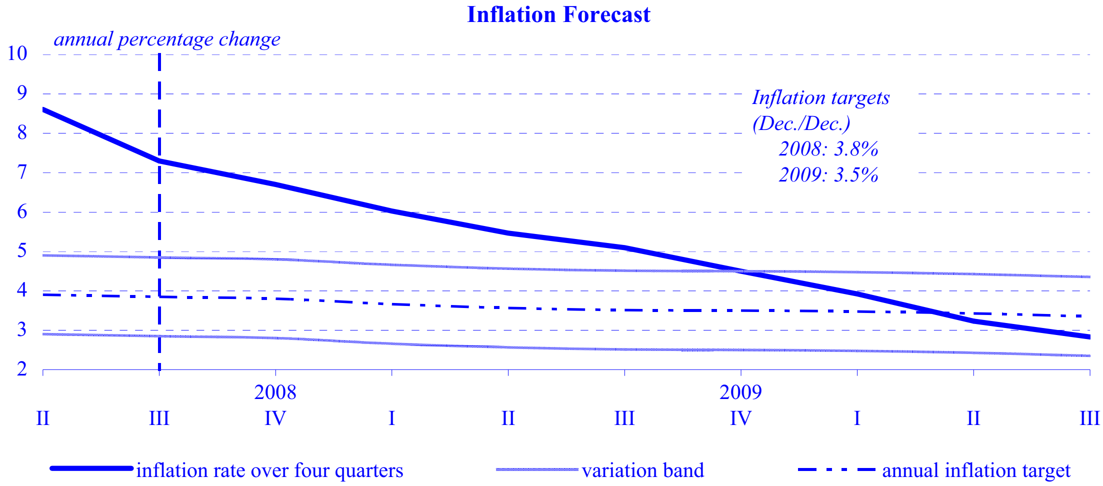
In response to the domestic macroeconomic developments and the global environment affected by heightened uncertainty, the NBR Board decided to keep the monetary policy rate at 10.25 percent per annum in its meeting of 25 September. The decision was meant to strike a balance between the gradual tightening of real monetary conditions once inflation has resumed its forecasted downward trend, with the aim of fulfilling the medium-term disinflation objectives, and ensuring an adequately prudent policy stance is maintained when faced with the emergence of new risk sources at macroeconomic level.

Inflation outlook

The recent deepening of the global financial turmoil caused a marked rise in volatility on world markets, posing major difficulties to forecasting the nature, magnitude and duration of the effects of the crisis on the domestic economy. Therefore, the quantitative assessments in the baseline scenario of the current projection are afflicted by a higher than usual degree of uncertainty. Against this background, the baseline scenario describes, to a far greater extent than in the previous exercises, a possible trajectory of inflation strictly conditional upon the adopted assumptions and the information available upon preparing the forecast. Consequently, deviations from the projected inflation path are more likely to occur in both directions in the current forecasting round, the identified risks being more balanced as concerns their upside versus downside impact on inflation than in the previous rounds.

[1] The annual weight of non-government credit in GDP amounted to 38.9 percent in 2008 Q2, compared to an average of 48 percent in Poland, Hungary and the Czech Republic.

[2] A limited direct impact of the financial crisis is also due to the measures taken over time by the National Bank of Romania to improve prudential supervision, increase policy efficacy and enhance financial stability. Special mention deserve the relatively high level of reserve requirements associated with foreign currency-denominated liabilities of credit institutions and also the recent prudential measures aimed at dampening credit expansion.



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

Source: NIS, NBR calculations

The baseline scenario of the current projection places the 12-month inflation rate at 6.7 percent for end-2008, 0.1 percentage points above the figure published in the August 2008 *Inflation Report*. For end-2009, inflation is forecasted to stand 0.3 percentage points above the previously projected level (4.5 percent versus 4.2 percent), which places it at the upper bound of the variation band around the end-year target.

The new projection puts the inflation rate trajectory above that presented in the August 2008 Inflation Report until end-2009. Compared to the previous projection, the factors boosting forecasted inflation include: more pronounced pressures from CORE2 inflation, which could be associated with higher pressures exerted by aggregate demand, as reflected by faster GDP growth in Q2 and expectations of robust GDP increase in Q3; looser fiscal and income policies expected during the projection horizon; a less favourable evolution of import prices as well as the assumption of a somewhat slower decrease in inflation expectations in the first part of the forecast horizon; and the assumed more rapid increase in administered prices. Such unfavourable influences are mitigated throughout the forecast horizon by the more favourable scenario regarding fuel price inflation. Adding to these influences is the difficult-to-precisely-assess effect of global financial turmoil on euro area economic activity, which may spill over quickly into the deceleration of domestic economic activity.

In light of the currently available data and taking into account the unusually high uncertainties, the baseline scenario of the projection assumes a noticeable slowdown in the growth rate of aggregate demand over 2009, given the combined pressures of successive monetary policy rate increases, the recent prudential measures taken by the NBR in order to curb lending growth, the temporary rise in the costs of both foreign borrowing and debt service of economic agents exposed to foreign-exchange denominated debt, as well as of the constraints on credit dynamics owing to the global financial turmoil. The envisaged deceleration in the pace of increase of euro area external demand for Romanian exports is seen as restricting the pace of domestic economic activity and, in turn, excess demand. Moreover, a slowdown in the dynamics of domestic absorption components, particularly private consumption, is projected, translating into a deceleration of import expansion. This development will pave the way for the controlled reduction of excess demand, with the projection foreseeing a temporary elimination of excess demand in 2009 Q2 and Q3, thus favouring disinflation. Subsequently, the pace of economic growth is seen returning to somewhat higher levels, insofar as the constraints triggered by the global financial crisis diminish gradually.

The NBR will further channel its efforts to driving the inflation rate towards the established targets while striving to ensure the adequate functioning and stability of the financial system amid the adverse effects of the global financial crisis. To this end, the firm monetary policy stance will be retained throughout the projection horizon. This will help bring inflation back within the variation band around the central target in the latter part of the forecast horizon, conditional upon adequate support from the other macroeconomic policies and the absence of any significant slippages from the coordinates of the baseline scenario.

The major uncertainties surrounding the effects of the global financial turmoil on the world economy and on the national economy have serious consequences both on the layout of the baseline scenario of the current projection and on identifying and quantifying the effects of risk factors most likely to become manifest during the current forecasting round. Compared to the previous rounds, risk factors associated with global market developments become increasingly relevant for the current projection due to the recent surge in the global financial crisis and the expectation of its more persistent effects on domestic economic developments in the medium term. The current projection round is characterised by relatively balanced upside versus downside inflation risks, whereas the specific macroeconomic environment in the previous rounds had tilted the balance of risks mainly towards scenarios indicating upside risks were prevalent. Thus, the risks accompanying the movements in oil and other commodity prices, administered prices and volatile food prices, as well as the risks associated with exchange rate dynamics are relatively symmetrically distributed against the projected trajectories. Special importance is also attached to asymmetric risks: on one hand, the risks of higher inflation due to real wage growth overtaking productivity gains and a more expansionary fiscal policy; on the other hand, the threat of lower inflation, which is likely to occur following a faster slowdown in economic growth than in the baseline scenario, under the impact of the global financial crisis.

Monetary policy decision

Considering the new coordinates of the medium-term inflation forecast as well as the complexity associated with the numerous uncertainties, the NBR Board has decided in its meeting of 30 October 2008 to keep the monetary policy rate unchanged at 10.25 percent per annum. At the same time, the NBR Board has decided to lower the minimum reserve requirement ratio on RON-denominated liabilities of credit institutions to 18 percent, from 20 percent previously, starting with the 24 November – 23 December 2008 maintenance period. This decision is aimed at improving liquidity management given that the trend of gradual reduction in excess liquidity in the banking system and, implicitly, in the central bank's net debtor position in its relation with credit institutions – as signalled by the NBR starting April 2008 – has become more pronounced of late. Moreover, the current 40 percent minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions was left unchanged. By taking these measures, the central bank is acting in a proactive manner towards consolidating the traditional monetary policy transmission channels with a view to ensure sustainable financing of the economy amid the anticipated slower dynamics of foreign-exchange loans as the effects of the global financial crisis continue to spread. The NBR seeks to fulfil its medium-term objectives by pursuing sustainable disinflation which can only be achieved by avoiding the aggravation of macroeconomic disequilibria and by maintaining financial stability. Against this background, the NBR Board has restated the need for the steady and sustained monetary policy efforts aimed at countering demand-pull inflationary pressures and anchoring inflation expectations to be supported by strengthening the other components of the macroeconomic policy mix and speeding up structural reforms.

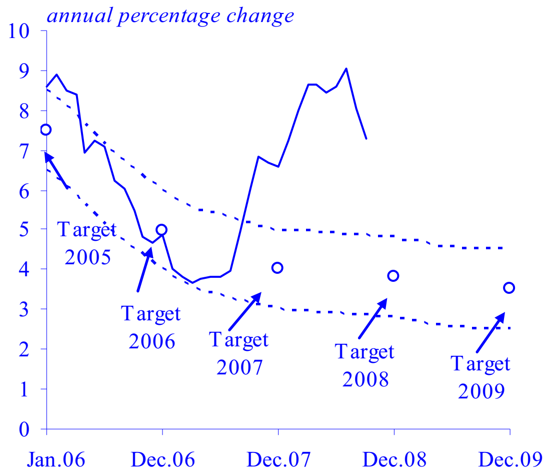
II. INFLATION DEVELOPMENTS

In 2008 Q3, the 12-month inflation rate entered a downward trend, after reaching a peak in July as a result of the energy price adjustment. At end-September, the annual inflation rate stood at 7.30 percent, i.e. 1.31 percentage points below the June figure, remaining however outside the ±1 percentage point variation band around the 2008 target of 3.8 percent. The main drivers of this performance were the dissipation of the supply-side shock which had affected the agri-food market starting with the latter half of 2007 and, towards the quarter-end, the favourable base effect associated therewith. Core inflation witnessed similar movements, the annual change falling to 6.9 percent in September. Amid the persistence of excess demand, the influence exerted by the satisfactory level of the 2008 crop on food prices was the main factor accounting for this performance.

In 2008 Q3, inflation developments were mainly influenced by the adjustment of some administered prices and the lower tensions on the agri-food market. Thus, following the hikes in the prices of electricity and natural gas by 4.51 percent and 12.53 percent respectively, the annual dynamics of administered prices accelerated by 3.8 percentage points month on month to reach 9.2 percent in July. However, the pressures exerted by this consumer price component diminished in the following months, as the impact of higher prices of water, sewerage and waste disposal services, and city transport (excluding the subway) was offset by the favourable effects generated on telephony prices by both domestic currency strengthening against the euro and Romtelecom cutting the prices for intercity calls down to the local calls' level. Nevertheless, in September, the annual dynamics of administered prices accelerated to 7.7 percent versus 5.4 percent in June.

During the period under review, volatile prices witnessed also sizeable movements, their annual change going down 8.4 percentage points from June to 7.9 percent. Behind this development stood chiefly the decrease in vegetable and fruit prices to the levels recorded in September 2007, given that at the end of Q2 annual increases had reached 16 percent and 22 percent respectively. The annual dynamics of volatile prices was further significantly positive and even faster than the average, owing to the fuel group: +15.1 percent in September year on year and slightly higher than in June. However, mention should be made that unlike the previous quarters, this acceleration was not due to oil products, as the slower growth rate of prices on the international oil market starting mid-July fed through quickly into domestic fuel prices.

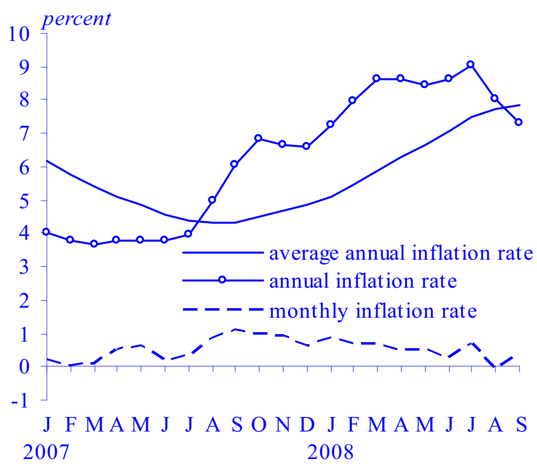
Inflation Developments



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

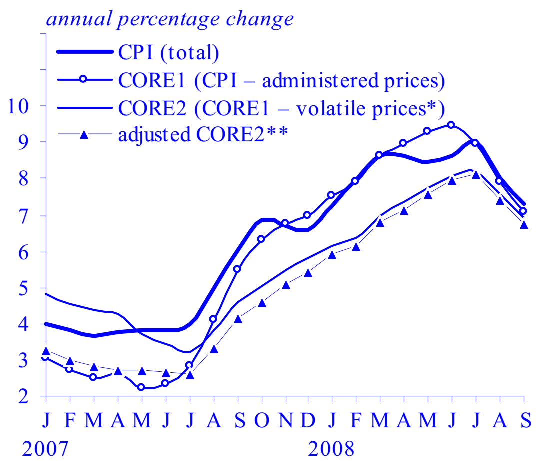
Source: NIS, NBR calculations

Inflation Rate



Source: NIS

Headline Inflation and CORE Inflation



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

**) excluding tobacco and alcohol

Source: NIS, NBR calculations

Administered Prices versus Market Prices

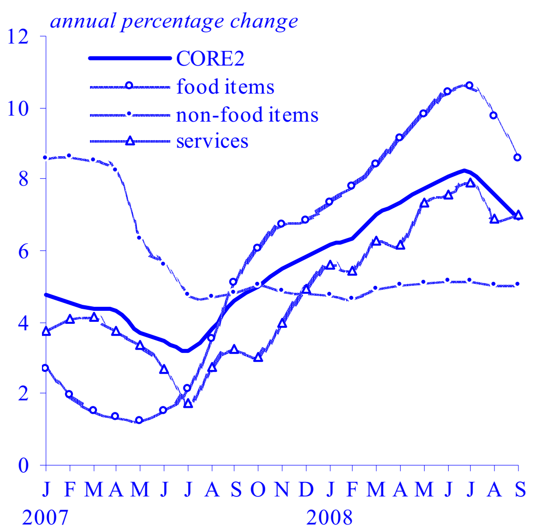
annual percentage change; end of period

	2007		2008		
	III	IV	I	II	III
Inflation Rate	**6.0**	**6.6**	**8.6**	**8.6**	**7.3**
Administered prices*	**7.3**	**5.0**	**8.5**	**5.4**	**7.7**
1. Non-food items*:	**5.7**	**0.5**	**4.2**	**2.8**	**8.3**
electricity	9.0	4.2	4.2	0.0	4.5
heating	20.8	5.8	5.9	6.0	6.0
natural gas	4.7	0.0	12.4	12.4	26.5
medicines	-5.7	-6.7	-4.2	-3.5	-1.5
2. Services*, of which:	**10.2**	**13.2**	**16.7**	**10.4**	**5.8**
water, sewerage, waste disposal	14.1	12.0	12.0	11.1	12.6
fixed telephony	-5.1	3.4	10.4	13.3	-0.3
passenger railway transport	37.2	27.4	16.5	8.1	0.0
(passenger) city transport	6.8	7.5	11.1	9.1	9.1
Market prices (CORE1)	**5.5**	**7.0**	**8.6**	**9.5**	**7.1**
CORE2**	**4.6**	**5.8**	**7.0**	**8.1**	**6.9**
CORE2 less tobacco, alcohol	4.2	5.5	6.8	8.0	6.7
tobacco, alcohol	9.3	10.0	9.0	9.2	8.7

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

Source: NIS, NBR calculations

CORE2



Source: NIS, NBR calculations

In 2008 Q3, the upward trend followed by CORE2 inflation during August 2007 – July 2008 came to a halt owing to developments in the vegetal output this time as well. Without reaching the magnitude of the slowdown in the dynamics of vegetable and fruit prices, the growth rates of some processed food prices (mainly milling and bakery products, and edible oil) decelerated as well (-1.9 percentage points versus June). Upside pressures became manifest on the "meat and products thereof" segment, the pork producers pointing to the steady increase in input costs (fodder, wages, utilities) and the import competition as the main culprits of the build-up of losses.

Market-priced services posted slower annual growth rates as well, albeit less pronounced (-0.5 percentage points to 7 percent), with the dampening impact of the domestic currency appreciation against the euro in the first two months of the quarter under review and of the emerging signs of weaker demand being partially offset by the pick-up in utility prices.

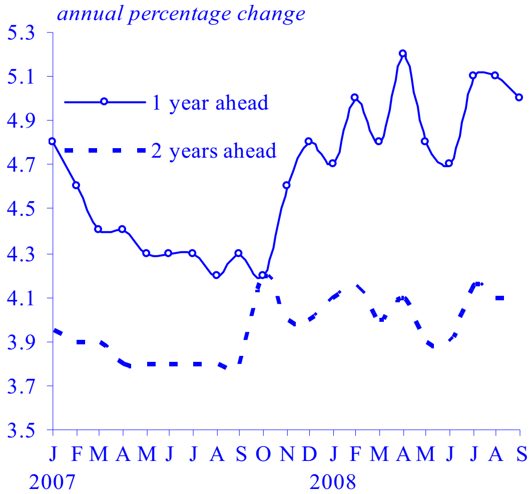
By contrast, non-food prices included in CORE2 inflation did not follow the same downward trend, their annual dynamics reaching 5.1 percent at end-September, i.e. a figure similar to that seen at the end of the previous quarter. Moreover, the quarterly change points to a faster growth rate of prices on this segment, the current figure of 1.5 percent being 0.6 percentage points higher than that recorded a quarter ago. Although this rise is mostly accounted for by higher excise duties on tobacco products in July, the following pressure-inducing factors cannot be overlooked: excess demand, second-round effects generated by the recent adjustment of electricity and natural gas prices, higher external prices and unit labour costs. Favourable influences on non-food related CORE2 came from the stronger RON against the euro and a relative improvement in inflation expectations, noticeable both in industry and trade surveys, and in the survey among financial analysts. The expansion of modern trade outlets continued to put competitive pressures, with the relevant analyses indicating a larger number of outlets opened in 2008 than in 2007, particularly on the non-food segment.

The same as in the previous quarters, the development pattern of tradables prices was driven by agri-food items and oil products, with the lower tensions on the relevant markets inducing a 2.8 percentage point slowdown in the annual dynamics to 6.7 percent in September. As concerns non-tradables, the trajectory recorded by the annual growth rates of prices illustrated further the major impact of administered prices, the peak reached in July being followed by consecutive decelerations to 8.4 percent in September.

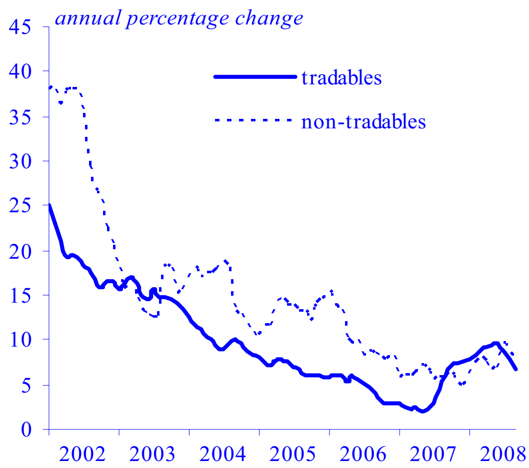
Despite the asymmetric effect generated by significant differences in the consumer basket structure, the dissipation of supply-side shocks that influenced developments in agri-foodstuff and energy prices by mid-2008 failed to bring about a narrowing in the gap between average annual HICP inflation in Romania and that of the three best-performing EU Member States. By contrast, the persistence of negative developments in some of the main inflation determinants (demand, wages, administered prices) contributed to the 0.4 percentage point widening of the gap compared to June (5.2 percentage points in September). The comparison to the average inflation rate for EU-27 remains as much as unfavourable for Romania notwithstanding the slightly smaller gap and somewhat slower uptrend (+0.2 percentage points from June to 4.2 percent).

In September 2008, the actual annual inflation rate was 0.4 percentage points below the projection in the August 2008 Inflation Report, owing to (i) the unanticipated reversal in the pronouncedly upward trend of the international oil price, (ii) the appreciation of the exchange rate beyond the level envisaged by the projection and also to (iii) the slight underestimation of the positive influence exerted by the new crop on some food prices.

Financial Analysts Expected Inflation



Tradables and Non-tradables Prices



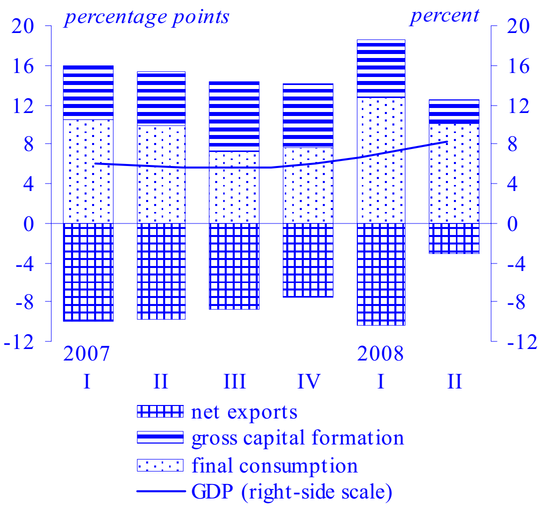
Source: EUROSTAT, NBR calculations

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2008 Q2, real GDP increased by 9.3 percent[3] – one of the fastest annual growth rates since 1999[4], outpacing by 1.1 percentage points the dynamics in 2008 Q1 and by only 0.2 percentage points the June benchmark projection. The economic growth was further bolstered by domestic absorption; moreover, the unfavourable influence from net external demand faded. On the supply-side, the step-up in the GDP growth rate was underpinned by all economic sectors.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

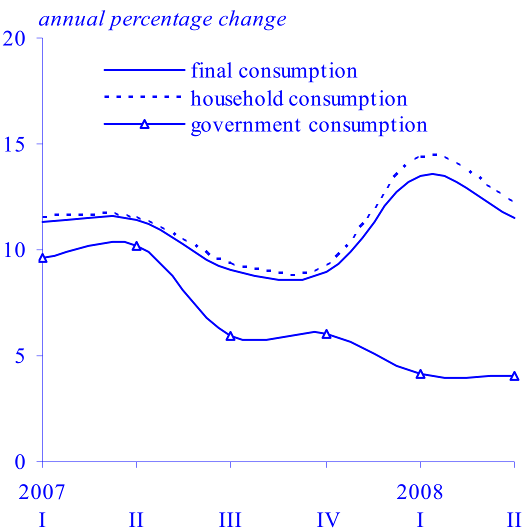
1.1. Demand

The same as in the previous quarters, in 2008 Q2, gross fixed capital formation was the fastest-growing demand component; nevertheless, its dynamics and that of final consumption slowed down slightly. These outcomes alongside the sharp decrease in the stocks of commodities and finished products led to the deceleration by more than 5 percentage points in the domestic demand dynamics to 10.7 percent. By contrast, external demand had a markedly lower negative contribution to GDP growth than in Q1 (-3.2 percentage points compared to -10.4 percentage points).

1.1.1. Consumer demand

In Q2, final consumption continued to grow at a fast pace (11.5 percent), although its growth rate slowed down 2 percentage points versus the previous quarter. This development was due to the private component, whereas government final consumption maintained its 4.1 percent annual dynamics.

Actual Final Consumption



Source: NIS

Household consumer demand

Although the annual growth rate of household actual final consumption decelerated by 2.1 percentage points versus the previous quarter, it remains further high at 12.2 percent. The analysis by expenditure shows that the slowdown is exclusively ascribable to the narrowing by almost 20 percent of the volume of expenditures related to "other consumption", while expenditures on "purchases of goods and services" accelerated slightly to 18.9 percent, those on "self-consumption and purchases on the agri-food market" edged up to 3.6 percent (mainly owing to good

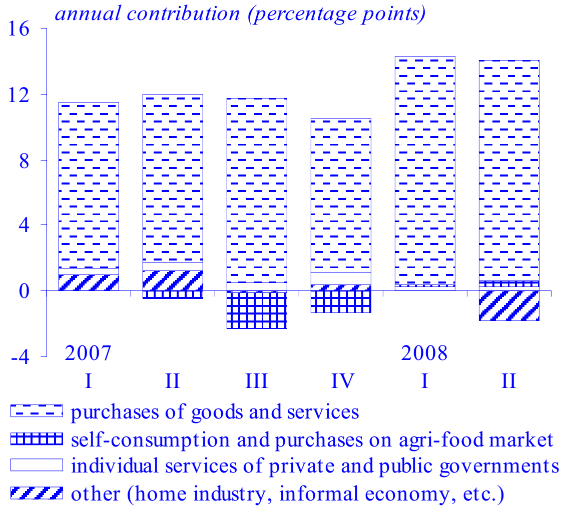
[3] Unless otherwise indicated, the growth rates in this section are annual percentage changes.

[4] The first year of annual GDP volume index series, with a quarterly periodicity.

vegetal output) and those on individual consumption incurred by the public and private governments rose to 2.4 percent. The drop in the spending on "other consumption" is difficult to explain in the absence of any public information on the main components – home industry, underground economy, the imputed rent for dwelling services, territorial correction[5]. However, mention should be made that the negative flow related to the "territorial correction" in the context of the NATO Summit organised in Bucharest in April 2008 is likely to post a considerable rise.

Household Final Consumption by Expenditure

annual contribution (percentage points)



Source: NIS, NBR calculations

As concerns the inflationary potential of consumer demand, the 0.9 percentage point step-up in the growth rate of household spending on retail purchases of goods and services seems to be accompanied by a higher pressure on the consumer price index. The analysis by group of commodities of retail sales in Q2 points to the dynamics of non-durable sales (almost 2 percentage points faster) as the key driver of this performance, given that non-durables hold a larger share of household consumer basket than durables.

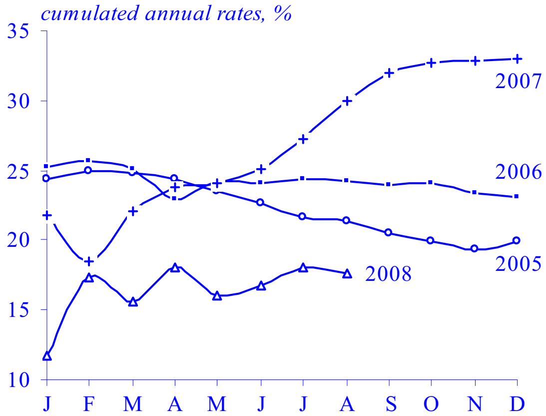
The main financing sources of household final consumption were further:

(i) disposable income[6], whose dynamics added another 3 percentage points in real terms (reaching almost 20 percent); its influence on consumer demand was heightened by the slower saving propensity, as illustrated by the deceleration in the growth rate of household deposits with banks, particularly deposits with a maturity shorter than two years (+10.8 percent in Q2 compared to +14 percent in the first three months of 2008);

(ii) borrowed sources, in view of the fact that despite the nearly 8 percentage point deceleration from Q1, the annual dynamics of consumer credit granted to households by commercial banks remained particularly fast (58 percent in real terms).

Retail trade in non-durables*

cumulated annual rates, %



*) turnover of retail trade in foodstuffs, beverages, tobacco, medicines and cosmetics, wearing apparel and footwear, fuels, direct-mail selling, automatic dispensers, street venders

Source: NIS, NBR calculations

The analysis by market of origin illustrates the upward trend followed by the propensity for imported consumer goods[7];

[5] Calculated as the difference between consumer spending of residents abroad and that of non-residents in Romania – according to ESA95 methodology, the two headings complement the balance-of-payments data, ensuring an improved estimation of both imports and exports of goods and services.

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

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

nevertheless, the upturn in the domestic supply of non-durables and durables (except for motor vehicles)[8] cannot be overlooked. On the motor market, the market share of the domestic component seems to have declined, possibly due to the strong competition from second-hand cars, on the moderate-priced product segment[9].

Government consumption

Government final consumption posted the same annual growth rate as in the previous quarter (4.1 percent), a development associated with some minor changes in the dynamics of job creation in the government sector.

Budgetary developments

After six months of execution, the consolidated general budget recorded a negative balance of about RON 5,192 million, accounting for approximately half of the programmed annual deficit[10] and about one percent of this year's projected GDP (a record-high in the past few years). The shares of the respective budgetary balances in GDP for the first half-years of 2003-2007 ranged between -0.9 percent and +1.1 percent.

The balance of the consolidated general budget slipped into negative territory in Q2 (totalling about RON 5,270 million), against the backdrop of a deceleration of the annual dynamics of both revenues and expenditures[11]. This was more pronounced on the revenue side (with a fall to 13 percent from 44 percent in the previous quarter[12]), due to the slowdown in the growth pace of incomes from VAT, excise duties and property taxes, except for those from profit tax, which saw a pick-up from 12 percent in Q1 to 21 percent. As for the 14 percentage points slackening in the annual dynamics of expenditures to 27 percent, this mirrors the

[8] After the significant decline in Q1, the volume of sales of domestic industrial companies on the domestic market went up both in the case of non-durables and durables (by 3.4 percent and 17.1 percent respectively). These growth rates were further slower than those posted by the physical volume of imports, i.e. nearly 16 percent for non-durables and 18.1-27.5 percent for the main categories of durables identified on the basis of the Combined Nomenclature.

[9] The annual dynamics of the turnover volume related to road transport means industry entered negative territory (-5.7 percent compared to +10.4 percent in Q1) whereas the dynamics of the physical volume of imports remained positive (11.8 percent), albeit somewhat slower than in the first half of the year.

[10] The deficit remained at 2.3 percent of GDP at the budget revisions performed in July and September.

[11] Unless otherwise indicated, the real annual growth rates are percentage changes.

[12] The high level recorded in Q1 includes the favourable base effect in the case of VAT collection, following the change in the manner of its collecting in the first part of 2007.

negative growth rate of interest payments on public debt and subsidies, as well as the decline in most categories of expenditures, except for transfers for social benefits and those including the contribution of Romania to the EU, whose annual rates of increase accelerated from 26 percent and 36 percent respectively in Q1, to 33 percent and 50 percent respectively.

Similarly to the previous years, the consolidated general budget posted in July a monthly surplus of 0.5 percent of GDP, though lower than in the same year-ago period, when it stood at 0.7 percent of GDP. Thus, the first seven months cumulated consolidated general budget deficit shrank to 0.6 percent of the GDP projected for the current year. In August, the preliminary data on budget execution suggest a possible renewed fiscal loosening, the cumulated general budget deficit for the first eight months of the year standing again at around one percent of GDP.

July and September witnessed the second and the third budget revisions of the current year. Both revenues and expenses were revised upwards, but the deficit target remained at 2.3 percent of GDP. At the same time, the projected GDP figure was successively raised from RON 440,000 million to RON 475,000 million and RON 505,000 million respectively. While in the case of the first budget revision most of the additional funds were earmarked for investment in transport infrastructure, at the second revision money was mainly channelled to financing current expenses (higher pensions, wage earnings obtained by court rules, as well as other social benefits).

1.1.2. Investment demand

Provisional statistical data for the period under review are indicative of an ongoing sharp uptrend in gross fixed capital formation. The 30 percent advance marks a Q2 record high in the contribution of investment to GDP dynamics, i.e. 8.6 percentage points, since 1999.

Larger investment was further recorded across the two major segments on the expenditure side: (i) construction works, consisting of both new construction works (up 34.8 percent) and capital repair (up 29.1 percent) and (ii) equipment purchase (including transport means bought by companies and institutions), which further posted a brisk growth rate (23.8 percent), albeit almost 11 percentage points slower compared to the previous quarter.

The step-up in capital investment was still bolstered by the own sources of the corporate sector and households, as well as by

Investment

annual percentage change

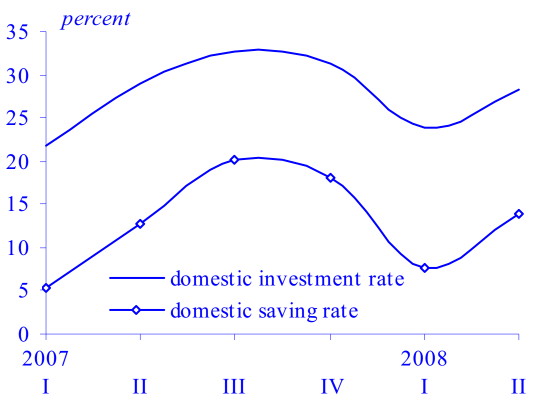
	Year	I	II	III	IV
Total	2007	22.8	28.3	31.9	29.5
	2008	34.9	30.0		
- new construction works	2007	27.9	32.8	38.9	26.4
	2008	32.5	34.8		
- equipment	2007	19.0	22.7	25.3	32.1
	2008	35.5	23.8		
- other*	2007	20.3	48.5	24.3	29.8
	2008	49.1	45.2		

*) 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

considerable funds from the public budget for the implementation of investment projects. Borrowings also stuck to an upward path, as follows: (i) real estate loans granted by domestic commercial banks kept growing (at an annual pace of increase in excess of 70 percent[13]), and loans for equipment purchase stepped up 16.7 percent – a growth rate lower than that seen in Q1; (ii) in H1, the local leasing market turnover was 36 percent higher from a year earlier, this type of financing being destined mainly to purchases of motor vehicles (structural analysis shows that commercial vehicles account for almost half of the total value of car leasing contracts) and to equipment purchase (especially for construction).

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

As for foreign financial inflows[14], their contribution to investment project financing continued to moderate, their trajectory being suggested, on the one hand, by the 2.7 time slowdown in the annual dynamics of medium- and long-term net loans to the non-bank non-government sector (to +49.7 percent in Q2), and, on the other hand, by the persistent downward trend of net flows in the form of foreign direct investment of non-residents, even though, in Q2, it decelerated from -21.8 percent to -8.5 percent from the prior period, due mainly to proceeds from the privatization of Electrica Muntenia Sud joint-stock company.

By market of origin, faster growth rates were seen in both imports (mechanical and electrical machinery and apparatus[15]) and the domestic demand for capital goods (the dynamics of turnover relative to the production of this industrial sub-sector rose around 9 times), so that the two market segments displayed similar rates of increase (11-12 percent).

Despite the persistently robust tempo of investment growth, the annual rate of change in gross fixed capital formation plummeted to 8.2 percent, one third lower than that seen in the prior quarter, and than the average for 2006-2007. This was due to the strongly negative change in stocks – a possible explanation lying with the contraction of raw material and agricultural product reserves, following the poor agricultural production of 2007, yet mention should be made that this position is determined in a residual manner.

[13] Changes in real terms, based on data provided by the CCR.

[14] Based on balance-of-payment data; average dynamics for the last four quarters (rolling basis).

[15] See footnote 5.

1.1.3. Net external demand

As regards the developments in external demand for goods and services, provisional national accounts data released by the NIS for Q2 illustrate a positive spread between exports and imports growth rates. Such a performance has not been recorded since 2002 Q4, being attributable to the rise in exports (to 26.9 percent) and especially to the slowdown in imports dynamics (from 35.2 percent to 24.4 percent).

It is noteworthy that the deceleration seen in the latter case might be overstated, the change in volume in Q1 being artificially boosted by the assumed more than 6 percent drop in prices of imports of goods and services for Q1, which was denied by the unit value indices in world trade (released previously) and by the exchange rate trajectory (nominal depreciation of local currency)[16].

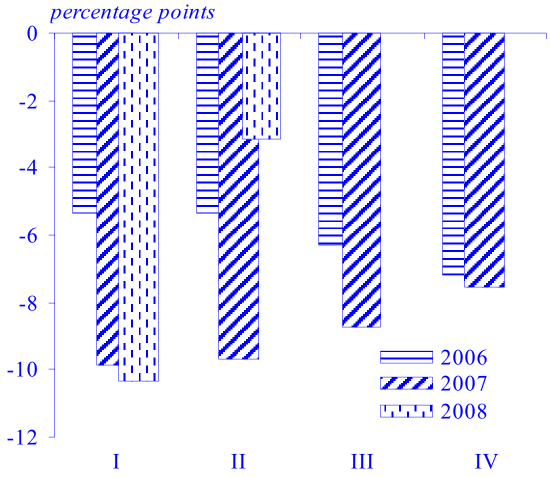
After the two trade balance components are deflated by the UVI, the expansion of exports still outpaces that of imports, but the levels are significantly lower than those estimated in the national accounts (14.6 percent and 12.6 percent respectively).

The annual dynamics of the physical volume of exports of goods accelerated by 6.5 percentage points compared to Q1, due largely to "mechanical and electrical machinery and apparatus", "transport means" and "mineral products" (growth rates ranging between 23.7 percent and 56.3 percent). By contrast, the volume of light industry exports diminished by more than 10 percent, given that the beneficial effect induced by the discontinuation of ULC growth on producer prices in wearing apparel, and leatherwear and footwear cannot ensure a satisfactory level of competitiveness on foreign markets as yet.

A high rate of increase, albeit lower, was also seen by the physical volume of imports, amid pressures from investment and consumer demand and higher intermediate consumption for exports. The growth pace was still below half of the average level for 2007, mainly on account of the 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 – at border crossing, not when

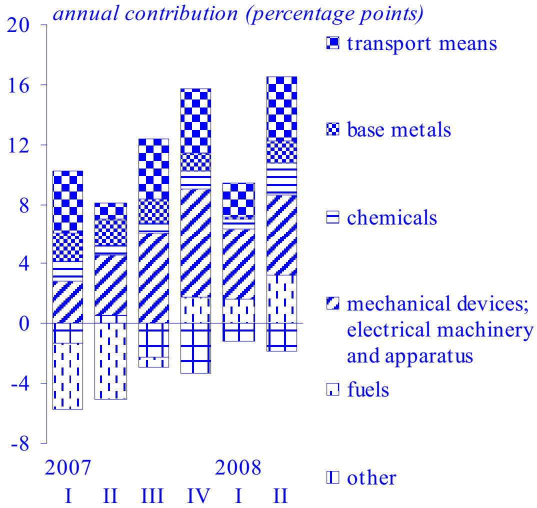
[16] As unit value indices in world trade (UVI) are not available upon the release of preliminary quarterly national accounts, the calculation of volume changes relative to exports and imports of goods and services is based on deflator estimates.

Net External Demand Contribution to GDP Growth



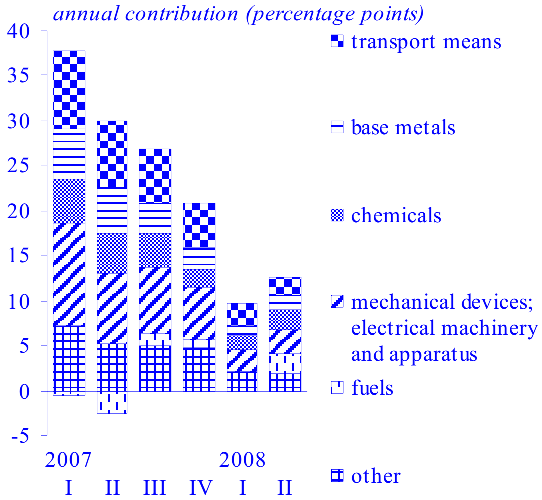
Source: NIS, NBR calculations

Export Physical Volume



Source: NIS, NBR calculations

Import Physical Volume



Source: NIS, NBR calculations

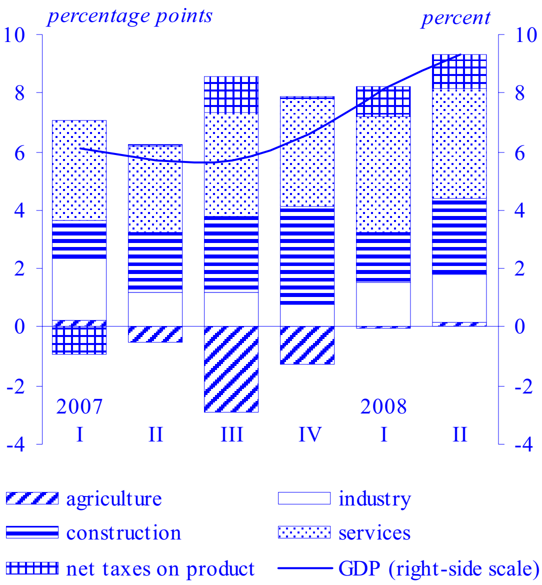
putting them into free circulation (the procedure applying prior to the EU accession).

1.2. Supply

In 2008 Q2, all economic sectors provided support to GDP growth.

In industry, gross value added increased by 6.1 percent (+0.7 percentage points compared to Q1) as a result of faster growth rates in the manufacturing and energy sectors, whereas the mining sector further experienced production shrinkage following natural resource decline and technological disruptions associated with the modernisation programme. The manufacturing production expanded mainly on account of developments in (i) food industry, given the consolidation of production capacities; (ii) chemicals sub-sector, annual dynamics almost quadrupled compared to the prior quarter due to domestic causes (Q2 was the last period when fertilizer producers benefited from the advantage of a lower natural gas price[17]) and a favourable external environment associated to the shrinkage of world fertilizer supply, following the implementation of tighter protectionist measures for China's exports; (iii) oil processing, where high annual dynamics of the production volume can be attributable to a base effect[18] and a favourable external environment.

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

For the sixth quarter in a row, the annual dynamics of gross value added in the construction sector exceeded 30 percent, supported by growth in all components (residential, non-residential and engineering works). Therefore, the contribution of the construction sector to GDP growth outpaced yet again that of industry (2.6 percentage points compared to 1.6 percentage points).

Gross value added in the agricultural sector rose by 3.7 percent, mainly on the back of the satisfactory performance of vegetal production and the milk production growth. Mention should be made, however, that the base effect associated with protracted drought in the previous year caused the 10 percent drop in gross value added in 2007 Q2.

[17] The agreement concluded with Romgaz securing producers a preferential price expired at end-June 2008.

[18] Overhaul of Arpechim in April 2007.

The services sector expanded at an annual growth pace similar to that seen in 2008 Q1 (7.6 percent[19]), the strongest dynamics being recorded yet again by the segment "trade, motorcar repairs, HoReCa, transports and telecommunications" (9.7 percent). The other two segments of the services sector, i.e. "financial, real estate activities, rentals and services to companies" and "other services" saw their growth rates moderating compared to the previous quarter, to 6.5 percent and 4.5 percent respectively.

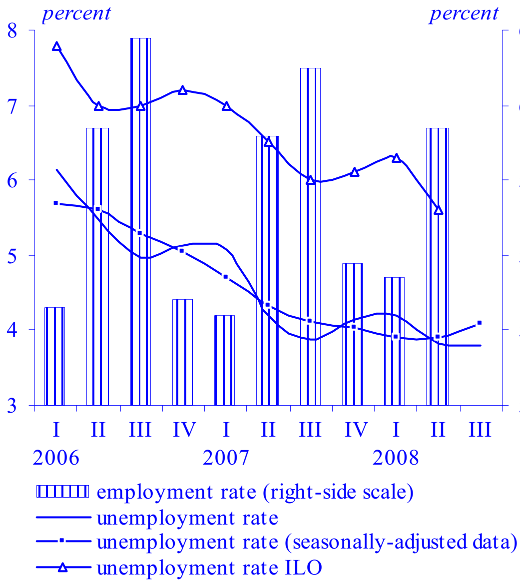
2. Labour market

Pressures on the labour market remained high in June-August 2008 and the relative easing of workforce supply suggested by the twofold increase in the number of university graduates failed to manifest. Wage growth rates remained vigorous inducing, along with the slowdown in labour productivity, further worsening of ULC. Nevertheless, the negative gap between ULC dynamics and that of industrial producer prices shows that, across industry, pressures were absorbed without entailing a narrower profit margin; structural analysis illustrates, however, the build-up of tensions in capital and intermediate goods sub-sectors.

2.1. Labour force

The registered unemployment rate (seasonally adjusted) rose to 4 percent June through August (compared to 3.9 percent January through May), but the rise was too small to represent an indication of labour market easing. Additionally, ILO unemployment rate hit a record low in 2008 Q2 after the introduction of the new methodology in 2002 (reaching 5.6 percent), even though unemployment outflows do not appear to be attributable to hirings, working age population employment rate standing at a level similar to that recorded in 2007 Q2 (59.7 percent); the explanation may lie with the transfer of the unemployed to the economically inactive population category by way of retirement, enrolment with an education institution or migration aboard[20].

Unemployment Rate and Employment Rate*



*) for working age population (15-64 years)

Source: NIS, NBR calculations

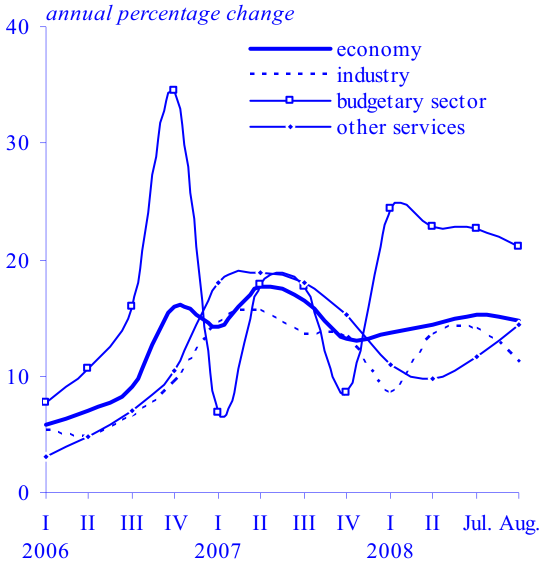
[19] NBR calculations, consisting in compiling volume indices relative to the three segments of the services sector, i.e. (i) trade, motorcar repair, and household appliances, hotels and restaurants, transports and telecommunications; (ii) financial and real estate activities, rentals and services companies; (iii) other services (public administration and defence, education, health and social assistance, other services to population).

[20] A similar move was seen in Q1, when the number of retired persons grew by 150.8 thousand year on year and by 96 thousand compared to 2007 Q4.

The relative improvement in workforce supply attributable to the twofold increase in the number of university graduates[21] has not yet been reflected in the NEA database, due possibly to the short time interval since graduation or to direct hiring by employers, as the number of job fairs for students or young graduates increased.

However, in terms of workforce demand, statistics continue to show different pictures. In step with the 2008 second-quarter economic expansion, data released by the NEA confirmed the rise in the number of employees across economy by roughly 84 thousand people compared to June-August 2007 (due to hirings in the construction sector and some services sub-sectors), while the number of vacancies and hirings reported by the NEA kept declining from the year-earlier period. These developments are indicative of employers' attempt to recruit workers directly or to maximise the already existing human resources (by improving employees' professional skills and providing retraining courses).

Net Real Wage*



*) deflated by CPI

Source: NIS, NBR calculations

2.2. Incomes

In the absence of any signs of an easing in labour market tensions that had built up over the past several years, net average wage further posted robust growth rates during June-August: 24.7 percent in annual terms, up 1.3 percentage points from the January-May average. The 1 percentage point drop in social contributions paid by employers as well as the stronger impact of seasonal factors (holiday entitlements, larger workforce demand in agriculture, construction, market services) also added to this development.

Labour Productivity and Real Gross Wage in Industry

annual percentage change

	2007			2008			
	II	III	IV	I	II	Jul.	Aug.
Labour productivity	8.9	9.4	8.6	8.8	10.3	8.8	2.2
Real gross average wage*	12.4	13.2	12.3	4.5	7.7	5.4	0.7
Real gross average wage**	16.5	17.1	12.4	-0.02	0.38	-2.9	-3.4

*) deflated by industrial producer price index for domestic market

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

Source: NIS, NBR calculations

Similar to the previous period, there was still a noticeable discrepancy in terms of growth rates (9-13 percentage points) between the majority privately-owned sector (industry, construction, non-budgetary services) and the public sector, which further witnessed net wage hikes in excess of 30 percent in annual terms; the granting of holiday entitlements to civil servants and of stability bonuses for healthcare professionals in public health facilities during this period had a stimulative effect.

The additional wage hikes coupled with the fall in productivity gains contributed to the further worsening of ULC in industry (+5.6 percentage June through August 2008 versus January-May 2008), with its annual growth rates already displaying significantly

[21] The reduction of university education duration from 4 to 3 years caused the simultaneous graduation of two classes. According to the estimates of some recruitment agencies, to number of university graduates could go beyond 250 thousand people in 2008.

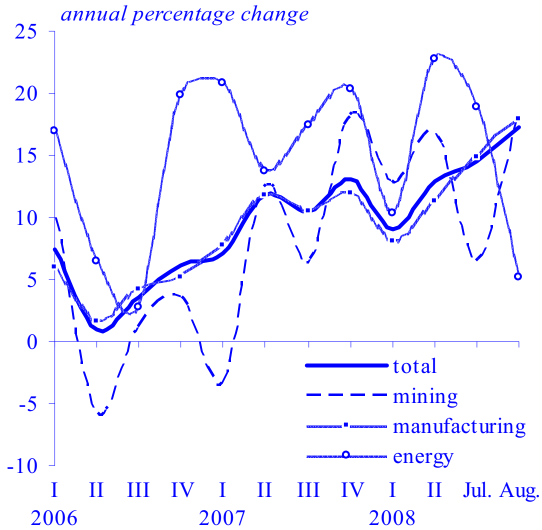
high values in the positive territory. For want of competition-driven constraints, pressures from labour costs were absorbed without squeezing profit margins, with producer price dynamics (19.9 percent) further outpacing ULC dynamics (15.8 percent). It is to be noted the persistent spread between the two indicators (4.9 percentage points January through May and 4.1 percentage points June through August), the slight narrowing of the spread pointing to ongoing pressures from raw material costs and the prevalence of these cost elements in producer price developments over the past three quarters.

The worsening of ULC dynamics was seen in most consumer goods sub-sectors, with textiles, tobacco products and oil processing witnessing the sharpest changes (20-25 percentage points). In the case of the last two sub-sectors, the reasons are predominantly incidental – the granting of holiday entitlements, technological overhaul of one leading oil refinery (with an impact on the productivity indicator), the handing-out of redundancy payments. The unfavourable developments in ULC change (+5.1 percentage points, up to 19.1 percent), albeit of a smaller magnitude, were also detected in food industry, but their passing onto prices was still facilitated by robust demand.

Highly positive ULC growth rates – sometimes even higher compared to the January-May level – were also displayed by intermediate goods sub-sector (woodworking, pulp and paper, rubber and plastic products) and capital goods sub-sector (electrical machinery and apparatus, and other transport means). By contrast to consumer goods sub-sectors that benefited from persistent excess demand, the said industries failed to completely pass onto prices the larger labour costs, the above one ULC indices showing an inflationary potential likely to influence their future behaviour.

On the demand side, statistics confirmed once again the faster pace of disposable income annual dynamics in the first part of 2008 (+19.5 percent in real terms, almost exclusively on account of wages and social transfers), pointing to the heightening inflationary risk associated with such developments. Although the pace of increase in household disposable income moderated slightly (to 18.7 percent), the July-August developments do not have noticeable effects on the overall picture.

Unit Labour Costs in Industry



Source: NIS, NBR calculations

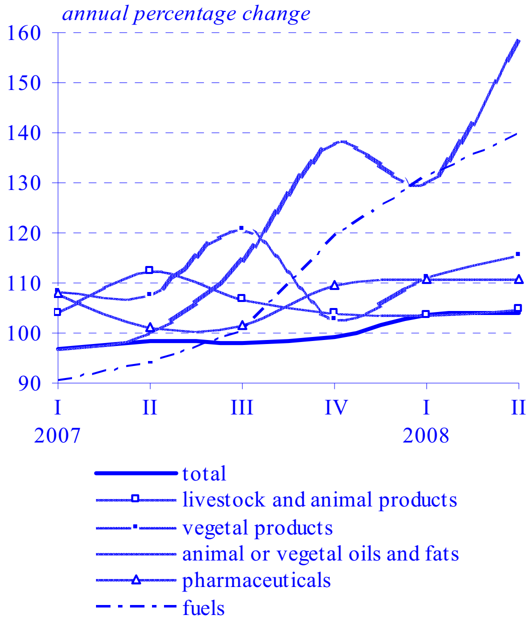
3. Import prices and producer prices

In 2008 Q2, inflationary pressures exerted by import prices and industrial producer prices intensified, due broadly to developments in energy products and consumer goods. As concerns prices for agricultural products, mounting tensions affecting prices for animal products were generally offset by the deceleration in prices for vegetal products. No trend reversals are expected for 2008 Q3, although the upward curve followed in the past quarters by the dynamics of prices for domestic industrial goods and import prices is likely to flatten out.

3.1. Import prices

In 2008 Q2, imported inflation had a stronger unfavourable impact on domestic price dynamics, generated by the faster increase in the annual unit value index of imports (104.2 percent versus 103.9 percent in 2008 Q1) as well as by the ongoing weakening of the domestic currency (annual depreciation of 10.1 percent against the euro, up from 8.3 percent in 2008 Q1)[22].

Major Inflationary Pressures on the Unit Value Index of Imports

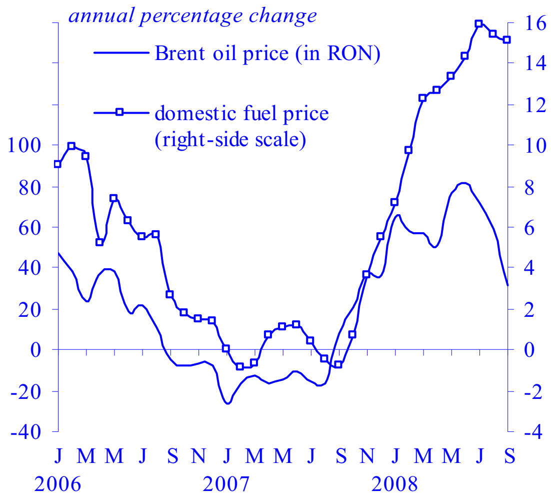


Source: NIS, NBR calculations

The same as in the previous quarter, pressures were significantly higher in the case of prices for foodstuffs and energy products, the related annual indices ranging from 104.8 percent to 157.8 percent. Moreover, prices for other consumer goods (wearing apparel, detergents) posted swifter growth rates. In fact, this category comprises the groups of imported goods posting above-average annual changes of unit values.

As concerns industrial commodities, the external prices for base metals posted a considerably higher growth rate (5.7 percentage points), which had an impact on producer prices in metal processing sub-sectors in the quarter under review[23].

Oil and Fuel Prices



Source: NIS, EIA, NBR calculations

Capital goods and transport means continued to post favourable developments, as the annual growth rate of external prices was further negative or slowed down as compared with prior quarters (in a range from -10.6 percent to 0.9 percent).

The trends manifest on external markets in the first half of the year are expected to reverse in 2008 Q3 (except metals), an additional contribution coming further from flagging demand for industrial goods, with an impact on both commodity prices and producers'

[22] The domestic currency strengthened further against the US dollar (in annual terms), although the magnitude of the appreciation decreased from 4.9 percent to 4.2 percent.

[23] See Subsection *3.2.1. Industrial producer prices*.

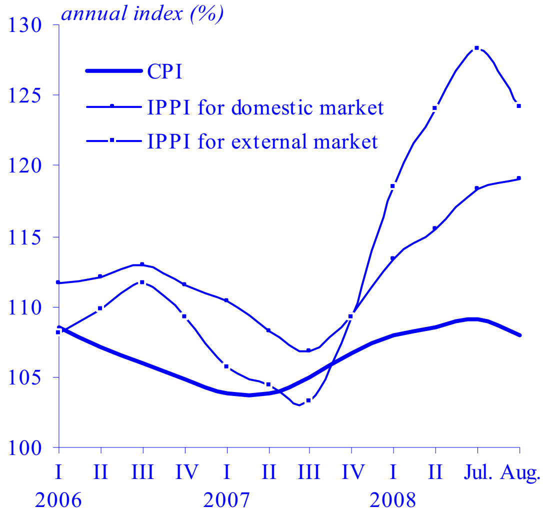
price policies. With regard to the exchange rate, the influences are still unfavourable, given the trend shift in the RON/USD exchange rate and the marginal alleviation of the domestic currency depreciation versus the euro.

3.2. Producer prices

3.2.1. Industrial producer prices

The second quarter of the year saw the continuation of the significantly upward trend witnessed by the annual dynamics of industrial producer prices in the past two quarters (up 2.2 percentage points to 15.6 percent). Behind this increase stood developments in manufacturing, the tensions built on this segment (annual change of 18.4 percent, up by another 4.2 percentage points from the previous level) offsetting the favourable impact of decelerating growth rates in mining and energy sectors.

Consumer Prices and Industrial Producer Prices

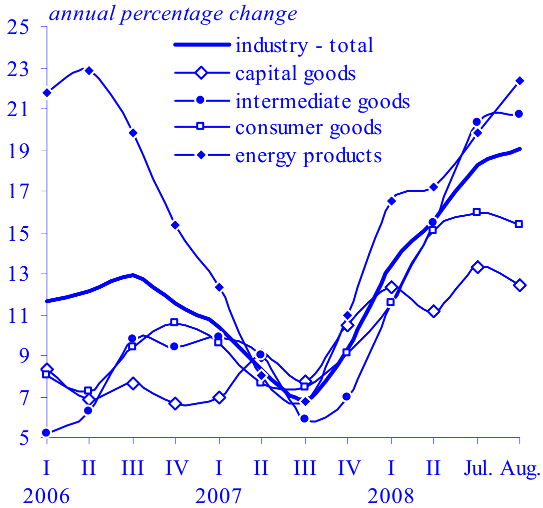


Source: NIS

The latter developments – the result of a base effect – contributed to the flattening of the upward curve followed by the annual growth rate of prices for energy products (17.2 percent, up by less than one percentage point), which had previously been the main driver of the acceleration of producer price dynamics. Current developments showed a relative slowdown in the growth rate of prices in the oil-processing sub-sector (average monthly change declining from 3.3 percent to 2.9 percent), in the context of exacerbated tensions on the world oil market. The explanations for the lack of response of domestic producer prices may lie with the increasing resort to domestic resources and the narrowing of producers' profit margins.

The growth rates of prices for intermediate goods and non-durables added nearly 4 percentage points to roughly 15.5 percent, under the main impact of negative developments recorded by input costs. Hence, costlier metals and escalating prices for energy products generated the substantial acceleration of producer price dynamics in metallurgy, metallic construction, chemicals, rubber and plastic products, whereas the growth rate of prices for food items added another 5.4 percentage points to 20.7 percent as compared with the same year-ago period, on the back of the persistent deficit of agricultural commodities.

Industrial Producer Prices for Domestic Market by Industrial Products Group



Source: NIS, EUROSTAT

The growth rate of prices for durables picked up 2.3 percentage points from the prior quarter to 10.8 percent, reflecting the hike in metal prices as well as the persistently high demand.

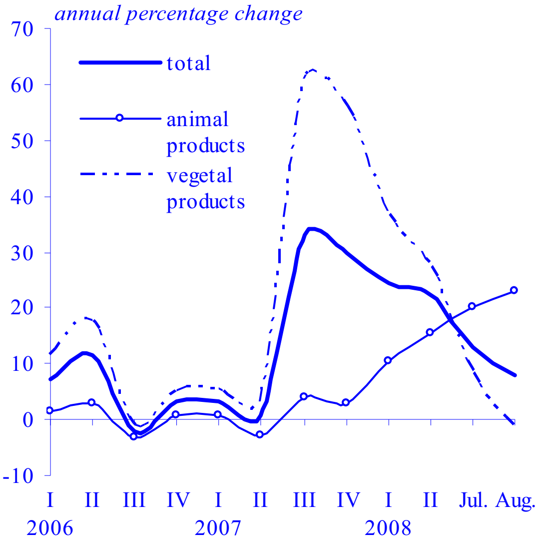
Capital goods were the only category of products whose annual growth rate of producer prices slowed down 1.3 percentage points to 11.1 percent as compared with the 2008 Q1 average. However, this development does not appear to indicate a trend shift, as it arises more likely from a base effect. In fact, the annual dynamics in July (13.3 percent) is significantly higher than the figures recorded in the past five years (due largely to the pick-up in road transport means, associated with the improved quality of Dacia Renault's products).

In 2008 Q3, raw material costs (particularly imported commodities) are seen to further make the largest contribution to industrial producer price dynamics, amid the expected slowdown in the growth rate of prices for consumer goods and renewed tensions in the case of prices for intermediate goods (particularly under the impact of costlier metals). Amid the lower tensions on the world oil market, the substantial rise displayed by producer prices in oil-processing, coal coking and preparation of nuclear fuels (2.5 percent in August versus July) is relatively surprising. However, consumer fuel price dynamics illustrates the fact that this movement was not generated by petroleum products.

3.2.2. Agricultural producer prices

Agricultural Producer Prices

annual percentage change



Source: NIS

The annual growth rates of agricultural producer prices remained high in 2008 Q2 (22.5 percent), the favourable signs of the new crop entailing, however, a slight deceleration as compared with the prior quarter.

This trend was underpinned exclusively by the vegetal component (down 9.2 percentage points versus Q1), with price dynamics slowing down significantly for the whole range of products under review, particularly grains (down 22 percentage points on average).

In contrast, prices for animal products saw faster growth rates, the annual change for the group as a whole standing at 15.4 percent, up 4.9 percentage points as compared with the 2008 Q1 average. The highest tensions built up on the pork and beef market (quarterly changes ranging between 13 percent and 15 percent), as producers recorded losses, following the constant rise in input costs (fodder, wages, utilities) and import competition.

According to data available for Q3, current trends in agricultural producer prices are seen to persist and they are even expected to sharpen. Hence, under the impact of a satisfactory level of the 2008 crop, the declines in prices for vegetable products are likely to be more pronounced, while inflationary pressures seem to build up in the case of animal products (meat in particular).

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In July 2008, the National Bank of Romania raised, for the seventh successive time, the monetary policy rate by a quarter of a percentage point to 10.25 percent per annum, a level which has been maintained subsequently. At the same time, the central bank left unchanged the minimum reserve requirement ratios and continued to pursue a firm control over money market liquidity. Throughout 2008 Q3, real monetary conditions saw a relative tightening, largely as a result of more restrictive interest rates.

In July, the NBR Board's decision to raise yet again the monetary policy rate stemmed primarily from the further upward move in the projected annual inflation rate throughout the forecast horizon[24]. This caused the return of the projected yearly inflation rate back inside the variation band around the medium-term target to be delayed by one quarter. The worsening of the inflation outlook was basically attributed to the stronger-than-previously-projected demand-pull inflationary pressures that were fuelled by the pick-up in GDP dynamics in 2008 Q1 and underpinned by the persistence of brisk wage growth in the budgetary sector and the planned increase of pensions in the near run. The upward revision of the inflation forecast was also driven by the likelihood of a steeper rise in fuel and administered prices as well as by the relative deterioration of inflation expectations.

In addition, the NBR decision was substantiated by the prevailing upside risks to inflation in excess of the projected rates of increase. The major risks arise from potentially unfavourable developments such as wage increases further overtaking productivity gains, lack of co-ordination between fiscal and income policies on the one hand and monetary policy on the other, renewed depreciation of the domestic currency owing to global shocks, additional worsening of corporate inflation expectations, and larger administered price adjustments than those anticipated at the time of drawing up the projection.

In September, the NBR Board decided to discontinue the series of successive policy rate hikes and kept it at 10.25 percent per annum. The chief drivers behind this decision were the resumption of disinflation and bigger uncertainties stemming from renewed financial woes worldwide, on the one hand, and, most notably, the further robust GDP dynamics in 2008 Q2, on the other hand. Such

[24] Compared to the forecast in the May 2008 *Inflation Report*.

a decision was meant to additionally tighten the broad monetary conditions by expanding the real interest-rate spread. Furthermore, the NBR Board deemed necessary to keep in place a tight policy stance over a longer period given the prospects in the months ahead of the forecasted annual inflation rate to remain above the upper bound of the 2008 target band.

Under the circumstances, the most significant risk to disinflation appears to be the likelihood of a larger positive output gap and implicitly of growing demand-pull inflationary pressures, the positive supply-side shock triggered by this autumn's bumper crops notwithstanding. The chief prerequisites of the still rising excess demand were the advance to 9.3 percent in the annual GDP dynamics in 2008 Q2 and the accelerating or the still rapid dynamics of some domestic demand indicators, i.e. net real wage, retail sales, construction works and public spending. In addition, there is an increased likelihood of looser income and fiscal policies to be implemented in the run-up to the elections, which induces the risk of a faster domestic absorption growth and of bigger inflation expectations. Seen from this perspective, the decision was aimed not only at anchoring the expectations regarding consumer price developments over the medium term, but also at fostering saving and enhancing the recent downtrend in the dynamics of loans to households[25].

The deceleration by 15 percentage points in the real annual dynamics of loans to households July through August versus the second-quarter figure to an average of 50.2 percent was due to nearly all major loan types. In fact, lending appeared to have been hit by (i) the adverse impact on demand for loans from higher lending costs and the likely tightening of other lending conditions, and (ii) the possible slowdown in the dynamics of banks' credit supply (probably also due to higher uncertainties surrounding the real-estate market). The real advance of RON-denominated loans to households slackened on average to 24.4 percent year on year, 3.7 percentage points lower than in the second quarter of 2008, although average lending rates on new business stayed on an upward trend, most notably in August. A sharper deceleration was manifest in case of forex loans to households (in euros and Swiss francs), down 29.6 percentage points to 77.9 percent on average. Unlike the previous months, housing loans were most affected by the general downturn, their annual pace of increase sliding on average by 17.9 percentage points to 55.3 percent against the period from April to July – in turn, the annual dynamics of consumer credit displayed a real 14.2 percentage point drop from the same reference period to 43.8 percent.

[25] Such a development was expected to be fostered in the upcoming months by the effects of prudential measures meant to contain credit risk associated with loans to households (Regulation No. 11 of 22 August 2008 issued by the NBR).

By contrast, RON-denominated household saving did not see any rebound July through August. The average annual growth rate of households' time deposits with maturity of up to two years further declined in real terms, albeit at a slower pace, reaching 0.4 percent (down 1.4 percentage points compared to a 3.3 percentage point decline in 2008 Q2), in spite of the still rising deposit rates on new business. The real annual dynamics of foreign currency-denominated deposits with maturity of up to two years also cooled off, shedding 4.1 percentage points as against 4.6 percentage points in 2008 Q2; given these conditions, the growth rate of household deposits with maturity of up to two years slowed on average by a real 3.4 percentage points to 7.4 percent year on year. An even steeper fall witnessed the real average annual rate of increase of households' overnight deposits, especially those in RON, as a result of the heavier debt service burden and the possibly faster advance in demand for goods and services. Conversely, the annual dynamics of time deposits with maturity longer than two years rose slightly July through August, solely due to RON-denominated deposits.

The NBR Board's decision to leave the monetary policy rate unchanged in September also originated in the higher uncertainties surrounding the short-term economic and financial developments both domestically and internationally against the background of the deepening global turmoil. The contractionary effects on the Romanian economy stemming from the economic slowdown in both the USA and the euro area could be visible most likely with a certain lag. A significant transmission channel of such effects might be the increase in costs and the potential curtailment in the dynamics of external financing, particularly that intended for the domestic banking sector. The first casualties of the stronger global financial turmoil were the Bucharest Stock Exchange and the exchange rate of the local currency. The former was subject to a meltdown, with market indices taking a nosedive, and the latter witnessed a considerable increase in volatility in September, reverting to the upward path.

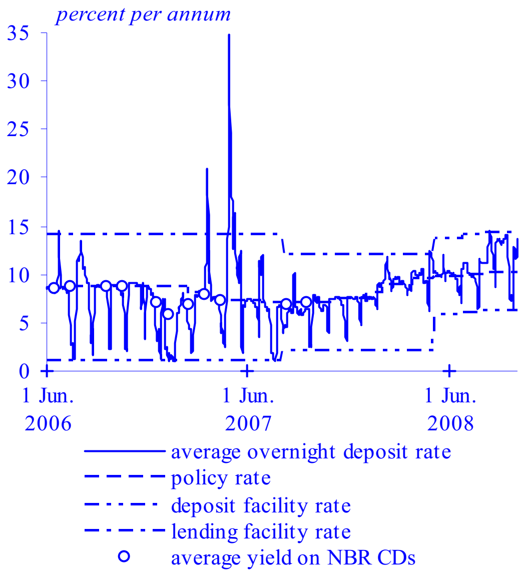
During the third quarter of 2008, the banking system further experienced excess liquidity, which however declined somewhat. In this context, the NBR pursued a firm control over money market liquidity. Hence, it engaged primarily in sterilisation operations by taking mostly deposits with one-week maturity (in July and September). In August, the central bank also performed two repo operations (maturing in six and seven days respectively) whereby it pumped RON 1,874 million into the system in an attempt at rebalancing liquidity conditions which had contracted temporarily under the impact of the autonomous liquidity factors.

2. Financial markets and monetary developments

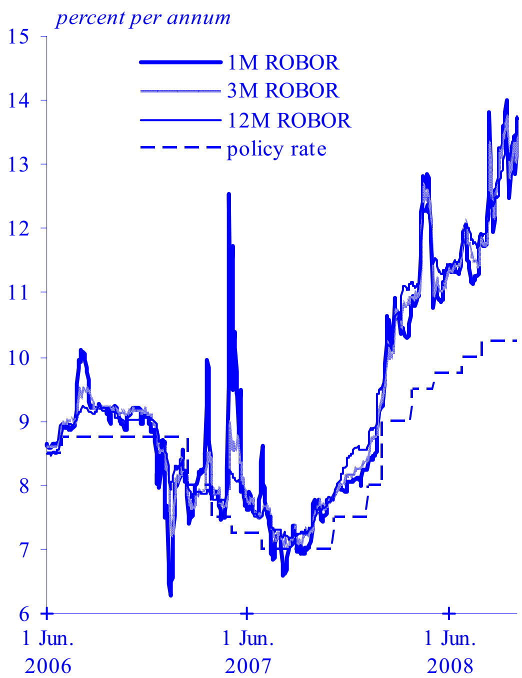
Interbank market rates stayed on an upward course in 2008 Q3, their levels usually exceeding the monetary policy rate. The RON/EUR exchange rate declined sharply in the first part of the quarter, but witnessed a sudden trend reversal in September, amid the deepening of the global financial turmoil. The annual dynamics of broad money decelerated in June-August 2008, owing mainly to the slower growth pace of credit to the private sector.

2.1. Interest rates

Interbank Money Market Rates



Policy Rate and ROBOR Rates



Interbank market rates remained on an uptrend in 2008 Q3, their levels exceeding the monetary policy rate for most of the period. The rise in interbank market rates was generated by the sharp fluctuations in the autonomous liquidity factors, the impact of which was higher in the context of the gradual narrowing of excess liquidity. Against this background, average interbank deposit rates added 1.4 percentage points from the prior quarter to 11.5 percent.

At the beginning of the quarter, overnight rates stayed close to the monetary policy rate, yet they declined swiftly at the end of the 24 June – 23 July reserve maintenance period. The decrease was caused by the substantial liquidity injections made by the State Treasury and, to a certain extent, by the banks' relative reluctance to place their excess reserves in one-week deposits with the NBR, as they anticipated the seasonal, considerable rise in budget payments at end-July. The settlement of budget payments led to a reserve deficit and an increase in interest rates. Nevertheless, the resulting higher rates proved to be persistent, the spread between overnight rates and the monetary policy rate staying around 3 percentage points from early August to mid-September, due mainly to higher uncertainty and cautiousness of market operators. The easing of liquidity conditions in the latter part of September, as a result of liquidity injections made by the State Treasury, caused the renewed fall in interest rates up to the end of the reserve maintenance period[26]. However, they reverted to relatively high levels in the last week of the month. Under the circumstances, the volatility of overnight rates increased, reaching a four-quarter high.

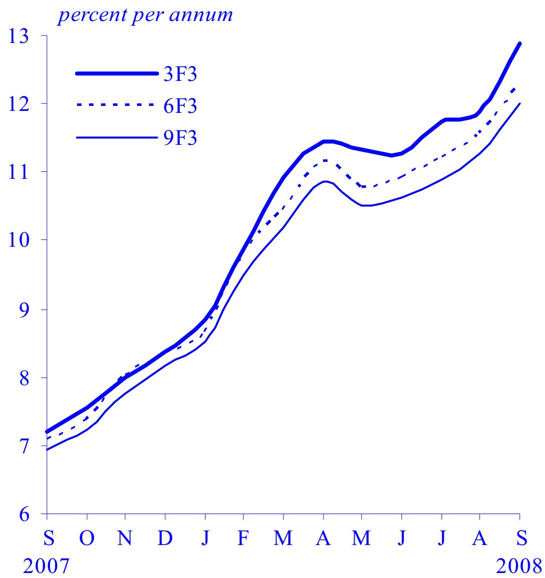
Moreover, the (1M-12M) ROBOR interest rates followed an upward path, reflecting the rise in the monetary policy rate as well as the higher unpredictability of market conditions. In September, average ROBOR interest rates saw a relatively smooth increase across the maturity spectrum (about 1.7 percentage points) versus June, their yield curve remaining therefore flat.

[26] The volume of the amounts placed via the deposit facility picked up in this period.

Implicit forward rates (calculated based on September average rates) indicated the renewed upward movement of the anticipated trajectory of the 3M ROBOR rates. The average 3M ROBOR rates projected for December 2008 stood at 12.9 percent, being anticipated to go down to 12.3 percent and 12.0 percent in March and June 2009 respectively.

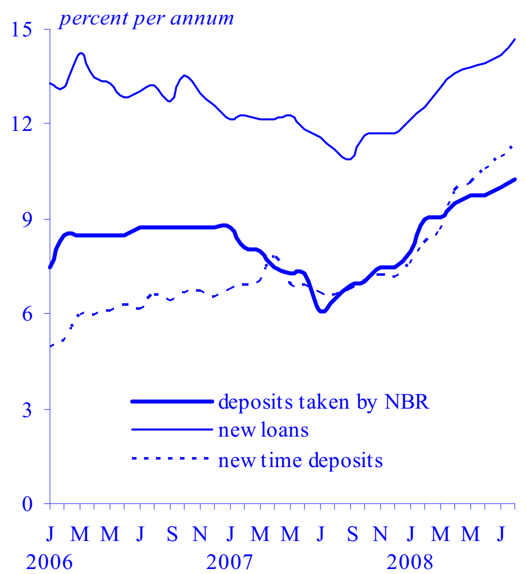
In their turn, interest rates on government securities stayed on an upward path, the Ministry of Economy and Finance raising the maximum accepted interest rates by 0.25 percentage points each, as follows: in two stages, the rates on 6-month, 3- and 5-year securities and in three stages, those on one-year Treasury certificates. As a result, the maximum accepted interest rates on government paper with maturities of up to one year stood at 11.24 percent and 11.5 percent respectively (6-month and one-year securities), while those on benchmark government bonds reached 10.5 percent and 10 percent respectively (3- and 5-year securities). Furthermore, average interest rates on government securities increased in a range from 0.1 percentage points to 0.6 percentage points, reaching 9.5 percent and 11.3 percent respectively in late Q3.

Implicit Forward Rates



The securities issued in July-September amounted to nearly RON 1,261 million, given that the MEF had announced a volume of RON 6,100 million. After a 5-month absence, non-residents resumed activity on the primary market for government securities in July and August, submitting bids totalling roughly RON 293 million, out of which 25 percent were accepted.

Bank Rates

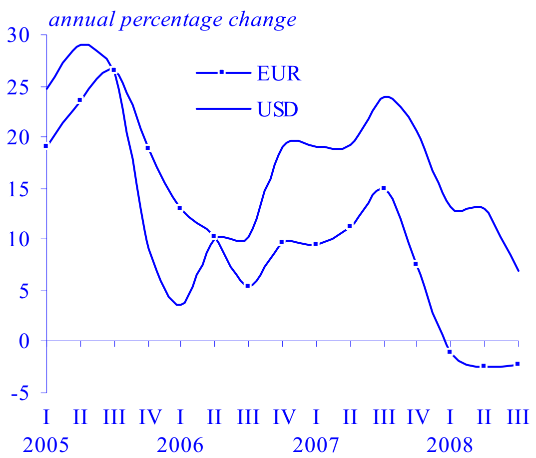


The quarterly volume on the secondary market for government securities rose to RON 4,690 million (from RON 2,500 million in Q2), owing almost entirely to repo operations conducted by the central bank in August (RON 1,874 million). Excluding the NBR, the most heavily traded securities were those with residual maturity of 1, 3 and 5 years. The average interest rates on these transactions ranged between 9.7 percent and 10.6 percent, being higher than those in the previous quarter (in a range from 0.2 percentage points to 0.6 percentage points).

The ongoing rise in the monetary policy rate and interbank rates fed through further into average deposit and lending rates on new business in June-August 2008. The magnitude of the rise was higher in the case of deposit rates on new business, which reflected further banks' enhanced need for resources. As concerns non-financial corporations, average deposit rates on new business added 1.25 percentage points in August versus May to 11.62 percent, whereas they advanced by 1.30 percentage points to 10.67 percent in the case of households. Average lending rates on new business picked up 1.09 percentage points to 15.20 percent in the case of non-financial corporations, while they rose by merely

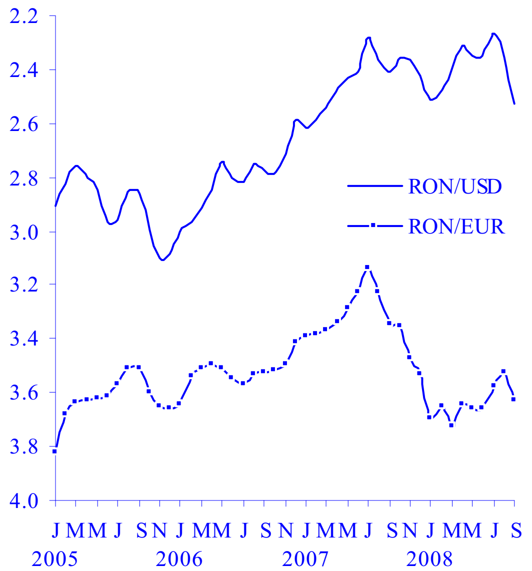
0.64 percentage points to 13.70 percent in the case of households, owing largely to the increase in interest rates on new consumer loans. In the latter case, average lending rates further displayed a relatively rigid development.

Developments of RON Exchange Rate*



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

Nominal Exchange Rate



2.2. Exchange rate and capital flows

The appreciation of the domestic currency against the euro gained momentum during July-August. In September however – amid the deepening of the US subprime mortgage crisis and its spill-over effects on the global financial market – the RON/EUR exchange rate posted higher volatility and re-entered a sharp uptrend, similarly to its major peers in the region.

Against this backdrop, the domestic currency gained merely 0.8 percent in nominal terms and 1.8 percent in real terms versus the euro July through September (1.8 percent and 3.1 percent respectively in 2008 Q2). Nonetheless, in relation to the US dollar, which strengthened considerably on global financial markets, the RON posted a depreciation of 7.1 percent in nominal terms and 6.3 percent in real terms. Calculated as an average annual change for 2008 Q3, the domestic currency depreciated at a slightly slower pace versus the EUR (9.6 percent in nominal terms and 2.3 percent in real terms), but saw a nominal weakening against the USD by 1.1 percent.

The appreciation trend that the local currency had witnessed versus the euro as of end-June gathered pace and continued into August, reflecting mainly: (i) the larger interest rate differential and expectations of this development to persist (also due to the protracted cycle of policy rate hikes by the NBR, in contrast with the regional trend of leaving unchanged/cutting policy rates); (ii) investors' relatively improved sentiment on the short-term outlook for domestic economic fundamentals, given that the data released during the reported period, including those regarding the external sector (record-high export values, export dynamics still outpacing import growth and the larger share of current account deficit financing via direct investment), were favourable (possibly also boosted by Standard&Poor's decision to revise downwards the likelihood of a recession hitting Romania[27]); (iii) the rise in current transfers of the central government[28]. These developments kindled non-residents' appetite for placements on the local financial market, as confirmed by the further increase in flows of

[27] Standard&Poor's also upgraded the ratings for the Romanian banking system on 4 August.

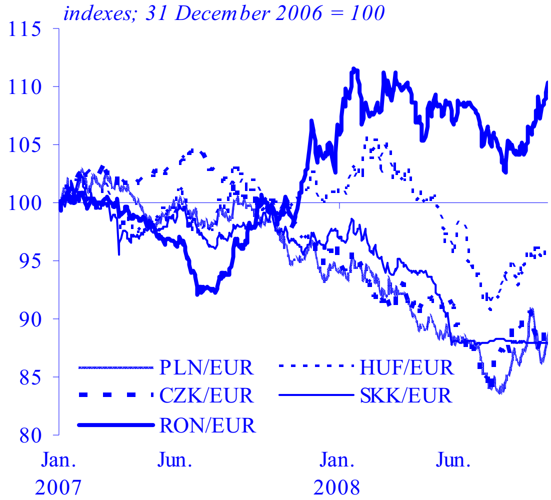
[28] The non-repayable funds granted to Romania by the European Union in relation to the EAFRD and EAGF amounted to EUR 352 million in July and August.

deposits[29] and the interbank forex market turnover hitting its second historical peak in August. Against this background, the RON/EUR exchange rate declined at a faster pace, posting the lowest reading year so far on 7 August, i.e. 3.4719, marking a divergent trajectory from most currencies in the region. The strengthening of the domestic currency was temporarily discontinued during the period under review by several episodes of turbulence and volatility on global financial markets, which led to short-lived depreciation sequences. Nevertheless, the RON appreciated 3.6 percent versus the EUR during July-August[30].

The exchange rate of the domestic currency witnessed a trend reversal in September, when it came – along with the other currencies in the region – under the impact of renewed risk aversion amid heightened fears surrounding the euro area economic outlook and escalating turbulences on the US financial market. Hence, the RON/EUR exchange rate rose to 3.60 from the very first days of the month and remained at elevated levels for a while. Its relative stabilisation reflected the temporary smoothing of conditions on global financial markets following the actions taken by the Fed and the US administration, also via the takeover of mortgage-loan institutions Fannie Mae and Freddie Mac. Subsequently, however, the global environment deteriorated abruptly, given that the bankruptcy of the Lehman Brothers investment bank and the hardships faced by AIG insurance company contributed to the serious deepening of the crisis rocking the US financial system[31]. Failure of a swift adoption of the bailout plan proposed by the US Treasury Secretary to stabilise the American financial system added to the general lack of confidence on financial markets. The highly volatile and tense international environment also left its imprint on domestic financial market developments, with increasingly jittery forex market operators bringing the exchange rate of the RON back on an upward trend. During the last 10-day period of the month, amid financial investors' higher risk aversion, the rise in the RON/EUR exchange rate accelerated abruptly, peaking at 3.7336 on the last day of September, the highest reading since 18 March 2008. The RON weakened in tandem with the rise in daily shifts in the RON/EUR exchange rate, whose volatility hit a 5-month high. As a result, the

Exchange Rate Developments on Emerging Markets in the Region

indexes; 31 December 2006 = 100



Source: NBR, ECB

Key Financial Account Items (balances)

EUR million

	2007 8 mos	2008 8 mos
Financial account	**9,397**	**10,881**
Direct investments	**4,809**	**6,502**
residents abroad	-73	66
non-residents in Romania	4,882	6,436
Portfolio investments and financial derivatives	**114**	**67**
residents abroad	-317	95
non-residents in Romania	431	-28
Other capital investments	**7,999**	**4,799**
medium- and long-term investments	2,094	3,556
short-term investments	-589	-870
currency and short-term deposits	4,352	-1,429
others	2,206	3,542
NBR's reserve assets, net ("–" increase/"+" decrease)	**-3,525**	**-486**

[29] Non-residents' deposits stuck to an upward path in July, mainly on account of short-term placements.

[30] During the same period, the Polish *złoty*, the Hungarian *forint* and the Czech *koruna* strengthened against the euro by 2.6 percent, 2.8 percent and 0.1 percent respectively.

[31] After the Lehman Brothers going bankrupt, Merrill Lynch was taken over by Bank of America, AIG received a USD 85 billion loan from the Fed in exchange for an 80 percent equity stake in the company, the Fed gave the nod to Goldman Sachs and Morgan Stanley becoming commercial banks, while the Washington Mutual was acquired by JPMorgan Chase.

domestic currency posted the strongest depreciation against the euro over the past eight months (2.7 percent), its developments being closely linked to those of the Hungarian forint and the Polish złoty.

2.3. Money and credit

Money

Annual Growth Rates of M3 and Its Components

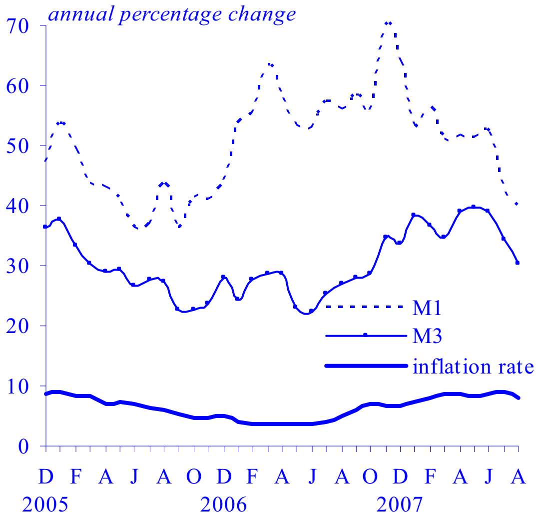
real percentage change

	2007		2008			
	III	IV	I	II	Jul.	Aug.
	quarterly average growth					
M3	20.8	24.1	26.5	28.2	23.2	20.8
M1	49.7	53.0	42.2	39.8	30.5	29.3
Currency in circulation	24.4	29.7	38.0	30.2	20.9	21.0
Overnight deposits	62.7	63.9	43.7	43.6	34.3	32.6
Time deposits (maturity of up to 2 years)	-0.1	2.4	12.6	16.7	15.2	11.6

Source: NIS, NBR

In June-August 2008, the average pace of increase[32] of broad money (M3) witnessed a slowdown, hitting the lowest level in the past three quarters at 24.0 percent. M3 developments were uneven during the period under review. Thus, its annual growth rate decelerated in July and August, returning to a relative normality after having peaked April through June at one of its highest values for the last 2½ years[33]. The trajectory of M3 dynamics reflected the opposite effects exerted by the increased debt service in relation to household loans and domestic and external borrowings of companies on one hand and the faster rise in public spending (particularly in June 2008) and the still fast-paced economic growth, on the other hand. Most of M3 counterparts acted towards slowing broad money expansion: the growth of credit to the private sector slackened, banks' net external assets contracted more sizeably, while long-term financial liabilities (capital accounts included) soared. An opposite influence came from the sharper decline in deposits of the central government.

Broad Money and Inflation Rate



Source: NIS, NBR

The quarter under review saw a slowdown in both M1 dynamics and, unlike the previous periods, the growth rate of time deposits with an agreed maturity of up to two years. Hence, the share of M1 in M3 widened further to hit, on average, a historical peak of 57 percent[34]. Both narrow money components further witnessed a slacker expansion, although the deceleration was slightly more pronounced for currency in circulation. The determinant in case of overnight deposits was the slower increase in both RON-denominated deposits of households and companies and in household deposits in foreign currency. Their impact was offset only to a small extent by the renewed pick-up in the expansion of forex overnight deposits of companies, also on account of the likely transfer of foreign currency placements over a longer term. The possible underlying reasons for the aforementioned developments in relation to households include the still fast rise in

[32] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2008.

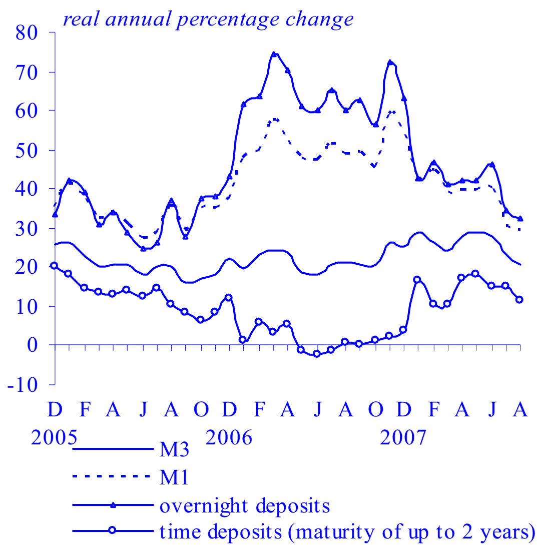
[33] The high level was mainly attributed to the settlement, in April 2008, of the privatisation of Electrica Muntenia Sud (EUR 820 million).

[34] Shifts in time deposits with an agreed maturity of up to two years and in overnight deposits were further influenced by the fading of effects induced by the statistical methodology introduced in 2007, reverting to levels close to those seen in 2006, namely higher in the former case and lower in the latter.

consumption of goods and services[35], the increased debt service to banks, and the decline in remittances from abroad[36].

Although the deceleration in the pace of increase of time deposits with an agreed maturity of up to two years was of a lower magnitude, it remained high from a historical perspective, exclusively on account of incorporating the one-off effect induced by the settlement, in April 2008, of the privatisation of S.C. Electrica. However, the analysis of data corrected for this effect indicates a decline in the annual change of corporate time deposits with an agreed maturity of up to two years in both domestic and foreign currencies, mainly due to the slacker dynamics of external financing[37], higher payments of profit tax[38], larger external debt service payments as well as the likely advance in the volume of repatriated gains. In turn, the growth rate of household time deposits with an agreed maturity of up to two years continued to decelerate during the period under review.

Main Broad Money Components



Source: NIS, NBR

The M3 structure improved slightly over the reported quarter, with the average share of forex deposits in M3 (29.7 percent) shrinking somewhat for the first time in the past year, largely on the back of developments in household deposits.

Credit

The growth rate[39] of loans to the private sector posted a faster decline June through August 2008 (down 6.9 percentage points to 44.2 percent), thus reverting to a level close to the previous year's reading. Developments in the M3 counterpart were also uneven, with its annual dynamics gaining momentum in June 2008 before decelerating swiftly to one of the lowest values in the past 2½ years. The forex-denominated component further witnessed a more sluggish pace of increase, although – given the accounting effect of a weaker RON[40] – the average share of foreign currency credit in total loans to the private sector remained somewhat stable at a high level, i.e. 54.6 percent. This development reflected the dampening impact on credit demand coming from: (i) higher lending rates on new business (except for housing loans, whose

[35] The average annual index of the turnover volume for retail trade, except motorcars and motorcycles, rose to 118.4 percent June through August 2008.

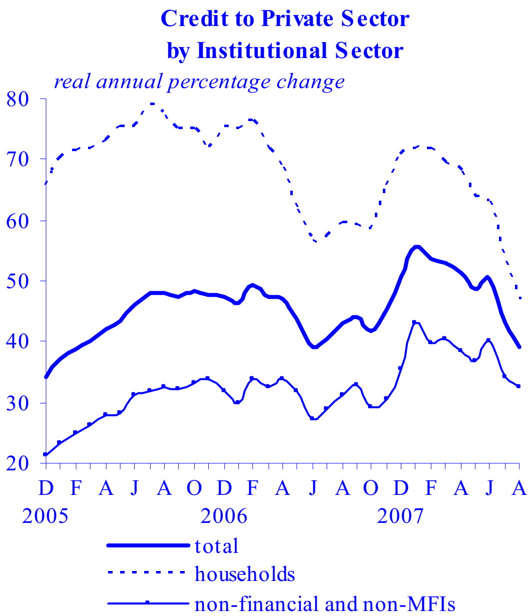
[36] The annual growth rate of workers' remittances from abroad posted a steady deceleration during June-August 2008.

[37] Financial loans and direct investment of non-banks.

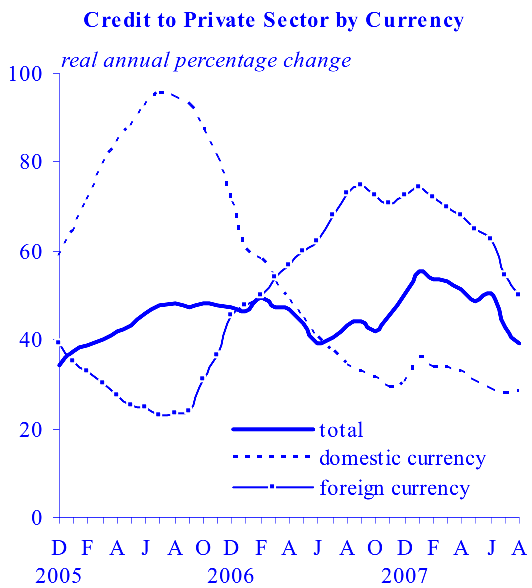
[38] According to consolidated budget data, the annual growth index of the profit tax collected June through August 2008 hit a 12-month high.

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

[40] Annual nominal depreciation of the RON against the EUR (end-of-month).



Source: NIS, NBR



Source: NIS, NBR

interest rates remained somewhat low, probably on account of promotional offers), (ii) certain customer categories[41] potentially reaching the indebtedness ceiling, and (iii) the base effect of the year-earlier easing of lending norms by most credit institutions. During the period under review, the supply of loans was stymied by the contraction of banks' excess liquidity and the tightening of external financing conditions for credit institutions.

Both the annual growth rate of household loans and that of corporate loans continued to decelerate, with slower dynamics manifest across all categories of loans, forex-denominated ones in particular. The pace of increase of the CHF-denominated component[42] of household loans (both consumer and housing loans) witnessed a marked slowdown. The RON-denominated component also lost momentum, on the back of developments in both consumer and housing loans (unlike the previous periods, the latter's dynamics posted a decline).

The demand for loans of non-financial corporations, the main segment of the corporate sector, also posted a deceleration during the reported period. Aside from higher financing costs, another possible determinant consisted in the additional resources that non-financial corporations had available in relation to the settlement of investments carried out by the local government[43]. However, loans to non-monetary financial institutions recorded an opposite development, with their growth rate accelerating considerably, due probably to the stronger impact exerted by liquidity constraints on global markets[44]. Nonetheless, the share of loans granted to this institutional segment in total corporate loans remained relatively moderate at 4.8 percent.

In turn, the negative value of net credit to central government contracted further amid the sharper decline in central government deposits, thus strengthening its expansionary impact on M3.

[41] According to monetary balance sheet data, the average share of overdue credit in total loans to the private sector widened steadily to reach a 5-year high in case of households (0.7 percent) and a 3-year high in case of non-financial corporations (1.4 percent).

[42] According to CCR data, June through August 2008, the average share of the CHF-denominated component (17.1 percent) in total new business to households shed 2.9 percentage points, while that of EUR-denominated loans (54.1 percent) advanced 4 percentage points. At the same time, the volume of new business in USD doubled from March-May 2008, although their average share in total loans remained subdued at 0.4 percent.

[43] The annual real decline in the balance of local government deposits became more abrupt during June-August 2008.

[44] For instance, in June 2008, some 67 percent of total liabilities of non-banks (which make up the majority of non- monetary financial institutions) were borrowings from non-residents.

V. INFLATION OUTLOOK

The recent deepening of the global financial crisis caused a marked rise in volatility on world markets, posing major difficulties for forecasting the short and medium term impact of the turmoil on both the domestic and international macroeconomic developments. The global financial deleveraging process also resulted in increased risk aversion and a subsequent flight to quality of non-resident investors' capital. Hence, risk factors associated with the international market developments have become increasingly relevant for the current projection, with the identified risks of inflation deviating from the baseline scenario being much more balanced than in the previous rounds. Nevertheless, the central bank will further channel its efforts to drive the inflation rate towards the established targets while striving to ensure the adequate functioning and stability of the financial system amid the adverse effects of the global financial crisis.

Taking into account the unusually high uncertainties surrounding quantitative assessments, the baseline scenario of the current projection places the 12-month inflation rate at 6.7 percent for end-2008, 0.1 percentage points above the figure published in the August 2008 Inflation Report. For end-2009, inflation is forecasted to stand 0.3 percentage points above the previously projected level (4.5 percent versus 4.2 percent). Subsequently, in early 2010, projected inflation is anticipated to converge relatively fast towards the central target.

When compared to the previous projection, the upward revision of the projected inflation for both 2008 and 2009 is due to both the adverse impact of recent and forecasted developments as well as to the materialisation of some risks indicated in the August 2008 Inflation Report. The first unfavourable effect is generated by stronger pressures from CORE2 inflation, which is supported, particularly over the course of the current year, by higher inflationary pressures exerted by aggregate demand. The envisaged deceleration of euro area economic growth, the effects of which should be particularly seen in early 2009, is expected, via the domestic aggregate demand channel, to help dampen inflationary pressures on prices included in the CPI basket. Another effect comes from the repositioning of the RON exchange rate at the beginning of the projection horizon at a level higher than that envisaged in the prior projection, which adversely affects import price dynamics (in the first part of the horizon) and *ceteris paribus* the tightness of real monetary conditions. Nonetheless, over the short-term, it is expected that the above mentioned adjustment of the exchange rate should have a transient restrictive impact on excess demand via higher costs expressed in RON of loans and of the corresponding debt denominated service denominated in foreign currency (wealth and balance sheet effect). Further restrictive effects on the aggregate demand could be exerted, as opposed to the hypotheses of the baseline scenario, by a deeper financial deleveraging, an increased efficacy of NBR's measures aimed to moderate lending or by a slower dynamics in the reinvested profits of non-resident companies. When compared to the August projection, the more rapid increase in administered prices and the slower decline in inflation expectations also contribute to the upward revision of the inflation forecast in the current round. Such unfavourable effects are mitigated throughout the forecast horizon by a more favourable scenario regarding fuel price inflation.

It is expected that the past monetary policy rate hikes, the NBR's prudential measures aimed at containing lending growth, the wealth and balance sheet effect related to exchange rate movements and the constraints imposed by the global financial crisis on the loan dynamics will jointly influence aggregate demand, particularly during 2009. The baseline scenario of the projection foresees a favourable effect on inflation following the temporary removal of excess demand anticipated to occur in Q2-Q3 of next year, despite the expected decline in 2009 of potential GDP dynamics. Afterwards, based on data available thus far and subject to the pronounced uncertainties, the pace of economic growth is projected to return to slightly higher levels insofar as the constraints triggered by the global financial crisis are anticipated to be less binding. Monetary policy will retain its restrictive stance throughout the forecasting horizon in order to mitigate the inflationary shocks triggered by the import and administered prices as well as those following from the expected income and fiscal policies. This will help inflation return to the variation band around the central target in 2010 Q1.

The major uncertainties induced by the global financial turmoil in terms of the nature and expected duration of its effects on the world as well as on the domestic economy have serious consequences both on the layout of the baseline scenario of the current projection and the identification and quantitative assessment of the effects of risk factors that are deemed as the most likely to manifest during the current forecasting round. For the current round, the risks regarding the dynamics of oil and commodity prices, administered prices and volatile food prices, as well as the risks associated with the exchange rate dynamics are relatively symmetrically distributed around the forecasted path of the CPI inflation from the baseline scenario. In other words, given the latest available data, each of the above-mentioned factors are perceived as having equal probabilities to deviate upwards or downwards from the hypotheses regarding their dynamics in the baseline scenario. Against this background, conditional upon the particular risk factors that could materialise, the projected trajectory of inflation rate is to be revised accordingly around the path described in the baseline scenario. On the other hand, asymmetric risks of higher inflation due to wage growth in excess of productivity gains and to a more expansionary fiscal policy are partly countered by the risk of lower inflation, which is likely to occur following a faster slowdown in economic growth than in the baseline scenario as a result of the global financial crisis.

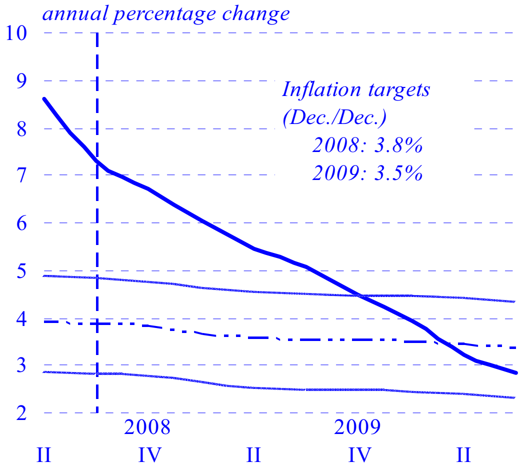
1. The baseline scenario of the forecast

1.1. Inflation outlook

The recent surge in the global financial crisis in the context of considerable difficulties of estimating its impact on a large set of macroeconomic variables renders the quantitative assessments described in the current projection as highly uncertain. As anticipated in the August 2008 Inflation Report, the 12-month CPI inflation peaked at 9.04 percent in July, but since August it re-embarked on a downward trend that is expected to persist throughout the entire horizon. Nevertheless, the magnitude of recent shocks that impacted inflation – both directly and indirectly (largely via energy and food price increases) – is expected to prevent the re-entering of this variable into the variation band around the central target until 2009 Q3. Against this background, annual CPI inflation is forecasted to reach 6.7 percent at end-2008 and 4.5 percent at end-2009. Compared to the projection from the August 2008 Inflation Report, the annual inflation rate is higher both in 2008 and 2009, by 0.1 and 0.3 percentage points respectively (for end-2009, the 4.5 percent forecasted inflation is equal to the upper bound of the variation band around the central target). Amid the unusual uncertainties surrounding the outlook for the economy over the short and medium term, deviations in both directions from the projected inflation path are likely to occur in the current forecasting round[45].

Inflation Forecast

annual percentage change



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

Source: NIS, NBR calculations

[45] Starting from a number of qualitative scenarios prepared by NBR experts regarding possible future effects of the global financial crisis, the NBR Board asserted in its meeting of 30 October 2008 that for the current projection round the likelihood of scenarios indicating CPI inflation standing above/below the central trajectory of the baseline scenario is significant and relatively evenly distributed. The NBR Board also stated that throughout the entire projection horizon the magnitude of such deviations could be approximated by a band reflecting the historical uncertainties associated with inflation projections (given that the inflation outlook published in the *Inflation Report* is the result of projections based on the medium-term forecast model and the assessments of Board members, the aforementioned historical uncertainties could relate to the past forecast errors of the annual CPI inflation entirely based on the cited model – for details, see also Section *1.4. Risks associated with the projection*).

Table 5.1. Annual inflation rate in the baseline scenario

percent

Period	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3
Target	3.8				3.5			
Forecast	6.7	6.0	5.5	5.1	4.5	3.9	3.2	2.8

Compared to the August 2008 Inflation Report, the upward revision of the projected inflation rates during the entire forecast horizon is attributed to:

– *rising inflationary pressures from aggregate demand, occurring especially in the first part of the horizon*; for this year, the assessment is supported by the stronger than previously expected second-quarter growth[46] and expectations of robust GDP increase in Q3; for next year, upward pressures on excess demand arise, *ceteris paribus*, from a looser fiscal and income policy than the hypotheses included in the August projection (for details regarding the fiscal impact on the inflation forecast, see *Box 1*). Nevertheless, the high uncertainty attached to the recent effects of the global financial crisis could result in downward deviations of the GDP growth rate from the baseline scenario[47], which could dampen inflationary pressures coming from this source;

– the revised magnitude of inflationary pressures coming from CORE2 inflation on the back of a less favourable dynamics of import prices and a somewhat slower decrease in inflation expectations, particularly in the first part of the forecast horizon;

– the building up of higher exogenous pressures related to the envisaged administered price adjustments; under the current baseline scenario, the efficacy of monetary policy in countering the second-round inflationary pressures stemming from this source within a timeframe compatible with inflation returning inside the variation band at end-2009 is limited by the delay of some natural gas price increases for early next year, instead of this year[48].

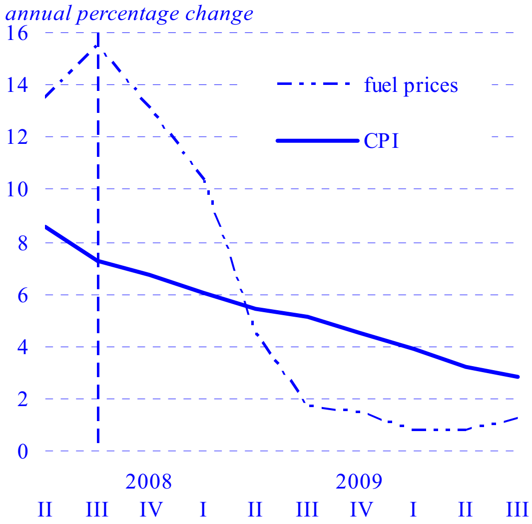
[46] According to the statistics for 2008 Q2 published by the NIS.

[47] On the one hand, this could follow from a confirmation of concerns regarding NIS data accuracy (see footnote 51 in the August 2008 Inflation Report). On the other hand, it could be the outcome of a faster deceleration in domestic economic activity during 2009, which could be ascribed to a more significant slowdown in euro area GDP growth (Romania's main trade partner) than that incorporated in the baseline scenario.

[48] Details on the exogenous assumptions underlying the baseline scenario are shown in Section *1.2. Exogenous inflationary pressures*.

Disinflation, which resumed since Q3, is foreseen to last throughout the eight-quarter horizon. Compared to 2008 Q3, the reduction in annual CPI inflation during 2008 Q4 is underpinned by a favourable statistical base effect[49] as well as by the downward revision of fuel price inflation[50] (compared to the August 2008 Inflation Report, it is seen exerting a favourable impact on inflation over the entire horizon). In contrast to the previous Inflation Report, the less favourable influence of volatile prices of fruit, vegetables and eggs and of the projected dynamics of administered prices could be offset, especially during the next year, by the effect on net exports of the envisaged slower growth rate of euro area demand[51]. This stems from the anticipated substantial deceleration in the euro area demand for Romanian products in 2009, on the one hand, while on the other hand it could follow from a monetary policy stance that is set to gradually counter excess demand, in line with the structural lags specific to the pass-through of policy impulses to the real economy, on the other hand.

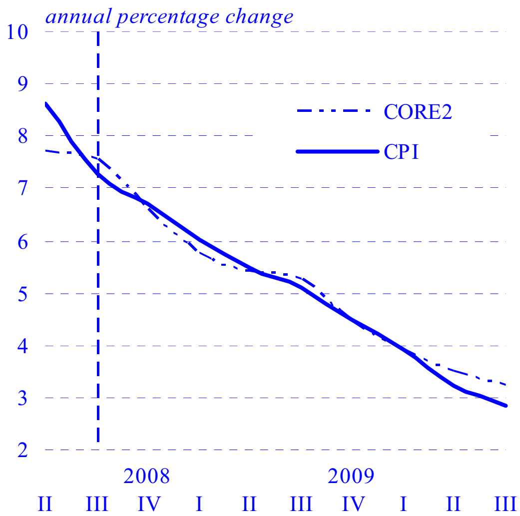
Fuel Prices and CPI



Source: NIS, NBR calculations

According to the baseline scenario, the annual CORE2 inflation rate is expected to follow a trajectory lower than that of the CPI inflation for most of the projection horizon, thus favouring disinflation. Similarly to the previous Inflation Report, the upward trend of the CORE2 inflation that had begun in 2007 Q3 is anticipated to reverse its trajectory starting with 2008 Q4. According to the projection, this indicator will embark on a steadily downward path over the next 8 quarters, reaching 4.5 percent at the end of 2009 (half of a percentage point higher than the previously projected figure). The explanation for the repositioning of CORE2 inflation at higher levels than those published in August lies with the less favourable impact of import prices, at least over the first quarters of the projection horizon – given the revised consumer price inflation forecast in the euro area and anticipations of a weaker RON in 2008 Q4 – and with inflation expectations reflecting partly the higher envisaged domestic CPI inflation during 2009.

CORE2 and CPI



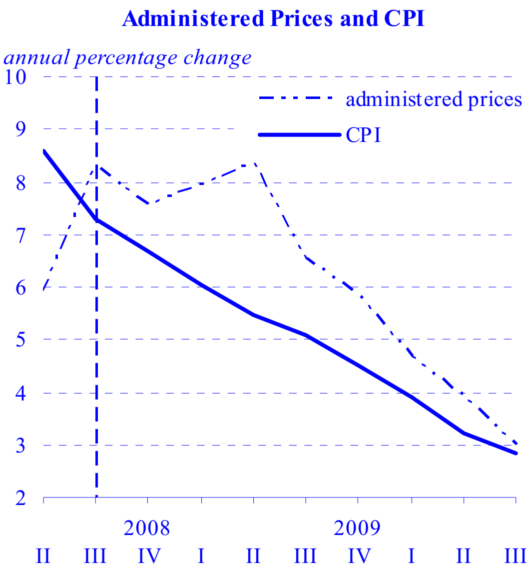
Source: NIS, NBR calculations

Among the consumer basket components, administered prices are expected to display a faster dynamics than the CPI inflation over the entire horizon. Fuel price inflation, although projected to exceed that of the overall consumer basket in 2008 Q4 and 2009

[49] By excluding from the annual CPI inflation the high levels recorded in 2007 Q4 and including 2008 Q4 inflation.

[50] The layout of the scenario on fuel prices considered an average oil price of USD 90 per barrel for 2008 Q4 (see Section 1.2.). Global uncertainties, which also affect the supply of and demand for this commodity could result in sizeable oil price volatility – in both directions – as against the above-mentioned level and have substantiated, to a greater extent than in the previous rounds, an assumed flat level of this indicator throughout the projection horizon.

[51] Romania's main trade partner.



Source: NIS, NBR calculations

Q1, will thereafter sustain disinflation following a more favourable dynamics of the oil price (see footnote 50 and Section 1.2). Moreover, volatile prices of vegetables, fruit and eggs, although envisaged to be higher than in the previous Inflation Report, are projected to favour during the entire horizon the gradual convergence of CPI inflation towards the target band.

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 0.4 percentage points higher than the forecast in the August 2008 Inflation Report. The decline in the cumulative effect of exogenous CPI components for 2008 is due mainly to the more favourable contribution of excise duties on cigarettes, while the increase in that for 2009 owes chiefly to larger adjustments of administered prices. Compared to the previous projection, the contribution of volatile prices of foodstuffs (vegetables, fruit, and eggs) was subject to a slightly upward revision both for 2008 and 2009. Excise duties on cigarettes are seen as having an additional contribution to consumer price inflation in 2009, following the upward revision of the reference exchange rate used for calculating the excise duty in RON (RON 3.7364[52]/EUR).

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	7.6	5.9	0.8	4.2
Previous projection	7.3	4.7	0.2	4.1

The larger contribution of administered prices to consumer price inflation both in 2008 and 2009 results from (i) the postponement for 2009 of some hikes in electricity prices initially scheduled for 2008; (ii) expectations of higher than previously anticipated increases in the natural gas price in 2009; (iii) the pick-up in fixed and mobile telephony prices following the recent depreciation of the domestic currency; (iv) the higher value in RON of excise duties on fuels and electricity due to a less favourable reference exchange rate set for 2009 than that considered in the previous projection.

[52] According to the legislation in force, the reference used for calculating excise duties in RON during 2009 is the official exchange rate set by the European Central Bank as of 1 October 2008.

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	4.5	3.5	7.5	9.3	22.0	15.5
Previous projection	4.4	3.5	16.77	8.32	21.43	8.15

The assumptions on the external variables used for the current projection are surrounded by uncertainty following the recent deepening of the global financial crisis. In view of the latest statistical data, the projected inflation rate in the euro area was revised upwards to 3.3 percent for 2008 as a whole. This adjustment is attributable to mounting wage pressures and second-round effects caused by previous rises in prices of commodities (mainly the oil price) and food. However, due to the high uncertainty which is reflected by the dispersion among other institutions' forecasts, the euro area inflation projection for 2009 was maintained at 2.1 percent. The European Central Bank[53] itself warns about the current upside risks to inflation being perceived as lower than the risk posed by its possible alleviation as a result of the significant slowdown in economic activity, particularly during 2009. Because of the volatility on the global financial markets, expert judgement was used in the form of an assumption that both the USD/EUR exchange rate and the oil price will remain constant throughout the projection horizon. The scenario on the 3-month EURIBOR interest rate builds on futures prices, the level of which might be subject to opposing pressures generated by the cut in the ECB's policy rate (downward pressures), on the one hand, and by the size of the liquidity premium induced by the present conditions on financial markets (upward pressures), on the other hand.

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 (%)*	4.95	4.25
Oil price (USD/barrel)**	108	90
EUR/USD exchange rate*	1.36	1.36
Annual inflation rate in the euro area (%)**	3.30	2.10

* in Q4

** year on year

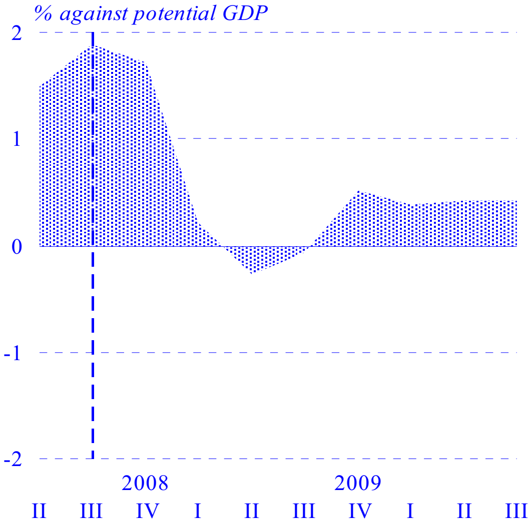
[53] ECB Monthly Bulletin, October 2008.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

The assessments of the future developments in the macroeconomic variables are affected by the high volatility associated with current evolutions on the international markets, with short- and medium-term effects on the domestic economy, the potential magnitude of which is afflicted by a high degree of uncertainty.

GDP Deviation



Source: NIS, NBR calculations

In 2008 Q2, real GDP posted a 9.3 percent growth rate, i.e. slightly faster than that forecasted in the August 2008 Inflation Report. In Q3, real GDP is seen rising further at a fast pace, its growth rate being expected to slow down starting with Q4. As concerns potential GDP, its growth rate is anticipated to remain high in Q3, both as a result of the swift dynamics of investment in the recent periods, with a positive impact on productivity, and of the significantly higher agricultural output than in 2007. Nevertheless, in Q3, demand is above potential GDP, being seemingly unaffected by the global financial crisis up to this quarter. July through September, excess demand rose from the previous three-month period. The growth rate of potential GDP is expected to fall in 2009 compared to 2008, considering the assumed spillover effects of the forecasted drop in investment activity.

The analysis of GDP components on the expenditure side reveals that in 2008 Q2 final consumption accounted for 84.5 percent of GDP[54], whereas gross fixed capital formation took 31.9 percent. The latter component, which has a significant impact on potential GDP growth, is expected to maintain its real annual dynamics of roughly 30 percent (a reading relatively similar to those reported over the past five quarters). The disequilibrium between Romania's GDP and the domestic absorption is mirrored by the still wide trade deficit[55] in Q3 that supports the assessment of a further sizeable excess demand during this period.

Household final consumption[56] is anticipated to rise above the trend level in Q3, with a markedly faster dynamics than that of the gross domestic product. The financing sources of consumption are household incomes and loans. Despite its deceleration, the

[54] Four-quarter cumulated nominal data.

[55] Nevertheless, the annual dynamics of the 12-month cumulated trade deficit has decelerated since December 2007; the latest available data refer to August 2008.

[56] Retail trade in goods continued to rise at a fast pace, its annual growth rate reaching 13.3 percent in August. By contrast, the annual dynamics of trade in motor vehicles and fuels decelerated over the past months to 6.1 percent in August.

dynamics of lending activity[57] remained high fuelling alongside wages the inflationary pressures attributable to the aggregate demand. The real net wage which exceeded the medium-term trend in Q3 and the unemployment rate indicate the persistence of pressures on the labour market[58]. Public consumption is forecasted to be the slowest-growing GDP component; however, the budget deficit projected for this year, along with the structure of public spending that is channelled primarily to consumption, will boost excess demand, having the same impact as household final consumption.

During the present quarter, gross fixed capital formation is anticipated to stand above the medium-term trend and is most likely to be adversely affected in the future by both global and domestic demand conditions[59]. Its fast dynamics reflects mostly the investment in the construction sector but also investment in equipment, with a direct impact on companies' retooling. Albeit on a downtrend, the medium- and long-term credit to economic agents, viewed as a significant investment financing source, continued to witness rapid real annual growth rates in September as well. Foreign direct investment posted further a positive dynamics, up approximately 35 percent in the first eight months of 2008 versus the same year-ago period. On the other hand, the share of capital good imports in total imports dropped in Q2 versus the previous period and the industrial output of capital goods posted a decrease in Q3[60] compared to the previous quarter.

The annual dynamics of the 12-month cumulated trade deficit continued to slow down, reporting an annual increase of 13.0 percent in August. The annual growth rate of exports[61] outpaced that of imports for the second quarter in a row, with the positive dynamics illustrating the favourable developments in output and labour productivity in industry over the course of the

57 The annual growth rate of the real stock of consumer loans stood at 43.0 percent in Q3 compared to nearly 60 percent in the previous quarters, while the equivalent dynamics of short-terms loans to households came in at 34.8 percent compared to growth rates of over 50 percent in the first two quarters of 2008.

58 In the event of the significant deceleration of GDP dynamics materialising, the lower capacity utilisation will ease to a certain extent the pressures on the labour market.

59 This picture owes to the unfavourable outlook on economic growth in the euro area (with a dampening impact on foreign investment channelled inclusively to Romania) and to tighter domestic lending conditions.

60 The latest available data refer to July and August.

61 The data were first used in the balance of payments and are available until August, as the data in the national accounts are only available until 2008 Q2. The readings are expressed in euro and quarter-on-quarter comparisons are based on the average reading for each quarter.

year. However, the latest available data[62] on the activity in industry and demand developments in Romania's main trade partners point to a potential deceleration in export dynamics in the forthcoming quarters. As for imports, the persistence of fast dynamics, albeit slower, is bolstered by the positive performance of household disposable incomes.

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

In 2008 Q3, the domestic currency appreciated in both real and nominal terms as against the previous quarter. The nominal appreciation seen in July-August occurred on the background of a relatively stable international context. Several domestic developments, namely higher-than-expected economic growth and export dynamics, the upward trend of interest rates and the decline in inflation rate have offset the potentially negative effects of a persistently wide current account deficit, thereby contributing to the domestic currency strengthening as compared with Q2.

Starting with September, the global economic context has worsened rapidly, following the pass-through of the US sub-prime mortgage market crisis effects to Europe. Hence, the nominal depreciation of the RON took place against the background of a sharp deterioration of the confidence in the international financial sector, combined with the less attractive investments in emerging economies[63]. The uncertainty still surrounding the possible effects of the international financial crisis has fed through into the assessment of future exchange rate movements of the domestic currency. In the current global context, it is more likely that some one-off factors that are not correlated with fundamentals will have an impact on the exchange rate as compared with the case in which financial markets would function under normal conditions. However, in the medium run, fundamentals are expected to play a major part in determining the exchange rate trajectory, Romania's real economic convergence with the euro area underpinning normally a moderate real appreciation trend of the RON (for details, see also Subsection 1.3.3.).

In 2008 Q3, the exchange rate is estimated to have a contractionary effect on aggregate demand and future inflationary pressures through the net export channel. Moreover, the nominal appreciation seen in July-August contributed to the decline in import prices, thus taking some pressure off inflation.

[62] In August 2008, industrial output fell by 1.5 percent versus the same month a year earlier, illustrating an 8.7 percent decline month on month.

[63] Investors' risk aversion to such investments increased within the context of global financial deleveraging process, which resulted in a general orientation towards lower risk and lower yield assets.

Acting towards bringing inflation back on a trajectory compatible with achieving the inflation targets, the NBR Board decided in its meetings of 26 June and 31 July 2008 to raise the monetary policy rate by a cumulative value of 0.50 percentage points to 10.25 percent. Given the firm control over money market liquidity, the average effective nominal interest rate on commercial banks' deposits with the NBR headed upwards as well. Therefore, the spread between the average effective interest rate and the monetary policy rate remained low. The alleviation of inflation expectations as compared with the values recorded in the previous quarter entails a rise in the real interest rate.

The NBR's effective interest rate influences the real economy indirectly, through commercial banks' deposit and lending rates. These rates usually adjust only gradually to the changes in the monetary policy rate. In the past two quarters however, commercial banks' nominal deposit rates rose faster than the NBR's effective rate. This development illustrates both the pass-through of the continuous NBR's effective rate increases in the past quarters, as well as the financial institutions' shift in focus towards taking deposits given the tighter access of banks to external financing and the relatively lower and unevenly distributed interbank market liquidity. The ongoing rise in real interest rates was also fostered by lower inflation expectations in the current quarter. Hence, starting with Q3, banks' real interest rates had a restrictive effect on economic activity. This effect has become more pronounced since October 2008.

Overall, in 2008 Q3, real monetary conditions as reflected by exchange rate movements and financial institutions' interest rates applied to their clients, had a more pronounced contractionary effect on aggregate demand and future inflation.

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. The actual economic growth (in 2008 Q2) and the larger projected growth (for 2008 Q3) compared to those presented in the August 2008 Inflation Report required the upward revision of inflationary pressures from aggregate demand in the economy (output gap widened by 0.2 percentage points in 2008 Q2 and 0.7 percentage points in 2008 Q3). As regards 2008 Q4, *ceteris paribus*, both the upward revision of prospects for economic growth and the expected effect of a much looser fiscal policy on aggregate demand are seen to render additional pressures on CORE2 inflation.

Throughout the projection horizon, the impact of the dynamics of real monetary conditions is expected to benefit from the NBR's prudential measures aimed at slowing down the credit growth (which came into effect following the release of the August 2008 *Inflation Report*[64]). The unusual uncertainties associated with the latest developments on the international financial markets[65] might temporarily bring about the deviation of the RON exchange rate from the trajectory compatible, over the medium run, with the fundamental factors underlying its dynamics. Accordingly, it is not unlikely for the domestic currency to display an increase of its volatility in both directions, which would therefore result in a repositioning of the RON exchange rate against the currencies concentrating the highest exposure of borrowers holding foreign debt. For instance, the build-up of stronger – and volatile – depreciation pressures at a certain point in the business cycle could have as a result, on one hand, a further deceleration of the growth rate of demand for corporate loans[66] and on the other, a contraction of resources allocated for consumption and investment for those agents that had previously taken foreign currency-denominated loans and whose current debt service would, as a result, be burdened by the RON exchange rate dynamics[67]. Under such conditions, via the wealth and balance sheet effects of the exchange rate, excess demand would decline markedly, thus supporting the gradual decline in inflation towards values close to the target band[68].

[64] The set of prudential supervision measures is presented in the NBR Regulation No. 11/2008.

[65] This relates to the emergence of a global financial deleveraging process accompanied by higher risk aversion to an entire class of regional financial assets (which also includes assets in Romania) and the consequently shift in placements towards low-risk, low-return assets.

[66] This is an additional effect, apart from that prompted by the implementation of above-mentioned prudential regulations regarding the slowdown in credit growth, which is expected to influence the growth rate of both RON and foreign currency denominated loans.

[67] Moreover, banks are expected to decide in favour of tightening the lending standards and conditions in relation to their clients, particularly given the competition between Romanian banks to attract deposits from domestic sources and the impact of global financial crisis, with its immediate direct effect of rising the costs of foreign currency financing (either from banks that have the capacity of shareholders of local banks or, where appropriate, from the global capital markets). According to the Survey on lending to non-financial corporations and households conducted by the NBR for 2008 Q2, the lending standards and conditions for non-financial corporations grew tighter as compared to the previous quarter and are expected to become even tighter in 2008 Q3 for loans to households as well. Should these expectations materialise, they will directly entail the slowdown in the growth rate of the loan supply, also causing the credit growth to decelerate.

[68] It is worth noting that the large increase in lending over the past several years added significantly to the growth rate of potential GDP, an effect that would be partially eliminated in the case of stronger deceleration of credit growth over the projection horizon. Therefore, reflecting the above-mentioned developments, the pace of increase in domestic economic activity could significantly slow down especially in 2009.

The removal of excess demand envisaged for the first part of 2009 – one quarter earlier than anticipated in the previous Inflation Report – is expected to be only temporary. Based on the latest available data and taking into account the unusually high uncertainties, the economic growth rate is expected to return to slightly higher levels in the latter part of the projection horizon in line with the alleviation of the financial crisis constraints that equally affect banks, households and economic agents.

The outstanding events that took place on international capital markets during the last weeks (which were consequently reflected on the dynamics of foreign exchange markets) renders as highly uncertain the length of the period necessary for the repositioning of the domestic currency close to values that would mainly reflect its fundamental drivers. Among these fundamental drivers, an adequate macroeconomic policy mix[69] is crucial during the entire projection horizon, producing beneficial effects provided that the action of factors associated with global financial market turbulences would gradually dissipate.

The successive rises in monetary policy rate during 2008 fed gradually into the nominal interest rates set by commercial banks, in line with the structural lags typical of the transmission of monetary policy impulses to the real economy. As a result, internal assessments of the NBR[70] show that both lending and deposit real interest rates have become restrictive starting with 2008 Q3. Restrictiveness of the real interest rates is projected to increase in the first part of the projection horizon amid the persistent restrictiveness of the previous gradual increases in monetary policy rate, putting downward pressures on the growth rate of credit to the private sector and favouring households' savings on the back of current consumption. Even in the context of a foreseen deceleration in reinvested earnings by non-resident economic agents, investment in the economy is seen to keep rising at a reasonable pace on the back of the domestic component, given the higher domestic saving ratio.

For the current round, the fiscal policy coordinates presented in the previous Inflation Report were revised in line with the latest available data. These data refer, on one hand, to the updating of the macroeconomic bases necessary to determine the corresponding revenue and expenditure components of the government budget[71] and, on the other hand, to the incorporation of the discretionary expenditure categories announced by the Romanian authorities

[69] Monetary, fiscal, structural and income policies.

[70] See Subsection *1.3.1. Current aggregate demand pressures*.

[71] They incorporate assumptions regarding GDP dynamics and the rise in its components in the current projection of the baseline scenario.

since the August 2008 Inflation Report. In this context, notwithstanding the uncertainties surrounding the possible reshaping of the public sector policies following the November 2008 elections, the forecasts of the budget deficit for 2008-2010 were revised upwards (a wider budget deficit), entailing – against the background of a cyclical budget component that was also revised upwards – a looser fiscal impulse to aggregate demand and thus stronger inflationary pressures induced by this component[72] of the macroeconomic policy mix.

As already mentioned in Section 1.1., one of the key factors underlying excess demand developments throughout the projection horizon is the expected dynamics of external demand for Romanian goods coming from the main trade partner (euro area). The contraction of euro area aggregate demand, expected to become manifest as early as the end of 2008, but forecasted to accelerate mainly during 2009, will be attributable, amid global financial market turbulences, to economic agents' increased difficulties in accessing funds, which will generate a contagion effect at real economy level in the form of an expected slowdown in all aggregate demand components.

[72] This results from a larger annual excess demand relative to the previous forecasting round.

Box 1. Fiscal projections and the macroeconomic forecast

In its capacity as a member of the European System of Central Banks (ESCB), the National Bank of Romania is required to prepare biannual projections and independent assessments of national fiscal policy by using the standard forecasting and analysis methodology developed within the ESCB's Public Finance Group, which draws on the experience of Member States and on that gained within the ECB's Fiscal Policies Division[73].

The NBR's fiscal projections are built to be consistent with the macroeconomic scenario resulting from the central bank's own forecasting and analysis model. The projections of relevant macroeconomic variables (GDP, deflators, consumption, employment, wages, interest rates, exchange rates, etc.) interact with the revenues and expenditures discretionary measures taken by competent authorities in order to project the general government budget (GGB) for the current year and the next two years. The considered revenues and expenditures of the GGB comply with ESA 95, which differs from the methodology underlying the drafting of the Annual Budget Law[74].

Fiscal balances result from both the fiscal authorities' decisions and the influence of factors beyond their direct control, of which the most important are fluctuations in economic activity. Adjustment of the GGB balance by the influence of cyclical factors facilitates the analysis of budget policies and therefore the projections of revenues, expenditures and implicit budget balances are also accompanied by the calculation of their structural component – according to the standard methodology of the ESCB. From an economic perspective, the cyclical adjustment seeks to determine the size of the GGB balance that would have prevailed if the economy was at its potential level. Identifying the structural fiscal position allows one to assess the manner in which fiscal policy acts as a macroeconomic stabiliser, which implies a looser stance in times of recession and a tighter stance during an economic boom. The forecasting process and the cyclical adjustment materialise in the components set out below:

- **Structural fiscal position (underlying fiscal position**) is a measure of the deficit that would have prevailed in the absence of business cycle effects. Below is an example[75] of the breakdown of the budget balance.

Actual fiscal position	=	Structural fiscal position	+	Cyclical component
(-2% of GDP)		(-2.5% of GDP)		(0.5% of GDP)

↑

Cyclical component	=	Excess Demand	x	Sensitivity of the budget balance to excess demand[76]
(0.5% of GDP)		(1% of GDP)		(0.50)

- Dynamically, the structural balance may be analysed from the perspective of **fiscal stance (orientation of fiscal policy)** that reflects the change in the structural balance. An alternative indicator is the **fiscal impulse**, which is equal to the fiscal position, but has an inverted algebraic sign. A positive fiscal impulse denotes a looser fiscal policy, which fuels inflation, even though the actual deficits may be on a downward path. If the positive fiscal impulse coexists with excess demand in the period under review, it can be asserted that the fiscal policy is **pro-cyclical**, namely that fiscal policy fails to act as a business cycle stabiliser and, moreover, it contributes to magnifying the amplitude of cyclical fluctuations and inflationary pressures induced by excess demand.
- The fiscal impulse to the economy is incorporated in the model which the NBR uses to prepare the projection as an element impacting aggregate demand. The consistency between the macroeconomic scenario and the fiscal projection is ensured by an iterative process in which the two elements interact until they converge.
- The cyclical adjustment of budget deficits is a standard procedure in macroeconomic analyses and is normally used by the European Commission, the OECD, the IMF, as well as the Romanian Ministry of Economy and Finance in the context of the annual update of the Convergence Programme.

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73 The methodology used by the ESCB is presented in detail in the ECB Working Paper No. 77 and 579.

74 ESA95 differs from the cash methodology mainly with respect to the treatment of revenues and expenditures (recorded on an accrual basis) and of EU funds (according to ESA95, the EU is a separate sector). For details, see "Government Finance Statistics Guide – January 2007", ECB, 2007.

75 Figures given herein are purely hypothetical and used for illustrative purposes alone.

76 The coefficient shows the shift in the (share-to-GDP) budget balance in relation to a one percentage point change in excess demand.

1.4. Risks associated with the projection

The global economic environment, affected by numerous uncertainties concerning both financial market developments and their impact on the real economy, is likely to induce significant deviations from the trajectory associated with the current baseline scenario. Under the circumstances, compared to the August projection, the much wider range of risks and the heightened uncertainties surrounding the possible future developments of the financial crisis point to a relatively symmetrical distribution of risks around the projected path in the baseline scenario. Taking this into consideration, the likelihood of deviations in both directions from the projected trajectory of both inflation and economic activity is estimated to be relatively balanced over the relevant horizon. Such an assessment occurs on the background of some risks described in the August 2008 Inflation Report materialising and also amid the plausibility of certain macroeconomic developments that might diverge, in case of other risk factors, from the trajectories projected at that particular point in time.

For the current round, risk factors with a relevant likelihood to occur during the projection horizon could be divided into two categories and relate to:

- developments on world financial and commodity markets amid uncertainties surrounding the dynamics of oil price or of the external demand for Romanian products;
- likely corrections or widening of domestic imbalances in line with developments on the labour market (the forecasted real wage dynamics in relation to productivity gains), on the foreign exchange market (heightened volatility of the domestic currency) or the coordination of macroeconomic policies (implementing divergent fiscal and wage policies compared to the assumptions of the baseline scenario).

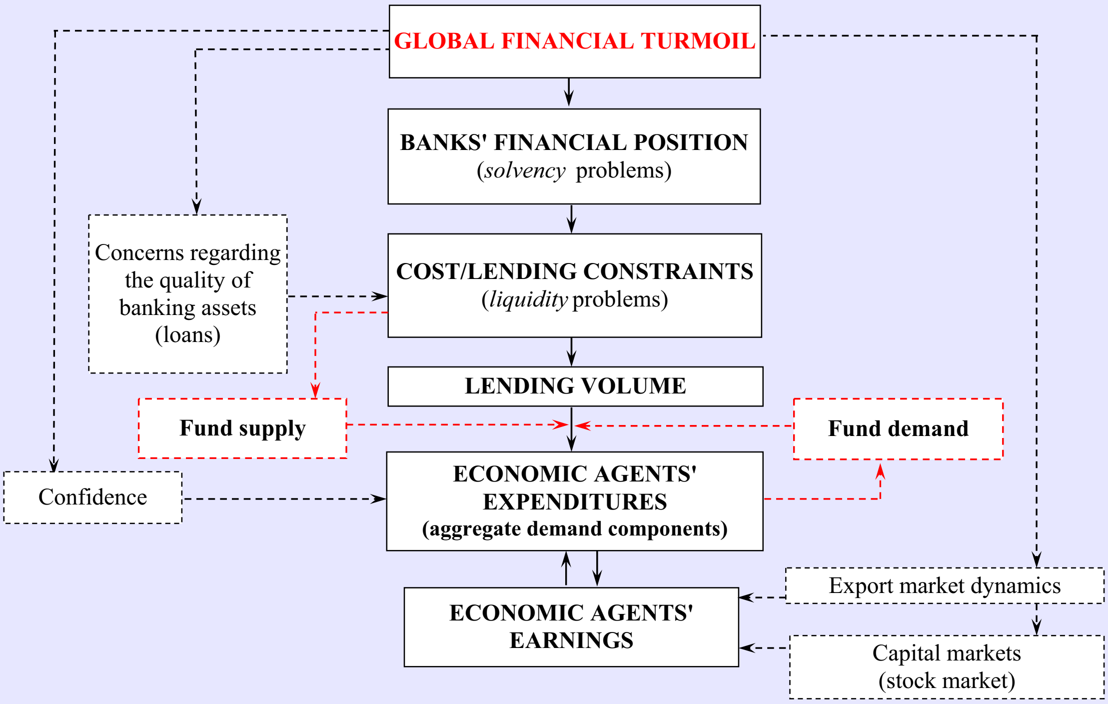
One of the risk factors having materialized since the release of the August 2008 Inflation Report relates to the layout – at least over the short run – of a fiscal policy whose updated coordinates based on the latest available information act towards a build-up of inflationary pressures in the economy (for further details see Subsection 1.3.3.). Looking further ahead, the persistent lack of coordination of the fiscal policy and of the public sector income policy with the monetary policy would be a major impediment in bringing inflation back within the variation band around the central target over the medium term.

The persisting uncertainties surrounding the international investment environment could cause the exchange rate to deviate from the assumptions of the baseline projection. The increase in the volatility of the domestic currency is seen as inevitable if the world financial crisis persists over the medium term (see *Box 2* for details on transmission channels of financial turmoil on various macroeconomic variables). Nevertheless, the RON might also deviate in the medium run from a path compatible with the action of economic fundamentals under the pressure of the widening domestic imbalances over the upcoming eight quarters. Thus, the persistent mismatch between wage increases and labour productivity gains could impair the external competitiveness of Romanian products, entailing a wider trade balance and, unavoidably, subsequent downward pressure on the RON. Adding to these adverse effects might be the possibly larger deviations of the fiscal policy coordinates from the assumptions of the baseline scenario, likely to signal vulnerabilities in the domestic economy for foreign investors. Against this background, their risk aversion could be accompanied – within an uncertainty-riddled global environment – by a slowdown in autonomous capital inflows and even potential repatriation of capital gains.

The sharp downward trend in oil price in recent months (the August 2008 *Inflation Report* assumed the oil price would remain constant at USD 140 per barrel throughout the eight quarters horizon) hints at a diminished role, at least temporarily, that oil (together with other commodities) has lately played as a reserve asset. Under these circumstances, the likelihood of an oil market coming increasingly under the influence of fundamental factors (demand, supply, oil reserves etc.) seems high at this point in time. However, according to the IMF's World Economic Outlook, October 2008, Chapter 3, with inventories and spare capacity still low, oil prices are expected to remain high, but below recent peaks. On the other hand, given a more persistent financial turmoil on world markets over a longer period of time, especially if such tensions are accompanied by a marked slowdown in economic activity in advanced economies – leading implicitly to flagging oil demand – there is an increased likelihood that the oil price could fall beneath the level incorporated in the baseline scenario, i.e. USD 90 per barrel.

The renewed surge in the global market crisis after the release of the August 2008 *Inflation Report* has generated an additional risk for the current projection round, considering the downward revision of the economic outlook for the euro area. In light of the available data, when the previous Inflation Report was released, it was estimated that the outlook for euro area GDP dynamics would exert a moderately restrictive influence on domestic macroeconomic variables. This autonomous risk factor has become increasingly relevant during the current forecasting exercise, given that the features of the ongoing global financial crisis jeopardise both the stability of the international financial and banking system and the adequate functioning of the global real economy. Taken together, these risks have a significant interconditioning amplification potential, as the net effect over the projection horizon may consist in sizeable distortions of the global economic environment. *Box 2* below includes a brief diagram describing the spillover effects of the global financial turmoil on real economy dynamics in developed economies.

Box 2. The financial crisis and the real economy



The subprime mortgage crisis in the United States, which emerged in the summer of 2007, lies at the root of the financial turbulences that have revived lately. Massive exposures of a large number of banks worldwide to subprime mortgage-backed securities[77] triggered, along with the collapse of the U.S. housing market, huge losses associated with such mortgage loans. The outcome was a *solvency crisis* for the exposed financial institutions.

The increased difficulty – amid highly sophisticated financial products – in identifying the affected classes of assets led to a global diminishing of investors' appetite for risk. Rising concerns regarding the asset quality of banks exposed to such assets entailed a generalized confidence crisis, as a result of which banks were faced with a liquidity crunch. Thus, banks' access to financing sources (for recapitalisation and business continuity purposes) in competitive cost conditions was significantly limited, which forced them to apply restrictions to the loans extended to the real economy (loan supply).

The contraction of the real estate market in a large number of countries and the shrinkage of activity on world stock markets (against the backdrop of investors reassessing the risk associated with such placements) had a direct impact on economic agents' earnings, in the sense of an overall cutback. Associated with the shocks that considerably diminished the real disposable income of economic agents worldwide (on the back of the global rise in commodity and food prices), these developments led to a confidence crunch, apparent in economic agents' increased caution in incurring further expenses. Hence, this has also restrained the resort to bank loans (loan demand).

The economies with low exposures of the banking system to financial instruments that lay at the origin of the crisis, mainly emerging economies, were initially hit via a deceleration in foreign capital inflows on domestic markets and higher exchange rate volatility of their domestic currencies. Given the foreign investors' subsequent repatriation of funds placed on these markets, perceived as inherently exposed to a higher degree of risk, emerging economies were hit as collateral victims.

A reasonably plausible risk scenario across the projection horizon might imply that global risk aversion leave an imprint on the economies perceived as displaying a series of vulnerabilities (excessive budget deficits, wide current account deficits, large volumes of loans extended over short periods and denominated in foreign currency) and thus being likely to witness an even more sizeable contraction of the real economy.

[77] Subprime mortgage-backed securities are mortgage lending products extended to debtors perceived as having a negative credit history (either as a result of their previous lack of exposure to the banking system or due to violations of previous financial commitments). Under the circumstances, the risk associated with these financial products was perceived as high.

A risk common to all projections so far concerns the developments in administered prices, given the repeated changes in their adjustment calendar. In addition, the inflation rate might deviate from the baseline scenario as a result of different than projected developments in volatile food prices provided that the 2009 agricultural output differs from the crop of the current year. Under these circumstances, the risks of upward and downward deviations of inflation from the level envisaged by the projection are considered to be relatively balanced.

As mentioned previously, an explicit measure of the individual impact of various risk factors – similarly to the quantitative/qualitative assessments described in the previous Inflation Reports – is perceived as having low relevance in the current forecasting round. This requires setting a procedure to determine a global quantitative measure for the uncertainty associated with the inflation path in the baseline scenario amid the high likelihood of a simultaneous action from the aforementioned risk factors, which have the potential to boost/mitigate one another.

Similar to the methodology adopted by other central banks which pursue an inflation targeting strategy, this measure will be constructed as a symmetric interval around the inflation trajectory projected in the baseline scenario[78]. Further details on the methodology employed in constructing the uncertainty interval are provided in *Box 3*.

[78] Placing the baseline scenario at the centre of the symmetric uncertainty interval is tantamount to assigning it the highest likelihood of becoming manifest over the projection horizon, given that it reflects the latest information on economy dynamics.

Box 3. Building the uncertainty interval associated with the baseline scenario inflation forecast

The emergence of unforeseen elements – such as shocks – in terms of both origin as well as regarding their magnitude or direction of action may very often impede upon the accuracy of the projection. Using forecast errors as a general measure for the uncertainty associated with the inflation forecast based on a macroeconomic model (namely the medium-term forecasting model used by the NBR) has an upside in that it provides a summary of the effects of all unforeseen shocks that acted in the past and thus led to *(ex post)* deviations of the inflation projection from actual levels. The methodology proposed in this box relies upon the use of forecast errors in constructing the uncertainty interval associated with the baseline scenario inflation forecast. This solution has the following advantages:

- it summarises the cumulative and quantifiable impact on inflation rate of all shocks from the past, irrespective of their nature and magnitude;

- by employing the entire track record of quarterly macroeconomic projections (starting from that published in the August 2005 *Inflation Report*), the deviations in both directions that led to over/underestimation of forecasted inflation will be captured;

- it avoids quantifying arbitrary assumptions on individual risk factors, which could prove to be the extremes in terms of their foreseen magnitude and their potential effects on the endogenous variables within the model;

- it features a certain flexibility, i.e. the uncertainty interval resulting from calculations related to forecast errors can be adjusted in order to reflect the assessments of monetary policy makers as regards the magnitude of future uncertainty relative to previous periods.

Among the downsides there is the fact that, seen as a synthetic measure, this methodology falls short of clearly specifying the relative importance of those risk factors considered as being highly relevant to the projection horizon.

The methodological details on the calculation of the uncertainty interval bounds include the following:

- forecast errors of projection cycles during August 2005 August 2008 were calculated as differences between the projected values (using the medium-term forecasting model) and the actual values of inflation on horizons spanning 1,2,..., 8 quarters ahead;

- the considered forecast errors were calculated on the basis of average quarterly inflation rates, not end-of-period rates, considering that the model is built on quarterly time series (in line with the horizon over which the described theoretical mechanisms have relevant efficacy);

- in order to summarise the gathered information, a synthetic indicator similar to MAE (mean absolute error) was determined for each relevant time horizon (1,2,..., 8 quarters ahead);

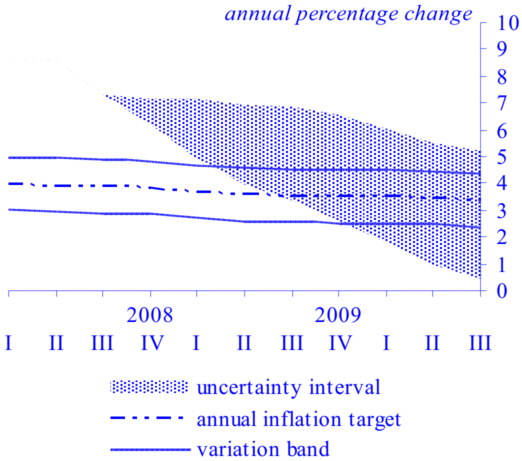
- results were adjusted using a logarithmic interpolation in order to smooth the uncertainty interval bounds and avoid the bias towards uneven narrowing/widening of uncertainty over various time horizons.

The size of the uncertainty interval associated with the baseline scenario inflation forecast should be interpreted in simple terms as a mean of the possible effects resulting from the future action of some risk factors uncertain at the current moment in terms of both origin and magnitude or direction. At the same time, it is a quantitative approximation of expected uncertainty incorporated in the inflation forecast.

Finally, for an effective impact on economic activity, the manner in which a central bank communicates its own assessments and uncertainties to the public is essential.

The chart illustrates the distribution of the uncertainty interval around the central projection of inflation in the baseline scenario for the current round. Taking into account the current economic environment subject to major uncertainties, it cannot be entirely ruled out – although it is rather unlikely – that inflation deviations from the central trajectory might exceed during the projection the variation limits defined by the uncertainty interval.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR calculations

2. Policy assessment

In August, annual inflation rate reverted to a downward trend after the peak reached in July but remained significantly above the upper limit of the variation band around the central target, standing at 7.3 percent in September. Behind this performance stood chiefly the sharp slowdown of the increase in some volatile food prices, largely as a result of a base effect. Adding to the disinflation-boosting factors in August were the drop in the yearly dynamics of administered prices and the slower CORE2 inflation. The magnitude of the latter was relatively more moderate given that the favourable effect on CORE2 inflation stemming from the decline in the year-on-year depreciation pace of the RON and the negative price dynamics of some processed foodstuffs was partly countered by the heightened demand-pull inflationary pressures and larger ULC.

The possible worsening and fast spillover of the detrimental effects of the global financial crisis onto the real sector of industrialised countries make highly uncertain the updated forecast of medium-term macroeconomic developments. Hence, it renders monetary policy calibration more difficult. The instant response of the central bank to the domestic macro-financial context is additionally hampered by the recent heightening of tensions on the foreign-exchange and interbank money markets amid the downbeat sentiment taking hold of the local banking environment, but especially following the upsurge in speculative transactions on those markets.

The baseline scenario of the forecast based on the assumptions more likely to materialise in the current context points to a slightly different pattern of the projected annual inflation rate from that presented in the previous round. In the current round, disinflation is foreseen to strengthen at a somewhat slower pace in 2009, but will slightly gather speed in the last part of the projection horizon; eventually, the annual consumer price index is seen returning inside the variation band around the central target in 2010 Q1.

Behind the relative deterioration of the inflation outlook in the near run stood primarily the short-term upturn in demand-pull inflationary pressures against the background of an expected rise in both magnitude and duration of the positive output gap. In the near term, the key prerequisites and reasons behind the advance in excess aggregate demand are: (i) further fast-paced GDP growth in 2008 Q2, (ii) stronger expansionary impact of fiscal and income policies as well as of swiftly growing private sector wages, (iii) insufficient tightening of real monetary conditions, and (iii) the time lag pertaining to the efficient transmission of the impact of monetary policy rate moves.

However, the forecast of economic growth and implicitly its inflationary potential are surrounded by very large uncertainties given that the current deepening of the global financial turmoil makes it exceedingly difficult to project both magnitude and timing of the potential indirect effects of the crisis on the Romanian economy. Even though the current projection incorporates relatively moderate and lagged effects of the crisis, it is highly likely that, assuming an abrupt worsening of expectations and perception regarding the evolution of domestic fundamentals along with the worse-than-anticipated external developments, they would be manifest in a much stronger and faster manner across the national economy.

Thus, a more pronounced decline in export dynamics amid an excessive slowdown of the pace of increase of EU Member States' economies could affect domestic economic growth. Nevertheless, a stronger impact on the Romanian economy could have a relative decline in direct investments, especially foreign borrowings – of credit institutions in particular –, and higher associated costs. Severe tightening of external financing conditions and/or narrower access to such loans might emerge assuming that (i) global money market woes persist or even increase, in spite of the broad-based co-ordinated measures taken by public authorities to restore normality, and (ii) foreign investors' risk aversion increases sharply.

The potential contractionary impact exerted by the latter channel on domestic demand could materialise basically in a relative compression of credit institutions' loan supply. Over the period ahead, constraints on loan supply will be heightened by (i) contraction in excess liquidity across the banking system and the ensuing stronger tensions on the money market; (ii) increased bank cautiousness, reflected by the tightening of lending terms and conditions, amid higher uncertainties surrounding macro-financial developments, but also as a result of the entry into force of the new NBR regulation on containing credit risk associated with loans to households; (iii) the reduction in both level and scope of potential borrowers' eligibility in the context of a relative drop in their indebtedness capacity. The parameters of household loan supply might also be subject to downward revisions as a result of heightened uncertainties on some real-estate asset prices.

Demand for loans in turn, especially household demand, is expected to be significantly dampened by a more abrupt upward trend in interest rates on RON- and foreign currency-denominated loans, the weaker domestic currency over the past few months and the more volatile and unpredictable movements in the exchange rate of the RON. Such developments in demand for loans along with the evolution of banks' potential credit supply could put a strong dent on the dynamics of consumer and housing loans to households, or even entail a drop in the loan stock. It is likely that the growth rate of loans to non-financial corporations, small- and medium-sized enterprises in particular, will also decrease noticeably as such entities are more sensitive to swings in the business cycle and financing conditions.

The anticipated consequence of a steeper downtrend in loan dynamics is the slower rate of increase in domestic demand components, especially household consumption growth and implicitly a slower advance in imports. Such an evolution might spur the decline and even the removal of inflationary pressures and could help narrow the current account deficit to sustainable levels. It is very likely that the gradual reinvigoration of household saving amid the substantially higher deposit rates applied by banks and the relative worsening of expectations of individuals regarding their future disposable income should act as a disincentive on private consumption. Moreover, consumer demand will most likely be affected by the restrictive balance sheet effect that follows from the recent substantial increase in bank debt service of households in both domestic and foreign currencies. The unexpectedly high magnitude of the debt service rise could exceed the payment capability of some individual debtors, possibly corporate debtors as well, which might generate adverse effects on the quality of some banks' loan portfolios and perhaps on their solvency indicators.

Private consumption and investment dynamics could be affected by the restrictive effects triggered by the global financial crisis. This phenomenon might however be cushioned and/or delayed by the potential expansionary impact exerted by the protraction, at least during the following months, of rather brisk wage growth rates and a possibly larger-than-projected loosening of fiscal and income policies in the election run-up.

There is a likelihood of such a slippage in both policies assuming a substantial increase in wages of a certain category of public sector employees, which could unleash claims of broad-based, sharp rises in salary earnings across the entire public sector. Adopting such a policy stance at macroeconomic level would primarily result in persistently high inflationary pressures and a wider budget deficit if no cuts in public investment expenses are made. Actually, deficit financing would be difficult and expensive given the tensions on both domestic and international financial markets.

In the longer term, this loosening would only cause a delay in sustainably adjusting the pace of economic growth and current account deficit widening. Moreover, it would increase the external vulnerability of the economy and the negative sentiment on the future developments in domestic fundamentals, adding to the potential unfavourable impact of the global financial turmoil on the financial system and the real sector. The immediate effects would be stronger pressures on the exchange rate of the RON and its exacerbated volatility against the backdrop of increased risk aversion on a global scale, entailing adverse effects on the stability of the local currency and of the entire financial system. Under these conditions, in order to prevent or at least alleviate part of these effects, domestic fundamentals should be improved as quickly as possible. This calls for implementing a more consistent mix of macroeconomic policies and stepping up structural reforms.

Considering the new coordinates of the medium-term inflation forecast as well as the complexity associated with the numerous uncertainties, the NBR Board has decided in its meeting of 30 October 2008 to keep the monetary policy rate unchanged at 10.25 percent per annum. At the same time, the NBR Board has decided to lower the minimum reserve requirement ratio on RON-denominated liabilities of credit institutions to 18 percent, from 20 percent previously, starting with the 24 November – 23 December 2008 maintenance period. This decision is aimed at improving liquidity management given that the trend of gradual reduction in excess liquidity in the banking system and, implicitly, in the central bank's net debtor position in its relation with credit institutions – as signalled by the NBR starting April 2008 – has become more pronounced of late. Moreover, the current 40 percent minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions was left unchanged. By taking these measures, the central bank is acting in a proactive manner for consolidating the traditional monetary policy transmission channels with a view to ensuring sustainable financing of the economy amid the anticipated slower dynamics of foreign-exchange loans as the effects of the global financial crisis continue to spread. The NBR seeks to fulfil its medium-term objectives by pursuing sustainable disinflation which can only be achieved by avoiding the aggravation of macroeconomic disequilibria and by maintaining financial stability. Against this background, the NBR Board has restated the need for the steady and sustained monetary policy efforts aimed at countering demand-pull inflationary pressures and anchoring inflation expectations to be supported by strengthening the other components of the macroeconomic policy mix and speeding up structural reforms.