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N O T E

The National Institute of Statistics, Ministry of Public Finance,
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U.S. Department of Energy
and National Bank of Romania supplied data.

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

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Foreword

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

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

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

Inflation Report was completed on 2 February 2009 and approved by the NBR Board in its meeting of 4 February 2009.

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
CCR	Central Credit Register
CD	certificate of deposit
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
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NCP	National Commission for Prognosis
NEA	National Employment Agency
NIS	National Institute of Statistics
OECD	Organisation for Economic Co-operation and Development
ON	overnight
OPEC	Organization of the Petroleum Exporting Countries
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
ULC	unit labour cost
UVI	unit value index
1W	one week
12M	12 months

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I. SUMMARY

Developments in inflation and its determinants

At the end of 2008, the 12-month inflation rate stood at 6.3 percent, down one percentage point from 7.3 percent in September. Although the inflation rate was well above the upper limit of the variation band around the central target of 3.8 percent, this development points to the confirmed consolidation of disinflation, a process that had resumed in 2008 Q3.

Among supply-side factors, the favourable dynamics of fuel prices following the fast declining oil prices on world markets had the strongest bearing on the slowdown in inflation. As a result of bumper crops, inflationary pressures coming from processed foodstuffs included in the CORE2 basket declined, exerting further favourable influence on overall inflation, along with administered price dynamics. However, fourth-quarter increases in volatile prices of certain food items dampened the inflation downturn.

In the period September-November 2008, industry-wide wage dynamics continued to overtake productivity gains, leading to a marked increase in unit labour costs. Since mid-2006, unit labour costs have deteriorated, thereby contributing to the slowdown in disinflation via pressures exerted on producer prices. Furthermore, this phenomenon brought about sizeable competitiveness losses and aggravated external disequilibria, thereby exerting increasingly strong depreciation pressures of late on the domestic currency.

In December, annual CORE2 inflation, down only 0.2 of a percentage point from September, was higher than headline inflation. The slower decrease in CORE2 inflation rate was due largely to the inflationary impact of a weaker domestic currency on import prices, which countered the favourable effects exerted during the final quarter of 2008 by the processed food price dynamics and the projected decline in aggregate demand pressures.

In 2008 Q3, the Romanian economy continued to advance at a rapid pace, posting an annual change of 9.1 percent and further fuelling excess demand. GDP expansion gathered momentum owing to a faster rise in final consumption, underpinned by brisk wage growth, on the background of a steep reduction in the share of bank loans in total resources for financing domestic absorption. Over the period, investment dynamics continued to slack off, remaining nevertheless substantial. Net external demand had a slightly lower negative contribution to growth, but the increase of imports again outpaced that of exports.

The final quarter of 2008 saw a turning point in the dynamics of domestic economic activity, given that the knock-on effects from the global crisis made themselves increasingly felt via the foreign trade channel and the financial channel. The substantial decline in external demand for Romanian products, along with economic agents' diminished access to financing, resulted October through November 2008 in sharp contractions of some indicators such as industrial output, industrial confidence indicator, turnover in services to population, and growth rate of retail sales. The developments in these indicators linked to GDP performance clearly show a significant slowdown in economic growth and the attendant reduction in excess demand in Q4.

Monetary policy since the release of the previous Inflation Report

On 30 October 2008, the National Bank of Romania Board decided to leave the monetary policy rate unchanged at 10.25 percent per annum, reaffirming the need to maintain a monetary policy stance in line with the achievement of medium-term disinflation objectives in a sustainable manner. At the same time, the NBR Board decided to lower the minimum reserve requirement ratio on leu-denominated liabilities of credit institutions to 18 percent from 20 percent previously starting with the 24 November - 23 December 2008 maintenance period. This measure was aimed at improving liquidity management on the interbank money market in order to ensure sustainable financing of the economy amid the deepening global financial crisis and the reduction in excess liquidity in the Romanian banking system.

Subsequently, international macroeconomic developments confirmed the broadening of the financial crisis fallout on the global real sector and indicated its spilling over to the Romanian economy as well. Following the fast-paced GDP growth in 2008 Q3, the developments in economic activity indicators in Q4 conveyed clear signals of a substantial slowdown.

As a confirmation of the NBR projections, the downward path in annual inflation rate consolidated in the run-up to the year-end. However, the outlook for the future inflation trajectory is surrounded by high uncertainties with regard to its determinants and their diverging evolution. The persistence of a still wide current account deficit, together with fewer available financing resources globally, generated increased volatility of the exchange rate of the leu in 2008 Q4, alongside its entering a relatively steep upward trend. Having an inflationary impact on import prices, such exchange rate evolution translates, on the other hand, into higher debt service for economic agents with exposure to foreign-currency-denominated financial instruments. The latter contractionary effect contributes to the narrowing of the output gap, thus augmenting the qualitatively similar impact of a persistently slower growth rate of credit to the private sector as a result of increasing external financing costs and tightening domestic lending conditions.

Furthermore, disinflation was adversely affected by the continued mismatch between wage dynamics and productivity gains as well as by the fiscal policy stance pursued during 2008 Q4. Over the period, the sizeable budget deficit widening offset the favourable effects from external deficit adjustment due to the private sector, thus diluting the reduction of the overall balance of payments imbalance towards levels that would mitigate the pressures on the exchange rate of the leu.

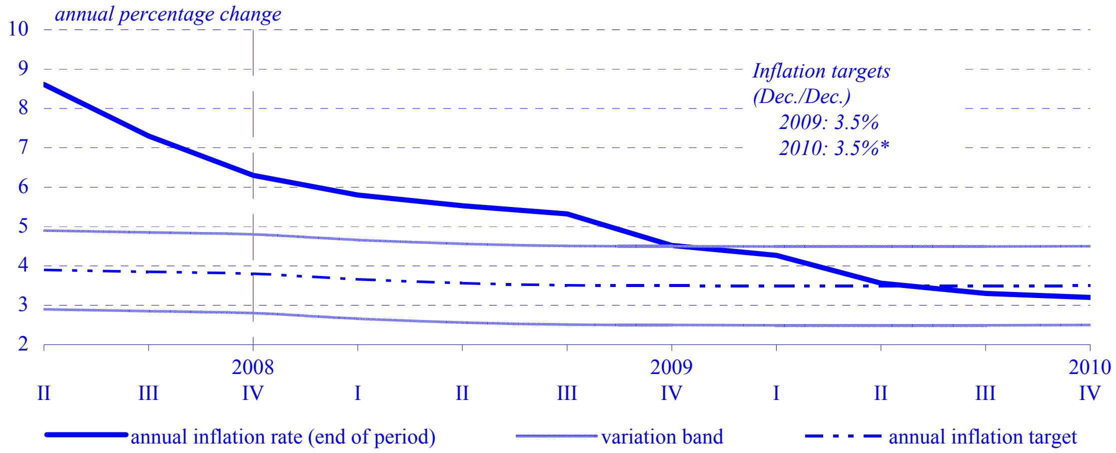
Against the background of major uncertainties coming from volatile macroeconomic conditions both nationally and internationally, alongside the ensuing risks to attaining the central bank's medium-term objectives, the NBR Board decided in its meeting of 6 January 2009 to maintain the monetary policy rate at 10.25 percent per annum. The decision was meant to ensure real broad monetary conditions supportive of a gradual, orderly adjustment of current macroeconomic imbalances and of convergence of inflation rate towards the announced medium-term targets. At the same time, in order to ensure smooth functioning of the interbank money market, the Board decided to pursue a more flexible liquidity management by resorting more frequently to open-market operations with a view to supporting sustainable financing of the economy.

Inflation outlook

The intensification of the global financial crisis at the end of the previous year has persisted into 2009, with knock-on effects on economic activity worldwide. The mutual reinforcement of negative developments in financial markets and the real sector maintains a volatile environment, thus adding to the difficulties associated with projecting the magnitude of short- and medium-term impact of the global crisis on domestic macroeconomic developments. Similarly to the previous forecast, the identified risks of inflation deviating upwards or downwards from the baseline scenario are broadly balanced.

Given the unusually high uncertainties surrounding quantitative assessments, the baseline scenario of the current projection places the 12-month inflation rate at 4.5 percent for end-2009, a level similar to that published in the November 2008 Inflation Report. For end-2010, inflation is forecasted to fall to 3.2 percent[1].

Inflation Forecast



Note: Variation band is ±1 percentage point around the central target *) working assumption

Source: NIS, NBR calculations

Behind the inflation forecast for end-2009 that envisages a level similar to that presented in the previous Inflation Report stood the mutual offsetting of partly diverging effects exerted by determinants. Compared to the previous projection, the upward revision of the CORE2 inflation forecast has an unfavourable contribution to CPI inflation, which is expected to be countered throughout 2009 by a more favourable scenario regarding administered price inflation and, in the first part of the year, fuel price inflation.

The upward revision of annual CORE2 inflation in 2009 is largely due to the repositioning of the exchange rate of the domestic currency at levels higher than those envisaged in the prior projection following the nominal depreciation of the national currency since 2008 Q4. The repositioning adversely affects import price dynamics. The magnitude of such effects more than offsets the opposite influence coming from the expected decline in aggregate demand as reflected by the projection of a negative output gap through a significant part of the forecast horizon.

[1] The inflation projection within the current forecasting round was substantiated by incorporating the assumption of a 3.5 percent central target for 2010.

For part of 2010, assuming comparatively faster fuel price increases, only partly offset by more favourable projected dynamics of CORE2 inflation and administered prices, the baseline scenario foresees an annual CPI inflation path slightly above that envisaged in the previous Inflation Report. The sharper drop in CORE2 inflation in 2010 owes both to a wider demand shortage projected for the first part of the year and a gradual fading-off of the adverse effects of import price dynamics. However, the current forecast assumes an annual inflation rate slightly below the 3.5 percent central target used as a working assumption for end-2010.

Throughout the forecast horizon, the conduct of monetary policy will remain committed to its primary objective, i.e. to ensure price stability in the medium and long term. At the same time, within the new domestic and international economic context, steady attention will be attached in the near run to achieving an orderly adjustment of macroeconomic disequilibria and maintaining financial system stability. A balanced monetary policy conduct will allow, provided that a coherent and credible set of macroeconomic policies is implemented, the anchoring of economic agents' expectations and the re-entry of inflation into the variation band around the central target as early as the first part of 2010.

The heightened uncertainties associated with the global financial turmoil fallout inevitably affect the baseline scenario projection coordinates, rendering difficult a likelihood ranking of various risk factors. On this backdrop, the risks which are deemed as most likely to become manifest during the current forecasting round are those capable of generating a less orderly adjustment of macroeconomic imbalances, namely a scenario in which the burden of such adjustments would be unevenly distributed across the macroeconomic policy mix components, in contrast to the baseline projection. The major risk factors are as follows: less available domestic and external financing resources for economic activity in the event of a marked worsening of the global crisis fallout; lower Romanian exports competitiveness in case of real wage dynamics further overtaking productivity gains; implementation of an insufficiently adjusted public-sector wage policy; the contraction of the privately-owned productive sector as a result of its crowding out by the public sector in the event of an insufficiently consolidated fiscal policy and/or a fiscal policy insufficiently oriented towards expenditures capable of generating positive externalities, given a limited pool of financing resources. Should these risks materialise, inflation might post substantial fluctuations relative to the forecasted path.

Risks associated with the evolution of oil and other commodity prices, administered prices and volatile food prices are relatively symmetrically distributed around the forecasted path of the CPI inflation in the baseline scenario.

Monetary policy decision

Considering the updated macroeconomic medium-term inflation forecast coordinates as well as the complexity associated with the numerous uncertainties, the NBR Board has decided to lower the monetary policy rate by 0.25 percentage points to 10 percent per annum in its meeting of 4 February 2009. Moreover, it has decided to continue to pursue an adequate management of liquidity in the banking system through the active use of open-market operations with a view to reducing market segmentation and dampening interest rate volatility, and to leave unchanged the existing minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. Against this background, the NBR Board has restated that achieving an orderly unwinding of macroeconomic imbalances in the near run and fulfilling the objective of price stability in the medium term require a rapid adjustment in the consistency and credibility of the macroeconomic policy mix and the speeding-up of structural reforms.

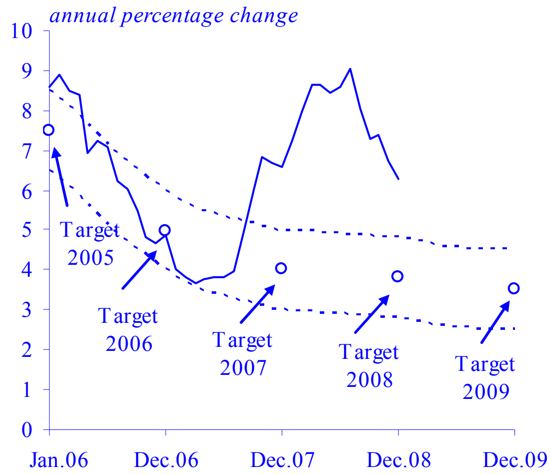
II. INFLATION DEVELOPMENTS

In 2008 Q4, the 12-month inflation rate posted a lower deviation from the upper bound of the ±1 percentage point variation band around the 3.8 percent target (from 2.4 percentage points to 1.5 percentage points) to reach 6.3 percent at end-2008. The main drivers of this performance were the positive influence on prices for agri-food items following a higher-than-expected agricultural output, the rapid fall in the international oil price and the dissipation of excess demand. Nevertheless, the favourable base effect associated with supply-side shocks affecting the same year-ago period cannot be overlooked. From the viewpoint of inflation, negative developments were further displayed by wages whose dynamics continued to overtake productivity gains and also by the exchange rate, with the domestic currency depreciating significantly versus the previous quarter. Under the impact of these factors, the downward trend of CORE2 inflation was less pronounced, its annual dynamics accelerating to 6.7 percent in December, i.e. only 0.2 percentage points below the September figure.

During 2008 Q4, behind the deceleration in the annual growth rate of inflation (down 1 percentage point versus September) stood mainly volatile prices, the lower quarter-on-quarter adjustment (-5.43 percentage points) notwithstanding. As regards the contribution of volatile prices to alleviating headline inflation, fuel prices declined at a faster pace than food prices, as the increasingly clear signals of a contraction in activity across the leading world economies led to a plunge in the international oil price. Moreover, the resumption of the depreciation trend of the domestic currency and the losses reported in the case of vegetables as a result of the sudden drop in temperatures dampened the previously favourable contribution of food items with volatile prices (+1.5 percentage points versus the end of Q3).

The annual dynamics of administered prices saw only a marginal deceleration of -0.3 percentage points to 7.4 percent in December. Furthermore, unlike the previous quarters that were marked by multiple trend reversals, in Q4, the growth rate of administered prices remained relatively unchanged, with the faster dynamics associated with the higher prices for heating (+7.52 percent in November versus October) and telephony services (a component anchored to the exchange rate) being offset by the sharper deflation reported in the case of medicine prices and by the slower growth rate of prices for city transport and local public services. In the same context, it is also worth mentioning that prices of electricity, natural gas, railway transport and rents remained flat.

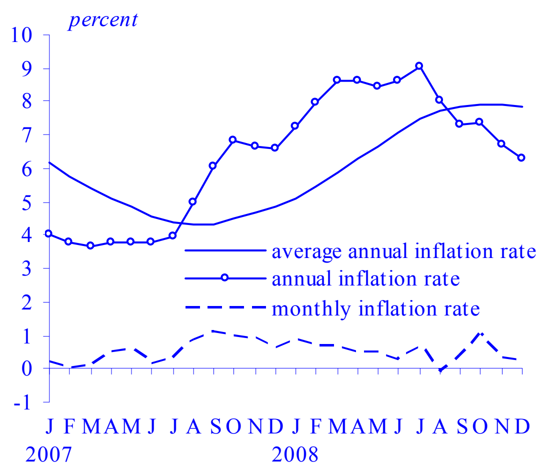
Inflation Developments



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

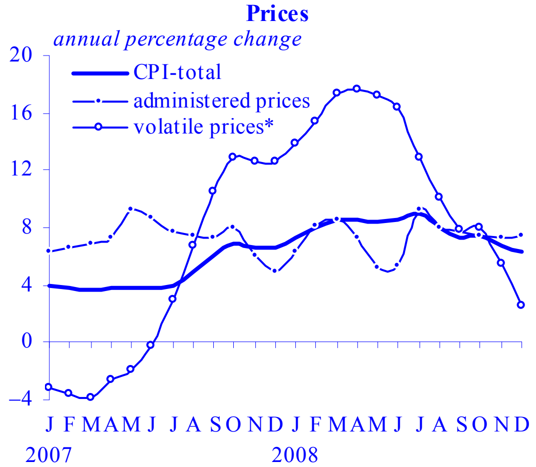
Source: NIS, NBR calculations

Inflation Rate



Source: NIS

Inflation Rate, Administrative Prices and Volatile Prices



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

Source: NIS, NBR calculations

Administered Prices versus Market Prices

annual percentage change; end of period

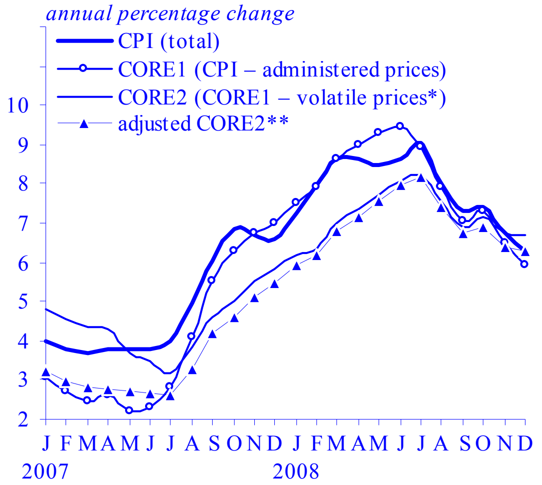
	2007	2008			
	IV	I	II	III	IV
Inflation Rate	**6.6**	**8.6**	**8.6**	**7.3**	**6.3**
Administered prices*	**5.0**	**8.5**	**5.4**	**7.7**	**7.4**
1. Non-food items*:	**0.5**	**4.2**	**2.8**	**8.3**	**7.6**
electricity	4.2	4.2	0.0	4.5	4.5
heating	5.8	5.9	6.0	6.0	10.1
natural gas	0.0	12.4	12.4	26.5	22.0
medicines	-6.7	-4.2	-3.5	-1.5	-2.5
2. Services*, of which:	**13.2**	**16.7**	**10.4**	**5.8**	**6.7**
water, sewerage, waste disposal	12.0	12.0	11.1	12.6	12.6
fixed telephony	3.4	10.4	13.3	-0.3	2.1
passenger railway transport	27.4	16.5	8.1	0.0	0.0
(passenger) city transport	7.5	11.1	9.1	9.1	8.1
Market prices (CORE1)	**7.0**	**8.6**	**9.5**	**7.1**	**5.9**
CORE2**	**5.8**	**7.0**	**8.1**	**6.9**	**6.7**
CORE2 less tobacco, alcohol	5.5	6.8	8.0	6.7	6.3
tobacco, alcohol	10.0	9.0	9.2	8.7	11.0

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

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation

annual percentage change



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

**) excluding tobacco and alcohol

Source: NIS, NBR calculations

During Q4, annual CORE2 inflation posted uneven developments, with the disinflation progress being by far smaller than that seen in the previous quarter (0.2 percentage points versus 1.2 percentage points). Moreover, given that the positive effects seen in the case of consumer prices in the latter part of 2008 were particularly detected at the level of volatile and administered components, in December, core inflation was 0.4 percentage points higher than headline inflation in year-on-year comparison. A significant contribution to the CORE2 inflation pattern and magnitude made the domestic currency depreciation, which hit especially market-priced services (particularly mobile telephony, public food services, skincare and body care, cultural and tourist services) the annual dynamics of which accelerated from 7 percent in September to 8.3 percent in December.

As concerns non-food prices included in CORE2 inflation, the 0.8 percentage point acceleration in the annual growth rate to 5.9 percent in December was due especially to the rise in tobacco product prices applied by the specialised producers ahead of the new exchange rate used for calculating excise duties starting January 2009. Removing this influence, the annual dynamics of non-food prices included in core inflation added, in Q4, only 0.4 percentage points to 4.2 percent at year-end. The same as with market-priced services, the main factor underlying the faster growth rate was the domestic currency depreciation, whose impact was however partly offset by: (i) the effect of lower demand, particularly manifest on the durables segment amid tightening lending conditions and deteriorating labour market outlook and (ii) the slower growth rate of external prices for both finished products and commodities – with a direct impact on the dynamics of domestic producer prices. Economic agents' expectations[2] on the narrowing activity and, therefore, on the slower price increase acted as an additional factor contributing to the slackening of dynamics of non-food prices included in CORE3 inflation (2.1 percentage points lower than both the sub-group average and headline inflation in December 2008).

The influence of exchange rate movements was less obvious in the case of food prices included in CORE2 inflation, their annual change following a steadily downward trend, i.e. from 8.6 percent in September to 6.9 percent in December. The main exception was the price of sugar, a commodity coming primarily from imports and used by domestic refining capacities. Without leaving out the

[2] According to the NIS/DG ECFIN survey among the managers in industry, trade and services.

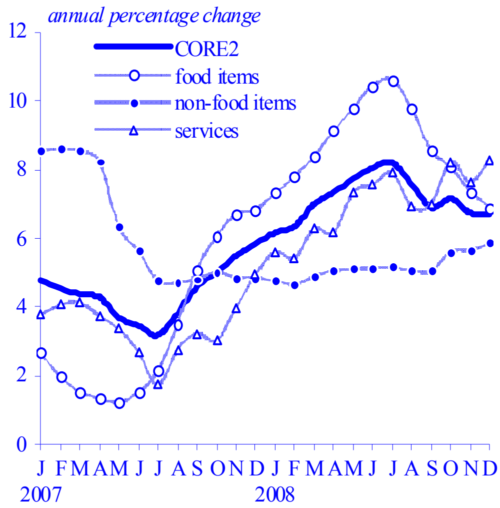
effect generated by the weakening of the leu, the developments in the prices of animal products (meat, milk and products thereof) revealed primarily the difficulties encountered by producers facing a drop in the number of livestock and higher operational costs.

From the standpoint of international competitive pressures, the trend shown by tradables prices was ascribable to the same two components, i.e. agri-food items and fuels that had either a downward or an upward impact on the evolution of this segment starting 2007 H2. Thus, the further easing of the international oil market and the dissipation of supply-side constraints in the case of agricultural commodities caused the deceleration by another 0.6 percentage points in the annual dynamics of prices to 5.1 percent in December. As concerns non-tradables, the annual growth rate of prices followed a slightly upward trajectory, with a 0.4 percentage point advance to 8.8 percent at year-end illustrating the pronounced sensitivity of services prices to exchange rate movements.

At end-2008, the gap between average annual HICP inflation in Romania and that in EU-27 was similar to that seen in September, i.e. 4.2 percentage points, while the gap between the former and the average for the three best-performing EU Member States widened slightly by 0.1 percentage points versus September to 5.3 percentage points, given that the pressures exerted by some inflation determinants (exchange rate, unit labour cost and inflation expectations) were more pronounced in Romania.

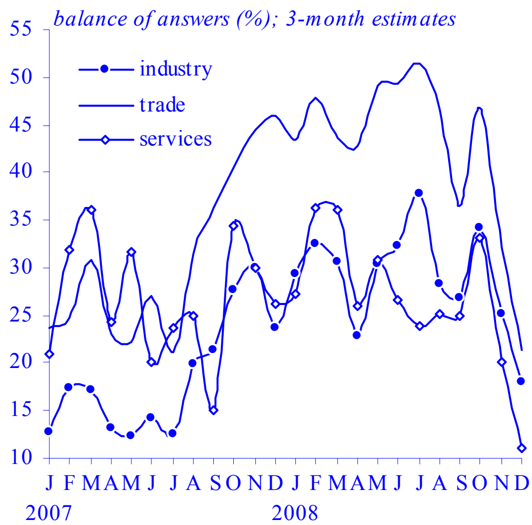
At end-December 2008, the actual annual inflation rate was 0.4 percentage points below the projection in the November 2008 Inflation Report, owing to the sharper deceleration in the annual growth rate of fuel prices (by 8.4 percentage points), following the plunge in the international oil price. As concerns the other components, a moderate deviation was reported in the case of CORE2 inflation (+0.4 percentage points) mainly due to a leu depreciation higher than that envisaged by the projection, whereas the deviations posted by administered prices and volatile prices of food items (vegetables fruit and eggs) were not significant.

CORE2



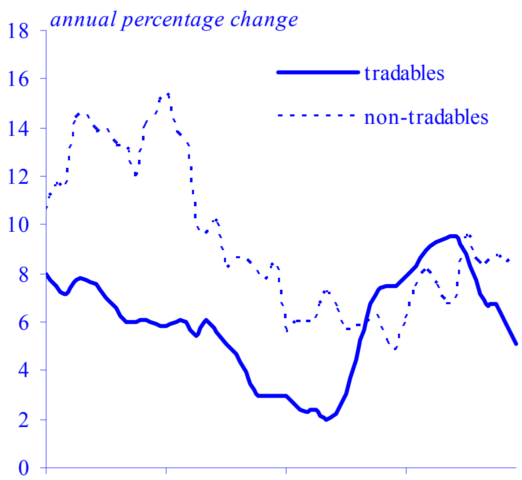
Source: NIS, NBR calculations

Inflation Expectations of Economic Agents



Source: DG ECFIN

Tradables and Non-tradables Prices



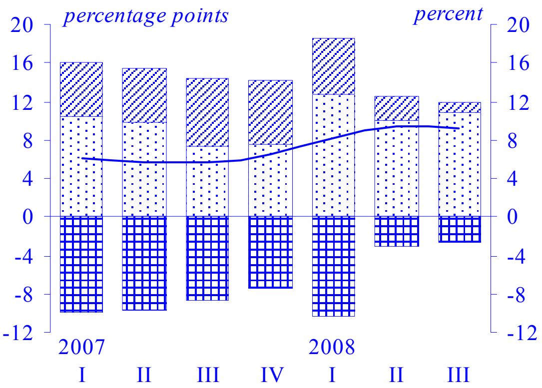
Source: EUROSTAT, NBR calculations

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2008 Q3, the annual dynamics of real GDP remained particularly fast (+9.1 percent[3]), slowing down however by 0.2 percentage points versus Q2 and falling 0.6 percentage points short of the September benchmark projection. The high GDP growth rate notwithstanding, the structural analysis illustrates unfavourable developments on both demand and supply sides.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

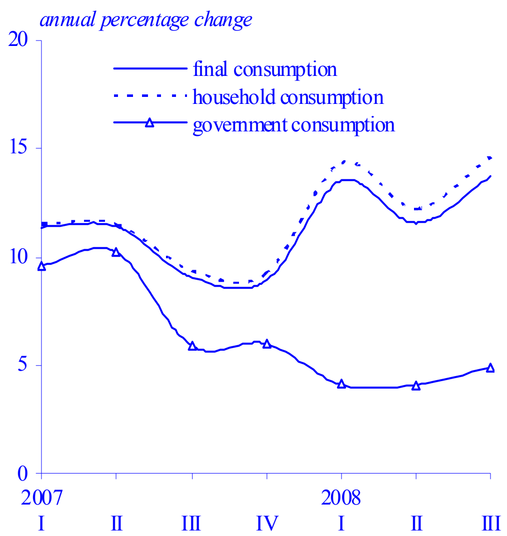
1.1. Demand

Domestic absorption strengthened its position as economic growth engine, but the segment accountable for this performance was consumer demand which posted the fastest growth rate since 1999[4] (13.7 percent). By contrast, gross fixed capital formation, albeit still the fastest-growing aggregate demand component, witnessed a new slowdown from 30 percent to 24.3 percent, while the pick-up in the exports of goods and services (17.4 percent) accounted for only two thirds of the advance seen in the previous quarter.

1.1.1. Consumer demand

The stronger contribution of final consumption to GDP growth was bolstered by the private component (+14.6 percent), rather than the dynamics of government consumption which was by far slower (+4.9 percent).

Actual Final Consumption



Source: NIS

Household consumer demand

The annual growth rate of household actual final consumption accelerated by 2.4 percentage points versus Q2 particularly due to "self-consumption and purchases on the agri-food market" and "other consumption" (home industry making the largest contribution in the latter case). Behind this development stood the extremely fast dynamics of the agricultural output (attributed to both bumper crops in 2008 and the modest base effect), the two previously-mentioned components recording growth rates of 23.5 percent (more than six times faster than in the previous quarter – an unprecedented level for the quarterly GDP series) and 6.1 percent respectively (versus -18.9 percent in Q2).

The annual dynamics of retail purchases of goods and services slowed down 2 percentage points, remaining however at a robust

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

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

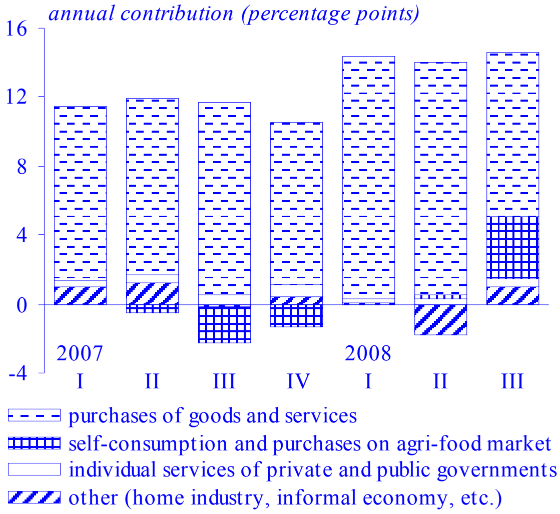
level of almost 17 percent. Furthermore, this development is not indicative of a lower pressure on the consumer price index – the analysis by group of commodities of retail sales in Q3 shows that the slight slowdown was due to durables, whereas no signs of deceleration were detected on the non-durables segment. On the contrary, among non-durables, retail sales of food items, beverages and tobacco, a category accounting for roughly 47 percent[5] of household consumer basket, even posted a slight advance against the average dynamics seen in Q2 (+12.9 percent year on year), with signs of a lower demand on this segment being visible as late as 2008 Q4 (the average for October-November came in at 9.2 percent).

The analysis of private consumption in terms of financing reveals the potential strengthening of household disposable income[6] as the main financing source, given that, on the one hand, this indicator continued to rise at a particularly fast pace in real terms (more than 19 percent), and, on the other, the resort to borrowed funds declined markedly – as suggested by: (i) a new slowdown in the dynamics of consumer credit granted by commercial banks (visible especially on the foreign exchange credit segment), as a result of a higher interest rate and a weaker domestic currency); (ii) the lower demand for financing motorcar purchases through leasing agreements following the change in the first car registration tax on 1 July 2008.

By market of origin, available statistical data illustrate the ongoing upward trend of the propensity for imports of consumer goods – in spite of the deceleration posted by their volume[7], both non-durables and the main categories of durables continued to rise at an annual pace faster than that of sales of domestic industrial companies on the domestic market. Nonetheless, neither the twofold acceleration in the annual dynamics of the supply of domestically-produced non-durables to 7 percent nor the fairly fast growth rate (albeit undergoing a deceleration) of sales of durables on the domestic market reported by domestic industrial companies (13.4 percent) can be overlooked. As concerns motorcar purchases, the upturn recorded in Q3 by the collections from the locally-manufactured motor vehicles (+4.2 percent versus -5.7 percent in the previous quarter) could not prevent the further

Household Final Consumption by Expenditure

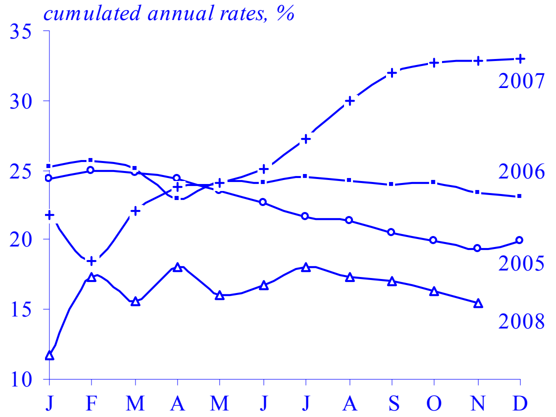
annual contribution (percentage points)



Source: NIS, NBR calculations

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, vending machines, market vendors

Source: NIS, NBR calculations

[5] The share is calculated for 2008 Q3 and matches the standard classification of individual consumption by purpose (COICOP).

[6] Household disposable income is approximated by the 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 of goods were calculated based on balance-of-payments data, by deflating by international trade-related unit value indices. The structural analysis was based on the Combined Nomenclature.

decline in the market share of domestically-produced cars due to a great extent to the expansion in used car sales[8].

Government consumption

Government final consumption moved up 4.9 percent, owing to further job creation in the government sector.

Budgetary developments

In Q3, the consolidated general budget deficit continued to widen, though at a slower pace, reaching almost RON 7,170 million after nine months of budget execution, i.e. approximately 1.4 percent of this year's projected GDP and about two thirds of the programmed annual deficit[9]. At the end of the first three quarters, the negative gap between revenues and expenditures reached a peak for the last years. In the first nine months of 2004-2007, the shares of the respective budget balances in GDP ranged between -0.2 percent and +1.7 percent.

At the end of Q3, the consolidated general budget deficit stood at about RON 1,980 million against the backdrop of a slowdown in the annual growth rates of both revenues and expenditures. Thus, the dynamics of revenues decelerated from 13 percent to 10 percent, due to the slower pace of increase of excise duties, customs duties and non-tax revenues, which in the period under review slipped into negative territory, as well as to the slackening in the collection of state social security contributions. At the same time, public expenditure dynamics decelerated from 27 percent to 21 percent, on the backdrop of a slower growth pace of goods and services spending, as well as of all categories of transfers.

In October, the consolidated general budget saw a wider monthly deficit, the share of which doubled versus the same year-ago period to reach about 0.2 percent of GDP. Thus, in the first ten months, the consolidated general government budget posted a cumulated deficit of over RON 8,100 million (approximately 1.6 percent of this year's projected GDP), in contrast with the surplus of about 0.1 percent recorded in the same year-ago period. The latest estimates of budget execution for November are indicative of an even more sizeable fiscal easing, with consolidated general government budget deficit coming in at about 2.9 percent of GDP at end-November.

[8] January through September 2008, the number of registered used cars was almost two times higher than in the same year-ago period, which brought about a significant increase in the market share of this segment (to about 40 percent) to the detriment of new motorcars.

[9] The deficit remained at 2.3 percent of GDP after the fourth budget revision performed in November.

The fourth budget revision which was performed in late November envisaged a reallocation of resources among ministries and an increase in the funds allotted from the general budget to local budgets, with the deficit target for 2008 being maintained at 2.3 percent of GDP.

1.1.2. Investment demand

The deceleration in the annual dynamics of gross fixed capital formation (by 5.7 percentage points to 24.3 percent) was attributed to all major spending categories.

(i) The growth rate of equipment purchases (including transport means purchased by companies and institutions) witnessed a new slowdown; the 15.1 percent advance in Q3 accounted for less than half the rise seen in 2008 Q1, causing the contribution of this segment to the expansion of capital expenditures to reach a two-year low (6 percentage points).

(ii) The volume of new construction and capital repair works decelerated as well to almost 28 percent. Even though the trajectory slope was less steep than that of equipment purchases, the steadily strong contraction of the volume of new orders throughout 2008 points to a drop in investment on this segment in the forthcoming period.

(iii) "Other investment" posted yet again the fastest dynamics (36.7 percent), albeit slackening somewhat probably as a result of the smaller number of transactions on the real-estate market.

Capital increases continued to be financed mainly from companies' and households' own sources. Mention should be also made that government resources made a larger contribution, as suggested by the strong acceleration in the real growth rate of capital expenditures from the public budget (to 61 percent versus almost 35 percent in the previous period).

From the standpoint of borrowed sources, in Q3, the dynamics of bank loans continued its downward trend[10], a development noticeable for both major investment objectives. Thus, during the period under review, the average growth rate of loans for equipment purchases came to 8 percent, i.e. half the level in the previous quarter and only one fifth compared to the reading reported in the same year-ago period. Turning to real-estate loans, although their annual pace of increase remained fast at 52.2 percent in Q3, starting 2008 it slowed down consistently quarter on quarter (by almost 9 percent on average).

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

Investment

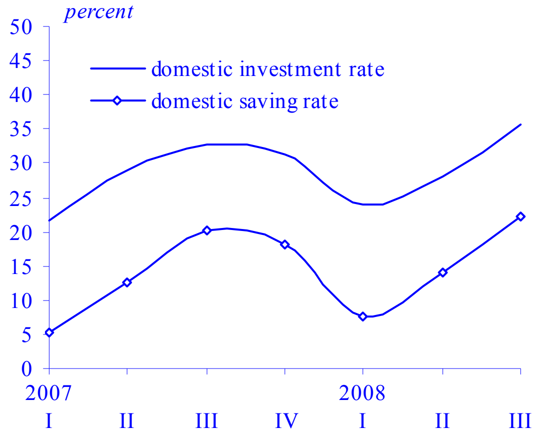
annual percentage change

	Year	I	II	III	IV
Total	2007	22.8	28.3	31.9	29.5
	2008	34.9	30.0	23.6	
- new construction works	2007	27.9	32.8	38.9	26.4
	2008	32.5	34.8	27.9	
- equipment	2007	19.0	22.7	25.3	32.1
	2008	35.5	23.8	15.1	
- other*	2007	20.3	48.5	24.3	29.8
	2008	49.1	45.2	36.7	

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

Source: NIS

Investment Rate and Saving Rate



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

Source: NIS, NBR calculations

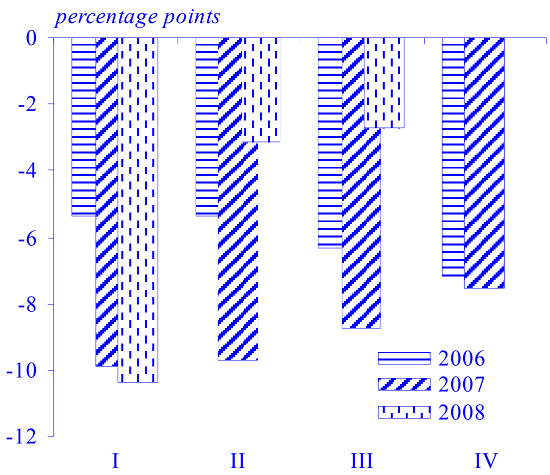
The local leasing market followed a downward trend as well, particularly on the real-estate segment (following the decisions to postpone or even cancel greenfield investment projects). On the motor vehicle segment, the decline in the financing of motorcar purchases was partly offset by the increasing interest in investment in commercial vehicles, whereas the number of loans for equipment purchases remained unchanged, according to the estimates made by companies in this line of business.

The resort to foreign financial inflows[11] for financing investment projects continued to moderate as the dynamics of net medium- and long-term loans granted to the non-bank non-government sector decelerated again (to 30.7 percent) and that of net placements of non-residents in the form of foreign direct investment fell more rapidly (-14 percent).

The analysis of the demand for capital goods by market of origin shows a possibly higher propensity for domestically-produced goods in view of the strong deceleration of the annual growth rate posted by the main investment goods imports[8] and of the much faster expansion of sales of industrial companies on the domestic market (+14 percent, i.e. slightly above the Q2 level).

1.1.3. Net external demand

Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

In Q3, the dynamics of both exports and imports of goods and services slowed down to 17.4 percent and 18.7 percent respectively. Thus, the contribution of net external demand to GDP growth remained in negative territory (-2.7 percentage points).

Mention should be made that, in the preliminary version of national accounts, deflator estimates are used to calculate changes in real terms. However, the volume indices might be overestimated, as also reflected by the fact that the price indices following the recalculation of export and import deflators on the basis of foreign trade UVI and the evolution of the domestic currency exchange rate are higher than the estimates[12].

Slower annual dynamics in real terms of the two trade balance components were also noticeable following the UVI deflation, their physical volume advancing at growth rates significantly slower than those estimated for the national accounts (12.1 percent and 9.5 percent respectively).

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[11] Calculations based on balance-of-payments data; average dynamics for the last four quarters (rolling basis).

[12] In Q3, annual foreign trade unit value indices surpassed 106 percent in the case of both exports and imports, while the national currency depreciated by 9.6 percent against the euro.

As concerns exports, the advantage arising from the depreciation of the domestic currency upon selling domestic products on foreign markets was offset by the drop in demand from the main trading partners, in Q3, the sharpest decelerations being reported by the exports of fuels and transport means. Negative contributions to the dynamics of the physical volume of exports had also base metals, whose annual growth rate entered negative territory, and light industry products, the dynamics of which slackened by almost 15 percent given that, in spite of putting a cap on the rise in the ULC in the wearing apparel and footwear industries, no external competitiveness gains could be generated due to more expensive commodities and the fierce competition from imports.

The dynamics of the physical volume of imports decelerated against the background of declining pressures from the demand for consumer goods and investment, and from that for intermediate goods used by outward-oriented industries. The base effect associated with the changes in the customs formalities and the registration method for intra-EU imports valid starting 1 January 2007 (namely, their registration at border-crossing instead of at the moment of putting them into free circulation) is worth mentioning once again.

1.2. Supply

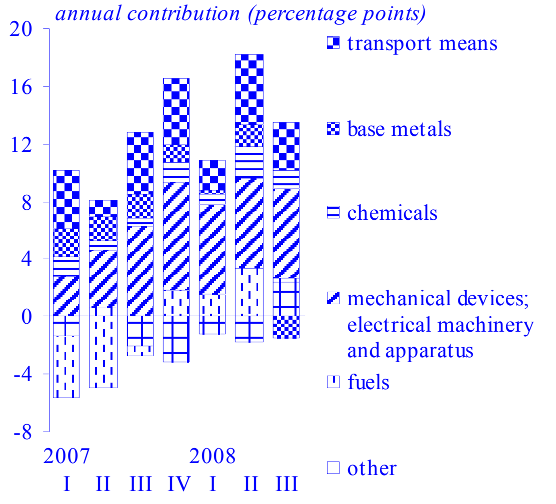
In 2008 Q3, the brisk GDP growth was bolstered only by agriculture and construction. However, this performance is not indicative of an optimistic outlook for the economy, owing to the following reasons:

(i) agricultural output hinges heavily on weather conditions (the 34.8 percent rise in gross value added in Q3 was attributable to both favourable weather conditions in 2008 and the base effect associated with the weak production in 2007 amid protracted drought);

(ii) the prospects for the construction sector appear to be increasingly dismal (even though at present they are only hinted at by the 5.3 percentage point deceleration in the annual dynamics of gross value added in Q3, to +28.6 percent), with the volume of orders contracting at a fast pace since the beginning of the year and real estate loans further posting a slowdown in real growth;

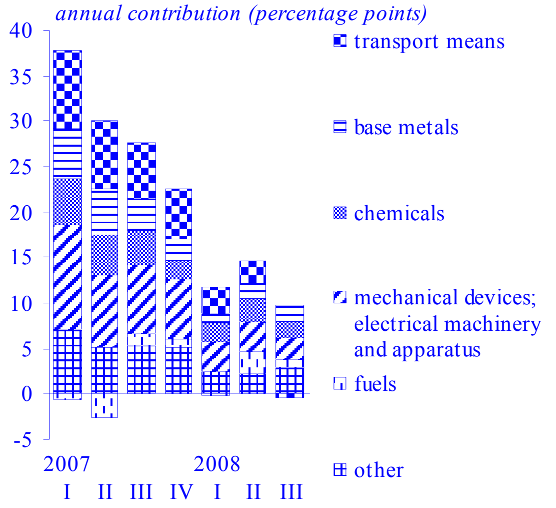
(iii) industry and services – the main contributors to GDP formation – showed a marked deceleration of annual growth

Export Physical Volume



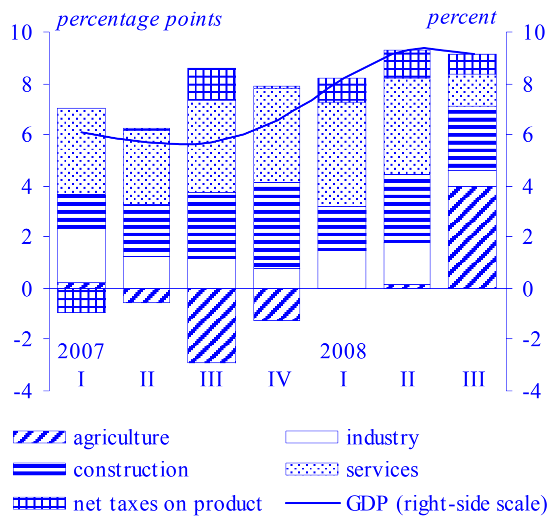
Source: NIS, NBR calculations

Import Physical Volume



Source: NIS, NBR calculations

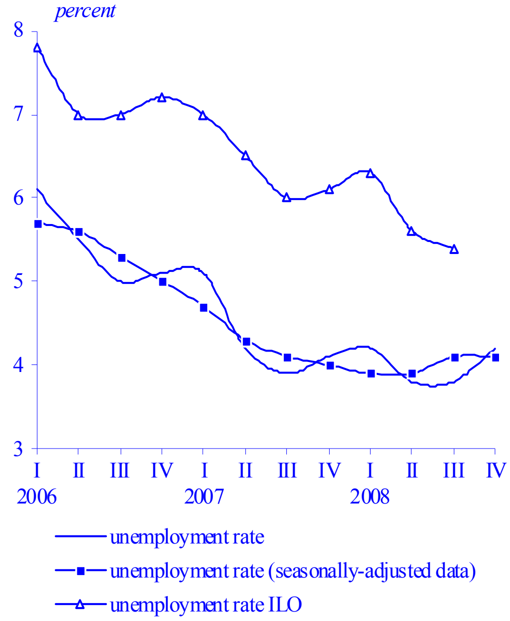
Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

rates in Q3, to 2.9 percent and 2.7 percent[13] respectively, that is less than half of the readings for the prior period. The main industrial sectors saw either a deceleration in output growth (particularly food industry, chemicals, machinery and equipment) or a drop in output volume (crude oil processing, metallurgy, electrical machinery and apparatus). The sharp decline in the contribution of the services sector to GDP growth (to 1.3 percentage points – a record low since 2001) is attributable to the slowdown in all three components (trade and market services including transport, financial and real estate activities, public services), the annual rates of increase ranging from 1.4 percent to 3.9 percent.

Unemployment Rate



Source: NIS, NBR calculations

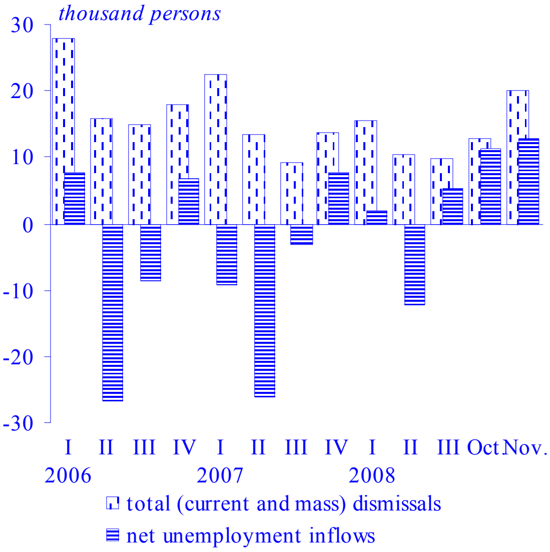
2. Labour market

Signs of looser labour market conditions became increasingly manifest during September-November 2008, yet statistical indicators did not reflect this tendency, as they remained at levels comparable to those in the first part of the year: registered unemployment rate did not go above 4.1 percent, while the growth rate of wages was further particularly brisk. The worsening of ULC in industry intensified visibly, although the negative connotation of developments is magnified by the discrepancy between activity indicators and labour market analysis indicators: declines in output often associated with technical unemployment, with no impact on the number of employees.

2.1. Labour force

Signs of looser labour market conditions became more numerous September through November 2008 in step with the increasingly frequent announcements of severe declines in activity across certain economic sectors. However, official statistics on unemployment rate have not yet captured this tendency (the seasonally adjusted value did not go above 4.1 percent), due mainly to staff cut schemes adopted by large companies – technical unemployment, discontinuation of recruitment and the decision not to offer temporary employment contracts. The additional explanatory factors include: (i) the extended duration of formalities required by mass dismissals; (ii) the possibility of voluntary termination of labour contracts, by mutual agreement of all parties involved, which is conditional upon the granting of redundancy payments; in this case, the former employee may temporarily delay registration formalities with the employment agency on grounds of immediate material comfort. Indices on

Dismissals and Net Unemployment*



*) calculated as a difference between unemployment inflows and unemployment outflows

Source: NEA, NBR calculations

[13] NBR calculations, consisting in compiling volume indices relative to the three segments of the services sector, i.e.: (i) trade, motorcar repairs and household appliances, hotels and restaurants, transports and telecommunications; (ii) finance, business services, real estate and renting services; (iii) other services (public administration and defence, education, health and social assistance, other services to population).

contracting workforce demand are also included in NEA statistics regarding the net unemployment flow, which has entered a steadily upward trend starting July, thus discontinuing the downward trend manifest over the past two years.

According to NEA statistics, the number of dismissals rose September through November by around one third year on year (peaking at 16.8 thousand persons in November); the most frequent announcements regarding the closure of some production capacities were made in industry, particularly in export-oriented sectors: petrochemicals, metallurgy and metallic constructions, road transport means and automotive spare parts, motorcars, electrical machinery and apparatus. Considering the relatively high degree of specialisation of these sectors, rehiring or professional reconversion of the staff made redundant is difficult to achieve.

2.2. Incomes

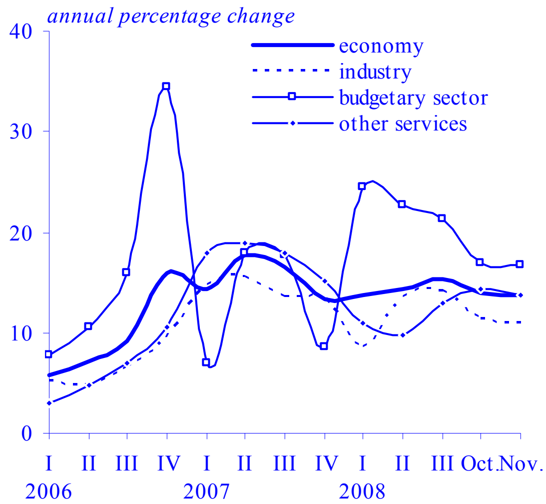
Despite the indications of looser labour market conditions September through November 2008, the annual dynamics of net wages remained particularly brisk (22.8 percent), the -1.1 percentage point drop compared to the January-August average being attributable to a base effect in the budgetary sector and to the decelerations in construction and agriculture (to 4.5 percentage points). In industry and non-budgetary services, the growth rate continued to accelerate.

The growth rates of wages remained high due to the implementation, in October, of the second stage of wage hikes for budgetary sector employees (on average, by 10.2 percent, a percentage lower than a year earlier); the impact of coming into effect, on the same date, of the new minimum wage economy-wide (RON 540, up from RON 500 during January-September) may be deemed inconsequential, as the directly affected segment represents less that 2 percent of the total number of employees[14], and the foreseeable change in labour market conditions questions the pass-through – limited anyway – to higher wage brackets.

Growth rates of net real wage remained robust (14.6 percent at aggregate level), going up 0.2 percentage points amid alleviation of the upward trend in consumer prices.

The worsening of ULC dynamics in industry, a development that has constantly marked labour market since mid-2006, became more visible in the period under review (+9.7 percentage points in the case of manufacturing), yet there are two developments that should not be overlooked: the seemingly aggravating influence of

Net Real Wage*



*) deflated by CPI

Source: NIS, NBR calculations

Labour Productivity and Real Gross Wage in Industry

annual percentage change

	2007		2008				
	III	IV	I	II	III	Oct.	Nov.
Labour productivity	9.4	8.6	8.8	10.3	6.2	1.1	-6.9
Average real gross wage*	13.2	12.3	4.5	7.7	4.4	3.6	6.5
Average real gross wage**	17.1	12.4	-0.02	0.4	-2.1	-3.3	3.4

*) deflated by industrial producer price index for domestic market

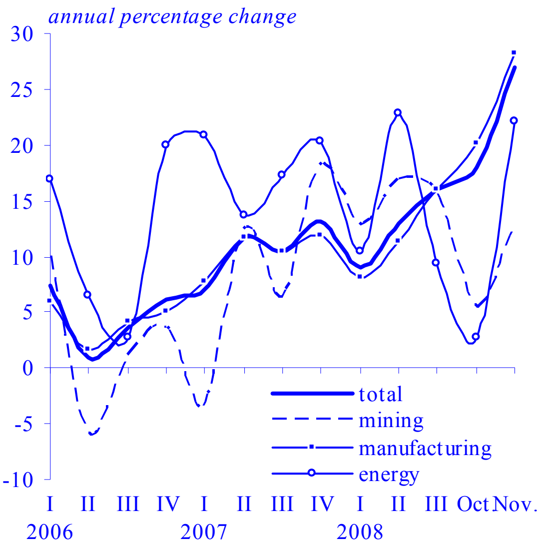
**) deflated by industrial producer price index for external market

Source: NIS, NBR calculations

[14] According to the statistical research on wages in October 2007 (NIS).

the discrepancy between activity indicators (adjustment of output in terms of demand by closing down certain production capacities) and workforce indicators (resort to technical unemployment, with no impact on the number of employees). Nevertheless, even amid the said distortion, the magnitude of the change detected in each sector may be seen as an indication of the severe difficulties encountered. Thus, the measures intended to adjust the size and/or the cost of workforce are most likely to be taken in metallic constructions, textiles, furniture, metallurgy, rubber processing, transport means other than road vehicles, the annual ULC index for September-November 2008 standing 18-50 percentage points above the average for the January-August period.

Unit Labour Costs in Industry



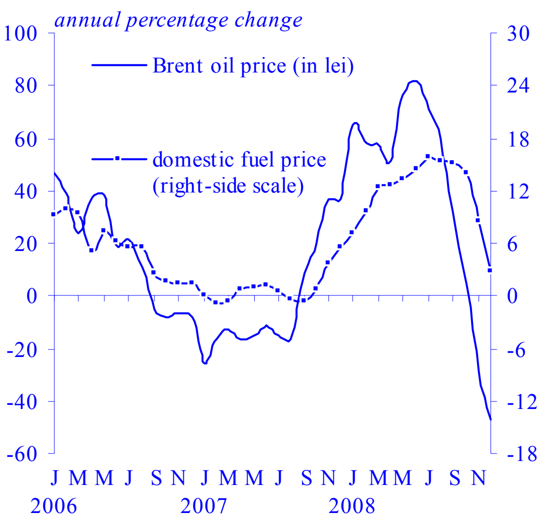
Source: NIS, NBR calculations

On the demand side, no sizeable changes were detected in 2008 Q3 in terms of pressures from disposable income, the annual dynamic of the indicator maintaining a level comparable to that seen in the prior quarter (19.4 percent in real terms). Real growth rates marginally higher than those in the prior period (by around 1 percentage point) were recorded by wages and remittances from abroad, while social transfers showed a deceleration of more than 4 percentage points. During October-November, there were signs of a possible shift in the trend of transfers from abroad, the annual growth rate of this component of disposable income turning highly negative (-15.5 percent); a likely explanation is the worsening of the current situation and the expectations associated with the economic environment in the countries where the Romanian workers hold a large share. As regards the other two components of disposable income, the corrections were less notable (decelerations of up to 3 percentage points) so that, on average, the annual real change in disposable income stood at 14.4 percent.

3. Import prices and producer prices

In 2008 Q3, the annual growth rate of producer prices for industrial goods stayed on an uptrend, while pressures induced by imported inflation increased as a result of both price changes on external markets and the domestic currency depreciation against major currencies. Agricultural producer prices saw a slightly negative annual dynamics, with grains being the only category to witness positive price changes.

Oil Price and Domestic Fuel Price



Source: NIS, EIA, NBR calculations

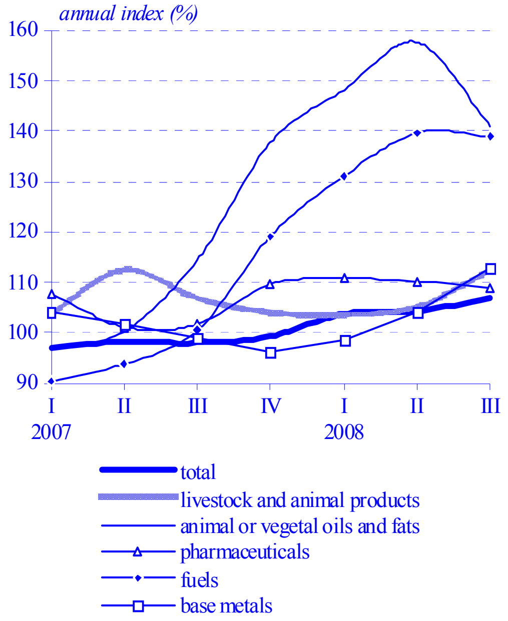
3.1. Import prices

Imported inflation put stronger pressures on domestic prices in 2008 Q3, given the rise to 106.9 percent in the annual unit value index of imports (+2.6 percentage points from the prior quarter) and the persistently unfavourable contribution of exchange rate developments.

The appreciation trend of the domestic currency against the US dollar came to a halt (from 4.2 percent in Q2 to -1.2 percent in July-September), which affected mainly import prices of commodities, thereby offsetting the positive impact of easing tensions on external commodity markets as of August 2008. However, given that prices for oil and base metals reached all-time highs in Q3, the unit value index of imports posted further sharp annual changes (12.7 percent for metals, up 8.8 percentage points from the prior quarter), and 39 percent for fuels.

The unit value index of imports from the EU saw similar changes, albeit lower (102.4 percent as compared with an average of 100.6 percent in 2008 H1). This trend was illustrated by developments in industrial producer prices for the EU external market, particularly prices for intermediate and capital goods[15].

Major Inflationary Pressures on the Unit Value Index of Imports



Source: NIS, NBR calculations

The same as in previous quarters, external prices for consumer goods continued to generate significant pressures, with main contributions coming from meat, fruit, processed food and some chemicals (particularly soap, detergents). The annual growth rate of import prices for meat posted a 3-year record high, almost three times larger than the import average (18.7 percent). Import prices of fats and pharmaceuticals showed significant annual changes (+41.1 percent and 8.8 percent respectively), without exerting additional pressures as compared with Q2.

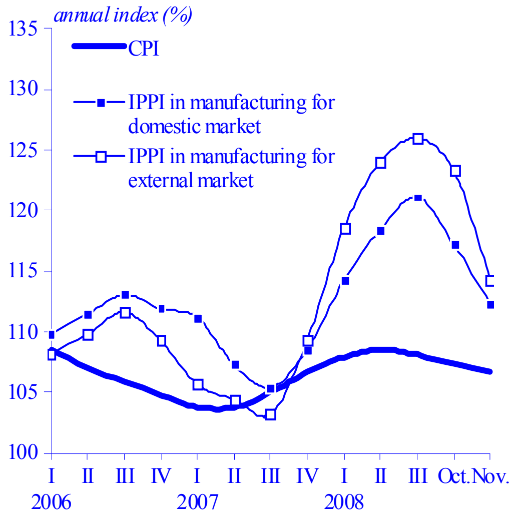
The trend of import prices during the first three quarters seems to have reversed in 2008 Q4, the significantly lower prices for commodities being likely to counteract the effect of the additional worsening of the exchange rate of the RON versus major currencies.

3.2. Producer prices

3.2.1. Industrial producer prices

In 2008 Q3, the annual growth rate of industrial producer prices for the domestic market added 2.5 percentage points from the prior quarter to 18.1 percent, largely on the back of the acceleration in producer price dynamics in manufacturing to 21.1 percent year on year. Costly commodities continued to be the main pressure-inducing factor, its impact being stronger in July and August when prices for energy resources and metals hit record highs on world markets.

Consumer Prices and Industrial Producer Prices



Source: NIS

In September however, the annual dynamics of producer prices in manufacturing slowed down 1.7 percentage points as compared

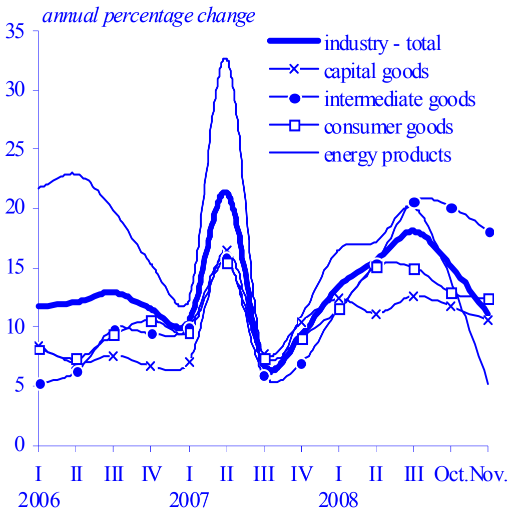
[15] In 2008 Q3, the annual growth rate of industrial producer prices for the EU27 external market accelerated by 1.9 percentage points and 0.5 percentage points respectively in the case of intermediate and capital goods.

with its peak value recorded in August (21.8 percent), due to several domestic and external factors: (i) the fast decline in world oil price caused the annual growth rate of producer prices in the crude oil processing sub-sector to decelerate by more than 6 percentage points and (ii) the bumper crops eased pressures on food industry. By contrast, the annual dynamics of producer prices in metallurgy accelerated further to 45.6 percent. The explanation may lie with the fact that the alleviating tensions on world metal markets were manifest with some delay, entailing smaller-sized adjustments, whose favourable impact was offset by the US dollar strengthening.

Against this background, the fastest growth rates in Q3 (up to 5 percentage points) were recorded by prices for intermediate goods and energy products (annual changes of over 20 percent in both cases), the prevailing share of raw materials in price structure enhancing the impact of price hikes on commodity markets.

The annual growth rate of producer prices for capital goods accelerated as well (+1.5 percentage points to 12.6 percent) in line with metal price developments. Nevertheless, in 2008 Q3, the upward trend was generated by transport means other than road vehicles, due mainly to the effect induced by production cycle characteristics[16]. The annual dynamics of producer prices in main capital goods industries (electrical machinery and apparatus, road transport means) remained relatively unchanged from Q2, as both sectors faced signs of flagging demand.

Industrial Producer Prices for Domestic Market by Industrial Products Group



Source: NIS, EUROSTAT

Consumer goods were the only category of products that did not witness growth rates of producer prices faster than in the previous period (-0.1 percentage points to 15 percent). The flattening trend was more visible in the case of quarterly developments (average change deceleration from 3.9 percent in Q2 to 2.8 percent) and was due mainly to developments in food industry, fostered by the rebound in agricultural output. As concerns durables, the adjustment of profit margins due to worsening demand conditions may have contributed to this performance.

In the last months of 2008, producer prices for the domestic market seem to have remained on the downward path they had entered in September, the favourable contribution of input prices being enhanced by the need to adjust prices to the new demand conditions. These effects are probably stronger in the case of

[16] Long period causing sudden increases in production and therefore in sales with a direct impact on producer prices. In August, the turnover of transport means other than road transport means for the domestic market rose by 75.5 percent as against the same year-ago period; the change was of 31.2 percent in Q3 as a whole.

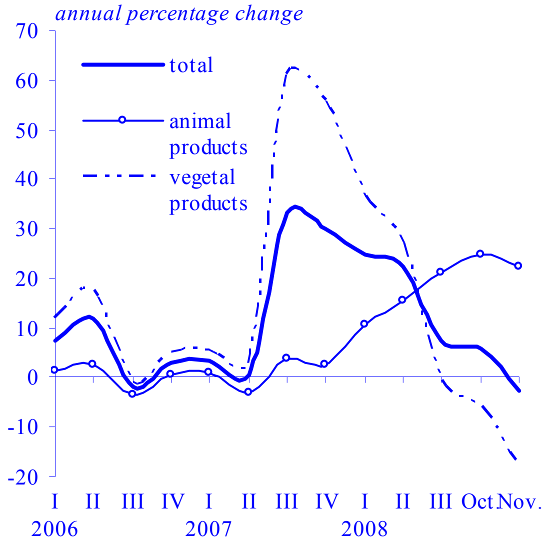
producer prices for intermediate goods and energy products, whose annual growth rates were considerably high over the past two quarters.

3.2.2. Agricultural producer prices

In 2008 Q3, the annual dynamics of agricultural producer prices was significantly slower (by about 15 percentage points as against Q2), as the materialisation of optimistic expectations on the new crops led to a trend reversal in prices for vegetal products (annual growth rate of -0.7 percent as compared with +27.3 percent in the previous quarter). This movement was generated by developments in prices for grains, in which case the annual negative changes were prevalent (-12 percent on average). The annual growth rates of prices for oil-yielding plants were further positive, yet they decelerated significantly by up to 79 percentage points.

Agricultural Producer Prices

annual percentage change



Source: NIS

Upside pressures, illustrated largely by current developments, were manifest in the case of some vegetables holding large shares in the CPI basket (beans and potatoes). In the first case, pressures were low, the average monthly growth rate of prices accelerating to 2.8 percent in August-September as compared with 0.2 percent in the first seven months of the year. Nevertheless, potato prices rose by 74.8 percent versus August. This movement included a major incidental component induced by fears that the extremely low temperatures recorded during the harvesting period might have a significant dampening impact on crops. Concurrently, producers reported considerable losses, due largely to competition from imports (January to July, the average growth rate of prices was of -8.2 percent).

In July-September 2008, the annual growth rate of producer prices for animal products stayed on the same sharply upward course as in the past two quarters (+5.7 percentage points as compared with Q2 to 21 percent). Meat was the most affected category, as all meat types under review posted higher price dynamics quarter on quarter (up to 15 percentage points in the case of beef). The main factor underlying this development is the decline in the number of livestock (cattle and pigs) on the back of costlier fodder and higher losses incurred by producers, which led to a low replacement ratio of slaughtered livestock. The main EU suppliers (Poland, Denmark, and Hungary) are also faced with the same problem.

In 2008 Q4, the current trends are expected to remain in place, with a significant contribution from vegetal products, whereas the growth rates of prices for animal products could accelerate yet again, due to the persistent difficulties encountered by producers and the likelihood of further costlier imports.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

The National Bank of Romania left the monetary policy rate unchanged at 10.25 percent per annum October 2008 through January 2009, but decided to reduce the minimum reserve requirement ratio on leu-denominated liabilities of credit institutions from 20 percent to 18 percent starting 24 November 2008. Over the period, both the depreciation trend of domestic currency and exchange rate volatility became more pronounced against the background of the intensified global financial crisis and investors' higher risk aversion.

The NBR Board's decision to leave the monetary policy rate unchanged at 10.25 percent per annum taken in its meeting of 30 October 2008 was attributed, on the one hand, to the slight slowdown in disinflation projected for the near-run forecast horizon compared to the previous forecast exercise of medium-term macroeconomic developments. The major driving force behind the temporary worsening of the inflation forecast was the short-term intensification in aggregate demand-pull inflationary pressures that were fuelled primarily by the significant pick-up in economic growth in 2008 Q2 and the stronger expansionary impact from fiscal policy in the period ahead, as well as by the substantial pay rises. The increase in the forecasted annual inflation rate was also triggered by the plans for higher administered price rises and the relatively slower alleviation of inflation expectations.

On the other hand, the central bank's decision was substantiated by the unprecedented increase in uncertainties associated with the projection of economic developments against the background of the ongoing broadening of the global financial crisis and the anticipated contagion effects onto the world economy and hence on the domestic economy. As a result, the identified risks of inflation deviating upwards or downwards from the baseline scenario became broadly balanced. Thus, the upside risk to the projected inflation rate owing to a potential mismatch between wage increases and productivity gains and a possibly larger-than-expected fiscal policy easing was offset by a downside risk of faster disinflation amid the likelihood of slower-than-anticipated growth following the broadening of the global economic crisis.

In the meeting of 6 January 2009, the monetary policy rate was yet again left unchanged at 10.25 percent per annum. The chief driver behind this decision was the risk of persisting inflationary pressures arising from the weaker domestic currency against the background of broader, more protracted contagion effects from the global economic and financial crisis, and from the gradual adjustment of external and domestic imbalances of the Romanian economy.

By contrast, the analysis revealed a relative decline of risks to inflation due to the evolution of aggregate demand given that the positive output gap could have closed at a faster pace in 2008 Q4, though it had been running high in the previous 3-month period due to the still brisk annual growth (9.1 percent versus 9.3 percent in 2008 Q2). However, the magnitude of the expected GDP dynamics compression in 2008 Q4 but especially the pace of decline of demand-pull inflationary potential were difficult to assess given the heterogeneity of recent developments in relevant indicators on aggregate demand, consumer demand in particular, and the uncertainties surrounding contagion effects from the global economic crisis. Thus, the macroeconomic environment at the beginning of 2008 Q4 was characterised by further strong dynamics of real net average wage and especially a much wider-than-expected budget deficit, on the one hand, and by the marked slowdown in the annual growth rate of retail trade turnover, the faster reduction in the year-on-year real dynamics of loans to households, particularly consumer credit, and the significant setback in annual dynamics of both household deposits with banks and major monetary aggregates, on the other hand.

The deceleration by 12.1 percentage points in the real annual dynamics of loans to households October through November versus the third-quarter figure to an average of 37.4 percent appears to have been driven chiefly by supply-side factors. Worth mentioning are the following: (i) less readily available external financing amid the global crisis, (ii) the depletion of excess liquidity in the banking system, (iii) the shift in banks' focus towards other, relatively more liquid investments such as government securities and, to some extent, foreign assets, (iv) increased bank cautiousness (as reflected by tighter lending terms and conditions, possibly also as a result of the enforcement of Regulation No. 11/2008 issued by the NBR), including against the background of stronger adverse selection risk, and (v) reduction in the eligibility level and scope of potential borrowers. On the demand side, contractionary effects were generated by: (i) higher lending rates on new business (unexpectedly high rates in some cases) and loans in progress as well as (ii) the weaker leu and heightened uncertainties surrounding exchange rate movements. Under these conditions, slower growth rates were recorded October through November for all types of loans to households. Worst hit were consumer loans in foreign currency, the annual dynamics of which fell on average by 24.4 percentage points to 50.5 percent against the third quarter, and housing loans, down 10.4 percentage points on average to 46.1 percent. The year-on-year pace of increase of leu-denominated loans to households decelerated more slowly (down 5.2 percentage points on average to 18.8 percent).

In turn, dynamics of household savings with banks slackened substantially year on year in October-November 2008, in line with the growth rate of corporate deposits. The sharpest drop was registered by overnight deposits of households, the real growth rate of which shed 13.8 percentage points year on year to 50.1 percent versus the third-quarter average figure, especially on the back of the forex component – the explanation for this performance could lie with the start of a dissaving process associated with the still fast pace of increase of consumption and related costs, as well as with the higher debt service burden. The possible emergence of such a process appears to be also suggested by the marked decline in the average annual growth rate of households' time deposits with maturity of up to two years (to merely 1.4 percent) as a result of the significant slowdown in the annual dynamics of foreign currency-denominated deposits, which slipped into negative territory October through November (-0.7 percent on average, 16.5 percentage points lower than in the third quarter of 2008). By contrast, the annual dynamics of households' time deposits in domestic currency with maturity of up to two years reversed its direction, reaching a rather modest 1.7 percent, in step with the recent stronger growth rates of credit institutions' interest rates on such investments. Over the reported period, the annual dynamics of time deposits with maturity longer than two years slackened, in contrast with its third-quarter performance.

The NBR Board's interest rate decision also took into account the risk of more protracted adverse inflation expectations, fuelled chiefly by the faster depreciation of the domestic currency against the euro and the unprecedented exchange rate volatility. The major determinant of these developments, relatively similar to those seen in other emerging economies, including European ones, was the new wave of increase in investors' risk aversion and wariness that took shape since the end of 2008 Q3 against the backdrop of the deeper global financial and economic turmoil, along with the broadening of its effects. The state-of-affairs on the financial markets in these economies was compounded over the period by the deteriorating picture in Iceland, which underscored the increased risk of massive capital outflows in countries facing major macroeconomic imbalances. In this context, the reasons pertaining to the high magnitude of the balance-of-payment current account deficit and the budget deficit respectively, and the banking system reliance on external financing caused investors to include Romania and other countries in the region into the group of economies with relatively higher vulnerability. The new abrupt worsening of investor sentiment, also confirmed by the downgrades in Romania's sovereign risk rating by some agencies, put more downward pressure on the domestic currency. Such pressures were for some time fuelled by the increase in speculative operations largely performed by non-residents on the interbank foreign exchange market.

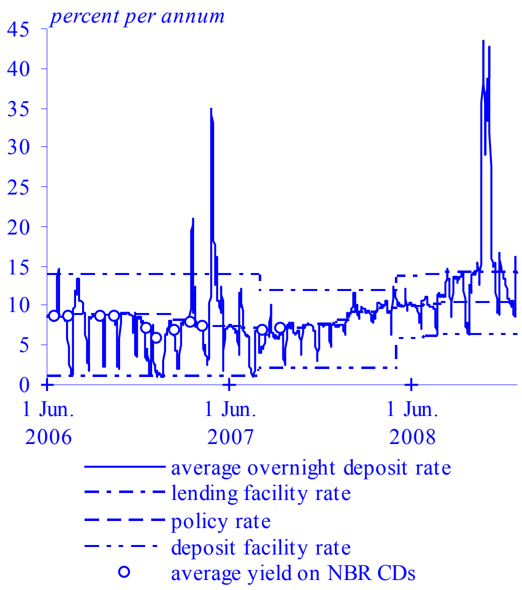
The performance of speculative transactions also added to the tensions on the interbank money market in October due to the participants' confidence crunch (see Subsection *2.1. Interest rates*) but especially to the reduction in the structural excess liquidity of credit institutions, which recorded a net liquidity deficit. Seeking to ensure smooth interbank money market functioning in such an intricate context, the central bank moved to render its liquidity management more flexible by providing liquidity via the lending facility, foreign exchange swaps and repo transactions; the National Bank of Romania also mopped up liquidity sporadically by resorting to the deposit facility and deposit-taking operations. Against this background, tensions on the money market faded gradually, also as a result of the decision to lower from 20 percent to 18 percent the reserve ratio on leu-denominated liabilities (starting with 24 November - 23 December 2008 maintenance period) in a move aimed at improving liquidity management across the banking system.

Although the Romanian banking system was relatively hard hit by the indirect effects of the intensification of the global financial crisis, solvency-related problems have not been reported thus far. Therefore, special measures designed to strengthen the banking system, as those included in the national schemes of other countries (e.g. government intervention to recapitalise credit institutions, government backing for some borrowings taken by banks and the purchasing of some bank assets) were not deemed necessary. The only measure, in line with ECOFIN Council recommendations, was to raise the guaranteed ceiling on household deposits to the equivalent of EUR 50,000 as from 15 October 2008 (Government Emergency Ordinance No. 129 of 14 October 2008).

2. Financial markets and monetary developments

Interbank market rates increased further in 2008 Q4, in a context marked by the change in the net liquidity position of the domestic banking system, as well as by the effects of heightened global financial turmoil. However, the domestic currency depreciated more quickly, incorporating the impact of severe deterioration of investors' risk appetite, the same as the parities of the other national currencies in the region. The annual dynamics of broad money decelerated at a faster pace, against the background of further slower rate of increase of credit to the private sector.

Interbank Money Market Rates



2.1. Interest rates

Interbank market rates headed upwards in the first half of 2008 Q4, under the impact of a structural change, namely the net liquidity deficit of the banking system. However, the effects of this change were heightened by the action of several external factors – arising from the protraction and the recent deepening of the global financial crisis – which materialised in occasional and unusually high increases in interbank rates and implicitly in the substantial rise of their volatility. In the second part of the quarter, the evolution of interest rate was relatively normal, so that the October-December average stood at 15.1 percent, up 3.6 percentage points from Q3.

In early October, interbank rates were close to the upper part of the corridor defined by the interest rates on the central bank's standing facilities, subsequently posting a sudden increase and remaining at particularly high levels by early November. Behind this development stood several factors such as: (i) credit institutions' confidence crunch in the context of deeper global financial market turmoil, (ii) relative domestic market segmentation and the possible downward adjustment of exposure limits among some banks[17], (iii) operators' higher uncertainty surrounding current and short-term liquidity conditions, (iv) non-residents' stronger speculative demand for domestic currency, particularly in the latter part of October.

The partial alleviation of some of these constraints, as well as the NBR's more flexible liquidity management entailed somewhat lower pressures on overnight rates, which subsequently posted relatively normal developments, given the banks' increased bias towards overnight deposits. The interbank market trading saw an upturn as well, the daily volume of new deposits reverting to usual values, after the contraction episode recorded in late October and early November. Hence, the spread between interbank rates and monetary policy rate narrowed gradually during the reserve maintenance periods ended in November and December. This development was also under the favourable impact exerted by the NBR Board decision to reduce the minimum reserve requirement ratio on leu-denominated liabilities of credit institutions with a view to improving liquidity management.

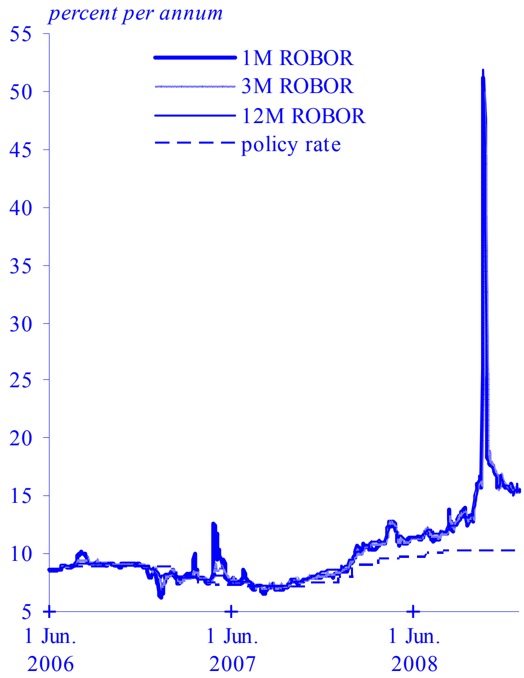
The volatility of overnight rates was lower, yet it remained at relatively high levels in the latter part of the quarter, reflecting the persistent uncertainty surrounding liquidity conditions. One of the main uncertainty sources was the highly unpredictable behaviour

[17] The temporary market disruptions, which resulted into inefficient liquidity redistribution across the banking system, were also reflected by banks' simultaneous recourse to lending and deposit facilities.

of the Treasury, against the background of the unprecedented rise in the public authority's resort to deposit-taking operations in order to finance the considerable increase in budget spending.

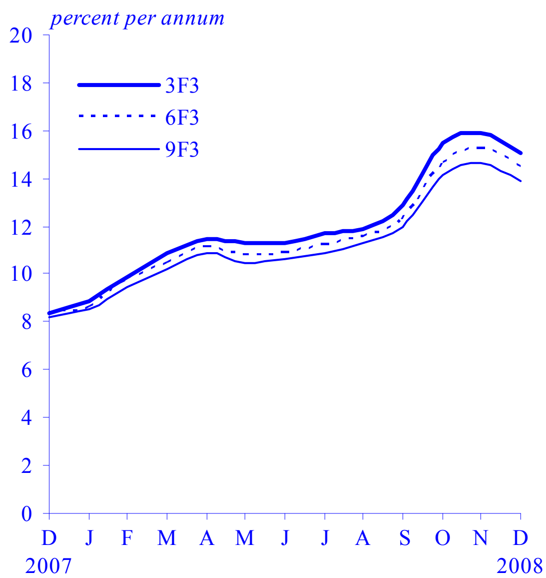
The temporary market disruptions in the first part of the quarter had a strong impact on ROBOR interest rates as well, which rose at an unexpectedly high pace and outran by far the actual interest rates on transactions. The risk of these hikes feeding through into lending rates – which had started to materialise – made the central bank amend the rules for determining ROBOR reference rates, by introducing the possibility to temporarily suspend the publication of those indices calculated based on participants' quotations, where they exceed by over 25 percent the interest rate on the lending facility[18]. Subsequently, ROBOR rates were gradually adjusted downwards, with the (1M-12M) ROBOR rates stabilising in December at around 15.5 percent (their average being nearly 2 percentage points higher than that recorded in the final month of the prior quarter).

Policy Rate and ROBOR Rates



The implicit forward rates (calculated based on December average rates) indicated the 3M ROBOR rates would follow a downward trend during 2009, their average levels being expected to stand at 15.0 percent in March, 14.5 percent in June and 13.9 percent in September. However, these figures should be interpreted with caution, considering that part of the factors behind the disruptions in the smooth market functioning continued to be manifest, inducing possible distortions in the yield curve and affecting its information content.

Implicit Forward Rates



The interest rates on government securities also remained on an uptrend, the public authority raising twice the maximum interest rates on all securities (in a range from 1 percentage point to 2.7 percentage points); hence, interest rates on Treasury certificates as well as on 3- and 5-year benchmark government bonds stood at 14.25 percent and 13 percent respectively. In addition, the average interest rates on government securities rose in a range from 0.4 percentage points to 2.3 percentage points, so that the interest rates on securities with maturities of up to one year as well as on securities with maturities of more than one year ran at 14.23 percent and 13 percent respectively at the end of Q4.

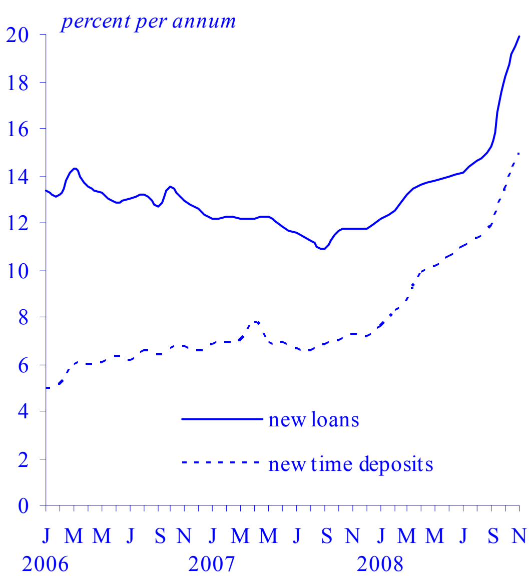
In 2008 Q4, the Ministry of Public Finance issued government securities tantamount to roughly RON 6,711 million, given that the pre-announced amount was of RON 9,900 million. The final

18 In this case, ROBID/ROBOR rates across the whole maturity spectrum will be established in line with the level of interest rates on the deposit/lending facility.

quarter of the year saw the highest allotment ratio (67 percent as compared to an average of 19 percent in the first three quarters), as the public authority accepted a higher-than-pre-announced volume of government securities at two out of six auctions held in December. The MPF started re-issuing 3-month Treasury certificates in November-December (after being discontinued for more than 3 years), thereby matching investors' increased bias towards shorter-term placements. Non-residents submitted bids only at the first two auctions in October, in amount of nearly RON 22 million, out of which 97 percent were accepted.

The average turnover of the secondary market for government securities almost trebled quarter on quarter, to more than RON 7,900 million (excluding the NBR), following the rise in the number and value of transactions between banks and their clients. The most heavily traded were securities with residual maturities of 1, 3 and 5 years, whose average interest rates ranged from 9.6 percent to 12.5 percent (higher than those in the prior quarter ranging from 0.1 percentage points to 2.8 percentage points).

Bank Rates



Against the background of the faster upward trend in interbank rates as well as of banks' enhanced need for domestic resources and their increased prudence in the context of heightened uncertainties surrounding the spillover effects of the global financial crisis on the Romanian economy, the average deposit and lending rates on new business rose at a faster pace in September-November 2008, recording the highest positive changes in the past 22 quarters. As against the previous quarter, the adjustments were substantial in the case of lending rates on new business, with lending rates on new business of non-financial corporations recording the highest rise: up 5.29 percentage points from August to 20.49 percent; as concerns households, lending rates added 3.75 percentage points to 17.45 percent. The magnitude of the change was even higher in the case of new loans with floating interest rate and initial rate fixation of up to one year[19] (4.05 percentage points to 17.48 percent for households and 5.32 percentage points to 20.51 percent for non-financial corporations). In turn, the average interest rates on new time deposits moved up 3.62 percentage points to 15.24 percent in the case of non-financial corporations and 3.46 percentage points to 14.13 percent in November in the case of households.

[19] In the period under review, such loans held on average nearly 60 percent of new leu-denominated loans to households and 98 percent of loans to companies.

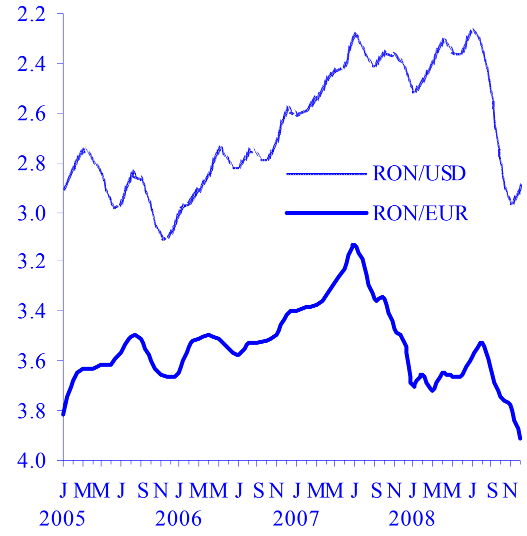
2.2. Exchange rate and capital flows

The upward movement seen in the RON/EUR exchange rate since September gained momentum in 2008 Q4, coupled with considerably higher volatility, amid the broader and deeper global financial crisis and its more pronounced fallout on emerging economies.

On this backdrop, the domestic currency lost 7.2 percent in nominal terms and 6.0 percent in real terms versus the euro October through December, after the appreciation seen in the previous quarter (0.8 percent and 1.8 percent respectively). Against the US dollar that strengthened considerably on global financial markets the leu eased by 12.6 percent in nominal terms and 10.7 percent in real terms over the reported period. Calculated as an average annual change for 2008 Q4, the domestic currency depreciated at a slightly slower pace versus the EUR (9.5 percent in nominal terms), but saw a significantly faster nominal weakening to the USD, i.e. 17.6 percent.

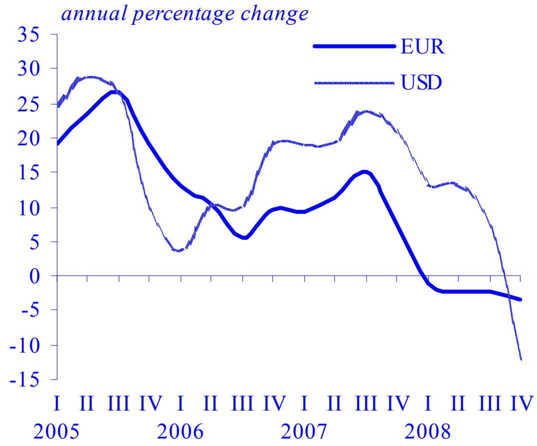
The fast-paced uptrend seen in the RON/EUR exchange rate as of the end of 2008 Q3 continued into early October amid financial investors' heightened risk aversion, reflecting: (i) the authorities postponing a concerted response to the issues afflicting the European financial system[20]; (ii) more signs of an imminent severe global recession, and particularly (iii) the deeper financial and economic crisis in several emerging economies[21]. The domestic financial market came under the impact of investors' worsening sentiment, with the negative balance of non-residents' operations on the local forex market reaching a record low, while their portfolio of securities and shares diminished considerably. By contrast, banks' external liabilities witnessed a sizeable increase during the reported period, mainly on account of financial borrowings and deposits from abroad. Further upward pressure on the RON/EUR exchange rate stemmed from residents' unprecedented purchases of foreign currency – most likely aimed at covering the external debt service and imports – and a larger volume of speculative transactions conducted in this context by some forex market operators. However, the latter developments were reined in by the central bank also via verbal interventions and tighter liquidity conditions on the money market. Under these

Nominal Exchange Rate



Developments of RON Exchange Rate*

annual percentage change

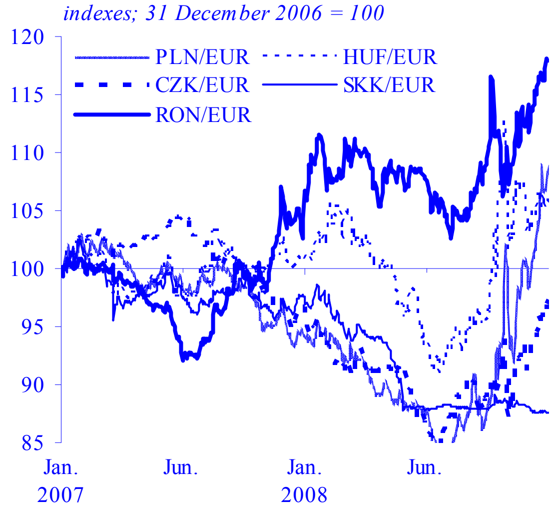


*) appreciation (+), depreciation (-) in real terms; deflated by CPI

Source: NIS, NBR

Exchange Rate Developments on Emerging Markets in the Region

indexes; 31 December 2006 = 100



Source: NBR, ECB

[20] Although the ECB and other central banks cut policy rates on 8 October and a euro-area-wide action plan was devised on 12 October meant to ensure, among others, bank recapitalisation and guarantee interbank lending, these measures were deemed insufficient by financial investors, as the global context was further plagued by lack of confidence and heightened volatility.

[21] After the deepening of the economic and financial crisis in Iceland, rumours on hardships faced by one of the major financial institutions in Hungary and the downgrade of the latter's sovereign rating triggered significant capital outflows from the regional financial market and a significant depreciation of local currencies. Furthermore, financial and economic conditions in the Ukraine and Serbia worsened abruptly during the period under review.

circumstances, the RON/EUR exchange rate posted a short-lived downward path, touching the fourth-quarter lowest reading on 22 October and thus disconnecting from the trajectory of the main currencies in the region.

Subsequently, the domestic currency resumed however its depreciation trend versus the euro under the impact of bleaker prospects of the global economy (it was confirmed that the leading world economies went into recession, along with the worsening of their short-term outlook[22]) and particularly the warnings on the imminent spillover effects of the financial crisis to emerging countries and the downgrading of the sovereign rating by major international agencies[23]. Investor sentiment on the region's economic outlook improved somewhat over a brief time span amid the actions taken by the major central banks to stabilise financial markets and the IMF's active role in cushioning the effects of the crisis, including via raising the lending threshold for emerging countries and concluding arrangements with Hungary, the Ukraine and Serbia. Against this backdrop, the operators' speculative transactions on the interbank forex market[24] shrank considerably. Coupled with legal entities' flagging demand for foreign exchange and a further narrowing of the trade deficit, this development limited the upward movement of the RON/EUR exchange rate to 0.8 percent in November.

However, the depreciation of the leu regained momentum in December 2008, when it came – along with other currencies in the region – under the adverse impact of investors' growing lack of confidence, amid the significant worsening of developments in some regional economies[25]. As far as the RON/EUR exchange rate is concerned, this impact was magnified by growing fears related to unfavourable developments in budget deficit and the somewhat higher degree of uncertainty surrounding the near-term economic outlook inherent to the election and post-election periods. Consequently, the RON/EUR exchange rate hit 3.9964 on 29 December, the highest reading since November 2003, with the average value for December also posting the second-highest level in 2008 (3.6 percent).

Key Financial Account Items (balances)

EUR million

	2007 11 mos	2008 11 mos
Financial account	**14,856**	**16,832**
Direct investments	**6,898**	**8,645**
residents abroad	-172	214
non-residents in Romania	7,070	8,431
Portfolio investments and financial derivatives	**315**	**-202**
residents abroad	-45	33
non-residents in Romania	360	-235
Other capital investments	**12,295**	**8,498**
medium- and long-term investments	3,825	5,252
short-term investments	413	-720
currency and short-term deposits	5,984	483
others	2,152	3,484
NBR's reserve assets, net ("–" increase/"+" decrease)	**-4,652**	**-109**

[22] The European Commission, the OECD and the IMF forecasted significant declines in advanced economies in 2009.

[23] Both Standard&Poor's and Fitch downgraded Romania's sovereign rating to below "investment grade" on 27 October and 10 November respectively.

[24] In November, both the interbank forex market turnover and the volume of transactions conducted by non-residents almost halved month on month.

[25] Data released during the reported period revealed slower economic growth in Hungary, the Czech Republic and Poland along with a wider trade deficit in the Czech Republic and Hungary. Furthermore, Latvia entered negotiations with the EU and the IMF for financial assistance.

2.3. Money and credit

Money

In September-November 2008, the average rate of increase[26] of broad money (M3) witnessed a steeper slowdown, hitting a 2-year low of 17.7 percent. Nevertheless, this development was manifest only in the last two months of the period under review, when M3 annual dynamics in real terms decelerated to the lowest reading in the past two years, an all-time low in the available data series, after a short-lived upturn in September. The more sluggish growth rate of the main monetary aggregate reflected the effects of tighter liquidity constraints on both companies and households – amid the faster rise of debt service relative to loans and the slower dynamics of new borrowings from banks – as well as slacker economic growth. From the perspective of M3 counterparts, the further slowdown in the dynamics of credit to the private sector, i.e. the main source of money creation, and to a lesser extent the pick-up in the growth rate of long-term financial liabilities (capital accounts[27] in particular) acted towards curbing broad money expansion. An opposite influence came from the faster advance in credit to the public sector and particularly from the sharper decline in the pace of increase of central government deposits, which touched the lowest level in the available data series.

The key components of broad money, i.e. monetary aggregate M1 and time deposits with an agreed maturity of up to two years, further posted a slower dynamics, while the growth rate of marketable securities picked up considerably on account of the increase in money market funds and hence a larger volume of issued shares; however, their average share in M3 remained very small at 0.2 percent. Both the pace of increase of currency in circulation and that of overnight deposits stayed on a downtrend, although the deceleration in the former case was not as pronounced as in the previous period. The slacker growth rate of overnight deposits was manifest for placements in both domestic and foreign currencies, largely reflecting the increased debt service relative to loans. Other possible determinants were the partial shift towards household time deposits in domestic currency and, in case of corporations, weaker lending and slower economic growth in 2008 Q4. The deceleration in the pace of increase of time deposits with an agreed maturity of up to two years mirrored similar developments in both household forex deposits – linked to

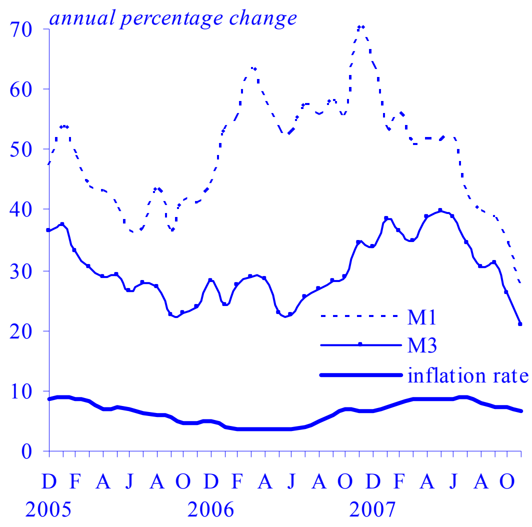
Annual Growth Rates of M3 and Its Components

real percentage change

	2007	2008				
	IV	I	II	III	Oct.	Nov.
	quarterly average growth					
M3	24.1	26.5	28.2	22.1	17.4	13.3
M1	53.0	42.2	39.8	29.7	25.3	18.9
Currency in circulation	29.7	38.0	30.2	19.4	23.5	20.0
Overnight deposits	63.9	43.7	43.6	33.8	26.0	18.5
(maturity of up to two years)	2.4	12.6	16.7	13.7	8.3	6.5

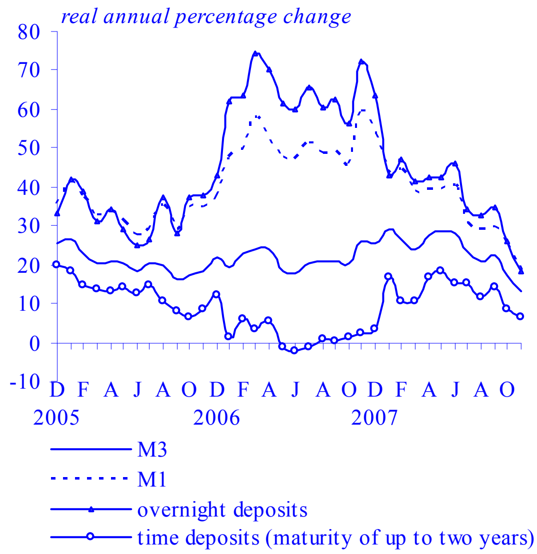
Source: NIS, NBR

Broad Money and Inflation Rate



Source: NIS, NBR

Main Broad Money Components



Source: NIS, NBR

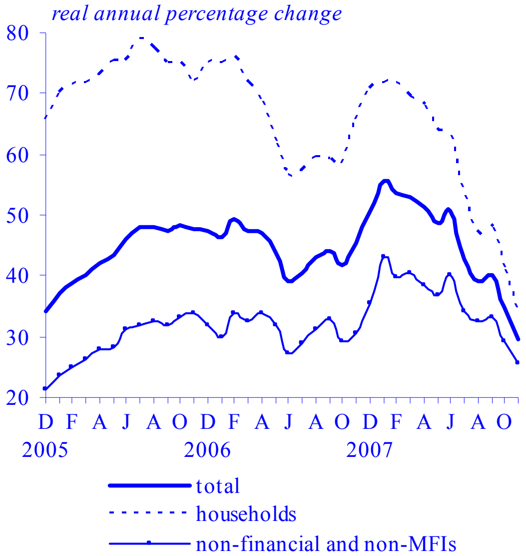
[26] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2008.

[27] However, the rise in capital accounts was largely due to favourable differences from the revaluation of foreign currency-denominated assets.

the more sluggish dynamics of remittances from abroad[28] – and corporate deposits[29] denominated in domestic and foreign currencies. The slower growth rate of corporate deposits was most likely ascribable to the decline in the volume of new loans and to the relative contraction in corporate profit and foreign currency collections (in November, exports posted a negative annual change for the first time in the past five years). Conversely, the dynamics of household time deposits with an agreed maturity of up to two years regained momentum, prompted by the increase in deposit rates and, possibly, the compensations paid during the reported period to individuals having resorted to CEC Bank deposits for motorcars purchase[30].

Credit to Private Sector by Institutional Sector

real annual percentage change



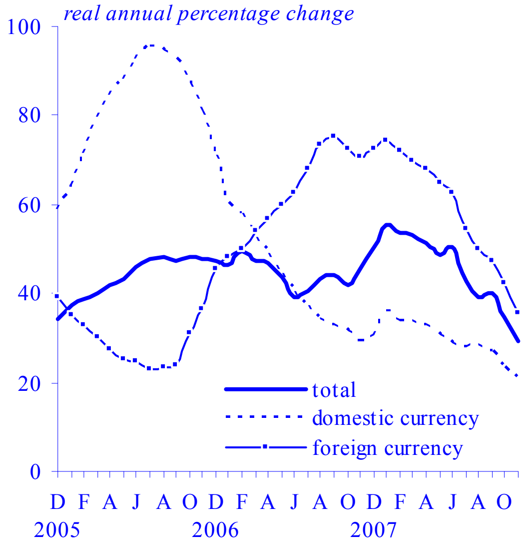
Source: NIS, NBR

Credit

The growth rate[31] of loans to the private sector stayed on a brisk downward track September through November 2008, hitting a 3-year low of 34.9 percent (down 9.3 percentage points)[32]. The decline was manifest irrespective of currency, with the dynamics of the domestic currency component posting a 3½-year low and that of forex loans a 2-year low. Despite the faster deceleration, the forex-denominated component further outperformed credit in domestic currency (particularly in case of households), so that the average share of foreign currency credit in total loans to the private sector peaked at a 3-year high of 55.9 percent.

Credit to Private Sector by Currency

real annual percentage change



Source: NIS, NBR

These developments reflected the impact of both credit demand and especially credit supply. The latter came under more intense pressure from several factors that had become manifest previously, such as: (i) tighter external financing conditions for banks and (ii) reduction of the liquidity surplus in the banking system, to which added (iii) credit institutions' increased wariness, also amid heightened adverse selection risk, (iv) customers' lower degree and/or scope of eligibility, partly due to the enforcement of NBR

28 Calculations based on balance-of-payments data show that the growth rate of remittances and current transfers stayed on a downtrend.

29 The growth rate of corporate time deposits with an agreed maturity of up to two years denominated in foreign currency remained high by historical standards, solely on account of incorporating the one-off effect induced by the settlement of the Electrica privatisation in amount of EUR 826.4 million in April 2008.

30 Payments amounting to RON 760.6 million, according to Government Emergency Ordinance No. 156/2007.

31 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2008 (end-of-month).

32 This occurred in spite of the statistical effect of a weaker leu versus the euro. However, the effect was more sizeable in September, when it was the only driver of the temporary spike-up in the annual dynamics of credit to the private sector.

Regulation No. 11/2008[33], (v) more restrictive lending terms and conditions[34], as well as (vi) banks' stronger appetite for government securities and external assets (although their share in the monetary balance sheet remained subdued). At the same time, credit demand was negatively influenced by: (i) the surge in lending rates, (ii) the worsening of market operators' expectations on economic[35] and hence financial developments, (iii) the weaker domestic currency and increased uncertainties surrounding its evolution, as well as (iv) the still high level of non-banks' financing from abroad[36].

The growth rate of household and corporate loans continued to decelerate across all categories during the period under review, along with the sizeable contraction in the volume of new business[37] to households (consumer and housing loans) and non-financial corporations. The dynamics of the CHF-denominated component of household loans posted the sharpest deceleration, with credit institutions relinquishing almost entirely their lending activity in Swiss francs in November[38]. At corporate level, the worst hit category was that of loans with a maturity of over 5 years (accounting for 28.5 percent of total corporate credit), whose forex component witnessed, for the first time, three successive monthly retrenchments in terms of volume.

Net credit to central government maintained its expansionary impact on M3 amid renewed fast growth of credit institutions' government securities portfolio and particularly the new record slowdown in the dynamics of central government deposits.

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33 NBR Regulation No. 11/2008 amending and supplementing NBR Regulation No. 3/2007 on limiting credit risk associated with loans to households, effective as of October.

34 According to the results of the survey on lending to non-financial corporations and households released in November.

35 According to the DG ECFIN survey, the confidence indicator in the domestic economy dropped in October and more significantly in November, while the NIS survey for November 2008 - January 2009 reveals expectations of a decline in activity in manufacturing and construction.

36 According to balance-of-payments data, the volume of net financial credits taken abroad by non-banks during September-November exceeded that recorded in the previous quarter, while non-residents' net direct investment in the non-bank sector remained at elevated levels, in spite of the protracted decline.

37 Calculations based on CCR data and data from the Reports on average interest rates (NBR Norms No. 14/2006).

38 According to calculations based on CCR data, the share of the CHF-denominated component in total new business to households declined to 1.6 percent in November from 17.5 percent in August.

V. INFLATION OUTLOOK

The intensification of the global financial crisis at the end of the previous year persisted into 2009, with knock-on effects on economic activity worldwide. The mutual reinforcement of negative developments in financial markets and the real sector maintains a volatile environment, thus adding to the difficulties associated with projecting the magnitude of short- and medium-term impact of the global crisis on the domestic macroeconomic developments. Therefore, the current projection is subject to major uncertainties relating to the future developments on the international markets. Similarly to the previous forecast, the identified risks of inflation deviating upwards or downwards from the baseline scenario are broadly balanced.

Given the unusually high uncertainties surrounding quantitative assessments, the baseline scenario of the current projection places the annual inflation rate at 4.5 percent for end-2009, a level similar to that published in the November 2008 Inflation Report. For end-2010, inflation is forecasted to fall to 3.2 percent.

When compared to the previous Inflation Report, the determinants of CPI inflation are projected to exert partially opposite effects, which are anticipated to alleviate one another, especially throughout 2009. Domestic currency depreciation, which began in 2008 Q4 and resulted in the repositioning of the exchange rate of the leu at levels higher than those envisaged in the prior projection, contributes to a higher annual CORE2 inflation trajectory, with the major contributor being the projected import price dynamics. The adverse impact of the exchange rate is expected to be countered by the projection of a larger negative output gap during 2009. Effects in the same direction will be exerted by the more favourable dynamics of fuel prices in the first part of 2009 and the administered price dynamics incorporated in the exogenous scenario throughout the horizon. For part of 2010, assuming comparatively faster fuel price increases, only partly offset by more favourable projected dynamics of CORE2 inflation and administered prices, the baseline scenario foresees an annual CPI inflation path slightly above that envisaged in the previous Inflation Report.

Throughout the forecast horizon, the conduct of monetary policy will remain committed to its primary objective, i.e. to ensure price stability in the medium and long term. At the same time, heightened attention will be attached in the near run to achieving an orderly adjustment of macroeconomic imbalances and maintaining financial system stability. A balanced monetary policy conduct will allow inflation to re-enter the variation band around the central target as early as the first part of 2010, conditional upon adequate support from the other macroeconomic policies and the absence of any significant slippages from the coordinates of the baseline scenario.

The heightened uncertainties associated with the intensification of the global financial turmoil inevitably affect the coordinates of the baseline scenario, rendering difficult a likelihood ranking of various risk factors. Thus, the risks which are deemed as most likely to occur during the next eight quarters are those susceptible of generating a less orderly adjustment of macroeconomic imbalances than that implied by the coordinates of the baseline scenario, namely: less available domestic and external financing resources for economic activity in the event of a marked worsening of the global crisis; lower competitiveness of Romanian exports in case of real wage dynamics further overtaking productivity gains; implementation of an insufficiently adjusted public-sector wage policy; the contraction of the privately-owned productive sector as a result of its crowding out by the public sector in the event of an insufficiently consolidated fiscal policy and/or a fiscal policy insufficiently oriented towards expenditures capable of generating positive externalities, given a limited pool of financing resources. Should these risks materialise, inflation might post substantial fluctuations relative to the forecasted path.

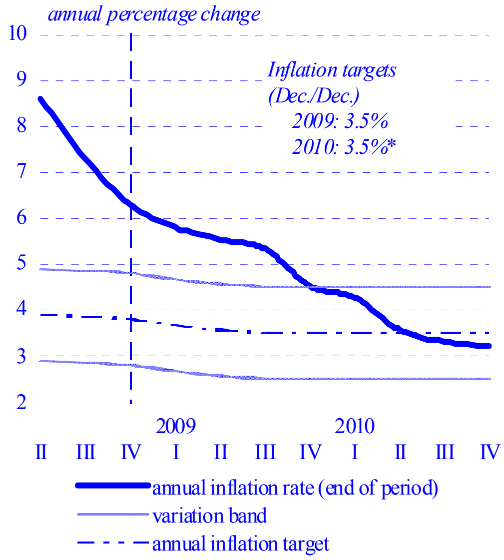
The risks associated with the evolution of oil and other commodity prices, administered prices and volatile food prices are relatively symmetrically distributed around the forecasted path of the CPI inflation in the baseline scenario.

1. The baseline scenario of the forecast

1.1. Inflation outlook

The baseline scenario of the macroeconomic forecast places the annual CPI inflation for 2009 at 4.5 percent, a level similar to that presented in the November 2008 Inflation Report, and the one for 2010 at 3.2 percent[39]*. The validity of these assessments is conditional upon that of the assumptions. Taking this into account, amid the unusual uncertainties surrounding the outlook for the economy over the short and medium term, deviations in both*

Inflation Forecast



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

*) working assumption

Source: NIS, NBR calculations

[39] The inflation projection within the current forecasting round builds upon the assumption of a 3.5 percent central target for 2010.

directions from the projected path of inflation are likely to occur in the current forecasting round[40].

Table 5.1. The annual inflation rate in the baseline scenario

percent

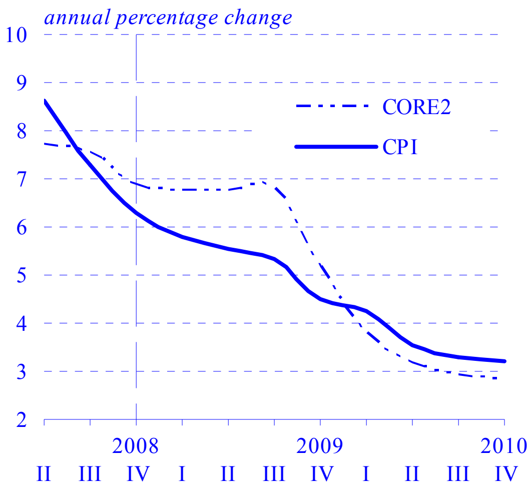
Period	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
Target				3.5				3.5*
Forecast	5.8	5.5	5.3	4.5	4.3	3.6	3.3	3.2

* working assumption

The projected CPI inflation rate for 2009 is maintained at 4.5 percent despite the substantial update of some of the assumptions used in the previous forecast:

– *(downward) revision of the inflationary pressures from aggregate demand*; on the one hand, this is the result of a less favourable scenario associated with the evolution of the external demand in the euro area (with a direct impact on Romanian exports); on the other hand, this stems from a projected slowdown – in 2008 Q4 and 2009 Q1, but with further effects in the future – in the dynamics of domestic aggregate demand components. Given that some of the risks to economic growth which have been mentioned in the previous Inflation Report have materialised and that the uncertainties surrounding the developments in international financial markets have persisted, GDP growth rates may still, *ceteris paribus*, exhibit downward deviations from the baseline scenario and hence affect future inflation rates;

CORE2 and CPI



Source: NIS, NBR calculations

– *(upward) revision of the projected CORE2 inflation path* conveying, on the one hand, the favourable impact exerted by the forecasted dynamics of economic activity and, on the other hand, the adverse effect of the projected exchange rate of the leu;

– the possibility of lower adjustments in administered prices and, in early 2009, of a more favourable scenario on fuel prices[41].

Considering that the scenarios on the short-term developments in real sector activity, in the CPI inflation components and in most

[40] Similarly to the November 2008 Inflation Report, the range of risks is illustrated by the use of a variation band around the projected trajectory of CPI inflation in the baseline scenario. For details, see *Box 3. Building the uncertainty interval associated with the baseline scenario inflation forecast* in the previous Inflation Report and Subsection *1.4. Risks associated with the projection* in this Inflation Report.

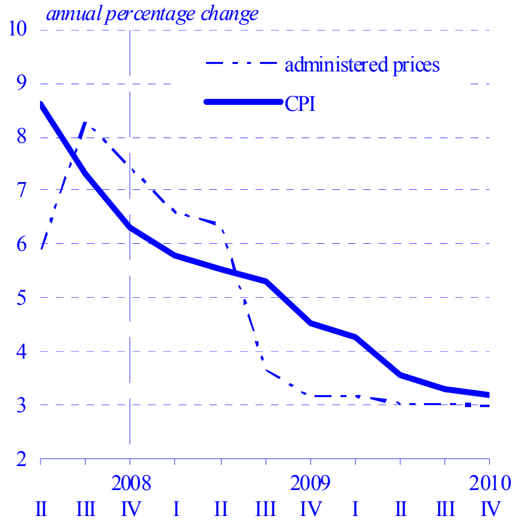
[41] For 2009, the average oil price used in the baseline scenario is substantially lower than the level considered in the November 2008 Inflation Report (USD 55 per barrel against USD 90 per barrel).

external variables indicate levels that deviate substantially in some cases from their recent trends, the forecast results should be interpreted with caution[42]. In view of the major uncertainties, anchoring economic agents' anticipations to a favourable trajectory is largely contingent on the consistency and predictability of macroeconomic policies to be implemented throughout the forecast horizon.

According to the baseline scenario, the annual CPI inflation rate is expected to continue its downward trend over the next eight quarters. In the near run, i.e. 2009 Q1, a less favourable impact of CORE2 inflation on consumer prices (compared to the November 2008 Inflation Report) is countered by a more favourable scenario regarding fuel price developments (lower levels than in November). Subsequently, owing to a more optimistic scenario regarding the dynamics of administered prices and a more favourable path of fuel prices over the next quarters, CPI inflation is expected to converge at the end of 2009 towards the upper bound of the variation band around the central target (4.5 percent).

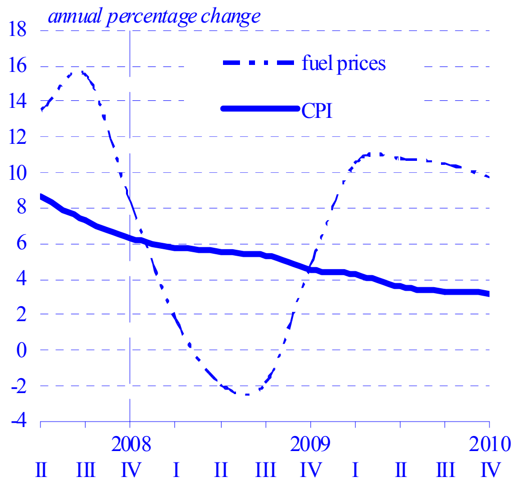
Compared to the November 2008 forecast, the reassessment of cyclical position of aggregate demand components and the persistence of their less stimulative levels relative to price developments are offset by the opposite impact of the exchange rate dynamics on import prices. As a result, the favourable influence of CORE2 inflation on consumer prices is expected to become manifest in the first part of 2010 (annual growth rate of 2.8 percent). Except fuel prices, whose forecast reflects the assumption of a rising oil price[43], the other consumer basket components are anticipated to see lower annual growth rates than that of headline inflation. Therefore, reflecting the influence of the entire set of determinants, annual CPI inflation is forecasted to reach 3.2 percent at end-2010.

Administered Prices and CPI



Source: NIS, NBR calculations

Fuel Prices and CPI



Source: NIS, NBR calculations

1.2. Exogenous pressures on inflation

The macroeconomic environment modelled during the current projection is expected to be volatile and likely to see significant changes, as the numerous uncertainty factors at present are gradually eliminated. Consequently, the resort to exogenous scenarios, whose validity influences the accuracy of the forecast

[42] For example, one may perform a direct comparison between the projected dynamics of macroeconomic variables under the current baseline scenario and that in the previous Inflation Report, but some methodological changes or the use of expert assumptions needed to capture the particular macroeconomic environment of the current round could generate misinterpretations of the resulting differences.

[43] By 18 percent during 2010 (2010 Q4 figure versus 2009 Q4 figure).

for the following eight quarters, is yet another additional methodological constraint, being however consistent with the use of all information available when making the projection.

The contribution of exogenous scenarios on administered prices and volatile prices of vegetables, fruit and eggs to CPI inflation is less sizeable in the current baseline scenario than in the previous projection. The cumulative effect of the two components to annual headline inflation is 0.5 percentage points and 0.2 percentage points lower in 2009 and 2010 respectively than in the November 2008 Inflation Report. While administered prices have a relatively similar contribution in 2009 and 2010 (about 0.66 percentage points of annual CPI inflation), volatile prices of vegetables, fruit and eggs are expected to have a larger contribution in 2009 (0.3 percentage points) and a roughly neutral one (0.03 percentage points) in 2010; for the current year, the differences arise from an unfavourable base effect[44].

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

percent

	Administered prices		Volatile food prices	
	2009	2010	2009	2010
Current projection	3.2	3.0	4.6	0.4
Previous projection	5.9	3.0*	4.1	1.62*

*annual inflation in 2010 Q3 (in the November 2008 Inflation Report, 2010 Q4 was not covered by the projection horizon)

The external sector assumptions regarding the current projection are markedly different from those used in the previous Inflation Report, confirming once again the volatility of the international economic environment gripped by the financial turmoil. In view of the present context marked by the significant slowdown in the dynamics of domestic aggregate demand components in the euro area, the assumption for 2009 considers a decelerating annual growth rate of foreign GDP to -0.2 percent[45]. Based on this assumption and taking also into account the anticipation of a moderation in the influence from commodity prices, euro area inflation is projected to decline to 1.5 percent in 2009 and to rise marginally to 2.9 percent in 2010 compared to the figures presented in the November 2008 Inflation Report.

The baseline scenario relaxed the assumption of a constant oil price throughout the projection horizon, which is not however indicative of expectations of lower uncertainties associated with oil price dynamics in the future. Under the circumstances, the

[44] When compared to the prices reported in 2008 in the context of an above-average agricultural output.

[45] This assumption is used to approximate during the projection period the influence exerted by external demand on Romanian exports dynamics.

assumed rise from USD 51.1 per barrel in 2009 Q1 to USD 70 per barrel in 2010 Q4 is linked to the extremely low price of oil at present, to which expert judgement on the evolution of world demand for oil[46] was added.

Table 5.3 summarises the expectations on the developments in the external variables included in the projection.

Table 5.3. Expectations on the developments in external variables

	2009	2010
3-month EURIBOR (%)*	1.8	2.8
Oil price (USD/barrel)**	55.1	65.9
EUR/USD exchange rate*	1.33	1.32
Annual inflation rate in the euro area (%)**	1.5	2.9

* in Q4
** year on year

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

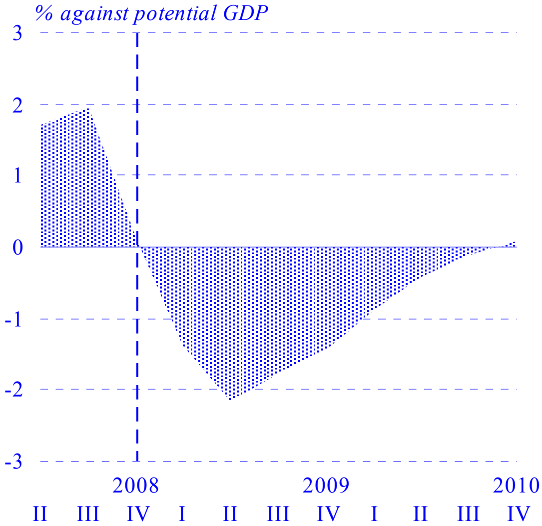
One of the key immediate effects generated by the international financial crisis was the heightening of uncertainties surrounding short- and medium-term developments in economic variables, with a negative impact on their predictability.

In 2008 Q3, the annual dynamics of real GDP (9.1 percent) was slower than that envisaged for assessing the excess demand in the November 2008 Inflation Report. Amid the increasingly strong effects of the international financial crisis in Q4, the annual growth rate projected for this period is significantly below the previously forecasted figures. Starting 2008 Q4, the drop in investment activity due to less available resources and higher financing costs is expected to have a negative bearing on potential GDP dynamics compared to the previous quarters. Against this background, the excess demand during Q4 is anticipated to fall below the figure in the previous forecasting round, while at the same time the positive output gap registered in the prior quarter being expected to close in this period.

In 2008 Q4, household final consumption is expected to have increased at a still faster pace than that of real GDP, albeit slower than the previous growth rates. In spite of household final consumption remaining the component with the largest influence on GDP dynamics, the slowdown in its annual growth rates contributes to the quarter-on-quarter decrease in the positive

GDP Deviation

% against potential GDP



Source: NIS, NBR calculations

[46] World demand for oil is expected to rebound gradually, in line with the dissipation of the strongest financial turmoil effects on real economy.

output gap from the trend level, and therefore to a drop in the inflationary pressures attributed to aggregate demand. Compared with the previous quarter, the decline in inflationary pressures is also suggested by the further decelerating annual growth rates of some indicators intended to approximate the volume of resources available to households in the short term. Amid the persistence of a relatively steady positive spread between real wage rises and productivity gains across the economy, the slower increase in the aforementioned resources is attributable to the marked deceleration in the annual dynamics of outstanding loans to households[47], illustrated in turn by the slower rise in retail sales[48].

The slowdown in the lending activity, though difficult to ascribe univocally to some factors relating to demand or supply of banking products and services, also mirrors to a great extent the influence of some factors such as the diminished access of financial institutions to external financing sources, the inherent gradual nature of shifting to lending based on attracting domestic financial resources, as well as the difficulties associated with the selection of liquid debtors, whose creditworthiness is less affected by anticipations of negative developments in the short and medium run. Furthermore, aggregate resources available to households will also be adversely affected by the anticipated moderation in the dynamics of the number of employees economy-wide.

Public consumption is projected to post a faster annual growth rate, remaining above the trend level. The dynamics of the consolidated general government budget deficit in Q4 (accounting for 2.94 percent of GDP in November) shows both the pick-up in expenditures, given the parliamentary elections at end-November, and the drop in collected revenues, following the stronger fallout from the global financial crisis on the Romanian economy.

In 2008 Q3, the annual pace of increase of gross fixed capital formation came to 24.3 percent, down from the previous quarters, owing to the slowdown in both the dynamics of investment in new construction works and that of equipment investment[49]. In 2008 Q4, the annual growth rate of gross fixed capital formation is seen

[47] The annual growth rate of short-term loans to households stood at 22.1 percent in real terms in 2008 Q4, staying on a downward trend compared to the previous quarters; in addition, the pace of increase of consumer loans came to 29.8 percent in real terms during the same period, slowing down versus 43.0 percent in the previous three-month period.

[48] The annual dynamics of retail trade in goods, except for motor vehicles and fuels, continued to decelerate, reaching 2.8 percent in November 2008 compared to more than 16 percent in September 2008.

[49] In 2008 Q3, annual growth rates of investment in new construction works and equipment investment fell to 27.9 percent and 15.1 percent versus 34.8 percent and 23.7 percent respectively in the previous quarter.

decelerating significantly, which places this variable close to the trend level. Under the circumstances, the positive contribution of this component to real GDP growth is foreseen to diminish considerably. The decreasing demand of economic agents for medium- and long-term real credit hints at their increased prudence and higher related costs, both factors being reflected by a declining annual growth rate in 2008 Q4[50]. The further slowdown in investment dynamics is also suggested by the drop in capital goods imports, whose growth rate lagged behind that of aggregate imports[51].

In 2008 Q4, the annual rate of increase of imports and exports is foreseen to decelerate. In the case of exports, the positive effects stemming from the favourable exchange rate dynamics are expected to be offset by the marked slowdown in the annual growth rates of industrial output and labour productivity in this sector; in November 2008, industrial output and labour productivity reported annual rates of increase of -11.5 percent and -6.9 percent respectively[52]. Furthermore, a declining external demand for Romanian products[53] is foreseen, as the already sluggish dynamics of economic activity in the trade partners may dip into negative territory. The moderation in import growth is supported by the slower expansion of resources available to households and companies whereas the credit to the private sector[54] continues to witness high, albeit declining, growth rates.

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

In 2008 Q4, the domestic currency depreciated in both real and nominal terms versus the average recorded in the previous quarter against the background of international and regional developments, as well as of specific domestic economic conditions. Financial investors' risk aversion increased, due mainly to signals pointing to a global recession and to the delay in finding a common solution to the problems facing the financial system worldwide (though subsequently the major central banks cut

[50] In 2008 Q4, the real annual growth rate moderated to 26.4 percent from 37.2 percent in 2008 Q3.

[51] The annual dynamics of capital goods imports (expressed in euro) was 5.8 percent in 2008 Q3, decelerating significantly from the annual growth rates seen in the first two quarters, i.e. 16.0 percent in 2008 Q2 and 17.6 percent in 2008 Q1. Moreover, in 2008 Q3, the share of capital goods imports in total imports FOB ran at 22.2 percent compared to an average of roughly 25 percent in the past six quarters (2007 Q1 - 2008 Q2).

[52] In 2008 Q3, labour productivity in industry rose 6.1 percent year on year, while industrial output grew 2.4 percent year on year.

[53] In 2008 Q3, the annual growth rate for euro area economy slackened to 0.6 percent versus 1.4 percent in the previous quarter (Source: Eurostat).

[54] In 2008 Q4, the real annual growth rate declined to 29.9 percent from 40.7 percent in Q3.

interest rates and took more measures to improve global liquidity conditions). Domestic factors such as the prospective rise in public sector wages, the persistence of the balance-of-payments current account deficit, as well as the negative outlook for the Romanian economy (also mirrored in the downgrading of the sovereign rating by the major agencies, including below "investment grade") also contributed to the depreciation of the domestic currency. Against this backdrop, speculative operations of some foreign exchange market participants also acted towards the weakening of the leu.

Following the sharp depreciation of the domestic currency in Q4, the exchange rate no longer exerted a dampening effect on aggregate demand through the net export channel, which became stimulative. On the other hand, wealth and balance sheet effects of the exchange rate turned restrictive, the depreciation of the leu leading to a significant increase in the domestic-currency-denominated costs of loans in foreign exchange. By cumulating the above-mentioned opposite effects of the exchange rate, it is estimated that in the near run the impact on aggregate demand and thus on inflation will be a restrictive one and could be increased by anticipations of negative shocks on external demand, associated with global economic recession, especially in the euro area (Romania's main trade partner). As for the direct impact of exchange rate on inflation, developments in import prices in Q4 had a larger contribution to inflation than in Q2 and Q3.

In the medium run, real exchange rate is expected to follow a trajectory determined by fundamentals such as sustainable capital flows and the productivity differential against trade partners. Nevertheless, it is anticipated that, at least for the first half of the projection horizon, the drop in liquidity on international markets and the persistently high risk aversion will prevent the leu from further appreciating in real terms.

During 2008 Q4, commercial banks recorded a net liquidity deficit on the interbank money market, leaving the NBR as a creditor to the banking system. Due to one-off factors (see Subsection *IV.2.1. Interest rates*), interbank interest rates saw a significant rise at the beginning of the period under review. The NBR's flexible management of liquidity in the banking system fostered the return of interbank rates at the turn of the year to levels similar to those recorded in Q3. In addition, tensions on the interbank money market manifest during Q4 put upward pressures on bank interest rates.

Nominal interest rates applied by commercial banks on loans and deposits further increased during Q4. The rise in nominal deposit rates mirrors the increasingly fierce competition among banks to attract domestic resources, in the context of diminished access to external financing sources (against the background of the global financial crisis) and tight conditions on the interbank money market. At the same time, the faster growth pace of nominal lending rates reflects both additional financing costs and the stronger risk aversion of commercial banks. The increases of nominal rates in the context of alleviating inflation expectations imply a substantial rise, in real terms, in both lending and deposit rates. Consequently, *ceteris paribus*, the restrictive impact of credit institutions' real interest rates applied to non-bank clients on the economy was more pronounced in Q4.

In 2008 Q4 overall, the cumulated effect of real exchange rate (via the two aforementioned channels) and credit institutions' lending and deposit rates on aggregate demand and future inflation has been less restrictive than in the previous quarter.

1.3.3. Demand pressures within the projection horizon

The increasingly strong effects of the financial crisis have passed on gradually and have already been reflected by the 2008 Q4 developments of some indicators on real economy activity[55], entailing high uncertainties and possible both-way deviations for the starting point of the forecasting rounds[56] and for the projected impact of real monetary conditions throughout the relevant time horizon. Under the circumstances, mention should be made that the results presented in this section are highly conditional upon the assumptions used, whereas the possible implications of some deviations from these assumptions are captured as an aggregate effect on plausible paths of CPI inflation dynamics in Subsection *1.4. Risks associated with the projection*.

When compared to the November 2008 Inflation Report, the GDP deviation from its trend was revised downwards in both 2008 Q4 and 2009 Q1[57]. This outcome reflects the anticipated considerable deceleration in GDP dynamics over the two mentioned quarters, on the one hand, and the reassessment of the impact exerted by the financial crisis on the projected dynamics of potential GDP[58], on the other hand. Under the impact of the entire range of determinants and compared with the November figures, the baseline scenario envisages a GDP deviation from its trend consistent with a

[55] See previous sections as well.

[56] GDP deviation from its trend in 2008 Q4 and 2009 Q1.

[57] The 1.6 percentage point deceleration of the GDP deviation in 2009 Q1 is partly the result of a slightly restrictive effect of fiscal policy on aggregate demand components during this quarter.

[58] The substantial rise in lending in recent years contributed significantly to the growth rate of domestic potential GDP, thereby exerting a stimulative impact on all its components; this increase is assumed to be partly eliminated amid the anticipated stronger deceleration of the growth rate of credit to the private sector throughout the projection horizon.

significantly faster weakening of inflationary pressures from aggregate demand.

The projected dynamics of real broad monetary conditions[59], the anticipated fiscal policy stance as well as the forecasted evolution of external demand for Romanian products are the main drivers of the GDP deviation throughout the projection horizon.

Given the large share of foreign currency denominated non-government credit to the private sector (non-financial corporations and households), the recent depreciation of the domestic currency will exert a strong contractionary effect on aggregate demand, particularly in the first part of 2009. This contraction is generated by higher debt service of economic agents earning domestic currency-denominated income but having exposure to foreign-currency denominated financial instruments[60]. The magnitude of this balance sheet effect is conditional upon the extent and duration of the unfavourable effects of the financial crisis on the domestic currency developments.

The baseline scenario envisages opposite impulses from the dynamics of net exports, following the opposing developments of its determinants. On the one hand, the anticipated slowdown in external demand dynamics, which is expected to persist throughout the projection horizon, will generate the fast deceleration in the domestic GDP growth pace, acting towards a deterioration of the foreign trade balance. However, the repositioning of the real effective RON exchange rate at higher levels following the nominal depreciation of the national currency since 2008 Q4 is seen exerting opposite effects on the foreign trade balance (by fostering exports and containing imports) throughout the projection horizon. The above-mentioned developments are projected to have a net expansionary effect on aggregate demand, which also supports the adjustment of external imbalances[61].

The efficient pass-through of real exchange rate impulses on real macroeconomic variables is surrounded by uncertainty. The dynamics of the domestic currency as a financial asset reflects

[59] In line with the NBR definition, real broad monetary conditions assess the impact of the real effective exchange rate (through the net export channel and the wealth and balance sheet effects) and of real interest rates, respectively, on GDP deviation and, thereby, on inflation. The assessment relies on filtration methods and the use of the NBR's forecasting model. Particular attention should be given to the difference between this definition and that of the Monetary Conditions Index which is widely used in professional literature.

[60] Over the short run, a weaker RON entails a larger share of amortisation expenditures with foreign currency-denominated loans in the budget of economic agents. Over the medium run, economic agents could seek to shield themselves against similar instances by increasing savings in domestic currency. In both cases, current and capital expenditures will decrease accordingly, leading to a possible contraction in aggregate demand.

[61] The implicit assumption is one of orderly financing of the current account deficit throughout the entire period for which such adjustments are made.

over a certain time horizon both the impact of fundamental (sustainable capital flows, productivity differential etc.) and that of transitory factors (fluctuations of short-term interest rates on financial instruments in various currencies, sovereign risk perception during periods of re-designing macroeconomic policies). In the context of increasingly strong fallout of the financial crisis, the effects of transitory factors are expected to prevail in the quarters ahead. Under the circumstances, the volatility of exchange rate dynamics could increase throughout the projection horizon[62]. In the event of such a scenario materialising, the impact of a future appreciation/depreciation of the real effective exchange rate on trade flows might prove different from the theoretically predictable impact[63].

In the event of a longer persistence of the negative impact coming from the financial crisis, there is a high likelihood that domestic financial institutions will be severely affected by a rapid exhaustion of external financing sources and will, thus, have to raise more domestic funds (for instance, by promoting more attractive saving instruments, such as deposits). *Ceteris paribus*, given the higher costs associated with taking on-balance-sheet liabilities, the lending rates will adjust accordingly, particularly in the short run.

In line with these adjustments, the financing opportunities of economic agents will be diminished accordingly, thus having the potential of depressing the real economy[64]. According to the baseline scenario, both lending and deposit rates set by the financial institutions are projected to exert a restrictive effect on the output gap, particularly in the first half of the projection horizon. Subsequently, conditional upon the gradual fading out of the most severe effects of the financial crisis, real deposit and lending rates will exert a relatively neutral impact on real economy, supporting the emergence of a moderate excess demand towards the end of 2010.

Throughout the forecast horizon, the conduct of monetary policy will remain committed to its primary objective, i.e. to ensure price

[62] This effect is difficult to be captured by a macroeconomic model which uses quarterly values of the RON exchange rate. By definition, the quarterly exchange rate is determined as an average of its monthly values, which implicitly mitigates the quarter-on-quarter fluctuations of this variable.

[63] For instance, when exporters cannot adjust rapidly – in response to exchange rate movements – the volume of their production factors (labour, capital etc.), higher exchange rate volatility will be mirrored, *ceteris paribus*, into increased volatility of their profits, without exerting a major impact on the volume of exports.

[64] The forecast of an economic growth rate under the stronger effects from the financial crisis could translate into a contraction of the value of collateral which economic agents could resort to when taking new loans or extending the credit lines already in progress. On this background, an intensification of the impact generated by the financial sector on the real sector cannot be precluded, owing to the relatively strong inter-connection of the two sectors.

stability in the medium and long run. At the same time, during the period in which the global financial crisis exerts a severe impact on the domestic economy, the central bank will attach particular attention to achieving the orderly adjustment of macroeconomic disequilibria, while at the same time ensuring the stability and smooth functioning of the financial system. By securing the appropriate liquidity volume on the interbank market, given the central bank's creditor position to the banking system, the restrictive impact of deposit and lending rates on economic activity is expected to be offset to a certain extent. A balanced monetary policy conduct will allow the re-entry of inflation into the variation band around the central target in the first part of 2010, provided that the other macroeconomic policies make an appropriate contribution in this respect and in the absence of significant deviations from the baseline scenario coordinates.

In order to establish fiscal policy coordinates in the baseline scenario, the latest available data concerning the draft budget for 2009 were used. The most significant revision as compared with the fiscal assumptions used in the previous Inflation Report is due to the reconfiguration of the scenario on the projected path of economic activity. Under the circumstances and taking into account the fiscal policy conduct throughout 2008, the fiscal impulse for 2009 is anticipated to exert contractionary effects on economic activity. For 2010, the insufficient data available so far, in the context of major uncertainties regarding the projected economic growth, point to a fiscal policy stance exerting a relatively neutral impact on the output gap.

1.4. Risks associated with the projection

As already mentioned in the previous sections, the baseline scenario of the projection is subject to a wide range of uncertainties, whose impact on the dynamics of the macroeconomic variables is not easy to quantify explicitly given the objective difficulties of assessing the likelihood of occurrence of such a broad spectrum of conceivable events. Out of the possible events, this section focuses on those that are deemed to have a higher likelihood to occur in the upcoming eight quarters. To sum up, risks to inflation are deemed to be relatively balanced around the trajectory of the indicator in the baseline scenario.

According to the latest survey on lending to corporations and households[65], financing standards and lending terms and conditions for both categories of operators continued to deteriorate during 2008 Q4. As a side effect of the protracted or even stronger adverse impact of the global financial crisis, one of the risks deemed as relevant over the projection horizon concerns a higher-

[65] NBR, Survey on lending to non-financial corporations and households, 2008 Q4.

than-anticipated increase in financial institutions' financing costs. Under these circumstances, economic agents' lower propensity to taking bank loans might be accompanied by financial institutions' increased reluctance to engage in lending activity, being perceived in the new environment as entailing a higher degree of risk. Such behaviour could seriously affect economic activity in sectors that are heavily reliant on financing via credit[66].

Without support from macroeconomic policies, the materialisation of this risk would entail a sharp downward correction of the dynamics posted by aggregate demand and supply components, which would bring the economy close to a scenario with more sizeable adjustments of the domestic and external imbalances. As a result, economic growth might witness a downward deviation from the baseline scenario trajectory, while inflation could deviate upwards in relative terms[67].

Risk sources related to the assumption[68] of an orderly current account deficit financing could emerge from: (i) the fiscal policy coordinates throughout the projection, (ii) additional difficulties in ensuring the timely and cost-effective financing of the private sector's external debt (short-term debt in particular), as well as (iii) the unavoidable contraction in FDI inflows and hence the need for a sizeable correction of the trade deficit. Given the keener competition for preserving external market shares, a persistent or even wider gap between real wages and productivity witnessed by the exporting companies[69] would be difficult to be covered by more favourable export prices (as a result of a weaker domestic currency compared to the November 2008 Inflation Report). Against this background, the cutback in exports could coincide with the contraction – already forecasted in the baseline scenario – in external demand for Romanian products, thus shaping a more pessimistic scenario of economic growth. If the higher corporate costs were to be passed on to retail prices (needed to prevent the narrowing of corporate profit margins), the effects on inflation might prove unfavourable compared to the baseline scenario.

Adjusting macroeconomic imbalances and/or minimizing the likelihood of their widening over the projection horizon require the coordination of macroeconomic policies, particularly of the

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66 Services, industry and construction are the institutional sectors accounting for the largest share of credit to the private sector.

67 Investors' increased risk aversion, together with a conceivable disorderly adjustment of macroeconomic imbalances, would make the adverse shocks affecting real economy spill over to a weaker domestic currency and hence to stronger inflationary pressures which would thus offset the disinflationary effect of lower aggregate demand.

68 In the baseline scenario.

69 The annual dynamics of EUR-denominated unit labour costs in industry posted successive rises during 2008, thus signalling deterioration in the export competitiveness of Romanian products.

fiscal and income ones with monetary policy. In addition, the mix of macroeconomic policies should also be predictable such as to provide efficient support to anchoring economic agents' expectations. A less restrictive fiscal policy stance compared to the baseline scenario coordinates, insofar as it poses problems related to budget deficit financing, could translate into fiercer competition between the public and private sectors for attracting the available financing resources. Taking into account the projected autonomous reduction in total financing sources under the impact of the financial crisis, the fiscal authority stance would be partially tantamount to a crowding-out of the private sector, also entailing, *ceteris paribus*, a relative deterioration of external equilibriums versus the baseline scenario coordinates.

Many of the outcomes projected in the baseline scenario are conditional upon both the duration and magnitude of the direct and indirect effects of the global financial crisis on the domestic economy. Although it seems quite unlikely at this point in time, an alternative scenario – in which the aftermath of the crisis is considerably milder and/or dissipating at a faster pace – cannot be entirely ruled out. Under such a scenario, amid investors' improved risk perception and assuming a faster rebound in external demand for Romanian products, the correction of external imbalances might be achieved in a more sustainable manner, benefiting also from an enhanced predictability of the future dynamics of financing sources.

As a side effect, the lower magnitude of the contraction in domestic aggregate demand – in line with achieving the new macroeconomic balances – would be reflected by a more favourable scenario regarding GDP dynamics[70]. Last but not least, lower volatility of the domestic currency would substantially diminish economic agents' propensity to fully transfer currency risk onto retail prices of goods and services, thus helping inflation rate to converge downwards.

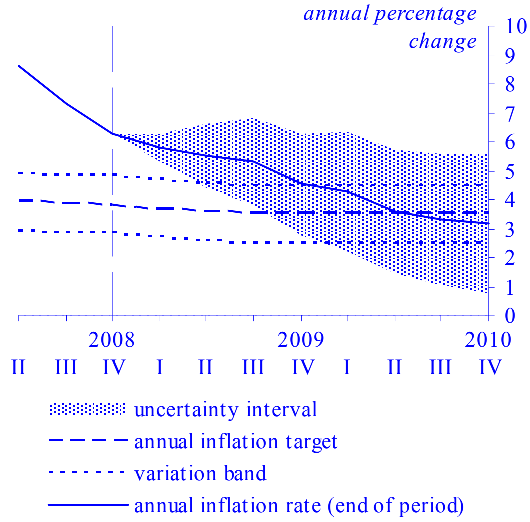
Similarly to the previous Inflation Reports, there is a persistent risk of a slippage in the exogenous dynamics of administered prices from the baseline scenario coordinates (see Subsection *1.2. Exogenous inflationary pressures* for a comparison between the current scenario and that included in the November 2008 Inflation Report). Moreover, fuel prices could diverge from the trajectory shown in the baseline scenario, given that oil price dynamics might come under the impact of a wide array of factors. They may relate either to less predictable changes in the future oil

[70] This would occur amid the removal of constraints associated with the low level of financial intermediation, thus fostering new investment projects.

supply of the main producers[71] or to demand dynamics deviating from the baseline scenario coordinates.

The chart illustrates the uncertainty interval around the central projection of inflation (in the baseline scenario) for the current round. The interval should be interpreted as an average value of possible deviations of the inflation outcome in both directions from the trajectory set in the baseline scenario, under the impact of certain factors that are not explicitly quantified. The impact of these risk factors is deemed to be approximated by an average of past projection errors.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR calculations

2. Policy assessment

In view of recent macroeconomic developments and the medium-term inflation forecast, still surrounded by unusually high uncertainties arising from the deeper and more protracted global financial crisis, the objective to bring inflation back and keep it onto a path compatible with attaining the medium-run inflation target poses further a challenge to the central bank. One of the difficulties that the monetary authority will have to overcome in the period ahead is the potentially adverse impact on expectations after the annual inflation rate stayed, in 2008 too, above the upper limit of the variation band around the central target for December, i.e. 3.8 percent ±1 percentage point. However, the steady deceleration in annual inflation rate during 2008 Q4 to a level lower than that seen in 2007 Q4 (6.30 percent as against 6.57 percent) could provide an underpinning in this respect.

Nevertheless, the complex and intricate nature of the context for monetary policy implementation arises mainly from the need for an orderly correction of macroeconomic imbalances (soft landing), which had already been initiated in 2008 following the broadening of the economic and financial crisis at a global level, so as to prevent a massive, lengthy contraction in economic activity and the purchasing power of the domestic currency (hard landing) that would adversely affect the growth potential of the Romanian economy in the medium and long term.

Starting from such prerequisites that imply a certain monetary policy configuration and from assumptions deemed as the most likely to manifest in the current context, the updated baseline scenario reveals a slight improvement of the inflation outlook in the first part of the projection horizon, followed by a relative slowdown in the consolidation of disinflation during 2010.

[71] Assuming a given scenario regarding developments in demand for oil, the coordinated production of OPEC members aimed at limiting the available supply could trigger more sizeable rises in the price of oil.

The annual inflation rate is expected to return to the variation band around the central target in 2010 Q1, the same as in the previous projection.

The slight downtrend in the annual inflation rate trajectory projected for 2009 compared to the previous forecast is due to the pronounced deceleration in the projected pace of economic growth this year and, implicitly, a faster and wider opening of the negative output gap than its potential level. The major hypothetical prerequisites and reasons behind the short-term emergence and increase of aggregate demand shortfall, a development reflecting mainly the relatively swift spillover of the global economic crisis fallout, are the following: (i) weaker-than-expected annual GDP dynamics in 2008 Q3, (ii) sharp decline in the year-on-year dynamics of some relevant indicators on external and domestic demand and, implicitly, on supply; (iii) significant tightening of lending conditions on foreign financial markets, but especially on the domestic market as a result of the substantial cut in loan supply; (iv) emergence and intensification of layoffs, entailing a rise in unemployment; (v) the presumed corrective strengthening of fiscal and income policies.

The economic growth forecast continues nevertheless to be afflicted by extremely large uncertainties, the most significant being the outlook for economic activity and market sentiment in the EU, particularly in the euro zone, given that the domestic economy has recently proved unexpectedly receptive to the effects of the deepening crisis in these countries. Thus, assuming a continued revision of the forecasts of European advanced economies to incorporate the deepening and protraction of expected recession, amid the persistence of unfavourable investor sentiment on the evolution of economic fundamentals in Romania – arising also from the two sovereign rating downgrades –, the economic slowdown could be more severe and the magnitude of the negative output gap could be larger.

Export dynamics, on the one hand, and the cost and volume of external financing available to local credit institutions, on the other, will remain the key channels whereby the fallout of the deeper recession across the euro zone will affect the domestic economic activity. In the near run, the “volume effect” on exports exerted by flagging external demand is expected to be stronger than the potentially expansionary impact from the recent weakening of the leu versus the euro. In addition, the ensuing contractionary impact on economic activity could be enhanced by the large size of export-oriented sectors in the process of rescaling and their capacity to give rise to adverse ripple effects across manufacturing. At the same time though, given the specific resilience, the decline in export growth will be accompanied by a slowdown in import dynamics, which might be augmented, possibly with a certain time lag, by a substitution effect arising from the protracted domestic currency depreciation.

The second channel will further affect largely the domestic component of aggregate demand and will translate basically into a credit crunch; a potentially faster compression of forex loan supply might strengthen the role played by interest rate within the monetary transmission mechanism and implicitly boost monetary policy efficacy in the future. The restrictive impact of external financing could however contradict unfavourable expectations assuming that parent undertakings, which account for most of the Romanian banking system's external liabilities, will opt for an almost entire rollover of their domestic investments coming to maturity in the period ahead.

Against this background, an important factor depressing future lending appears to be banks' cautiousness regarding the short-term outlook for the economy and their significantly deteriorated perception of risk associated with household and corporate loans. This has already been manifest in the substantial tightening of lending terms and conditions, their easing in the coming period being highly unlikely, although the central bank has recently revised the provisions on lending requirements on mortgage-backed loans extended to households; in this context, the current tightening of broad monetary conditions appears to be higher than that reflected by interest rates, exchange rate and required reserves.

In what regards the demand for loans, especially household demand, the most relevant factors that will continue limiting the advance of credit to the private sector are the following: (i) high lending rates, (ii) the recent marked depreciation of the domestic currency and the increased volatility and unpredictability accompanying the exchange rate of the leu, (iii) the worsening of expectations on incomes amid retrenchment in some sectors and resumption of the rise in unemployment, and (iv) the decline in borrowers' indebtedness capacity.

It is expected that the impact of the sizeable slowdown in lending to be further reflected particularly in the flagging consumer demand. It should be pointed out that, during the first part of 2008 Q4, a close correlation between the halt in credit expansion and the abrupt decline in private consumption indicators dynamics was manifest, despite the still relatively fast-paced wage growth year on year. The possible cut in consumption propensity – as suggested by these developments –, albeit beneficial for the adjustment of macroeconomic imbalances, will most likely be enhanced by the balance sheet effect of interest rates on loans in progress and that of a weaker leu.

Such effects will also depress the current and investment activity of companies and, in an indirect manner, the state of the banking system. Thus, the likelihood of bank debt servicing to exceed the repayment capacity of some debtors, individuals and perhaps companies as well, is further rising, posing substantial risks to banks' loan portfolio quality and possibly to their solvency indicators. The latter could also be adversely affected by the recent excess increase in interest rates on leu-denominated deposits as well as on interest rates on loans in domestic currency performed by credit institutions that rely heavily on external financing.

Nevertheless, investment dynamics may prove more resilient to the contractionary impact of credit developments assuming the persistence of the dynamics of foreign direct investment in the first part of Q4, along with that of external borrowings granted to non-banks. This domestic demand component will also be supported by the potential materialisation of the authorities' intention to increase sharply spending on public investment and to expand the volume of absorbed EU funds.

The multiplication effect of such investment could mitigate the adverse effect on domestic demand as a result of the envisaged significant decline in private sector wage dynamics and of the planned curtailment of government spending on wages and purchases of goods and services. The tight fiscal and income policy, which is expected to translate into a substantial narrowing of the budget deficit and implicitly of the saving-investment gap, is a *sine qua non* prerequisite for minimising social and economic costs associated with the adjustment of macroeconomic imbalances in an adverse global environment afflicted by a severe, protracted economic and financial crisis.

A potential delay of fiscal correction – as a result of stronger pressures from budgetary-sector trade unions – would lead to an expansion in the magnitude, duration and costs attached to macroeconomic adjustment in case of foreign investors' persisting wariness in regard to Romania's economic prospects. In the near run, such an option would have adverse effects, i.e. higher demand-pull inflationary pressures, worsening inflation expectations, less available and costlier budget deficit financing, as well as a steadily weaker domestic currency that might pose major threats to financial stability.

In fact, even assuming a tighter fiscal policy and a sizeable slowdown in economic growth, disinflation is expected to be further stymied by the persistent nature of inflation and lingering unfavourable inflation expectations. Such anticipations will primarily be fuelled by the recent depreciation of the domestic currency and the still highly volatile exchange rate against the backdrop of a continuing rise in risk aversion and worsening investor sentiment as regards the outlook for the economies in the region.

Considering the updated macroeconomic medium-term inflation forecast coordinates as well as the complexity associated with the numerous uncertainties, the NBR Board has decided to lower the monetary policy rate by 0.25 percentage points to 10 percent per annum in its meeting of 4 February 2009. Moreover, it has decided to continue to pursue an adequate management of liquidity in the banking system through the active use of open-market operations with a view to reducing market segmentation and dampening interest rate volatility, and to leave unchanged the existing minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. Against this background, the NBR Board has restated that achieving an orderly unwinding of macroeconomic imbalances in the near run and fulfilling the objective of price stability in the medium term require a rapid adjustment in the consistency and credibility of the macroeconomic policy mix and the speeding-up of structural reforms.