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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.

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

Foreword

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

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

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

Inflation Report was completed on 4 May 2009 and approved by the NBR Board in its meeting of 6 May 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
IFI	International financial institutions
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 2009 Q1, the 12-month CPI inflation rate stood at 6.71 percent, up 0.41 percentage points from 6.3 percent at end-December 2008. The faster dynamics of consumer prices were largely due to the effects of the sizeable depreciation of the domestic currency during the first quarter of 2009 following the worsening of investor sentiment relative to the vulnerabilities and prospects of Central and East European economies in the context of a deeper global financial and economic crisis.

The inflation rate was adversely affected mainly by supply-side factors. Volatile prices of certain food items grew at a significantly quicker pace in 2009 Q1. Fuel prices and administered prices were impacted by the weaker leu, but the impact on the latter category was mitigated by the slowdown in the annual growth rate of natural gas price. A favourable influence on inflation came from the protracted effects of bumper crops in 2008 on the prices of processed food items included in the CORE2 basket.

Unit labour costs in industry increased noticeably in 2008 Q4, this evolution continuing, albeit at a relatively slower pace, into January-February 2009, owing to the sharp decline in productivity. The additional deterioration of unit labour costs adds to upward pressures on producer prices. In the near run, such pressures are mitigated to a certain extent by the drop in external and domestic demand amid the economic turmoil.

In March, annual CORE2 inflation outpaced headline inflation, largely on the back of the considerably faster increase in prices of tobacco products as a result of higher excise duties. By contrast, adjusted CORE2 inflation (6.2 percent), which excludes prices for tobacco products and alcoholic beverages, stood below CPI inflation, slightly lower when compared to December 2008. A further fall in adjusted CORE2 inflation rate was prevented by the impact of the weaker domestic currency on import prices and the persistence of high inflation expectations. This impact offset the favourable effects from processed food price dynamics and the disinflationary pressures arising from the negative output gap which emerged in 2008 Q4 and is expected to have increased in 2009 Q1.

In 2008 Q4, economic growth slowed down sharply owing to the rapidly expanding fallout from the global crisis on the Romanian economy via the foreign trade and financial channels. The annual pace of GDP growth decelerated to 2.9 percent from 9.1 percent in 2008 Q3, wiping out the excess demand from previous quarters and causing GDP to fall below its potential level. GDP dynamics remained in positive territory due to the positive contribution of net exports – for the first time since 2002 – triggered by the pronounced decline in imports and the moderate rise in exports over the same year-ago period. By contrast, domestic demand contributed negatively to growth, with final consumption contracting for the first time in eight years and the dynamics of gross fixed capital formation severely losing momentum versus the previous quarter. The falling domestic demand reflects, on the one hand, the markedly slower rise in own and borrowed financing resources available to companies and households, and, on the other hand, a stronger saving propensity amid downward revised expectations concerning future incomes, given the uncertainties generated by the economic crisis.

Monetary policy since the release of the previous Inflation Report

On 4 February 2009, the National Bank of Romania Board decided to lower the monetary policy rate by 25 basis points to 10 percent per annum. On the one hand, the easing of the monetary policy was driven by the ongoing reduction in inflation rate in 2008 Q4 and the clear signals of a substantial slowdown in economic growth and the emergence of a negative output gap which is expected to widen in the near run. On the other hand, the cautiousness of the move was motivated by the still high persistence in inflation and inflation expectations amid the strong downward pressures on the domestic currency at the turn of the year, which could also have detrimental effects on the servicing of loans denominated in foreign exchange.

Subsequent to this decision, the financial crisis increasingly affected the global real sector, with effects spilling over to the Romanian economy faster than before. After the release of fourth-quarter statistical data confirming the marked slowdown in annual GDP advance, short-term indicators on economic activity in 2009 Q1 continued to indicate a persistently bleak outlook for economic growth.

The annual inflation rate followed an upward path in January and February, notwithstanding the sharp slowdown in economic growth. Such evolution pinpoints not only the challenges to monetary policy in a domestic and external environment fraught with major uncertainties, but also the need for cooperation from the other components of the macroeconomic policy mix in order to restore macroeconomic equilibria. Supply-side shocks, especially the weaker leu and the front-loaded implementation of the hike in excise duties on tobacco products, had a major contribution to the step-up in inflation. However, the lagged effects from last year's lax income policy and the abrupt widening of the budget deficit in 2008 Q4, along with larger current expenditures in early 2009, are very likely to have contributed to a relatively low sensitivity of inflation to the economic slowdown. Such effects added to the influence of structural rigidities on the labour market, which led to industry-wide higher unit labour costs against the backdrop of a noticeable fall in output.

Significant uncertainties pertaining to the duration and magnitude of the global economic crisis weigh upon the assessment of domestic macroeconomic outlook. In this vein, an important issue is the magnitude of the crisis fallout on the dynamics of aggregate demand and potential GDP, making the size of the negative output gap and the strength of the ensuing disinflationary pressures difficult to assess. In addition, in the course of 2009 Q1, foreign financial market volatility and investors' risk aversion both regionally and internationally still generated uncertainties as to the future path of the exchange rate of the leu.

Against this background, in its meeting of 31 March 2009, the NBR Board opted for retaining a prudent monetary policy stance, capable of fostering the ongoing controlled adjustment of the current account deficit towards sustainable levels in the longer term and the convergence of inflation rate towards the announced medium-term targets, along with ensuring financial stability. For this purpose, the NBR Board decided to maintain the monetary policy rate at 10 percent per annum. It also decided to reduce the minimum reserve ratio on credit institutions' foreign-currency-denominated liabilities with residual maturities of more than two years to zero from 40 percent starting with the 24 May – 23 June 2009 maintenance period. The measure was aimed at paving the way for reviving sustainable financing of the Romanian economy, as well as at achieving further alignment of the required reserve mechanism to ECB standards in the field.

During 2009 Q1, the National Bank of Romania's creditor position vis-à-vis the domestic banking system strengthened, with the central bank gradually accommodating banks' stronger demand for reserves and making active recourse to open-market operations, in particular to repo transactions. Through such transactions the monetary authority was able to perform an adequate liquidity management, which allowed both the avoidance of excessive exchange rate volatility and a smooth functioning of the interbank money market, concurrently with a relative convergence and stabilisation of interbank rates around the policy rate. At the same time, the central bank's operations resulted in improved liquidity in the banking system given the increase in banks' holdings of government securities, which in turn boosted government credit, thus countering part of the anticipated and already manifest contraction of credit to the private sector.

For 2010, the inflation target was set at 3.5 percent ±1 percentage point, thus confirming the working assumption used in the February 2009 Inflation Report.

Inflation outlook

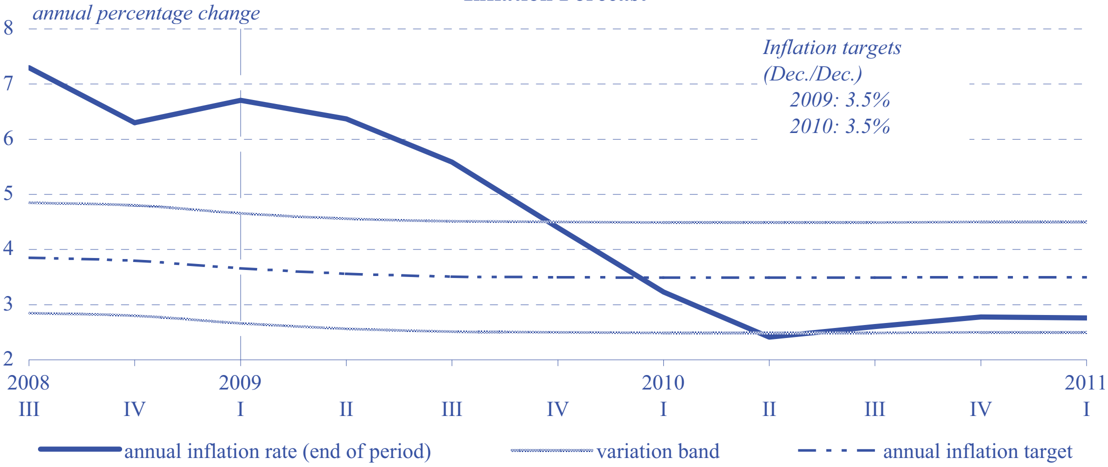
In 2009 Q1, the Romanian economy remained in the grip of the global financial and economic crisis. Similarly to the previous forecast, the uncertainties related to the duration and the magnitude of the crisis pose difficulties in projecting its short- and medium-term impact on domestic macroeconomic developments. Nevertheless, recent developments hint at a relative alleviation of the inflationary risks associated with a less orderly than envisaged adjustment of macroeconomic imbalances.

Given the substantial downward adjustment of the trade and current account deficits starting in 2008 Q4, the weakening of depreciation pressures on the domestic currency in the latter half of 2009 Q1 indicates a relative stabilisation trend for the exchange rate, in line with the correction of external imbalances. This trend became more pronounced after the conclusion of the IMF and EU-led multilateral financial package aimed at pre-emptively ensuring the sustainability of official reserves, given declining private capital inflows for the economy. This multilateral financing package led to a relative improvement in financial investors' sentiment as regards Romania's sovereign risk.

Under such conditions, the balance of risks associated with the current projection, while largely remaining in equilibrium, implies a moderately higher likelihood of inflation deviating downwards, rather than upwards, from the baseline scenario.

For end-2009, the baseline scenario of the current projection places the annual inflation rate at 4.4 percent, a level close to that published in the February 2009 Inflation Report (4.5 percent). For end-2010, inflation is forecasted to fall to 2.8 percent, i.e. below the central target (3.5 percent), as well as the previously forecasted figure (3.2 percent).

Inflation Forecast



Note: Variation band is ±1 percentage point around the central target
Source: NIS, NBR calculations

As far as end-2009 is concerned, maintaining the forecast for the inflation rate close to the level published in the previous Inflation Report mainly comes through as the result of reassessing the effects of the dynamics of exchange rate and aggregate demand, which are expected to partially offset each other throughout the year. The persistence of domestic currency depreciation in 2009 Q1 at a faster pace than that incorporated in the prior forecast had detrimental effects on the projections of import prices, fuel prices and administered prices. Such effects are augmented by inertial inflation expectations in the first part of the projection horizon. By contrast, the considerable slowdown in economic growth over the past two quarters translated into projecting a wider demand shortage than in the previous forecasting round over the entire horizon. The resulting disinflationary pressures on CORE2 inflation are foreseen to counter any opposite effects on the projected consumer price dynamics in 2009.

For 2010, the projection of a CPI inflation rate 0.4 percentage points lower than that released in February is substantiated by the prevalence of anticipated effects from the demand shortage and a sustained downtrend in inflation expectations.

The conduct of monetary policy will aim at safeguarding the balance between the objective of repositioning the inflation rate inside the variation band around the central target and that of ensuring its sustainability via the ongoing orderly adjustment of macroeconomic disequilibria and maintaining financial stability. The forecast envisages the inflation rate to re-enter the variation band around the central target in the final quarter of 2009. For the growth rate of consumer prices to remain close to the projected path, future developments in exogenous factors should not deviate significantly from the baseline scenario projection coordinates and monetary policy should enjoy adequate support from the other components of the macroeconomic policy mix.

Considering that the developments in exchange rate and aggregate demand are the main drivers of projected inflation, the major risks associated with the current forecast are linked to their future dynamics. Knock-on effects from the global crisis emerging at a different intensity than that envisaged in the baseline scenario would involve deviations from the projected levels of exchange rate and economic growth. In the near run, owing to the typical reaction of foreign investors in emerging economies, the crisis might bring about more severe effects via sharper leu depreciation and weaker GDP growth, while faster recovery of economic activity may lead to opposite-direction deviations from the baseline scenario.

The risks of a less favourable than anticipated evolution may be induced particularly by external shocks that could interfere with the orderly adjustment of macroeconomic imbalances. Such external causes, contingent upon the future developments in the global crisis, could be enhanced by domestic factors such as an insufficient coherence and time consistency of macroeconomic policies, as well as the persistence of rigidities on the labour market and in the price-setting behaviour. Nevertheless, the identified risks appear to be significantly mitigated against the previous forecasting round, following the sustainability of external financing resources made available by the multilateral financing arrangement with the IMF and the EU, and the coherent macroeconomic and structural policy mix to be implemented under the terms of the said agreement.

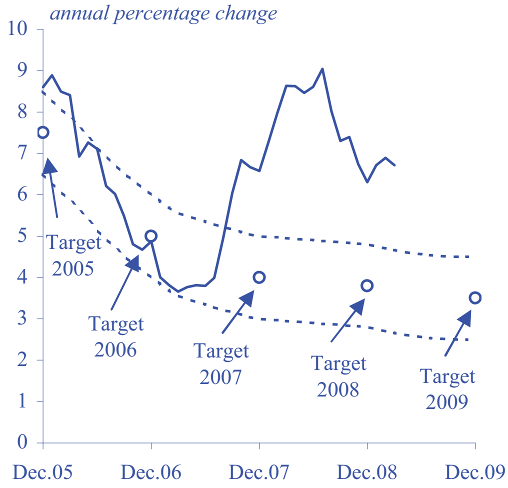
The risks usually associated with the evolution of oil and other commodity prices, administered prices and volatile food prices are deemed as relatively symmetrically distributed around the forecasted path of CPI inflation in the baseline scenario.

Monetary policy decision

Considering the improvement in the medium-term inflation forecast and the prospects of an ongoing orderly adjustment of the external imbalance amid the implementation of economic policy measures agreed under the arrangement concluded with the IMF and the EU, the NBR Board has decided in its meeting of 6 May 2009 to lower the monetary policy rate by 50 basis points to 9.5 percent per annum. Moreover, it has decided to continue to actively use open-market operations in order to ensure an adequate management of liquidity in the banking system and to leave unchanged the current minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. On March 31, 2009 the NBR Board had decided to cut to zero the minimum reserve ratio on foreign currency-denominated liabilities with residual maturities of over two years, starting with the May 24 – June 23, 2009 maintenance period. In this context, the NBR Board reiterated that the consolidation of disinflation and of financial stability requires the firm and consistent implementation of the economic – monetary, fiscal and income – policy mix as well as of the agreed structural reforms.

II. INFLATION DEVELOPMENTS

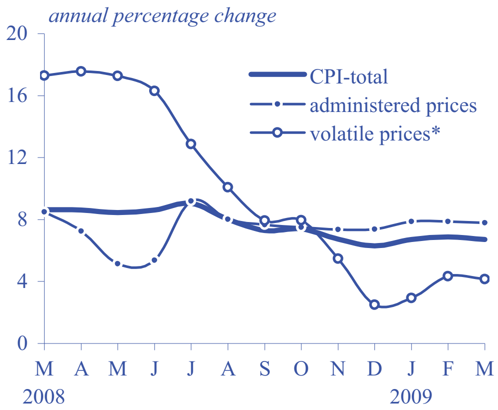
Inflation Developments



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

Source: NIS, NBR calculations

Inflation Rate, Administrative Prices and Volatile Prices



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

Source: NIS, NBR calculations

At the end of 2009 Q1, the 12-month inflation rate stood at 6.71 percent, as its downward trend manifest in the second part of the previous year was discontinued. The 0.41 percentage point acceleration in the annual growth rate of consumer prices versus December 2008 was primarily due to the depreciation of the domestic currency, by means of euro-denominated prices and imports, as well as following the change in the exchange rate used for calculating excise duties and medicine prices. Additional contributions to this development had the rise in crude oil prices on the international markets and the announced front-loaded implementation of the hike in excise duties. Moreover, the shock induced by the weakening of the national currency was (including via the expectations channel) an essential factor in putting a brake on the disinflation manifest in adjusted CORE2 inflation starting 2008 Q3, in spite of more numerous signals on the contraction in consumer demand and further favourable influence exerted by last year's output on agri-food prices.

Unlike the previous quarters, when volatile prices acted as a disinflation factor, in the first three months of 2009, they put a significant pressure on inflation (+1.7 percentage points versus December 2008 to 4.2 percent at the end of 2009 Q1). More specifically, most prices in this category posted faster annual growth rates under the influence of multiple factors. Food prices went up, owing to the insufficient output of potatoes and more expensive related imports, to which added the unfavourable base effect on eggs prices. Fuel prices rose primarily as a result of the updated exchange rate used for calculating excise duties[1] and the resumption of the upward trend in oil prices on foreign markets[2]; however, the pressures exerted by other price items (mainly, the introduction of Euro 5 standard and the pick-up in excise duties in euro applied to unleaded petrol and diesel oil) cannot be overlooked.

Tobacco product prices contributed markedly to the faster increase in annual inflation, their contribution being comparable to that of volatile prices, in spite of their obviously smaller share in the consumer basket. The impact of this group of prices was heightened by the changes in the related excise duties, namely the front-loaded implementation of the hike in the excise duty in euro and the update of the exchange rate used for the conversion into leu. Although the decision on earlier implementation of the calendar for increasing excise duties does not refer to Q1, the hikes following to be applied

[1] From RON/EUR 3.3565 to RON/EUR 3.7364 (the exchange rate valid on 1 October 2008, as published by the European Central Bank).

[2] From USD 35.82 per barrel (Europe Brent Spot, fob) at end-2008 to a maximum level of USD 51.89 per barrel on 26 March 2009. Source: EIA.

in two stages, namely in April and September (each time by EUR 7/1,000 cigarettes), during the period under review producers started to gradually raise prices reflecting the announced measure even before its coming into force. Under the impact of the two factors mentioned before, the annual growth rate of tobacco product prices rose to 18.9 percent in March (+5.2 percentage points versus December 2008).

As concerns administered prices, the change in the annual dynamics was comparable in terms of size but of opposite sign to that seen in the previous quarter (+0.4 percentage points to 7.8 percent in March). Relatively flat developments were recorded during the quarter under review, given that the accelerated dynamics of medicine prices, prices of telephony services, and to a lesser extent, prices for heating and electricity were offset by the significant deceleration in the annual growth rate of natural gas price which has been left unchanged since July 2008. Behind the increase in the annual dynamics of the afore mentioned components stood the development in the exchange rate (telephony), the update of leu/euro exchange rates used for calculating medicine prices and excises, the rise in the excise duty in euro applied to electricity, regular price corrections by heating providers.

In view of the shock that hit tobacco products, the analysis of core inflation calls again for the use of adjusted CORE2[3]. The elimination of signal distortions induced by the change in excise duties led to an annual rate of increase relatively unchanged (6.2 percent in March), with a progress of only -0.1 percentage points in the first three months of 2009. The only factor supporting disinflation was the foodstuff group (except for food items with volatile prices) with annual growth rates decelerating further to a level about 1 percentage point lower at end-March than at end-December 2008, owing to the favourable impact of vegetal output recovery on producer costs incurred by producers of edible oil, milk and milk products, milling and bakery products.

Opposite influences came from non-food prices (+0.21 percentage points) and particularly from prices of services included in adjusted CORE2 (+1.2 percentage points). The main culprit for the performance of both components was the exchange rate change, the type of prevailing effect (direct on the services segment and indirect on non-food items) accounting largely for the different reaction of consumer prices. Thus, in the case of services, the accelerating trend in the annual dynamics of prices was induced by those components with prices pegged to the euro (particularly telephony and rents), while the other components in this group were dampened by the falling demand. As concerns non-food items, faster increases in prices saw the products in those sub-groups coming mainly from imports (household appliances, home

[3] Tobacco products and alcoholic beverages are excluded from CORE2.

Administered Prices versus Market Prices

annual percentage change; end of period

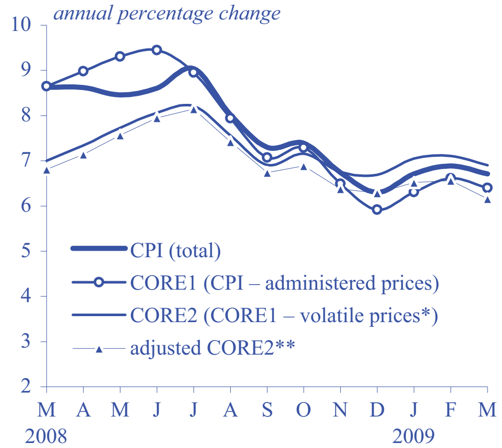
	2008				2009
	I	II	III	IV	I
Inflation Rate	**8.63**	**8.61**	**7.30**	**6.30**	**6.71**
Administered prices*	**8.50**	**5.37**	**7.67**	**7.38**	**7.78**
1. Non-food items*:	**4.20**	**2.79**	**8.31**	**7.60**	**7.64**
electricity	4.16	0.00	4.51	4.51	4.76
heating	5.86	6.04	6.04	10.10	11.95
natural gas	12.39	12.39	26.47	22.01	12.53
medicines	-4.22	-3.49	-1.51	-2.50	4.56
2. Services*, of which:	**16.71**	**10.36**	**5.81**	**6.73**	**7.93**
water, sewerage, waste disposal	11.98	11.15	12.58	12.55	12.79
fixed telephony	10.45	13.25	-0.34	2.08	5.73
passenger railway transport	16.54	8.15	0.00	0.00	0.00
(passenger) city transport	11.13	9.12	9.10	8.15	7.99
Market prices (CORE1)	**8.65**	**9.45**	**7.07**	**5.92**	**6.40**
CORE2**	**7.00**	**8.06**	**6.91**	**6.69**	**6.90**
CORE2 less tobacco, alcohol	6.80	7.95	6.74	6.29	6.16
tobacco, alcohol	9.05	9.19	8.65	11.04	14.95

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

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation

annual percentage change



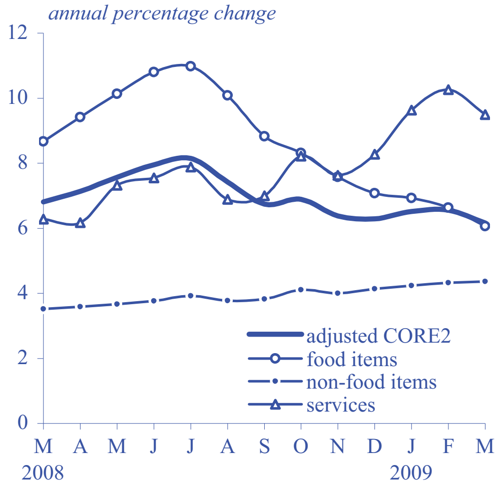
*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

Source: NIS, NBR calculations

Adjusted CORE2

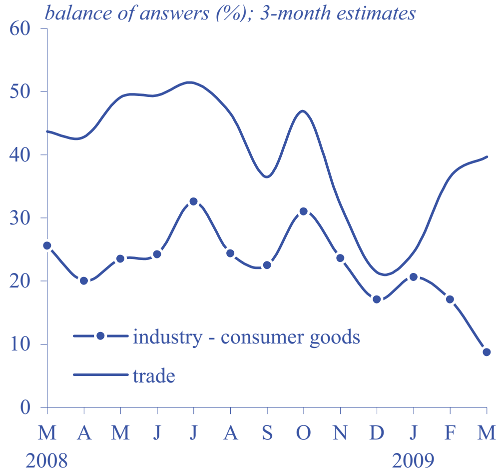
annual percentage change



Source: NIS, NBR calculations

Inflation Expectations of Economic Agents

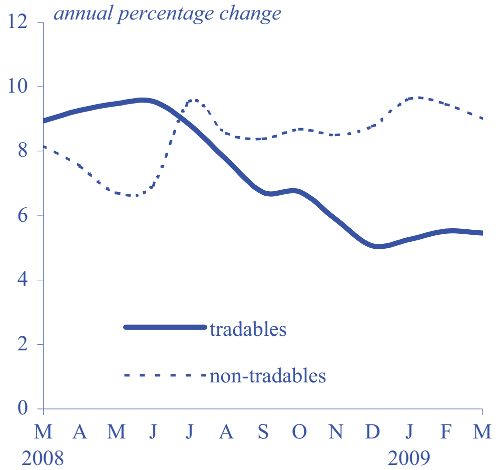
balance of answers (%); 3-month estimates



Source: DG ECFIN

Tradables and Non-tradables Prices

annual percentage change



Source: Eurostat, NBR calculations

electronics, skincare and body care products, chemicals) or whose prices are expressed directly in euro (motorcars); however, the more moderate response to exchange rate movements is associated with the drop in consumer demand – the main culprit, as a matter of fact, for the modest evolution recorded by prices of the other non-food items – and with the decline in import unit value. Nevertheless, mention should be made that producers' possibility/willingness to react to the outlook of further unfavourable sales dynamics via price adjustments was contained by labour cost pressure amid a pronounced cyclical decline in labour productivity and by the shock on supply as a result of difficulties encountered when financing production activity (more frequent payment arrears, less readily available credits, higher related costs).

In spite of an increasingly obvious downtrend in consumption, during the period under review, inflation expectations of trading companies followed a steadily upward path, adding to the factors that put a brake on disinflation. The totally opposite development in manufacturing and the significant role of imports in meeting domestic consumption show how exchange rate volatility came to modify retailers' sentiment compared to the last three months of 2008.

Unlike 2008 Q3-Q4, when the annual growth rates of tradables and non-tradables prices recorded diverging trends, the shocks generated in 2009 Q1 by the leu depreciation and the administrative measures adopted or announced in the first months of 2009 led to faster paces of increase on both segments (by 0.4 percentage points and 0.2 percentage points respectively compared to end-2008). The difference between the two annual dynamics (5.5 percent and 9 percent), accounted for by the incidence of international competitive pressures in the tradables sector, remained at a level comparable to that seen in December 2008.

From the standpoint of the nominal convergence criterion relative to inflation[4], during the reviewed period, the gap widened steadily to reach 4 percentage points in March (compared to 3.8 percentage points in December 2008), the slight disinflation in the 12-month average of HICP inflation in Romania notwithstanding. This performance was due to (i) the stronger reaction of consumer prices in Western European states to the drop in commodity prices and the slowdown in the economic activity, which has become more pronounced starting mid-2008; (ii) a favourable base effect seen in one of the three benchmark countries, following the hike in VAT in 2007, and also to (iii) the absence of shocks triggered by exchange rate developments. The gap between the 12-month average of HICP inflation in Romania and the 12-month average

[4] 1.5 percentage points above the average of the three best-performing EU Member States in terms of price stability (assessed on the basis of the 12-month average of HICP inflation).

of HICP inflation in EU-27 posted a similar development, reaching 4.4 percentage points in March, i.e. 0.2 percentage points higher than that seen in December 2008.

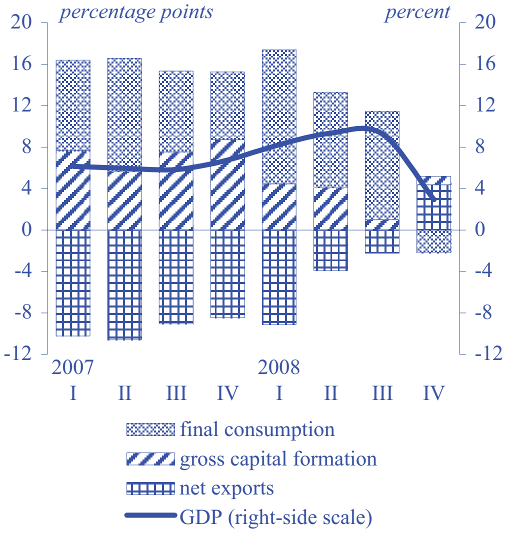
In March 2009, the actual annual inflation rate was 0.9 percentage points above the projection in the February 2009 Inflation Report. The deviation was due mainly to the difficulties encountered in estimating the un-modellable elements incorporated in the forecast (volatile prices and prices subject to administrative decisions), with the gap narrowing to 0.1 percentage points at the level of adjusted CORE2. Thus, the factors making the largest contribution to the deviation of the actual annual inflation rate from the projected figures were (i) the significant increase in medicine prices, following the updated exchange rate used for their calculation (the measure was announced subsequent to the projection and its anticipation was impossible, given that over the past four years the average monthly change in medicine prices was slightly negative); (ii) the expectations of changes below the actual figures for tobacco products, to the impact of changing the conversion rate of excise duties into leu adding that of earlier-than-planned price adjustments made by producers in the field, as a result of the announcement on the front-loaded implementation of the hike in excise duties (following the decision adopted in March by the Ministry of Public Finance); (iii) the underestimation of rises envisaged for fuel prices, as their development came under the influence of a host of factors (previously mentioned) in 2009 Q1.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

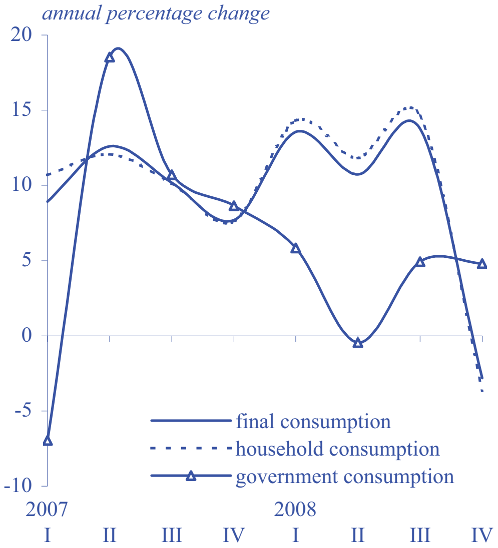
In 2008 Q4, amid the deepening economic and financial crisis, the decline in demand both domestically and internationally affected markedly the evolution of real gross domestic product, the annual dynamics of which came in at 2.9 percent[5], i.e. less than one third of the advance seen in the previous quarter. This deceleration outpaced that implied by the 6 percent benchmark projection made in December 2008.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

Actual Final Consumption



Source: NIS

1.1. Demand

The slowdown in the annual dynamics of GDP in the final quarter of 2008 was attributed solely to the 1.3 percent contraction in domestic absorption, whereas the net export of goods and services made a positive contribution to economic growth (a performance no longer recorded since 2002).

1.1.1. Consumer demand

For the first time in eight years, final consumption saw a drop in terms of volume (by 2.8 percent), due solely to household consumption, while government consumption rose at a pace similar to that seen in Q3 (4.8 percent).

Household consumer demand

In Q4, private final consumption declined by 3.7 percent mainly as a result of the 2.8 percent fall in retail purchases of goods and services, which were affected by the slowing dynamics of household financial resources and also by the deterioration of household expectations on the economic and financial developments. As expected, durables were most hit, an additional contribution being made by the depreciation of the domestic currency, given the large share of imports in this group of products. Thus, the annual dynamics of turnover volume on this segment moved significantly into negative territory in Q4 (down by more than 7 percent, after an increase of almost 17 percent in the previous quarter). The growth rate of non-durables remained in positive territory, yet it decelerated about 15 times versus the previous quarter. This development hints at a lower pressure on the consumer price index, the more so as the volume of sales of "food items, alcoholic beverages and tobacco" (accounting

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

for the largest share of household consumer basket, i.e. roughly 47 percent[6]) posted only a marginal increase year on year.

The trajectory followed by purchases of goods and services was paralleled by the marked slowing in the dynamics of "self-consumption and purchases on the agri-food market" (to 2.7 percent compared to 23.5 percent in Q3). This development may be explained by the decline in the favourable contribution of the bumper 2008 crops (a typical feature at the start of the cold season), concurrently with the reduction in animal output.

From the standpoint of financing means for private consumption, the final quarter of 2008 witnessed even more pronounced decelerations in both household disposable income[7] (to 15.6 percent) and bank loans (the dynamics of consumer credit decelerated by almost 13 percentage points in real terms as compared to that of the previous quarter, as a result of higher interest rates, banks' reluctance in the current economic and financial context, and also of the domestic currency depreciation). Furthermore, financing of motorcar purchases through leasing agreements saw a negative dynamics – mention should also be made that against the background of a higher debt service, the recovery of motor vehicles from customers saw an unprecedented intensification in the final part of 2008.

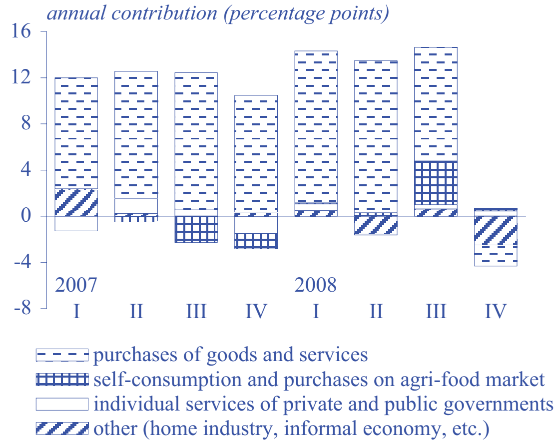
The analysis by market of origin illustrates sharply decelerating growth rates on both segments. As far as non-durables are concerned, the available statistical data show an ongoing bias for imported products, as their dynamics[8] continued to outpace the growth of sales volume of domestic industrial companies on the domestic market in spite of a more pronounced slackening (more than 5 percentage points). Durables followed an even steeper downward trajectory, with the pace of increase of the domestic component slowing to less than one third of that seen in Q3, and the external segment recording negative real growth rates (particularly imports of electronic appliances and furniture). Moreover, purchases of motorcars went down by more than 30 percent on both markets of origin.

[6] According to the standard classification of individual consumption by purpose (COICOP).

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

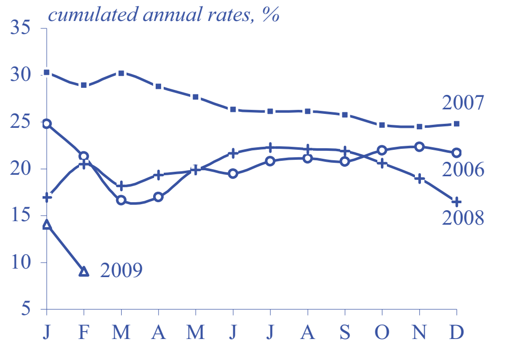
[8] The changes in the physical volume of exports and imports of goods were calculated based on balance-of-payments data, by deflating by international trade-related unit value indices. The structural analysis was based on the Combined Nomenclature.

Household Final Consumption by Expenditure



Source: NIS, NBR calculations

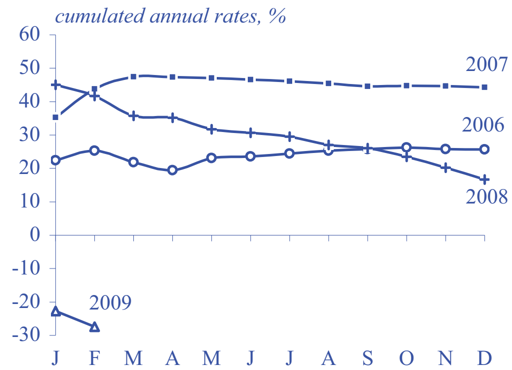
Retail Trade of Non-durables*



*) turnover of retail trade in foodstuffs, beverages, tobacco, medicines and skincare products, wearing apparel and footwear, fuels, direct mail and internet selling.
Recalculated data based on the data series of fixed-basis indices for 2005.

Source: NIS, NBR calculations

Retail Trade of Durables*



*) turnover of retail trade in furniture, electronic and IT&C apparatus, household appliances, and retail and wholesale trade in motor vehicles.
Recalculated data based on the data series of fixed-basis indices for 2005.

Source: NIS, NBR calculations

Government consumption

Final government consumption saw its annual dynamics remaining at a level similar to that recorded in the previous quarter, i.e. 4.8 percent. This development was associated with new hirings in general government sector.

Budgetary developments

At end-2008, the consolidated general budget deficit[9] ran at RON 24,655 million, accounting for 4.9 percent of GDP[10], much above the projected level of 2.3 percent of GDP and those recorded during the 1991-2007 period[11]. The overly large deviation of the budget deficit from the target was mainly the result of oversized levels of projected revenues and implicitly expenditures, that were not adjusted at the November budget revision[12], which focused only on redistribution of outlays. In 2008, in spite of the 14 percent[13] rise against 2007, revenues accounted for only 86 percent of the projected level, entailing an annual dynamics of 32 percent, whereas expenses accounted for 93 percent of the 29 percent higher projected figure. In year on year comparison, the share of revenues in GDP stayed relatively flat at 32.6 percent, and that of expenditures widened 2 percentage points to 37.5 percent, due mainly to the rise in the relative weights of transfers (up 1.3 percentage points), goods and services expenses (up 0.5 percentage points) and staff costs (up 0.4 percentage points).

In 2008 Q4, budget execution witnessed a record high deficit, at least for the last decade, of RON 18,726 million, up 38 percent from the previous year and accounting for 3.7 percent of GDP (3.1 percent in 2007).

Against the backdrop of the steep deceleration in economic growth, total revenues declined 10.3 percent October through December 2008, after recording a 10.2 percent expansion in Q3.

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[9] As of December 2008, the composition of the consolidated general budget published by the MPF was changed, thus significantly affecting data comparability. In order to alleviate distortions as much as possible, an attempt at reconstructing historical data series was made, based on the information released by the MPF (comprising data included in the Report regarding the draft government budget act for 2009). The results are partially satisfactory, as for the time being the information obtained allows the deriving of comparable budget executions only for 2007 Q4 and 2008. Therefore, for all the other periods, the rates of change of the consolidated general budget components were computed according to the previous composition of the budget execution published by the MPF.

[10] The latest GDP data were taken into account.

[11] According to International Financial Statistics data.

[12] Government Emergency Ordinance No. 186 of 25 November 2008.

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

Tax revenues were among the most affected components, with an 18.2 percent drop versus the same year-ago period, after posting a 13.8 percent rise in the previous quarter. The developments in tax revenues were only partially offset by the growth rate of social insurance contributions, which remained in positive territory at 7.8 percent (albeit at a lower level than in the prior quarters, due also to the cut in health insurance contributions[14] in 2008 Q1 and Q3), and the increase in non-tax revenues to 6.1 percent following a 10.5 percent decline in Q3.

By contrast, the growth pace of expenditures remained in positive territory, in spite of losing considerable momentum, to reach 0.8 percent (down from 21.1 percent in the previous quarter). The deceleration was accompanied by a deterioration in expenditure composition. Thus, outlays for investment posted a sharp contraction to -35.1 percent from 67.3 percent in the preceding quarter, whereas current expenditures witnessed a relatively quick growth pace of 10 percent, down only 6.6 percentage points against the previous quarter. These developments were due mainly to the approximately 20 percent increase in the "pension point" starting October 2008, with social security expenses recording an annual growth rate of 22.1 percent. In turn, dynamics of staff costs and expenses for goods and services (5.6 percent and 4.3 percent respectively) were above that of total expenditures, in spite of the downward adjustment against the figures recorded in 2008 Q3.

For 2009, the initial budget planning[15] envisaged a deficit of 2 percent of GDP given a projected 2.5 percent economic growth. Against the backdrop of an ongoing deceleration in economic growth, which led to a faster negative dynamics of total revenues (down 12.8 percent), and expenditures posting an annual growth pace of 3 percent (including on the back of paying off past-due debts of central and local governments), after the first two months of consolidated general budget execution, a RON 3,334.5 million deficit was recorded, compared to a RON 1,255.9 million surplus in the same year-ago period. These developments, along with the adjusted outlook for the key macroeconomic indicators[16] in the context of preliminary talks on concluding a loan agreement with the IMF and the EU, the fiscal target for the current year was changed to 4.6 percent deficit-to-GDP.

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[14] In compliance with Law No. 388 of 31 December 2007 – the Government Budget Act for 2008.

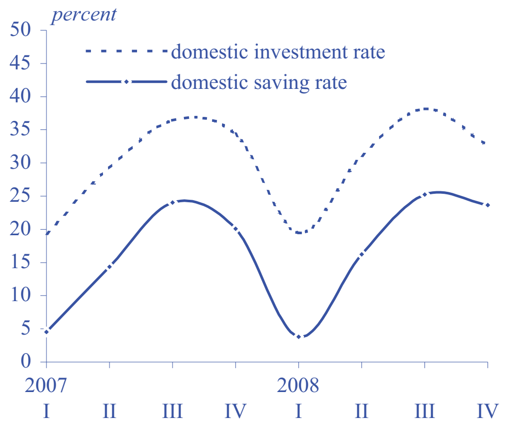
[15] Approved by Laws Nos. 18 and 19 of 26 February 2009 – the Government Budget Act and the State Social Security Budget for 2009 respectively.

[16] Including by using the revised assumption of a 4 percent decline in real GDP in 2009.

In April, in order to achieve this target, the government approved a budget revision[17] whereby, on the one hand, projected total revenues of consolidated budget[18] were adjusted downwards (in line with the reviewed macroeconomic scenario), and, on the other hand, corrective measures with a view to ensuring budget execution within the limits of the newly planned deficit were implemented. The measures envisaged mainly a 0.85 percent of GDP cut in expenditures, including capital expenditure, staff costs and goods and services expenses (which were limited by freezes in hirings and in purchasing/renting of cars and office equipment for certain public institutions), as well as the redistribution of revenues, so as to ensure the necessary funds for social security expenses (especially pensions) and interest payments. Moreover, the minimum annual tax was introduced and some tax deductions were removed; the reason for taking such measures was to ensure additional budget revenues (projected at 0.25 percent of GDP).

1.1.2. Investment demand

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 worsening of the economic and financial context was reflected also by the investment trajectory, with the annual pace of increase of gross fixed capital formation slowing approximately nine times from Q3 to +2.8 percent. Structural analysis shows unfavourable outcomes in all components: (i) 3-4 time deceleration in the annual dynamics of new construction works, capital repairs and equipment purchases (including transport means purchased by companies and institutions); (ii) trend reversal in the growth rate of "other spending" (-21.1 percent), possibly due to the decline in the housing market.

As concerns financing resources of capital investment, unfavourable developments were recorded by both own incomes (as suggested by the slackening real dynamics of household disposable income and the declining activity of the corporate sector) and domestically borrowed funds – (i) equipment loans saw a quarter on quarter decrease for the first time in 2008 (down 2 percent[19]) which caused the annual growth rate in 2008 Q4 to account for less than one third of the reading in the same year-ago period; (ii) although relatively fast (surpassing 40 percent), the annual pace of increase of real-estate credit followed further a downward trend; (iii) the severe decline in the activity of the leasing market in Q4 was due not only to the contraction in purchases of motor vehicles by companies and

[17] Government Emergency Ordinance No. 34 of 11 April 2009 on budget revision for 2009 and enforcement of some financial and fiscal measures.

[18] The projected levels of key budget revenue items that were lowered were those of VAT, non-tax revenues, excise duties, social security contributions, wage and income tax, as well as profit tax.

[19] The changes in equipment and real-estate loans are expressed in real terms, based on Central Credit Register data.

institutions, but also to the drop in the value of real-estate contracts and that of contracts for equipment purchases.

In the case of resources taken from abroad[20], developments were mixed. On the one hand, the dynamics of flows related to medium- and long-term net foreign borrowings by the non-bank non-government sector moderated to less than 20 percent. On the other hand, net inflows of foreign direct investment by non-residents posted an upturn (+25 percent compared to -14 percent in Q3), with capital investment making the largest contribution; however, mention should be made that the deterioration in the domestic and international business conditions and the uncertainties surrounding the rapid recovery in the economic environment led, in some cases, to decisions to delay the initiation of investment projects.

The unfavourable trend of investment demand in Q4 was illustrated by the sign reversal in the real dynamics of purchases of capital goods from both domestic and foreign markets[8].

1.1.3. Net external demand

Foreign trade dynamics slowed down markedly in 2008 Q4.

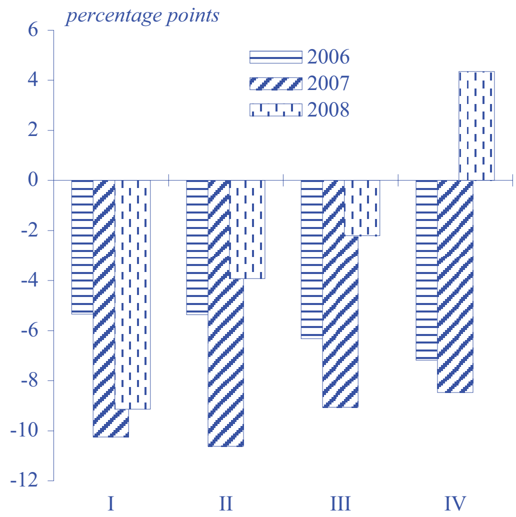
As for exports, national accounts data show that the downward trend in their 12-month growth rate was more pronounced, so that the rise in volume was only 1.6 percent, given that the further decrease in major trade partners' demand countered the favourable influence stemming from the softer leu.

Nevertheless, external demand was still supportive of GDP expansion in 2008 Q4. It contributed 4.3 percentage points to economic growth as a result of the substantial setback in imports of goods and services (down 10.2 percent), triggered by the contraction in domestic absorption, lower volume of intermediate goods for manufacturing export-bound products, as well as the adverse effect of a weaker domestic currency.

Similar conclusions regarding the trajectory of the two trade balance components can also be reached following the calculation of export and import deflators on the basis of foreign trade UVI deflation – the physical volume of exports remained actually unchanged from 2007 Q4, whereas the real growth rate of imports witnessed a trend reversal from the prior period (-9.8 percent).

Structural analysis shows that the impact of subdued external demand on exports volume affected particularly the following commodity groups: (i) fuels and chemicals, the annual dynamics of

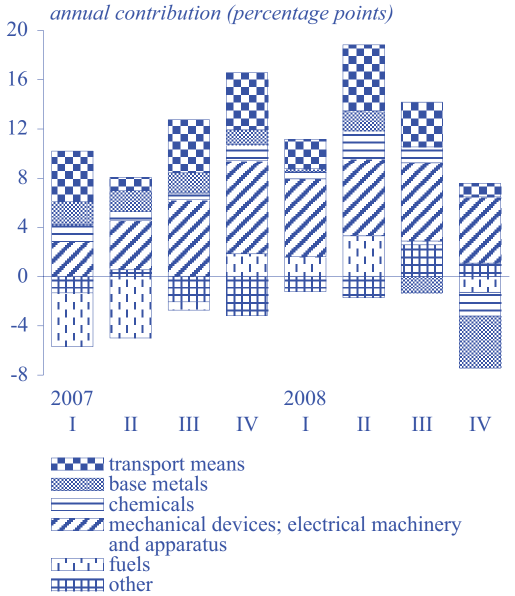
Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

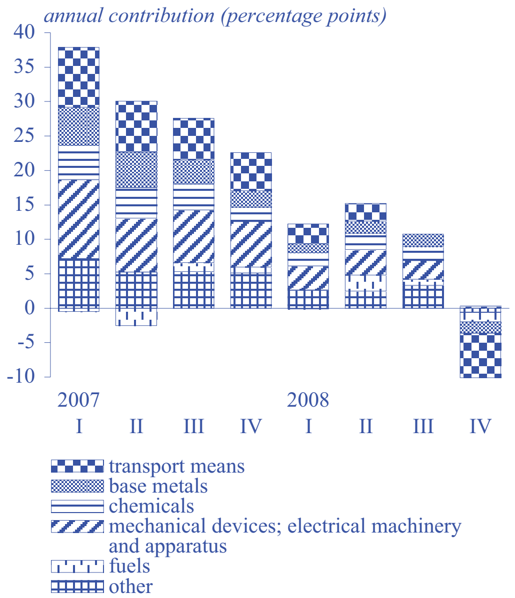
[20] Calculations based on balance-of-payments data; average dynamics for the last four quarters (rolling basis).

Export Physical Volume



Source: NIS, NBR calculations

Import Physical Volume



Source: NIS, NBR calculations

which dropped well below zero for the first time in 2008; (ii) base metals, whose decline sharpened compared to the previous quarter, which widened by 4.2 percentage points the negative contribution of this category to exports growth; (iii) transport means, whose annual growth rate decelerated almost 4 times from Q3. Nevertheless, mention should be made that the further positive growth rates of the physical volume of capital goods (23.2 percent for "electrical machinery and apparatus" and 8.5 percent for "transport means") led to the increase up to around 41 percent in the share of processed goods with higher value added in total exports.

As for imports, the strongest negative influence was due to the 45.6 percent fall in the volume of transport means purchases. Apart from this commodity group, which accounted for about two thirds of the overall drop in imports, "fuels", "base metals" and "mineral products" also posted declines ranging between 12 percent and 15 percent as compared to the same year-ago period.

1.2. Supply

Weaker performance was reported in all economic sectors, i.e. lower gross value added in industry and slower expansion in services, construction and the agricultural sector.

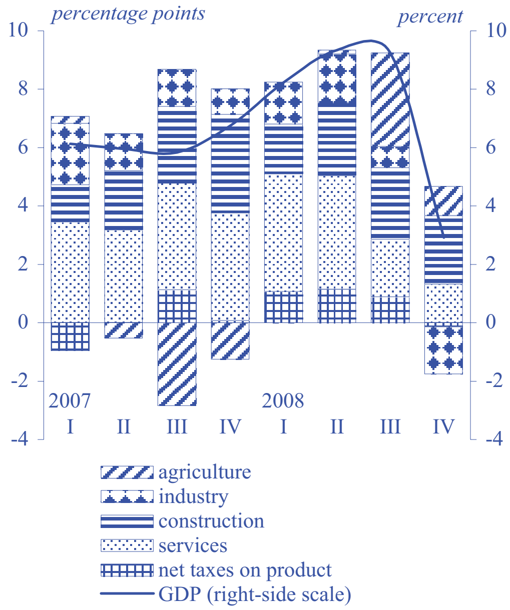
Gross value added in industry stood 7.7 percent lower due to the sharper decline in output in some major sectors such as metallurgy, oil processing, electrical machinery and apparatus, light industry) and the trend reversal in the dynamics of chemicals and road transport means. However, the declines as low as 39 percent recorded in the aforementioned sub-sectors were partly offset by the pick-up in the annual dynamics of food industry.

In 2008 Q4, construction was the largest contributor to GDP advance (2.3 percentage points). Although gross value added continued to see fast expansion (up 18.9 percent), this sector's performance was a far cry from the thriving activity seen over the past two years. The analysis by type of construction reveals that the main culprit for this slowdown was represented by the volume of residential and engineering works, the annual dynamics of which fell four times and twice respectively, against the background of tighter financing and economic conditions, uncertainties surrounding the outlook for this sector and the stalemate in housing demand induced by soaring prices. This influence was however offset by the non-residential buildings segment that continued to witness fast-paced expansion (around 33 percent).

Gross value added in the agricultural sector also posted brisk dynamics (18.2 percent), albeit slowing noticeably compared to Q3. Despite the good performance in the vegetal sub-sector (particularly maize and sunflower crops) in Q4, this sub-sector made a smaller contribution to the dynamics of the agricultural sector compared to the previous period, given the seasonal change in weather conditions. Moreover, the stock-breeding segment witnessed new losses in terms of both meat and milk production.

The services sector exhibited the weakest annual growth rate of gross value added since 2001, i.e. +2.6 percent[21]. The main factor behind this development was "financial and real estate activities", which posted a trend reversal (-1.5 percent in 2008 Q4 against +4.8 percent in Q3). Annual dynamics of gross value added relative to trade and provision of market services slowed slightly to 3.4 percent, whereas that of public services gained momentum to reach 4.4 percent.

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

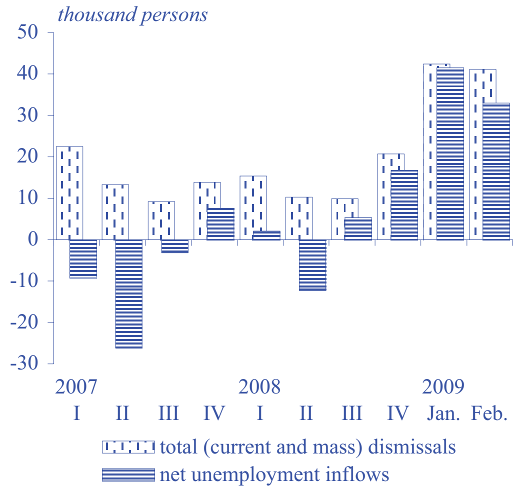
2. Labour market

The drop in sales and the bleak prospects for most economic sectors caused in the first two months of 2009 a reversal in the labour demand/supply ratio, with employees losing their power of negotiation in favour of employers. The signals regarding the adjustment of wage packages and the cut in hiring wage, albeit insufficiently captured in statistics, are indicative of the weak support these incomes have lent to household consumption. In industry, despite the measures taken with a view to reducing labour costs, companies have failed to counteract the impact of the sharp decline in output on unit labour costs, yet subdued demand currently contains the pass-through of this shock on to consumer prices.

2.1. Labour force

The downswing in workforce demand, manifest starting with the final part of 2008, gained momentum in the first two months of 2009. According to data provided by employment agencies[22], an increasingly large number of companies put a freeze on their recruitment plans, while other companies announced their intention to lay off staff or actually shed jobs. Such decisions were taken by companies in industry (particularly in the following sectors: manufacturing of road transport motor vehicles, wearing apparel, metallurgy, metallic construction, furniture), construction and related services (transport and warehousing, real estate

Dismissals and Net Unemployment*



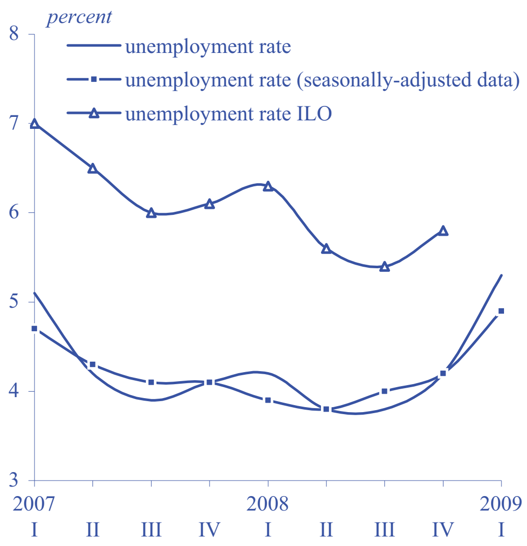
*) calculated as a difference between unemployment inflows and unemployment outflows

Source: NEA, NBR calculations

[21] Gross value added dynamics for the services sector is an NBR estimate as, starting with the January 2008 Monthly Bulletin, the NIS has no longer released national accounts data as a whole, but separately by segment, i.e. (i) trade, motorcar repair and household appliances, hotels and restaurants, transports and telecommunications; (ii) financial activities, real estate transactions, rentals and services to companies; (iii) other services (public administration and defence, education, health and social assistance, other services to population).

[22] Data supplied by the NEA and statements of representatives of private recruitment agencies.

Unemployment Rate



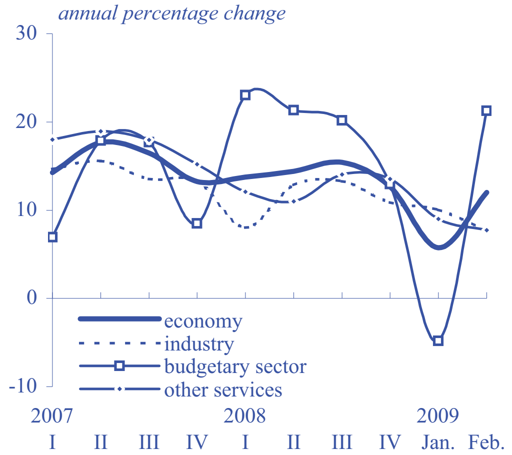
Source: NIS, NBR calculations

transactions, trade). The reasons behind these decisions were the contraction in the volume of domestic and external orders, the putting on hold of some investment projects and the escalation of uncertainties regarding the fallout from the financial crisis on Romania's economy and on its foreign partners. Although the number of vacancies shrank markedly overall, new hirings were further reported in the following sectors: IT, fast-moving consumer goods industry (especially food industry), pharmaceuticals.

Statistics on the number of employees and jobless have captured labour market changes only partly and/or with a certain delay. On the one hand, some companies resorted to measures that did not affect the reported staff numbers (short-time unemployment, shedding staff without formal labour contracts) or measures whose impact will manifest in the upcoming period (initiation of formalities in view of mass/voluntary dismissals), so that the downward path of this indicator in the first two months of 2009 (-1.2 percent in annual terms) is expected to sharpen. On the other hand, not all employees made redundant got registered with the NEA[23] immediately, among which most likely those who were granted redundancy payments or those who are not eligible for unemployment benefit. Therefore, the seasonally-adjusted registered unemployment rate witnessed only slight increases in 2008 Q4 (+0.2 percentage points compared to the average for the prior quarter), entering a sharper upward path no sooner than the outset of 2009 (+0.7 percentage points, to 4.9 percent in 2009 Q1).

Private recruitment agencies have actually noticed a keener competition among the persons looking for a job, including both jobless and employees in search of a more secure or better paid job, given that certain companies proceeded to adjust their wage packages (by cutting basic wage, changing the ratio of fixed wage to variable wage, relinquishing bonuses, perquisites and other benefits).

Net Real Wage*



*) deflated by CPI

Note: The shift to NACE Rev. 2 caused a break in the data series at the onset of 2009.

Source: NIS, NBR calculations

2.2. Incomes

The adjustment of wage earnings already signalled by recruitment agencies is difficult to identify in statistics, given the following: (i) the significant inertial component that affect annual growth rates, including as a result of the validity of labour contracts concluded in the spring of 2008 (wage negotiations usually take place in March); (ii) adverse base effects in January and February associated with the change of the period when the 13-month salary is granted to public sector employees; (iii) the impact (albeit limited), of the rise in gross minimum wage economy-wide, from RON 540 during

[23] Data supplied by the NEA show a discrepancy between the number of employees affected by mass dismissals (according to companies' announcements) and the number of jobless resulting from such dismissals.

October-December 2008, to RON 600 starting with 1 January 2009 and (iv) redundancy payments granted by some companies.

Nevertheless, the comparison between gross nominal wages in February 2009 and those paid in November 2008 (December data are influenced by the bonuses granted) points out declines ranging between 1.5 percent and 5.2 percent in industry, construction, transport and warehousing, information and communication technologies, real estate transactions, hotels and restaurants. Moreover, the analysis of the 12-month dynamics[24] during January-February 2009 illustrates the persistence of the downward trend which started in 2008 Q4, even though growth rates continued to be substantial in all economic sectors (relatively close to the 16.4 percent average).

Notwithstanding the inconsistencies in the annual index series due to methodological changes in the absence of revised figures for 2007[25] and to the distortion at productivity level generated by short-time unemployment[26], statistics show a sharp worsening of nominal ULC in industry in 2008 Q4, followed by a slight moderation of its dynamics during January-February 2009. Despite the increasing number of signs regarding the bleak economic and financial prospects[27], the annual increase in nominal ULC stood high (22.8 percent in industry as whole, 23.6 percent in manufacturing), as a result of the fact that economic agents did not resort yet to ample lay-offs and wage cuts. It is estimated that the same will hold true for the whole quarter, giving that, overall, companies generally react to a sharp drop in output with some delay, when they perceive it as a long-lasting development. In terms of inflationary pressures, mention should be made that productivity losses might be supported, to a large extent, by producers, the fall in household demand containing drastically the possibility to pass the rise in ULC on to consumer prices.

On the demand side, in 2008 Q4, pressures from the real disposable income on consumption eased slightly, the annual dynamics of the former running at 15.6 percent, down 4 percentage points from the prior period. All the components of this indicator witnessed decelerations (of up to 5.6 percentage points), wages and social

[24] Whose accuracy is affected by the non-release of revised series according to NACE Rev. 2 relative to wage earnings in 2007.

[25] The change of the base year (2005 instead of 2000) and the shift to the NACE classification Rev. 2 (i.e. food and beverage industry was divided into the two sub-sectors, and pharmaceuticals sub-sector was separated from chemicals).

[26] As already shown in the *February* 2009 *Inflation Report*, the fall in labour productivity is overestimated by the taking into consideration of the total number of employees reported by employers, which includes the employees subject to short-time unemployment.

[27] See also the business surveys conducted by the NIS and the NBR.

transfers further posting high growth rates (13.9 percent and 23.4 percent respectively); it is to be noted that the level of remittances from abroad was still higher compared to the same year-earlier period (by 4.1 percent), despite the global spreading of the financial crisis. On the other hand, this component contracted by around 18 percent in the first two months of 2009, which, along with the further slowdown in the dynamics of revenues from domestic sources, fuelled the downward trend of the annual growth rate of real disposable income (down to 6.6 percent).

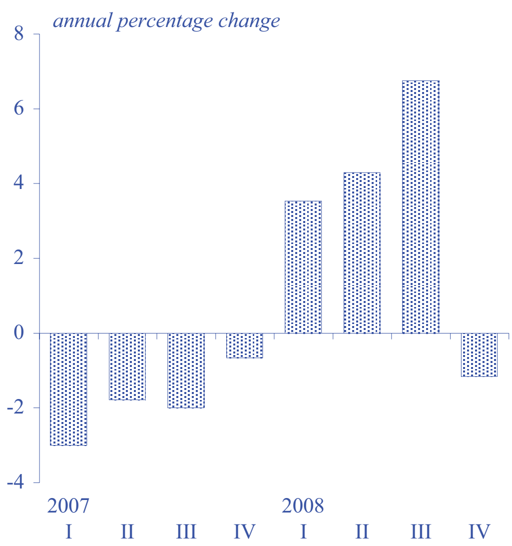
3. Import prices and producer prices

In 2008 Q4, inflationary pressures eased on the back of price developments in both imported goods and domestic industrial products; the drop in commodity prices on international markets was the main driver of this performance. The negative annual change in agricultural producer prices was due solely to developments in the vegetal component, whereas the growth rates of prices for animal products accelerated again.

3.1. Import prices

After three consecutive quarters with positive price dynamics, in 2008 Q4, the annual unit value index of imports was again below par (98.8 percent, down from 106.8 percent in Q3). This is indicative of the abating pressures on domestic prices. However, the faster depreciation of the domestic currency had an adverse impact on domestic prices.

Unit Value of Imports



Source: NIS, NBR calculations

Some goods holding large shares in the CPI basket (vegetal oil, fuels and pharmaceuticals), along with the decline in oil and agricultural commodity prices on international markets had a significant contribution to the trend reversal in external prices. The annual changes in external prices for pharmaceuticals went down to -2 percent from 8.8 percent in Q3, due to flagging demand and the shift in consumption to generic medicines (significantly cheaper than the original ones), as well as to changes in the calculation method of prices for imported medicines[28] applied by the Ministry of Public Health.

As for consumer goods, meat prices posted an opposite move, the annual growth rate of unit value of imports accelerating to 19.3 percent. The analysis by country of origin shows pressures in the case of both EU and non-EU imports[29] (18.7 percent and 27.3 percent respectively). In both cases, the explanation lies with

[28] The decision referred to the final quarter of 2008, while talks with medicine producers and distributors are to be resumed in 2009.

[29] Brasil, Argentina.

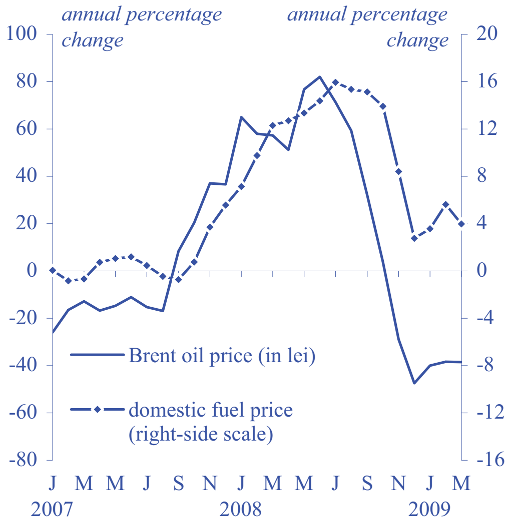
the unfavourable impact the lower number of livestock exerted on supply, while for the non-EU imports, an additional factor was the appreciation of the US dollar versus the euro.

Positive changes were also reported by external prices of transport means, up 4.4 percent against the same year-ago period, in line with the dynamics of industrial producer prices of EU-15 exports for this sector.

The annual growth rates of capital goods stayed in negative territory, the downward trend in prices being even sharper (-6.1 percent against 2007 Q4).

Data available for 2009 Q1 indicate the likely re-emergence of some pressures from import prices, given that the size of adjustments in external prices for commodities was lower than in the previous quarters, while the depreciation of the domestic currency against major currencies was even faster.

Oil Price and Domestic Fuel Price



Source: NIS, EIA, NBR calculations

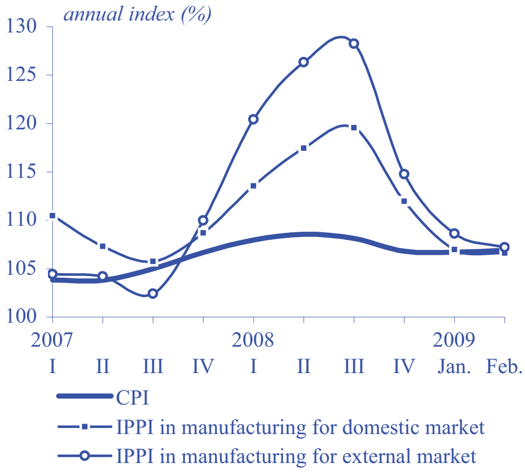
3.2. Producer prices

3.2.1. Industrial producer prices

In 2008 Q4, the annual growth rate of industrial producer prices for the domestic market decelerated by 5.9 percentage points to 10 percent against the previous quarter, due broadly to the decline in commodity prices, in line with external market developments. The alleviation of pressures was even more visible in the case of quarterly changes which saw a trend reversal (-1.7 percent versus 3.4 percent in Q3).

Despite the different magnitude, these movements were largely manifest in the case of low-value added industrial products (energy and intermediate goods), whose producer prices are largely affected by commodity price developments. While the annual growth rate of producer prices for energy products decelerated by more than three times as compared with the prior quarter (to 4.7 percent), producer prices for intermediate goods were highly rigid (their dynamics coming down by only 3.6 percentage points versus the prior quarter to 15.1 percent), on the back of developments in metal manufacturing industries[30]; given the plunge in external prices for metals, the inadequate adjustment of producer prices in metallurgy could be attributed to labour costs, considering the staff policy implemented by most producers (widespread short-time unemployment).

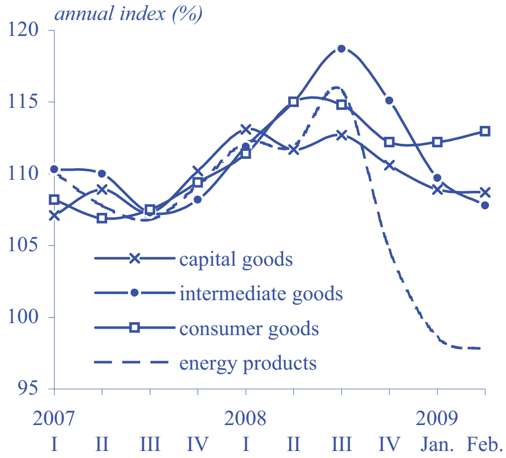
Consumer Prices and Industrial Producer* Prices



*) recalculated data based on the data series of fixed-basis indices for 2005.
Source: NIS

[30] The annual growth rate of producer prices for the domestic market in metallurgy exceeded 30 percent in 2008 Q4.

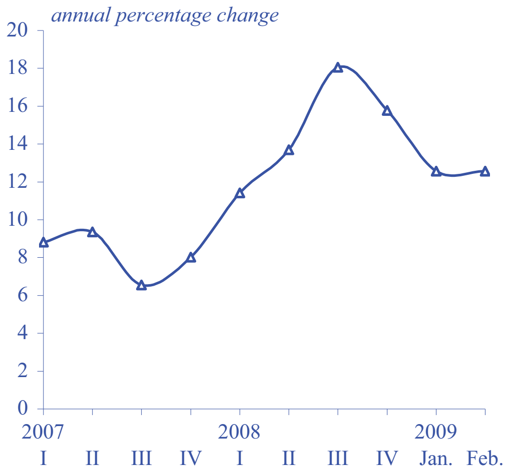
Industrial Producer Prices for Domestic Market by Industrial Products Group*



*) recalculated data based on the data series of fixed-basis indices for 2005.

Source: NIS

Industrial Producer Prices on Domestic Market* for New Orders



*) in order-based manufacturing sector

Source: Eurostat

As regards the CPI, a favourable impact was exerted by the 2.6 percentage point deceleration in the annual change of producer prices for the domestic market in the case of consumer goods (to 12.2 percent), yet unlike the previous quarters, in 2008 Q4, it was due solely to food industry, whereas the annual dynamics of producer prices for consumer goods, excluding food items, beverages and tobacco[31] remained unchanged at the previous quarter's level of 8.2 percent.

The downtrend in the annual growth rates of aggregate industrial producer prices continued in January and February 2009 (to 5.8 percent in February), yet it slowed down as compared with the prior quarter. On the one hand, this evolution indicates a weaker favourable impact associated with the decline in world oil prices (which was prevalent in 2008 Q4) as well as the effects of some one-off factors – the obligation to implement the Euro 5 standard for all types of fuels or the significant hike in medicine prices, following the update of the exchange rate used in their calculation.

On the other hand, the flattening trend in such prices illustrates the limited possibility/availability of domestic producers to cut production costs, despite the unfavourable context. The explanation for their slow response to the gradual decline in demand lies with: (i) expenses related to the steady resort to short-time unemployment and the severance payments; (ii) faster domestic currency depreciation, which led to the widespread resumption of contract renegotiation; (iii) difficulties encountered in production financing (expansion of arrears, less-readily affordable loans, higher credit costs).

In the short run, disinflation will carry on in industry, the annual dynamics of prices for new orders[32] in January-February 2009 (12.6 percent) standing 3.2 percentage points lower than the Q4 average.

3.2.2. Agricultural producer prices

In October-December 2008, the annual rate of increase of agricultural producer prices fell back into negative territory (-0.5 percent versus 7.6 percent in Q3), solely on the back of developments in the vegetal component. In this case, the annual negative changes accelerated to -14.7 percent, given that domestic supply exceeded significantly last year's figure for most groups of crops. In fact, this was a worldwide trend, as major international suppliers of vegetal products (USA, Australia, the EU) recorded

[31] Eurostat estimates.

[32] Eurostat estimates. They include solely the manufacturing sub-sectors relying on orders (excluding food industry, oil processing and coking products).

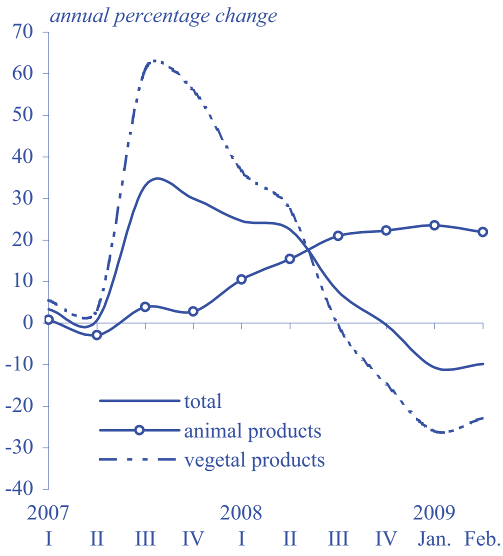
bumper crops, while demand declined as compared with the same year-ago period.

Mounting pressures, reflected mainly by current developments, continued to be manifest in the case of potatoes, whose producer prices rose 55.8 percent from the prior quarter, despite the marginal decrease in production (-1.7 percent) versus 2007. This movement was due to costlier imports given that some key suppliers (Poland, Turkey) reported declines in production and the leu resumed its depreciation trend against the euro.

The growth rate of producer prices for animal products continued to advance to 22.3 percent, the major contribution coming from beef prices, whose annual dynamics accelerated twice as much as in the previous quarter, reaching 50.1 percent. This may be attributed mainly to the lower livestock numbers against the background of costlier fodder and losses incurred by producers, the impact of this factor being enhanced by higher import prices, as this situation is seen not only in EU Member States. Swine numbers decreased significantly as well, yet the impact on prices was limited by consumer reluctance generated by the information on dioxin-contaminated pork imports.

In 2009 Q1, the factors weighing on agricultural producer prices are expected to remain broadly unchanged, so that prices are likely to stay on the trends observed in late 2008.

Agricultural Producer Prices



Source: NIS

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

During February-March, a prudent easing of monetary policy stance was initiated. Thus, the NBR Board decided to lower the monetary policy rate by 25 basis points to 10.00 percent per annum and to cut to zero (from 40 percent) the minimum reserve ratio on foreign currency-denominated liabilities of credit institutions with residual maturities of more than two years starting with the 24 May - 23 June 2009 maintenance period. However, the minimum reserve ratios on both leu- and foreign currency-denominated liabilities of credit institutions with residual maturities of up to two years were left unchanged at 18 percent and 40 percent respectively. After having picked up considerably in January, the depreciation of the domestic currency slowed down and even reversed towards the end of Q1 against the backdrop of global investors' relatively stronger appetite for risk and an improved sentiment regarding the local economy in the context of completing preliminary talks on signing a loan agreement with the IMF, the EU and a number of international financial institutions.

The NBR Board's decision to lower the monetary policy rate by 25 basis points to 10 percent per annum taken in its meeting on 4 February was based on the slight downward shift in the trajectory of the forecasted annual inflation rate during 2009 as against the previous quarterly forecasting round of medium-term macroeconomic developments[33]. The inflation outlook saw a relative improvement as a result of a slower pace of projected economic growth, including the anticipations of a faster and wider opening of the negative output gap. The prerequisites for the near-run emergence and widening of the aggregate demand shortfall, reflecting mainly the relatively quick spillover effects of the global economic crisis, were: (i) lower-than-expected economic growth in 2008 Q3, (ii) the marked decline in the annual dynamics of relevant demand and supply indicators in the run-up to year-end, (iii) significant tightening of lending conditions on both foreign and domestic markets, (iv) the emerging payroll cuts and the ensuing rise in unemployment, and (v) the envisaged corrective tightening of income and fiscal policies.

The National Bank of Romania calibrated with utmost care the adjustment pace of the monetary policy rate given that, despite the significant deceleration in economic growth, disinflation was expected to be further stymied by the persistence of inflation and

[33] November 2008 Inflation Report.

the protracted unfavourable inflation expectations, fuelled largely by the weaker leu and the still high exchange rate volatility.

In the NBR Board meeting of 31 March 2009, the monetary policy rate was left unchanged at 10 percent per annum. The chief drivers behind this decision were the rebound in inflation over January-February 2009 and the outlook for a deterioration of short-term developments in consumer prices compared with the most recent medium-term forecast[34]. The analysis revealed that the worsening annual inflation path owed not only to the faster leu depreciation and sharper adjustment of some administered prices and excise duties, but also to the persistent nature of CORE2 inflation. This component did not respond yet to the very likely opening of the negative output gap in 2008 Q4 and its anticipated widening over the next months. However, both magnitude and pace of widening of the negative output gap were difficult to assess given that the broadening and the intensification of the global economic and financial crisis – which translated mostly into a decline in external demand and all funding sources – entailed a contraction in aggregate demand and significant downward adjustment of potential GDP.

Against this background, it was almost certain that annual GDP growth would slip into negative territory in 2009 Q1, but great uncertainties still surrounded the scale of the negative GDP dynamics and the extent of the decline of major aggregate demand components given the persistent heterogeneity, during the first months of 2009, of developments in some indicators relevant to the dynamics of investment, but especially consumption. Thus, at the turn of the year, data showed a relatively robust annual dynamics of real net average wage, larger consumption-oriented public spending[35] (partly associated with paying off some past-due debts) and a still positive year-on-year dynamics in food and non-food retail sales. At the same time however, unemployment grew at a faster tempo, imports lost further momentum, the 12-month growth rate of retail sales of motor vehicles and fuels saw a sharper contraction, the downtrend in household deposits came to a halt and loans to households – new business – saw a marked compression[36].

The latter performance materialised in the 27.8 percent decline in the real average annual dynamics of loans to households January through February (7.2 percentage points below the 2008 Q4 figure); the adjustment was larger than that recorded by corporate loan dynamics (down 5.4 percentage points to 20.1 percent). On the supply side, the major driving force behind the evolution of loans to households was the sizably stronger wariness of credit

[34] February 2009 Inflation Report.

[35] Resulting in a budget deficit amounting to 0.63 percent of GDP at end-February 2009.

[36] Based on CCR data.

institutions arising from the grimmer expectations on future economic developments, the heightening risk of adverse selection and the reassessment of their clients' risk profile, as well as the recent worsening of the loan portfolio. Banks continued to tighten their terms and conditions applied to household lending and, at the same time, displayed an increasing propensity for investments in less risky, highly liquid debt instruments such as government securities. In addition, the loan supply was contained by the relative drop in external financing volume and banks' net liquidity falling deeper into negative territory.

In turn, a dampening effect on demand for loans had the bleaker prospects of household income, higher lending rates (fairly pronounced in case of foreign-exchange-denominated loans) and growing uncertainties on the movements in the exchange rate of the leu. Under the joint impact of these factors, the declines in growth rates of all types of household loans continued during January-February, their magnitude being generally lower than that seen in 2008 Q4. The real annual dynamics of consumer loans declined on average to 23.3 percent (down 6.6 percentage points from the figure for October-December period), with the 12-month growth rate of loans in domestic and foreign[37] currencies decelerating by 6.6 percentage points and 5.6 percentage points respectively to 9.8 percent and 29.6 percent on average. The average year-on-year rate of increase of housing loans in real terms fell to 36.8 percent during January-February 2009 (5.6 percentage points below the fourth-quarter reading), with decelerations being reported both by leu-denominated loans (down 4.9 percentage points to 3.5 percent) and foreign-exchange-denominated loans (down 13.1 percentage points to 30.0 percent).

In contrast to the previous months, the developments in household savings with banks improved somewhat. Their annual dynamics decreased further (as a result of higher debt service of households), but at a much slower pace, and the composition by maturity improved noticeably. Thus, the annual growth rate of overnight deposits declined abruptly in January and February, reaching 14.4 percent and -1.2 percent respectively, down 37.3 percentage points on average from the figure recorded in 2008 Q4. At the same time, the real year-on-year dynamics of households' time deposits in domestic and foreign currencies saw a sharp rise; this holds valid both for time deposits with a maturity of up to two years, whose pace of increase added 18.8 percentage points versus the fourth-quarter average to 29.3 percent, and time deposits with a maturity of more than two years. This performance occurred against the backdrop of a relatively faster rise in interest rates on time deposits and their being included into non-taxable income, which might be indicative of a favourable shift in households' saving behaviour.

[37] Expressed in euro.

Another major driver of the NBR Board's rate decision was the risk of ongoing depreciation pressures on the leu in an environment characterised by unfavourable economic and financial conditions worldwide, but especially by the substantial increase in investors' risk aversion towards Central and East European economies. The latter was fuelled by fears of a bleaker outlook on the region's economies and their potentially adverse impact on local banking systems and, in turn, on the banking systems of some developed economies in the European Union (see Subsection *2.2. Exchange rate and capital flows*). In this context, a certain adjustment of the exchange rate of the leu was deemed as being inevitably associated with the ongoing correction of the external imbalance towards sustainable levels in the medium term. However, excessive depreciation of the domestic currency could induce large slippages of exchange rate movements in relation to the evolution of economic fundamentals and might jeopardise the attainment of the inflation target (via prices of imported goods and services and prices geared to exchange rate developments, as well as through inflation expectations), entailing major repercussions on financial stability.

From this perspective, policymakers sought to avoid an excessive increase in exchange rate volatility. To this end, the central bank tailored its liquidity management on the money market to the particular conditions described above. At the same time however, the need to ensure smooth functioning of the interbank money market and implicitly the necessary conditions for furthering financial intermediation was taken into account as well. Thus, in 2009 Q1, the National Bank of Romania implemented an adequate control over liquidity by gradually accommodating banks' demand for reserves and making active recourse to open-market operations, repo transactions in particular. Given that banks' net liquidity fell much deeper into negative territory, money injections performed by the central bank rose markedly versus 2008 Q4; over the period, banks attracted liquid funds by also resorting to the lending facility, but the share of such operations in total liabilities to the NBR declined sizably compared to the previous months. Furthermore, the monetary authority occasionally conducted reverse repos whereby it mopped up the temporary excess reserves – nevertheless, the volume of such operations was far lower than that of liquidity-providing operations.

Also in its March meeting, the NBR Board decided to reduce the minimum reserve ratio on credit institutions' foreign-currency-denominated liabilities with residual maturities of more than two years[38] to zero from 40 percent, starting with the 24 May-23 June 2009 maintenance period. The measure was aimed at achieving

[38] Starting with the end of the observance period and not including contractual provisions on early repayments, withdrawals, and transfers.

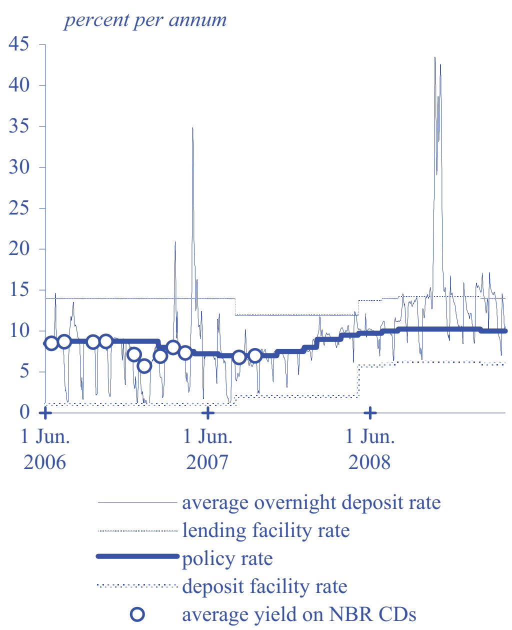
further alignment of the required reserve mechanism to ECB standards in the field and paving the way for resumption of sustainable financing of the Romanian economy, with a focus on sectors with longer-term development prospects.

2. Financial markets and monetary developments

Interbank market rates declined in the first part of the year, due mainly to the waning unfavourable effects that the global financial crisis had exerted on this financial market segment, as well as to the change in the NBR's manner of managing liquidity in the banking system. However, the exchange rate of the leu followed a sharper depreciation trend in January, but subsequently it showed signs of a relative stabilisation. The annual dynamics of broad money decelerated further, against the background of the protracted slowdown in the pace of increase of credit to the private sector.

2.1. Interest rates

Interbank Money Market Rates



In 2009 Q1, interbank market rates remained on the downtrend they had followed since late 2008 Q4, with very short-term rates staying close to the monetary policy rate in the final part of the period. As a result, the quarterly average of interbank deposit rates went down 2.4 percentage points quarter on quarter to 12.7 percent.

In early 2009 Q1, overnight rates headed downwards on the back of the relatively balanced liquidity conditions, coming closer to the monetary policy rate in the last week of the reserve maintenance period. Nevertheless, their downward drift was alleviated to a certain extent by the Treasury's mounting demand for short-term liquidity. Subsequently, the temporary tightening of liquidity conditions[39] caused, however, overnight rates to record relatively higher levels. By the end of the first 10-day period of March, such rates fluctuated in the upper part or slightly above the ceiling of the corridor defined by the interest rates on the central bank's standing facilities.

The subsequent downward adjustment was relatively quick, given that banks' demand for reserves was broadly covered via repo transactions conducted by the central bank. Consequently, overnight rates reverted to levels close to the policy rate, their both-way deviations from that level being only occasional (at the end of the maintenance period in March and at the onset of the following period) and lower in terms of magnitude.

In this context, the volatility of interbank rates declined significantly quarter on quarter, yet remaining relatively high as against the

[39] Also mirrored by banks' higher resort to the lending facility.

previous quarters. Moreover, interbank market trading stabilised at usual levels, after the decline reported in the first part of 2008 Q4.

Reflecting the persistent uncertainties surrounding liquidity developments, ROBOR rates further exceeded, by mid-March, the interest rate on the lending facility by about one percentage point; one-month ROBOR rates temporarily saw substantial increases, as they were more sensitive to changes in liquidity conditions. However, against the backdrop of the subsequent alleviation of these effects, the interest rates across the whole maturity spectrum followed a downward path that became sharper in the final week of March. As a result, average (1M-12M) ROBOR rates fell by 0.3 percentage points in the final month of the quarter versus December 2008.

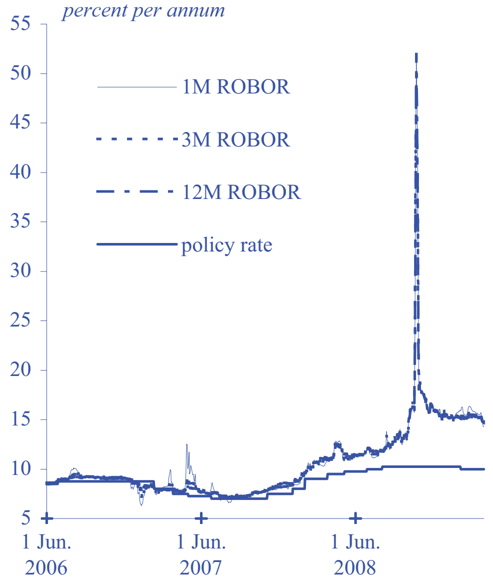
The implicit forward rates (calculated based on March average quotations) indicated the three-month ROBOR rates would stay on a downward trend throughout the following quarters, their average levels being expected to decrease to 14.6 percent in June, 14.0 percent in September and 13.5 percent in December.

In 2009 Q1, interest rates on government securities posted a trend reversal, the maximum interest rates accepted by the MPF declining sharply for all types of securities. Interest rates on Treasury certificates dropped 2.75 percentage points across the whole maturity spectrum to reach 11.5 percent, while maximum interest rates on 3- and 5-year benchmark government bonds fell 1.5 percentage points to 11.5 percent. In 2009 Q1, government securities issues rose considerably to a cumulative amount of RON 20.3 billion, higher than the pre-announced amount of RON 18.9 billion. They included almost entirely short-term paper, given credit institutions' stronger bias towards such instruments.

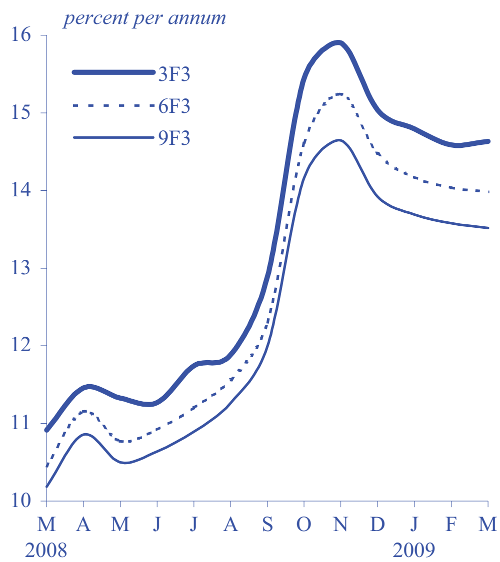
By contrast, the quarterly turnover of the secondary market for government securities (excluding the NBR) declined to RON 5.8 billion as compared with the prior quarter. The most heavily traded were securities with residual maturities of up to one year and 3 years, whose interest rates followed a downward path throughout the quarter to reach, on average, nearly 11 percent and 10 percent respectively.

In turn, average deposit and lending rates on new business rose at a slower pace during December 2008 – February 2009. Thus, the average interest rates on new time deposits increased by 1.88 percentage points to 17.12 percent in the case of non-financial companies and by 2.18 percentage points to 16.31 percent in the case of households. Nonetheless, the cumulative growth rates were slower in the case of lending rates on new business, posting both-way monthly changes in the reviewed period under the impact of: (i) the more frequently resorted to practice of regular (quarterly/half-yearly) adjustment of lending rates to interbank rates and

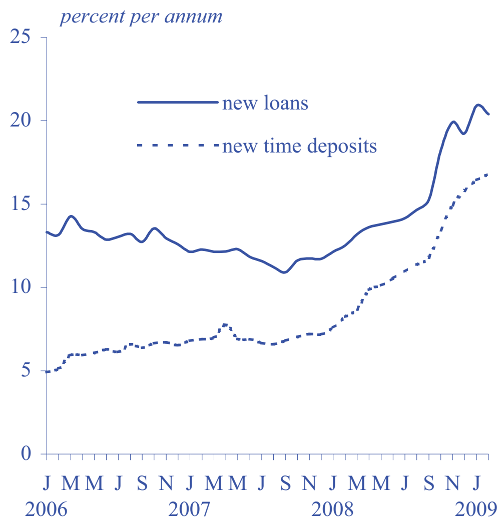
Policy Rate and ROBOR Rates



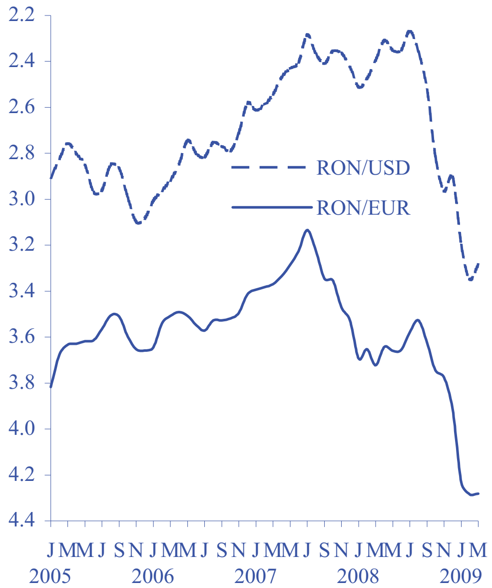
Implicit Forward Rates



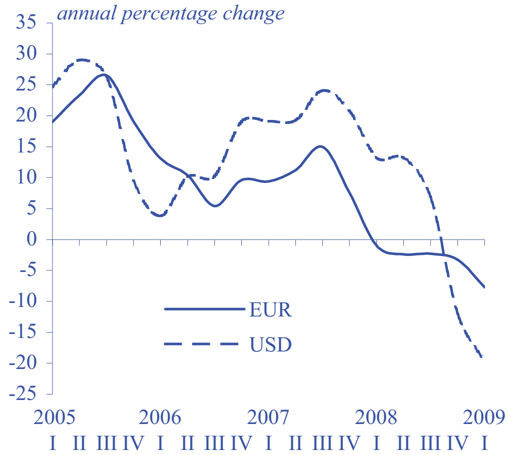
Bank Rates



Nominal Exchange Rate



Developments of RON Exchange Rate*



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

Source: NIS, NBR

(ii) the increase in their spread versus the benchmark rates, accounted for by the heightening of the risk perceived by banks and/or their attempt to maintain the spread against deposit rates. Under the circumstances, the average interest rates on new loans in the domestic currency were higher in February than in November as regards both non-financial institutions (0.19 percentage points to 20.68 percent) and households (1.17 percentage points to 18.63 percent).

2.2. Exchange rate and capital flows

The upward movement seen in the RON/EUR exchange rate gained momentum in the first part of 2009 Q1, amid worsening developments in emerging economies and the sharp deterioration in investor perceptions on their outlook. Subsequently, the uptrend in the exchange rate slowed and even stabilised at the end of the period, against the backdrop of an improved market sentiment worldwide and investors' less pessimistic expectations on future developments of the domestic economy. At the same time, the volatility of the RON/EUR exchange rate also dwindled significantly.

The cumulated depreciation of the domestic currency versus the euro January through March (by 8.6 percent in nominal terms and 6.2 percent in real terms) exceeded, however, that seen in 2008 Q4 (7.2 percent and 6.0 percent respectively). Against the US dollar, the leu depreciated at a slightly slower pace compared to the previous quarter, i.e. 11.6 percent in nominal terms and 9.3 percent in real terms. Calculated as an average annual change for 2009 Q1, the domestic currency saw a faster nominal weakening against both the EUR (13.5 percent) and the USD (24.9 percent).

In line with the movements in the exchange rates of the major currencies in the region, the RON/EUR exchange rate followed a sharply upward path by mid-January, induced by the severe deterioration in investors' perceptions on the economic outlook for the emerging economies in the region, given that: (i) the statistical data published during the reported period showed the worsening of key macroeconomic indicators, as well as deeper recession of world economy[40] and (ii) the controversy between the Russian Federation and the Ukraine regarding natural gas supply was perceived as an additional risk to economic developments across the region. To this unfavourable external environment added the uncertainties regarding the incoming government's ability to take and implement the necessary steps for an orderly unwinding of macroeconomic imbalances and preventing economic growth from abruptly slipping into negative territory. The RON/EUR exchange rate also came under the impact of the

[40] Statistical data released during the reported period painted a bleaker picture of US, EU, Chinese and Japanese economies. To these unfavourable developments added the downgrading by rating agencies of the sovereign rating for Ireland, New Zealand, Greece, Spain and Portugal.

negative signals from the downward revision by the European Commission and the EBRD of the growth outlook for the Romanian economy in 2009. Against this background, banks' external liabilities witnessed a more sizeable decline, mainly on account of medium- and long-term financial borrowings and deposits, while speculative transactions on the interbank forex market saw a relative spike-up. Consequently, pressures towards a weaker leu gathered momentum, so that the RON/EUR exchange rate posted successive historical highs and peaked at 4.3127 on 21 January[41]. The exchange rate volatility, albeit more pronounced, remained below that witnessed by the major currencies in the region.

Downward pressure on the currencies in the region built up in February amid the ongoing across-the-board worsening of investor sentiment towards Central and Eastern European economies. Foreign investor fears were heightened by the fast-paced deterioration of the outlook for the region[42] as well as by some analysts exacerbating the warning signs in relation to the potentially adverse effects exerted by future developments in these economies on the banking systems and economies of developed countries[43]. Against this backdrop, currencies in the region weakened considerably versus the euro, in some cases only partly justified by the evolution of economic fundamentals. In response, the authorities in these countries resorted to measures including verbal interventions with a view to deterring the excessive pressure on their currencies. Moreover, on 23 February, the central banks in Romania, the Czech Republic, Hungary and Poland conducted such a joint intervention for the first time ever, by organising simultaneous press conferences. The RON/EUR exchange rate was partly disconnected from the trajectory of the main currencies in the region, also due to the still tight monetary policy stance and the reduction in excess liquidity on the interbank forex market. Thus, by losing a mere 1.2 percent against the euro in February, the leu fared much better than its regional peers.

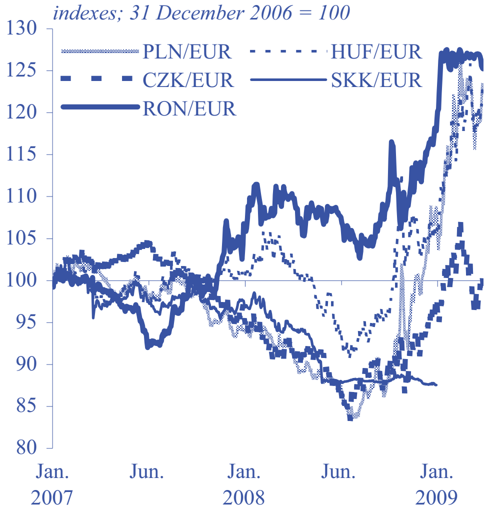
The exchange rate of the domestic currency further witnessed a slower upward movement and even re-entered a slight downtrend towards end-March, mainly on account of financial investors' somewhat rekindled risk appetite, which eased the pressure on the currencies in emerging economies. To this added the positive

[41] At the same time, the RON/EUR exchange rate hit a record high on average in January, as the domestic currency depreciated at a faster pace compared to the major currencies in the region, i.e. 7.5 percent.

[42] Based on weaker-than-anticipated GDP growth in Hungary, the trade balance in Hungary and Poland, the labour market and industrial output in the Czech Republic.

[43] During the period under review, both Moody's and Standard&Poor's warned that Eastern European countries might see a deeper recession in 2009, while some major European banks could face downgrades on account of the large exposure to such economies.

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

Key Financial Account Items (balances)

EUR million

	2008 2 mos	2009 2 mos
Financial account	**2,419**	**514**
Direct investments	**1,093**	**1,436**
residents abroad	98	62
non-residents in Romania	995	1,374
Portfolio investments and financial derivatives	**377**	**-133**
residents abroad	105	-18
non-residents in Romania	272	-115
Other capital investments	**931**	**-2,128**
medium- and long-term investments	666	-29
short-term investments	-137	-801
currency and short-term deposits	110	-1,353
other	292	55
NBR's reserve assets, net ("–" increase/"+" decrease)	**18**	**1,339**

impact induced by (i) the release of balance of payments data, showing favourable developments in the trade balance and direct investment in January; (ii) the initiation of talks and the ensuing announcement on the conclusion of negotiations between the Romanian authorities and the IMF-EU-IFI delegation for a stand-by arrangement – as part of a multilateral financial support package, as well as (iii) Moody's confirming Romania's sovereign rating. As a result, the RON/EUR exchange rate remained, on average, relatively unchanged in March, amid considerably lower volatility, reverting to the lowest level since August 2006.

2.3. Money and credit

Money

In December 2008-February 2009, the pace of increase[44] of broad money (M3) continued the slowdown manifest since 2008 Q3 (-6.8 percentage points to 10.8 percent, comparable to the 2004 level), its developments mainly reflecting the more sluggish economic activity and tighter financing conditions.

Annual Growth Rates of M3 and Its Components

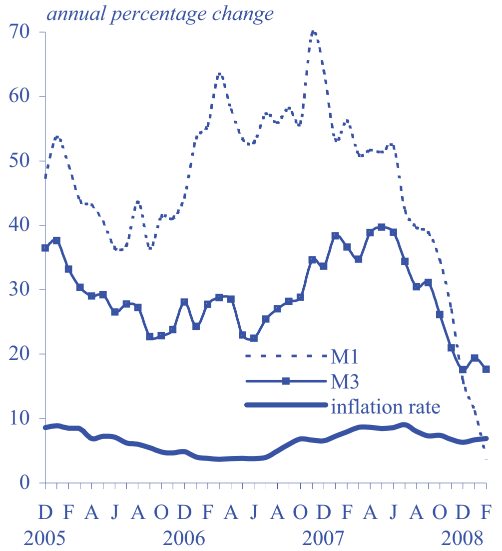
real percentage change

	2008				2009	
	I	II	III	IV	Jan.	Feb.
	quarterly average growth					
M3	26.5	28.2	22.1	13.8	11.9	10.1
M1	42.2	39.8	29.7	17.7	4.1	-2.8
Currency in circulation	38.0	30.2	19.4	18.2	12.7	9.8
Overnight deposits	43.7	43.6	33.8	17.6	1.0	-7.2
Time deposits (maturity of up to two years)	12.6	16.7	13.7	8.9	20.5	25.1

Source: NIS, NBR

The M3 structure saw sizeable changes, given the massive shift of monetary assets from more liquid components towards time deposits. Thus, the growth rate of narrow money (M1) contracted seven times and entered negative territory in February, while that of time deposits with an agreed maturity of up to two years doubled from the previous quarter, reaching a historical high in February. Of the M1 components, overnight deposits posted the steepest slowdown. This narrow money component came under the impact of more sluggish money demand for current transactions, on one hand, and higher interest rates on new time deposits and the bringing – as from January 2009 – of interests on time deposits and/or saving instruments[45] under non-taxable incomes, on the other hand. Household shift to placements with longer maturities to the detriment of overnight deposits was manifest irrespective of denomination, whereas in case of companies this trend was visible only for forex deposits.

Broad Money and Inflation Rate



Source: NIS, NBR

Nevertheless, total M3 deposits of both households and companies witnessed a slacker expansion, hinting at tighter liquidity constraints, given the contraction in own financing sources[46] and

44 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2008-February 2009. The annual changes in monetary indicators calculated based on the former statistical methodology were used for the period prior to December 2005.

45 Government Emergency Ordinance No. 200/2008 amending and supplementing Law No. 571/2003 on the Tax Code.

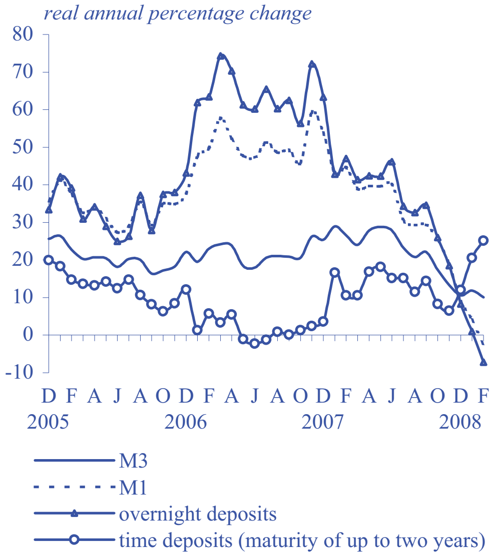
46 Suggested by the faster decline in real terms in collections from profit tax December 2008 through February 2009.

borrowings (domestic and external), as well as the higher debt service in relation to loans.

The analysis of M3 structure by currency reveals an increase in the average share of forex-denominated deposits, which peaked at a 3½-year high of 32.2 percent, on account of the faster dynamics compared to those of deposits in domestic currency (this trend being due to corporate behaviour) as well as the weaker leu.

From the perspective of M3 counterparts, the deceleration in the dynamics of credit to the private sector further acted as the main determinant of the slower growth rate of liquidity in the economy, to which added the slacker decline in central government deposits. The contractionary effect of these factors more than offset the impact exerted by (i) the much faster rise in credit to the public sector, (ii) the more sluggish growth rate of long-term financial liabilities, and (iii) the slower retrenchment in banks' net external assets.

Main Broad Money Components



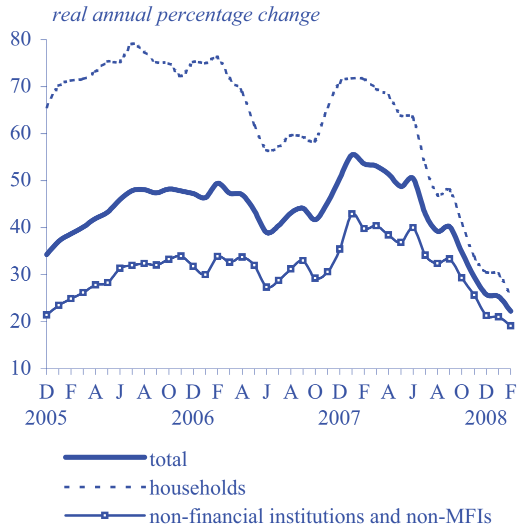
Source: NIS, NBR

Credit

December 2008 through February 2009, the growth rate[47] of credit to the private sector (24.5 percent) posted the most sizeable contraction in the past nine years, down 10.4 percentage points. Thus, credit dynamics halved from the peaks seen in 2008 Q1, reaching a level comparable to that seen in the first part of 2005.

The deceleration was more pronounced in case of the domestic currency component, whereas the average share of foreign currency credit in total loans to the private sector was on a steady uptrend, peaking at a 3½-year high of 58.9 percent[48]. During the reported period, credit supply was further stymied by: (i) credit institutions' increased wariness, amid bleaker economic prospects, heightened risk of adverse selection and customers' lower degree of eligibility, (ii) more restrictive lending terms and standards for both households and non-financial corporations[49], (iii) tighter external financing conditions for banks, (iv) reduction of the liquidity surplus in the banking system, as well as (v) credit institutions' keener appetite for placements in government securities. The main factors stifling credit demand were: (i) slower economic growth and worsening

Credit to Private Sector by Institutional Sector



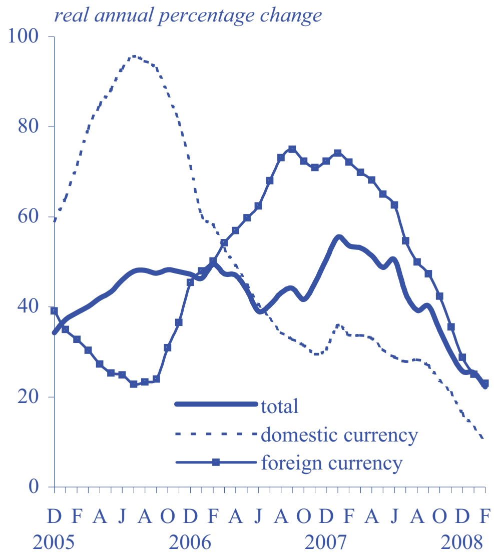
Source: NIS, NBR

[47] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2008-February 2009 (end-of-month). The annual changes in monetary indicators calculated based on the former statistical methodology were used for the period prior to December 2005.

[48] To this contributed also the accounting effect of a weaker leu versus the euro (the monthly pace of depreciation hit an 8-year high in January). January through February, the weaker domestic currency acted as the single determinant of the spike-up in the monthly dynamics of credit to the private sector.

[49] According to the results of the survey on lending to non-financial corporations and households, published in January 2009.

Credit to Private Sector by Currency



Source: NIS, NBR

outlook for corporate and household incomes, (ii) higher lending rates on new business to households in leu and EUR, as well as the maintenance of lending rates on new business in domestic currency to non-financial corporations at very high levels as compared to past four years' levels, and (iii) the weaker domestic currency and increased uncertainties surrounding exchange rate movements.

The growth rate of both household and corporate loans decelerated by almost one third against the previous quarter, with slacker dynamics being manifest across all credit categories. These developments were underpinned, especially in case of households, by the contraction in the volume of new business[50] during the period under review. However, corporate lending seems to have rebounded slightly in February, as the slowdown in the annual dynamics of forex-denominated loans with a maturity of up to 5 years and RON-denominated loans with a maturity of up to 1 year came to a halt, at least temporarily. Developments in the latter component could mirror a relative increase in the demand for resources required for financing current operations, as suggested by the larger share of overdraft loans.

By contrast, net credit to central government exerted a larger expansionary impact on M3 and entered positive territory for the first time in the past five years and a half. Developments were exclusively due to the higher balance of loans extended to this sector, as credit institutions' government securities portfolio doubled versus the previous period.

[50] Based on CCR data.

V. INFLATION OUTLOOK

In the first quarter of 2009, the Romanian economy remained in the grip of the global financial and economic crisis. Similarly to the previous forecast, the substantial uncertainties related to the duration and the magnitude of the crisis pose difficulties in projecting its short- and medium-term impact on domestic macroeconomic developments.

Given the uncertainties surrounding this period, the baseline scenario of the current projection places the annual inflation rate for end-2009 at 4.4 percent, a level close to that published in the February 2009 Inflation Report (4.5 percent). For end-2010, inflation is forecasted to fall to 2.8 percent, i.e. below the central target (3.5 percent), as well as below the previously forecasted figure (3.2 percent).

As for end-2009, maintaining the forecast for the inflation rate close to the level published in the previous Inflation Report mainly comes through as the result of reassessing the effects of the dynamics of exchange rate and aggregate demand, which are expected to partially offset each other throughout the year. A higher-than-anticipated depreciation of the domestic currency in 2009 Q1 had detrimental effects on the projections for import prices, fuel prices and administered prices. Such effects are augmented by inertial inflation expectations in the first part of the projection horizon. By contrast, the considerable slowdown in economic growth over the past two quarters under the impact of falling external demand translated into projecting a wider negative output gap than in the previous forecasting round over the entire horizon. The resulting disinflationary pressures on CORE2 inflation are foreseen to counter any opposite effects on the projected consumer price dynamics in 2009. For next year, the lingering effects of the negative output gap, along with the sustained downtrend in inflation expectations, are the prevalent factors for projecting a CPI inflation rate 0.4 percentage points lower than that forecasted in February.

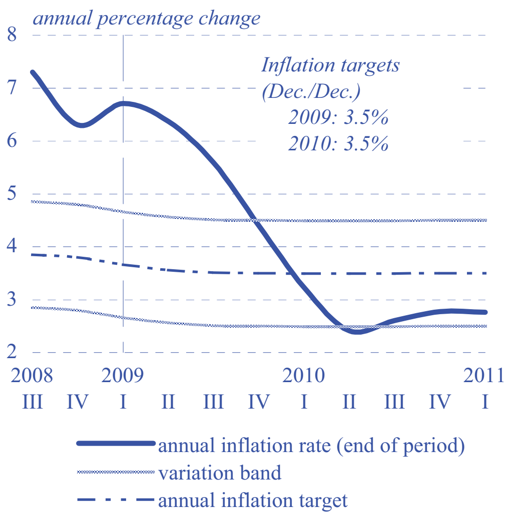
The forecast envisages the inflation rate to re-enter the variation band around the central target in the final quarter of 2009. The NBR will seek to ensure broad real monetary conditions in line with the sustainable maintenance of inflation rate within the projected coordinates. This objective is conditioned by the future development of exogenous factors which should not deviate significantly from the baseline scenario projection coordinates and by an adequate support received by the monetary policy from the other macroeconomic policies. At the same time, ensuring a lower inflation rate in a sustainable manner implies an ongoing orderly adjustment of macroeconomic disequilibria and maintaining financial stability.

Considering that the developments in exchange rate and aggregate demand are the main drivers of projected inflation, the major risks associated with the current forecast are linked to their future dynamics. Knock-on effects from the global crisis emerging at a different intensity than that envisaged in the baseline scenario would involve deviations from the projected levels of exchange rate and economic growth. In the near run, owing to the typical reaction of foreign investors in emerging economies, the deepening of the crisis might bring about more severe effects reflected in a sharper leu depreciation and weaker GDP growth, while a faster recovery of world economic activity (or a lower-than-projected downturn) may lead to opposite-direction deviations from the baseline scenario. For the current forecasting round, the balance of risks associated with the projection, while largely in equilibrium, implies a moderately higher likelihood of inflation deviating downwards, rather than upwards, from the baseline scenario.

The risks of a less favourable than anticipated evolution may be induced particularly by external shocks that could interfere with the orderly adjustment of macroeconomic imbalances. Such external causes, contingent upon the future developments in the global crisis, could be enhanced by domestic factors such as an insufficient coherence and time consistency of macroeconomic policies, as well as the persistence of rigidities on the labour market and in the price-setting behaviour. Nevertheless, the identified risks appear to be significantly mitigated as against the previous forecasting round.

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

Inflation Forecast



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

Source: NIS, NBR calculations

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 4.4 percent, down by 0.1 percentage points from the level published in February. In 2010, annual inflation rate is forecasted to fall to 2.8 percent, i.e. below the central target (3.5 percent), as well as below the previously forecasted figure (3.2 percent). Against the backdrop of substantial uncertainties, the balance of risks associated with the current projection remains largely in equilibrium, implying though a moderately higher likelihood of inflation deviating downwards from the baseline scenario. The key support of such an assessment is the likely mitigation of exchange rate volatility within a shorter horizon than that assumed in the baseline scenario.

Table 5.1. The annual inflation rate in the baseline scenario

percent

Period	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1
Target			3.5				3.5	
Forecast	6.4	5.6	4.4	3.2	2.4	2.6	2.8	2.8

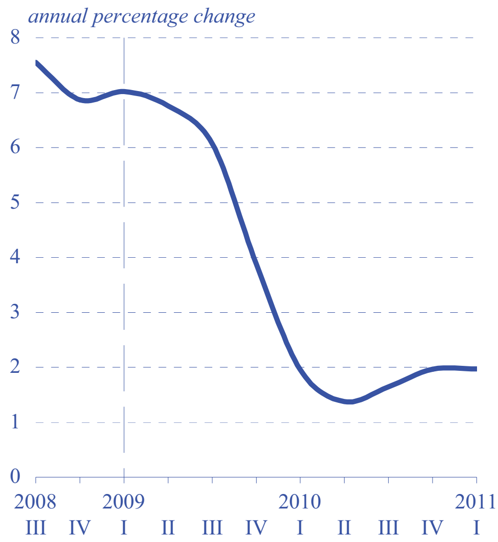
The projected CPI inflation rate for 2009 is maintained at levels close to those incorporated in the prior projection, despite the substantial update of the coordinates underlying some assumptions used in the previous forecast:

– *significant (downward) revision of inflationary pressures from aggregate demand*; the fallout from the global financial crisis, reflected by the marked slowdown in economic activity in 2008 Q4, is expected to persist throughout the eight quarters projection horizon, supporting the assumption of a certain decline in economic growth, including in the growth rate of potential GDP[51]. Even under such circumstances, compared to the previous projection, the output gap is forecasted to fall deeper into the negative territory throughout the forecast horizon[52];

– *stronger inflationary impulses arising from the dynamics of the exchange rate of the leu*; compared to the previous forecasting round, the persistence of investors' risk aversion of the recent periods, entailing adverse effects on the projected trajectory of the domestic currency in early 2009, led to the upward revision of the dynamics of the consumer basket components that are directly contingent upon exchange rate developments (fuel prices, import prices, administered prices)[53].

According to the baseline scenario, the 12-month CPI inflation rate is foreseen to follow a downward path over the next eight quarters. CORE2 inflation dynamics is anticipated to be the main driver of this process, amid expectations of a substantial slowdown in economic activity[54] (for example, for this year, CORE2 inflation is the only CPI basket component that is projected to post lower annual[55] levels than those published in the February 2009 Inflation

CORE2 Annual Inflation



Source: NIS, NBR calculations

[51] For further details, see Subsection *1.3.1. Current aggregate demand pressures.*

[52] Hence, disinflationary effects from aggregate demand are expected to have a greater impact than that projected in February with its high intensity expected to endure in the second part of the forecast horizon.

[53] According to the assessments in the baseline scenario, following the projected alleviation of the exchange rate volatility, the aforementioned inflationary effects are foreseen to fade relatively fast.

[54] Marginal costs associated with domestic production factors are projected to fall sizeably given the downturn in output volume (amid expectations of a significant moderation of domestic aggregate demand dynamics). Starting from these prerequisites, retail prices would, *ceteris paribus*, be subject to an adjustment in the same direction (this result is strictly conditional upon maintaining an exchange rate dynamics similar to the one projected in the baseline scenario).

[55] Annual inflation at the end of 2009.

Report). By contrast, the weaker leu in 2008 Q4 and 2009 Q1[56] is envisaged to alleviate disinflationary pressures from aggregate demand, entailing second-round effects on the price dynamics of the other CPI basket components[57], except volatile food prices. For the end of 2009, these developments entail an annual CPI rate of 4.4 percent, placed marginally below the upper bound of the variation band around the central target, i.e. 3.5 percent ±1 percentage point.

Administered Prices Annual Inflation

annual percentage change

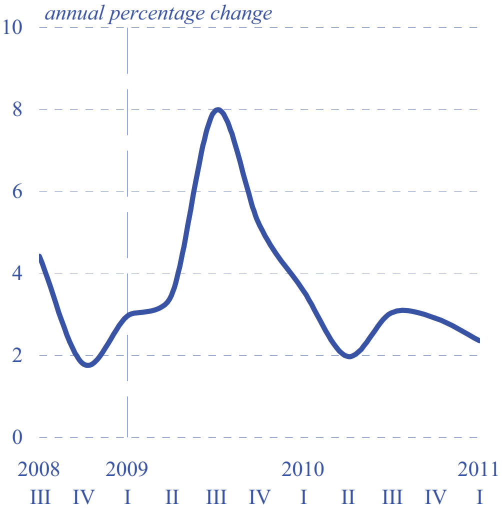
Source: NIS, NBR calculations

As the excessive volatility of the exchange rate is projected to be eliminated and its dynamics resume gradually along a trajectory determined mainly by fundamental factors[58], consumer prices are expected to reflect mostly the ongoing adjustment of domestic aggregate demand components. Thus, CORE2 inflation is foreseen to be the major driver of disinflation in 2010, as this is the only CPI basket component which is projected to post lower levels than that of the entire basket. In contrast, fuel prices are seen as the major culprit for inflation – their forecasted adjustment reflects both the hypothesis of a gradual increase in the oil price as well as that of a slight strengthening of the euro versus the US dollar. Compared to the February 2009 forecast, the lower inflation rate projected for December 2010 (by 0.4 percentage points) might largely be ascribed to the revision of the current scenario for the evolution of economic activity.

1.2. Exogenous pressures on inflation

Vegetables, Fruit and Eggs Prices Annual Inflation

annual percentage change



Source: NIS, NBR calculations

The contribution of the exogenous scenarios on administered prices and volatile prices of vegetables, fruit and eggs to CPI inflation is more sizeable in the current baseline scenario than in the previous projection. Administered price inflation is expected to make a larger contribution to annual headline inflation over the entire projection horizon, i.e. 0.9 percentage points in 2009 and 0.6 percentage points in 2010. Similarly, volatile food price inflation is anticipated to be slightly higher throughout the projection

[56] A lagged effect of the past depreciation of the leu on the future price-setting behaviour was considered as a working assumption given also the exchange rate volatility of the recent months (appreciation episodes followed rapidly by depreciation episodes). Given the dilution of the informational content provided by the exchange rate, some producers could choose to set their prices based on a more depreciated level of the leu, deemed as sufficient to cover the spectrum of possible future outcomes of this variable.

[57] Part of the CORE2 inflation dynamics derives from the scheduled adjustments in excise duties on cigarettes and from the evolution of import prices, both of them depending upon the forecasted path of the exchange rate of the leu.

[58] The baseline scenario foresees a marked correction of the external imbalance in 2009, thus creating favourable conditions for an improvement in investors' sentiment and removing the burden of achieving such adjustments by resorting primarily to the exchange rate.

horizon, having a higher contribution to CPI inflation than in the previous projection.

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

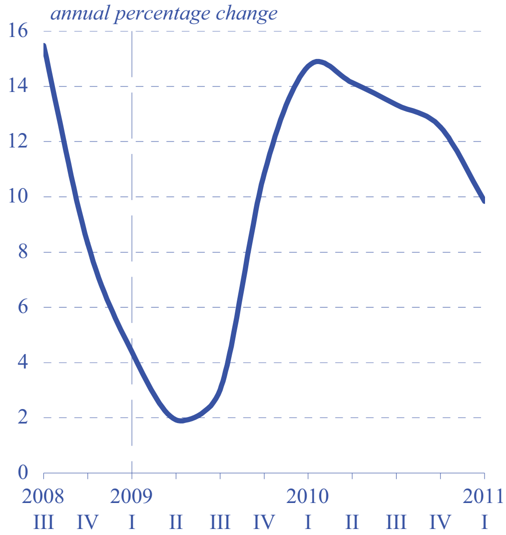
percent

		Administered prices		Volatile food prices	
		2009	2010	2009	2010
Current projection	Annual change	5.1	3.5	5.2	2.9
	contribution to CPI inflation (pp)	*0.9*	*0.6*	*0.4*	*0.2*
Previous projection	Annual change	3.2	3.0	4.6	0.4
	contribution to CPI inflation (pp)	*0.7*	*0.6*	*0.3*	*0.0*

Electricity and natural gas prices hold the largest share in the group of administered prices, i.e. more than 40 percent. The baseline scenario of the current projection incorporates the assumption of the electricity price[59] and the natural gas price remaining at the present level during 2009, both being expected to increase starting with January 2010.

Fuel Prices Annual Inflation

annual percentage change



Source: NIS, NBR calculations

Table 5.3. The scenario for the energy prices growth rates

percent, annual change

	Electricity		Heating		Natural gas	
	2009	2010	2009	2010	2009	2010
Current projection	0.2	3.0	8.6	5.2	0.0	3.0
Previous projection	0.0	3.0	8.2	3.6	0.0	3.0

The adjustments in the excise duty on cigarettes are projected to put larger inflationary pressures than estimated in the February 2009 Inflation Report. The inflationary contribution of the excise duty on tobacco was reassessed mainly due to earlier implementation of the initial calendar for adjusting excise duties[60], the largest impact of this change being expected in the course of 2009.

During the projection horizon, CPI basket components are anticipated to be affected to a different extent by the dynamics of external variables. Thus, the assumption of a rising oil price[61] on

[59] Excluding hikes applied in January 2009.

[60] According to the initial calendar, the total excise duty was supposed to be raised in one stage on 1 July 2009, from EUR 50 to EUR 61.2/1,000 cigarettes. In line with the new calendar, the excise duty went up from EUR 50 to EUR 57/1,000 cigarettes as early as 1 April 2009. Likewise, an additional increase, from EUR 57 to EUR 64/1,000 cigarettes is expected for 1 September 2009. For 2010, the calendar was left unchanged, with the total excise duty set to reach EUR 74/1,000 cigarettes.

[61] The same as in the previous projection, the international oil price is expected to increase gradually to USD 70/barrel in 2010 Q4.

the international markets is seen to have, *ceteris paribus*, adverse effects on domestic fuel prices. By contrast, expectations of a lower inflation rate in the euro area will have a favourable impact on import prices and therefore on CORE2 inflation. Forecasts indicate an annual HICP inflation rate of only 0.8 percent in 2009, against the background of an estimated 2.7 percent contraction in the economic growth of the euro area. However, the cuts in the key rate by the European Central Bank over the past few months are expected to contribute gradually to the revival of the economic activity and to help ensure price stability in the medium run. For 2010, a slight recovery in the main macroeconomic indicators of the euro area is anticipated (see Table 5.4.).

Table 5.4. The expected developments of external variables

annual averages

	2009	2010
3-month EURIBOR interest rate (%)	1.6	1.8
Oil price (USD/barrel)	52.8	66.0
EUR/USD exchange rate	1.29	1.30
Annual inflation rate in the euro area (%)*	0.8	1.2
Economic growth in the euro area (%)	-2.7	0.0

* in Q4

1.3. Aggregate demand pressures

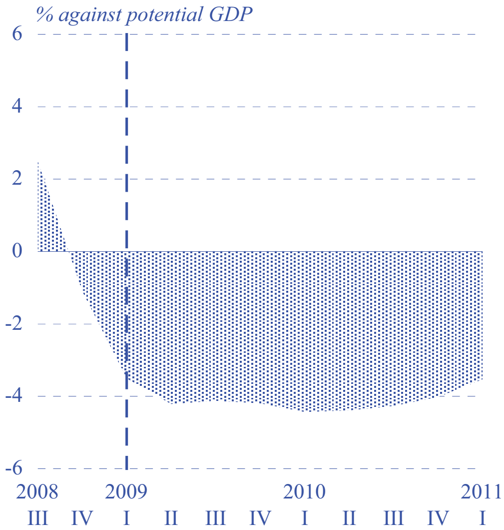
1.3.1. Current aggregate demand pressures

The effects of the deeper global financial and economic crisis on the economic context in Romania generate higher uncertainties surrounding the projections of the medium-term developments in the macroeconomic variables. An important uncertainty issue refers to the size of the unfavourable crisis effects on aggregate demand and potential GDP growth, creating difficulties in assessing the magnitude of the negative output gap and, consequently, the intensity of the ensuing disinflationary pressures.

In 2008, the average annual dynamics of real GDP calculated by the NIS (7.1 percent) was lower than the previously forecasted figures. The annual growth rate recorded in 2008 Q4 (2.9 percent) had a major contribution to the faster-than-expected slowdown in economic activity, reflecting the stronger-than-projected effects of the global financial crisis on the Romanian economy. The substantial fall in liquidity on international markets led to the contraction of financial inflows in emerging economies and hence to a drop in domestic lending (in both demand and supply terms). The above-mentioned spillover effects are expected to drag on into 2009 Q1, with a negative bearing on economic growth and implicitly on the potential GDP dynamics due to the sharp fall in investment activity since as early as 2008 Q4. Against this background, the output gap for 2008 Q4 was revised to a negative value, a persistent demand shortage being expected for 2009 Q1 as well, which implies the build-up of disinflationary pressures from current aggregate demand.

In 2009 Q1, household final consumption, the main GDP component, is forecasted to remain on the downtrend it has followed since 2008 Q4. The 2008 Q4 developments in household final consumption are significantly different from those recorded in the first three quarters of the year, the statistical data revealing a 3.7 percent drop as compared to the same period the year before, which was attributed to lower expenses related to household final consumption[62]. The anticipated slowdown in consumption dynamics in 2009 Q1 illustrates the further decelerating growth rate of resources available to households in the short term[63]. The slower increase in the aforementioned resources was particularly determined by the sudden drop in the volume of new loans extended to households[64], caused by factors related to both supply (increased financing costs of the banks, rise in banks' risk aversion to non-bank clients) and demand (amid the downward revision of prospects on future incomes as a result of the uncertainty generated by the economic crisis). In addition, the annual growth rate of the real net wage continued to slow down in January and February as compared with the 2008 Q1 average to about 9 percent (as against an average annual growth rate of nearly 14 percent throughout 2008), remaining however above the medium-term levels. Furthermore, aggregate resources available to households are expected to decline also due to the anticipated downward dynamics of the number of economy-wide employees[65].

GDP Deviation



Source: NIS, NBR calculations

Public consumption is projected to post a negative quarterly change in 2009 Q1[66], being below the trend level, as compared with 2008 when its deviation from the trend was estimated to be positive.

In 2008 Q4, gross fixed capital formation declined sharply as compared with the previous quarter, its annual growth rates decelerating as well to 2.8 percent. The slowdown is attributable

[62] They dropped 4.7 percent as compared to 2007 Q4.

[63] In addition, the annual dynamics of the retail trade turnover (except for motor vehicles and motorcycles) in January and February 2009 reduced to -5.7 percent as compared with the 2008 Q1 average.

[64] New loans extended to households in both leu and foreign currency decreased by about 75 percent in 2009 Q1 against the 2008 Q1 average. Moreover, the real annual growth rate of consumer loans continued to slow down in 2009 Q1 to 20.8 percent, as compared with the values recorded in 2008 Q3 which exceeded 40 percent.

[65] In 2009 Q1, unemployment rate rose to an average of 4.9 percent versus 4.1 percent in the prior quarter and 3.9 percent in 2008 Q1 (seasonally adjusted data).

[66] In line with the seasonally adjusted data for the respective component.

to the 2008 Q4 developments in all investment components: the annual growth rate of new construction works stood at 7.3 percent, down about 20 percentage points from the 2008 Q3 figure, while total equipment, including transport means, recorded an annual growth rate of merely 3.6 percent as compared with 15.1 percent in the prior quarter.

In 2009 Q1, gross fixed capital formation is expected to worsen further, along with the emergence in this context of temporarily idle production capacities. The assessments indicate that gross fixed capital formation is below the medium-term trend level for the second consecutive quarter. This development, also mirrored by the negative growth rates of imports of capital goods and industrial output of capital goods[67], is attributable to a decline in financing sources for investment projects, as well as to a deterioration of economic agents' expectations on future economic prospects, reflected by the anticipated dynamics of demand for their products. Furthermore, interest rates on loans extended to economic agents are high, illustrating both the additional financing costs in the banking sector, as well as the stronger risk aversion to non-bank clients. Hence, the pace of increase of medium- and long-term loans to economic agents[68] – seen as a financing source for investment – slowed down having a contractionary impact on investment in recent quarters.

In 2008 Q4, net exports made a positive contribution to GDP dynamics, following the year-on-year sharp fall in imports and the marginal increase in exports. The adjustment initiated in the case of net exports throughout 2008 Q4 is expected to continue in 2009 Q1. Hence, in the case of exports, the potential expansionary effect of the domestic currency depreciation in the last quarter of 2008 is offset by the effect of the sluggish dynamics of economic activity of the trade partners[69], which led to flagging external demand for domestic products. The contraction in external demand has a negative impact on industrial output, whose annual growth rates remain in the negative territory in 2009 Q1[70]. The main factors behind the anticipated substantial decrease in imports are the falling

[67] Industrial output of capital goods went down in the first two months of 2009 Q1 by nearly 18 percent as compared with the 2008 Q1 average, while imports of capital goods decreased in 2008 Q4 by about 24 percent as compared with the average for the same quarter of the previous year (data on imports of capital goods are seasonally adjusted and expressed in euro).

[68] The dynamics of the medium- and long-term loans to economic agents decelerated in 2009 Q1 to 16.3 percent as compared with 26.4 percent in the prior quarter.

[69] The euro area countries are Romania's main trade partners. The annual growth rate of GDP in the euro area (as an approximation of external demand for Romanian goods) stood at -1.6 percent in 2008 Q4 (non-seasonally adjusted data).

[70] In January and February 2009, the annual growth rate of industrial output stood at nearly -14 percent as compared with the 2008 Q1 average.

domestic demand amid slower expansion in available resources of households and economic agents[71], as well as domestic currency depreciation in 2008 Q4.

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

While in the first weeks of January 2009 the domestic currency depreciated significantly in nominal terms against the euro compared to the average recorded in the final quarter of 2008, it remained relatively stable throughout the rest of Q1. During this period, the leu was subject to downward pressures similar to those manifest in other emerging economies, against the backdrop of a worsening external environment and investors' reassessment of the risks associated with investments in these countries. The main domestic factors indicating the vulnerability of the Romanian economy, at least in 2008 Q4, were the persistence of a wide current account deficit, the dependence of the banking system on external financing, the expectations of a significant slowdown in GDP dynamics for 2009, and the procyclical budget policy. These factors contributed to the increase in the risk premium associated to Romania and put stronger depreciation pressures on the domestic currency in 2009 Q1. Such developments occurred in the context of ignoring favourable economic fundamentals such as a low total public debt, a relative moderation in the spillover effects of the global crisis via net export and credit channels, the sound banking system, etc. The resort to an external loan led by the IMF- EU in order to proactively offset a possible decrease in official reserves via declining private capital inflows translated into improved investors' sentiment, with a direct impact on the downward pressures of the leu in the latter half of March.

The decrease in exports due to falling external demand has been softer given the noticeable depreciation of the domestic currency in the first quarter of 2009 and outpaced by the adjustment of imports in the context of the drop in domestic demand, altogether contributing to a further narrowing of the current account deficit. Thus, the exchange rate exerts, via the net export channel (mainly the transfer of import demand onto domestic output), a larger stimulative effect on future aggregate demand than in the previous quarter. On the other hand, an opposite effect of the domestic currency depreciation on domestic demand, when compared to the one mentioned above, is present through the wealth and balance sheet effects, due to the increase in the cost of servicing loans denominated in foreign currency. In the near run, the weaker domestic currency will contribute to the increase of imported and exchange rate-indexed goods' prices, exerting upward pressures on

[71] In 2009 Q1, the annual growth of the non-government credit balance continued the downtrend started in Q2, reaching 20.9 percent.

CPI inflation, albeit a moderation in the relative pass-through is expected insofar as aggregate demand declines.

In the medium term, the domestic currency is expected to follow a trajectory in line with the adjustment of the current account deficit to sustainable levels, amid further relatively high risk aversion and low liquidity on international markets. However, such an adjustment should not be performed solely on the back of the exchange rate. The external financing package will allow for a gradual adjustment of existing imbalances, thus avoiding the substantially stronger negative effects of a disorderly correction.

In 2009 Q1, the NBR accommodated the demand for liquidity on the interbank money market and, at the same time, gradually lowered interest rates on liquidity-providing operations, thus consolidating its position as creditor vis-à-vis the banking system. The ongoing relatively high interbank rates and the keen competition among banks to attract domestic resources, in the context of less readily available external financing sources, led to further noticeable rises in deposit rates as compared to the previous quarter. Thus, the additional financing costs, together with the higher risk aversion of commercial banks vis-à-vis non-bank clients, caused nominal lending rates to go up. Against this background, the increase of the nominal interest rates applied by commercial banks to non-bank clients during 2009 Q1, amid moderately lower inflation expectations, implies a sizeable restrictiveness on aggregate demand in the coming periods.

In 2009 Q1, the joint effect of the leu exchange rate and of the credit institutions' interest rates applied to non-bank clients on future economic activity has been relatively more stimulative than in the previous quarter.

1.3.3. Demand pressures within the projection horizon

Since the February 2009 Inflation Report, the uncertainties surrounding the prospects for the macroeconomic and financial developments in Romania increased markedly amid the effects of the deepening global economic and financial crisis[72]. In this context, the current projection relies on a GDP deviation from the trend level sizeably revised downwards at the starting point[73]. Subsequently, during the projection horizon, the forecasted trajectory of the output gap is conditional upon the assumptions regarding the economic growth in the euro area[74] and the expected

[72] As an illustrative macroeconomic indicator, GDP growth released by the NIS for 2008 Q4 was below the benchmark projection released in February.

[73] 2009 Q2.

[74] Romania's main trade partner, GDP dynamics in the euro area is used to approximate demand for exports addressing domestic producers.

developments of the major determinants of the output gap: broad real monetary conditions, domestic lending, external demand for domestically produced goods and services and the macroeconomic policy mix.

Taking into account the entire set of determinants, during the projection horizon, the dynamics of output gap in the baseline scenario shows values that are consistent, *ceteris paribus*, a sharper easing of inflationary pressures from aggregate demand in both 2009 and 2010[75].

One of the most important pass-through channels for the effects of the global financial crisis on the Romanian economy is the financial channel, given that a large share of the private financing lines have been extended based on substantial funds channelled to local banks by the parent banks. Moreover, foreign currency-denominated loans hold a large share in total loans to the private sector[76]. Therefore, the recent depreciation of the leu is expected to have a restrictive effect on domestic demand in the short run, as a result of the higher debt service – expressed in domestic currency – ascribed to the foreign currency-denominated loans taken previously, effect that is manifested to a large extent at household level, despite the set of measures taken by the NBR over time[77] designed to contain the share of foreign currency-denominated loans. Along with the projected alleviation of the recent excess volatility of the exchange rate[78], its dynamics will be gradually and to a great extent influenced by economic fundamentals[79]. Thus, the restrictive effect exerted via this channel on GDP dynamics is expected to gradually fade away.

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[75] For an assessment of certain uncertainties attached to the impact of the economic downturn on the consumer prices growth rate, see Subsection *1.4. Risks associated with the projection*.

[76] In March 2009, foreign currency-denominated loans accounted for 59 percent of the outstanding loans, while 49 percent of the new loans was denominated in foreign currency (all the data is expressed in domestic currency – leu).

[77] Given the rapid slowdown in the real wage growth over the past several months, the balance sheet effect associated with a weaker leu reduces economic agents' resources available for consumption. However, for the outstanding loans, the baseline scenario of the projection envisages the offsetting to a certain extent of this balance sheet effect, following the projection of a gradual decline (particularly during 2009) of EURIBOR interest rate and of a gradual reduction of the sovereign risk premium.

[78] To this will also contribute the expected improvement in the financial investors' negative perception regarding Romania's overall sovereign risk in the context of the IMF-EU-IFI-led multilateral financial arrangement and of the improved sustainability of external financing resources induced by this agreement.

[79] The baseline scenario foresees a marked correction of the external imbalance in 2009, thus creating favourable conditions for the improvement in the investors' sentiment and removal of the burden of performing such adjustments by resorting primarily to the exchange rate.

Compared to the wealth and balance sheet effects of the exchange rate, the dynamics of the loans extended to the private sector is expected to have more persistent effects on aggregate demand components. As a result, the adverse effects on the economic sectors that rely on bank loan financing are foreseen to be ampler and lasting longer than previously expected[80].

Financial institutions' reassessment of the lending-related risks (reassessment of lending rates applied by these institutions to credits), as well as the keener competition among banks aimed at attracting domestic financial resources pushed interest rates higher, as early as 2009 Q1, compared to the previously expected levels. As a result, the projection envisages throughout the horizon tighter real interest rates set by the financial institutions compared with those in the previous forecasting round. This implies, on the one hand, a higher debt service ascribed to the loans taken previously, and on the other hand, a slowdown of demand for loans, given the larger costs incurred by economic agents.

The higher than previously expected economic downturn in the euro area, implies a worsening of the prospects for imports demand of the euro area and has a negative impact on the dynamics of the Romanian exports. In this context, the projection of the real exchange rate situated above the trend level[81] throughout the projection horizon is expected to entail particularly costlier imports, thereby fostering both the domestic savings and the partial switch of domestic demand towards local producers. At the same time, the expansionary effect of the exchange rate on exports is expected to have a considerably smaller magnitude compared to the previous forecasting round, being highly conditional upon the unfavourable dynamics of demand on the international markets. The net outcome of the two antagonistic factors – subdued external demand and real depreciation of the domestic currency – is expected to stimulate aggregate demand, contributing to the shaping of a fast-paced but controlled adjustment scenario of the trade balance. Should future developments be in line with the projection, conditions would be created to avoid an alternative scenario that would imply an even sharper contraction of domestic aggregate demand components.

Throughout the projection horizon, the conduct of monetary policy will be governed by the primary objective of ensuring price stability over the medium and long run. At the same time, given the worsening of the fallout from the global financial crisis and the persistently high risk aversion of international investors, the central bank will give pre-eminence to the controlled adjustment

[80] The January 2009 survey on lending to non-financial corporations and households shows the tightening of lending conditions for both households and legal entities.

[81] For further details, see Subsection *1.3.2. Implications of recent exchange rate and interest rate developments on economic activity.*

of macroeconomic imbalances, while securing the stability of the financial system. The adequate management of liquidity on the interbank market is projected to partly offset the restrictive effects on the economic activity level of the projected trajectory of interest rates set by the financial institutions, without causing a higher volatility of the exchange rate of the leu.

The fiscal policy stance has been formulated based on the latest available information, corroborated by information contained in the IMF-EU-led arrangement. However, there are still uncertainties surrounding the elasticity of collected revenues with respect to the expected contraction in economic activity, as well as the efficiency of the measures aimed at cutting budget expenditures to be implemented during 2009, given the existence of the automatic stabilisers. Taking into consideration the fiscal policy measures implemented so far, as well as the expectation of a stronger deceleration of GDP and its components, the fiscal projection envisages the actual budget deficit for both 2009 and 2010 at a higher level than in the previous Inflation Report. The anticipated effect of the fiscal impulse is expected to become more restrictive starting with the second part of 2009[82]. Against this background, the discretionary fiscal policy is slightly pro-cyclical vis-à-vis the economic activity over the following eight quarters.

1.4. Risks associated with the projection

The baseline scenario of the projection is subject to a wide range of uncertainties. Out of the possible events, this section focuses on those that are deemed to have a higher likelihood to materialize in the upcoming eight quarters. To sum up, the balance of risks associated with the current projection, while largely in equilibrium, implies a moderately higher likelihood of inflation deviating downwards, rather than upwards, from the baseline scenario. The assessment is based on the likely mitigation of exchange rate volatility within a shorter horizon than that assumed in the baseline scenario.

For the current round, uncertainties surrounding the duration and magnitude of the financial crisis on the dynamics of macroeconomic variables represent the risk with the most significant impact on the uncertainty interval around the projected CPI inflation. The knock-on effects of the financial crisis are likely to be deeper and more protracted than envisaged in the baseline scenario. This could trigger a sharper contraction in economic growth, a smaller degree of utilization of available resources and an inflation rate below that implied by the baseline scenario. On the other hand, given the potentially faster rebound in world economic activity and the macroeconomic policy mix yielding more effective results

[82] The relation between the fiscal impulse and the structural deficit is presented in *Box 1* in November 2008 Inflation Report.

domestically, economic activity is likely to recover at a quicker pace than that assumed in the baseline scenario of the projection.

One of the relevant risks to the baseline scenario coordinates relates to the unwinding of external imbalances (mainly trade deficit and current account deficit) and domestic imbalances (associated with the inflation rate reverting close to the central bank's target band) over the projection horizon. Compared to the previous forecast, the budget deficit was substantially revised to more negative levels for both 2009 and 2010. Under the circumstances, a faster-than-anticipated deceleration in economic activity would imply a stronger correction of the aforementioned disequilibria and might prove ambitious in terms of the private sector's ability to bear most of the burden of these adjustments. The difficulty in ensuring the sustainability of this process could generate additional depreciation pressures on the domestic currency, with potentially negative consequences both on the envisaged path of the disinflationary process and on the level of foreign currency denominated debt service of households and companies.

The current forecasting round is fraught with high uncertainties surrounding the necessary time span for the economic activity to recover. Amid the protracted or even aggravated contagion effects of the global financial crisis, an undermining of the baseline scenario assumptions regarding the lending dynamics throughout the projection horizon could entail a stronger contraction in economic activity in the main sectors, paralleled by similar developments in other countries. Thus, risks relating to an even more sizeable slowdown in consumer price dynamics would be equally higher.

The recent divergent developments in economic activity (downside) and CORE2 inflation (upside) signal the risk of structural rigidities becoming manifest, which are likely to delay the elimination of the domestic imbalance. For instance, when faced with a decline in the volume of sales and the difficulty of swiftly implementing staff and/or wage cuts, some economic agents might initially choose to make up for the profitability loss by maintaining the high prices or even raising them further. Subsequently, the impossibility of selling their products and thus attaining the proposed sale targets could trigger bottlenecks in payments to suppliers, employees or even to the government budget. This could lead to a contraction in economic activity, which might be accompanied by higher inflation.

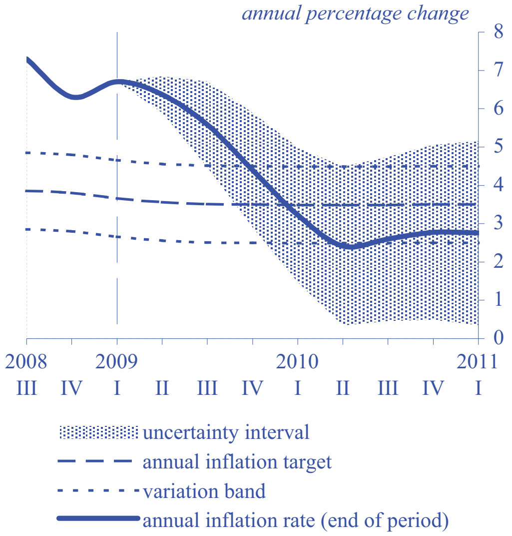
The dynamics of external financial flows (private and public borrowings, foreign direct investment) stand out as a major risk source in relation to exchange rate developments and further normal functioning of the economy. The financing the current account deficit is closely connected with the uncertainties surrounding external financial flows. Given the forecasted deceleration in domestic economic activity and the reassessment by the foreign investors of the risks associated with investments in emerging economies, FDI inflows are likely to witness a more sizeable contraction in the future, but this has yet to be confirmed by available statistical data. This would call for a sharper correction of the current account deficit, to a level consistent with its sustainable financing over the medium term.

Despite the significant budget deficit revision to more negative levels within the baseline scenario, the risks of a larger-than-previously-projected slippage should not be overlooked. Thus, if economic activity decelerates at a faster pace than that assumed in the baseline scenario, the action of automatic stabilizers and the likelihood of a high elasticity of tax revenue collection might entail a wider budget deficit, in the absence of any counteracting measures. Given the ongoing financial crisis and the autonomous reduction in available financing resources, the public sector's higher funding needs could trigger a crowding-out of the private sector, thus delaying the resumption of economic growth, even if government credit dynamics potentially offset part of the envisaged contraction in credit to the private sector. In addition, the macroeconomic policy mix would inherently be thrown off-balance, which might bring about higher volatility in economic activity. This would affect the necessary time span for the economy to re-embark upon a sustainable growth trajectory over the medium term.

As regards CPI basket components, the most significant risks in the current round relate to the projected trajectory of fuel prices. According to the baseline scenario, the oil price is expected to rise by about 32 percent over the next eight quarters[83]. The risk of its trajectory deviating from this hypothesis cannot be ruled out. Such a risk would become relevant amid more protracted or stronger-than-anticipated fallout from the financial crisis on world economic activity (thus leading to a substantial decline in global oil demand). Although the share of fuel prices in the consumer basket is low, the projected effects would contribute, *ceteris paribus*, to a decline in CPI inflation.

The chart illustrates the uncertainty interval around the central projection of inflation in the baseline scenario. 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 taken into account. However, it is foreseen to remain in positive territory. The impact of these risk factors is approximated by an average of past forecasting errors[84].

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR calculations

[83] The trajectory also took into account the subdued oil prices in recent periods.

[84] The uncertainty interval is symmetrically distributed around the projected trajectory of inflation in the baseline scenario. It illustrates the average general uncertainty associated with the inflation forecast and not necessarily the particular uncertainty related to risk factors specific to the current projection.

2. Policy assessment

Since the previous quarterly forecasting round for medium-term macroeconomic developments, the NBR Board has taken the necessary steps to substantiate and set the 2010 inflation target. Following the assessment of the projection scenarios, as well as the risks and uncertainties surrounding the updated forecast of macroeconomic indicators, policymakers opted for keeping the 2010 inflation target at 3.5 percent ±1 percentage point, thus confirming the working assumption announced in the February 2009 Inflation Report.

The first reason for this option was the pressing need to achieve the inflation target in 2010, which is instrumental in preserving central bank credibility given the overshooting of the annual targets over the past two years due to many powerful exogenous shocks occurring successively or concurrently. In addition, to attain a more ambitious target in a sustainable manner next year is difficult given the prospects of persistently adverse effects of external imbalance adjustment and the sizeable uncertainties surrounding the duration and magnitude of the economic downturn.

The National Bank of Romania's cautious approach to setting the 2010 inflation target was also substantiated by the predictable persistence, over the next years, of direct inflationary effects from factors outside the central bank's sphere of influence, of which the most significant are: (i) adjustment of administered prices and indirect taxes, (ii) resumption of convergence of the Romanian economy, including price level convergence after a period marked by a simultaneous economic downturn, and (iii) the persistence of some asymmetric nominal rigidities.

At the same time, the current level of the inflation target is regarded as further fulfilling the requirement to consolidate disinflation in a sustainable manner and achieve, according to the timetable for euro adoption, an inflation rate in line with the inflation criterion laid down in the Maastricht Treaty and the European Central Bank's quantitative definition of price stability.

Seen from the perspective of monetary policy conduct, accomplishing these objectives is complicated by the focusing – in the near run at least – on the support lent to the ongoing orderly correction of macroeconomic imbalances and the maintenance of financial stability. Such an approach is substantiated by the need to prevent a massive, lengthy contraction in economic activity and the purchasing power of the domestic currency, which would depress the growth potential of the Romanian economy in the medium and long term.

Starting from such prerequisites that imply a certain monetary policy configuration as well as from recent developments and assumptions deemed as more likely to materialise in the foreseeable future, the updated baseline scenario shows a relative worsening of the inflation outlook in the first fourth of the projection horizon as compared to the prior projection, followed however by a faster and more considerable improvement in the next quarters. The annual inflation rate is expected to return inside the variation band around the central target and especially to fall into the lower half of this corridor earlier than foreseen in the previous projections (2009 Q4 and 2010 Q1 respectively).

The major driver of faster disinflation is the predictable widening of the negative output gap arising from the anticipated downturn of the Romanian economy in 2009 under the impact of an intensified and broader global crisis. Economic growth is estimated to have already dipped into negative territory in 2009 Q1. The signs and prerequisites of the trend reversal are: (i) larger-than-expected decrease in the annual GDP dynamics in 2008 Q4 and its inertial nature, (ii) entering/staying in negative territory of the year-on-year dynamics of some relevant indicators on demand for consumption and investment, as well as on supply, in early 2009, (iii) sharper worsening trend in EU economies, with a noticeable contractionary impact on the domestic economy, (iv) ongoing tightening of lending conditions, especially on the local financial market, associated with the considerable slowdown in lending, despite interbank rates nearing the monetary policy rate and their expected further convergence, and (iv) a faster increase in unemployment rate in 2009 Q1.

Against this background, the NBR is concerned about the overly slow pace of deceleration of forecasted inflation in the near run, despite the envisaged widening of aggregate demand shortage in the next quarters. For the central bank to identify the sources of the high inflation persistence is both difficult and important. This is vital for an adequate calibration of monetary policy response, implicitly for firmly anchoring inflation expectations and ensuring sustainable disinflation.

Hence, the stronger inflationary pressures manifest in the first part of 2009 as a result of hefty adjustments in administered prices and excise duties, fuelled by the weaker leu versus the major currencies, may explain only part of the short-lived mismatch that appears to have emerged between the developments in the real sector and those in the consumer price index. Consequently, adjusted CORE2 inflation is seen playing a central role in containing disinflation in the months ahead, as its downward rigidity may exceed the values justifiable by the inherent lag in the transmission of effects related to the beginning and deepening of the economic downturn. Under the circumstances, alongside the direct impact from the recent weakening of the domestic currency, the overly slow deceleration of adjusted CORE2 inflation reflects most likely its significant persistence and unfavourable inflation expectations, which are heavily fuelled by strong volatility of the exchange rate of the leu and its increasing unpredictability. Another possible effect could arise from the – likely temporary – incentive to domestic output as a substitute for imports via expenditure switching and the stimulus from a lower contraction in aggregate demand over the near run than that in independent forecasts.

The persistent nature of adjusted CORE2 inflation appears to originate not only in the sizeable pass-through of the exchange rate of the leu, including as a result of the large share held directly and directly by imported products in the CPI basket, but also – most likely – in the price-setting behaviour of several retailers (reflecting certain structural drawbacks across the economy) and the wobbly anchoring of inflation expectations.

Furthermore, the substantial increases in unit labour costs born by certain companies in the past, along with the sizeable decreases in output and productivity, seem to play a certain role in the lagged effects from the opening of the negative output gap on consumer prices. Adding to these factors is the likelihood of prevailing accommodative expectations in the case of some companies – especially expectations on the nature of fiscal and wage policies to be implemented by the authorities – and/or the persistence, in certain fields, of overly optimistic anticipations on the duration and magnitude of the economic downturn.

However, once the evidence on the economic decline crystallises and its ripple effects flow through to the labour market, the consumer price-setting mechanism is envisaged to undergo a significant correction, which may fuel disinflation within a short time frame. This might be additionally spurred by a larger-than-expected GDP fall, which is a plausible assumption considering the still high uncertainties surrounding the current forecast of medium-term macroeconomic developments at a European and global level.

A sharper contraction of the Romanian economy could largely be induced by: (i) a possibly stronger and longer setback in foreign trade, entailing a deeper plunge in Romania's exports and (ii) further tightening of lending conditions both nationally and internationally given the assumption of a still high risk aversion and expanding financial deleveraging on a global level.

Over the short term, the "volume effect" on exports exerted by the ampler compression in external demand is expected to further counter the impact of potential competitiveness gains arising from the recent depreciation of the leu versus the major currencies. At the same time however, in view of its specific elasticity, the slower export dynamics will most likely be accompanied by a faster decline in import growth rate, which could be enhanced with a certain lag by a shift towards domestically-manufactured goods and services as a result of the developments in the domestic currency.

The possible delay in restoring confidence of the world's financial environment in the global real sector, resulting in further tightening of external financing available to the Romanian economy, might trigger primarily a faster decline in domestic aggregate demand. The contractionary impact of this channel, exerted primarily through a slowdown in domestic lending, might however contradict the unfavourable expectations if parent undertakings – holding the largest part of foreign bank assets in Romania – roll over nearly all their local investments maturing in the period ahead. The likelihood of such behaviour has recently been reinforced by the arrangement concluded by the Romanian authorities with the IMF, the EU and IFI, as part of a multilateral financial package, to which there is attached a formal commitment by the respective banks to maintaining their overall exposure on the local market.

In this context, key factors likely to contain lending in the future are banks' persisting mistrust in the short-term outlook of the Romanian economy and their enfeebled perceptions of risks to household and corporate lending, on the one hand, and the continued sluggish demand for loans on the back of worsening expectations on future incomes of potential loan applicants and higher prices attached thereto, including as a result of past leu depreciation, on the other hand. The unfavourable expectations regarding supply of and demand for loans could however be partly countered given that, despite the gradual decline in the domestic and foreign-currency-denominated[85] loan stock in 2009 Q1, new business[86] to both companies and households in February and especially March saw an upturn, although it is uncertain how long this would last. Moreover, the rising path in lending rates came to a halt, while some banks have recently lowered their rates. In addition, the slight easing in lending conditions might be enhanced in the following months by the coming into force of the reduction in the minimum requirement reserve ratio on credit institutions' foreign-currency-denominated liabilities with residual maturities of more than two years to zero from 40 percent starting with the 24 May-23 June 2009 maintenance period.

Nevertheless, at least in the near run, lending is expected to remain subdued, loans to households in particular, thereby fuelling the drop in consumption propensity, a phenomenon that appears to have taken shape of late. A shift in consumption behaviour is suggested by the unexpectedly abrupt decline in consumer demand

[85] Expressed in euro.

[86] According to CCR data.

failing to match the recent developments in the annual dynamics of disposable income, which stayed relatively high, and the share of loans in households' financing sources; another sign is the steady growth in deposits of households, the pronounced rise in their bank debt service notwithstanding. Against this background, the sharp adjustment in consumption could be attributed rather to the strong increase in households' fears on future developments in incomes and their capacity of servicing borrowings, which has already been considerably dampened by the higher interest rates and the softer leu.

In this context, the ongoing fall in consumption, along with balance-sheet effects of interest rates and domestic currency depreciation, will also have an impact on the companies' current and capital expenditures and, indirectly, may affect the standing of the banking system. Thus, the likelihood of bank debt service to outstrip the payment capacity of some – household and, possibly, corporate – borrowers is on the rise and might impair noticeably some banks' loan portfolios.

Prospects of investment dynamics are however very uncertain, given that, on the one hand, the rate of increase of construction activity is decelerating, domestic and external consumer demand keeps declining, similarly to own and borrowed financing resources, and, on the other hand, foreign direct investment dynamics remained strong in January and February 2009, while the authorities committed (in the recently approved budget revision) to giving a substantial boost to public investment expenditure and to augmenting the volume of absorbed EU funds. A matter of concern is that an ongoing rapid fall in investment over the near run under the impact of prevailing contractionary factors would translate into a lower growth potential of the economy in the years ahead.

Against this backdrop, another risk source comes from the constraints that the potentially insufficient tightness of budget spending policy relative to wages and purchases of goods and services might exert on the implementation of public investment programmes. Nevertheless, this risk was substantially mitigated by the recent commitments by the authorities under the arrangement concluded with the IMF, the EU and IFI. Therefore, an increased restrictiveness in government consumption and budgetary-sector wage policy that would lead to a narrowing of the budget deficit and especially of the gap between savings and investment is essential for restoring foreign investors' confidence in the outlook for the Romanian economy and implicitly for minimising social and economic costs at domestic level as a result of the severe and protracted global financial and economic crisis.

Furthermore, the beginning of fiscal correction this year would help prevent subsequent increases in magnitude, duration and hence costs of the macroeconomic adjustment process, as it would contribute to fiscal policy sustainability and, implicitly, to the improvement of the outlook for the Romanian economy. In addition, Romania would be in a better position to adopt the euro in line with the calendar assumed by the authorities. The immediate effects of such an action would also be favourable, namely weaker persistence of core inflation, improved expectations on price developments, less costly budget deficit financing, and a relative stabilisation in the exchange rate capable of supporting disinflation and financial stability. Yet, one should not ignore a short-lived resurgence in depreciation pressure on the exchange rate considering the – less likely however – assumption of renewed increase in risk aversion and worsening investor sentiment as regards the outlook for the Romanian economy and other economies in the region.

Considering the improvement in the medium-term inflation forecast and the prospects of an ongoing orderly adjustment of the external imbalance amid the implementation of economic policy measures agreed under the arrangement concluded with the IMF and the EU, the NBR Board has decided in its meeting of 6 May 2009 to lower the monetary policy rate by 50 basis points to 9.5 percent per annum. Moreover, it has decided to continue to actively use open-market operations in order to ensure an adequate management of liquidity in the banking system and to leave unchanged the current minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. On 31 March 2009, the NBR Board decided to cut to zero the minimum reserve ratio on foreign currency-denominated liabilities with residual maturities of over two years, starting with the 24 May – 23 June 2009 maintenance period. In this context, the NBR Board reiterated that the consolidation of disinflation and of financial stability requires firm and consistent implementation of the economic – monetary, fiscal and income – policy mix as well as of the agreed structural reforms.