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N O T E

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

The drafting, English version and technical coordination of the Inflation Report were carried out by the Economics Department.

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Foreword

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

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

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

Inflation Report was completed on 3 August 2009 and approved by the NBR Board in its meeting of 4 August 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)
ESA	European System of Accounts
Eurostat	Statistical Office of the European Communities
FED	Federal Reserve System
FOMC	Federal Open Market Committee
GFCF	Gross Fixed Capital Formation
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IFI	international financial institution
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MFI	monetary financial institution
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
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
ULC	unit labour cost
UVI	unit value index
1W	one week
12M	12 months

Contents

I. SUMMARY

Developments in inflation and its determinants

In June 2009, the 12-month CPI inflation rate stood at 5.86 percent, down 0.85 percentage points from 6.71 percent in March. During 2009 Q2, the effects of lower aggregate demand on the rate of increase of consumer prices grew stronger and had a significant impact also on the components usually affected by supply-side factors such as fuel prices and food prices.

As for the group of volatile prices, inflation rate was favourably affected mainly by fuel price movements, the impact of demand contraction and the stronger leu versus the US dollar in 2009 Q2 prevailing over that of the rise in oil prices on world markets towards the end of the period under review. Food price dynamics had a favourable bearing on inflation rate as well. The slowdown in inflation was moderate for volatile food items, but relatively pronounced for the food items included in the CORE2 basket.

The annual pace of increase of unit labour costs in industry was very elevated January through February, but it has decelerated since March. Thus, inflationary pressures from past increases in wage costs, albeit not entirely eliminated, have been alleviated significantly across the industrial sector. However, for the economy as a whole, marked pressures still persist, stemming from other sectors, especially from the public sector.

In June, annual CORE2 inflation was slightly above headline inflation, largely due to the marked pick-up in the growth rate of prices of tobacco products as a result of higher excise duties. By contrast, adjusted CORE2 inflation, which excludes prices for tobacco products and alcoholic beverages, declined considerably below CPI inflation to as low as 4.8 percent, down 1.4 percentage points as against March 2009. Favourable effects were generated by import price and food price dynamics, as well as by a relative moderation in inflation expectations.

In 2009 Q2, the reduction in adjusted CORE2 inflation, albeit significant, appears to be relatively slow given the pace of decline in aggregate demand. The observed inertia reflects, apart from possible effects of high uncertainties, the persistence of structural rigidities in the economy, manifest in some segments of both product and labour markets. Such rigidities are illustrated by the flat dynamics of non-food prices included in the adjusted CORE2 index, highlighting the critical importance of the need to carry on structural reforms in order to ensure sustainable disinflation in the long term and to foster the sound and sustainable rebound of economic activity.

During 2009 Q1, the fallout from the global crisis on the Romanian economy, which originally spilled over via the foreign trade and financial channels, increased noticeably. For the first time since 2000, economic growth has fallen into negative territory, posting an annual rate of -6.2 percent and causing real GDP to further decrease below its potential level compared to 2008 Q4. The primary source of the economic downturn was the pronounced decline in domestic demand across its components. Private consumption dropped at a significantly faster pace than in the previous quarter, while gross fixed capital formation contracted slightly and the change in stocks had a strong negative bearing on economic growth. Domestic demand shrank due to both unfavourable dynamics of financing resources available to households and corporations and the relative decline in the propensity for consumption and investment (concurrently with a higher propensity for saving) amid the uncertainties surrounding the duration of knock-on effects from the economic crisis on future incomes. The magnitude of the first-quarter real GDP contraction was limited by the favourable contribution of net exports, as the annual decline in imports was much faster than that of exports. At the same time, the difference in the growth rates of imports and exports played a role in the sizeable adjustment of the current account deficit.

Monetary policy since the release of the previous Inflation Report

On 6 May 2009, the National Bank of Romania Board decided to lower the monetary policy rate by 50 basis points to 9.5 percent per annum. The decision was motivated by the downward revision in the medium-term inflation forecast and the relative mitigation of the upside risks associated with the projection. The inflation forecast revision was backed by the marked slowdown in GDP growth in 2008 Q4 and the gradual build-up of evidence pointing to the growth rate turning negative at the turn of the year.

In the period after the monetary policy decision of 6 May 2009, statistical data confirmed the macroeconomic trends that had been anticipated by the NBR. In May, annual inflation rate stayed on the downward path that had started in March and the annual economic growth turned negative in Q1. However, the magnitude of GDP contraction turned out to be significantly larger than expected, with the deeper global economic crisis aggravating its fallout on the Romanian economy.

Disinflationary pressures triggered by the widening negative output gap were shored up by a moderation in the volatility of the exchange rate of the leu at lower levels than those seen at the turn of the year, on the back of the sizeable narrowing of the external imbalance and the conclusion of the multilateral external financial arrangement with the International Monetary Fund, the European Union and other international financial institutions.

Nevertheless, in the period under review, the curbing of inflation proceeded at a relatively slow pace given the magnitude of the fall in aggregate demand. Apart from the impact of incidental factors, the relative rigidity of inflation was underpinned by the lagged or insufficient adjustment of wage cost dynamics to productivity dynamics in certain segments of the economy.

After examining these macroeconomic developments, in its meeting of 30 June 2009, the NBR Board pointed out the need to retain a balanced monetary policy stance, capable of consolidating the prospects of inflation rate converging towards medium-term targets, concurrently with supporting a sustainable revival of lending in the Romanian economy. The monetary policy decision included a package of measures aimed at recalibrating real monetary conditions and ensuring a smooth flow of liquidity, along with an adequate level of liquidity, as well as at allowing the progressive return of banks' lending and deposit rates to the natural, functional position relative to the monetary policy rate. The Board decided: to lower the monetary policy rate by another 50 basis points to 9.0 percent per annum and to reduce the minimum reserve ratio on credit institutions' leu-denominated liabilities with residual maturities of up to two years to 15 percent from 18 percent and that on foreign currency-denominated liabilities with residual maturities of up to two years to 35 percent from 40 percent starting with the 24 July - 23 August 2009 maintenance period.

Inflation outlook

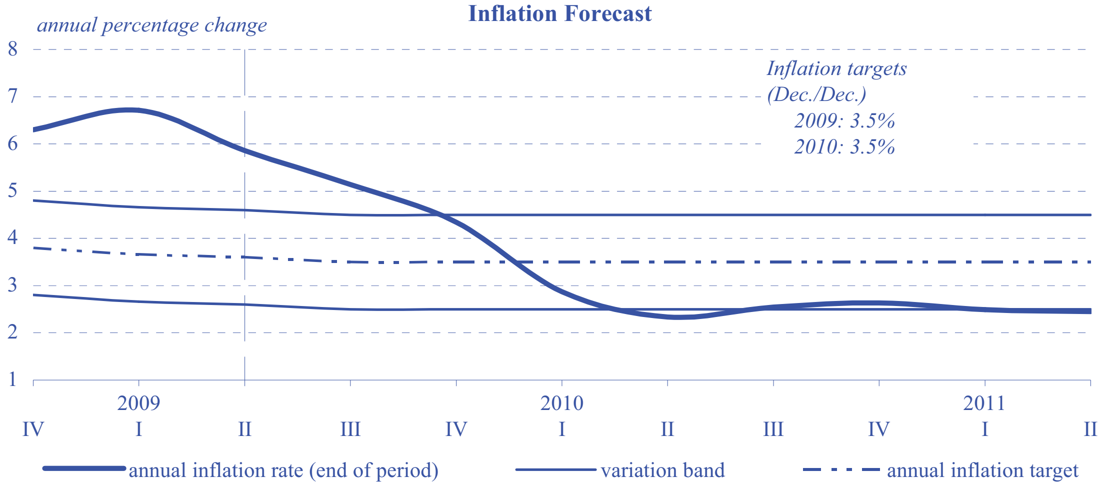
At the end of 2009 Q2, the annual inflation rate was 0.5 of a percentage point below the level projected in the May 2009 Inflation Report. The larger-than-anticipated economic downturn in Q1 and the unfavourable expectations for Q2 suggest however the build-up of a substantial negative output gap. The time span needed for its disinflationary effects to grow stronger is one of the main uncertainties surrounding the inflation outlook.

The current account deficit continued to narrow in the first part of 2009 Q2. The inevitable correction of the external imbalance, which had begun in 2008 Q4, was augmented by the impact of the shortage in external financing resources in the aftermath of the global crisis. The pace of this correction raises the issue of a possible excessive adjustment of the Romanian economy, reflected by the abrupt decline in imports on the back of flagging domestic demand, although most of the external deficit correction might have occurred in the first part of 2009.

On the one hand, the pronounced narrowing of the external imbalance contributed, by mitigating one of the major vulnerabilities of the Romanian economy, to the recent moderation in the volatility of the exchange rate of the leu, thus containing the importance of the exchange rate in exerting inflationary pressures over the projection horizon. On the other hand, as the public sector still posted a significant deficit, the external adjustment was borne mostly by the private sector. To this contributed not only the contracting consumer demand, but also the decline in investment, in line with the abrupt fall in capital inflows. Such effects are expected to induce a temporary slowdown in the potential GDP growth rate; nevertheless, this should be reversed gradually, insofar as the contractionary effects from the global crisis fade away.

The baseline scenario of the projection places the annual CPI inflation for end-2009 at 4.3 percent, 0.1 percentage point lower than the figure forecasted in the May 2009 Inflation Report. In 2010, annual inflation rate is forecasted to fall to 2.6 percent, i.e. below the central target (3.5 percent) and the previously forecasted figure (2.8 percent).

Inflation Forecast



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

Source: NIS, NBR calculations

Although the CPI inflation forecast for 2009 features only a marginal deviation from that published in May, the current scenario incorporates a reassessment of relative contributions of aggregate price index determinants. The projected growth rates of volatile prices (fuel prices and certain food prices) and administered prices have a favourable bearing compared to the previous projection. This effect is offset by a slower-than-previously-forecasted reduction in

CORE2 inflation by end-2009, in spite of a significantly wider negative output gap. One of the anticipated deterrents to disinflation is the persistence, over the first part of the projection horizon, of the current tendency of core inflation to respond in a subdued manner and with a lag to the decrease in aggregate demand. In addition, the current projection incorporates the assumption of a stronger adverse impact of the planned hike in excise duties on tobacco products, which is expected to feed through into prices both directly and indirectly (via inflation expectations).

For 2010, the projection envisages faster disinflation, hinging mainly upon the build-up of demand shortage pressures and the gradual consolidation of the downtrend in inflation expectations. The downward revision of the forecasted CPI inflation rate by 20 basis points is also due to more favourable scenarios on the growth rates of administered prices and fuel prices.

Similarly to the May 2009 forecast, the current projection assumes the repositioning of the inflation rate back inside the variation band around the central target for 2009 Q4. The National Bank of Romania will further calibrate real monetary conditions so that inflation rate remains within the projected coordinates and, at the same time, will seek to create the necessary conditions for the sustainable revival of the lending process in the Romanian economy. The fulfilment of these objectives in a sustainable manner is conditional upon the absence of powerful, adverse external shocks and the adequate coordination between monetary policy and other macroeconomic policies.

The risks associated with inflation rate deviating from the trajectory shown in the baseline scenario of the current projection appear to be relatively balanced. The highest risks come from the uncertainties regarding the future developments in the global economic crisis. Knock-on effects of the crisis emerging at a different intensity from that envisaged by the baseline scenario may cause both inflation rate and GDP growth to deviate from the projected trajectories. *A priori*, the probability of distribution of deviations on either side appears to be symmetrical.

The risk of unfavourable developments in both variables increases however in the absence of coherent and time consistent macroeconomic policies. For example, a potential excessive easing of the fiscal policy against the background of scant financing resources may disrupt the orderly adjustment of the external imbalance and/or entail a crowding-out of the private sector. Particularly if additional public spending were not channelled primarily to investment, but rather to current – especially staff-related – items, the potential of boosting the economy would be quickly exhausted, thus inducing inflationary pressures in the short term and delaying, at least temporarily, the rebound of economic activity. The identified risks could be significantly mitigated provided macroeconomic policies follow the coordinates set out in the context of the multilateral external financing arrangement with the International Monetary Fund, the European Union and other international financial institutions.

Other risks to inflation are generated by the ongoing structural rigidities in certain segments of the labour market and the product market. Inertia of wage costs and prices higher than assumed in the baseline scenario could delay both the reduction of inflation and the rebound in economic activity.

Compared to the assumptions incorporated in the baseline scenario, the risks to the developments in oil prices and prices of other commodities, administered prices and volatile food prices appear to be relatively symmetrically distributed around the projected CPI inflation path.

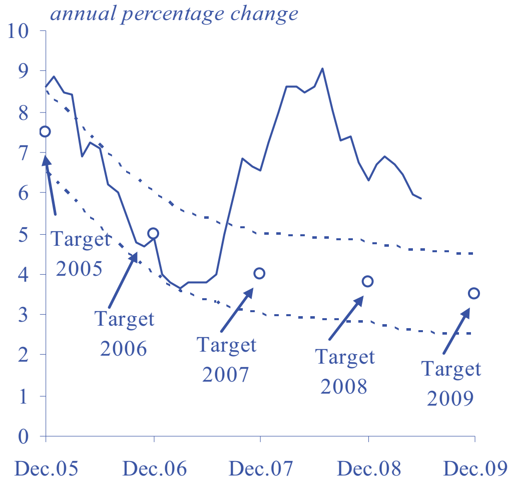
Monetary policy decision

Considering the perspectives for the ongoing alleviation in medium-term inflationary pressures, amid the sharper downturn of the Romanian economy during 2009, the NBR Board has decided in its meeting of 4 August 2009 to lower the monetary policy rate by 50 basis points to 8.5 percent per annum. Moreover, with a view to enhancing central bank's efficacy in managing money market liquidity and, implicitly, the impact of monetary policy instruments on short-term interest rates in this market, the NBR Board decided to cut to one week from one month the maturity of auction-based repo operations. In order to ensure improvement of liquidity in foreign currency and the continuation of a alignment to European Central Bank standards, it decided to lower to 30 percent from 35 percent the minimum reserve ratio on credit institutions' foreign currency-denominated liabilities with residual maturities of up to two years, starting with the 24 August - 23 September 2009 maintenance period. Against this background, the NBR Board reaffirmed that a balanced macroeconomic policy mix and faster implementation of structural reforms are essential for consolidating disinflation and minimising economic costs attached to the attainment of inflation targets in the medium term.

II. INFLATION DEVELOPMENTS

Inflation Developments

annual percentage change

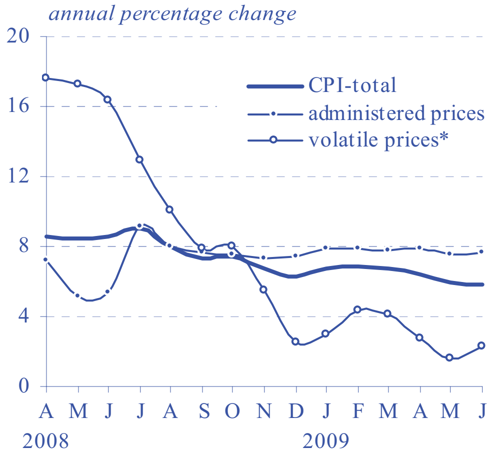


Note: Variation band is ±1 percentage point around the central target

Source: NIS, NBR calculations

Inflation Rate, Administrative Prices and Volatile Prices

annual percentage change



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

Source: NIS, NBR calculations

According to expectations, in 2009 Q2, the 12-month inflation rate resumed its downward trend, falling by 0.85 percentage points quarter on quarter to 5.86 percent. The main drivers of this performance were the stabilisation of the exchange rate trajectory and the decline in consumer demand amid the deterioration of households' present financial standing and the uncertain outlook for the future flow of disposable incomes. An opposite impact had the implementation of the first stage of increasing excise duties on tobacco products, the contribution of this group of products to inflation rate reaching almost 1.2 percentage points. Removing the effect of changes in the excise duties regime, the deceleration reported by the adjusted CORE2 index (-1.4 percentage points) outpaced by far the slowdown in the general consumer price index, due primarily to the alleviation of the volatility of the leu exchange rate and to the drop in the tendency to consumption, a favourable influence coming also from the moderation of inflation expectations.

After the short-lived trend reversal seen in the previous quarter, in 2009 Q2, the annual dynamics of volatile prices reported again the largest deceleration, i.e. -1.9 percentage points. Among volatile prices, fuel prices made the largest contribution to this performance as their average monthly growth halved compared to the first three months of the year, given that the severe contraction in demand[1] and the appreciation of the domestic currency versus the US dollar[2] alleviated the opposite effect generated by the steeper upward trend of international oil prices[3]. In the same direction acted food items with volatile prices although the loss of momentum was of a much lesser magnitude, as the drop in fruit prices to a level below that seen in the same year-ago period was not followed suit by similar movements in the other two components (vegetable prices stagnated, whereas egg prices were affected by an unfavourable base effect).

The same as in the past two quarters, the change in the annual growth rate of administered prices was insignificant (-0.1 percentage points to 7.7 percent in June). "Energy" was the main driver of this performance, following the cut in natural gas prices by almost 3.5 percent April through May, the prices of electricity and heating remaining unchanged throughout the

[1] The annual dynamics of the turnover volume of retail trade in motor fuels slowed down to -25.6 percent in May from -16.5 percent in March 2009.

[2] By 9.4 percent in June versus March 2009.

[3] The monthly growth rate of *Europe Brent Spot* (fob) prices accelerated from 5.2 percent in 2009 Q1 to 13.8 percent in the period under review (source: EIA, NBR calculations).

quarter. The other items saw broadly faster growth rates, with the dynamics of fixed telephony prices posting only a minor acceleration (in line with the lower volatility of the exchange rate) and that of prices of medicines, local public services and subway city transport reporting more significant speed-up.

Tobacco products posted a singular development during Q2, standing out among CPI components as a significant source of inflationary pressure – their annual dynamics neared 26 percent in June, surpassing by 7 percentage points that seen at the end of the previous quarter. Behind this development stood again the changes in excise duties, following the implementation of the first stage for increasing excise duties out of the two stages announced for this year (by EUR 7/1,000 cigarettes in April and September). This measure exerted a considerable impact on inflation during the period under review, in spite of the significant hike that producers implemented earlier than planned with a view to alleviating the shock upon its enforcement.

In view of the persistence of signal disruptions generated by this tax-related measure, the analysis of core inflation must take further into account the relevant adjusted CORE2 measure, the downward trend of which became visibly more pronounced during the quarter under review (from 6.2 percent in March to 4.8 percent in June, after a marginal advance in the first three months of the year). Food items (except for those with volatile prices) continued to be the main source of disinflation, their annual pace of increase being 2.6 percentage points slower in June than that in March. Most staples reported slower annual dynamics owing to the protracted positive effect from the bumper crop recorded in the previous year (milling and bakery products, and particularly edible oil), on the one hand, and in response to the weaker consumer demand (meat, milk and products thereof), on the other. The latter driver accounts also for the developments in prices of market-priced services (whose annual growth rate decelerated by 0.8 percentage points), the influence coming from the exchange rate – to which this segment is, in general, highly sensitive – being deemed relatively modest.

By contrast, prices of non-food items included in adjusted CORE2 have turned out to be more rigid as their annual dynamics remained at a level similar to that seen at the end of the first quarter in spite of the gradual contraction in consumer demand. This development can be explained by the domestic producers' reluctance to cut prices, given that the adjustment of labour costs to the contraction in the volume of activity is still underway in some sectors and that the less readily available financing sources are further seen as a factor containing output. Moreover, the significant share of imports causes the exchange rate to be more relevant to the evolution of prices for this category of items, which

Administered Prices versus Market Prices

annual percentage change; end of period

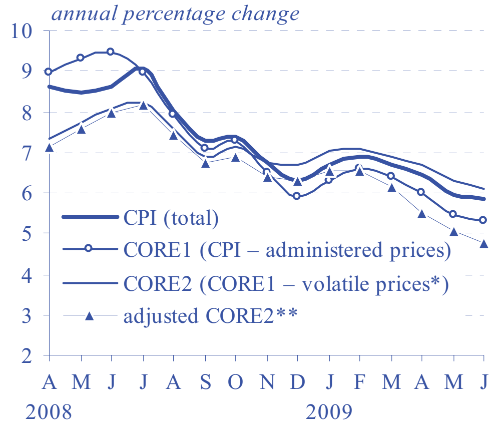
	2008			2009	
	II	III	IV	I	II
Inflation rate	**8.61**	**7.30**	**6.30**	**6.71**	**5.86**
Administered prices*	**5.37**	**7.67**	**7.38**	**7.78**	**7.70**
1. Non-food items*:	**2.79**	**8.31**	**7.60**	**7.64**	**7.00**
electricity	0.00	4.51	4.51	4.76	4.76
heating	6.04	6.04	10.10	11.95	11.77
natural gas	12.39	26.47	22.01	12.53	8.64
medicines	-3.49	-1.51	-2.50	4.56	5.61
2. Services*,	**10.36**	**5.81**	**6.73**	**7.93**	**9.09**
of which:					
water, sewerage, waste disposal	11.15	12.58	12.55	12.79	14.66
fixed telephony	13.25	-0.34	2.08	5.73	5.92
passenger railway transport	8.15	0.00	0.00	0.00	0.00
(passenger) city transport	9.12	9.10	8.15	7.99	8.77
Market prices (CORE1)	**9.45**	**7.07**	**5.92**	**6.40**	**5.33**
CORE2**	**8.06**	**6.91**	**6.69**	**6.90**	**6.08**
CORE2 less tobacco, alcohol	7.95	6.74	6.29	6.16	4.79
tobacco, alcohol	9.19	8.65	11.04	14.95	20.11

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

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation

annual percentage change

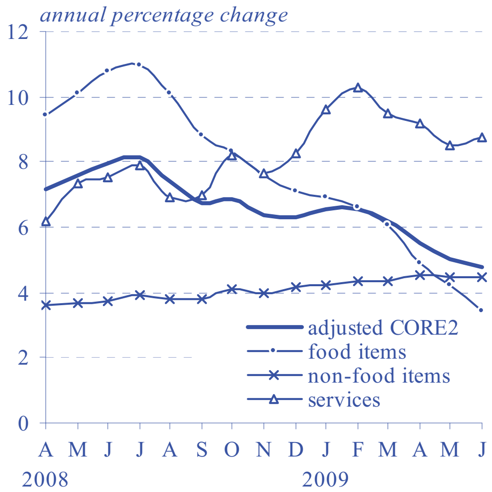


*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

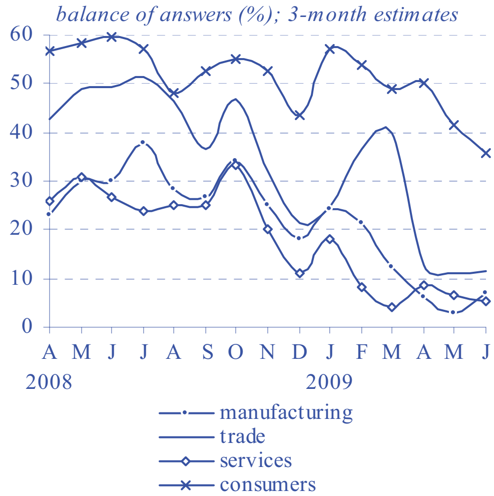
Source: NIS, NBR calculations

Adjusted CORE2



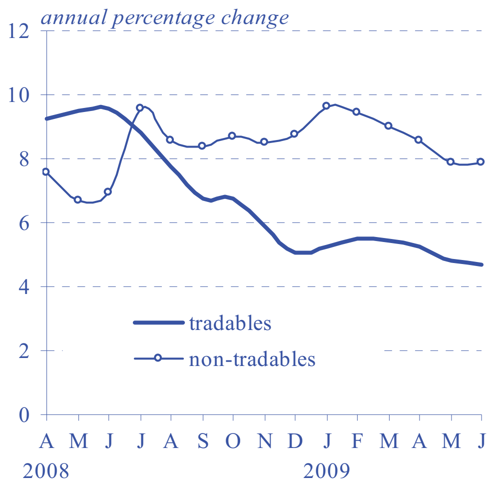
Source: NIS, NBR calculations

Inflation Expectations of Economic Agents and Consumers



Source: DG ECFIN

Tradables and Non-tradables Prices



Source: Eurostat, NBR calculations

could provide an explanation for the resilience of prices to drops during the period under review.

After the fading of the shock induced by the rapid depreciation of the domestic currency in January 2009 and amid the spreading of the world crisis effects on the Romanian economy, inflation expectations of both economic agents across industry, trade, services and consumers saw a broad-based moderation, additionally boosting disinflation over Q2; the change in banks' expectations on inflation became visible as late as towards the end of the period under review.

The intensification of competitive pressures against the background of the contracting consumer demand, both nationally and internationally, translated into the slowdown by 0.8 percentage points in the annual dynamics of tradables prices to 4.7 percent (June versus March 2009); the movement was markedly offset by the tobacco product segment which was affected by the hike in the excise duty. Given the contracting demand, to which added the drop in the natural gas price, the annual pace of increase of non-tradables prices saw a more pronounced slowdown (-1.1 percentage points to 7.9 percent), which caused a narrowing of the gap between the annual dynamics of non-tradables prices and that of tradables prices compared to the end of 2009 Q1.

The downward trend manifest in the nominal convergence criterion on inflation[4] starting 2008 Q4 became more pronounced during the period under review, amid the deepening of recession in Western European countries. Against the background of highly persistent inflation, Romania saw a lower drop in the 12-month average HICP inflation, the spread between this index and the nominal convergence criterion on inflation widening further from 4 percentage points in March 2009 to 4.4 percentage points in June. The gap between the 12-month average HICP inflation in Romania and that in EU-27 posted a similar development, reaching 4.6 percentage points at the end of Q2, i.e. 0.2 percentage points larger than that seen in March.

In June 2009, the actual annual inflation rate stood 0.5 percentage points below the projection in the May Inflation Report. Both volatile and administered prices and adjusted CORE2 inflation posted slower-than-forecasted annual growth rates, owing to (i) the exchange rate falling below the estimated 4.3 RON/EUR level; (ii) the decision to cut the natural gas price – announced subsequent to the forecast; (iii) the overrating of increases in food prices, comprising both volatile prices (the exogenous component) and prices included in CORE2 (the endogenous component).

[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 HICP).

III. ECONOMIC DEVELOPMENTS

1. Demand and supply[5]

Demand remained stuck to a downward trend both nationally and internationally, which caused real GDP to decrease in 2009 Q1 for the first time since 2000, the contraction in the activity being visible across all economic sectors. The drop (-6.2 percent) was steeper than that implied by the benchmark projection made in March 2009 (-1.5 percent).

1.1. Demand

Aggregate demand components posted a development similar to that in 2008 Q4, with the decline in domestic absorption being partly offset by the positive contribution of net export.

1.1.1. Consumer demand

Final consumption went down again in terms of volume (by 9.1 percent), owing, the same as in the previous period, solely to the private component, whereas government consumption remained on an upward trend.

Household consumer demand

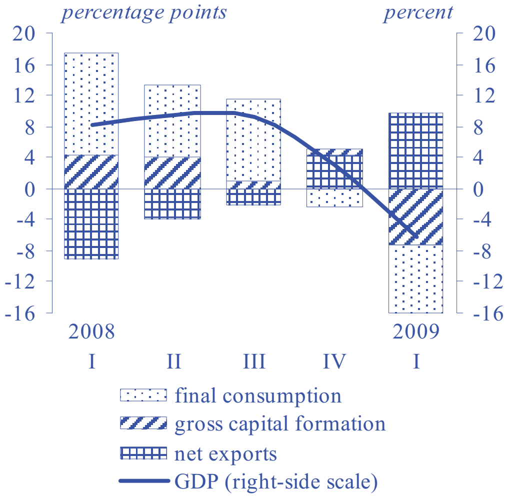
Household final consumption decelerated almost three times faster than in the last three months of the previous year to reach -10.5 percent, mainly on account of retail purchases of goods and services (-13.4 percent) against the background of the contraction in financial resources of households and further worsening expectations on the economic and financial developments.

Sales of durables, holding a low share in the CPI basket, were the strongest impacted category. Their downward trend became more pronounced, with the volume of turnover on this segment falling by about 30 percent in 2009 Q1.

Purchases of non-durables contracted by more than 3 percent in terms of volume; nevertheless, this performance was primarily the result of the severe drop in fuel sales, in line with the contraction in motor trade activity and the adjustment in households' consumer behaviour. Purchases of other non-durables such as food items, tobacco, medicines, skincare products, wearing apparel and footwear, stood on an upward path in terms of volume, their dynamics accelerating in annual terms compared to 2008 Q4 (the cumulative growth rate came in at almost 4 percent). Although the resilience in the consumption of such products is due, to a certain

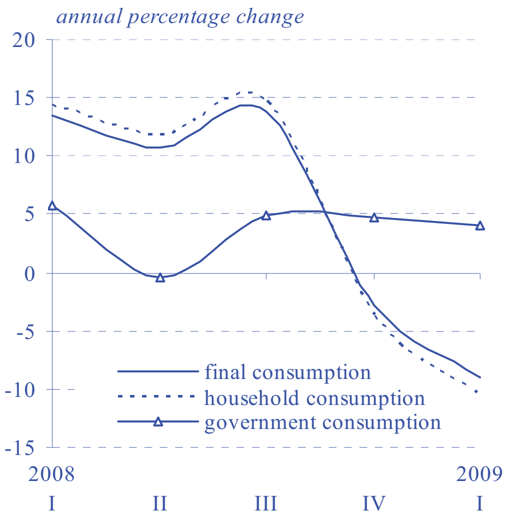
[5] Unless otherwise indicated, the growth rates in this section are annual percentage changes (in terms of volume).

Contribution of Demand Components to GDP Growth



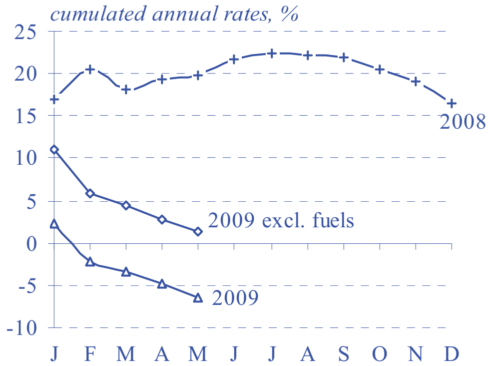
Source: NIS, NBR calculations

Actual Final Consumption



Source: NIS

Retail Trade of Non-durables*

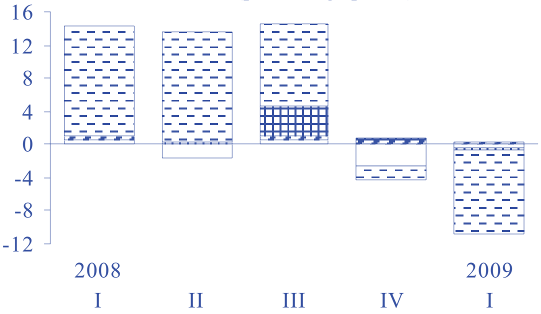


*) turnover of retail trade in foodstuffs, beverages, tobacco, medicines and skincare products, wearing apparel and footwear, fuels, direct mail and internet selling.

Source: NIS, NBR calculations

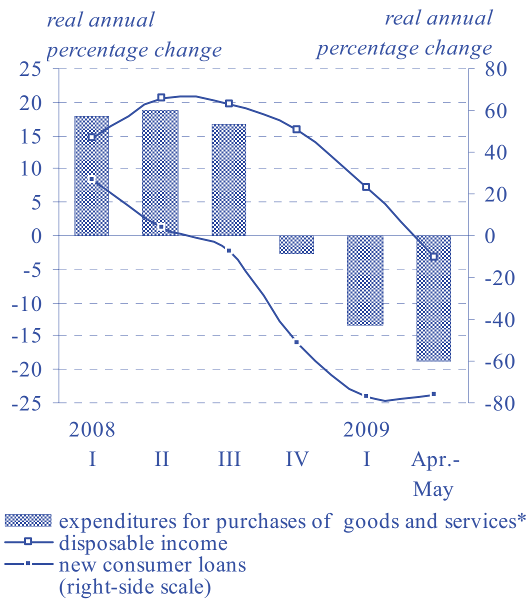
Household Final Consumption by Expenditure

annual contribution (percentage points)



Source: NIS, NBR calculations

Household Consumption and Main Financing Sources



*) for Apr.-May 09 - the turnover volume for retail and services

Source: NIS, NBR calculations

extent, to consumers' shift in preference for less sophisticated, cheaper products, the faster increase in purchases, along with the large share of non-durables in the consumer basket, except for fuels (about 60 percent), offsets significantly the favourable influence on CPI initially hinted at by the decline in household final consumption.

Additional contributions to the drop in private final consumption, albeit of a lower magnitude, made also "self-consumption and purchases on the agri-food market" and "other consumption" (with home industry accounting for the largest share in the latter category). In view of the strong correlation between these categories and the agricultural output results, the volume contractions reported in Q1 (by 12 percent and 3.9 percent respectively) can be accounted for by the unfavourable developments in animal output.

In terms of the financing channels of household consumption, available statistical data show that both own sources and borrowed sources remained on a downward trend. Thus, the growth rate of household disposable income[6] slowed down to less than half the level seen in 2008 Q4, (to reach +7.1 percent). As expected, borrowed sources witnessed the strongest adjustments.

(i) Against the backdrop of persistently unfavourable lending conditions (as suggested by the rise in interest rates and the fast-paced depreciation of the domestic currency), and also amid the uncertainties surrounding the recovery of the economic and financial situation, consumer loans plunged as suggested by the faster downward trend in the volume of new business in Q1 (to -77 percent in annual terms, compared to -52 percent in 2008 Q4).

(ii) Financing via leasing, a type of financing aimed primarily at purchases of motorcars, saw a steep decrease, the first estimates hinting at a decline in the value of contracts concluded over the first three months of the current year to one fourth of the level in 2008 Q1.

Consumer demand narrowed also as a result of the stronger propensity for saving, with the volume of new time deposits made in Q1 increasing more than two times from the same year-ago period. Although this performance is not entirely attributed to new amounts, illustrating to a great extent the substitution of current account deposits with competitive interest rates by time deposits amid the improved supply of banks on the latter segment, it is

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

indicative of households' enhanced willingness to tie up longer-term loans and therefore of a lower appetite for consumption.

The analysis by market of origin shows that the weaker consumer demand affected especially the domestic segment, the dynamics of sales of domestic industrial companies on the domestic market slowing to considerably negative readings for both non-durables (-16.5 percent) and durables, except for motor vehicles (-37.8 percent). By contrast, the physical volume[7] of imports of non-durables remained unchanged compared to the first three months of 2008, while that of imports of durables decreased at a slower pace than that of purchases of similar domestically-produced goods (decreases by at most 25 percent). Households' appetite for purchases of motor vehicles diminished strongly for both domestically-produced and imported motor vehicles (-35.4 percent and -70.7 percent respectively).

Government consumption

Final government consumption increased by 4 percent. This evolution is associated with developments in the number of employees in the general government sector.

Budgetary developments

The persistence of an unexpectedly high annual growth rate in actual government consumption reflected, at least partially, a significant worsening in budget execution in 2009 Q1 against the same year-ago period. Thus, the consolidated general budget deficit widened to RON 7,925 million at end-Q1 (equivalent to 1.5 percent of GDP), versus a RON 53.8 million deficit seen at end-March 2008[8]. Moreover, primary balance posted a deficit of 1.26 percent of GDP, thus reversing the 0.12 percent of GDP primary surplus of the consolidated general budget recorded in the same year-ago period. In the context of a significant contraction in economic activity, the main components of the consolidated general budget witnessed mixed developments. Thus, the share of revenues in GDP went down 0.83 percentage points year on year, while that of expenditures moved up 0.65 percentage points.

In absolute terms, the negative dynamics of total budget revenues increased slightly against 2008 Q4 (-11.5 percent[9] from

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

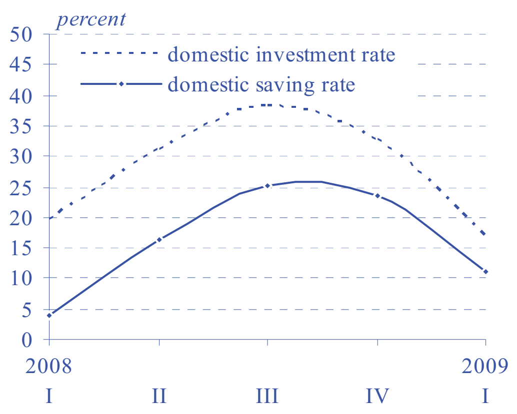
[8] The Ministry of Public Finance revised 2008 Q1 data in order to ensure comparability with data for 2009.

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

-10.3 percent[10]). This development was due mainly to the decrease in VAT receipts (-22.1 percent), along with a decline in profit tax revenues (-19.1 percent) and non-tax revenues (-15.5 percent). These effects were partly offset by the increase in wage and income taxes (up 11.4 percent), against the background of a further, albeit slower, enlargement of tax base.

Nevertheless, budget expenditure growth pace accelerated to 6.8 percent (versus 0.8 percent in the previous quarter), due chiefly to the faster growth rate in primary expenditures (5.7 percent against 0.7 percent in 2008 Q4). These developments occurred mainly on the back of larger amounts destined to social security (13.6 percent) and to staff costs (7.8 percent). Social security expenditure pressures are expected to be on the rise in the months ahead, following the impact of the increase in nominal terms in the "pension point" by roughly 3 percent[11], by the introduction of the guaranteed minimum social pension starting April[12], as well as the rise in minimum guaranteed income starting July[13]. By contrast, capital expenditures further posted a negative dynamics, which nevertheless was slower than that recorded in 2008 Q4.

On 13 May 2009, the European Commission published its report initiating the excessive deficit procedure against Romania for the 2008 budget execution. The main causes for exceeding the reference value (3 percent deficit-to-GDP), as mentioned in the EC documents, are: (i) the slippage in current expenditures, especially staff and social security expenditures, (ii) the unrealistic programming of revenues, and to a smaller extent, (iii) the decline in collected revenues, amid a slowdown in economic activity in 2008 Q4. Moreover, in July, the ECOFIN decided the initiation of excessive deficit procedure for Romania and recommended the reduction of the deficit computed in compliance with the ESA95 standard to below 3 percent of GDP by 2011.



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

1.1.2. Capital investment

In 2009 Q1, gross capital formation fell by 36.7 percent year on year, i.e. the most significant contraction in real terms over the 10-year period for which quarterly data on national accounts are available. The decline was only marginally attributed to

[10] As comparable data for 2007 Q4 are not available, the dynamics of consolidated general budget components for 2008 Q4 was computed according to historical data series, constructed from data provided by the MPF for budget executions comparable at end-September and end-December 2007 and 2008.

[11] According to Law No. 19 of 26 February 2009 - The State Social Security Budget.

[12] According to Government Emergency Ordinance No. 6 of 18 February 2009 on establishing the guaranteed minimum social pension.

[13] According to Government Emergency Ordinance No. 57 of 27 May 2009 on amending Law No. 416/2001 regarding the guaranteed minimum income.

investment, the major contribution being made by the change in inventories[14] – whose negative flow widened 2.7 times from 2008 Q1. Although this performance can be explained, to a certain extent, by economic developments (such as the drop in producers' inventories following the contracting industrial activity, the reluctance of hypermarkets and supermarkets to build up stocks amid the declining consumption), the influence of the residual component should not be overlooked.

After reporting an almost 9 times slower annual dynamics in quarter-on-quarter comparison in 2008 Q4, gross fixed capital formation saw a slight volume contraction (-0.3 percent) in the first three months of 2009. The fall into negative territory was due to the sign reversal posted by the annual dynamics of two types of spending (i) equipment purchases, including transport means bought by companies and institutions (-11.3 percent compared to +3.6 percent in 2008 Q4); (ii) capital repair works (the volume of which shrank by 6 percent after an expansion by more than 22 percent in the previous quarter). Nevertheless, the downward trend was alleviated by the still positive dynamics of new construction works (9.2 percent), bolstered particularly by the housing segment.

The contraction in investment demand was put down on slower or even negative growth rates of main financing sources. As concerns domestic channels, to the unfavourable developments in own incomes (suggested by the worsening of the economic standing of companies and by the significantly slower advance in household disposable income) added 10-11 times decreases, in nominal terms, in the flows related to equipment and real-estate loans[15] compared to 2008 Q1. Furthermore, public capital expenditures diminished by 20.8 percent in real terms, whereas financing via leasing plunged on all segments, i.e. motorcar purchases, investment in equipment and real-estate leasing.

The same as in the previous quarter, capital inflows from abroad[16] reported mixed developments. On the one hand, the flow related to medium- and long-term net external borrowings by the non-bank non-government sector diminished by almost 11 percent. On the other hand, net inflows of foreign direct investment by nonresidents expanded at a swifter pace (to 35 percent), mainly on account of the rise in equity stakes – however, it should be noted that, in some cases, the launching of initial investment projects

Investment

annual percentage change

	Year	I	II	III	IV
Total	2008	34.3	30.2	23.2	2.3
	2009	–0.3			
- new construction works	2008	32.5	34.8	27.8	7.3
	2009	9.2			
- equipment	2008	34.7	23.9	14.4	3.6
	2009	–11.3			
- other*	2008	46.7	49.9	36.3	–21.1
	2009	23.9			

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

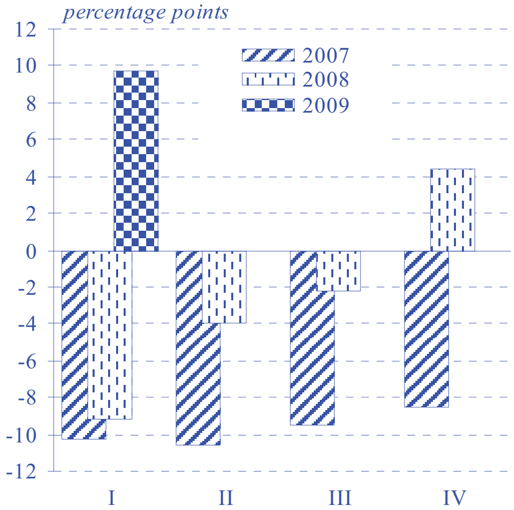
Source: NIS

[14] According to national accounts methodology, the change in inventories at a given time is calculated by subtracting outflows from inflows.

[15] Calculations based on CCR data; the flow related to a quarter is estimated by subtracting the balance reported at the beginning of the period concerned from that recorded at its end.

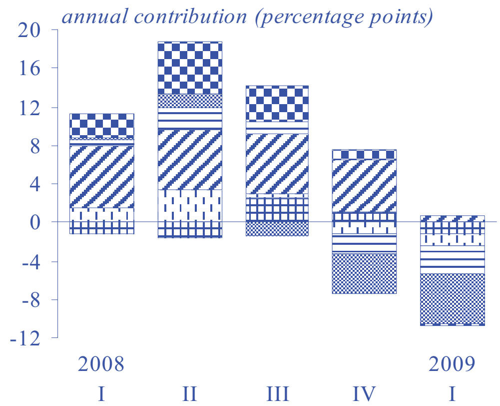
[16] Calculations based on the balance-of-payments data; average dynamics for the last four quarters (rolling basis).

Net External Demand Contribution to GDP Growth

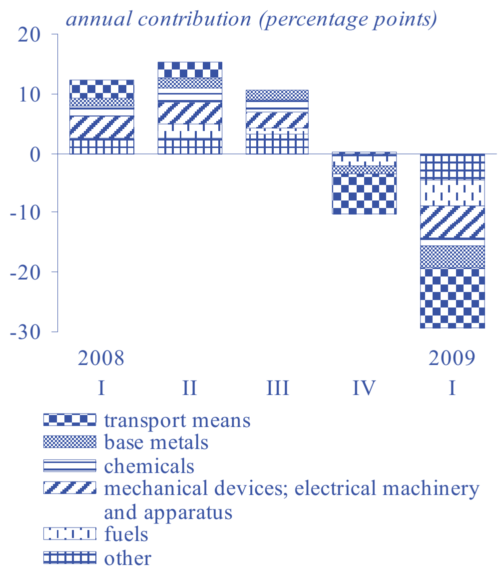


Source: NIS, NBR calculations

Export Physical Volume



Import Physical Volume



Source: NIS, NBR calculations

was postponed, given the negative perception and the pessimistic expectations on the domestic and international business environment.

The analysis by market of origin of capital goods shows that the contraction in investment demand led to an even more pronounced downward path of both sales of domestically-manufactured goods and imports[7].

1.1.3. Net external demand

Provisional data on national accounts point to the significant contraction in the volume of foreign transactions in goods and services in 2009 Q1.

The favourable influence exerted by the fast depreciation of the domestic currency on exports was offset by the drop in the main foreign trade partners' demand, so that the dynamics of exports of goods and services posted a strong trend reversal, entering negative territory for the first time since 1999 (-19.6 percent).

Nevertheless, the developments in net external demand offset partly the decline in domestic absorption, its positive contribution to annual GDP growth rising markedly versus 2008 Q4 (from 4.3 to 9.7 percentage points). This performance owed to the three times faster adjustment in the volume of imports of goods and services (to -31.4 percent) against the background of the falling domestic demand, the lower consumption of intermediate goods used for manufacturing products destined to foreign markets, and also of the unfavourable developments in the exchange rate.

Most categories of goods reported lower exports, with base metals, fuels, chemicals and textiles (whose growth rates ranged between -12.7 percent and -44.3 percent during Q1) making the largest contributions to the contraction in the physical volume of exports. The only groups that remained on an upward trend, albeit reporting visibly slower paces of increase, were "vegetal produce", "food items" and "mechanical devices, electrical machinery and apparatus" whose increase (by 3.2 percent) offset the slight decrease in sales of transport means, causing the share of products with high added value to remain at 41 percent in total exports.

The dynamics of imports was negatively impacted by the adjustment in the domestic demand for motor vehicles; in Q1, the volume of imports of such goods fell to less than a third of the level reported in the previous year. Imports of fuels, base metals and mechanical devices recorded also steeper declines than in the last part of 2008 (by 37-38 percent each heading).

1.2. Supply

Poor performance was reported in all economic sectors, i.e. lower gross value added in industry, services and agriculture and slower expansion in construction.

Gross value added in industry was 11.1 percent lower due mainly to the poor performance in manufacturing, given (i) the sharp decline in output in some key sectors such as metallurgy, where the output volume dropped to less than half compared to 2008 Q1 as well as oil processing and light industry), (ii) the trend reversal in the dynamics of food industry, chemicals and pharmaceuticals, building materials and (iii) the further decrease, albeit less pronounced than in 2008 Q4, in the output of electrical machinery and apparatus and road transport means.

However, positive signs, corroborated by the April and May performance, were seen in the final month of the period under review:

(i) the coming to a halt of the output decline in food industry, which may be attributed to the fact that recession affected the structure of consumption rather than its volume, as households opted for buying cheaper products;

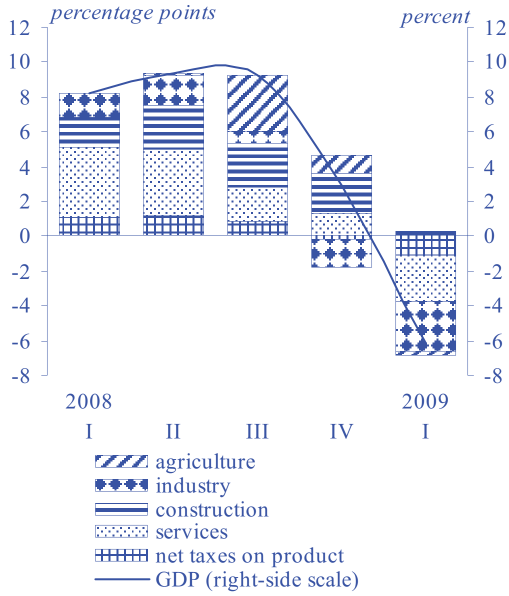
(ii) the pick-up in the output of road transport means, associated basically with additional external supply, as certain countries showed interest in initiating car park renewal programmes.

The annual dynamics of gross value added in the services sector entered negative territory (-4.9 percent[17]), 2009 Q1 witnessing poor performance of trade and transports on the one hand and of financial activities, real estate transactions, rentals (down 7.6 percent and 3.8 percent respectively) on the other, as well as the 1.3 percentage point slowdown for "other services" (public services in particular).

The annual dynamics of gross value added in the agricultural sector also posted a trend reversal (-10.9 percent) along with the poor results in the stockbreeding sub-sector – preponderantly in the first quarter of each year, as vegetal production is weather-dependent.

Construction was the only sector which had a positive contribution to GDP advance, yet the annual growth rate of gross value added in 2009 Q1 (4.7 percent) was well below the advance reported in 2008 Q4. The favourable effect of faster dynamics in the new construction works segment (from 7.3 percent to 9.2 percent) was offset by the contraction in the volume of current and capital repair works.

Contribution of Supply Components to GDP Growth



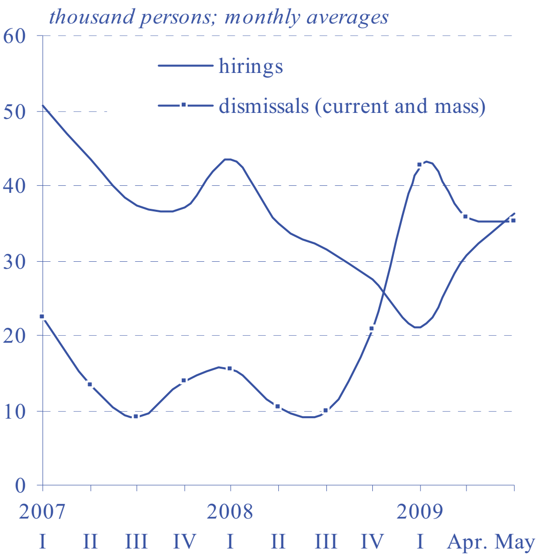
Source: NIS, NBR calculations

[17] NBR calculations

2. Labour market

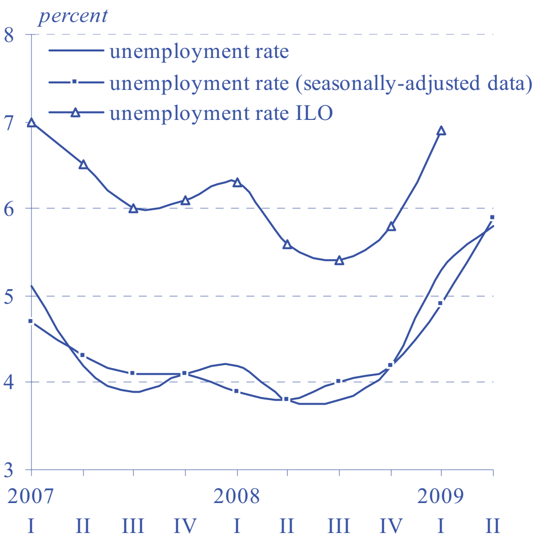
In 2009 Q2, labour market conditions were further favourable to the easing of inflationary pressures induced by wage developments given the persistent competition for vacancies that was stiffer compared to the year-earlier period. Nevertheless, compared to the previous period, labour demand rebounded somewhat, as illustrated by the step-up in recruitment activity and the drop in mass dismissals to almost half. On the other hand, additional labour supply continued to rise at a pace similar to that reported in 2009 Q1, due possibly to the delay with which the laid-off staff re-enter the labour market as unemployed. The staff- and wage-related adjustments made by private companies as early as 2009 Q1 impacted aggregate statistics which reflected a marked improvement of ULC in industry and a slowdown in the annual growth rate of wages economy-wide.

Labour Force Demand Measures



Source: NEA, NBR calculations

Unemployment Rate



Source: NIS, NBR calculations

2.1. Labour force

In April-May 2009, workforce absorption rebounded compared to 2009 Q1, yet staying well below the year-earlier reported level. The high quarterly dynamics of the staff hired via the NEA was attributable only partly to seasonal activities, as it was also illustrated by non-seasonal data, which might be indicative of certain companies' capacity to identify business opportunities in the new economic environment plagued by the global crisis. Moreover, in 2009 Q2, the number of mass dismissals diminished and those envisaged to take place in 2009 Q3 are also expected to decline.

However, the companies' uncertainties regarding the sustainability of economic growth are illustrated by: (i) the bias for temporary employment contracts the share of which in total hirings from among the unemployed rose to around 30 percent (from 19.3 percent a year earlier), (ii) the wages negotiated upon hiring, which, according to private recruitment agencies, dropped year on year and (iii) the shift in staff policies towards raising hiring standards and/or the switch to promoting own staff and keeping in place the staff schemes to the detriment of job creation.

The change in labour demand dynamics did not put a break on the uptrend in seasonally-adjusted registered unemployment rate (monthly dynamics stood at about 0.3 of a percentage point to reach 5.9 percent in May 2009). This development might be attributed to the fact that the laid-off persons choose to join the jobless ranks with a lag and to the period of granting unemployment benefit[18] being extended for another three months, which contributed to the rise in the number of indemnified

[18] According to Government Emergency Ordinance No. 28/18 March 2009

unemployed, including by restoring the rights of those removed from NEA records as, once the period of granting unemployment benefit expired, they did not announce the NEA about their intention to take a job.

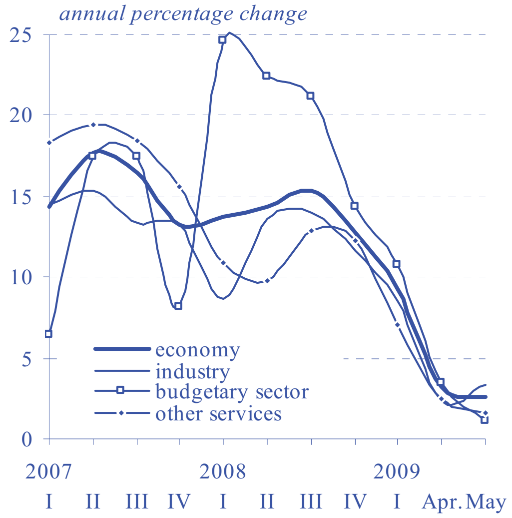
Therefore, in April-May, the ratio of unemployed to vacancies (43:1) was close to the level reported in 2009 Q1, but more than double compared to the year-ago period. Moreover, additional competition from the staff looking for a safer job while still on payroll illustrates the fact that conditions are in place for further slowdown of wage dynamics, which will help ease consumer demand-induced pressures.

2.2. Incomes

In line with expectations, in April-May 2009, wage statistics illustrated more extensively the adjustments reported by employers and recruitment agencies as early as the outset of the year. The renegotiation of collective labour contracts in the new economic environment, after the expiry, in March, of the contracts concluded in 2008 as well as the removal of the distortion induced by the annual pattern of granting the 13th month wage to public sector employees[19] contributed to slowing down the dynamics of gross nominal average wage by 7.5 percentage points from the average for 2009 Q1, to 9.6 percent. Nevertheless, mention should be made that, even though certain companies relinquished bonuses and even cut wages to avoid dismissals, in some sectors wages moved up due to occasional bonuses (Easter bonuses) and the prior years' profit sharing (net), in compliance with the provisions of collective labour contracts, which softened the impact of the measures aimed at containing wage hikes.

Net Real Wage*

annual percentage change



*) deflated by CPI

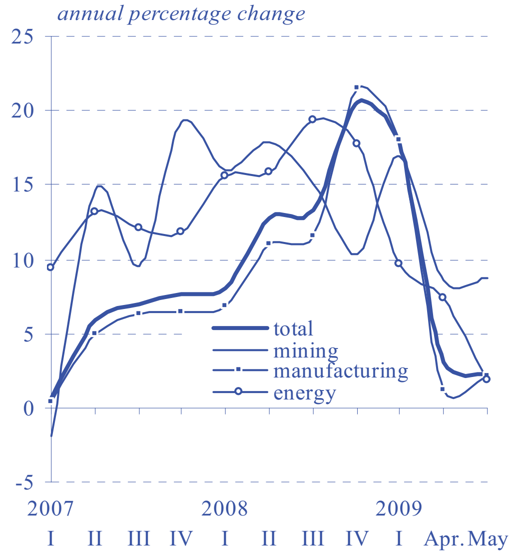
Source: NIS, NBR calculations

By sector, the annual growth rate of gross nominal wage ranged between 6 percent in construction and 12.3 percent in agriculture; annual dynamics of wages in industry (9.4 percent) was marginally different from the economy-wide wage, lower growth rates being reported in the public sector (9 percent, down 9.6 percentage points from 2009 Q1) and in the private services sector.

In industry, the measures aimed at restructuring and improving activity brought labour productivity dynamics into positive territory starting with March and the deceleration of annual dynamics of the gross nominal wage (by 6.9 percent in April-May 2009 compared to the average for 2009 Q1) sped up the fall in ULC. Therefore, the annual ULC index dropped to 102.7 percent in the period under review compared to the 117.9 percent average for 2009 Q1. The farthest-reaching adjustments were reported in manufacturing (-16.3 percentage points, to 101.7 percent), the

Unit Labour Costs in Industry

annual percentage change



Source: NIS, NBR calculations

[19] During 2009 Q1, instead of granting the full amount in January

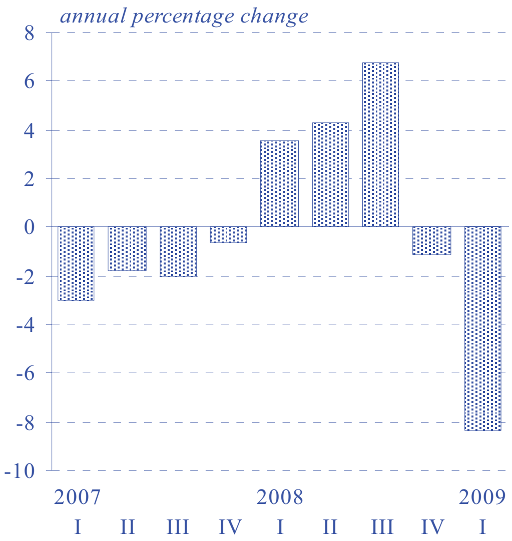
main contributors being: road transport means, oil processing, electrical equipment, furniture as well as metallurgy, which further reported a highly negative performance. In contrast, costs continued to rise in the light industry, chemicals and pharmaceuticals, given the fall in labour productivity by 9 percent to 20 percent year on year, and wages increased on average by 8 percent to 15 percent.

In terms of the pressures that household incomes might put on consumer demand (assuming that the saving behaviour remains unchanged), the easing of these pressures is mirrored by the slowdown in the annual dynamics of the real disposable income, from 15.7 percent in 2008 Q4 to 7.1 percent in 2009 Q1. The main reasons behind this development are the contraction by roughly 17 percent in remittances from abroad and the halving of the annual wage dynamics (to 7.3 percent); social transfer dynamics stood high (18.5 percent), on the back of the large number of persons that were paid unemployment benefit, average wage and health insurance. In April-May 2009, provisional statistics illustrate that the tendencies under scrutiny appear to have sharpened, causing real disposable income to diminish in annual terms following the fast drop in both wages (due to wage adjustments and staff cuts) and transfers from abroad.

3. Import prices and producer prices

In 2009 Q1, the developments in import prices and producer (industrial and agricultural) prices indicate the alleviation of inflationary pressures, the dampening effect of the abrupt domestic currency depreciation being offset by the easing of conditions on external commodity markets, demand contraction and several base effects associated with the all-time highs recorded by certain prices in the same period a year ago. The impact of these factors was also reflected by price developments in 2009 Q2, although the contribution to price dynamics could be different as compared with the first three-month period of the year. As regards agricultural producer prices, after three quarters in which the deceleration in their annual growth rate was solely due to movements in prices for vegetal products, in April-June 2009, tensions related to prices for animal products could diminish, owing mainly to the lower demand for certain products.

Unit Value of Imports



Source: NIS, NBR calculations

3.1. Import prices

In 2009 Q1, the annual unit value index of imports was largely below par (91.7 percent versus 98.8 percent in the final quarter of 2008), yet the favourable impact on domestic prices was offset by the sharper depreciation trend of the domestic currency against the euro and the US dollar.

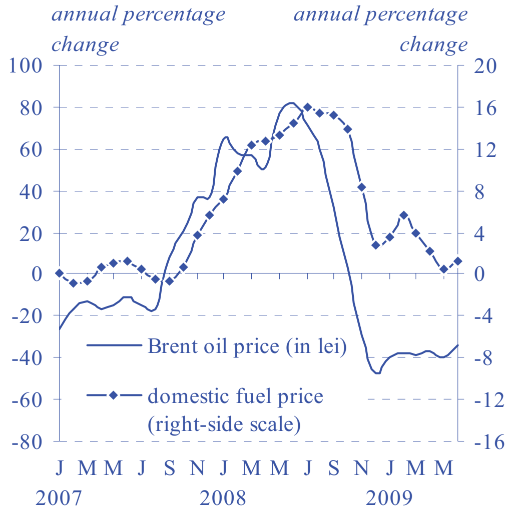
The annual growth rates of external prices for most groups of goods followed a downward course, except mainly for pharmaceuticals, whose price dynamics saw a trend reversal as compared with 2008 Q4 (from -2 percent to 10.3 percent). This development may be attributed to changes in producer prices of pharmaceuticals for the external market charged by some of the main EU suppliers[20], as well as to the appreciation trend in euro terms of the national currencies of some non-EU countries (United States and Switzerland), which supply significant amounts of pharmaceuticals to Romania.

The growth rates of external prices for other consumer goods decelerated markedly as compared with the previous quarters, the weakening pressures being more visible in the case of food commodities (meat, vegetal products, oils and fats) and fuels, whose annual unit value indices dropped to 68 percent.

The external prices of transport means further showed positive annual changes (4.7 percent as compared with the same year-ago period), in line with developments of producer prices for the external market in the euro area. However, the annual unit value indices of capital goods followed a sharper downtrend, falling to 77.5 percent in the case of electrical appliances.

In 2009 Q2, external prices are likely to stay on the downward path they have followed in the first months of the year. Signs of mounting tensions are increasingly manifest on the international energy markets, yet the base effects associated with the all-time highs recorded in the same year-ago period entail the persistence of strongly negative annual growth rates of external prices related to this segment.

Oil Price and Domestic Fuel Price



Source: NIS, EIA, NBR calculations

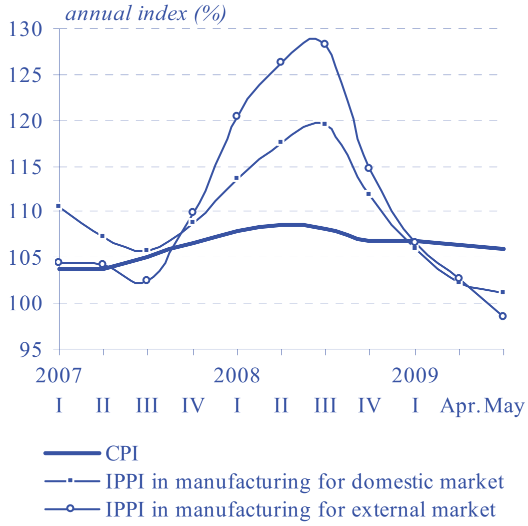
3.2. Producer prices

3.2.1. Industrial producer prices

In 2009 Q1, the annual growth rate of industrial producer prices for the domestic market decelerated further as compared with the previous quarter (down 4.7 percentage points to 5.3 percent), yet the main impact was exerted by prices for low-value added industrial products (energy and intermediate goods), in line with external prices for commodities and energy resources.

In fact, the annual change in producer prices for consumer goods accelerated to 12.3 percent, up 0.2 percentage points as against the prior quarter. However, this movement was mainly attributable to producers' response to the implementation of some administrative measures (rise in excise duties on beverages and tobacco,

Consumer Prices and Industrial Producer Prices

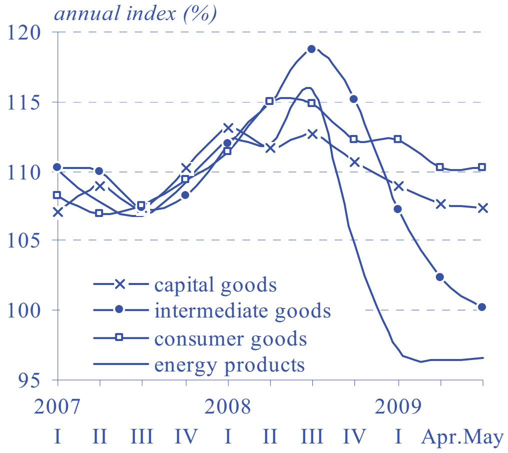


Source: NIS

[20] Producer prices of pharmaceuticals for the external market in Hungary, United Kingdom, the Czech Republic, Poland (which supply nearly 20 percent of medicine imports) saw faster growth rates of up to 15 percentage points as compared with 2008 Q4.

Industrial Producer Prices for Domestic Market by Industrial Products Group

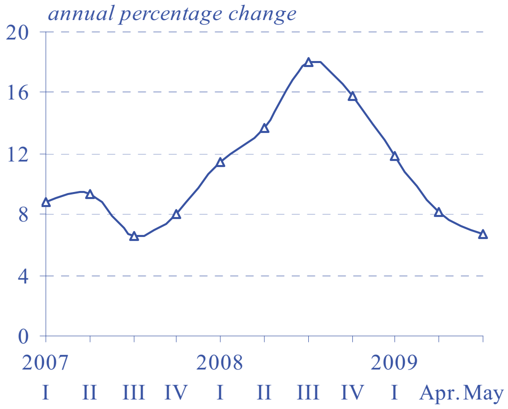
annual index (%)



Source: NIS

Industrial Producer Prices on Domestic Market* for New Orders

annual percentage change

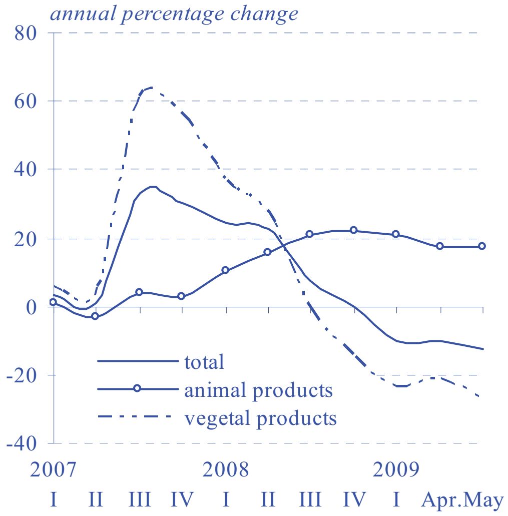


*) in order-based manufacturing sector

Source: Eurostat

Agricultural Producer Prices

annual percentage change



Source: NIS

adjustment of producer prices for medicines to the updated exchange rate). Mounting pressures are revealed by quarterly price changes, the growth pace of industrial producer prices for the domestic market accelerating to 3.3 percent in the reviewed quarter, from 1.9 percent in 2008 Q4.

The quarter-on-quarter comparison is indicative of less favourable developments at aggregate level as well as versus the final quarter of 2008, the significant slowdown in the downward trend (from -1.7 percent to merely -0.1 percent) being associated with the abrupt depreciation of exchange rate and the increasingly higher financing costs, given the difficulties facing numerous producers as regards delivery-related issues or in their attempt at collecting receivables (linked to sold merchandise).

Disinflation will continue in industry in 2009 Q2. Under the pressure of lower demand and given the slowdown in exchange rate volatility, industrial producer prices for new orders in manufacturing followed a sharper downtrend (from annual growth rates of 11.9 percent in 2009 Q1 to 7.4 percent in April-May), their monthly dynamics turning negative.

3.2.2. Agricultural producer prices

In 2009 Q1, the negative annual change of agricultural producer prices was even sharper (-10.4 percent as compared with -0.4 percent in 2008 Q4), this trend being further generated by movements in prices for vegetal products (-23.5 percent), particularly grains and technical crops. By contrast, the growth rate of potato prices accelerated to 22 percent as against the same year-ago period, the rise in prices for additional imports (amid scarce supply and domestic currency depreciation) enabling domestic producers to raise prices in order to cover losses accumulated from cheap imports.

The dynamics of producer prices for animal products remained relatively unchanged from the previous quarter (21 percent), while the analysis by component shows similar developments in the case of main meat types, except for mutton. In the latter case, the annual growth rate of producer prices accelerated to 81.6 percent, mainly on the back of narrower domestic supply following the increased bias towards the external market.

In 2009 Q2, the annual negative changes in agricultural producer prices are likely to accelerate given that a similar trend is set to persist in the case of vegetal products (the first data on 2009 crops are not indicative of pressures, whilst the base effect is still very strong). In what concerns animal products, consumer bias is estimated to shift to cheaper meat types (poultry instead of beef or pork), which might lead to favourable price movements. Additionally, a similar impact may exert the alleviation in pork consumption, owing to the psychological effect associated with the first cases of AH1N1 virus contamination in Europe.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In 2009 Q2, the downtrend in the monetary policy rate was consolidated. The NBR lowered in May and June the key interest rate by 50 basis points each time, down to 9.0 percent per annum. At the same time, the NBR Board decided to lower by 3 and 5 percentage points respectively the minimum reserve ratio on leu- and foreign currency-denominated liabilities of credit institutions with residual maturities of up to two years starting with the 24 July – 23 August 2009 maintenance period. Given the moderation in the volatility of the exchange rate of the domestic currency and the sharper economic downturn, the decisions taken by the monetary authority in the period under review were meant to ensure real monetary conditions supportive of inflation rate convergence towards medium-term objectives, along with a sustainable rebound in lending to the Romanian economy.

The NBR Board's decision to lower the monetary policy rate to 9.5 percent per annum taken in its meeting held in May relied mainly on the relative improvement in the medium-term inflation outlook, associated with the prospects of the Romanian economy posting negative growth in 2009 as a result of the deepening of the global financial and economic crisis. The economic downturn started as early as Q1, as reflected by: (i) the larger-than-expected contraction in the annual GDP dynamics in 2008 Q4 and its inertial nature; (ii) entry/maintenance of the dynamics of some relevant indicators on consumer demand and investment demand, as well as on supply, into/in negative territory during the first months of 2009; (iii) faster rate of economic decline in EU Member States, triggering sizeable contractionary effects on the Romanian economy; (iv) further tightening of lending conditions, particularly on the domestic financial market, entailing a considerable slowdown in credit growth; and (v) quicker rise in unemployment in 2009 Q1. Other reasons behind the Board's decision were the faster adjustment of the external imbalance in the early months of 2009 (followed by a moderating trend in the exchange rate volatility) and the prospects of an ongoing orderly unwinding of this process amid the implementation of economic policy measures agreed upon in the arrangement signed with the IMF, the EU and other IFIs. These reasons were seen as the prerequisites for enhancing sustainable disinflation. In addition, the balance of risks associated with the medium-term inflation outlook had been in equilibrium, with disinflationary factors prevailing slightly, the high uncertainties surrounding future macroeconomic developments notwithstanding.

The unexpectedly large economic downturn revealed by first-quarter statistical data and, implicitly, the prospects on further alleviating inflationary pressures during the policy-relevant horizon led the NBR Board in June to decrease further the restrictiveness of broad monetary conditions via reducing the policy rate by another 50 basis points to 9.0 percent per annum and lowering the minimum reserve ratio on leu- and foreign currency-denominated liabilities of credit institutions with residual maturities of up to two years to 15 and 35 percent respectively, starting with the 24 July – 23 August 2009 maintenance period. The substantial fall in annual GDP growth in 2009 Q1 (-6.2 percent) was solely attributed to the sizeable setback in domestic demand dynamics (-13.7 percent), owing mainly to the sharp decline in private consumption and the huge negative change in inventories. Their impact was partly offset by the significant increase in the positive contribution of net exports to GDP dynamics, given the faster-than-projected adjustment of the external imbalance.

At the same time, economic facts and figures released in the course of the second quarter hinted at the likelihood of negative GDP dynamics to deepen and even surpass, at least in period under review, the levels incorporated in the medium-term forecast of macroeconomic developments prepared in May by the NBR staff. However, great uncertainties persisted over the scale of this contraction as well as over the magnitude of the decline in investment and consumption – nevertheless, the latter's dynamics was seen slowing further, as a result of an increase in pessimism and higher households' insecurity regarding their future income and implicitly their capability of repaying debts. The faster negative dynamics of key domestic demand components was suggested by the marked decline, in April, in relevant indicators on consumer demand and investment demand (retail trade turnover volume, imports volume, value of construction works) and by the noticeable deceleration in the annual growth rate of net real wage and the dwindling volume of remittances from abroad; adding to these developments were the sharply higher decline in the dynamics of corporate loans in April-May and the persistent improvement of households' net savings with banks, due largely to the steeper reduction in the growth rate of loans extended to this sector.

Average annual dynamics of loans to households slowed April through May to 14.2 percent (10.7 percentage points below the first-quarter average) under the impact of the major determinants manifest in the previous months as well. On the supply side, the major drivers behind the contraction in loans to households were the stronger wariness of credit institutions arising from pessimistic expectations on future economic developments, the heightening risk of adverse selection, the larger liquidity crunch and the decrease in external financing of commercial banks. On the other hand, demand for household loans was adversely affected by the deteriorating outlook on future incomes (amid the economic downturn, which is anticipated to carry on in the near run), along with the still high interest rates on new business. During April-May, all household credit types posted sharper declines in terms of average rates of increase. Nonetheless, a more considerable adjustment saw consumer credit, whose real average dynamics decelerated to 11.6 percent (compared to 20.8 percent in 2009 Q1), chiefly on account of the sluggish dynamics of leu-denominated credit (to 2.0 percent, down 6.2 percentage points from the first-quarter average). Analysis by breakdown of new business intended for consumption shows that the decline was basically due to the lower volume of consumer loan contracts destined most likely to purchase big ticket items, whereas overdraft loans (aimed rather to meet current needs) remained on an upward trend. A smaller deceleration witnessed the average annual growth pace of housing loans (to 25.1 percent, 8.2 percentage points below the first-quarter reading); in May, the annual change of such loans even added 2.7 percentage points to 26.5 percent, possibly as a result of the boost given by the potential easing of some specific lending terms and conditions, as well as of the likely broadening of debt rescheduling practices.

In turn, the annual dynamics of household savings with banks remained robust in April-May, standing on average at 13.8 percent, down from the first-quarter reading, owing to the slower dynamics of wage incomes and remittances, as well as to the still high pressure from debt servicing. Similarly to previous months, there was a shift in allocation of household funds from overnight deposits to time deposits amid the relative increase in the latter's interest rates; the dynamics of overnight deposits fell deep into negative territory, reaching -16.3 percent in April and -20.9 percent in May. By contrast, households' time deposits with a maturity of up to two years further saw a fast annual pace of increase, standing on average at 41.2 percent, largely on account of a swifter growth rate of leu-denominated deposits that came in at 47.1 percent, up 18 percentage points from the first-quarter average. Analysis by breakdown of leu-denominated loans[21] shows that deposits with maturity of two to three months held the largest share in total leu-denominated time deposits, i.e. 49.4 percent, to the detriment of one-month deposits and longer-maturity deposits.

The National Bank of Romania continued to calibrate with utmost care the adjustment pace of the monetary policy rate given that, similarly to prior months, despite the larger-than-expected widening of the negative output gap, disinflation was still expected to be stymied by the persistence of core inflation and the

[21] Based on data reported pursuant to Norms No. 14/2006 issued by the NBR.

inertia of inflation expectations. Another reason for such an approach was the still looming risk of the exchange rate to destabilise in the event of risk aversion at global or regional level reverting temporarily to high levels, in spite of the recent gradual restoration of investors' risk appetite and their improved perceptions on the economies in the region, the Romanian economy[22] included. A favourable impact on foreign investor sentiment towards the local economy had also the ongoing reduction in the current account deficit in 2009 H1 and the conclusion of the multilateral external financing arrangement with the IMF, the EU and other international financial institutions, which was shortly followed by the reaffirmed commitment by parent undertakings of nine leading foreign banks in Romania to take all the necessary steps for supporting their local subsidiaries. All this caused the RON/EUR exchange rate volatility to slow considerably, especially starting in the latter part of Q2.

Seen also from this perspective, the monetary authority's management of liquidity conditions took account of the ongoing convergence of yields on interbank transactions to the policy rate. By ensuring smooth functioning of the interbank money market, the central bank sought to increase the signalling role of the NBR's interest rate and lay the foundations for the future correction of the distorted interest rates applied by credit institutions to their customers. With this aim in view, the National Bank of Romania changed the manner in which key liquidity-providing operations were performed; starting in the latter half of April, the central bank conducted increasingly repo transactions via fixed-rate tenders (policy rate) with one-month maturity and full allotment. The change resulted in the gradual decline of yields/quotations in the interbank money market at the longer end of the maturity spectrum, thus nearing the policy rate (see Subsection *2.1 Interest rates*). The central bank consolidated its creditor position vis-à-vis the banking system, with the net average volume of liquidity-providing operations rising by 55.6 percent in Q2 versus Q1. In order to mop up the temporary excess liquidity, the monetary authority occasionally conducted reverse repo and deposit-taking operations, and even resorted to the deposit facility.

Also in its June meeting, the NBR Board decided to cut the minimum reserve ratio on credit institutions' liabilities with residual maturity of up to two years[23] as follows: to 15 percent from 18 percent in the case of leu-denominated liabilities and to

[22] Reflected *inter alia* by the relatively good performance of some relevant indicators such as spreads on credit default swaps, option-adjusted spreads and yields on Romanian bonds issued on international markets.

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

35 percent from 40 percent in the case of foreign currency-denominated liabilities. The measure came into force starting with the 24 July-23 August 2009 maintenance period. Moreover, it was aimed at improving liquidity conditions for both domestic and foreign currencies, ensuring further alignment of the required reserve mechanism to ECB standards in the field and supporting a sustainable financing of the Romanian economy.

2. Financial markets and monetary developments

In 2009 Q2, interbank market rates – including longer-term rates – came close to the monetary policy rate, while the RON/EUR exchange rate volatility was lower. The annual dynamics of broad money decelerated further, against the background of the sharper slowdown in the pace of increase of credit to the private sector.

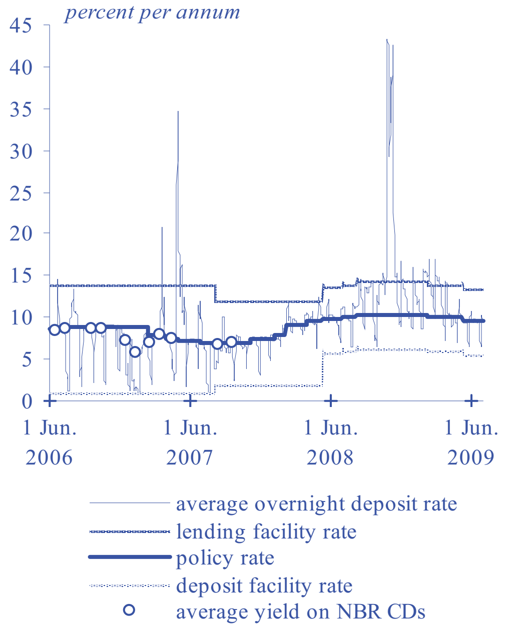
2.1. Interest rates

In April-June 2009, interbank market rates stayed on a downtrend, stabilising close to the monetary policy rate. Reflecting the decline in the policy rate, as well as the effect of the change made by the central bank in the liquidity management conditions, the quarterly average of interbank market rates saw a faster decline, dropping 3.1 percentage points to 9.6 percent versus the previous quarter.

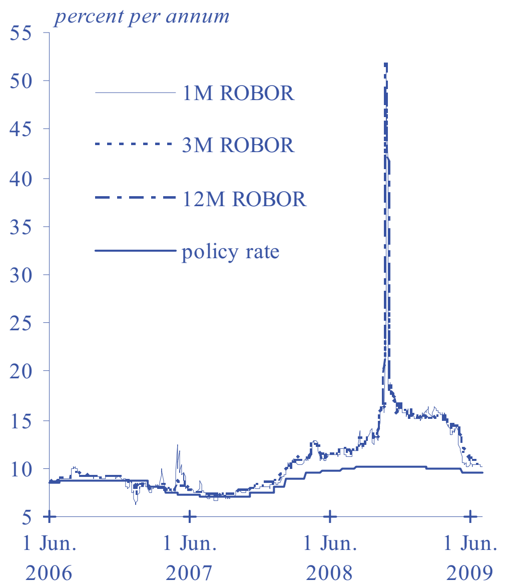
Overnight rates developed in line with the monetary policy rate during the period under review, reverting to levels in line with the latter ever since the end of the previous quarter. Given that the central bank focused on systematically ensuring balanced liquidity conditions, by providing the necessary reserves via repo operations, the volatility of very short-term interbank rates decreased substantially to a four-quarter record low. These rates posted a relatively higher increase only in the last week of April, under the restrictive seasonal impact of operations on account of the Treasury. Conversely, at the end of the reserve maintenance periods in the quarter under consideration, very-short term rates saw temporarily downward movements, following the build-up of short-lived excess liquidity.

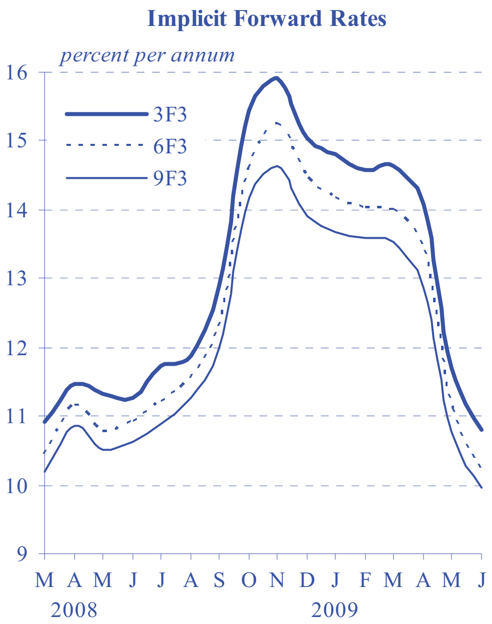
With regard to (1M-12M) ROBOR rates, they remained relatively high until the last part of April, yet they were subsequently adjusted to levels compatible with the policy rate. Behind this adjustment stood mainly the initiation in the first month of the quarter and the subsequent performance by the NBR of auction-based repo operations. As a result, average (1M-12M) ROBOR rate fell by 4.6 percentage points in June versus March; above-average decreases were reported by 1M and 3M ROBOR rates (down 5.2 percentage points and 4.8 percentage points respectively).

Interbank Money Market Rates



Policy Rate and ROBOR Rates

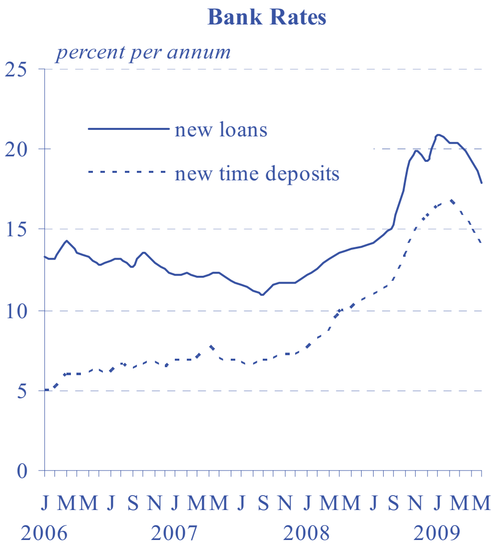




The implicit forward rates (calculated based on June average quotations) took a plunge as well. They indicated that the three-month ROBOR rates would decline to 10.8 percent at the end of Q3, 10.2 percent in December 2009 (over 3 percentage points lower than the figures calculated in March) and 10.0 percent respectively at the end of 2010 Q1.

In 2009 Q2, interest rates on government securities declined further, the maximum interest rates accepted by the MPF going down to 11.25 percent for almost all types of securities[24]. Government securities issues equalled RON 20.4 billion, which is similar to both the pre-announced amount and the previous quarter's issues. They included further mostly short-term paper, given credit institutions' bias towards such instruments.

The quarterly turnover of the secondary market for government securities (excluding the NBR) increased by nearly 13 percent as compared with the previous quarter to RON 6.6 billion, most transactions performed being irreversible. The most heavily traded were the securities with residual maturities of up to one year, whose interest rates followed a downward path throughout the quarter to reach on average roughly 10.6 percent (down about 1 percentage point versus the previous quarter).



Due to the sharper downtrend of interbank rates, average lending and deposit rates on new business applied to the non-government sector as a whole declined during March-May 2009. However, the adjustments were mixed as regards the two categories of customers. Hence, in the case of non-financial corporations, average interest rates captured almost entirely the decline in ROBOR rates: the average interest rate on new time deposits fell by 3.82 percentage points to 13.3 percent, while the average interest rates on new loans dropped 3.12 percentage points to 17.56 percent. Conversely, the average interest rates applicable to households saw a relatively high rigidity, which is attributed in the case of new deposits to the ongoing stiff competition among credit institutions in order to take leu-denominated funds and in the case of new loans to the further deterioration in banks' perception on the risk associated with this category of customers (as reflected by higher risk margins). Thus, in the quarter under consideration, the average interest rate on time deposits of households diminished by merely 1.33 percentage points to 14.98 percent, while the average interest costs associated with new loans of households rose by 1.06 percentage points to 19.69 percent in May.

[24] Except for one-month securities, whose maximum accepted interest rate fell to 10.75 percent.

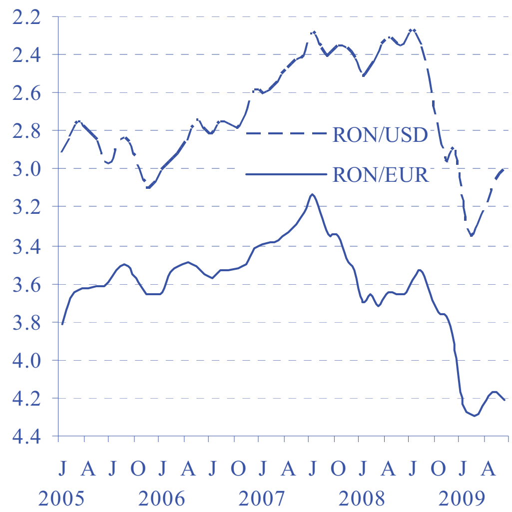
2.2. Exchange rate and capital flows

The domestic currency appreciated slightly versus the euro during 2009 Q2, as the trend reversal seen in April was followed by a relative stabilisation of the exchange rate of the leu, reflecting mainly the lower fluctuations in global risk appetite. At the same time, exchange rate developments became increasingly correlated to those of the major currencies in the region, while its daily volatility dwindled.

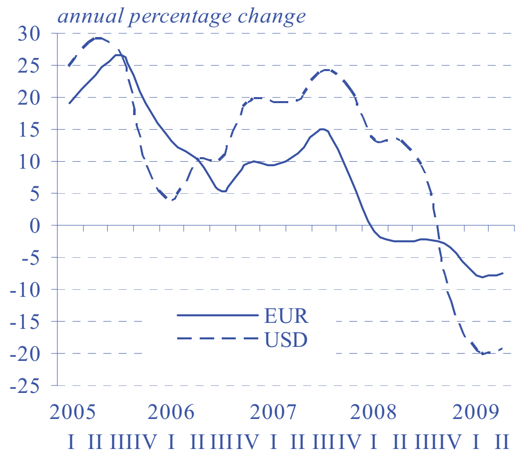
April through June, the domestic currency strengthened against the euro by 1.5 percent in nominal terms and 2.1 percent in real terms (compared to a depreciation of 8.6 percent and 6.2 percent respectively in 2009 Q1). The leu appreciated at a much faster pace versus the US dollar, i.e. 8.2 percent in nominal terms and 8.9 percent in real terms, given that the latter weakened considerably against the euro. Calculated as an average annual change for 2009 Q2, the domestic currency witnessed a slightly slower nominal depreciation to both the euro and the US dollar, by 12.9 percent and 24.1 percent respectively.

In the first part of April, the downward movement manifest since March in the RON/EUR exchange rate picked up[25] slightly, amid the ongoing revival in financial investors' risk appetite[26] and improved sentiment towards emerging markets, also as a result of the G20 decision to increase the funds allotted to the IMF. To this added the positive impact induced by the release of balance-of-payments data reflecting a larger-than-expected narrowing of the current account deficit in February. Nevertheless, the RON/EUR exchange rate posted a short-lived trend reversal at mid-April, mainly on account of: (i) Fitch agency warnings on a deeper economic recession in East European countries in 2009; (ii) the rating downgrades in Lithuania, Latvia and Romania, as well as (iii) the release of IMF forecasts on higher financing requirements of emerging economies in 2009. The impact of these factors on the domestic financial market was, however, moderate and was subsequently offset by the impact exerted by the higher quarter-on-quarter average volume of capital inflows similar in nature to financial borrowings and deposits. Furthermore, the balance of non-resident customer transactions re-entered positive territory for the first time over the past five months, while the interbank forex market deficit narrowed to a nine-month low. Thus, the domestic currency witnessed in April its first nominal appreciation versus the euro (2.1 percent) during the last eight months.

Nominal Exchange Rate



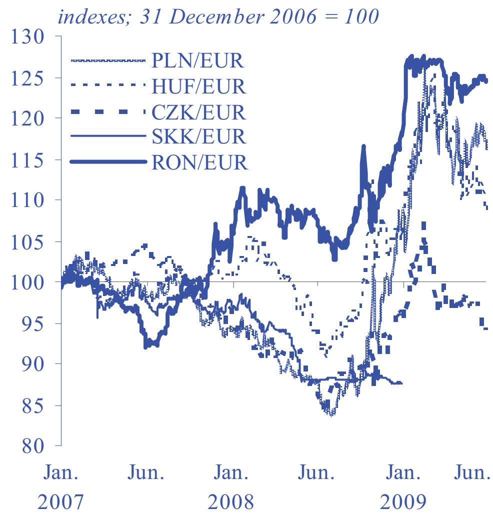
Developments of RON Exchange Rate*



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

Source: NIS, NBR

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

[25] The RON/EUR exchange rate stood at 4.1189 on 10 April, the lowest reading year so far.

[26] After the abrupt fall seen in the first quarter of the year, Dow Jones STOXX, S&P 500 and Nikkei 225 resumed the upward path in April.

Key Financial Account Items (balances)

EUR million

	2008 5 mos	2009 5 mos
Financial account	**7,901**	**1,473**
Direct investments	**4,429**	**2,466**
residents abroad	160	-9
non-residents in Romania	4,270	2,475
Portfolio investments and financial derivatives	**202**	**-197**
residents abroad	-334	14
non-residents in Romania	536	-211
Other capital investments	**3,500**	**-355**
medium- and long-term investments	2,337	-78
short-term investments	-99	-1,567
currency and short-term deposits	-653	-3,726
other	1,915	74
NBR's reserve assets, net ("–" increase/"+" decrease)	**-230**	**-440**

The slightly downward trajectory that the exchange rate of the domestic currency had re-embarked upon persisted into early May, with no visible impact being manifest in the aftermath of the higher-than-expected policy rate cut decided by the NBR Board on 6 May. Instead, the trend was underpinned by the announcement on the approval by the IMF Board of the stand-by arrangement with Romania and the further narrowing of the trade deficit, as indicated by statistical data released during the period under review.

Similarly to its peers in the region, the leu thereafter came under the impact of a temporary deterioration in global market sentiment, as a result of the announcements regarding: (i) the downward revision of EBRD estimates on the developments in some East European economies in 2009, Romania included; (ii) the larger-than-anticipated decline in euro area industrial output and bleaker outlook on its short-term developments; (iii) Standard & Poor's lowering its outlook for the United Kingdom to "negative" and fears – which subsequently were invalidated – of a possibly similar downgrading of the outlook on the USA. However, this impact was alleviated by the positive signal conveyed by the largest foreign banks in Romania upon reaffirming their commitment of 26 March to maintaining their global exposures to the domestic market. Moreover, net foreign currency sales by non-resident customers peaked at a 13-month high in May, while the interbank forex market deficit hit the lowest reading year so far. Against this background, the domestic currency continued to strengthen slightly versus the euro during May. Furthermore, daily volatility of the RON/EUR exchange rate diminished, while exchange rate developments became increasingly correlated to those of the major currencies in the region.

The RON/EUR exchange rate maintained its slightly upward course in June, amid the relative worsening of the sentiment to the region, on the back of: (i) rumours of a potential devaluation of the Latvian currency; (ii) poorer-than-expected economic performance of the euro area, along with the downward revision by the ECB of the forecasts on the related prospects for 2009, and (iii) negative signals conveyed by several reports and analyses, including the ECB Financial Stability Review, which highlighted the risk of unfavourable developments in the European banking sector over the short term. Although the RON/EUR exchange rate reverted to a slightly downward path towards the end of the reported period, under the positive impact of developments in the region[27], the

[27] The European Commission approved the second loan instalment for Latvia and the Hungarian Parliament adopted a fiscal package aimed at achieving fiscal consolidation and supporting economic growth over the medium and long term.

domestic currency shed 1 percent to the euro in nominal terms during the month under review.

2.3. Money and credit

Money

March through May 2009, the pace of increase[28] of broad money (M3) hit a 7-year low of 6.6 percent, mainly on account of the bleaker economic picture and the ongoing financial deleveraging both domestically and globally. However, the downward slope of the annual change in this monetary aggregate was not as steep as in the previous periods due to the impetus provided in May 2009 by the rise in the Treasury's injections.

The structural analysis of broad money is indicative of an ongoing shift in funds from overnight deposits to time deposits. Under these circumstances, the balance of overnight deposits contracted from the same year-ago period for the first time in the past 3½ years, both in case of households and in case of companies, irrespective of denomination. The growth rate of currency in circulation also decelerated further, with its percentage change touching an 8-year low[29]. Hence, the M1 balance witnessed a steady retrenchment, accounting – for the first time over the past two years – for less than half of the M3 value (45.7 percent as average for the period). This reflected the fast-paced decline in money demand for current transactions and the possibly keener demand for money as a financial asset (for precautionary reasons), amid (i) the worsening of both current and expected financial position of various categories of economic agents and (ii) the rise in the opportunity cost of holding highly-liquid monetary assets. Against this backdrop, the dynamics of time deposits with a maturity of up to two years hit a new all-time high, primarily on the back of the upward movement in household investments in both domestic and foreign currencies.

Nevertheless, total M3 deposits of both households and companies further witnessed a slacker expansion. The slowdown was more visible in case of corporate deposits. Thus, the growth rate of the leu-denominated component fell deeper into negative territory, while that of the foreign-currency-denominated component halved. Behind these developments stood, among others, the slacker consumer and investment demand, the slowdown in lending activity, the lower volume of non-residents' direct

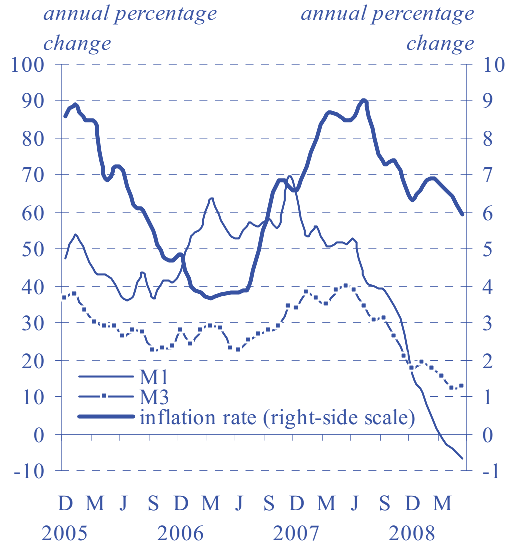
Annual Growth Rates of M3 and Its Components

real percentage change

	2008			2009		
	II	III	IV	I	Apr.	May
	quarterly average growth					
M3	28.2	22.1	13.8	10.0	5.5	6.2
M1	39.8	29.7	17.7	-2.1	-9.8	-12.2
Currency in circulation	30.2	19.4	18.2	8.9	2.9	-0.2
Overnight deposits	43.6	33.8	17.5	-6.0	-14.3	-16.5
Time deposits (maturity of up to two years)	16.7	13.7	8.9	24.1	22.2	27.3

Source: NIS, NBR

Broad Money and Inflation Rate

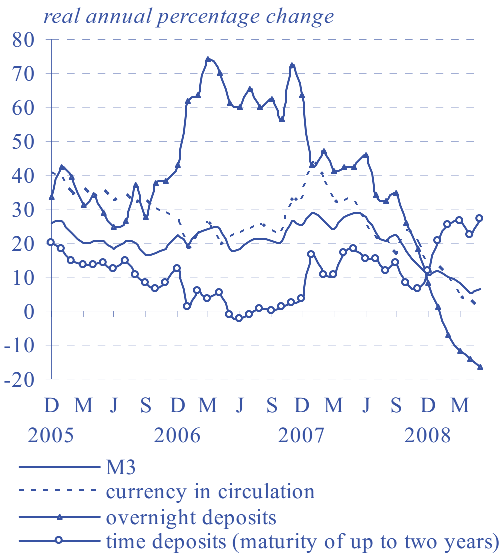


Source: NIS, NBR

[28] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March-May 2009.

[29] The annual growth rate of currency in circulation (real terms) entered negative territory at end-May 2009, for the first time in the past eight years.

Main Broad Money Components



Source: NIS, NBR

investment[30] and the fading of the effect generated by last year's privatisation of Electrica Muntenia Sud. By contrast, the dynamics of household deposits included in M3 saw a less steep downward slope than in the previous period, most likely owing to more sluggish consumption and certain amounts from budgetary sources[31] being earmarked for households, offsetting part of the impact of the slowing pay rises[32] and of the considerable retrenchment in remittances from abroad. Against this backdrop, the pace of increase of household M3 deposits in domestic currency witnessed a stalemate, while that of foreign-currency-denominated deposits decelerated markedly. However, household further accounted for more than half of residents' deposits in foreign currency. Thus, the M3 structure by denomination remained unchanged, with forex deposits accounting on average for 32.3 percent of broad money.

Money market fund units posted an opposite development, as their growth rate picked up considerably, although their share in M3 was further subdued at 0.4 percent in May 2009. This development may be explained by the shift – possibly driven by incidental factors – of certain customer categories towards these financial instruments to the detriment of other (monetary or non-monetary) asset classes, fostered *inter alia* by the high yields of the former investments.

From the perspective of M3 counterparts, the deceleration in the dynamics of credit to the private sector was further the main determinant of the slower M3 expansion, while central government net credit contributed to the faster growth rate of liquidity in the economy. To the contractionary impact on M3 added the steeper decline in banks' net foreign assets[33] and the slight step-up in the dynamics of long-term financial liabilities (capital accounts included).

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[30] According to balance-of-payments data, the average monthly volume of non-residents' net direct investment in the non-banking sector more than halved March through April 2009 compared to December 2008 – February 2009.

[31] According to press releases APIA (The Agency for Payment and Intervention for Agriculture), payments under the SAPS campaign (Single Area Payment System) amounted to EUR 347 million April through May 2009, from European funds co-financed by MPF.

[32] The average annual dynamics of the net average wage in real terms hit a 6½-year low.

[33] The drop in the M3 external counterpart was largely due to the weaker US dollar versus the euro, which had a detrimental effect on the value of NBR's foreign assets. However, the negative impact of the exchange rate change was not passed through to M3, as it was offset by a liability item in the central bank's balance sheet.

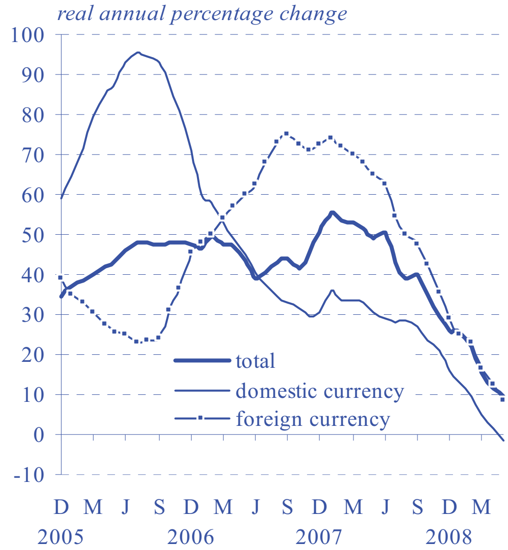
Credit

During March – May 2009, the growth rate[34] of credit to the private sector posted a brisker slowdown (12.1 percent), halving from the previous period and thus hitting a 7½-year low. Although the deceleration was further manifest irrespective of denomination, it remained more pronounced in case of the domestic currency component. However, the structure of credit to the private sector remained unchanged, with the forex-denominated component accounting on average for 58.9 percent of such loans during the period under review.

Both credit supply and credit demand were further influenced mainly by depressing factors. Thus, credit supply was primarily affected by (i) credit institutions' increased wariness, as highlighted by the still tight lending terms and standards[35], (ii) the smaller share of unsecured loans in total new business to households[36], as well as (iii) credit institutions' keener appetite for investments in government securities. The main factors stifling credit demand were further: (i) slower economic growth and worsening outlook for corporate and household incomes, (ii) high lending rates on new business, and (iii) the still high level of non-banks' financing from abroad[37]. The growth rate of corporate loans decelerated at a faster pace, with the annual dynamics of credit in both domestic and foreign currencies posting a steady downtrend. Moreover, the pace of increase of the leu-denominated component even entered negative territory in May 2009, for the first time in eight years. Conversely, the dynamics of household loans did not witness an across-the-board slowdown. Thus, in May 2009, housing loans saw their annual growth rate picking up on account of the rebound in the dynamics of the domestic currency component and the stalemate in the pace of increase of foreign currency-denominated credit, after 11 and 15 successive months of deceleration respectively. This development may have also been underpinned by the enforcement of the new regulations on collateralised household loans backed by high-quality real estate assets[38]. Against this background, the average share of household loans in total credit to the private sector equalled that of corporate loans for the first time ever.

Credit to Private Sector by Currency

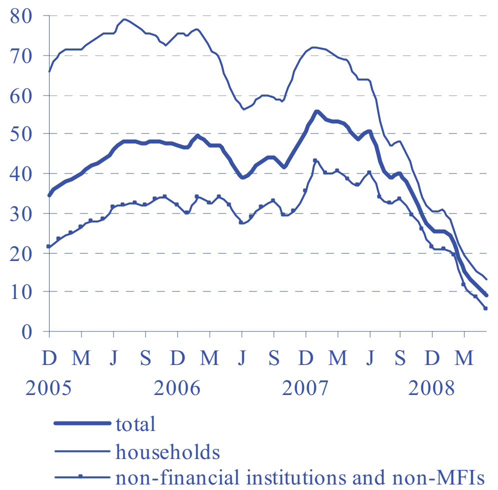
real annual percentage change



Source: NIS, NBR

Credit to Private Sector by Institutional Sector

real annual percentage change



Source: NIS, NBR

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34 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March-May 2009.

35 According to the results of the survey on lending to non-financial corporations and households, published in May 2009.

36 Based on CCR data.

37 According to balance-of-payments data, the monthly average volume of net financial credit taken from abroad by non-banks during March-April 2009 exceeded by about one-third that recorded in the previous quarter.

38 Regulation No. 2/2009 amending Regulation No. 3/2007 on containing credit risk associated with loans to households.

Nevertheless, the data released by CCR[39] on the monthly flows of new loans reveal a slight improvement in the lending process during the period under review. The volume of new business to households exceeded that seen during the previous period (although remaining about four times lower than a year ago), while the volume of new business to companies exceeded the previous three quarters' readings, given that services and industry posted absolute highs in terms of credit flows in March and April respectively. Aside from companies' higher financing needs, generated by the decline in own resources[40], these developments were probably also driven by the more frequent resort to debt rescheduling, which reflects the credit institutions' concern to avoid a severe deterioration of their portfolio quality[41]. However, the volume of new loans stayed below that of repayments, with household and corporate borrowings thus recording successive monthly declines.

Net credit to central government continued to exert an expansionary impact on M3, primarily via an increase in credit institutions' government securities portfolio. Thus, the average share of these placements in total bank assets peaked at a 5½-year high. The steeper fall in central government deposits had a similar influence on M3 dynamics, particularly visible at the end of the period under review.

[39] Referring to loans in amount of more than RON 20,000.

[40] Profit tax saw sizeable annual contractions in real terms March through April 2009.

[41] The share of overdue loans of both households and non-financial corporations in total credit to the private sector reached a 7½-year high of 2.8 percent, on average during the reported period. Non-financial corporations account for almost three quarters of the volume of these loans.

V. INFLATION OUTLOOK

The baseline scenario of the projection places the annual CPI inflation for end-2009 at 4.3 percent, 0.1 percentage point lower than the figure forecasted in the May 2009 Inflation Report (4.4 percent). In 2010, annual inflation rate is forecasted to fall to 2.6 percent, i.e. below the central target (3.5 percent) and the previously forecasted figure (2.8 percent).

Although the CPI inflation forecast for 2009 features only a marginal deviation from that published in May, the current scenario incorporates a reassessment of relative contributions of aggregate price index determinants. The projected growth rates of volatile prices (fuel prices and certain food prices) and administered prices have a favourable bearing compared to the previous projection. This effect is offset by a slower-than-previously-forecasted reduction in CORE2 inflation, in spite of a significantly wider negative output gap. One of the anticipated deterrents to disinflation is the persistence, over the first part of the projection horizon, of the current tendency of core inflation to respond in a subdued manner and with a lag to the decrease in aggregate demand. In addition, the current projection incorporates the assumption of a stronger adverse impact of the planned hike in excise duties on tobacco products, which is expected to feed through into prices both directly and indirectly (via inflation expectations).

For 2010, the projection envisages faster disinflation, hinging mainly upon the build-up of demand shortage pressures and the gradual consolidation of the downtrend in inflation expectations. The downward revision of the forecasted CPI inflation rate by 0.2 percentage points is also due to more favourable scenarios on the growth rates of administered prices and fuel prices.

Similarly to the May 2009 forecast, the current projection assumes the repositioning of the inflation rate back inside the variation band around the central target for 2009 Q4. The NBR will further calibrate real monetary conditions so that inflation rate remains within the projected coordinates and, at the same time, will seek to create the necessary conditions for the sustainable revival of the lending process in the Romanian economy. The fulfilment of these objectives in a sustainable manner is conditional upon the absence of powerful, adverse external shocks and the adequate coordination between monetary policy and other macroeconomic policies.

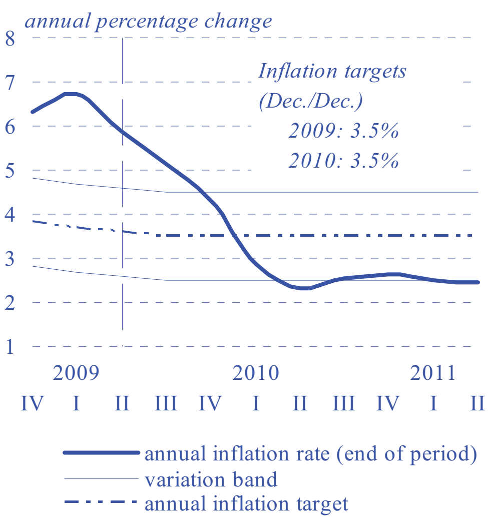
The risks associated with inflation rate deviating from the trajectory shown in the baseline scenario of the current projection *appear to be relatively balanced. The highest risks come from the uncertainties regarding the future developments in the global economic crisis. Knock-on effects of the crisis emerging at a different intensity from that envisaged by the baseline scenario may cause both inflation rate and GDP growth to deviate from the projected trajectories. A priori, the probability of distribution of deviations on either side appears to be symmetrical.*

The risk of unfavourable developments in both variables increases however in the absence of coherent and time consistent macroeconomic policies. For example, a potential excessive easing of the fiscal policy against the background of scarce financing resources may disrupt the orderly adjustment of the external imbalance and/or entail a crowding-out of the private sector. Particularly if additional public spending were not channelled primarily to investment, but rather to current – especially staff-related – items, the potential of boosting the economy would be quickly exhausted, thus inducing inflationary pressures in the short term and delaying, at least temporarily, the rebound in economic activity. The identified risks could be significantly mitigated provided macroeconomic policies follow the coordinates set out in the context of the multilateral external financing arrangement with the International Monetary Fund, the European Union and other international financial institutions.

Other risks to inflation are generated by the ongoing structural rigidities in certain segments of labour and product markets, as well as budget expenditures. Inertia of wage costs and prices higher than assumed in the baseline scenario could delay both the reduction of inflation and the rebound in economic activity.

Compared to the assumptions incorporated in the baseline scenario, the risks to the developments in oil prices and prices of other commodities, administered prices and volatile food prices appear to be relatively symmetrically distributed around the projected CPI inflation path.

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 4.3 percent, 0.1 percentage points lower than that published in May. In 2010, annual inflation rate is forecasted to fall to 2.6 percent, i.e. below the central target of 3.5 percent, as well as below the previously forecasted figure of 2.8 percent.

Table 5.1. The annual inflation rate in the baseline scenario

percent

Period	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2
Target		3.5				3.5		
Forecast	5.1	4.3	2.9	2.3	2.5	2.6	2.5	2.5

The projected inflation rate for the current round is the result of the revision of some of the assumptions used in the previous forecast, as follows:

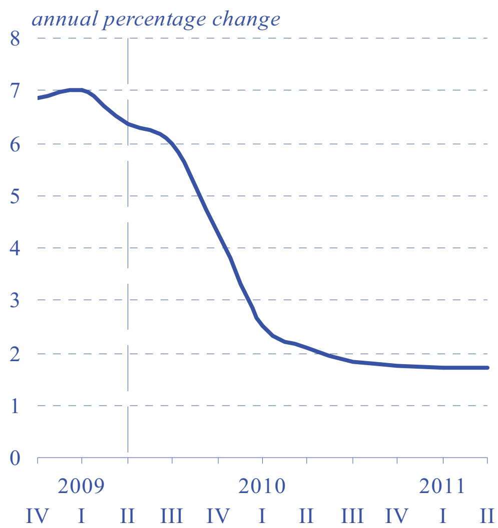
– *downward revision of GDP deviation from its potential level* – the negative output gap is expected to be wider throughout the projection horizon. This is reflected by a larger-than-previously projected decline in production capacity utilisation economy-wide, implying *ceteris paribus* stronger disinflationary pressures over the projection horizon;

– *more favourable scenarios for the exogenous components of the CPI*[42] – the trajectory of the administered prices inflation rate and of the volatile prices of vegetables, fruit and eggs inflation rate is more supportive of disinflation compared to the previous projection (May 2009 Inflation Report) almost throughout the forecast horizon;

– the revision of the dynamics of fuel prices inflation rate over the next eight quarters. This arises mainly from *an exogenous scenario which encompasses an increase in the oil price* (for 2009 Q3-2010 Q4) *below that assumed previously*.

According to the baseline scenario, the annual CORE2[43] inflation rate is foreseen to slow down over the next eight quarters. Although it comes under the impact of a substantially revised negative output gap, especially during 2009, the largest contribution to disinflation coming from the annual CORE2 inflation rate is anticipated to become manifest starting with 2010 Q1[44]. The explanation for the assumption regarding the delayed incorporation of the disinflationary pressures from aggregate demand into CORE2 inflation and, further on, into the CPI lies in a set of both empirical[45] and

Annual CORE2 Inflation



Source: NIS, NBR calculations

[42] For further details on the scenario regarding the exogenous components of inflation, see Section *1.2. Exogenous pressures on inflation.*

[43] The dynamics of this inflation measure includes the impact of adjustments in the excise duty on tobacco products.

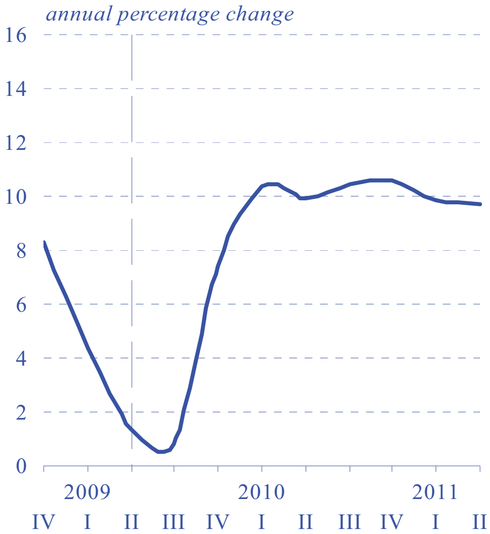
[44] Starting with this quarter, the annual CORE2 inflation rate in the baseline scenario is projected to fall below that of the entire CPI basket.

[45] This positioning of the annual CORE2 inflation rate vis-à-vis the annual CPI rate was highlighted even in the previous forecasting round and was confirmed by the latest statistical data on price developments (NIS). CORE2 inflation has run steadily above the CPI in terms of both monthly and quarterly (average) rates since November 2008 and 2008 Q4 respectively.

theoretical[46] factors. The most important determinant endorsing this assumption is the unusually high uncertainty faced by companies, entailing direct effects on their capability to adequately anticipate the future dynamics of aggregate demand for their products. Such an assumption explains the use in the baseline scenario of the hypothesis of an increased cautiousness of companies in taking the radical decision of adjusting prices to the signals coming from the aggregate demand[47], at least over the near run.

The persistence of the negative output gap over a longer period of time is expected to lead to the gradual adjustment of the annual price dynamics towards levels compatible with the lower aggregate demand. Against this background, the maintenance of output gap at more negative values when compared to the levels shown in the May 2009 Inflation Report will provide support to and even cause a sharper downtrend in the annual CORE2 inflation rate during 2010. However, compared to the trajectory published in the previous Inflation Report, the annual CORE2 inflation rate in the current projection is foreseen to run at higher levels until 2010 Q3. This development is also partly due to the unfavourable revision, in the current projection, of the impact that the adjustment of the excise duty on tobacco has on inflation expectations[48] of economic agents.

Fuel Prices Annual Inflation



Source: NIS, NBR calculations

The forecasted path for fuel price inflation is lower than that published in the May 2009 Inflation Report. This is attributed to the annual fuel price inflation declining faster (by 0.6 percentage points) in 2009 Q2 compared to the anticipated level, on the one hand, and the slightly more favourable exogenous scenario regarding the oil price[49], on the other hand.

[46] Even amid the substantial reduction in exchange rate volatility in the past few months compared to that seen at the turn of the year, the recent stabilisation of the exchange rate of the leu versus the euro around a more depreciated *level* than that recorded in the pre-crisis period might induce producers' stronger wariness of adjusting sale prices, even if demand for their products were to drop sharply. Such a behaviour cannot be ruled out, given the large share of import prices in CORE2 inflation, on the one hand, and the high euroisation of the Romanian economy, on the other hand.

[47] Dedicated literature refers to this phenomenon as "asymmetric price adjustment". For instance, given the decline of the demand for their products (which does not necessarily imply lower factor costs – see, for example, a certain downward rigidity of ULC in some sectors of the Romanian economy), company managers could decide to keep sale prices unchanged either in an attempt to preserve their profit margins in the face of heightened uncertainties surrounding the future developments in activity or as a result of market's structural features (e.g. holding quasi-monopoly or even monopoly positions).

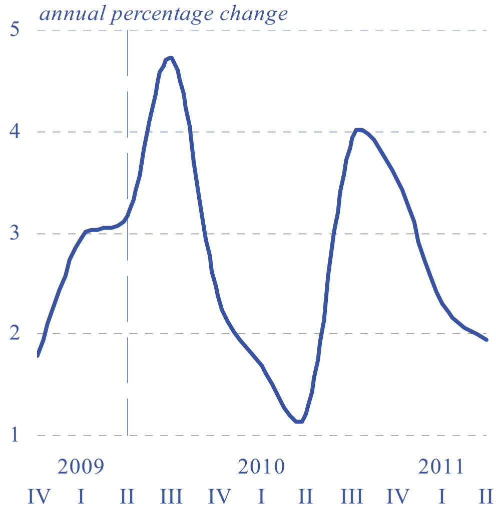
[48] The frequency and magnitude of adjustments in excise duties on tobacco have repeatedly caused disruptions in the anchoring of inflation expectations.

[49] For further details on the scenario regarding the oil price, see Section *1.2. Exogenous pressures on inflation.*

1.2. Exogenous pressures on inflation

The contribution of the exogenous scenarios on administered prices and volatile prices of vegetables, fruit and eggs to CPI inflation is more favourable in the current baseline scenario than in the previous projection (except for the contribution of volatile prices of vegetables, fruit and eggs in 2010). Administered price inflation is expected to have a lower contribution to the annual headline inflation over the entire projection horizon, i.e. 0.7 percentage points in 2009 and 0.4 percentage points in 2010. Compared to the previous baseline scenario, volatile food inflation is anticipated to exert a lower contribution to headline inflation in 2009 (0.2 percentage points), but to have a marginally higher contribution in 2010 (0.3 percentage points).

Vegetables, Fruit and Eggs Prices Annual Inflation



Source: NIS, NBR calculations

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

		Administered prices		Volatile food prices	
		2009	2010	2009	2010
Current projection	Annual change (%)	3.7	2.3	2.4	3.5
	Contribution to annual CPI inflation (pp)	*0.7*	*0.4*	*0.2*	*0.3*
Previous projection	Annual change (%)	5.1	3.5	5.2	2.9
	Contribution to annual CPI inflation (pp)	*0.9*	*0.6*	*0.4*	*0.2*

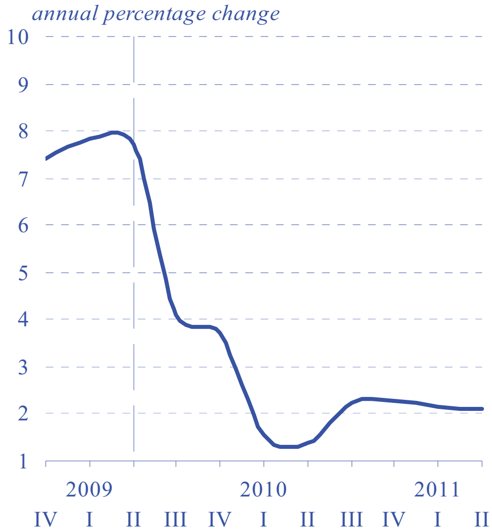
The exogenous scenario on the developments in administered prices is mainly determined by the dynamics of heating prices, electricity prices and natural gas prices. Compared to the previous projection, the baseline scenario of the current projection incorporates the cut in the natural gas price in July 2009 and the assumption of the electricity price and the natural gas price remaining unchanged during 2010.

Table 5.3. The scenario for the energy prices growth rates

annual percentage change

	Electricity		Heating		Natural gas	
	2009	2010	2009	2010	2009	2010
Current projection	0.2	0.0	8.1	5.2	-8.3	0.0
Previous projection	0.2	3.0	8.6	5.2	0.0	3.0

Administered Prices Annual Inflation



Source: NIS, NBR calculations

Adjustments in *the excise duty on cigarettes* are projected to exert slightly higher inflationary pressures than estimated in the May 2009 Inflation Report[50]. Thus, the excise duty on tobacco is forecasted to make a 1.2 percentage point contribution to annual CPI inflation in 2009 (the largest impact being expected in Q4) and a 0.7 percentage point contribution in 2010 (while its contribution is expected to be on a downward trend throughout the next year).

In view of the recent developments in the oil price on the international markets, the current projection incorporates the assumption of its gradual rise during the projection horizon[51]. Annual HICP inflation rate in the euro area is seen decelerating in 2009 by 0.2 percentage points compared to the figures used in the previous projection against the background of a larger economic contraction (the average annual dynamics of euro area GDP expected for 2009 is 1.7 percentage points slower than that published in May). The anticipation of a slight upturn in the economic activity in the euro area in the latter half of 2010 is illustrated by the assumption of a favourably revised economic growth (by 0.4 percentage points) for that year compared to the figures used in the previous projection and of a higher annual inflation rate (by 0.1 percentage points). In line with the projected GDP and inflation rate dynamics, the 3M EURIBOR is expected to stick, in the short run, to the low values reported lately and subsequently to follow a trajectory consistent with the anticipated hike in the ECB key rate. Table 5.4 sets out the projected dynamics of the external macroeconomic variables.

Table 5.4. Expectations on the developments in the external variables

annual averages

	2009	2010
3M EURIBOR (%)	1.3	1.6
WTI oil price (USD/barrel)	58.3	71.5
EUR/USD exchange rate	1.35	1.37
Annual inflation rate in the euro area (%)*	0.6	1.3
Economic growth in the euro area (%)	-4.4	0.4

* in Q4

[50] According to Government Emergency Ordinance No. 29 of 25 March 2009, the excise duty shall increase to EUR 64/1,000 cigarettes on 1 September 2009 and to EUR 74/1,000 cigarettes during 2010, from EUR 57/1,000 cigarettes on 1 April 2009.

[51] According to the current projection, the international oil price will increase gradually between 2009 Q3 and 2010 Q4 by 16 percent, starting from a significantly higher initial level than that anticipated by the previous projection. The difference between the initial levels is larger than that forecasted for the levels at the end of the forecasting horizon, which explains a lower rise than that of 24 percent anticipated by the previous projection.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

In 2009 Q1, the risks previously identified by the NBR, regarding the contraction in economic activity in annual terms, materialised in the GDP decline exceeding that expected in the previous projection. The analysis of the available statistical indicators for 2009 Q2 shows that the effects of the global economic and financial crisis continued to pass through into the Romanian economy, hinting at the annual growth rate of GDP falling deeper into negative territory. Against this background, in the current projection the assessment on the negative output gap in Q1 was subject to a downward revision as compared to the previous projection; for Q2 we anticipate the negative output gap to persist. *Ceteris paribus,* this results in the intensification of disinflationary pressures over the next quarters. Accordingly, the assessment of the growth rate of potential GDP points to a decrease in 2009 versus 2008, amid the foreseen contraction of investment and financial intermediation activities.

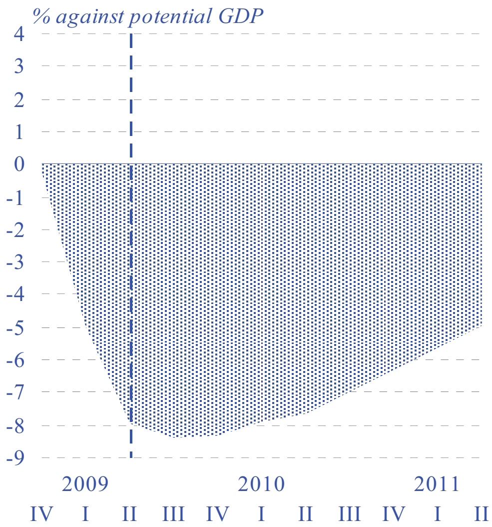
According to the data released by the National Institute of Statistics (NIS), in 2009 Q1, GDP fell 6.2 percent in real terms as compared to 2008 Q1 (non-seasonally adjusted data). Seasonally adjusted statistical data provided by the NIS[52] point to negative quarterly growth rates starting with 2008 Q3, which shows a gradual contraction in the economic activity undergoing strong intensification in 2009 Q1. This performance can be explained by the negative effects induced by some external factors on the domestic economic activity. An important role was played by the global liquidity crunch with a negative impact on lending by financial institutions. The persistence of a high level of risk-aversion and the shift in focus of banks towards domestic financing sources resulted in higher financing costs that were passed through to lending rates. The lending activity has contracted amid the increase in banks' risk aversion and also on account of economic agents' still pessimistic outlook on the overall economic developments, entailing also a drop in the demand for loans. On the other hand, the significant decline in the economic activity of Romania's main trading partners has been conducive to the worsening of external demand for domestic goods, therefore having a negative impact on the dynamics of exports.

In this context, the assessment of the cyclical position of the economy in 2009 Q1 was revised significantly as compared with the previous forecasting round, resulting in a wider negative output gap. Moreover, the negative output gap is seen rising

[52] According to seasonally-adjusted data, GDP posted a quarterly dynamics of -0.1 percent in 2008 Q3, -2.8 percent in 2008 Q4 and of -4.6 percent in 2009 Q1.

further in Q2 compared with Q1. *Ceteris paribus*, this means disinflationary pressures of aggregate demand that are significantly higher than previously estimated.

GDP Deviation



Source: NIS, NBR calculations

In 2009 Q1, household final consumption dropped 10.5 percent year-on-year (non-seasonally adjusted data). This GDP component is expected to decrease further in Q2, yet at a slower annual pace. This would imply the persistence of a negative deviation from the trend of household final consumption for the third consecutive quarter, amid the anticipated fall in resources for consumption available to households. To this contributes the decrease in the number of employees and the slower growth rate of whole-economy net real wage[53]. At the same time, new consumer loans to households declined sharply as compared with the same year-ago period[54], due to the impact of both demand- and supply-side factors. In this context, retail turnover (except for motor vehicles and motorcycles) continued to go down in April-May 2009, its annual rate standing at -12.1 percent[55].

In the first quarter of 2009, government final consumption posted an annual growth rate of 4 percent (non-seasonally adjusted data). In 2009 Q2, this GDP component is expected to show slower annual growth rates than those recorded in the previous quarters.

In 2009 Q1, gross fixed capital formation dropped 0.3 percent year-on-year (non-seasonally adjusted data). As regards investment components, equipment continued to post unfavourable developments, falling 11.3 percent in Q1 year-on-year, while new construction works further showed positive growth rates, accelerating slightly versus the previous quarter[56]. On the other hand, first-quarter imports of capital goods declined markedly by 50.4 percent (expressed in EUR) as against 2008 Q1[57].

The relatively high real lending rates and the economic agents' negative expectations on economic outlook are estimated to further have a restrictive impact on investment dynamics.

[53] In April and May, unemployment rate went up to 5.9 percent as compared with the Q1 average of 4.9 percent (seasonally-adjusted data); considering the average for April and May 2009 as compared with the average for 2008 Q2, the annual dynamics of net real wage (deflated by consumer price index, seasonally-adjusted data) is 2.1 percent (staying on a downtrend as compared with the annual rate of 15.3 percent recorded in 2008 Q3).

[54] New consumer loans to households (in both domestic and foreign currency) in 2009 Q2 dropped 74.2 percent (non-seasonally adjusted data) as compared with the average for 2008 Q2.

[55] In 2009 Q1, the annual growth rate of retail turnover was -6.3 percent (seasonally- and working-day adjusted series).

[56] The annual growth rate of new construction works stood at 9.2 percent in 2009 Q1 as compared with 7.3 percent in 2008 Q4.

[57] In April and May 2009, industrial output of capital goods showed signs of recovery as compared with the average for the previous quarter, the annual growth rate standing at 11.3 percent (seasonally-adjusted data).

As compared with the values recorded in prior quarters, the annual growth rate of medium- and long-term loans granted to economic agents continued to slow down in 2009 Q2[58].

In 2009 Q1, the quarterly dynamics of exports and imports of goods and services followed a sharper downward dynamics[59], an alleviation being expected starting with Q2. Given the faster adjustment of imports than that of exports of goods and services, trade deficit narrowed considerably. The domestic currency depreciation during the prior quarters had a limited contribution to offsetting the negative effects of the lower external demand[60] for Romanian goods. The significant decline in imports shows the contraction of domestic demand and the inflationary effects of the recent domestic currency depreciation on import prices expressed in domestic currency.

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

In 2009 Q2, the domestic currency appreciated in both nominal and real terms compared to the average recorded in the prior quarter[61]. The downward dynamics of the exchange rate of the leu was closely related to that of other currencies in the region. The weakening of the depreciation pressures was due to the relative improvement in financial investors' risk appetite and sentiment towards emerging markets (mainly as a result of G-20 decision in April to increase funds earmarked to the IMF and the conclusion of agreements between international financial institutions and countries deemed as facing macroeconomic imbalances). Nevertheless, some negative signals stemmed from the sharper-than-expected decrease in industrial output in the euro area and the downward revision of the forecasts on economic

[58] The real annual growth rate of medium- and long-term loans extended to economic agents stood at 5.0 percent in 2009 Q2 as compared with the average for 2008 Q2. The annual growth rates of this indicator slowed down in the last quarters, standing at 37.2 percent in 2008 Q3, 26.3 percent in 2008 Q4 and 16.4 percent in 2009 Q1.

[59] The quarterly growth rate of exports of goods and services was -8.1 percent in 2009 Q1 and -6.6 percent in 2008 Q4, while that of imports of goods and services stood at -14.3 percent and -13.7 percent respectively (seasonally-adjusted data). In 2009 Q1, the annual growth rates of exports and imports of goods and services are -19.6 percent and -31.4 percent respectively (non-seasonally adjusted data).

[60] Euro area countries are the main trading partners of Romania. The contraction of real GDP in the euro area continued in 2009 Q1 with a quarterly growth rate of -2.5 percent lower than -1.8 percent recorded in 2008 Q4. The annual growth rates recorded in 2008 Q4 and 2009 Q1 were -1.7 percent and -4.9 percent respectively, according to seasonally-adjusted data.

[61] The effective exchange rate based on which the analysis is carried out implies RON/EUR and RON/USD exchange rates respectively, their weighting system reflecting the importance of the two currencies in Romania's foreign trade.

growth in Central and Eastern European countries by some financial institutions.

Domestically, the steeper-than-expected narrowing of the current account deficit and the IMF Board approval of the stand-by agreement with Romania in early May had a positive impact on the exchange rate developments. In 2009 Q1, the current account deficit was substantially adjusted (mainly on the back of the decline in private sector demand), accounting for about 10 percent of GDP against 12.3 percent at end-2008[62]. Nevertheless, in the short run, financial investors' sentiment might be depressed by uncertainties surrounding the consolidated general budget outlook for the current year and the possible deepening of the economic downturn during the same period. Against this background, the multilateral external financial arrangement with the IMF, the EU and other IFIs is meant to ensure, besides the financial resources needed to offset the drop in private external financing, a formal framework for the orderly unwinding of macroeconomic imbalances, by minimising social costs.

As compared to the previous quarter, in the current quarter, the exchange rate of the domestic currency exerts a positive, albeit weaker impact on future aggregate demand via the net export channel. On the other hand, through the wealth and balance sheet effects, the impact of the exchange rate is slightly restrictive. The net effect of the exchange rate on future aggregate demand via the two aforementioned channels is deemed to be stimulative, albeit lower than in the prior quarter. Thus, via the aggregate demand channel, *ceteris paribus*, the domestic currency further mitigates disinflationary pressures. In 2009 Q2, the leu appreciated in nominal terms as compared to 2009 Q1 and had a direct positive impact on developments in prices of imported goods, thereby fostering, *ceteris paribus*, the decrease of CPI inflation.

Throughout 2009 Q2, the NBR maintained its position as creditor vis-à-vis the banking system and accommodated the liquidity shortage on the interbank money market via liquidity- providing operations (mainly repo operations).

Although during 2009 Q2 a convergence process of the overnight ROBOR with the policy rate took place, the reductions in banks' nominal lending and deposit rates were not significant. These developments occurred amid an ongoing process of gradual adjustment of banks' behaviour to the new financing conditions. Thus, the keen competition among banks to attract domestic resources, in the context of difficult access to external financing sources, led to a slight reduction in deposit rates. At the same time, nominal lending rates followed a slightly downward path, further

[62] Data in nominal terms, not seasonally adjusted.

reflecting commercial banks' high degree of caution vis-à-vis non-bank clients, as well as the additional financing costs generated by the attraction of new resources.

In 2009 Q2, the cut in nominal lending and deposit rates applied by credit institutions to their non-bank clients was outpaced by the decline in inflation expectations, which implies real interest rates that exert increased restrictiveness on economic activity in following periods.

During 2009 Q2, the cumulative effect of the exchange rate of the leu and of credit institutions' interest rates applied to non-bank clients on future economic activity is deemed to be stimulative, albeit weaker than in the previous quarter.

1.3.3. Demand pressures within the projection horizon

According to the current baseline scenario, throughout the projection horizon, the GDP deviation from the trend level is expected to post more negative values compared to the figures in the May 2009 Inflation Report. This trajectory is the result of the sizeable revision at the starting point[63] of the negative output gap forecast as well as of the adjustment – rather substantial in certain cases – of the expected developments of the major determinants: economic growth in the euro area, domestic lending, broad monetary conditions and fiscal policy stance.

One of the most relevant determinants of the revision of the negative output gap forecast is the sharper than previously anticipated drop in the euro area economic activity in 2009 Q1[64] and, hence, the adoption of a bleaker assumption regarding the developments of this indicator throughout the year. This revision entails an additional contraction of the euro area demand for imports and implicitly of Romanian export dynamics, at least in the first part of the projection horizon[65]. The favourable effect of the real exchange rate on net exports, lower than in the previous projection, only partly offsets the restrictive effects generated by the external demand contraction.

Real monetary conditions will further stimulate aggregate demand throughout the projection horizon, as a result of projecting a decreasing tightness of real interest rates and a favourable influence from the real exchange rate. The adequate management of liquidity via open market operations by the central bank created favourable conditions for a more efficient pass-through of policy

[63] 2009 Q3.

[64] Annual rate of -4.9 percent.

[65] Export dynamics is expected to enter positive territory during 2010 and 2011, reverting from the negative values anticipated for the current year. Nevertheless, the return to growth rates comparable with those seen in the periods prior to the outbreak of the global economic crisis is not expected to occur during the current projection.

rate impulses to interbank rates. This will also promote a more efficient pass-through of the signals sent by the central bank to the interest rate during the projection horizon, allowing the gradual fading of the tightness of lending and deposit rates of the recent periods. In this respect, the return to normal liquidity conditions will eliminate distortions such as those observed in the banks' recent behaviour, i.e. deposit rates higher than the policy rate[66].

The conclusion of an IMF-EU-led multilateral financial arrangement had a favourable effect on the foreign investors' risk perception. The fulfilment of the financial obligations governed by this arrangement is expected to mitigate exchange rate volatility, so that exchange rate developments should be influenced mainly by economic fundamentals. These two effects (improved investor sentiment and lower exchange rate volatility) might act, at this horizon, as an additional stimulus to aggregate demand via the wealth and balance sheet channel[67].

The current projection retains the assumption of a persistent shortage of financing sources[68] for a large part of Romania's household and corporate sector, although the farthest-reaching effects of the lending standards' tightening are supposed to have already taken place in the first two quarters of 2009. The cut in the minimum reserve ratios on leu- and foreign currency-denominated liabilities[69] applied by the NBR is anticipated to have a favourable impact on the average cost and volume of the credit institutions' financial resources, thereby entailing the fall in lending and deposit rates applied to non-bank clients. As a result, also benefiting from certain complementary projects with an impact on lending[70] initiated by the authorities, the baseline scenario foresees a more sustained recovery in lending starting with 2009 Q4, which would lead to a gradual improvement of aggregate demand in the economy.

The fiscal policy coordinates were laid down based on the objectives assumed by the Ministry of Public Finance in the IMF-EU-led multilateral financial arrangement. The sharper trajectory of the negative output gap throughout the projection

[66] Bringing deposit rates below the policy rate at the projection horizon is expected to boost consumption and investment, thereby heightening the stimulative nature of the real monetary conditions.

[67] For further details regarding this channel, see the Box entitled "Wealth and balance sheet effects of exchange rate", p. 43 in the November 2005 Inflation Report.

[68] According to the latest "Survey on lending to non-financial corporations and households" (NBR, May 2009), in 2009 Q1, lending standards became tighter than in 2008 Q4, yet less tight than in the previous period. Except consumer loans, there are no signs of easing in the quarters ahead.

[69] In compliance with the NBR Board Decisions of 30 June and 4 August 2009.

[70] For instance, "First Home" Project initiated by the Government, in progress since July 2009.

horizon leads to a fiscal impulse[71] of a more pronounced procyclical nature compared to the previous projection during the current year and the following year as well[72].

1.4. Risks associated with the projection

This section details the specific risk factors deemed to be particularly relevant over the current projection horizon. The difficulty of rigorously quantifying the impact of all these factors calls for the presentation of assessments that are rather qualitative in nature. As an overall assessment of the uncertainties surrounding the baseline scenario of the current projection, the balance of risks to inflation is deemed to be in equilibrium.

Similarly to the May 2009 Inflation Report, the most relevant risk refers to the duration and magnitude of the knock-on effects from the global financial crisis on the domestic economic developments. The likelihood of a strong rebound in external demand at a quicker pace than currently assumed cannot be entirely ruled out. Under the circumstances, the negative annual rate of domestic economic growth could decelerate and even post a trend reversal, benefiting from the more favourable contribution of net exports compared to the baseline scenario assumptions. As the impact of the financial crisis fades away, the improvement of the overall economic environment would be accompanied by a significant decline in global investors' risk aversion, which would lead to the dissipation of exchange-rate inflationary pressures conveyed via import prices. A rebound in foreign capital inflows would foster the resumption of real economy financing, particularly of the productive activities, while also anticipating the revival of the domestic aggregate demand and the likelihood of upcoming inflationary pressures becoming manifest. Thus, although the consequences on economic activity would obviously be favourable, the balance in case of inflation could tilt either towards cost-push or demand-pull factors, however without excluding the case when their influences would mutually offset. On the other hand, deeper negative effects of the global financial crisis might exert opposite effects to those described above.

As far as non-resident investors are concerned, in the current context, the perception of risk associated with investing in an emerging economy such as Romania is closely related to the size and nature of the external imbalance adjustment (current account deficit) as well as the existence and availability of the necessary resources for financing the deficit. A faster-than-anticipated

[71] For details relative to the assessment of the fiscal impulse and its impact on the macroeconomic projection, see Box 1 in the November 2008 Inflation Report.

[72] The structural component of the fiscal policy stance is expected to have a restrictive impact on aggregate demand, which is stronger in 2009, yet more favourable in 2010.

deceleration in economic activity would imply a stronger correction of the external imbalance than that assumed in the baseline scenario. The burden of the additional adjustment could be borne differently by the public sector and the private sector respectively. Thus, since the latter is generally more compliant, it would witness a faster correction but at a higher cost. If the public sector's shortage of resources proves overly large to be countered by the adjustment of the private sector, postponing the necessary corrections will have a negative impact both on risk perception and on the credibility of the macroeconomic policy mix[73], most likely leading to costlier deficit financing.

The baseline scenario of the projection is based on fiscal balance values that are in line with those undertaken by Romania following the multilateral external financial arrangement with the International Monetary Fund, the European Union and other international financial institutions. However, deviations from those values cannot be ruled out, either driven by less favourable macroeconomic conditions[74] or due to slippages in implementing the corrective measures agreed with IFIs. Against this background, the new, higher level of expenditures associated with a wider budget deficit could have a stimulative effect on the economy over the short run. Nevertheless, over the medium run, particularly amid the ongoing financial crisis and the ensuing reduction in available financing resources, the stimulative effect would eventually be offset, on one hand, by the impact of the crowding-out of the private sector[75] and, on the other hand, by the consequences of a wider fiscal imbalance on financial markets' risk perception and hence on exchange rate dynamics. Amid these developments, a fiscal policy potentially looser than that assumed under the baseline scenario coordinates might delay and stifle the magnitude of the economic recovery.

The current forecasting round is fraught with high uncertainties surrounding the persistence of the trend that became manifest over recent periods, namely the elimination of certain structural rigidities specific to the labour market. A significant slowdown in

[73] For instance, a potentially excessive loosening of the fiscal policy would require, amid a heightened external imbalance, a tighter monetary policy as an offsetting measure. However, such a policy mix is unsustainable beyond the short term because it generates contractionary effects on the economic activity, budget revenues and net exports, thus widening the initial disequilibria.

[74] Given the action of the automatic stabilisers, less favourable GDP dynamics than assumed in the baseline scenario would generate higher expenditures and lower budget revenues, which – in the absence of offsetting measures – would entail a wider budget deficit.

[75] The share of credit to the private sector in total credit declined to 84.4 percent in June 2009 from 93.7 percent in November 2008, in favour of the credit extended to the public sector. Provided this trend persisted at a faster pace than the autonomous contraction in the private sector's credit demand, it would reflect the crowding-out phenomenon.

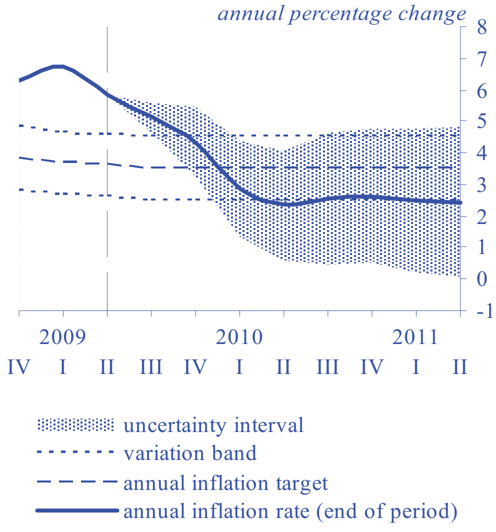
the annual dynamics of labour costs[76] would facilitate the medium-term rebound in aggregate supply economy-wide at a faster pace than that assumed in the baseline scenario. Since cost factors are major determinants of inflation rate developments, this could have a positive impact on economic agents' anticipations and might contribute to the consolidation of disinflation.

Another specific risk in the current projection is the likelihood of a weaker-than-expected crop for 2009[77]. Thus, the negative impact of food prices in this case could send ripple effects to all the other CPI basket components, including CORE2 inflation[78]. Furthermore, any deviations of the future trajectory of administered prices from the figures forecasted in the current round are riddled with major uncertainties as a result of repeated changes, over the past projection rounds, in the coordinates of scenarios regarding these prices. In the absence of any precise information on the actual course of these changes, assessments point to a balanced distribution of risks stemming from this source in relation to the projected trajectory of CPI inflation in the baseline scenario.

Given the uncertainties currently dominating the global economy, another risk – which is common to a certain extent to the previous projection rounds as well – relates to developments in oil prices and, hence, to the projected dynamics of fuel prices. Although the share of this inflation item in the consumer basket is relatively low (around 7 percent), in the event of such a risk materialising, the CPI inflation rate could deviate significantly from the projected trajectory in the baseline scenario, with both-way deviations possible.

Alongside the risks specific to each forecasting round, this section includes an assessment of the overall uncertainty associated with the inflation rate projection in the baseline scenario. In order to illustrate the rising uncertainty over time, the size of the uncertainty interval widens as it encompasses more distant time horizons. The assessment of the uncertainty is based on the CPI inflation forecasting errors[79] computed using the NBR's macroeconomic model. The interval should be interpreted as an average value of possible deviations of inflation from the trajectory set in the baseline scenario, under the impact of certain risk factors that are not explicitly identified.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR calculations

[76] The annual growth rate of the whole-economy average nominal wage decelerated slightly in 2009 Q1, from an average of 23.1 percent in 2008 to 17.6 percent in March 2009, followed by a steep decline to only 8.7 percent in May 2009.

[77] As a result of a possibly less favourable year in terms of weather conditions.

[78] The relevance of this risk is given by the large share of food items in the CORE2 inflation basket, i.e. 45.4 percent.

[79] For further details, see Box 3 in the November 2008 Inflation Report.

2. Policy assessment

During 2009 Q2, disinflation – which resumed at the end of Q1 – carried on at a pace faster than that anticipated in the May 2009 Inflation Report, with annual inflation rate falling to 5.86 percent in June. Consequently, the annual growth rate of consumer prices, while remaining above the upper bound of the variation band around the central target, reverted to levels below those seen after the outbreak of the global financial turmoil and since the emergence of agri-food and oil price shocks (in the summer of 2007). The chief drivers of the 0.85 percentage point drop in second-quarter inflation rate were the resumption of volatile prices disinflation, especially in terms of fuel prices, and the decline in adjusted CORE2 inflation; the latter's evolution reflected the impact of a moderation in the volatility of the exchange rate of the leu and, to some extent, the effects of a sharper economic downturn.

The updated scenario of the forecast on macroeconomic indicators draws on the latest developments and assumptions with higher likelihood of materialising in the medium term. It reveals an improvement in the inflation outlook over the longer forecast horizon and is in line with the previous forecasting round's coordinates in the near run. Similarly to the previous projection, the annual inflation rate is expected to return inside the variation band around the central target and thereafter to slip in the lower half of this band (in 2009 Q4 and 2010 Q1 respectively).

The more pronounced decline in the projected annual inflation rate in the latter part of the projection horizon is mainly due to the increase in the expected magnitude and duration of the negative output gap, which is associated with the prospects of sharper and faster economic downturn in 2009 compared to the previous projection. By contrast, the rebound in economic activity in 2010 is anticipated to see a slightly quicker pace than projected previously, including as a result of a base effect, which however will unfold gradually.

The main prerequisites and signs of the considerable increase in the scale of the economic downturn over the near run are the following: (i) larger-than-expected contraction of the Romanian economy in 2009 Q1, hinting at greater elasticity of domestic demand relative to weakening external demand; (ii) sharper downtrend of economic activity across key sectors in terms of consumer and investment demand (retail trade, imports, construction works) and slower dynamics of corporate and household incomes in April-May; (iii) ongoing deterioration in the economic performance of EU Member States, as reflected by the latest statistical data and updated projections of national and international institutions; (iv) protracted financial deleveraging concurrently with the improving trend in households' net savings with banks; and (v) further upward, albeit slower, trend in unemployment rate in 2009 Q2.

From the perspective of its primary objective[80], the National Bank of Romania is further concerned about the maintenance, at least in the short term, of the disparity between the relatively slow deceleration of core inflation and the foreseeable pick-up and deepening of the economic downturn, implicitly of the aggregate demand shortage, reflecting chiefly the inertial nature of core inflation and its high persistence. Apart from an insufficient anchoring of inflation expectations, such a behaviour of core inflation arises most likely from some structural features, either consolidated or recently outlined, of the Romanian economy.

In this respect, the most significant features are the strong pass-through of the increase in the exchange rate of the leu, due mostly to pronounced euroisation of the Romanian economy and the large share of imported goods in the CPI basket, as well as some structural rigidities in the labour and product markets (consumer goods in particular), as well as budget expenditures. Such rigidities consist in the relatively low competition prevailing on certain product markets and the still fast dynamics of unit labour costs in some manufacturing sub-sectors, despite the sharper downtrend in this indicator in this sector as a whole. These developments appear as yet to be resilient to the abrupt decline in household consumption over the previous quarters, a possible explanation lying with the annual dynamics of food and non-durables purchases remaining positive or slipping marginally into negative territory. At the same time however, manufacturing sub-sectors where domestic demand seems to be relatively robust have been reporting sharp output declines – only partly motivated by the weaker external demand for their products –, hinting at the severe hardships producers are grappling with in their attempt at shifting the focus onto the local market.

Against this background, the major reason for the central bank's concern is the potential constraint on monetary policy implementation arising from such a behaviour in core inflation, i.e. a relatively low elasticity of the CPI to the ongoing retrenchment in aggregate demand. Assuming that such an evolution carries on, continuation of disinflation, along with resuming sustainable economic growth as soon as possible, can only be achieved by rebalancing the macroeconomic policy mix (which implies the relative strengthening and reconfiguration of public spending policy) and by speeding up structural reforms. The potential constraint might however be alleviated in the

[80] Pursuant to Law No. 312/2004 – The NBR Statute, the primary objective of the central bank is "to ensure and maintain price stability".

foreseeable future by a possibly sharp adjustment of the retail price setting and wage setting behaviours, in response to the unprecedented fall in first-quarter GDP and increasingly clear-cut evidence on a sharper economic downturn in the period ahead. Nevertheless, the tightening of fiscal and income policies is essential for reanchoring inflation expectations and, implicitly, ensuring sustainable disinflation.

Seen from this perspective, another major concern for the NBR is the trend towards an excessive economic contraction that appears to have taken shape in the past few months. This trend is also suggested by the faster- and larger-than-expected reduction in the current account deficit – especially in imports – which, correlated with the recent sharp downtrend in investment, poses the risk of depressing the growth potential of the Romanian economy over the coming years. A key reason for the central bank's concern is the prospect of a more severe fall in economic activity at mid-2009 amid the deepening of the global financial and economic crisis. The main causes for such deterioration are the following: (i) further downturn, albeit at a slower pace, in advanced economies and world trade and (ii) the protraction of very tight external and domestic financing conditions, given the still high risk aversion and expanding financial deleveraging on a global scale.

Capping the downturn of the Romanian economy and returning to ever lower negative levels of the annual GDP dynamics are expected to follow with a lag the similar developments in industrialised countries, EU Member States in particular. However, the U-turn in these countries' business cycle is difficult to foresee, despite the clear signs of a slowdown in the pace of economic decline. The start of such a trend will most likely affect the Romanian economy via the export channel. Under the circumstances, the gradual recovery in Romania's exports is expected to be underpinned not only by the "volume effect" arising from external demand, but also by the emerging "price effect", owing to the depreciation of the leu against the major currencies in the past months. The latter has been annihilated so far by the global economic downturn.

In addition, in view of the developments seen in the past quarters, it is quite possible that, apart from prompting an upturn in imports, the rebound in exports will boost other domestic demand and supply components, thereby having a decisive contribution to the economic revival. A relatively similar effect, albeit to a smaller extent, could be exerted by a stabilisation and subsequent recovery of activity in construction. Such a recovery to emerge shortly is however unlikely given the recent significant decline in construction works, the still incomplete downward adjustment of the real-estate market and the persistent lack of confidence of investors, including financial investors, in the short-term outlook of the constructions sector. Overall, this could however be fostered by the implementation of the “First Home” programme and, to a greater extent, by a substantial increase in expenditures on public investment and the expansion of European funds absorbed and taken from international financial institutions. Such measures were undertaken by the authorities under the budget programme and the recently signed agreements.

Great uncertainties persist as regards the external financing directed in the near run towards the local economy, as it takes time for the foreign investors to restore their confidence in the outlook for the world economy and, implicitly, the Romanian economy and for the external banking system to alleviate concerns over its own portfolio quality and capitalisation needs. However, the contractionary effect exerted by this channel on domestic demand is expected to continue to be manifest to a lesser extent via the funds provided to local banks. Such funds will remain substantial, including as a result of the reaffirmed commitment of parent banks in the context of the agreement concluded with the IMF, the EU and other IFIs as part of a multilateral financing arrangement.

Nevertheless, given the pro-cyclical stance of the financial sector, the local one included, the recovery of lending to the private sector is anticipated to be difficult, even assuming a smooth unfolding of the “First Home” programme recently launched by the authorities. Such a revival is conditional upon the mitigation of banks’ mistrust in the short-term outlook for the economy and of the risk perception associated with lending to companies and households, on one hand, and upon the gradual upturn in credit demand, on the other hand. Over the period ahead, the rebound in economic agents’ recourse to bank loans is based on the expected deepening and initiation – in case of household loans – of an easing trend in credit institutions’ lending terms and conditions, in response to the recent consolidation of the policy rate’s downward path and to the cut in banks’ minimum required reserve ratios (in both local and foreign currencies) as of 24 July. However, the drop in lending rates – which will also diminish a potential further deterioration in credit institutions’ portfolio quality – is expected to lag behind in terms of both pace and magnitude the downward adjustments that banks have already started operating in relation to deposit rates. In spite of these corrections, deposit rates continue to be overly high.

However, the potentially stimulative effect exerted by the lower borrowing cost on the credit demand could be alleviated or even offset over the short term by the further contraction in current and expected incomes of both households and companies. By contrast, the cut in lending rates together with the relative stabilisation of the exchange rate of the leu will ease the wealth and balance sheet effect on consumption- and investment-oriented expenses of debtors. Even under these circumstances, there is a low likelihood of a relatively fast halt in the decline of household consumption and corporate investment.

Major hindrances to private consumption might be: (i) the prospects of a persistently subdued propensity for consumption, associated with the trend of improving households' bank saving, amid ongoing fears on future developments in incomes and their capacity of servicing borrowings and (ii) the annual dynamics of households' disposable income falling deeper into negative territory – a trend that seems to have begun in 2009 Q2 –, especially on account of slowing wage dynamics (and even the recourse to pay cuts in the private sector, linked to widespread redundancies) and the contraction in remittances. However, a temporary reinvigoration in the consumption of certain goods and services cannot be ruled out during the summer months, along with a seasonal standstill in the unemployment rate, which is still considerably lower than in other European countries. An increase in self-consumption is equally possible, which is likely to have a favourable impact on agri-food prices.

The pronounced decline in profitability and the worsening outlook for own sales will further depress the current and particularly the investment activity of companies. Against this background, companies are expected to further resort to cuts in working hours and wages, and even layoffs. However, the investment activity could be underpinned to some extent by foreign direct investment flows – assuming their higher-than-expected dynamics seen in the first five months of the year carry on – and by public investment expenditures, scheduled to pick up and augment in 2009 H2.

However, the analysis of the 2009 H1 budget execution pinpoints to a more pronounced risk that the implementation of public investment programmes be constrained by the possibly insufficient tightening of staff-related public expenditure policy and by the persistence of lower budget revenues; moreover, there is the risk that the authorities resort to a widening of the fiscal deficit scheduled for this year. The former risk materialising would imply a sharper economic downturn over the near run, amid the still lower propensity for consumption, a relative weakening of the economic growth potential in the medium run as well as worsening inflation expectations and stronger demand-pull inflationary pressures insofar as the appetite for consumption is restored.

In the event of the latter risk materialising, the private sector's activity would face constraints over the short and medium term, primarily via impeded access to credit. Furthermore, the sentiment of global economic and financial market players vis-à-vis the outlook for the domestic economy might deteriorate – assuming an excessive upward adjustment of the programmed fiscal deficit –, thereby potentially delaying the return to the real convergence of the economy. This might be associated with renewed pressures, at least temporarily, for a weaker domestic currency – potentially heightened by renewed episodes of declines in the global risk appetite –, which entails risks to disinflation and financial stability.

Considering the perspectives for the ongoing alleviation in medium-term inflationary pressures, amid the sharper downturn of the Romanian economy during 2009, the NBR Board has decided in its meeting of 4 August 2009 to lower the monetary policy rate by 50 basis points to 8.5 percent per annum. Moreover, with a view to enhancing central bank's efficacy in managing money market liquidity and, implicitly, the impact of monetary policy instruments on short-term interest rates in this market, the NBR Board decided to cut to one week from one month the maturity of auction-based repo operations. In order to ensure improvement of liquidity in foreign currency and the continuation of a alignment to European Central Bank standards, it decided to lower to 30 percent from 35 percent the minimum reserve ratio on credit institutions' foreign currency-denominated liabilities with residual maturities of up to two years, starting with the 24 August – 23 September 2009 maintenance period. Against this background, the NBR Board reaffirmed that a balanced macroeconomic policy mix and faster implementation of structural reforms are essential for consolidating and continuing disinflation in the medium and long run, as well as for resuming sustainable economic growth as soon as possible.