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N O T E

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

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Foreword

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

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

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

Inflation Report was completed on 2 November 2009 and approved by the NBR Board in its meeting of 3 November 2009.

All issues of this publication are available in hard copy, as well as on the NBR website (http://www.bnr.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

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I. SUMMARY

Developments in inflation and its determinants

In September 2009, the 12-month CPI inflation rate dropped to 4.94 percent, down 0.92 percentage points from 5.86 percent in June. Favourable developments in some supply-side factors and the pressures exerted by the persistent decline in aggregate demand contributed, with a certain lag, to the continuing downtrend in consumer price inflation, amid low volatility of the leu exchange rate.

Inflation rate dynamics were favourably affected by significantly slower growth rates of administered prices and food prices. The deceleration in food prices inflation was considerably faster for the items with volatile prices than for the food items included in the CORE2 basket. An adverse impact came from faster annual dynamics of fuel prices, owing to a base effect which more than offset the slower growth of the global oil price during 2009 Q3.

In July-August 2009, some signals pointing to the alleviation of inflationary pressures from aggregate wage costs became manifest on some segments of the labour market, particularly in the private sector. A clear trend was seen in the industrial sector, where the annual change in unit labour costs has been moving deeper into negative territory since June, even though the aggregate dynamics resulted from diverging intra-sectoral developments.

In 2009 Q3, annual CORE2 inflation remained above headline inflation, due to a significant inflationary impact exerted by a new rise in excise duties on tobacco products in September. Adjusted CORE2 inflation rate, which excludes prices for tobacco products and alcoholic beverages, remained below CPI inflation rate, falling to 4.2 percent, down 0.6 percentage points as against June 2009. This was due mainly to the disinflationary pressures exerted by demand contraction, in the absence of adverse shocks on prices for agri-food items, as well as to slower dynamics of import prices than at the end of the previous quarter.

The consolidation of disinflation with a certain lag, against the backdrop of a widening negative output gap, confirms the persistence of some structural rigidities across the economy, also illustrated by persistently high growth rates of domestic market producer prices for consumer goods. With uncertainties surrounding the outlook for economic rebound and a volatile political climate that complicates significantly the implementation of firm structural reforms, the elimination of these rigidities may be further delayed.

During 2009 Q2, the ongoing fallout from the global crisis aggravated the decline in domestic economic activity. The annual growth rate of real GDP fell deeper into negative territory compared to the previous quarter, to -8.7 percent, thereby causing a wider gap between real and potential GDP. Nonetheless, the annual pace of GDP contraction was slower than anticipated in the previous forecasting round. At the same time, the decline in GDP decelerated markedly in quarter-on-quarter terms versus 2009 Q1.

The primary source of economic downturn in 2009 Q2 was the strong decline in domestic demand. Both gross fixed capital formation and household final consumption declined at a faster annual pace than in the previous quarter, with the former component posting a particularly steep fall. The contraction in domestic demand was due to further shrinking financing resources available to households and corporations, as well as to increased caution with regard to incurring consumption and investment expenditures given the persistent uncertainties surrounding future income streams. Similarly to the previous period, the magnitude of the second-quarter real GDP contraction was limited by the favourable contribution of net exports. The annual pace of decline slowed against 2009 Q1 for both imports and exports, although the latter witnessed a considerably smaller drop. This development in net exports favoured further adjustment of the current account deficit.

Monetary policy since the release of the previous Inflation Report

On 4 August 2009, the National Bank of Romania Board decided to reduce the monetary policy rate by 50 basis points to 8.5 percent per annum. The decision was motivated by the renewed confirmation of firm disinflation prospects in the medium term, along with the severe worsening of short-term economic growth prospects, as illustrated by the analysis of the updated macroeconomic forecast and associated risks. At the same time, the Board decided to lower the maturity of auction-based repo transactions from one month to one week in an attempt at increasing the effectiveness of money-market liquidity management by the central bank. In addition, with a view to improving foreign currency liquidity conditions and ensuring further harmonisation of the minimum reserve requirements mechanism with ECB standards in the field, the decision was taken to cut the minimum reserve requirements ratio on foreign currency-denominated liabilities of credit institutions to 30 percent, from 35 percent, for residual maturities of up to two years.

After the monetary policy decision of August, statistical data confirmed the trends anticipated by the central bank. The annual inflation rate stayed on a downward path in August, whereas the economic downturn gathered pace considerably year on year in 2009 Q2, albeit to a lesser extent than projected. The current account deficit adjustment continued and contributed, together with a decrease in investors' risk aversion towards the region that occurred in the same period, to lower volatility of the leu exchange rate.

During 2009 Q3, developments in leading indicators on economic activity dynamics pointed to a persistent downturn. Signs that the economic contraction may be bottoming out exist, but a clear upward trend in economic growth is still difficult to ascertain at this point; the uncertainties surrounding the assessments are augmented by the recently emerging signs of political instability. At the same time, the still high persistence of inflation delays the firm anchoring of expectations to the trajectory implied by the evolution of most fundamentals.

Acknowledging the significant risks surrounding the macroeconomic projections stemming from these uncertainties, the National Bank of Romania Board reiterated, in its 29 September meeting, the need to maintain a prudent and balanced monetary policy stance so as to allow improving prospects for inflation rate convergence towards medium-term targets, in parallel with a sustainable revival of lending to the domestic economy as a whole. Hence, the Board decided to lower the monetary policy rate to 8.0 percent per annum from 8.5 percent, to keep in place the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions, and to further exert adequate management over the banking system liquidity with a view to consolidating monetary policy transmission channels.

Inflation outlook

At the end of 2009 Q3, the annual inflation rate was 0.2 percentage points below the level projected in the August 2009 Inflation Report. The baseline scenario in the current projection foresees a macroeconomic environment marked by GDP remaining below its potential level over the entire forecast interval. Nevertheless, the *negative* output gap is forecasted to narrow gradually, in line with the expected unwinding of the propagated effects of the global economic crisis, on the one hand, and with a macroeconomic policy mix that complies over the entire projection horizon with the commitments under the multilateral external financing arrangement, on the other hand. The considerable adjustment of the balance-of-payments current account that was manifest already in 2009 mitigates the weight of the external imbalance as a source of pressures on the exchange rate and inflation throughout the projection horizon. Provided that the recent worsening of investor sentiment regarding the Romanian economy dissipates relatively quickly and the macroeconomic policy mix is being rebalanced, the forecast envisages the gradual consolidation of disinflation concurrently with the rebound in economic growth towards the end of the projection horizon.

The baseline scenario of the current projection places the annual CPI inflation for end-2009 at 4.5 percent, 0.2 percentage points higher than the figure forecasted in the August 2009 Inflation Report (4.3 percent). In 2010, the inflation rate is forecasted to fall below the central target of 3.5 percent to as low as 2.6 percent, the same level as in the previous projection.

The upward revision of the end-2009 CPI inflation forecast is largely due to reassessing the quarterly distribution of the effects from the upcoming stage (rescheduled for 1 January 2010) of raising the excise duties on tobacco products; these items hold a significant share in the consumer basket, i.e. 4.6 percent. The implementation of the hike in excise duties earlier than assumed in the previous projection led to a stronger inflationary impact in 2009 Q4 due to its partial *ex ante* incorporation into consumer prices.

Although the negative output gap is projected to narrow gradually starting 2010, it will remain the major factor exerting disinflationary pressures during the entire projection horizon. The forecasted path of the annual CPI inflation rate runs slightly above that presented in the August 2009 Inflation Report in the first part of the projection horizon, but will fall beneath it starting 2011 Q1. The direction of these revisions was prompted by the reassessment of the cumulated effects of CORE2 inflation and administered prices, which are expected to be unfavourable in the first part of the projection horizon, whereas the scenarios on the developments in volatile prices (for vegetables, fruit and eggs as well as for fuels) see them exerting a favourable contribution over most of the period under review.

As for core inflation, apart from the above-mentioned impact of the hike in excise duties on tobacco products, the slower-than-previously-forecasted disinflation over the first part of the period under review is attributed to the reassessment of inflation expectations amid the uncertainties surrounding the persistence of recent adverse supply-side shocks. The lagged impact on inflation expectations exerted by the sharp depreciation of the domestic currency in late 2008 and early 2009 stands out among these shocks. For the latter part of the projection horizon, CORE2 inflation is expected to decline progressively under the prevailing influence of aggregate demand-side factors. This will allow the downward adjustment of inflation expectations towards levels compatible with the established inflation targets, thereby fostering disinflation.

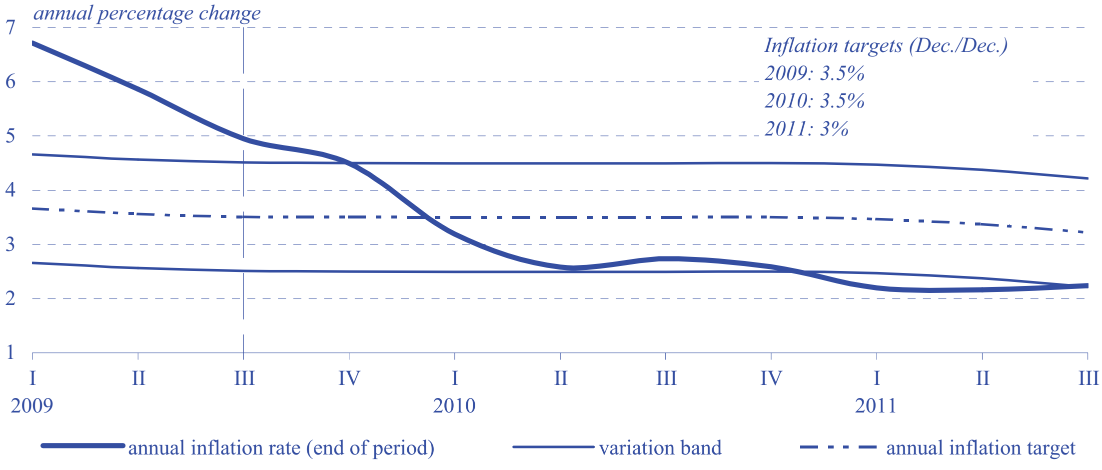
The current projection envisages the inflation rate falling to the upper bound of the variation band around a central target in 2009 Q4 and subsequently positioning itself gradually in the lower part of the band towards the latter part of the projection horizon. The monetary policy stance will remain prudent and balanced, and in the near run it will be aimed at removing the gap between interbank rates and the monetary policy rate. Thereafter, it will seek to adjust broad monetary conditions in order to keep the inflation rate inside the established target band in a sustainable manner, while also supporting the revival of the lending process in the Romanian economy as a whole. The fulfilment of these objectives is largely conditional upon the absence of any significant deviations from the forecast assumptions regarding external developments and the coordinates of the macroeconomic policy mix components other than monetary policy.

The analysis of risks associated with the current forecast indicates that upside risks to inflation appear to be somewhat higher than downside risks, particularly over the short term. Since the baseline scenario was built on a consistent set of macroeconomic policies – whose key coordinates were defined in the context of the multilateral external financing arrangement with the International Monetary Fund, the European Union and other international financial institutions – any significant slippages from these coordinates stand out as a major risk.

The assessment of risks differs from the previous Inflation Report mainly on account of the unstable political field over the past weeks, which may entail fiscal and income policy slippages while possibly delaying the adoption of the required structural reforms. In fact, recent and anticipated budgetary developments confirm that increasing difficulties are being faced in attaining the scheduled parameters in terms of deficit magnitude, expenditure structure and access to financing sources. In the absence of firm corrective measures of the previously-accumulated slippages, the anticipated negative consequences of suboptimal macroeconomic policies could fuel expectations of a weaker leu, with self-fulfilling effects on both the exchange rate and inflation. Although it appears slightly tilted especially over the first part of the projection horizon, the balance of risks to inflation and economic activity in the baseline scenario will regain relative equilibrium over the medium term, following the anticipated return of the macroeconomic policy mix under a more efficient coordination.

Similarly to the previous forecasting rounds, a major risk stems from the uncertainty surrounding developments in global economic activity and financial markets over the projection horizon. Deviations from the assumptions incorporated in the baseline scenario are possible via the foreign trade and financial flow channels, being likely to entail slippages of both inflation rate and economic growth from the forecasted trajectories. A priori, the risks of both-way deviations are deemed as balanced. Risks related to developments in prices of oil and other commodities, administered prices and volatile food prices also 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

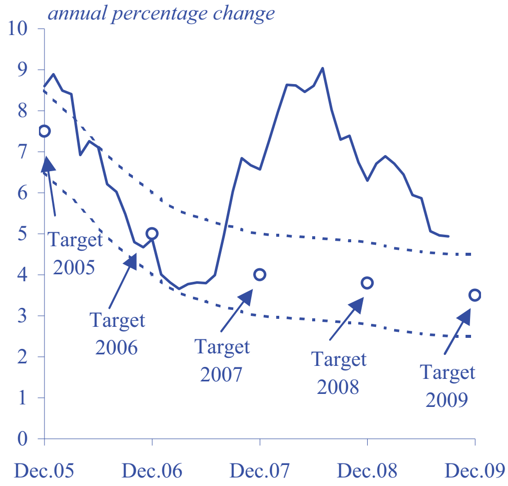
Monetary policy decision

In the short-run, there are prospects of inflationary pressures, due to an anticipated upward adjustment of excise duties starting with 1 January 2010, as well as of an unfavourable impact on expectations coming from heightened risks related to fiscal and income policies, given the volatile political climate. Therefore, the NBR Board has decided, in its meeting on 3 November 2009, to leave the monetary policy rate unchanged at 8.0 percent per annum. Moreover, the Board decided to ensure a firm management of liquidity in the banking sector in order to consolidate the transmission of monetary policy signals and warrant a return of the interbank rates in the vicinity of the monetary policy rate, as well as to maintain the existing level of minimum reserve requirements ratios on both leu- and foreign currency-denominated liabilities of credit institutions. Against this background, the Board reiterated the need that the central bank's ongoing sustained efforts aimed at effectively anchoring inflation expectations and implicitly countering the persistence of core inflation should be backed by a rapid fulfilment by the other components in the macroeconomic policy mix and structural reforms of the commitments under the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions.

In the same meeting, the NBR Board set the annual inflation target for 2011 at 3.0 percent, with a ±1 percentage point variation band, down from 3.5 percent in 2010. The target will be discussed with the government.

II. INFLATION DEVELOPMENTS

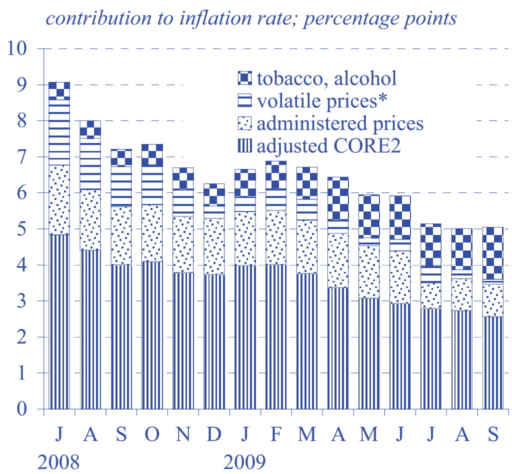
Inflation Developments



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

Source: NIS, NBR calculations

Annual Inflation Rate



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

Source: NIS, NBR calculations

In 2009 Q3, the 12-month inflation rate posted a faster downward trend, falling by 0.92 percentage points versus the end of the second quarter to 4.94 percent. Although among the drivers of this performance were further those identified in the previous Inflation Report – the current quasi-stable evolution of the exchange rate and the flagging demand – the generally comfortable agricultural output and the lower impact of administered prices had the largest influence. An opposite effect was exerted this time too by the hike in the excise duty on tobacco products, the annual dynamics of prices for such products exceeding 30 percent at quarter-end. The deceleration in the adjusted CORE2 index was less significant (-0.6 percentage points) than that reported in the previous quarter, as the disinflationary impact of a declining consumer demand and an adequate supply of agri-food items was mitigated by some statistical effects.

After posting a relatively steady annual growth rate for three quarters, in 2009 Q3, administered prices recorded the fastest deceleration among CPI components, i.e. -3 percentage points. Behind that stood the “energy” group, following the cut in natural gas prices by approximately 5.1 percent in July and the dissipation of the unfavourable base effects caused by the adjustments in electricity and natural gas prices in July 2008. The over-ground urban transport (-1.2 percentage points) acted in the same direction, albeit to a lower extent. By contrast, an opposite impact was exerted by local public services prices, whose annual pace of increase accelerated by 1.7 percentage points, and fixed telephony services prices, the annual dynamics of which advanced by 10.7 percentage points, as a result of statistical effects on both euro-denominated prices and the RON/EUR exchange rate[1].

Volatile prices made also a significant contribution to disinflation, albeit of a lower magnitude than in the previous quarter; their annual change narrowed by another 1.2 percentage points to only 1 percent. Unlike the precedent quarter, when fuels were the main driver of this group’s downward trend, during the quarter under review, food items with volatile prices made the largest contribution, their dynamics slackening by 3 percentage points, mainly owing to the positive impact exerted by the vegetable output. On the contrary, the annual growth rate of fuel prices accelerated by 1.2 percentage

[1] In the former case, the statistical effect is associated with the reduction in euro-denominated prices applied by Romtelecom on certain services in August 2008, whereas in the latter case, it is linked to the appreciation of the domestic currency during 2008 Q3, which – given the current stable evolution – led to a faster annual depreciation.

points versus the end of the second quarter to 2.4 percent in September, with the trend reversal being accounted for by the presence of a favourable statistical effect during the comparison period[2] and not by current developments (0.56 percent average monthly change, down from 0.95 percent in the previous quarter, mainly as a result of a slower increase in the international oil price).

"Tobacco products" stood out again among the CPI components, by putting a significant inflationary pressure – their annual dynamics reached 31.5 percent in September, i.e. 5.7 percentage points above that recorded at the end of the previous quarter. This performance was further accounted for by the change in excise duties, following the implementation of the second stage of raising excise duties announced for this year (by another EUR 7/1,000 cigarettes in September). This measure exerted a considerable impact on inflation, the cumulative contribution during the period under review coming in at 0.44 percentage points.

In view of the persistence of signal distortions generated by this tax-related measure, the analysis of core inflation must further take into account the relevant adjusted CORE2 measure, the annual dynamics of which continued to decelerate versus the end of the previous quarter (-0.6 percentage points to 4.2 percent). "Food items" (except for those with volatile prices) continued to be the main source of disinflation in 2009 Q3 as well, its annual pace of increase being 1.2 percentage points slower in September than in June. Nevertheless, the pace of downward adjustment was slower than that in 2009 Q2 for most staples (except for milk and products thereof) after the dissipation of the favourable statistical effect which had a bearing on inflation developments starting in mid-2008; the phenomenon was visible particularly in the case of the edible oil price, whose annual growth slowed down by only 3.4 percentage points in the reviewed period compared to a quarterly average of more than 25 percentage points in July 2008 - June 2009 (an additional rationale for this performance might be provided by the price nearing the level reported prior to the tensions stemming from the poor agricultural output in 2007).

A slight disinflation was also reported on the segment of non-food items included in adjusted CORE2, given the gradual decrease in consumer demand and the drop in imported inflation[3] – the joint consequence of the deceleration in the dynamics of external prices

Administered Prices versus Market Prices

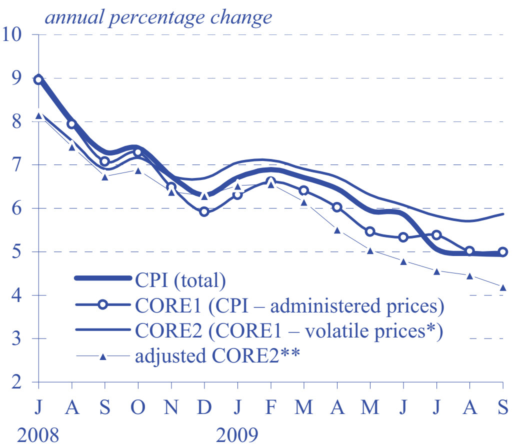
annual percentage change; end of period

	2008		2009		
	III	IV	I	II	III
Inflation rate	**7.30**	**6.30**	**6.71**	**5.86**	**4.94**
Administered prices*	**7.7**	**7.4**	**7.8**	**7.7**	**4.7**
1. Non-food items*:	**8.3**	**7.6**	**7.6**	**7.0**	**0.9**
electricity	4.5	4.5	4.8	4.8	0.2
heating	6.0	10.1	12.0	11.8	11.8
natural gas	26.5	22.0	12.5	8.6	-8.4
medicines	-1.5	-2.5	4.6	5.6	5.7
2. Services*,	**5.8**	**6.7**	**7.9**	**9.1**	**13.5**
of which:					
water, sewerage, waste disposal	12.6	12.6	12.8	14.7	16.3
fixed telephony	-0.3	2.1	5.7	5.9	16.6
passenger railway transport	0.0	0.0	0.0	0.0	0.0
(passenger) city transport	9.1	8.1	8.0	8.8	7.6
Market prices (CORE1)	**7.1**	**5.9**	**6.4**	**5.3**	**5.0**
CORE2**	**6.9**	**6.7**	**6.9**	**6.1**	**5.9**
CORE2 less tobacco, alcohol	6.7	6.3	6.2	4.8	4.2
tobacco, alcohol	8.7	11.0	14.9	20.1	24.2

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

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation



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

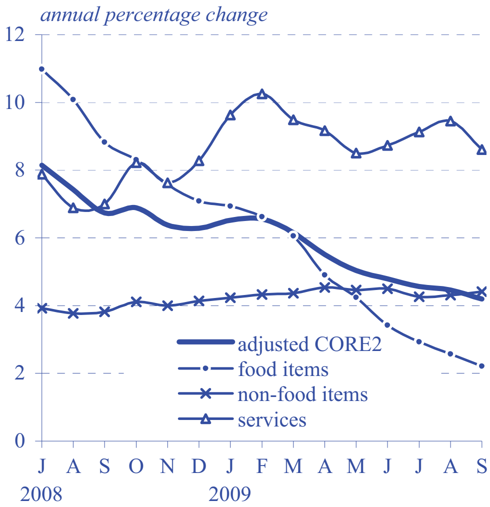
**) excluding tobacco and alcohol

Source: NIS, NBR calculations

2 In 2008 Q2, oil prices were still on a strong upward trend.

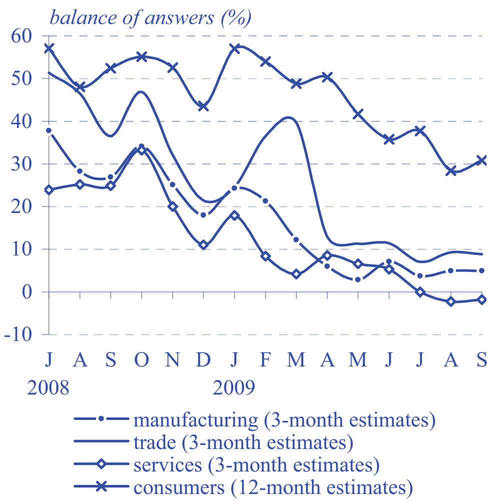
3 In EU15, export prices returned to levels comparable to those in the same year-ago period, their annual growth rate running at less than 1 percent starting June 2009.

Adjusted CORE2 Components



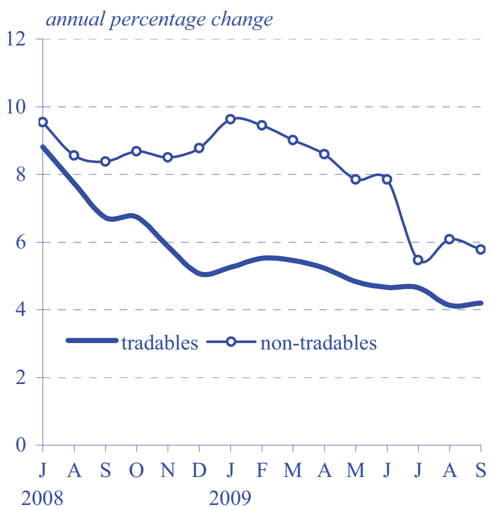
Source: NIS, NBR calculations

Inflation Expectations of Economic Agents and Consumers



Source: EC - DG ECFIN

Tradables and Non-tradables Prices



Source: Eurostat, NBR calculations

and the absence of shocks from the RON/EUR exchange rate. Nevertheless, the evolution of domestic market producer prices put further a brake on CPI disinflation, given that the annual paces of increase remained fast (roughly 10 percent for durables – accelerating slightly against the previous quarter and about 8 percent for non-durables). The rigid behaviour of producers of such goods may be accounted for by the persistent pressures from labour costs on the one hand, and by the difficulties in financing operating activity amid the delays faced by industrial companies in receivables recovery, on the other.

Although under the impact of shrinking demand most services at market-determined prices saw a slower increase in the annual dynamics of their prices, the growth rate of the whole group reported in September was similar to that seen in June 2009. This performance may be accounted for by the faster pace of increase visible in the prices of telephony services (holding almost 29 percent of the group's total) in line with the swifter depreciation in annual terms of the domestic currency versus the euro, mainly owing to the base effect induced by the appreciation recorded in 2008 Q3.

Unlike the previous quarter, when inflation expectations posted an apparent downward trend on all segments reviewed by the NIS-DG ECFIN survey (i.e. consumers and managers in industry, trade and services), in July-September 2009, the trend levelled off, underpinning disinflation to a less obvious extent.

As concerns tradables, the significant disinflation visible in food items was accompanied by relatively steady annual paces of increase of non-food item prices and also by faster growth rates of prices of tobacco products and fuels. Thus, the aggregate annual dynamics decelerated by only 0.5 percentage points during 2009 Q3 to 4.2 percent. The same as in the previous quarter, the slowdown in the annual pace of increase of non-tradables prices was more pronounced (2.1 percentage points to 5.8 percent), as a result of the persistent dampening impact of demand and the slower dynamics of administered prices.

In spite of the faster disinflation in Romania, the gap between the 12-month average HICP inflation in Romania and that in EU-27 widened to reach 4.8 percentage points in September from 4.6 percent in June 2009, as economic agents in Western-European countries pursued more flexible price policies given the present context.

Thus, two of the member states (Ireland and Portugal) witnessed deflation in annual terms, the convergence criterion on inflation[4] being calculated by their being left outside the comparison group[5]. Compared to this reference level, Romania's position remained unchanged against the end of 2009 Q2, i.e. a 4.4 percentage point gap.

In September 2009, the actual annual inflation rate stood 0.2 percentage points below the projection presented in the August Inflation Report. Both volatile prices and adjusted CORE2 inflation posted slower-than-forecasted annual growth rates, owing to (i) the overestimate of increases/the underestimate of decreases in food prices, comprising both volatile prices (the exogenous component) and prices included in CORE2 (the endogenous component) and also to (ii) the exchange rate falling below the forecasted level.

[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 inflation rate).

[5] Although the Maastricht Treaty does not make any explicit mention on such cases, the calculation manner that was adopted is based on the precedent seen in the ECB's Convergence Report 2004, when the value of the criterion was established by eliminating Lithuania, which had recorded deflation during the assessment period.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2009 Q2, real GDP decreased at a faster pace, its annual dynamics reaching -8.7 percent[6]*, i.e. 2.5 percentage points below the already significantly negative level seen in January-March 2009. The magnitude of the decline was lower than that implied by the benchmark projection made in June 2009 (-10 percent). On the demand side, the worsening of the economic climate was put down on the contraction in domestic absorption, whereas on the supply side all economic sectors reported weaker performances.*

In quarter-on-quarter terms, GDP reported also a negative growth rate, albeit significantly slower than in 2009 Q1 (to -1.1 percent)[7]*. Nevertheless, household actual final consumption and gross fixed capital formation, the main components of domestic demand, saw larger declines in terms of volume than in the previous quarter (by 2.3 percentage points and 6.4 percentage points respectively to -3.2 percent and -13.5 percent).*

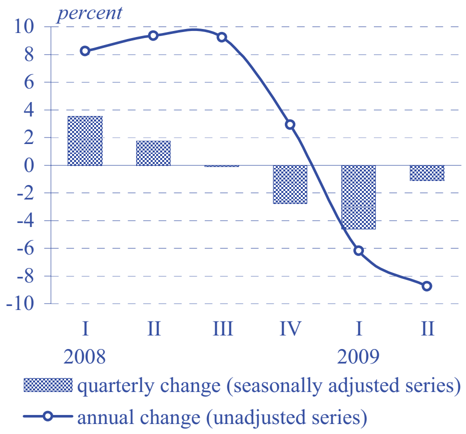
A significant contribution to the slower decline in GDP in quarter-on-quarter comparison made the marked alleviation of the inventory absorption process – a trend confirmed by the DG ECFIN survey, highlighting retailers holding larger inventories, as well as by the statements of some producers, indicating a build-up of finished product inventories, owing to the difficulties encountered in recouping the equivalent value of the sold goods.

External demand exerted also a favourable influence on GDP quarterly change, with trend reversals over the previous quarter being posted by both exports of goods and services (+5 percent – as a result of the upturn in intra- and extra-EU sales) and imports (+3.1 percent due to the improved industrial activity).

1.1. Demand

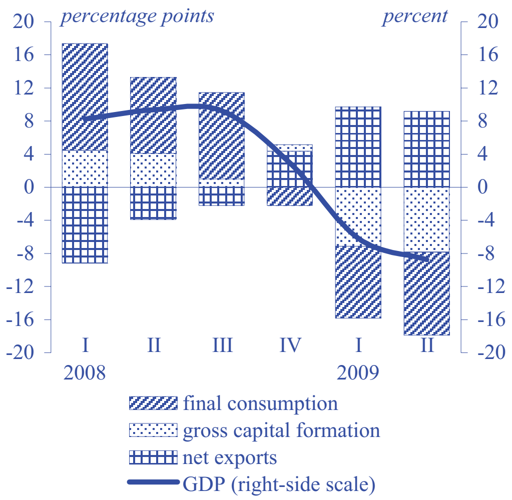
The sharper downward trend in the volume of domestic demand in 2009 Q2 (-15.6 percent) was due to the severe adjustments in both final consumption and capital investment. However, this development was once again partly offset by net external demand whose positive contribution to GDP dynamics came in at 9.2 percentage points.

Real Gross Domestic Product



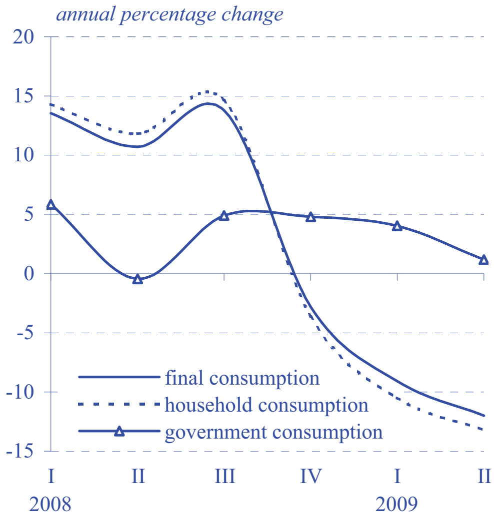
Source: NIS

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

Actual Final Consumption



Source: NIS

[6] Unless otherwise indicated, the growth rates in this section are annual percentage changes, calculated based on the unadjusted series of national accounts.

[7] Quarterly changes are calculated based on the seasonally adjusted data series.

1.1.1. Consumer demand

Final consumption remained on a downward path (-12 percent), with the significant contraction in the private component being only marginally offset by government consumption.

Household consumer demand

Household final consumption dropped by 13.2 percent year on year, primarily as a result of the more pronounced downtrend in the volume of retail purchases of goods and services (-18.5 percent) against the background of the contraction in own and borrowed financial resources and further worsening of household expectations on the economic and financial developments.

The analysis by category of products shows that apart from durables and fuels which were further the hardest hit by the demand adjustment (with sales going down by almost 33 percent and 23.5 percent respectively), the dynamics of purchases of non-durables, except for fuels, fell into negative territory from +3 percent January through March 2009 to about -5 percent, as a result of lower purchases of foodstuffs and pharmaceuticals.

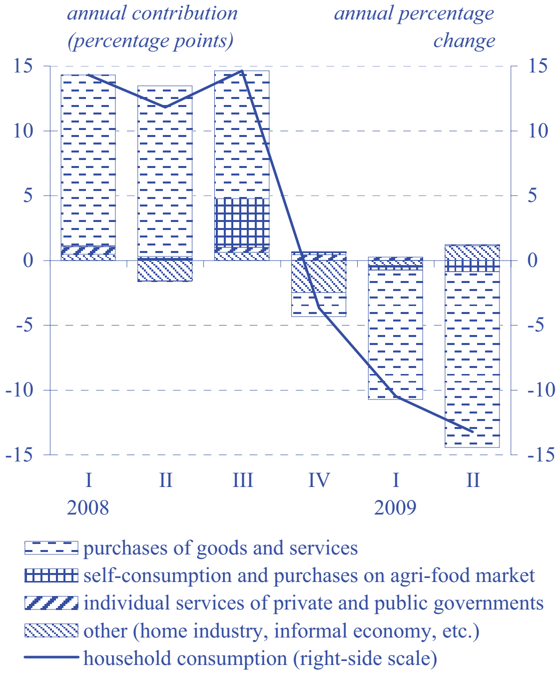
Quarter-on-quarter developments in the volume of turnover[8] of products holding a large share in the CPI basket illustrated that sales of foodstuffs remained flat, whereas those of semi-durables posted a decrease, which hints at a lower pressure from demand on consumer prices in 2009 Q2.

An additional contribution to the drop in private final consumption, albeit of a lower magnitude, made "self-consumption and purchases on the agri-food market", the volume of which contracted by 11.2 percent in annual terms in line with the poorer performances reported by agriculture in year-on-year comparison.

In 2009 Q2, the financing channels of household consumption were less-readily available. On the one hand, as concerns own resources, the growth rate of household disposable income[9] fell into negative territory for the first time in 8 years to reach -6.5 percent in annual terms.

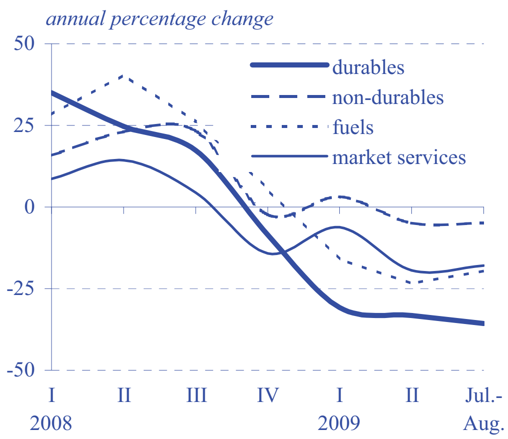
On the other hand, as regards borrowed sources, consumer credit remained on a strongly downward trend, with the volume of new loans granted during the period under review accounting for only one fourth of that seen in 2008 Q2. The performance was the result of the cautiousness of both commercial banks and households

Household Final Consumption by Expenditure



Source: NIS, NBR calculations

Purchases of Goods and Services*



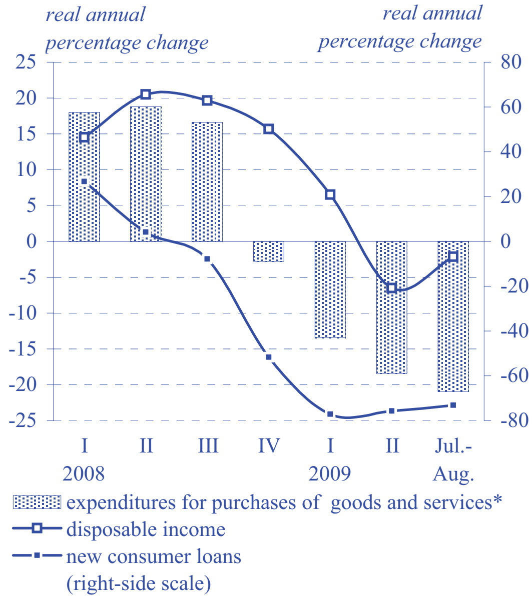
* based on data on the turnover volume for retail trade and services to households

Source: NIS, NBR calculations

[8] Working day and seasonally adjusted data.

[9] Household disposable income is approximated by the sum of incomes from wages, social transfers (state social security, unemployment benefit and health insurance) and remittances from abroad, and current private transfers by nonresidents.

Household Consumption and Main Financing Sources



*) for Jul.-Aug. 09 - the turnover volume for retail trade and market services

Source: NIS, MPF, NBR calculations

regarding consumer loans, in view of further high costs related to such loans and consumers' persistent pessimism about the improvement in their standing and in the economic activity by and large.

The uncertainties surrounding the financial outlook and the attractive bank deposit rates continued to foster households' appetite for longer-term saving. Thus, the volume of new time business during the period under review increased to reach a level more than double that seen in the same year-ago period.

By market of origin, in 2009 Q2, both purchases of consumer goods on the domestic market and imports of such products continued to decline, as suggested by data on developments in the sales of domestic industrial companies on the domestic market and the physical volume of imports respectively[10]. The annual growth rate of non-durables continued to decrease at a faster pace than in 2009 Q1 to as low as -18.2 percent for sales on the domestic market and approximately -12 percent for imports. As for domestically-produced durables (except for motor vehicles), the drop in their volume was even more pronounced (-40.7 percent), whereas the imports of such products reported decreases ranging between 27-32 percent for most categories, except for electrical machinery and apparatus, the volume of which reverted to a slightly upward trend (+6 percent). Albeit slower, the downward path of the demand for motor vehicles was further particularly steep for both domestically-produced and imported motor vehicles (-25.4 percent and -65.1 percent respectively).

Government consumption

Final government consumption posted a slower annual dynamics, i.e. 1.2 percent, in line with the developments in the number of employees in the general government sector.

Budgetary developments

In Q2 budgetary execution ended on a deficit below that recorded in the first three months of the year (RON 6,457 million, accounting for 1.3 percent of GDP[11] compared to RON 7,926 million, or 1.6 percent of GDP), against the background of a slower annual growth rate of effective final public government consumption. In turn, the primary deficit narrowed from 1.3 percent of GDP to 0.9 percent of GDP in the period under review. Thus, at mid-2009, the negative balance of the consolidated general budget stood at

[10] 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.

[11] Taking into account the newly estimated GDP (RON 497,325 million), on which the budget revision performed on 29 August 2009 was based.

RON 14,383 million (2.9 percent of GDP), in line with the deficit ceiling of RON 14,508 million agreed upon with the IMF for this period.

Total revenues further posted a negative annual growth pace[12] (-10.1 percent), similar to that recorded in the last two quarters. Again, the decrease in revenues was due mainly to the sharp negative dynamics in VAT collection (-19.4 percent, slightly recovering from Q1). To this decline added the contraction in non-tax revenues (the annual change of which dropped to -26.5 percent, 10.9 percentage points below the previous quarter. The diminished collection of profit tax (-10 percent, though relatively less marked than the steep drop seen in Q1), social insurance contributions (-7 percent from -5.6 percent in Q1) and wage and income taxes (-7.5 percent against an 11.4 percent increase in the first three months of 2009) also contributed to the decrease in revenues. These developments were offset only to a small extent by the rise in revenues from excise duties (10.9 percent from -3.3 percent in Q1) following the increases implemented since April.

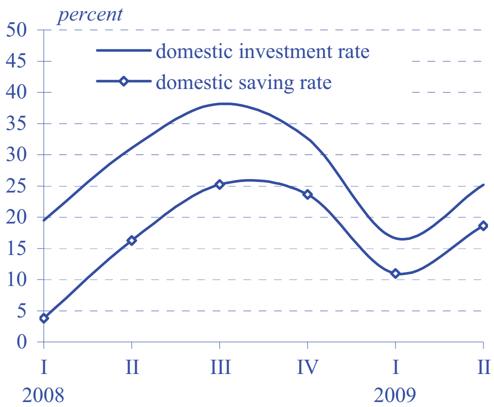
Unlike the previous quarter, the growth rate of total budget expenditures fell sharply (-8.4 percent from 5.7 percent), mainly as a result of primary expenditure cuts. These developments were attributed to the contraction in other transfers (-67.1 percent against -0.1 percent in Q1) and in the dynamics of capital expenditures (-28 percent, 19 percentage points less than in Q1), along with the slowdown in the growth pace of goods and services spending (-16.8 percent from 1.6 percent in Q1). By contrast, the year-on-year rate of increase of staff costs remained in positive territory (2.7 percent, nonetheless decelerating against the previous quarter), and that of social insurance expenditures even accelerated to 16.3 percent from 13.6 percent in Q1, due also to the 3 percent rise in the pension point, along with the introduction of the minimum guaranteed social pension starting April.

Against the backdrop of slacking economic activity and the downward revision of the projected nominal GDP, the second budget revision[13] was performed in August, after which, the total revenues to the consolidated general budget were lowered by about 3.5 percent of GDP. The main adjustments were those made in social insurance contributions and non-tax and VAT revenues. In turn, total expenditures were reduced by about 1.1 percent of GDP, causing a rise to 7.34 percent of GDP of the deficit target for the current year.

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

[13] Ordinances No. 19 and 20 of 29 August on the revision of the government budget and of the state social security budget for 2009.

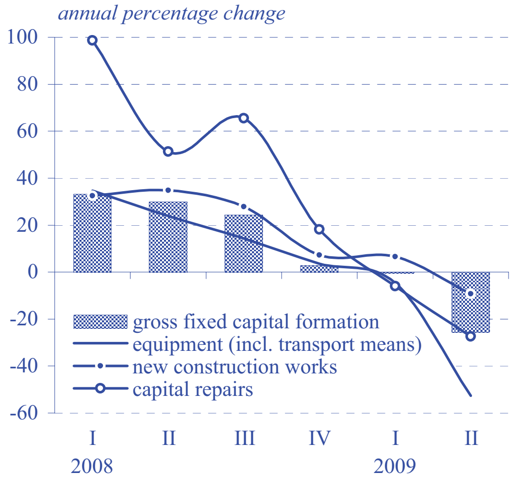
Investment Rate and Saving Rate



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

Source: NIS, NBR calculations

Investment



Source: NIS

1.1.2. Capital investment

In 2009 Q2, gross capital formation accounted for only three quarters of the level recorded in the same year-ago period, owing to the sharper downward trend in investment (-25.6 percent), whereas changes in inventories had only a marginal influence. The performance was mostly accounted for by the strong adjustment in retooling-related spending, as indicated by the 52.7 percent plunge in the investment in equipment (including transport means purchased by companies and institutions). A similar influence, albeit of a lower magnitude, was induced also by the marked contraction in construction, given that the volume of capital repair works dropped by more than 27 percent and that of new construction works saw a trend reversal to reach -9.2 percent in 2009 Q2.

In terms of the financing manners of investment projects, mention should be made that lower volumes were reported by all domestic channels as follows:

(i) own sources, in view of the negative dynamics of household disposable income and the losses incurred lately by the corporate sector;

(ii) public funds, with capital expenditures incurred in 2009 Q2 diminishing by almost 28 percent in real terms;

(iii) borrowed funds, given that the estimates on the volume of new loans granted in 2009 Q2 for purchases of equipment and real-estate projects hint at declines by 70-80 percent versus 2008 Q2[14], whereas the leasing market (held in a proportion of almost 90 percent by the corporate sector) saw significant adjustments in the first half of 2009, particularly on "motor vehicle" and "equipment" segments (when expressed in euro, the value of the contracts concluded plunged by 76 percent and 82 percent respectively).

Capital inflows from abroad[15] followed also downward trends; thus net inflows of foreign direct investment went down by almost 20 percent on account of all components (equity stakes, reinvested earnings and intra-group credits), while medium- and long-term foreign borrowings by the non-bank non-government sector in the past four quarters decreased at a 4 times faster pace to reach -46 percent.

The contraction in capital investment in 2009 Q2 caused a more pronounced decline in the related domestic market (sales of domestic industrial companies on the domestic market stood

[14] Calculations based on the data provided by the Central Credit Register; the flow related to a quarter is estimated as the difference between the stock reported at the end of the period concerned and that recorded at its beginning.

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

28.8 percent below the level seen in the previous year) and also in imports (facing a decline by more than 60 percent in the physical volume[10]).

1.1.3. Net external demand

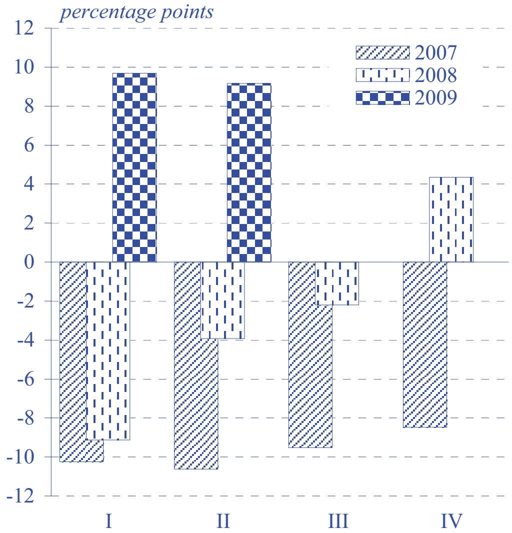
The same as in the previous quarter, provisional data on national accounts point to significant decreases in foreign transactions in goods and services. Thus, exports contracted by 12.2 percent in terms of volume amid the trading partners' demand remaining on a downward trend (albeit slower). Behind the reduction in imports stood the drop in domestic absorption, the lower consumption of intermediate goods used for manufacturing products destined to foreign markets, and also the weaker domestic currency than in the same year-ago period. Therefore, the contraction in the import volume (-26.9 percent) was more than 2 times larger than that in the export volume, which provided in fact the only channel for mitigating the decline in real GDP.

Volume decreases comparable in terms of size to those previously mentioned were also reported after deflating the two trade balance components by the international trade-related unit value index.

The trend followed by exports was mainly the result of developments in base metals, chemicals, fuels and textiles, reporting decreases in a range from 17 percent to 40 percent versus 2008 Q2. By contrast, the further increase in exports of vegetal and animal products, food items and electrical machinery and apparatus exerted an opposite influence. An additional positive contribution made the upturn in external demand for "transport means", particularly following the national car fleet renewal programmes unfolded in countries such as France and Germany. As a result, the share of products with high added value increased to 43 percent in the total value of exports.

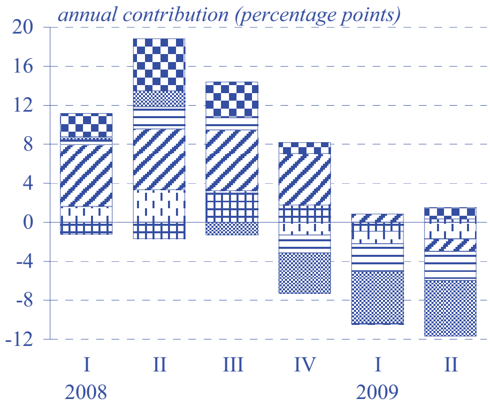
The volume of imports dropped for most categories of products; "transport means" was the hardest hit group, the decrease in its volume accounting for one third of the contraction in the volume of total imports. In 2009 Q2, "fuels", "base metals" and "apparatus and mechanical devices" reported contractions in a range between 30 percent and 41 percent in annual terms, making further significant contributions to the decline in the import volume.

Net External Demand Contribution to GDP Growth

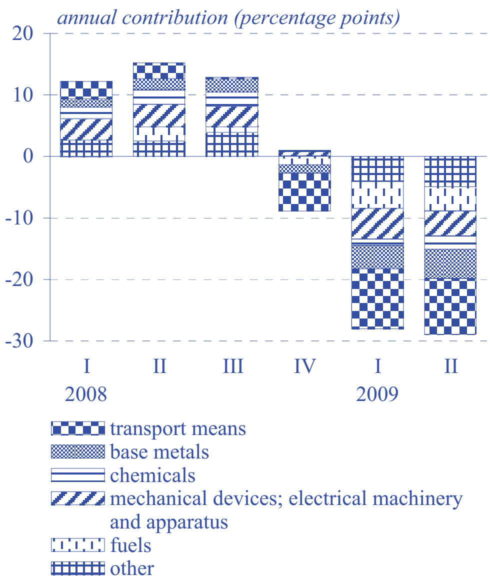


Source: NIS, NBR calculations

Export Physical Volume

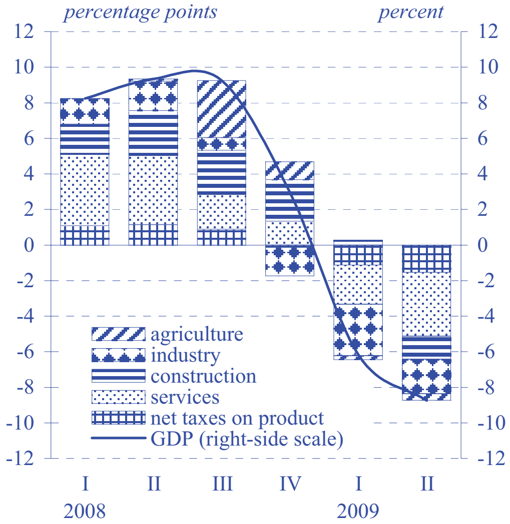


Import Physical Volume



Source: NIS, NBR calculations

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

1.2. Supply

Weaker performance was reported in all economic sectors. Almost half of the GDP decline was due to the services sector where the setback, which was more pronounced compared to Q1 (down to -7.4 percent, in annual terms) was attributable to the faster contraction of gross value added in trade, hotels and restaurants, transports and telecommunications as well as in financial activities, real estate transactions and rentals.

Construction performance followed the most abrupt downward path, with gross value added dynamics falling to -14.2 percent – the first negative annual change since 1999 Q4. The development was attributable, on the one hand, to the trend reversal in the dynamics of construction works (-15.2 percent for non-residential buildings and -2.5 percent for residential buildings) and, on the other hand, the threefold acceleration in the contraction of expenses for infrastructure (-21.4 percent).

A flattening out of the downward path was seen in industry (by 3.8 percentage points, to -7.3 percent), the most significant developments consisting in the rebound of the production of road transport means and of electrical machinery and apparatus as well as in the halt of the decline in food industry and the slower decrease in oil processing.

In agriculture, gross value added contracted further (-9.1 percent), with both vegetal and stock-breeding sub-sectors reporting dismal performance compared to the previous year.

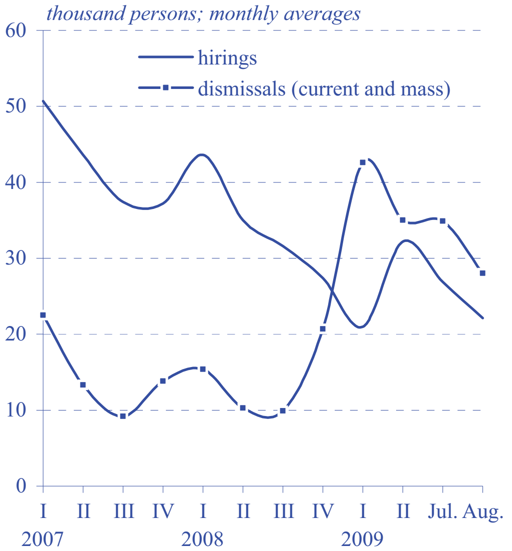
2. Labour market

In 2009 Q3, labour market was further under the impact of economic downturn and companies' persistent uncertainties regarding business prospects. Thus, after a short-lived upturn in spring, labour force absorption resumed its downward trend, while recent lay-offs fuelled (with a certain time lag) excess labour supply. In industry, on the backdrop of restructuring measures implemented by companies, visible progress was made in cutting ULC and, implicitly, in restoring external competitiveness. Moreover, a favourable development in terms of economic growth resuming a sustainable path and of strengthening disinflation is the marked deceleration of the annual dynamics of average wage of public sector employees, following the implementation of certain measures to tighten wage policy.

2.1. Labour force

In July-August 2009, the still weak demand for goods and services suppressed job creation and, implicitly, staff absorption, the upturn of which, in Q2, proved to be only temporary[16]. The drop in the number of vacancies is illustrated by both the statements of the representatives of private recruitment agencies and the statistics provided by the NEA. However, this development could be somewhat overestimated, given that an increasing number of companies appear to have performed recruitment activities by using there own database, without making public their intention to take on staff, which enabled them to cut related costs. Moreover, there is anecdotal evidence regarding the increase in illegal hirings, amid high uncertainties surrounding the volume of orders and of the increasing number of temporary contracts.

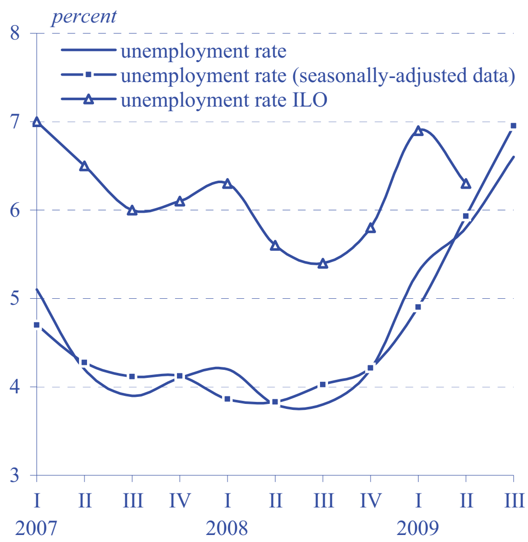
Labour Force Demand Measures



Source: NEA, NBR calculations

Over a 12-month period (September 2008-August 2009), the number of employees economy-wide (based on employers' reports) shrank by 348 thousand. The large difference from the rise by only 256 thousand in the number of jobless is an argument for the delay with which registered unemployment rate mirrors the changes in labour market[17]. Furthermore, in July-August 2009, although statistics on the number of mass dismissals (-9 percent on average from Q2) suggest a relative slowdown in labour shedding, registered unemployment rate moved up 0.3 percentage points on a monthly basis to 6.6 percent (6.9 percent in the case of seasonally-adjusted series). A reason behind these developments was the rise by almost 50 percent in annual terms of applications addressed to the NEA by new graduates, a category that is heavily affected in the current juncture by both the bleaker prospects for obtaining a job and the sharp cut in wages.

Unemployment Rate



Source: NIS, NBR calculations

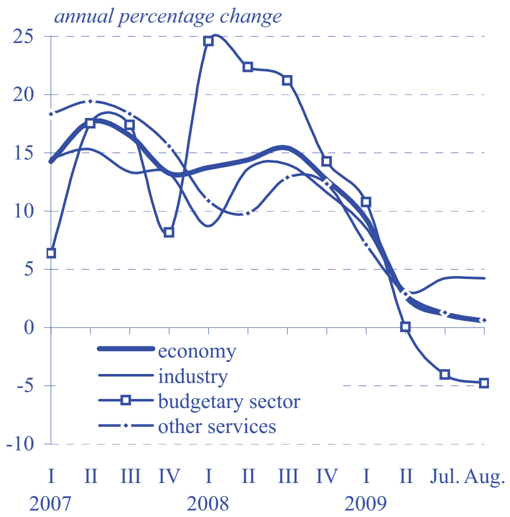
2.2. Incomes

The slowdown in the annual growth rate of net average wage economy-wide, manifest starting with April, carried on in July-August 2009 (5.9 percent, down 3 percentage points from Q2). This time, the main contributor was the deceleration to 0.4 percent in the growth rate of the public sector wage, following the measures aimed at cutting staff costs, implemented either at central level or locally/by ministries (elimination of holiday entitlements, elimination of occasional bonuses, elimination or reduction of certain bonuses and financial inducements). The annual dynamics of wages saw less sizeable adjustments in

[16] These comparisons were made versus the previous period, but the drop in the number of vacancies was sharp in annual terms as well.

[17] Statistics on the number of registered unemployed also include the persons whose employment contracts were terminated but are still employed without legal forms, a situation more frequent in case such persons are entitled to unemployment benefit.

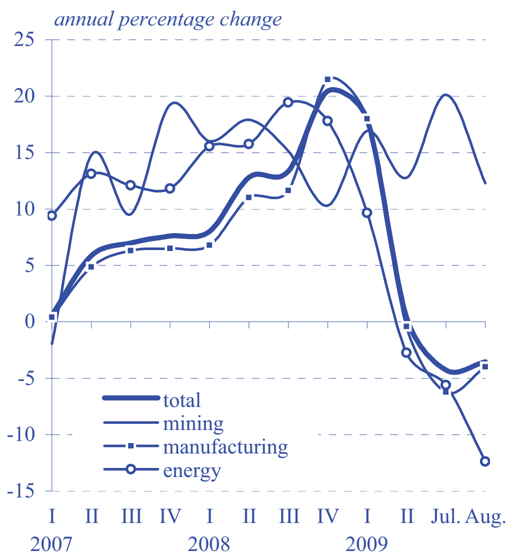
Net Real Wage*



*) deflated by CPI

Source: NIS, NBR calculations

Unit Labour Costs in Industry



Source: NIS, NBR calculations

construction and private services (to 2.8 percent and 6 percent respectively), whereas in industry it remained flat (at 9.5 percent).

The developments in industry were largely due to the fast-paced annual dynamics of wages in mining and oil processing, following the wage hike in July[18] as well as to the granting of occasional bonuses and allowances from the wage fund in August. In addition, in the other industrial sub-sectors, wages showed strong rigidity, the annual growth rate staying, with some exceptions, above the economy-wide average. The explanations could lie with the impact of compensations for mass dismissals but also with the decision taken by an increasing number of employers to resort to gradual lay-offs rather than wage adjustments, possibly seen as insufficient for boosting activity and as having adverse effects on motivating employees.

In fact, the staff cuts[19] had a major impact on the uptrend in labour productivity and, thereby, on the reduction in ULC. The annual change in these costs entered negative territory starting with June 2009 (down to -3.9 percent in July-August compared to 0.4 percent in Q2[20]), due mainly to food industry, tobacco, road transport means, electrical machinery and apparatus. The situation was completely different in light industry, chemicals and pharmaceuticals, metallurgy – sub-sectors where, despite the sizeable slowdown[21], the annual dynamics of ULC remained strong.

In 2009 Q2, the easing of inflationary pressures was attributed not only to supply-side factors, but also to the drop in real disposable income of households (by 6.7 percent in annual terms), with a dampening effect on consumer demand. After staying in positive territory for eight years, the annual dynamics of real disposable income turned negative, mainly as a result of the fall to almost half in remittances from abroad and of total wage bill cut by 2.3 percent, amid the drop in the number of employees[22]. On the other hand, social transfers were still higher compared to a year earlier (7.7 percent), posting, however, a marked deceleration (-9.5 percentage points versus the previous quarter), given the reduction of budget expenditures for the special health fund. In Q3, the annual drop in real disposable income is expected to

[18] Petrom announced wage hikes of 14 percent on average.

[19] The number of employees in industry fell by 220 thousand in August 2009 from a year earlier, accounting for around 63 percent of labour shedding economy-wide.

[20] In manufacturing, the annual dynamics of ULC stood at -5.2 percent in July-August compared with -0.4 percent in Q2.

[21] Except for pharmaceuticals.

[22] The annual dynamics of net real average wage, albeit 6.6 percentage points lower from that in 2009 Q1, stayed in positive territory (2.7 percent).

decelerate slightly on the back of additional social transfers and slowdown in the contraction of remittances from abroad.

3. Import prices and producer prices

In 2009 Q2, the alleviation of inflationary pressures was underpinned by developments in both import prices and producer (industrial and agricultural) prices, to which added the persistence of some favourable base effects. Such developments are seen to continue in Q3, with demand contraction contributing to the slowdown in the dynamics of producer prices in both industry and agriculture (animal products) since April. Fuel producer prices were the major exception, as their quarterly growth rates returned to positive territory.

3.1. Import prices

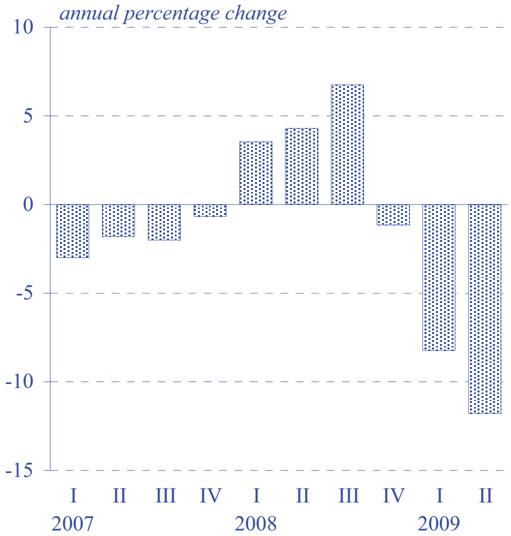
In 2009 Q2, external prices had a higher favourable contribution to the alleviation of inflationary pressures, the annual unit value index of imports falling to 88.2 percent as against 91.8 percent in Q1. An adverse impact was further exerted by the depreciation of domestic currency versus the euro and the US dollar.

As compared with previous quarters, the downward trend of external price dynamics became visible for more groups of imported goods, a notable exception being pharmaceuticals whose annual unit value index of imports remained considerably above par (107.4 percent). The analysis by origin market shows the latter group's price developments may be associated with the significant annual growth rates of producer prices of pharmaceuticals for the external market charged by some of the main EU suppliers (Hungary, United Kingdom, Czech Republic, Poland). Similarly, external prices for fruit increased 3.6 percent from the same year-ago period. The pressures on this CPI component, which were manifest in most EU Member States, were mainly ascribable to smaller crops recorded in 2008.

As for other consumer goods, the annual unit value index of imports was below par, this favourable development being more visible in the case of some non-food non-durables (for instance, clothing). In addition, external prices for road transport means saw the first negative annual changes in the past six quarters.

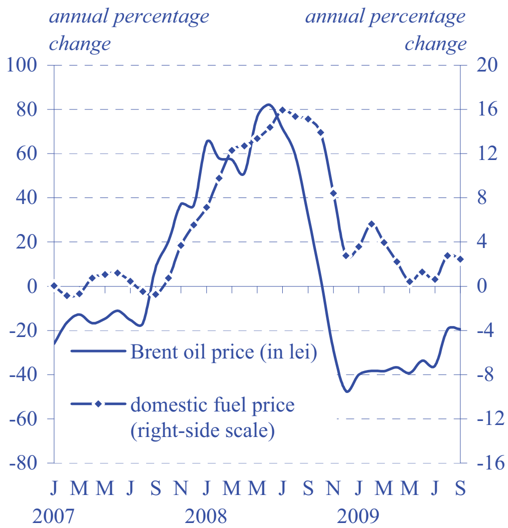
Current developments in external prices could continue in 2009 Q3, the ever higher pressures initially manifest on the energy markets and then on other commodities being offset by a favourable base effect.

Unit Value of Imports



Source: NIS, NBR calculations

Oil Price and Domestic Fuel Price



Source: NIS, EIA, NBR calculations

3.2. Producer prices

3.2.1. Industrial producer prices

In 2009 Q2, the average annual growth rate of industrial producer prices for the domestic market slowed down to 2.2 percent (less than half of the previous quarter's figure), the further major contribution of prices for intermediate and energy goods being accompanied this time by the significant deceleration in the dynamics of producer prices for industrial manufactured goods.

In manufacturing, the average annual growth rate of producer prices slowed down to 1.2 percent as compared with 5.8 percent in 2009 Q1, on the back of both current developments and a favourable base effect. Unlike the previous quarters, producer prices for new orders[23] also followed a downward trend, posting the first negative quarterly change in the past four years (-1.0 percent).

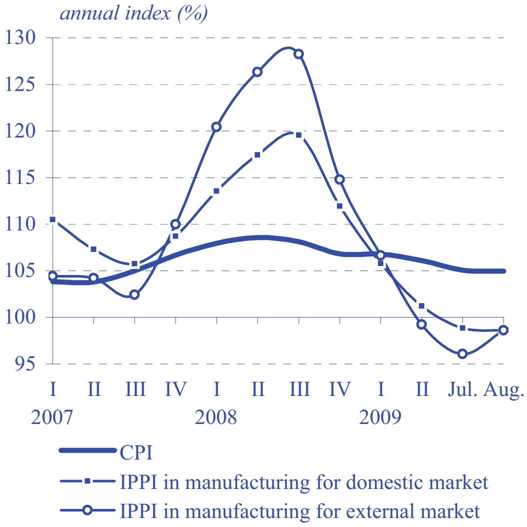
The annual growth rates of producer prices for capital and consumer goods, although lower than in the prior quarter, were further well above the net aggregate value (7.3 percent and 9.8 percent respectively). In the case of capital goods, the main explanation lies with the developments in the exchange rate given the high share of imports of intermediate goods, whereas in the case of consumer goods administrative measures further made a significant contribution[24].

The other sub-sectors producing goods holding shares in the CPI basket posted mixed developments, the further downtrend of the annual changes in producer prices of food items (down to 3.5 percent) being accompanied by faster growth rates of prices for textiles and wearing apparel (up to 11.3 percent). In the absence of any pressures from commodity prices, the higher prices of light industry products may be attributed to the significant worsening of unit labour costs.

Despite the still markedly negative annual growth rates, a less favourable development in quarter-on-quarter comparison was recorded in oil processing sub-sector, where industrial producer prices for the domestic market saw a trend reversal (from -14.9 percent in Q1 to 4.2 percent in Q2), putting pressure on fuel consumer prices.

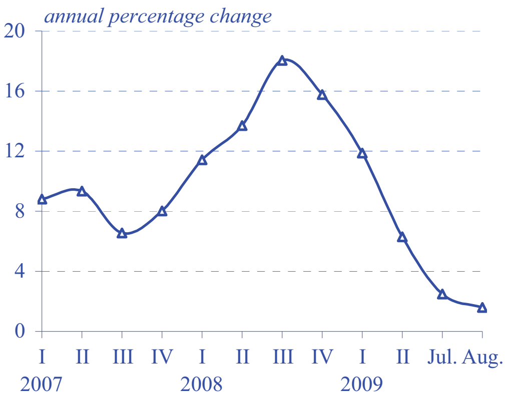
In July-August 2009, the annual growth rate of producer prices entered negative territory (reaching all-time lows), where it is

Consumer Prices and Industrial Producer Prices



Source: NIS

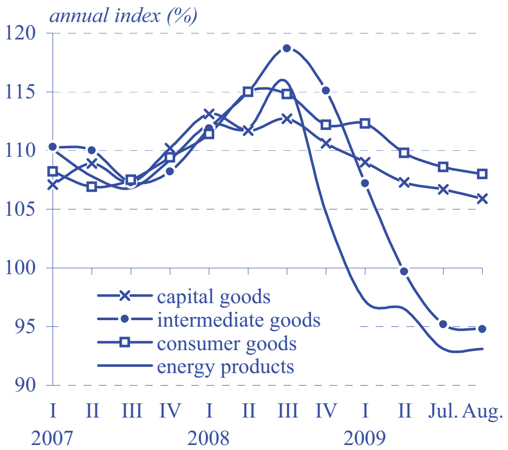
Industrial Producer Prices on Domestic Market* for New Orders



*) in order-based manufacturing sector

Source: Eurostat

Industrial Producer Prices for Domestic Market by Industrial Products Group



Source: NIS

23 In the order-based manufacturing sub-sectors.

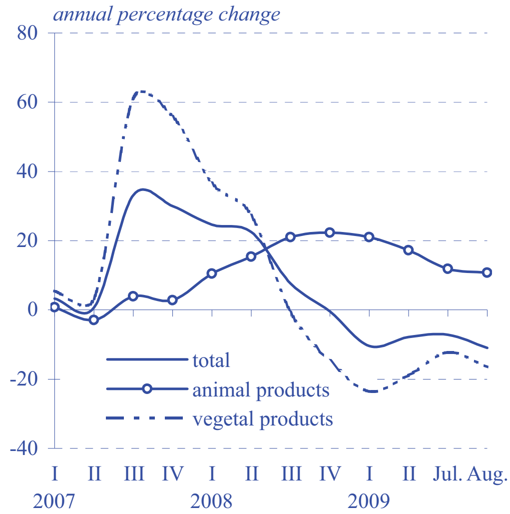
24 The impact was mainly exerted by the policy of local tobacco producers to raise prices gradually in order to disperse the effect of higher excises; mention should be made however that, although they do not incorporate indirect taxes, producer prices in the tobacco industry saw significant hikes when the new excise duties were applied. As for medicines, prices increases starting 1 April were due to the change in the calculation methodology.

expected to remain during the whole quarter, given the persistence of significant base effects.

3.2.2. Agricultural producer prices

In 2009 Q2, agricultural producer prices continued to decline in annual terms, although at a slower pace (-7.8 percent) than in the first part of the year. The same as in the prior quarter, prices for vegetal products made a significant contribution to this development (-18.9 percent), due to the steep declines in prices for grains and technical crops (to -36.6 percent). Yet, a significant role was played by some base effects. Prices for vegetables saw far less favourable movements, as their annual dynamics stood at 33.7 percent, owing possibly to costlier competitive imports (following the domestic currency depreciation) and the upward trend in demand for inferior goods during economic downturn.

Agricultural Producer Prices



Source: NIS

The annual growth rate of producer prices for animal products remained high (+17.2 percent), the only notable changes versus the previous quarter being the significant slowdown in the dynamics of prices for pork and the upward movement in prices for poultry. This may be attributed to consumers' shift towards cheaper meat types.

In 2009 Q3, the dynamics of agricultural producer prices will remain relatively unchanged, whereas the negative annual changes in prices for vegetal products could be further significant despite the diminishing favourable base effects. The dynamics of prices for animal products is not expected to post considerable changes on condition that influencing factors remain unchanged.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In 2009 Q3, the downward trend in the monetary policy rate continued, with the NBR lowering the key interest rate in August and September by 50 basis points each time to 8.0 percent per annum. At the same time, the NBR Board decided to reduce by 5 percentage points[25] the minimum reserve ratio on foreign currency-denominated liabilities of credit institutions with residual maturity of up to two years to 30 percent, whereas the maturity of central bank's main policy instrument, i.e. auction-based repo transactions, was shortened to one week from one month previously. Against the background of a further low volatility of the leu exchange rate and the ongoing economic downturn, these measures were aimed at calibrating broad monetary conditions from the perspective of consolidating inflation rate convergence towards medium-term targets, along with ensuring favourable conditions for a sustainable revival in lending.

The prospects of further alleviating inflationary pressures over the medium term arising from the updated forecast of macroeconomic developments led the NBR Board to reduce the monetary policy rate by another 50 basis points to 8.5 percent in August. The faster decline in the forecasted annual inflation rate in the latter part of the projection horizon – down to 2.6 percent in December 2010, well below the central target of 3.5 percent – was basically due to the expansion in the expected magnitude and duration of the negative output gap, which was associated to the prospects of a sharper economic downturn in 2009 compared to the previous projection. The key signs and prerequisites of such an evolution were the following: (i) larger-than-expected GDP contraction in 2009 Q1, hinting at a higher elasticity of domestic demand *vis-à-vis* the decline in external demand, (ii) steeper downward drift, during the early months of 2009 Q2, in the economic activity of sectors relevant to consumer demand and investment demand (retail trade, imports, construction works) as well as in household and corporate income dynamics, (iii) ongoing worsening trend of economic performance in EU Member States, as reflected by statistical data and forecasts released by local and international institutions in April-May, (iv) persistence of financial deleveraging and of an improving tendency in households' net saving with banks, and (v) the still rising unemployment rate in Q2. In the near run however, the decline in the annual inflation rate was projected to be less pronounced (in line with the coordinates described in the previous

[25] Starting with the 24 August – 23 September 2009 maintenance period.

forecasting round[26]), due largely to the persistent tendency of core inflation to respond with a lag to the wider negative output gap. At the same time, the risks associated to inflation rate deviating from the trajectory shown in the medium-term projection remained relatively balanced. The most relevant risks were further those induced by the uncertainties regarding the future evolution of the global economic crisis.

In September, the NBR Board proceeded to yet another lowering of the monetary policy rate. The key interest rate was reduced by another 50 basis points to 8.0 percent. The major determinant behind this move was the further improvement in the medium-term inflation outlook, amid a severer and persistent economic downturn. Largely validating the trends anticipated by the central bank, annual GDP dynamics fell deeper into negative territory in Q2, reaching -8.7 percent, owing chiefly to the setback in domestic demand (-15.6 percent) triggered mostly by the ongoing decrease in private consumption and the sizeable plunge in gross fixed capital formation. The impact of domestic absorption squeeze was to some extent countered by the favourable performance of net exports, reflecting the ongoing adjustment of the external imbalance, whose contribution to yearly GDP dynamics remained in positive territory, although it declined somewhat versus the previous quarter.

Moreover, incoming economic statistics and data during 2009 Q3 pointed to the persistence of negative GDP dynamics fraught with great uncertainties surrounding its magnitude, and hence the point of economic contraction bottoming out. Signs rather suggested a possibly sharper decline in investment[27] in annual terms, whereas the negative dynamics of consumer demand might have stalled year on year, given the persistence of the behaviour shift seen in the previous quarters. Such a trajectory was outlined by the mixed developments in some relevant consumption indicators, as the available data revealed, on the one hand, a still positive growth rate of the average annual real net wage in July (together with a relative improvement in the negative annual change of Romanian workers' remittances) and the sizeable public deficit widening during July-August 2009, along with a still large weight of staff costs in total expenditures. On the other hand, July saw a relative stalemate in the negative annual real dynamics of turnover in retail trade and services sectors (compared to the second-quarter average) and a slightly faster unemployment rate, accompanied by an increasingly pronounced upturn in households' net savings with banks.

This owed largely to the protracted sharp downtrend in the annual real growth rate of loans to households, its average level halving from 2009 Q2 to stand at 6.3 percent July through August. The real

[26] May 2009 Inflation Report.

[27] Suggested also by the developments in new construction works, capital goods imports and foreign direct investment.

monthly rate of increase of such loans stood a tad higher in August, re-entering positive territory after six months of negative growth. The drivers of these developments were the largely mitigating effects of the major determinants of demand for and supply of loans. The principal effects were those triggered by the worsening anticipations on incomes (implicitly on the households' capability of taking new loans and of repaying current debt) and by the banks' ongoing wariness, reflected also by the further tightening of lending standards[28] and terms in Q2, that was however less pronounced than in the early months of 2009, with fewer banks stating their intention to proceed with such measures during 2009 Q3. In the latter half of the period under review, lower interest rates on some new leu- and euro-denominated loans granted to households, the relative reduction in the volatility of the exchange rate of the domestic currency and the unfolding of "First Home" programme[29] could have acted as an incentive on loans to households. Nevertheless, there are still no signs of a clear-cut recovery in such loans, as the assessment based on the developments in new business[30] (averaging slightly higher July through August than in Q2) can be questioned by the strong effect exerted by the broadening of debt rescheduling practices. Under the cumulated impact of the above-mentioned factors, nearly all household loan types saw their average annual growth rates losing momentum in July – August 2009, with the dynamics of the leu-denominated component even falling into negative territory. Structural analysis by loan purpose shows that consumer credit was the hardest hit, its average dynamics more than halving against Q2. By contrast, the average growth pace of housing loans posted a tepid deceleration (by 0.5 percentage points to 23.4 percent) amid the relatively faster increase in the leu-denominated component (at odds with the upward trend in the average interest rate on such loans) and the slower decline in the foreign currency-denominated component (partly ascribable to the rescheduling of loans in progress) coupled with the stronger statistical effect of a weaker domestic currency.

At the same time, the average annual dynamics of household savings with banks remained high at 14.1 percent, as the aforementioned statistical effect caused this indicator to inch up versus 2009 Q2. Looking through this influence, both the average rate of increase of leu-denominated deposits and that of foreign currency-denominated deposits (expressed in euro) lost momentum

[28] According to the latest survey conducted by the National Bank of Romania on lending to non-financial corporations and households, the change in households' lending standards was substantiated by: (i) expectations on households' financial standing and the risk associated with customers' creditworthiness; (ii) real-estate market outlook, including collateral risk and (iii) the unfavourable performance of households' past-due loans ratio.

[29] Including via the potential side effect of initiating a larger adjustment of banks' supply of housing loans.

[30] Based on data available at the CCR and those included in credit institutions' reports submitted pursuant to Norms No. 14/2006 issued by the National Bank of Romania.

against the April-June average, reflecting the persistence of the constraint arising from the more sluggish income expansion and the increase in debt service, albeit at a pace slower than in Q2. Nonetheless, the uptrend in households' demand for money for precautionary reasons remained unchanged – households' time deposits with a maturity of up to two years recorded on average a higher annual pace of increase in real terms July through August (50.5 percent), largely on account of a swifter growth rate of leu-denominated deposits, concurrently with a stronger propensity for deposits on a relatively longer term[31] that was underpinned by attractive yields on such investments.

The National Bank of Romania further calibrated carefully the adjustment pace of the policy rate. Such a conduct was warranted by the need to firmly anchor inflation expectations given the outlook for lingering inflationary risks and pressures in the near run. These threats derived mainly from the still significant persistence of core inflation and the potential inflationary effects of cost-push/supply-side factors. Among the latter factors the following deserve mention: (i) downward rigidity of nominal unit labour costs in a number of consumer goods producing sectors; (ii) implementation of the second stage of the hike in excise duties on cigarettes (in September); and (iii) the envisaged increase in heating and fuel prices. Adding to these factors was the risk of renewed leu exchange rate swings if investor sentiment on global or domestic economic and financial developments were to worsen abruptly. This risk gained in importance in early September when the RON/EUR exchange rate increased somewhat, thus veering off from the nearly flat trajectory seen over the past two months, against the backdrop of worsening risk perceptions on the financial markets in the region and the wider shortfall of residents' foreign currency transactions.

Similarly to the previous quarter, the rate cut decisions were accompanied by measures addressing the central bank's money market liquidity management. Seeking to render this activity more effective and, implicitly, to increase the impact of the policy rate on short-term money market rates, in August the National Bank of Romania shortened the maturity of its main monetary policy instrument, i.e. auction-based repo transactions, from one month to one week.

Furthermore, the monetary authority lowered by another 5 percentage points (down to 30 percent) the minimum reserve ratio on credit institutions' foreign-currency-denominated liabilities with residual maturity of up to two years starting with the 24 August-23 September 2009 maintenance period. This move was aimed at improving liquidity conditions on the foreign exchange market and

[31] July through August, new leu-denominated household deposits with maturity of between 3 and 12 months accounted on average for 23.8 percent of total new business (up from 12.7 percent in Q2).

ensuring further alignment of the required reserve mechanism to ECB standards in the field.

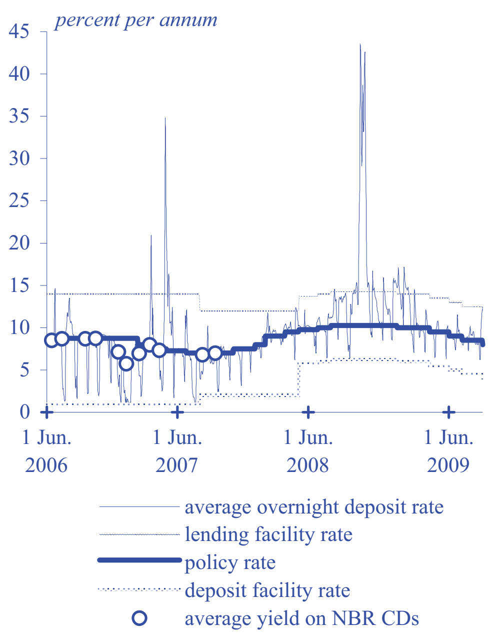
These measures were implemented at a time when the central bank's creditor position vis-à-vis the banking system declined gradually, mainly as a result of larger liquidity injections performed by the State Treasury and following the reduction in the minimum reserve ratio on credit institutions' leu-denominated liabilities to 15 percent from 18 percent starting with the 24 July-23 August 2009 maintenance period. From July to September liquidity was provided chiefly via auction-based repo transactions, their volume averaging 39 percent lower than in Q2, whereas the lending facility was seldom resorted to. Temporary excess liquidity was mopped up via reverse repo and deposit-taking operations, as well as by resorting to the deposit facility. As a result, the average volume of liquidity-absorbing operations went up slightly in Q3 versus Q2, but remained well below that of liquidity injections.

2. Financial markets and monetary developments

In 2009 Q3, interbank market rates came close to the monetary policy rate, whereas the exchange rate of the leu remained relatively stable for most of the period under consideration. The deceleration in the annual dynamics of broad money came to a halt, the contractionary effect of the decline in credit to the private sector being offset by the expansion in net credit to the general government.

2.1. Interest rates

Interbank Money Market Rates

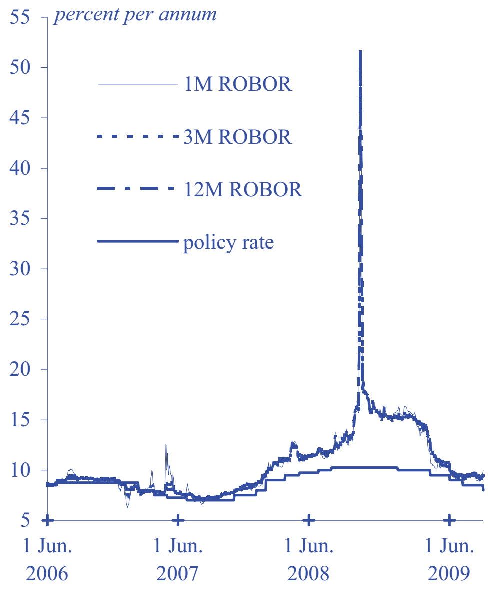


In July-September 2009, interbank market rates stayed close to the monetary policy rate, reflecting the downward adjustment of the latter. In this context, the quarterly average of interbank market rates decreased further to 8.9 percent, down 0.7 percentage points from the previous quarter.

During the period under review, the spread between very short-term interbank rates and the monetary policy rate remained relatively low, given that the cut from 18 percent to 15 percent in the minimum reserve requirements ratios on leu-denominated liabilities of credit institutions starting with the 24 July-23 August maintenance period and the active use of open-market operations ensured the adequate management of liquidity in the banking system.

Interest rates saw relatively more pronounced changes towards the end of reserve maintenance periods ended in the first and last month of the quarter, owing both to the temporary mismatches between liquidity demand and supply and to the inefficiencies in excess liquidity redistribution in the banking system[32]. In July, the significant volume of deposits taken by the Treasury from the money market was a potential source of higher interest rate changes. At the end of Q3, the tightening of liquidity conditions proved relatively more persistent, so that in the final week of September overnight rates reached the upper bound of the corridor defined by interest rates on standing facilities. Against this background, the volatility of very short-term rates was marginally higher than in the prior quarter, despite the five-quarter low recorded in August.

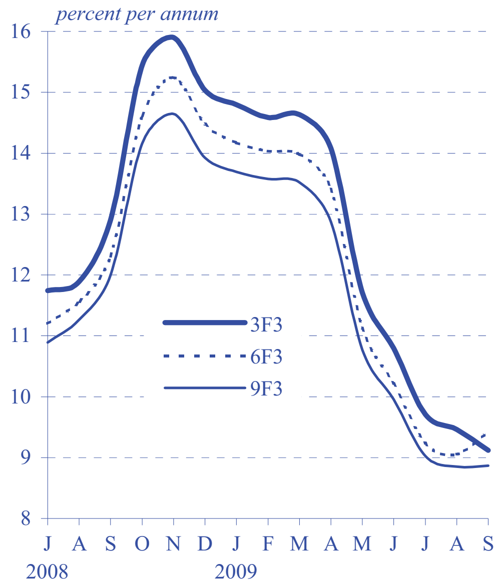
Policy Rate and ROBOR Rates



Longer-term money market rates decreased at a slower pace, given that they had gradually returned close to normal levels, a process that started in Q2. The downward movement continued for most of the period under review, reflecting the successive cuts in the policy rate, as well as market expectations regarding the occurrence of similar movements in the period ahead. Towards the end of the quarter however, (1M-12M) ROBOR rates followed an upward course, under the impact of a relative increase in credit institutions' uncertainties surrounding future developments in liquidity conditions. Nevertheless, average (1M-12M) ROBOR rates dropped 1.2 percentage points in September versus June, with 6M-12M ROBOR rates posting slightly steeper declines of 1.3 percentage points.

The developments in implicit forward rates also confirmed the relatively slower downward shift in the yield curve. The expected three-month ROBOR rates (calculated based on September average quotations) stood at 9.1 percent in December, 9.4 percent in March 2010 and 8.9 percent in June 2010. These figures are lower by as much as 1.7 percentage points than those recorded in June.

Implicit Forward Rates

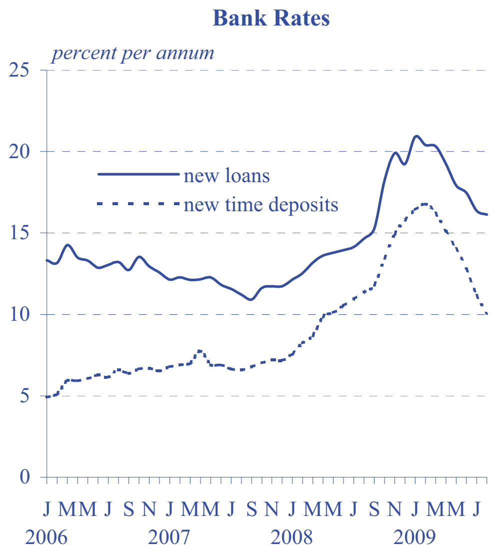


In 2009 Q3, interest rates on government securities went down further, the maximum interest rates accepted by the MPF decreasing by up to 10 percent for all types of securities. Government securities issues declined versus the previous quarter to a total of RON 14.9 billion, which is significantly lower than the pre-announced amount of RON 20.8 billion. Interest rates fell at a slower pace in July, when higher borrowing requirements prompted the MPF to launch one of the largest volumes of government securities issues up to present. Nevertheless, the drop in interest rates was faster in August and continued in September, given that the MPF used part of the substantial foreign currency funds it had raised from end-July in order to cover financing needs.

In addition, the interest rates on outright operations performed on the secondary market for government securities went down in July-September across the maturity spectrum, on the back of a rebound

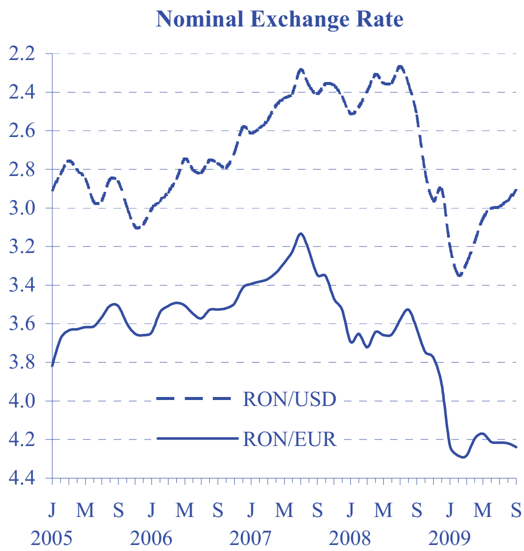
[32] Highlighted also by the simultaneous resort to the standing facilities of the central bank during the said periods. The volume of such simultaneous transactions was high, particularly on 22 and 23 September.

in the volume of transactions (manifest particularly in September), also due to the non-residents' higher interest in government securities. Hence, the quarterly turnover of the secondary market for government securities (excluding the NBR) ran at RON 13.7 billion (two times higher than in the prior quarter), most transactions performed being outright transactions (over 90 percent). The most heavily traded were further the securities with residual maturities of up to one year.



Average lending and time deposit rates on new business stayed on a downtrend in June-August 2009, thus partially adjusting their distorted position in relation to interbank rates. Average interest rates on time deposits of non-bank clients declined sharply by 3.96 percentage points against May to 10.06 percent, particularly on the back of the sizeable drop in interest rates applicable to households (down 4.29 percentage points to 10.68 percent). Average lending rates on new business decreased at a slower pace (down 1.79 percentage points to 16.14 percent), the adjustment being relatively evenly distributed between the two major categories of customers. As regards non-financial corporations, average interest rates on new loans dropped 1.87 percentage points, the adjustment being more visible (-2.75 percentage points) in the case of small-value loans (the equivalent of up to EUR 1 million). Unlike the previous months, lending rates on new business of households followed a downward path as well, dropping 1.74 percentage points to 17.95 percent, due mainly to the 2.12 percentage point decrease in interest rates on consumer loans. By contrast, average interest rates on housing loans added 0.99 percentage points to 11.74 percent.

2.2. Exchange rate and capital flows



After witnessing a relative stability during the first two months of the third quarter, the RON/EUR exchange rate moved up slightly in September, amid the worsening of investor sentiment towards the financial markets in the region and higher uncertainties surrounding the short-term developments of the domestic economy. At the same time, exchange rate developments became less correlated to those of the major currencies in the region and the daily volatility increased somewhat towards the end of the reported period.

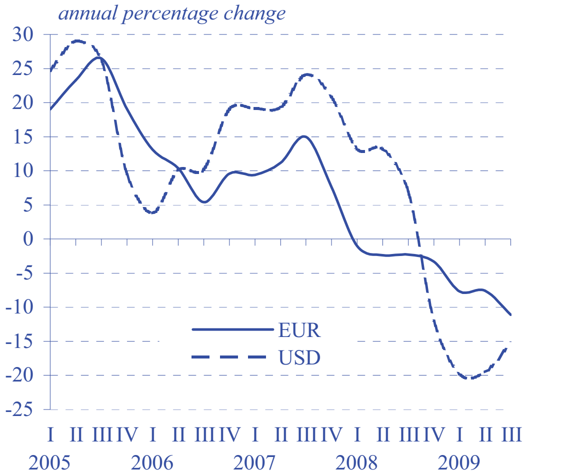
Consequently, July through September, the domestic currency weakened against the euro by 0.5 percent in both nominal and real terms, compared to an appreciation of 1.5 percent and 2.1 percent respectively in 2009 Q2. In relation to the US dollar, however, the leu strengthened 3.1 percent in nominal terms and 3.3 percent in real terms, given that the US currency weakened against the euro. Calculated as an average annual change for 2009 Q3, the domestic currency posted a faster nominal depreciation versus the euro

(15.3 percent), but a slower depreciation against the US dollar (19.3 percent).

The RON/EUR exchange rate remained relatively stable in July and August, under the impact of divergent developments in some of its major determinants. On the one hand, the global risk appetite was rekindled during that period by favourable external developments, such as better-than-expected financial results reported by some major financial companies worldwide, as well as better-than-anticipated statistical data relating to economic performance of several EU Member States[33]. On the other hand, the positive impact induced by the ongoing larger-than-expected narrowing of the current account deficit[34] was more than offset by the detrimental impact on investor sentiment exerted by: (i) ECOFIN initiating the excessive deficit procedure against Romania on 8 July, (ii) sharper GDP contraction in 2009 Q2, as highlighted by statistical data released during the period under review, and (iii) the IMF's marked revision of this year's forecasted economic downturn, resulting in a wider budget deficit agreed in the stand-by arrangement. Amid the sharper economic contraction and the significant decline in the appetite for financial transactions in foreign exchange, interbank forex market turnover dwindled in August to a seven-month low. Against this backdrop, the RON/EUR exchange rate fluctuated within an extremely narrow variation band, in contrast to the strengthening trend versus the euro witnessed by the major currencies in the region. Therefore, exchange rate volatility remained well below that posted by other currencies in Central and Eastern Europe[35]. Neither the successive policy rate cuts (fully anticipated by the market), nor the foreign currency-denominated loans taken by the MPF on the domestic market during the period under review fed through into exchange rate movements.

Starting in September however, investor sentiment on the risk associated with investments in the financial markets across the region worsened mainly on account of: (i) the substantial upward revision of budget deficit projections for 2010 in Poland and the Czech Republic; (ii) slower-than-anticipated GDP growth in the Czech Republic in 2009 Q2; (iii) increasing likelihood of further sovereign rating downgrades by Fitch Ratings and Moody's in several Central and Eastern European countries and (iv) statements by EBRD and World Bank executives on a possibly slower recovery for these economies. Hence, the exchange rates of the major currencies in the region embarked upon an upward trajectory. As for the domestic currency, the downward pressure on the leu

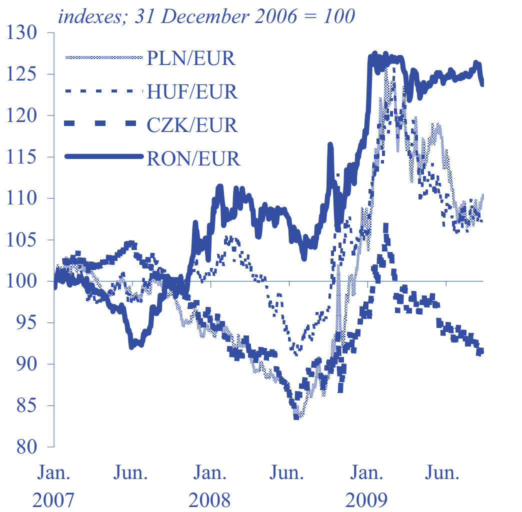
Developments of RON Exchange Rate*



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

Source: NIS, NBR

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

[33] Including data released in August, indicating a potentially swifter economic recovery in Germany, France and the Czech Republic.

[34] The current account deficit narrowed 73.8 percent January through July 2009 versus the same year-ago period.

[35] RON/EUR exchange rate volatility dropped to a three-year low in August.

Key Financial Account Items (balances)

EUR million

	2008 8 mos.	2009 8 mos.
Financial account	**12,073**	**1,912**
Direct investments	**6,833**	**3,064**
residents abroad	109	-89
non-residents in Romania	6,725	3,154
Portfolio investments and financial derivatives	**160**	**-60**
residents abroad	-256	-322
non-residents in Romania	416	262
Other capital investments	**5,566**	**-451**
credits and loans from the IMF	0	4,925
medium- and long-term investments	3,956	1,264
short-term investments	-264	-2,599
currency and short-term deposits	-1,167	-4,952
other	3,041	912
NBR's reserve assets, net ("–" increase/"+" decrease)	**-486**	**-640**

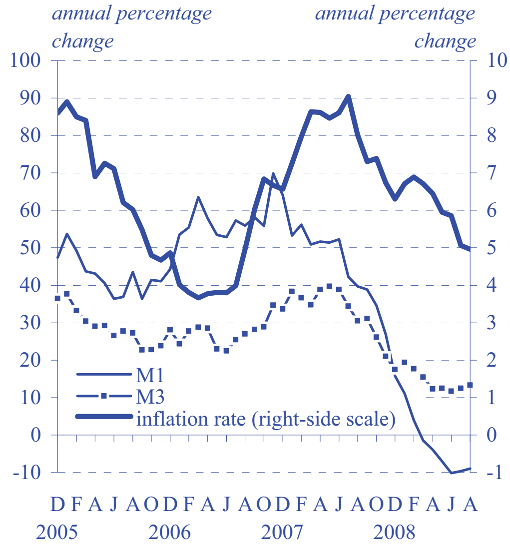
Annual Growth Rates of M3 and Its Components

real percentage change

	2008		2009			
	III	IV	I	II	Jul.	Aug.
	quarterly average growth					
M3	22.1	13.8	10.0	5.7	7.0	8.0
M1	29.7	17.7	-2.1	-12.4	-14.0	-13.3
Currency in circulation	19.4	18.2	8.9	-0.1	-1.9	-3.1
Overnight deposits	33.8	17.6	-6.0	-16.7	-18.3	-16.9
Time deposits (maturity of up to 2 years)	13.7	8.9	24.1	26.8	32.5	33.6

Source: NIS, NBR

Broad Money and Inflation Rate



Source: NIS, NBR

was amplified by higher uncertainties afflicting short-term developments of the domestic economy, amid escalating social and, subsequently, political tensions. To this added the spike-up to a record high of the deficit posted by residents' foreign currency transactions, largely attributable to remitted earnings by some major companies operating on the local market and to private external debt servicing. As a result, the RON/EUR exchange rate followed an upward path in the first part of the period under review, hitting the highest reading of the reported quarter on 14 September, i.e. 4.2747. Although the exchange rate saw a temporary trend reversal towards end-September, the domestic currency shed 0.5 percent to the euro in nominal terms during the month under review. At the same time, daily variations in the RON/EUR exchange rate increased slightly from the previous month.

2.3. Money and credit

Money

June through August 2009, the pace of increase[36] of broad money (M3) saw its downward trend coming to a halt[37] and remained somewhat stable at one of the lowest readings in recent years (6.8 percent), amid the bleaker economic picture and the ongoing financial deleveraging both domestically and globally. Despite the slowdown witnessed so far this year, the M3 annual dynamics remained in positive territory, in relative contrast to the marked GDP contraction. The evolution hints at slower money velocity on account of higher money demand for saving[38].

Against this backdrop, the growth rate of narrow money was more closely linked to developments in economic activity. Thus, M1 dynamics fell deeper into negative territory during the period under review (-14.1 percent, 4.3 percentage points below the previous 3-months' reading) on the back of the decline posted by both components. Conversely, the pace of increase of time deposits with a maturity of up to two years gained momentum and hit a new all-time high, i.e. 32.4 percent, reflecting the keener demand for money for precautionary reasons, amid the worsening of both current and expected financial position of non-bank sectors. The development was primarily due to household time deposits with a maturity of up to two years, with the growth rate of the leu-denominated component and the dynamics of the forex component hitting an 18-month high. The pace of increase of corporate deposits also witnessed a rebound, solely on the back of a faster increase in the leu-denominated component, whereas the dynamics of deposits

[36] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2009.

[37] M3 annual dynamics decelerated in June, but picked up over the following months.

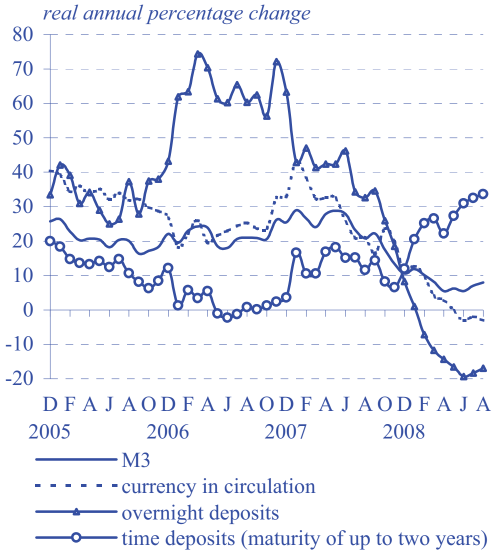
[38] As reflected by the lower average share of M1 in M3 (45.1 percent versus 56.1 percent during the same year-ago period).

in foreign currency – albeit still high – posted a further downtrend[39].

The breakdown of monetary developments by institutional sector reveals more favourable developments in M3 deposits of both households and companies. Nevertheless, this is ascribable mainly to the statistical effect of a weaker domestic currency[40]. Under this impact, the growth rate of total M3 deposits of households remained constant, although both the leu-denominated component and the forex one (expressed in euro) witnessed more sluggish dynamics. However, deposits in domestic currency were less affected, because – similarly to the previous period – certain amounts from budgetary sources were earmarked for households[41]. Conversely, the pace of increase of total corporate deposits included in M3 returned into positive territory, as the balance of placements in domestic currency saw a less steep decline (amid, *inter alia*, payments from the government budget[42]), while foreign currency-denominated deposits further witnessed positive, albeit decelerating, dynamics. Against this background, the average share of foreign currency-denominated deposits in broad money shed 0.8 percentage points to 31.5 percent, which is still one of the highest levels in the past four years.

Main Broad Money Components

real annual percentage change



Source: NIS, NBR

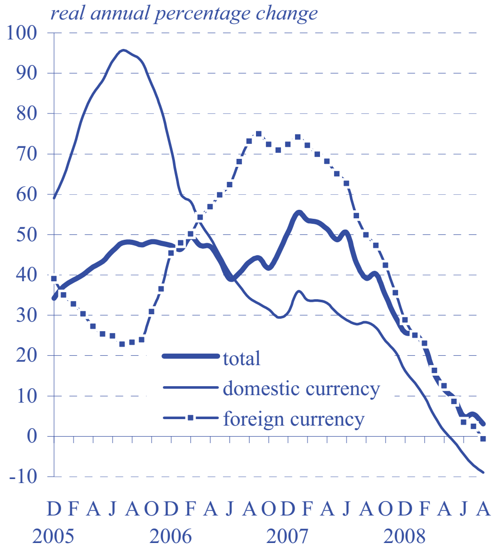
From the perspective of M3 counterparts, credit to the private sector acted as the sole deterrent to the growth of liquidity in the economy. However, its influence was offset by the joint impact exerted by the pick-up in central government net credit, the less steep decline in banks' net foreign assets and the slower increase in long-term financial liabilities (capital accounts included).

Credit

During June – August 2009, the growth rate[43] of credit to the private sector declined more rapidly (-7.6 percentage points to 4.5 percent), thus hitting an 8-year low. The development was due both to the domestic currency component, whose percentage change turned negative for the first time in the past eight years, and to forex-denominated loans, whose dynamics slackened below 2 percent for the first time over the last eight-and-a-half years. Hence, the structure of credit to the private sector worsened

Credit to Private Sector by Currency

real annual percentage change



Source: NIS, NBR

[39] The further lower growth rate of these deposits compared to that in the previous period is ascribed, to a significant extent, to the favourable base effect until March 2009 following the privatisation of "Electrica".

[40] The leu witnessed the most sizeable annual depreciation versus the euro in the past 5½ years.

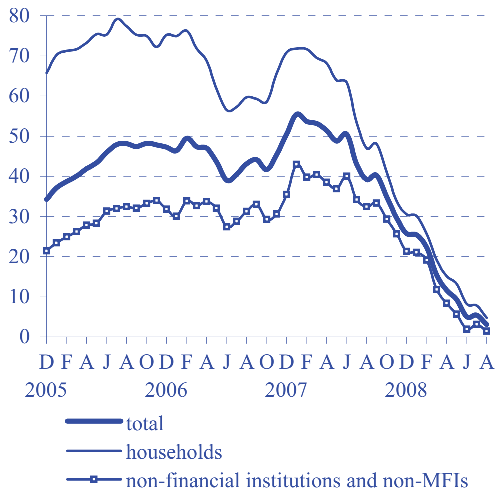
[41] Payments such as those earmarked for agriculture (also from European funds).

[42] According to calculations based on the information available on the Romanian Government's website, VAT refund July through August exceeded RON 1.6 billion.

[43] See footnote 36.

Credit to Private Sector by Institutional Sector

real annual percentage change



Source: NIS, NBR

somewhat, with the average share of forex loans peaking at a 4-year high of 59.5 percent, largely attributable to the statistical effect of a weaker domestic currency.

Both credit demand and credit supply were further dampened mainly by (i) the decline in economic activity and its unfavourable prospects over the short term[44] and (ii) credit institutions' increased wariness, as highlighted by tighter lending terms and standards[45] (although to a lesser extent than in the previous quarters) and larger holdings of government securities.

The structural breakdown by institutional sector pinpoints that the growth rate of corporate borrowings further posted a steeper deceleration, down 75 percent from the previous period to 2.2 percent. All credit types of such borrowers followed a downward trajectory, with individual dynamics either entering or falling deeper into negative territory. Only long-term corporate loans in foreign currency further witnessed positive annual growth rates (albeit declining as well), possibly due also to the impact of debt rescheduling.

The pace of increase of loans to households halved to 6.9 percent, especially on account of the steeper decline in consumer credit dynamics (irrespective of denomination). Conversely, the growth rate of leu-denominated housing loans rebounded for the first time since mid-2008 (despite somewhat higher interest rates), while that of forex loans – albeit on the wane – remained relatively alert. The development could be ascribed, *inter alia*, to the budding effects of the housing loans programme backed by government collateral (the "First Home" initiative).

Nevertheless, the data released by CCR[46] indicate that the flow of new business rose further in all sectors versus the preceding period, with the exception of agriculture. The possible determinants of this development include: (i) less readily available external financing for non-banks[47], (ii) the relatively lower volatility of the RON/EUR exchange rate, (iii) lower lending rates on most new business to households and non-financial corporations, and particularly (iv) continued resort to debt rescheduling, reflecting the credit institutions' ongoing concern to avoid a deterioration of their

[44] According to NIS surveys conducted during the period under review on the expectations of managers of commercial companies in major economic fields.

[45] According to the outcome of the survey on lending to non-financial corporations and households published in August 2009.

[46] Referring to loans in excess of RON 20,000 approved during the period under review.

[47] According to balance-of-payments data, the net value of financial credit taken from abroad by non-banks during May-July 2009 posted steady negative readings.

portfolio quality[48]. Companies engaged in industry, services and construction reported the most significant flows of new business since October 2008 to date, with the value recorded by the first two sectors even reaching two successive historical highs in June and July. Lending to households also seems to have rebounded, as the volume of new business to households in June and July posted the highest reading year so far. However, the level of these transactions remained approximately four times lower than a year earlier.

Contrary to the developments in credit to the private sector, net credit to central government exerted a stronger expansionary impact on M3, primarily via an increase in credit institutions' government securities portfolio.

[48] The share of overdue loans of both households and non-financial corporations in total credit to the private sector rose further, reaching an average of 3.4 percent, up 0.6 percentage points from the previous period.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the annual CPI inflation for end-2009 at 4.5 percent, 0.2 percentage points higher than the figure forecasted in the August 2009 Inflation Report (4.3 percent). In 2010, the inflation rate is forecasted to fall below the central target of 3.5 percent to as low as 2.6 percent, the same level as in the previous projection.

The upward revision of the end-2009 consumer-price inflation forecast is largely due to reassessing the quarterly distribution of the effects from the upcoming stage (rescheduled for 1 January 2010) of raising the excise duties on tobacco products, which hold a significant share in the consumer basket, i.e. 4.6 percent. The implementation of the hike in excise duties earlier than assumed in the previous projection led to a stronger inflationary impact in 2009 Q4 due to its partial ex-ante incorporation into consumer prices.

Although the negative output gap is projected to narrow gradually starting 2010, it will remain the major factor exerting disinflationary pressures during the entire projection horizon. The forecasted path of the annual CPI inflation rate runs slightly above that presented in the August 2009 Inflation Report in the first part of the projection horizon, but will fall beneath it starting 2011 Q1. The direction of these revisions was prompted by the reassessment of the cumulated effects of CORE2 and administered price inflation, which are expected to be unfavourable in the first part of the projection horizon, whereas the scenarios on the developments in volatile prices (for vegetables, fruit and eggs as well as for fuels) foresee a favourable contribution over most of the period under review.

As for core inflation, apart from the above-mentioned impact of the hike in excise duties on tobacco products, the slower-than-previously-forecasted disinflation over the first part of the period under review is attributed to the reassessment of inflation expectations amid the uncertainties surrounding the persistence of recent adverse supply-side shocks. The lagged impact on inflation expectations arising from the sharp depreciation of the domestic currency in late 2008 and early 2009 stands out among these shocks. For the latter part of the projection horizon, CORE2 inflation is expected to decline progressively under the prevailing influence of aggregate demand-side factors, thereby fostering disinflation.

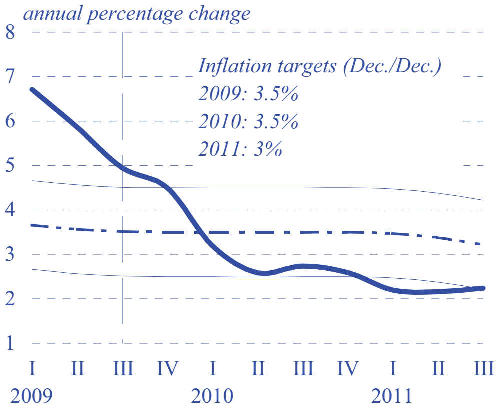
The monetary policy stance will remain prudent and balanced, and in the near run it will be aimed at removing the gap between interbank rates and the monetary policy rate. Thereafter, it will seek to adjust broad monetary conditions in order to keep the inflation *rate inside the established target band in a sustainable manner, while also supporting the revival of the lending process in the Romanian economy as a whole. The fulfilment of these objectives is largely conditional upon the absence of any significant deviations from the forecast assumptions regarding external developments and the coordinates of the macroeconomic policy mix components.*

The analysis of risks associated with the current forecast indicates that upside risks to inflation appear to be somewhat higher than downside risks, particularly over the short term. In the medium term however, the balance of risks to inflation and economic activity in the baseline scenario will regain relative equilibrium following the anticipated return of the macroeconomic policy mix under a more efficient coordination.

Over the short term, the principal risk to the current forecast relates to budgetary developments, given that the unstable political field over the past few weeks reveals the likelihood of greater difficulties being faced in attaining the scheduled parameters, expenditure composition and, against this backdrop, the tighter access to financing sources. In the absence of firm corrective measures of the previously-accumulated slippages, the anticipated negative consequences of suboptimal macroeconomic policies could fuel expectations of a weaker leu, with self-fulfilling effects on both the exchange rate and inflation.

Similarly to the previous forecasting rounds, a major risk stems from the uncertainty surrounding developments in global economic activity and financial markets over the projection horizon. Deviations from the assumptions incorporated in the baseline scenario are possible via the foreign trade and financial channels, being likely to entail slippages of both inflation rate and economic growth from the forecasted trajectories. A priori, the risks of both-way deviations are deemed as balanced. Risks related to developments in prices of oil and other commodities, administered prices and volatile food prices also 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

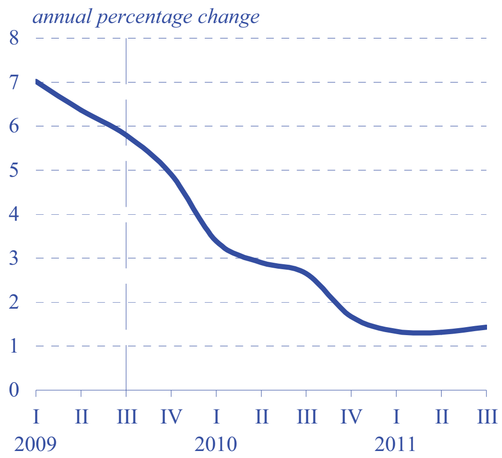
The baseline scenario of the forecast places the annual CPI inflation for year-end 2009 at 4.5 percent, 0.2 percentage points higher than that published in the August 2009 Inflation Report. For end-2010, annual inflation rate is forecasted to fall to 2.6 percent, the level shown in the previous forecast. Thus, the projected annual CPI inflation rate will range within the ±1 percentage point variation band around the 3.5 percent central target set for end-2009 and end-2010 respectively.

Table 5.1. The annual inflation rate in the baseline scenario

percent

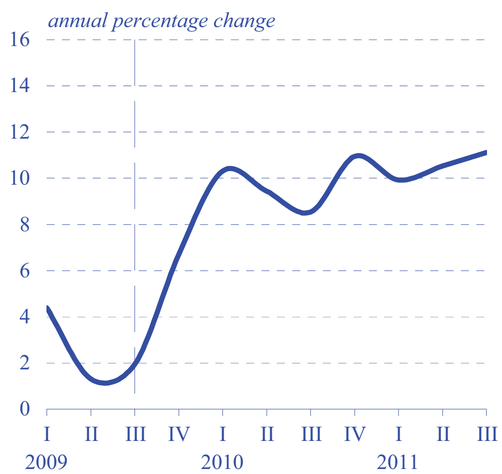
Period	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011
Target	3.5				3.5			
Forecast	4.5	3.2	2.6	2.7	2.6	2.2	2.2	2.2

Annual CORE2 Inflation



Source: NIS, NBR calculations

Fuel Prices Annual Inflation



Source: NIS, NBR calculations

Over the projection horizon, the evolution of annual CPI inflation rate is determined by the projected trajectories of CORE2 inflation and fuel price inflation, as well as by the scenarios considered for the inflation of administered prices and that of volatile prices of vegetables, fruit and eggs. Compared to the August 2009 Inflation Report, the current forecast includes the following revisions:

(i) cumulated contribution from *inflation of administered prices and that of volatile prices of vegetables, fruit and eggs* to CPI inflation is lower in 2009 and 2010, but will exert additional inflationary pressures during 2011. The explanation for this change lies with the inflation of volatile prices of vegetables, fruit and eggs being revised downwards in 2009 and 2010 and upwards in 2011. This effect will partly be countered by the opposite revision of the scenario in administered prices inflation rate in all three years[49].

(ii) the *annual fuel prices inflation rate* is expected to post developments more favourable to disinflation over the first part of the projection horizon, but will have a larger contribution to the annual CPI inflation rate over the remaining period. This component will evolve above the CPI inflation rate throughout the projection horizon, although it benefits from a lower starting point[50] than in the August 2009 Inflation Report given the expected oil price[51] increase over the entire horizon and the adjustment in the excise duty on petrol and diesel fuel as from 1 January 2010;

(iii) the trajectory of the annual CORE2 inflation rate was revised upwards in the first part of the projection horizon, but the disinflation associated with this variable will be more pronounced during the latter part of this period. Given that the goods included in the CORE2 index basket hold a significant share in the CPI, CORE2 inflation is the largest contributor to disinflation.

[49] For further details on the scenarios regarding the exogenous components of inflation, see Subsection 1.2. *Exogenous pressures on inflation.*

[50] The first quarter in the forecast is 2009 Q4.

[51] The increase in oil price in 2011 Q3 against 2009 Q4 stands at 14.2 percent.

The annual CORE2 inflation rate is foreseen to follow a downtrend[52] for most of the projection horizon and these dynamics will speed up in 2010 H2. This rate was revised in the first part of the projection horizon, due largely to the assumed sharper increases in tobacco and cigarettes prices in 2009 Q4, ahead of raising the excise duty levied on such goods on 1 January 2010. Compared to the August 2009 Inflation Report, the impact of the hike in the excise duty for tobacco and cigarettes on the quarterly CORE2 inflation rate is expected to be more pronounced in 2009 Q4 and 2010 Q1, but less significant in the following quarters of next year. The high frequency of excise duty increases in tobacco and cigarettes[53] and the magnitude of such adjustments can fuel renewed inflation expectations of economic agents both in the final quarter of 2009 and beyond the first quarter of 2010, since part of the adjustments might exert second-round effects on the prices for a wider range of goods.

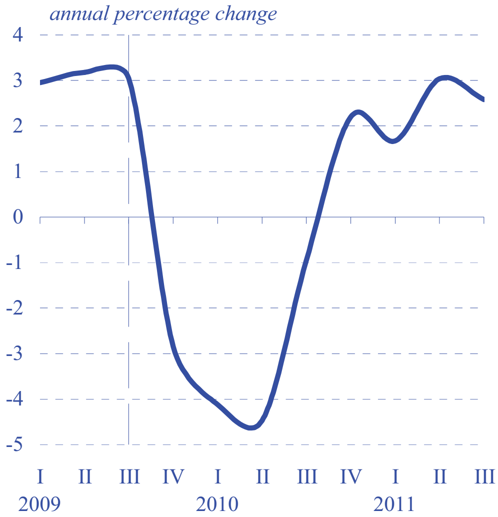
Aggregate demand is seen contributing to curbing CORE2 inflation over the entire projection horizon. The magnitude of the negative output gap is running high, similarly to the previous projection. The lagged pass-through of disinflationary pressures from aggregate demand into CORE2 inflation is largely attributed to the heightened uncertainties faced by companies, as the recent, adverse supply-side shocks that hit the economy had a persistent negative impact on their inflation expectations. The current projection incorporates the assumption of a gradual abatement of negative supply-side effects (the main culprit being the hike in excise duties on tobacco and cigarettes), pushing down inflation expectations from the current levels to lower ones, which are compatible with attaining the inflation target. Concurrently with the gradual dampening of supply-side shock effects, demand-side factors will become the main determinants of CORE2 disinflation, as its projected trajectory will fall below that of CPI inflation starting 2010 Q3.

In line with a gradual recovery of euro area economy, as incorporated in forecast assumptions, the annual HICP inflation rate is foreseen to post increasing quarterly levels over the projection horizon, but lower than those presented in the previous baseline scenario. Considering also the expected decline of inflationary pressures generated by the exchange rate, amid foreign investors' lower risk aversion, import price inflation will further have a favourable contribution to CORE2 inflation.

[52] The substantial reduction in the annual CORE2 inflation rate forecasted for 2009 Q4 against that recorded in 2009 Q3 (4.9 percent from 5.8 percent) is also due to a pronounced base effect. Thus, the quarterly rate projected for 2009 Q4 is 3.7 percentage points lower than that seen in 2008 Q4.

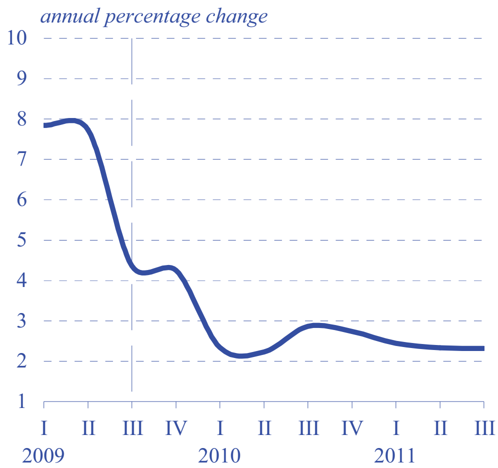
[53] The latest hike was implemented in September 2009 and the next is due for January 2010.

Vegetables, Fruit and Eggs Prices
Annual Inflation



Source: NIS, NBR calculations

Administered Prices Annual Inflation



Source: NIS, NBR calculations

1.2. Exogenous pressures on inflation

The abundant supply of vegetables and fruit reported this year together with the effect induced by a declining demand had a favourable impact on volatile food inflation (vegetables, fruit and eggs). In view of the anticipated persistence of such influences over the projection horizon, the contribution of this component to CPI inflation was subjected to a downward revision. Thus, compared to the previous forecasting round, volatile food inflation will have a lower contribution to annual CPI inflation both in 2009 and 2010.

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

		Volatile food prices			Administered prices		
		2009	2010	2011	2009	2010	2011
Current projection	Annual change (%)	-2.8	2.2	4.6	4.3	2.7	2.0
	Contribution to annual CPI inflation (pp)	*-0.2*	*0.2*	*0.3*	*0.8*	*0.5*	*0.4*
Previous projection	Annual change (%)	2.4	3.5	2.6	3.7	2.3	2.4
	Contribution to annual CPI inflation (pp)	*0.2*	*0.3*	*0.2*	*0.7*	*0.4*	*0.5*

The scenario on administered price inflation is built on assumptions concerning the dynamics of energy product prices. Compared to the previous forecasting round, the baseline scenario of the current projection incorporates the expected hike in the heating prices in the final quarter of 2009 and an additional increase in electricity prices in January 2010.

Table 5.3. The scenario for the energy prices growth rates

percent, annual change

	Electricity			Heating			Natural gas		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Current projection	0.2	0.2	0.0	10.1	5.2	1.5	-8.4	0.0	0.0
Previous projection	0.2	0.0	0.0	8.1	5.2	1.5	-8.3	0.0	0.0

The assumptions on the developments in external variables do not differ significantly from those in the previous forecast. The current projection incorporates the scenario of a higher vulnerability of the US currency on financial markets, highlighted by a persistently weaker exchange rate versus the euro. Against the background of improved forecasts on the performance of global economy and, therefore, of an anticipated upturn in the demand for commodities, the current projection takes into account the assumption of a larger increase in the oil price over the following quarters.

Moreover, the forecasts on the economic growth in the euro area were subject to a favourable revision – in the context of the marked decrease in the expected 3-month EURIBOR interest rate over a 2-year horizon[54]. Starting from the present very low readings, the 12-month HICP inflation is seen to enter an upward trend on the projection horizon and then near 2 percent, a level consistent with the ECB's definition of price stability.

Table 5.4. Expectations on the developments in external variables

annual averages

	2009	2010	2011
WTI oil price (USD/barrel)	60.1	72.4	78.7
EUR/USD exchange rate	1.39	1.42	1.38
3-month EURIBOR interest rate (% per annum)	1.25	1.25	2.21
Economic growth in the euro area (%)	-3.9	1.2	1.3
Annual inflation rate in the euro area (%)*	0.4	1.3	1.7

* in Q4

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

In 2009 Q2, the contraction in economic activity manifest since the end of 2008 deepened, with GDP posting a real 8.7 percent drop versus the same year-ago period[55]. The lower GDP reduction in 2009 Q2 than that anticipated within the previous forecasting round brought about a downward revaluation of the negative output gap for this quarter. As concerns 2009 Q3, the economic activity is seen contracting further, albeit at a slower quarterly pace. In view of the analysis of a larger set of statistical indicators, the negative output gap is expected to continue to widen over the third quarter, inducing *ceteris paribus* an intensification of disinflationary pressures from aggregate demand during the next quarters.

The increasing spill-over effects of the global economic crisis on the Romanian economy were also illustrated by the significant contraction in investment, the lower capital flows (with a negative bearing on the retooling of companies in Romania), and the decrease in the pressures previously accumulated on the labour market as a result of labour shedding and higher unemployment rate. Under the circumstances, the assessment of potential GDP growth rate for 2009 points toward a significant decrease as compared to 2008. On the assumption of an improvement in economic agents'

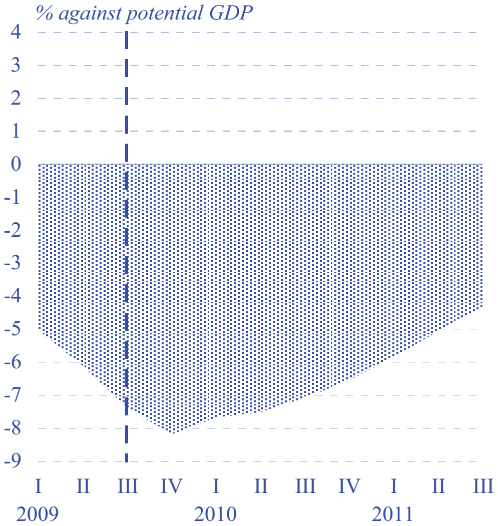
[54] The influence exerted by the other macroeconomic policy mix components on the economic activity should not be overlooked.

[55] Non-seasonally adjusted data provided by the NIS.

perception of the economic outlook and an upturn in investment during 2010, the quarterly growth rates of potential GDP are seen gathering pace versus 2009.

According to the data released by the National Institute of Statistics (NIS), in 2009 Q2, the GDP quarterly growth rate improved significantly as against Q1[56] (seasonally-adjusted data provided by the NIS), yet it remained in negative territory for the fourth quarter in a row. GDP dynamics decelerated considerably quarter on quarter against the background of markedly negative quarterly changes in household actual consumption and gross fixed capital formation. Such declines were offset to a certain extent by the quarterly change in exports, which returned to positive territory (outpacing that of imports), by government actual consumption, as well as by the considerably lower statistical discrepancy and changes in inventories[57]. The further tightening of lending conditions, as illustrated by the relatively high lending rates as well as by the increased prudence of companies amid the unfavourable expectations on future income flows contributed to the steeper fall in domestic demand, whereas the domestic currency depreciation in the previous quarters and the economic stabilisation in partner countries[58] entailed a positive growth rate of net exports.

GDP Deviation



Source: NIS, NBR calculations

In this context, the assessment of the cyclical position of the economy in 2009 Q2 was revised significantly as compared to the previous forecasting round, resulting in a relatively narrower negative output gap. The negative output gap is seen rising in Q3 versus Q2, revealing, *ceteris paribus*, the persistence of high disinflationary pressures of aggregate demand.

In 2009 Q2, total final consumption dropped 2.8 percent quarter on quarter (seasonally-adjusted data provided by the NIS)[59], reflecting the negative dynamics of household actual consumption, whereas the quarterly growth rate of government actual consumption returned to positive territory. In 2009 Q3, household actual consumption is expected to remain unchanged from the prior quarter, and thus further below the trend level considering the

[56] According to seasonally-adjusted data, the quarterly dynamics of GDP stood at -0.1 percent in 2008 Q3, -2.8 percent in 2008 Q4, -4.6 percent in 2009 Q1 and -1.1 percent in 2009 Q2.

[57] The quarterly growth rates of household actual consumption (seasonally-adjusted data) were of -3.2 percent in 2009 Q2 and -0.9 percent in Q1, those of gross fixed capital formation stood at -13.5 percent in Q2 and -7.1 percent in Q1, those of government actual consumption were 4.4 percent in Q2 and -14.7 percent in Q1, those of exports equalled 5.0 percent in Q2 and -8.1 percent in Q1, while those of imports ran at 3.1 percent in Q2 and -14.3 percent in Q1.

[58] In 2009 Q2, the quarterly GDP growth rate in the euro area was -0.2 percent, as compared to the previous quarter’s figure of -2.5 percent (seasonally-adjusted data).

[59] The seasonally-adjusted data point to an annual growth rate of total final consumption of -7.0 percent in 2009 Q2.

uncertainties surrounding future income flows. Such developments are reflected by a higher-than-average unemployment rate[60], the slower growth rate of whole-economy net real wage[61], as well as the persistently negative dynamics of new loans to households[62]. In addition, deposits with an agreed maturity of up to and including two years continued to increase in 2009 Q3, yet their quarterly growth rate was slower than in the first two quarters[63]. Against the background of a severe demand contraction, the supply of goods and services declined sharply as compared to previous quarters, the annual rate of retail turnover (except motor vehicles) remaining strongly negative, whilst its quarterly rate turned slightly positive[64].

In the period under review, the quarterly growth rate of government final consumption returned to positive territory, standing at 4.4 percent (seasonally-adjusted data released by the NIS). In 2009 Q3, this component is expected to record growth rates slightly above the medium-term trend. Public deficit widened further, amid a drop in incomes that reflected the poor economic conditions along with the insufficient adjustment of accrued expenses. The preliminary data available at end-September indicate a 5.1 percent share in GDP of public deficit.

Gross fixed capital formation, together with private consumption, had a significant contribution to the negative GDP dynamics in 2009 Q2, posting a decline from the previous quarter (-13.5 percent, seasonally-adjusted data released by the NIS)[65]. In 2009 Q3, the quarter-on-quarter decline is expected to decelerate on the back of still strong negative annual dynamics.

As regards investment components, equipment fell sharply (52.7 percent) in Q2 year on year, indicating the companies' increased prudence in providing funds for retooling due to the

[60] Unemployment rate (registered unemployment, non-seasonally adjusted data) continued to rise starting with July 2008 (3.7 percent), reaching 6.9 percent in September 2009.

[61] In August 2009, whole-economy net real wage rose 0.4 percent compared to the average for 2008 Q3, as against 2.7 percent in 2009 Q2 versus the same quarter a year earlier.

[62] New consumer loans to households (in both domestic and foreign currency) in 2009 Q3 fell by 70.8 percent in nominal terms as compared to the average for 2008 Q3, versus -73.9 percent in 2009 Q2 as compared to the average for 2008 Q2.

[63] This category includes deposits redeemable at notice with a maturity of up to and including three months. In 2009 Q3, deposits with an agreed maturity of up to and including two years rose 3.8 percent versus the previous three-month period, their quarterly growth rates standing at 21.8 percent and 6.5 percent respectively in 2009 Q1 and Q2.

[64] In the first two months of 2009 Q3, retail turnover (except for motor vehicles and motorcycles) went down 12.7 percent as compared to the average for 2008 Q3, its quarterly growth rate being of 0.7 percent.

[65] In 2009 Q2, the annual dynamics of gross fixed capital formation was -27.6 percent (seasonally-adjusted data provided by the NIS).

economic crisis, which has a negative impact on the growth rate of potential GDP. The strong decline in equipment was also accounted for by the still negative (annual and quarterly) growth rates[66] of imports of capital goods. Moreover, starting with 2009 Q2, new construction works also saw negative growth rates of 9.2 percent. Considering the significant drop in external financing sources, the bias towards domestic bank credit is contained by tight real lending rates, the quarterly growth rate of medium- and long-term loans to companies being only marginally positive[67] in 2009 Q3.

In 2009 Q2, the quarterly dynamics of net exports reverted to a slightly positive level of 0.2 percent, on the back of positive quarterly growth rates recorded by both exports and imports[68], yet it is further below the medium-term figure. In the considered period, behind the positive quarterly dynamics of exports (also reflected by industrial output dynamics[69]) stood most probably the stabilisation of external demand[70], as well as the domestic currency depreciation in previous quarters. The downward trend in imports was affected by narrower domestic demand amid the decline in household incomes, as well as by the domestic currency depreciation in prior quarters.

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

In 2009 Q3, domestic currency evolution was quasi-stable[71], showing a slight appreciation in terms of the effective exchange rate[72] compared to the average recorded in the previous quarter both in nominal and real terms. In quarter-on-quarter comparison, the trajectory of the exchange rate of the leu was less closely related to that of other currencies[73] in the region, which saw stronger

[66] In 2009 Q2, imports of capital goods fell by 56.2 percent (expressed in EUR) as compared to the average for the same year-ago period and by 14.0 percent as against 2009 Q1 (seasonally-adjusted data).

[67] The annual growth rate of medium- and long-term loans to companies stays on a downtrend (-3.9 percent in 2009 Q3 as compared to the average for 2008 Q3), the quarterly dynamics turning slightly positive (2.6 percent in Q3 as compared to the average for 2009 Q2).

[68] See footnote 57.

[69] In Q2, industrial output rose by 1.6 percent versus 2009 Q1 and by 1.4 percent in the first two months of Q3 as compared to the average for 2009 Q2. The positive quarterly dynamics the industrial output of intermediate and capital goods recorded in 2009 Q2, namely 4.4 percent and 12.1 percent respectively, was reflected by the development in exports of intermediate and capital goods, whose quarterly growth rates stood at 0.3 percent and 14.8 percent respectively in Q2 (seasonally-adjusted data released by the NIS).

[70] See footnote 58.

[71] For further details on developments in the leu exchange rate in Q3, see Chapter IV, Subsection 2.2. *Exchange rate and capital flows*.

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

[73] Hungarian forint, Czech crown and Polish zloty.

appreciation accompanied by higher volatility. The developments in the exchange rates of Central and Eastern European countries' currencies were due also to the improvement in financial investors' sentiment towards the economies in this region, spurred by positive data on economic activity in countries such as Germany, France, the Czech Republic and Poland[74].

Over the reported period, the real effective exchange rate of the domestic currency exerted via the net export channel a stimulative impact on future aggregate demand, albeit slightly weaker than in the previous quarter. On the other hand, through the wealth and balance sheet effects, the impact of the exchange rate was slightly restrictive. The net effect of the exchange rate on future aggregate demand via the two aforementioned channels is deemed to be stimulative, though to a lesser extent than in the prior quarter. Thus, via the aggregate demand channel, *ceteris paribus*, the domestic currency further mitigated the disinflationary pressures. In 2009 Q3, the slight appreciation of the leu in nominal terms against 2009 Q2 had a direct positive impact on the developments in prices of imported goods, thereby acting, *ceteris paribus*, towards a decrease in the CPI inflation rate.

During 2009 Q3, the NBR remained a creditor vis-à-vis the banking system and accommodated the liquidity shortage on the interbank money market via liquidity-providing operations (mainly repo operations).

Over the period under review, the overnight ROBOR stayed on a trajectory close to that of the policy rate, reflecting the efficient transmission of the cuts in NBR's interest rate and in minimum reserve requirement ratios on both leu and foreign currency-denominated liabilities. The developments in nominal lending and deposit rates applicable to bank clients point to an asymmetrical transmission of developments in interbank rates with the decline in deposit rates being steeper than that in lending rates. This latter fact reflects, on the one hand, a moderation in the competition among banks to attract domestic resources against the background of improving liquidity conditions and, on the other hand, commercial banks' persistently high degree of caution in lending to non-bank clients.

Overall, nominal lending and deposit rate cuts applied by credit institutions to their non-bank clients in Q3 were broader compared to inflation expectations, thus dampening the restrictive impact exerted by these interest rates on economic activity over the next quarters.

[74] These countries recorded positive quarterly growth rates of GDP in Q2 (seasonally-adjusted data).

For 2009 Q3, the cumulated effect of the leu exchange rate and of credit institutions' interest rates applicable to non-bank clients on future economic activity is estimated to be neutral.

1.3.3. Demand pressures within the projection horizon

Compared to the previous round, GDP deviation from the trend level remains broadly unchanged throughout the projection horizon due to some relatively less sizeable revisions of the expected developments of major determinants: economic growth in the euro area, broad monetary conditions and fiscal policy stance[75]. The cumulative impact of these factors is responsible for the negative output gap throughout the projection horizon, which translates into persistent ample disinflationary pressures from aggregate demand[76].

The scenario for economic growth in the euro area was favourably revised for the entire projection horizon given the increasing number of signals that might be indicative of recession bottoming out and of a faster economic recovery of leading euro area economies[77]. However, the contribution of external demand to the deviation of Romania's exports from the trend level appears to remain restrictive until the end of the following year, albeit on the wane compared to the previous round. The persistence of a favourable effect exerted by the real exchange rate on exports, concurrently with a large deceleration in imports, is expected to lead to a substantial and persistent adjustment of trade deficit in the current year.

During the projection horizon, monetary policy impulses will contribute to the adjustment of real monetary conditions in line with the progress in disinflation and the dynamics of the output gap. The expansionary effect of real broad monetary conditions will increase gradually underpinned by declining real interest rates and the ongoing favourable impact of the real exchange rate.

The speed and magnitude of the cut in real interest rates also hinge on factors such as the dynamics of inflation expectations and the manner in which commercial banks will choose to respond to

[75] Although the information available prior to the final macroeconomic projection did not suggest, compared with the August 2009 Inflation Report, a significant reassessment of the coordinates of the GDP cyclical component, a more in-depth analysis of their potential developments during the projection horizon, updated in line with the latest developments, is presented in Subsection 1.4. *Risks associated with the projection*.

[76] In the absence of adverse supply-side shocks (i.e. higher excise duties, higher prices for oil or other commodities, etc.), the existence of a negative output gap of such proportion might entail much more sustained disinflation dynamics.

[77] In 2009 Q2, Germany and France posted positive real GDP growth rates (seasonally-adjusted data) for the first time since the onset of the global financial and economic crisis. See also footnote 74.

monetary policy signals. For the time being, some of the distortions relative to interest rates applied by commercial banks may be attributed to the persistent impact of the financial crisis which caused a constant widening of the spread between lending and deposit rates[78]. Therefore, taking into account all the determinants, real lending and deposit rates are expected to become stimulative for aggregate demand starting with 2010 H2.

The further fulfilment of the obligations assumed under an IMF-EU-IFI-led multilateral financial arrangement may mitigate both foreign investors' risk perception towards Romania and the exchange rate volatility. In terms of the impact on companies' wealth and balance sheet, such a development is expected to have a positive contribution to external demand dynamics, also via the channel of restoring confidence in the economy.

As regards aggregate demand components, net exports are envisaged to be the largest contributor to the narrowing of the negative output gap throughout the projection horizon. Public consumption will have only a marginal contribution to this development. The contributions of gross fixed capital formation and private consumption are projected to remain in negative territory. However, the pace of increase in investment towards the equilibrium level is expected to be much faster than that of consumption. As a result, investment and net exports will be the drivers of economic rebound during the projection horizon.

The configuration of the fiscal stance scenario took into account the constraints stipulated in the IMF-EU-IFI-led multilateral financial arrangement as well as the latest data available. The shift in the cyclical position of the economy (measured by output gap dynamics) in 2009 compared to 2008 and the fiscal adjustment in 2010 are the main factors underlying a negative fiscal impulse and therefore a pro-cyclical conduct of fiscal policy[79], a slight reversal being expected for 2011.

[78] The wider spread between lending and deposit rates stems mainly from the increased downward rigidity of lending rates, as commercial banks appear to manifest high aversion to risk and external financing has diminished. Moreover, the persistence of a positive spread between money market interest rates and the policy rate also contribute to fostering the downward rigidity of lending and deposit rates. The baseline scenario envisages a gradual narrowing, at different speed, of the two said spreads (the spread between lending and deposit rates is expected to be more persistent), which should lead to an adequate adjustment of real monetary conditions.

[79] However, it is necessary in terms of fiscal consolidation.

1.4. Risks associated with the projection

The baseline scenario described in the previous sections encompasses the projections with the highest likelihood of materializing over the upcoming eight quarters, based on the set of information currently available. The high degree of uncertainty surrounding the future trajectories of macroeconomic variables requires an in-depth analysis of the risks to inflation and economic activity. This section details the specific risk factors deemed to be particularly relevant over the current projection horizon. The analysis of risks associated with the current forecast indicates that upside risks to inflation appear to be somewhat higher than downside risks, particularly over the short term (over a similar horizon, risks to developments in economic activity are deemed as slightly tilted to the downside). Although it appears slightly tilted especially over the first part of the projection horizon, the balance of risks to inflation and economic activity in the baseline scenario will regain relative equilibrium over the medium term, following the anticipated return of the macroeconomic policy mix under a more efficient coordination.

The unstable political field over the past weeks may entail fiscal and income policy slippages at least in the near run. Under the circumstances, the risk of a substantial slippage from the budget deficit targets agreed under the multilateral external financial arrangement with international institutions should not be overlooked, as it may result in the delayed adoption of the required structural reforms. The materialization of this risk cannot be ruled out even assuming the rigorous implementing of the corrective measures agreed with IFIs, in a scenario of less favourable macroeconomic developments[80]. Any delay in correcting the previously-accumulated slippages would lead to a suboptimal coordination of macroeconomic policies over the first part of the projection horizon, likely to fuel expectations of a weaker leu, with self-fulfilling effects on both the exchange rate and inflation, amid worsening fundamentals. In addition, the need for financing resources aimed at bridging excessive budget deficits calls either for resorting to a larger extent to the domestic market, which could

[80] A major source of uncertainty stems from the impossibility of determining the extent to which aggregate supply economy-wide will further be eroded by the latent effects of the economic crisis, with a potential impact on the capacity to collect budget revenues. For instance, the number of companies reducing or ceasing their activity is likely to rise even further during the forecast period, while lending terms and standards – which have become increasingly tighter – are likely to have a stronger negative impact on corporate business. Furthermore, labour supply across the economy is likely to be hit by rising unemployment, which may stick to high values over a longer period. In addition, the outlook for a considerable slowdown in wage dynamics might have a major detrimental impact on social security contributions and direct taxes (i.e. the categories holding the largest share in total budget revenues) collected by the government.

lead to the crowding-out[81] of the private sector[82], or for the adoption of compensating measures[83], required in order to boost budget revenues. In either case, the projected dynamics of economic activity would be subject to a significant downward revision compared to the baseline scenario coordinates, particularly in the first part of the projection horizon. However, the balance of risks to economic activity is expected to regain relative equilibrium over the medium term, following the anticipated gradual fulfilment by the macroeconomic policy mix components of the commitments under the multilateral external financing arrangement with the EU, the IMF and other IFIs.

Signs of a rebound in global economic activity have emerged over the recent period. However, it is still too early to anticipate whether these recent developments will lead to a sustained and fast-paced recovery of economic activity worldwide or the knock-on effects from the global financial crisis will linger on and thus entail a slower upturn. On the one hand, a faster rebound in domestic economic activity compared to the baseline scenario is possible assuming more favourable developments in external demand for Romanian products. The risks implied by such a scenario refer to slower disinflation on account of pressures induced by the revival of aggregate demand and the impact of rising external inflation on import prices on the domestic market. On the other hand, even assuming the elimination – to a significant extent – of liquidity constraints on international financial markets, both financial institutions and investors may still display a relatively high risk aversion and hence contribute to maintaining global economic activity at a rather subdued level. Under these circumstances, assuming a weaker external demand for Romanian products, domestic economic growth might witness a slower revival than anticipated in the baseline scenario of the projection, thus exerting additional disinflationary pressures.

The uncertainties surrounding the time span required by the global economy to recover and the magnitude of this process are closely linked to developments in oil and other commodity prices on international markets over the projection horizon. The projected oil

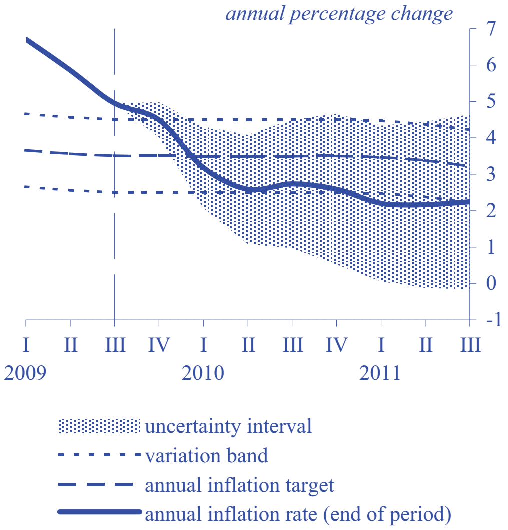
[81] The unfavourable impact exerted by this process is expected to augment as economic growth re-enters positive territory.

[82] The share of credit to the public sector in total domestic credit advanced from 9.56 percent in January 2009 to 17.78 percent in September 2009.

[83] On the income side, the solutions for bridging the budget deficit include raising certain categories of taxes and levies, streamlining the collection thereof or changing the taxation base. In terms of higher taxes, corrective measures could for instance refer to an increase in VAT (such a solution has recently been adopted in Germany, Hungary, and the Baltic States – Latvia, Lithuania and Estonia). The measure is expected to have an immediate detrimental impact on CPI inflation. Moreover, higher VAT will most likely have second-round effects both on inflation expectations, thus delaying the convergence of annual CPI inflation to the central target, and on economic activity, due to the necessary response on the part of monetary policy aimed at mitigating the risks of inflation slippages.

prices[84] and hence fuel prices may witness a further hike in the event of a strong rebound in global demand at a faster-than-anticipated pace. On the other hand, the protracted negative impact of the global financial crisis could generate opposite effects in relation to developments in such prices.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR calculations

Similarly to previous projections, a relevant risk relates to developments in administered prices, since their adjustment calendar to the levels agreed with the EU has seen repeated changes over the past projection rounds. Given that such changes may incorporate either upward or downward movements, 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.

The chart illustrates the risks of upward or downward deviations of inflation from the trajectory set in the baseline scenario. The uncertainty interval around the central projection of inflation in the baseline scenario quantifies the average value of possible deviations of the inflation outcome in both directions from the trajectory set in the baseline scenario, under the impact of general risk factors that are not explicitly identified. In order to illustrate the rising uncertainty over time, the size of the uncertainty interval widens as it encompasses more distant time horizons. The uncertainty concerning these general risk factors is based on past CPI inflation forecasting errors[85].

2. Policy assessment

In the context of the current quarterly medium-term forecasting round and of drafting the November 2009 Inflation Report, the NBR Board took the necessary steps to substantiate and set, in consultation with the government, the 2011 inflation target. Following the assessment of the projection scenarios, as well as the risks and uncertainties surrounding the updated forecast of macroeconomic indicators, the decision was taken to set the end-2011 inflation target at 3.0 percent ±1 percentage point.

The option for a sharper downtrend in annual inflation targets relies largely on the outlook for the annual inflation rate, which is projected to fall close to the lower bound of the variation band around the central target set for end-2010 (3.5 percent ±1 percentage point), due to the severe contraction of the Romanian economy following the global financial and economic crisis. Another major argument is the target's capacity to fulfil the requirement of consolidating disinflation and ensuring achievement of the inflation

[84] The share of this inflation item in the consumer basket stands at 6.8 percent.

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

criterion laid down in the Maastricht Treaty in a manner consistent with the timetable for euro adoption, as well as the subsequent compliance with the European Central Bank's quantitative definition of price stability.

At the same time, the option for a 3.0 percent inflation target in 2011 reflects the National Bank of Romania's concern to set realistic goals, the achievement of which is essential for enhancing central bank credibility and, implicitly, for effectively anchoring medium-term inflation expectations. In the given context, maintaining a prudent approach regarding the reduction step for the 2011 target is substantiated by the risks and uncertainties surrounding the magnitude of direct inflationary effects exerted by factors outside the central bank's sphere of influence, the most significant being: (i) adjustment of administered prices; (ii) resumption of convergence of the Romanian economy, including price convergence after the synchronised economic downturn is over; and (iii) the persistence of some asymmetric nominal rigidities.

According to the current analysis, the third quarter of 2009 saw a consolidation of disinflation, with annual inflation rate reaching in September 4.94 percent, slightly below the figure published in the August 2009 Inflation Report. Behind the 0.92 percentage point drop in third-quarter inflation rate stood both supply-side factors, i.e. the slower annual dynamics of administered prices and volatile prices, and effects, albeit less pronounced, of a widening output gap. Against this background, the deviation of the annual inflation rate against the upper bound of the variation band around the central target dropped to a 24-month low in September 2009, and may well be eliminated in the final quarter of the year.

Such outlook is confirmed by the updated scenario of the forecast on medium-term macroeconomic developments showing an annual inflation rate of 4.5 percent at year-end. Compared to the previous forecasting round, the projected pace of disinflation in 2009 Q4 is however somewhat slower – the key explanation lies with the relative increase in the ex-ante inflationary impact of the hike in excise duties on tobacco products starting 1 January 2010. Because of the influence of larger excise adjustments, the forecasted annual inflation rate will follow a higher-than-previously-expected path in the first three quarters of next year. Nevertheless, this indicator is seen dropping into the lower half of the variation band around the central target as early as 2010 Q1, according to a pattern similar to that incorporated in the previous projection. In addition, over the second part of the medium-term horizon, the inflation outlook improves compared to the previous forecasting round.

The significant pick-up in forecasted disinflation during 2010-2011 is due chiefly to the magnitude of the estimated aggregate demand gap in 2009 and to the prospects of its persisting into the following quarters – its size, however, is seen diminishing gradually, including as a result of a reduction in potential GDP. The expected negative deviation of the GDP from its potential level remains high in 2009, although it was somewhat adjusted downwards in the current projection, in line with the slightly downward revision of the projected scale of this year's economic downturn. Accordingly, the pace of economic recovery in 2010 is expected to be marginally slower than in the previous forecast, but faster in the course of 2011.

The main prerequisites and signs of the relative mitigation, compared to the previous forecasting rounds, of the magnitude of the projected economic decline in 2009 are the following: (i) slightly lower-than-expected contraction of the Romanian economy in 2009 Q2; (ii) stabilisation of economic activity at global level and the budding recovery in the leading European economies; (iii) slowdown and even halt in the downtrend in activity over the first months of Q3 across key sectors in terms of consumer and investment demand (retail trade, construction works), though this could prove only temporary; (iv) further positive, albeit weakening, annual dynamics of the average net real wage; and (v) ongoing reduction in the negative annual growth rate of industrial production during the first part of Q3.

From the perspective of current macroeconomic developments and those anticipated in the near run, a main concern for the National Bank of Romania continues to be the persistence, in the period ahead, of the lag between the overly slow deceleration in core inflation, on the one hand, and the magnitude and speed of deepening of the negative output gap, on the other hand. It is assumed that, apart from the pass-through of the leu exchange rate movements and the structural rigidities on labour and product markets, inflation expectations are still accountable, to a large extent, for such a behaviour of core inflation.

Under the circumstances, retaining a prudent monetary policy conduct aimed to firmly anchor these expectations is essential for dampening the persistence of inflation in the medium and long term. In the current context, such an attitude is also required by (i) the worsening of foreign investors' perception regarding the Romanian economy amid heightened tensions in the domestic political field, (ii) the possible underestimation of the ex-ante impact on inflation caused by higher excise duties on tobacco products as from 1 January 2010, posing the risk of a halt in disinflation and of the annual inflation rate exceeding the upper bound of the variation band around the central target of 3.5 percent ±1 percentage point set for next December, and (iii) the threat, albeit minor currently, that the announced increases in other excises at the onset of 2010 and possibly other indirect taxes might trigger second-round effects.

In order to be effective in countering the persistence of inflation over a longer horizon, monetary policy actions should however be backed by a relative tighter stance of fiscal and income policies, which implies the rebalancing the macroeconomic policy mix, and by the implementation of consistent structural reform measures. Over the short term, the persistence of inflation might also be eroded by a possible change in the wage and retail price setting behaviour in response to the sharp downturn in first-half GDP and to the delayed emergence of clear signs of a trend reversal. Should these assumptions materialise, the current constraints on monetary policy implementation could diminish, thereby allowing monetary policy conduct to be gradually adjusted to the perspective of an annual inflation rate close to the lower bound of the variation band around the central target set for December 2010, which would derive largely from the magnitude and extended persistence of the negative output gap.

Against this background, another major concern of the central bank is the broad-based adjustment of the Romanian economy in the aftermath of the impact of the global financial and economic crisis. Compared to other countries in the EU or in the region, the relatively sharper economic contraction is largely attributable to the overheating tendency and deepening of the domestic and external imbalances that had characterised the Romanian economy in the pre-crisis period. The key evidence on the large-scale adjustment of the economy is the faster-than-expected pace and magnitude of the contraction in the current account deficit seen of late, reflecting mostly the substantial reduction in domestic demand, implicitly in demand for imports. Together with the recent protraction of the sharp descending trend in investment, these developments could dampen the economy's growth potential over the years ahead; however, the decline could be contained by the likely resumption of growth starting from a real GDP only slightly below that recorded in 2007.

The chief contributor to bringing the downturn of the Romanian economy to a halt and to returning to ever lower negative annual growth rates followed by positive rates of increase, is expected to be the favourable performance of industrialised countries, euro area members in particular. The sustainability of the slowing of the latter economies' decline and the pace of potential future growth are still questionable, owing largely to the uncertainties regarding the duration of implemented government stimulus packages.

Adding to these is the difficulty to estimate the time lag associated with the domestic economy's recovery in response to that of advanced economies, especially European ones. Nonetheless, this is expected not to exceed significantly the lag with which the outbreak and subsequent deepening of the global economic downturn has spilled over to the domestic economy. From this perspective and in view of the recent evolution of some key indicators on domestic demand, the likelihood that the Romanian economy has bottomed out in 2009 Q3 is relatively high.

A major role in slowing down the economic decline, and even in its likely halt, has recently been played by the noticeable reduction in the negative dynamics of exports and, implicitly, of industrial production. This also reflects to some extent the favourable influence of stimulus packages implemented by certain EU Member States to foster consumption. Also from this viewpoint, the effects of the future potential revival in Europe's economies are anticipated to affect the Romanian economy primarily via the rebound in exports. Against the background of the expected gradual recovery in external demand, a stimulative impact on exports could be the result of the accumulated past depreciation of the leu versus the major currencies. In turn, the rebound in exports could act as an incentive on other components of domestic demand and supply, thereby having a decisive contribution, albeit with a relative lag, to the resumption of economic expansion.

The sustainable return of the Romanian economy to positive growth is also conditional upon the future developments in external financing, but there are still great uncertainties surrounding the volume and attached costs of such financing. From this perspective, the recent steeper downtrend in foreign direct investment and the delayed emergence of signs on an improvement in the behaviour of external financial borrowings are a matter of concern. All this reflects, most likely, the sluggish recovery of foreign investor confidence in the outlook for the global real sector, and implicitly the outlook for Romania, as well as lingering concern of the foreign banking sector regarding the quality of its own portfolio and the related capitalisation needs.

The same pro-cyclical attitude appears to be a feature of the local banking sector. A positive signal however should be the slightly upward trend in new loans[86] – to companies and households – and

[86] Data supplied by CCR.

the recent rise in the housing loan stock, which could be related to the implementation of the “First Home” programme. The rebound in credit to the private sector is however foreseen to proceed slowly, being contingent upon the decrease in banks’ mistrust in the short-term economic outlook and the risk perception regarding corporate and household loans, on the one hand, and the gradual restoration of demand for loans, on the other hand. Nevertheless, corporate resort to bank credit could be spurred in the period ahead by the potential easing of credit institutions’ lending conditions, which started also in response to the recent consolidation of the policy rate’s downward path and the past cuts in minimum reserve ratios on credit institutions’ leu- and foreign-currency-denominated liabilities. Yet, the decline in lending rates – also beneficial in terms of the wealth and balance sheet effect and implicitly of credit institutions’ loan portfolios – appears set to be slower and more modest than in the case of banks’ reductions in deposit rates. In addition, downward adjustments in bank interest rates could be slowed down over the short term by the potential persistence of the recently-shaped spread between interbank rates and the policy rate.

In this context, the domestic demand outlook is still afflicted by severe uncertainties, also beset by the heterogeneous nature of developments in some leading indicators. Thus, although private consumption is the first component of domestic absorption, the decline of which appears to have ceased, the consumer confidence indicator keeps deteriorating, contrariwise to most other indicators reflecting expectations of the business environment. In addition, the relatively marked propensity for saving might carry on, given households’ ongoing fears concerning: (i) their jobs, (ii) future developments in incomes, which have declined lately, and (iii) their capacity of servicing borrowings.

By contrast, the recent change in confidence indicators of the business environment hints at a possible future improvement in investment – a desirable thing from the viewpoint of the need to alter the growth pattern –, although until recently the downturn in this domestic demand component kept deepening, at least in construction. It is still very uncertain when the turning point will occur, given mainly the ongoing deterioration of companies’ profitability and sales outlook, as well as the incomplete downward adjustment of the real-estate market; against this background, a possible protraction of companies’ resort to shorter working hours, wage cuts and, ultimately, layoffs is foreseen. Investment could however be spurred somewhat by the implementation of the “First Home” programme and the potential increases in: (i) public investment spending, (ii) the volume of absorbed EU funds and

(iii) the resources taken from international financial institutions and bodies, as assumed by the authorities under the budgetary programme and arrangements signed earlier this year.

From the perspective of budget execution January through September 2009, an increase in public investment in the run-up to the year-end is however unlikely. The explanation lies with the insufficient adjustment of public wages, when judged in the context of the requirements to keep the budget deficit no higher than 7.3 percent of GDP and those to continue the correction of macroeconomic imbalances. Over the short term, such an inefficient public expenditure composition might delay the return of growth to positive territory and fuel unfavourable inflation expectations. Over the medium term, the likelihood of further pursuing such a public spending policy would only perpetuate the growth pattern generating macroeconomic imbalances, and implicitly inflation, by weakening the capacity of restoring the potential output and relatively spurring consumption and imports.

Another risk to disinflation, as illustrated by recent budget performance, is a higher-than-programmed public deficit, assuming the public expenditure dynamics over January-September persists and even gather pace as a result of the election run-up in Q4; adding to this is the risk of delaying the start of fiscal consolidation scheduled for 2010 and 2011, owing to the uncertainties surrounding the current strains in the political field. Should these risks materialise, the difficulties and the costs attached to financing/refinancing of public deficit and respectively public debt would increase; this could also occur as a result of a possible disruption of the ongoing financing agreements signed with international financial institutions. At the same time, a potential deterioration in the perceptions of the domestic and external financial and economic environment concerning the outlook for the Romanian economy might fuel the depreciation pressures on the leu – recently intensified by the worsening investor sentiment with regard to the economies in the region – and implicitly inflation expectations.

In the short-run, there are prospects of inflationary pressures, due to an anticipated upward adjustment of excise duties starting with 1 January 2010, as well as of an unfavourable impact on expectations coming from heightened risks related to fiscal and income policies, given the volatile political climate. Therefore, the NBR Board has decided, in its meeting on 3 November 2009, to leave the monetary policy rate unchanged at 8.0 percent per annum. Moreover, the Board decided to ensure a firm management of liquidity in the banking sector in order to consolidate the transmission of monetary policy signals and warrant a return of the interbank rates in the vicinity of the monetary policy rate, as well as to maintain the existing level of minimum reserve requirements ratios on both leu- and foreign currency-denominated liabilities of credit institutions. Against this background, the Board reiterated the need that the central bank's ongoing sustained efforts aimed at effectively anchoring inflation expectations and implicitly countering the persistence of core inflation should be backed by a rapid fulfilment by the other components in the macroeconomic policy mix and structural reforms of the commitments under the multilateral external financing arrangement with the EU, the IMF and other international financial institutions.