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NOTE

*The National Institute of Statistics, Ministry of Public Finance,
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and National Bank of Romania supplied data.*

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

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

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Foreword

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

To this end, the National Bank of Romania revised both the structure and the frequency of its *Inflation Report*, which has become a quarterly publication in accordance with the frequency of the forecast cycle. In addition to the information on economic and monetary developments, as well as 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 policy assessment.

The analysis in the *Inflation Report* is based upon the latest statistical data available at the time of drafting. Consequently, the reference periods of indicators used herein may vary.

This issue of the *Inflation Report* was completed on 2 February 2010 and approved by the NBR Board in its meeting of 3 February 2010.

All issues of this publication are available both in hard copy and 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
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

At end-2009, the 12-month CPI inflation rate went down to 4.74 percent, i.e. 0.24 percentage points above the upper limit of the 3.5 ± 1 percent variation band and 0.2 percentage points below the September reading of 4.94 percent. The persistent negative GDP gap and the leu exchange rate dynamics were conducive to the decline in consumer price inflation. Nevertheless, their contribution was largely offset by the adverse impact of supply-side factors, and particularly by the hikes in excise duties on tobacco products.

Throughout 2009, the prices of tobacco products contributed by more than one third to the annual expansion in consumer prices, following the successive increases in excise duties. In 2009 Q4, the rapid rise in such prices was generated by producers' earlier incorporation into prices of the new exchange rate that was to be used, starting January 2010, for calculating excise duties (the increase in the EUR-denominated excise duty is estimated to be incorporated in consumer prices at the beginning of 2010).

By contrast, the annual dynamics of adjusted CORE2 inflation¹, which responds more accurately to aggregate demand management, decreased September through December 2009 by 1.4 percentage points to 2.8 percent². Behind the deceleration in adjusted CORE2 inflation stood the disinflationary pressures arising from falling demand, softer depreciation of the domestic currency in annual terms, absence of negative supply-side shocks from the agricultural sector in 2009 and diminishing inflationary pressures from wage costs.

In 2009 Q4, the annual dynamics of inflation rate continued to incorporate the favourable influence from slower growth rates of food prices and the relatively moderate evolution in administered prices. A significant contribution to disinflation was borne by volatile prices of some food items, whose annual growth rates were negative in 2009 Q4. By contrast, inflation was markedly fuelled by the significantly faster annual dynamics of fuel prices, owing to both the quarter-on-quarter rise in the international oil price and a large base effect.

The annual pace of increase of economy-wide average real net wages reported negative readings in late 2009, in line with the widening mismatch between demand and supply on the labour market. As a consequence, the signals pointing to the alleviation of inflationary pressures from wage costs became stronger. In industry, this trend was more pronounced, with the annual negative change of unit labour costs speeding up markedly during this period. Nevertheless, in some industrial sub-sectors, developments were opposite to those reported for the industrial sector as a whole.

In 2009 Q3, the economic downturn deepened. However, the annual pace of real GDP contraction was significantly slower than in the preceding quarter, reaching -7.1 percent against -8.7 percent. This evolution was supported by most economic sectors, except construction where the rate of decline accelerated. At the same time, the gap between the quarterly growth

¹ Total CPI excluding the following groups: administered prices, volatile prices (of fruit, vegetables, eggs, and fuels), tobacco prices and alcoholic beverage prices.

² NBR calculations.

rate of third-quarter GDP and that estimated for potential GDP indicated the persistence of demand shortage and, implicitly, ongoing disinflationary pressures.

Behind the slowing downtrend of real GDP in 2009 Q3 stood the relative reduction in the negative contribution of domestic demand to GDP formation, whereas the positive contribution of net exports marginally decreased. Nevertheless, the prevailing influence on the slower fall in domestic demand came from the substantial inventory build-up (largely a residual position), while the moderation in the negative dynamics of final consumption was only marginal and the annual rate of decline of gross fixed capital formation was stronger quarter on quarter. The protracted decline in both GDP components was due to the further compression of financing resources available to households and corporations, as well as to prudence in incurring consumption and investment expenditures given the still uncertain outlook for their income flows. In 2009 Q3, the decline in imports slowed down markedly, while the annual dynamics of exports returned to positive territory, reflecting the improvement in external demand.

Monetary policy since the release of the previous Inflation Report

On November 3, 2009, the Board of the National Bank of Romania decided to leave the monetary policy rate unchanged at 8.0 percent per annum. Against the background of a temporary standstill in disinflation, the decision was motivated by expectations of additional inflationary pressures exerted, over the short term, by the anticipated upward adjustment of excise duties on tobacco products starting with January 1, 2010 as well as by the adverse impact on inflation expectations arising from heightened risks related to income and fiscal policies given the volatile political climate. In the same meeting, the Board decided to 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.

On November 16, 2009, the Board of the National Bank of Romania held a special meeting to assess the macroeconomic implications of the delay in the external borrowing calendar for the fourth quarter of 2009 under the multilateral arrangement signed by Romania with the EU, the IMF and other international financial institutions. Given the postponed external inflows, adequate liquidity conditions in the banking system were required in order to ensure a proper financing of the government sector borrowing needs from domestic market resources in the last part of 2009, while preserving macroeconomic equilibria. Therefore, the Board decided to lower the minimum reserve ratio on credit institutions' foreign currency-denominated liabilities with a residual maturity of up to two years down to 25 percent, from 30 percent.

Subsequent to the monetary policy decisions taken in November, statistical data confirmed that the risks related to the strong inflationary impact of the hike in excise duties on tobacco products materialised, as anticipated by the central bank. This contributed, in November, to a temporary halt in the downward trend in annual CORE2 inflation and the CPI inflation rates.

At the same time, the release of third-quarter GDP data pointed to the ongoing contraction in the economic activity. Nevertheless, the decline of seasonally-unadjusted GDP series slowed down noticeably compared to the previous quarter in terms of both quarterly and annual dynamics. Although the slowdown hinted at the economic contraction possibly bottoming out, the fourth-quarter developments in various leading indicators of economic activity dynamics were mixed, thereby suggesting a small likelihood of the resumption of economic growth in 2009 Q4.

In December 2009, domestic political tensions began alleviating once the Parliament approved the new cabinet, thus paving the way for a reactivation of the multilateral external financing

arrangement signed with the EU, the IMF and other international financial institutions. This brought about a reassessment of the risks of macroeconomic policy slippages, thereby boosting foreign investors' sentiment regarding the outlook for the Romanian economy, as reflected by the appreciation trend of the leu that began in the run-up to year-end.

The lower likelihood of sizeable depreciation pressures on the domestic currency in the short term compared with those registered in 2009, in conjunction with the anticipated fading, after 2010 Q1, of the effects induced by the inflation shock coming from the increases in excise duties indicated a more favourable outlook for the consolidation of disinflation. In view of such prospects, on January 5, 2010, the Board of the National Bank of Romania decided to lower the monetary policy rate to 7.5 percent per annum from 8.0 percent.

Inflation outlook

Similarly to the previous projection, the updated baseline scenario foresees a macroeconomic environment in which GDP remains below its potential level over the entire forecast horizon, implying persistent disinflationary pressures. However, the negative output gap is forecasted to narrow gradually, prompting economic growth to return to positive territory in 2010 and to gather momentum in 2011. The considerable reduction in the balance-of-payments current account deficit in 2009 caused the external balance to adjust close to a potentially sustainable medium-term level that could foster a lasting rebound in economic activity free of significant inflationary pressures stemming from leu exchange rate corrections. Maintaining this equilibrium is strictly conditional upon the implementation of a coherent set of macroeconomic policies; the adequate policy mix was defined under the multilateral external financing arrangement signed in 2009 by the Romanian government and the central bank, on the one hand, and the EU, the IMF and other international financial institutions, on the other hand. The arrangement was reactivated and updated in January 2010. Provided this programme is implemented consistently, the risks of macroeconomic variables deviating from the projected trajectories relate mainly to developments in the external environment and are assessed to be relatively symmetrically distributed around the baseline scenario coordinates.

The current projection indicates the continuation of disinflation, placing annual CPI inflation at 3.5 percent for end-2010 and 2.7 percent for end-2011. CPI inflation is expected to return inside the variation band around the central targets, i.e. 3.5 percent in 2010 and 3.0 percent in 2011, as early as the first part of the current year.

The upward revision of the end-2010 CPI inflation forecast is largely attributed to reassessing as more unfavourable the projected effects of exogenous and supply-side factors, mainly due to estimates of a stronger-than-previously-forecasted inflationary impact of the hike in excise duties on tobacco products on 1 January 2010 and the projection of higher increases in administered prices. Similar, albeit less significant, influences are due to higher projected rises in fuel prices and some volatile food prices.

For 2010, the current projection envisages the path of CORE2 inflation rate running above that presented in the previous forecasting round, especially due to the additional first-quarter effect of the adjustment of excise duties on tobacco products, as well as a slightly lower negative output gap projected for the current year. Nevertheless, while being projected to gradually decline starting with 2010 Q2, the sizeable negative output gap is expected to continue to exert disinflationary pressures over the entire forecast horizon. Such pressures will induce a consolidation in the decrease of adjusted CORE2 inflation in 2010, which will benefit also from

moderate import price dynamics in the absence of inflationary pressures similar in magnitude to those exerted in 2009 by the leu exchange rate.

It is anticipated that the projected decline in CORE2 inflation rate below that of headline inflation starting with 2010 Q2 will support the gradual anchoring of inflation expectations at levels compatible with the established targets and thus foster the disinflation process over the entire projection horizon.

For 2011, the current projection anticipates a consumer price inflation trajectory largely in line with that presented in the previous Inflation Report. A marginally unfavourable contribution will be generated towards the end of the projection horizon by the incorporation of higher increases in administered prices into the current baseline scenario. The annual CORE2 inflation is foreseen to fall rapidly in early 2011, particularly as a result of a strong base effect expected in Q1. The downward trend will reverse towards the end of the period under review, in line with the gradual fading of disinflationary pressures from the negative output gap and the influence of an acceleration of the euro area inflation rate on imported goods prices.

The monetary policy stance will remain prudent, aiming to alleviate potential second-round effects of adverse exogenous shocks such as those at end-2009 and those expected for 2010 Q1. Throughout the projection horizon, the central bank will pro-actively seek to ensure a balanced adjustment of real broad monetary conditions with a view to consolidating the prospects of both inflation returning in the vicinity of the established medium-term targets and sustainable revival of lending in the Romanian economy. The fulfilment of these objectives is strictly conditional upon the other elements of the macroeconomic policy mix complying with the updated coordinates of the multilateral external financing arrangement signed by Romania with the EU, the IMF and other international financial institutions, on the one hand, and the absence of any significant deviations from the forecast assumptions regarding the impact of exogenous factors and external developments, on the other hand.

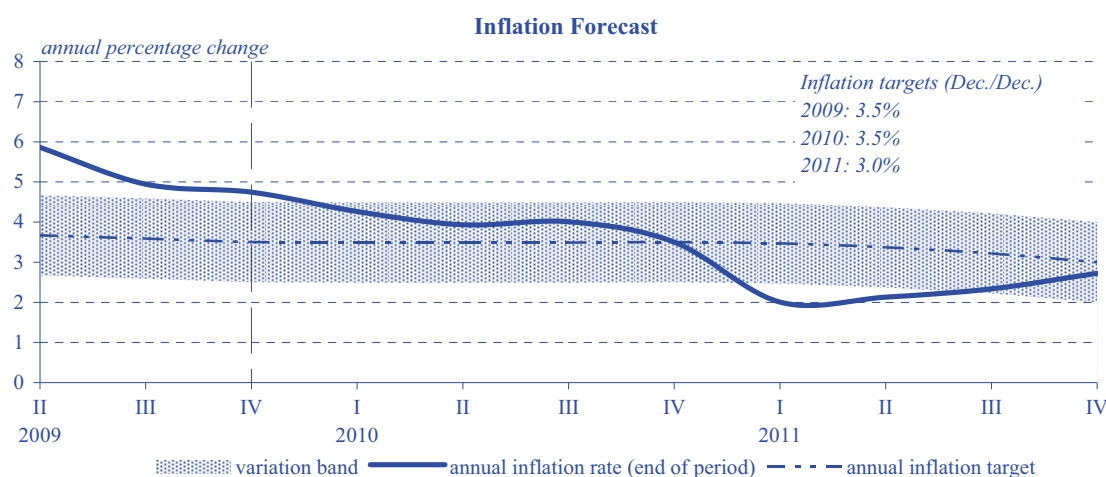
Against the background of persistently high uncertainties surrounding the macroeconomic developments both domestically and internationally over the current projection horizon, the overall risks of inflation rate deviating from the baseline scenario trajectory appear to be relatively balanced. Compared with the assessment in the previous forecast, the current one foresees relatively lower risks posed by possible slippages in the coordination and implementation of the macroeconomic policy mix, although such risks have not yet dissipated altogether. The present revision relies on the stabilisation over the past months of the domestic political climate, in the absence of a deterioration of the macroeconomic environment, and the reactivation of the multilateral external financing arrangement in January. Although the risks of some macroeconomic policy components deviating from the coordinates in the programme due to domestic reasons cannot be overlooked, developments in the external economic environment appear to be the major potential source of uncertainties surrounding the current projection.

From the perspective of the risks posed by the external environment, particularly relevant is the extent to which the recent signals on the global economic recovery and the growing confidence on international financial markets will be sustainably confirmed in the future, absent the resurgence of any fallout from the global crisis. Over the medium term, a reversal in the optimistic developments that are manifest in the short run could adversely impact the Romanian economy, thereby amplifying the risks related to growth and public deficit financing and putting renewed pressure on the leu exchange rate. At the same time, such a scenario would imply lower commodity prices on foreign markets inducing stronger disinflationary pressures on

domestic prices. Under the circumstances, it is difficult to assess in which direction the inflation rate will deviate from the forecasted path, though downside deviations in the near run and upside deviations in the medium term are considered as being more likely to occur.

On the other hand, a more favourable scenario than that incorporated in the current forecast regarding the developments in the real sector and global financial markets could boost investor confidence in the prospects for the Romanian economy, with beneficial effects on the domestic currency and the financing of real economy. By contrast, world commodity prices might increase at a faster pace, fuelling domestic inflation. The short-term implications on the deviation of the inflation rate from the baseline trajectory are difficult to foresee, however, such a scenario is expected to relatively improve the outlook for disinflation in the medium and long term, amid the persistence, over this horizon, of the stability of the domestic macroeconomic environment.

The assumptions regarding future developments in administered prices and volatile food prices imply relatively high uncertainties. Hence, the risks for such prices to deviate from the baseline scenario coordinates are deemed as being relatively symmetrically distributed around the projected CPI inflation path for both price categories, with a slightly higher likelihood of upward deviations for food prices.



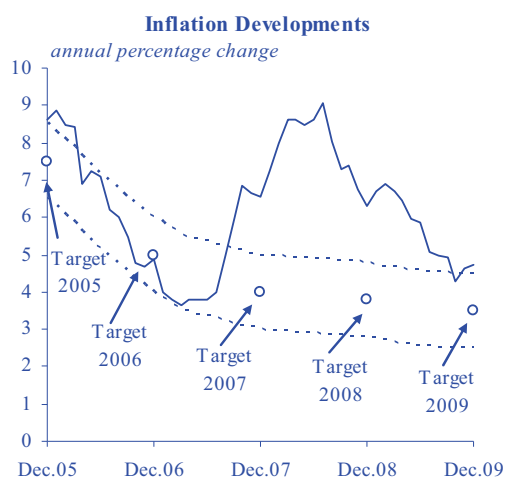
Note: Variation band is ± 1 percentage point around the central target

Source: NIS, NBR calculations

Monetary policy decision

Given the prospects of a gradual pick-up in demand-side disinflationary pressures, enhanced by the prerequisites of further consistent implementation of the economic programme agreed with the EU, the IMF and other international financial institutions, the Board of the National Bank of Romania has decided, in its meeting on February 3, 2010, to lower the monetary policy rate by 50 basis points to 7.0 percent per annum. Moreover, the Board decided to ensure an adequate management of liquidity in the banking system and to maintain the existing levels of minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities. In this context, the Board of the National Bank of Romania reiterated that keeping the macroeconomic policy mix – monetary, fiscal, income policies and structural reforms – in line with the coordinates agreed under the multilateral external financing arrangement signed with the EU, the IMF and other international financial institutions is essential for further achieving sustainable disinflation, maintaining financial stability and restarting a lasting economic recovery.

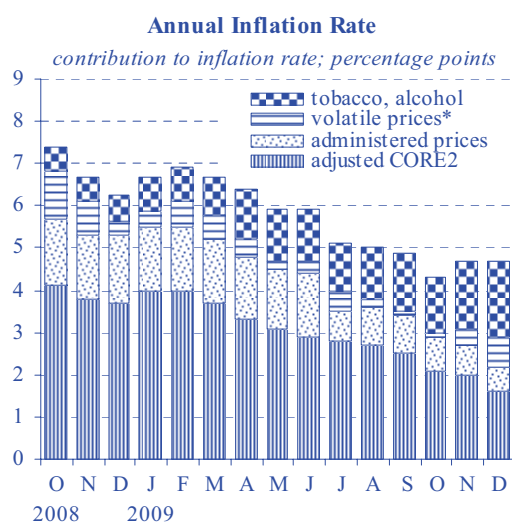
II. INFLATION DEVELOPMENTS³



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

Source: NIS, NBR calculations

At end-2009, the 12-month inflation rate came in at 4.74 percent, 0.24 percentage points above the upper limit of the variation band of ± 1 percentage point around the 3.5 percent target. After falling during 2009 Q2-Q3, the inflation rate hit a two-year low of 4.3 percent in October. Subsequently, the downward path was temporarily discontinued by the cigarette producers' decision to incorporate earlier into prices the inflationary impact of the new exchange rate of the leu that was to be used, starting January 2010, in calculating excise duties. In fact, the successive hikes in the cigarette prices throughout 2009 contributed by more than one third to the 12-month inflation (1.8 percentage points), acting as the main determinant of overshooting the target⁴. Moreover, the pressures manifest on the international crude oil market during October-November sent fuel prices higher, a development that overlapped a strong unfavourable base effect. By contrast, the annual dynamics of adjusted CORE2 inflation saw a steeper decline in 2009 Q4 (-1.4 percentage points) to approximately 2.8 percent owing to the satisfactory supply of food items, the slower depreciation of the domestic currency in annual terms, the ongoing adjustment in labour costs and the persistent dampening impact of low demand.



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

Source: NIS, NBR calculations

The annual growth rate of volatile prices had an adverse bearing on the inflation rate, its +4.3 percentage point acceleration being solely accounted for by the faster advance in fuel prices from 2.4 percent in September to 13.2 percent in December; this was the result of current developments (the average monthly change in fuel prices went up to 0.8 percent in 2009 Q4 from 0.6 percent in 2009 Q3, in line with the hike in the international crude oil price⁵) and particularly of the considerable base effect caused by the easing of conditions on world energy markets simultaneously passing through into the domestic market in 2008 Q4⁶. The impact

³ The annual changes in special aggregate measures (except for CORE1 and CORE2) and their contributions to the 12-month inflation rate, as well as the contribution of tobacco products are calculated by the NBR.

⁴ At the moment of setting the inflation target for 2009 (August 2007), neither the subsequent changes in excise duties regime (the frontloaded implementation in 2009 of part of the increase planned for 2010 with a view to complying with EU requirements on the minimum level and the frontloading of the hike on 1 January 2010 instead of 1 July 2010), nor the magnitude of the national currency depreciation amid the financial crisis could be anticipated.

⁵ The Brent crude oil price posted daily readings higher than USD 78/barrel during the reviewed period, with its monthly average (USD 74.6/barrel) exceeding by 9.4 percent that reported in 2009 Q3.

⁶ The steep fall in the Brent crude oil price (from a monthly average of almost USD 97/barrel in September 2008 to USD 40/barrel in December 2008) was conducive to a 7.3 percent drop in the fuel price.

exerted by these two influences on the group of volatile prices was alleviated by the foodstuff component⁷, the annual change of which entered negative territory (-1.8 percent at end-2009 compared to 0.4 percent in September); among the contributors to this performance were the low volatility of the exchange rate (which weighs significantly on the prices of vegetables and fruit coming largely from imports at this time of the year) and a favourable base effect (partly associated with the depreciation of the domestic currency during the same year-ago period).

In 2009 Q4, administered prices saw minor monthly changes, amid energy prices remaining unchanged⁸ and moderate movements in the exchange rate. In annual terms, the dynamics of administered prices continued to slow down (by 1.3 percentage points to 3.4 percent) owing to some favourable base effects in the case of heating and telephony services, whose prices soared in the comparison period (by 7.5 percent for covering input costs and 8 percent, respectively, as a direct and immediate consequence of domestic currency weakening).

The prices of tobacco products continued to rise at a fast pace, with the cumulative 10.6 percent change reported during 2009 Q4 contributing almost 0.5 percentage points to the 12-month inflation rate. The impact of the second stage of increasing the euro-denominated excise duty⁹ was felt in October as well, albeit to a smaller extent, being followed by the complete factoring into prices during November and December of the recalculated value of the leu-denominated excise duty, based on the exchange rate applicable starting January 2010 (RON/EUR 4.2688 compared to RON/EUR 3.7364 in 2009). The cigarette producers' decision was aimed at avoiding an overly strong shock on consumer prices in January 2010, given the little likelihood that the steps taken in order to postpone a new hike in the euro-denominated excise duty (by another EUR 10/1,000 cigarettes) until July materialise in the context of the political climate at end-2009. As a result, the annual dynamics of tobacco product prices gathered speed for the fifth straight quarter (up 7.1 percentage points during the period under review) to reach 38.6 percent at year-end.

In view of the persistence of signal distortions generated by the mentioned tax measures, the analysis of core inflation must further take into account the relevant adjusted CORE2 measure, the annual dynamics of which decelerated to almost 2.8 percent. A significant factor behind the faster disinflation in 2009 Q4 (by more than 1.4 percentage points compared to 0.6 percentage points in Q3) was the annual depreciation of the domestic currency versus the euro coming down to only half that seen in the previous quarter, which

⁷ Vegetables, fruit, eggs.

⁸ Except for a 0.3 percent increase in the price of heating in October 2009.

⁹ Up EUR 7/1,000 cigarettes in September 2009 to EUR 64/1,000 cigarettes.

Administered Prices versus Market Prices

annual percentage change; end of period

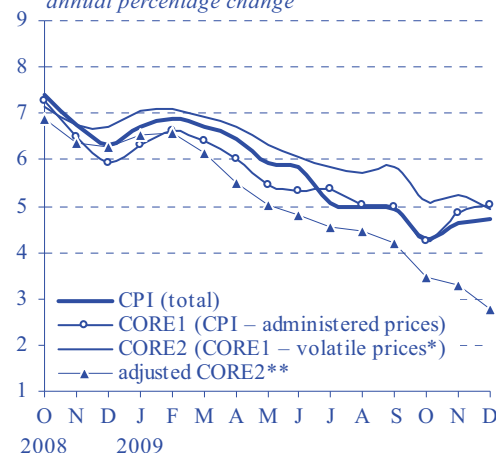
	2008	2009			
	IV	I	II	III	IV
Inflation rate	6.30	6.71	5.86	4.94	4.74
Administered prices*	7.4	7.8	7.7	4.7	3.4
1. Non-food items*:	7.6	7.6	7.0	0.9	0.6
electricity	4.5	4.8	4.8	0.2	0.2
heating	10.1	12.0	11.8	11.8	4.2
natural gas	22.0	12.5	8.6	-8.4	-8.4
medicines	-2.5	4.6	5.6	5.7	8.2
2. Services*,	6.7	7.9	9.1	13.5	9.9
of which:					
water, sewerage,					
waste disposal	12.6	12.8	14.7	16.3	15.0
fixed telephony	2.1	5.7	5.9	16.6	7.9
passenger railway					
transport	0.0	0.0	0.0	0.0	0.0
(passenger) city					
transport	8.1	8.0	8.8	7.6	7.4
Market prices (CORE1)	5.9	6.4	5.3	5.0	5.0
CORE2**	6.7	6.9	6.1	5.9	4.9
CORE2 less tobacco,					
alcohol	6.3	6.2	4.8	4.2	2.8
tobacco, alcohol	11.0	14.9	20.1	24.2	29.3

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

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation

annual percentage change



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

**) excluding tobacco and alcohol

Source: NIS, NBR calculations

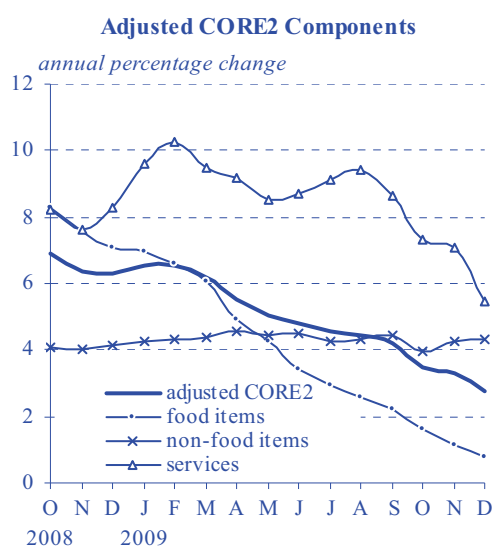
entailed a favourable base effect for all three component groups (particularly visible in services at market-determined prices and less obvious in the goods groups). Thus, food items (except for those with volatile prices) no longer had the largest contribution to the drop in core inflation, as their contribution was equalled by that of market-determined services prices.

Nevertheless, the annual growth rate of food items continued to decelerate considerably (to approximately 1 percent) with prices of staples being relatively flat in 2009 Q4. There were two exceptions: (i) prices of dairy produce, whose average monthly change, albeit positive, stood below the readings seen in the same period of previous years and (ii) the edible oil price, which continued to fall, nearing the level recorded prior to the tensions generated by the poor agricultural output in 2007. The drivers of such developments were the absence of negative supply-side shocks in the 2009 agricultural year and the responses of producers and modern retail companies to further modest consumer demand¹⁰, i.e. implementing cost adjustment measures (particularly for adjusting labour costs) and launching many promotional campaigns.

Non-food items included in adjusted CORE2 further witnessed the slowest disinflation, the progress becoming however more visible in 2009 Q4 under the joint impact of some supply-side factors (favourable developments reported by producer prices on both domestic and external markets¹¹) and demand insufficiently boosted by the adjustment measures previously implemented by the economic agents (the volume of retail sales of non-food items picked up in October-November by only 0.6 percent¹² versus the average for July-September).

Although the marked deceleration in the annual growth rate of services at market-determined prices was due primarily to the above-mentioned base effect, which was heightened by the large share of exchange rate-sensitive components (telephony services, rents, personal and medical care), the restrictive influence exerted by consumer demand on the price policy pursued by companies providing such services cannot be overlooked.

After supporting more or less visibly disinflation over the previous quarters, inflation expectations and their overall influence in the period under review are hard to assess, as the trends illustrated by the outcome of business surveys among economic agents



Source: NIS, NBR calculations

¹⁰ In October-November 2009, the volume of retail sales of foodstuffs stood 4.8 percent lower than in the same year-ago period, the quarter-on-quarter change (-6.6 percent, seasonally-adjusted data) pinpointing a faster decline in the demand for such items.

¹¹ Starting August, the annual growth rates of industrial producer prices on the EU15 external market have recorded negative readings.

¹² Seasonally-adjusted data.

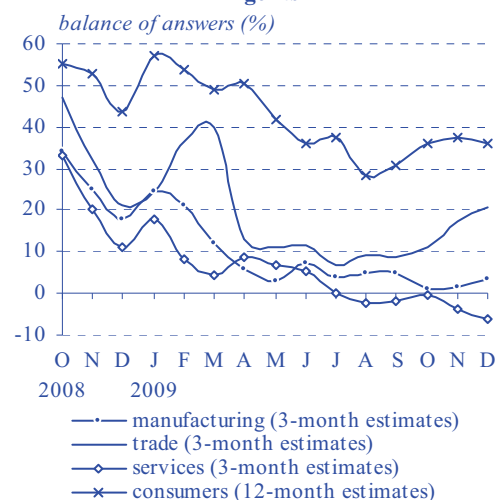
(companies and consumers) are very mixed: obvious improvement in the services sector, stagnation in the consumer goods industry, and a worsening among consumers and in the trade sector. The appraisal becomes even more complicated in view of the divergent anticipations on the main trade sub-sectors, i.e. upward on the food segment (caused, at least partly, by tobacco being part thereof), downward on the non-food segment.

The analysis of the dynamics of tradables prices relative to the growth rate of non-tradables prices lost much of its relevance, as their trajectories were influenced by extra-market factors rather than the strength of competitive pressures. Thus, the acceleration in the annual dynamics of tradables prices was associated with the higher excise duties and the base effect which influenced the change in fuel prices, whereas the slower growth rate of non-tradables prices was mainly the result of a number of base effects (heating, other components whose prices depend on exchange rate movements).

Disinflation was further visible in the 12-month average of the HICP, which fell to 5.6 percent in 2009 Q4 (down by another 0.6 percentage points). Albeit less wide than at the end of the previous quarter, the gap between the 12-month average of the HICP in Romania and the corresponding Maastricht criterion continued to be significant (4 percentage points), given that, throughout 2009, the domestic economic agents were slower than those in Western-European economies in adjusting to the unfavourable environment shaped by the global economic and financial crisis and that the shock generated by the change in the excise duties was a significant one¹³. The comparison to the 12-month average of the HICP in EU27 is even more unfavourable (a 4.6 percentage point gap), considering that four of the Member States posted negative average 12-month inflation rates in December 2009.

At the end of 2009 Q4, the actual annual inflation rate was 0.2 percentage points higher than the projection presented in the November Inflation Report. The deviation is attributable to the cumulative effect of small, yet similar in direction, forecast errors, associated with the exogenous variables, stemming from the slight underestimation of the hike in fuel and cigarette prices, of the pick-up in volatile food prices and of the RON/EUR exchange rate level in the first two months of the reviewed quarter; the projection was lower than the actual annual inflation rate also as a result of the error arising from the imperfect manner of aggregating components, namely the aggregation of monthly price indices¹⁴ and not of price indices calculated compared to the reference period (the average for 2007).

Inflation Expectations of Economic Agents

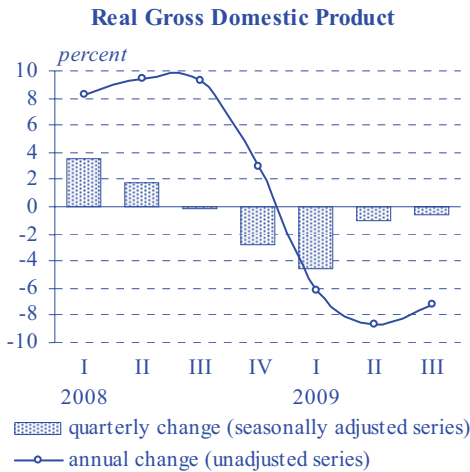


¹³ In 2009 as a whole, the adjustment in the 12-month average of the HICP in Romania (-2.3 percentage points) was lower than the change in the Maastricht criterion (-2.5 percentage points).

¹⁴ The only data released to the public.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

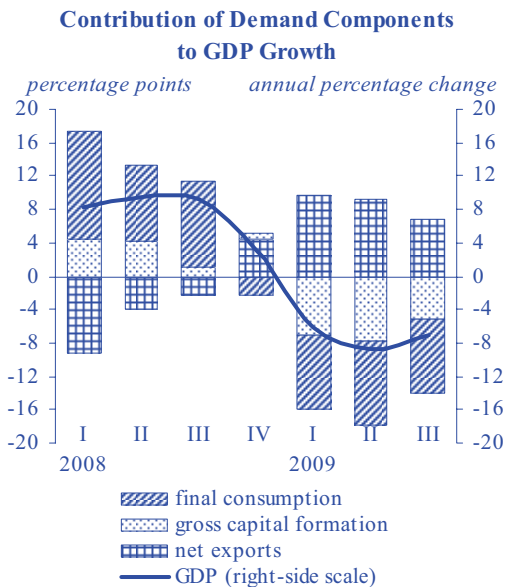


Source: NIS

In 2009 Q3, real GDP remained on a downward path, its annual rate of decline slowing down however by 1.6 percentage points versus 2009 Q2 to -7.1 percent¹⁵.

Based on the NIS seasonally-adjusted data series, in 2009 Q3, GDP contracted by -8.8 percent in annual terms or -0.6 percent in quarter-on-quarter terms, slightly less than in the September projection (-9 percent and -0.8 percent respectively).

The moderation in the negative annual dynamics of real GDP was due mainly to the dissipation of the base effect induced by the rapid economic expansion reported in the first three quarters of 2008, as the series of quarterly indices¹⁶ further showed a GDP contraction in Q3 (albeit less stronger than in the previous quarter).



Source: NIS, NBR calculations

The slowdown by 0.5 percentage points in the quarterly rate of decrease of real GDP was propelled by the two main components of domestic demand, the growth rates of which reached -1.1 percent (final consumption) and -4.6 percent (gross fixed capital formation). It is to be noted that the provisional data on national accounts point to "changes in inventories" as the largest contributor to GDP dynamics in Q3 (+7 percentage points). Nevertheless, the influence of this component (accounted for only marginally by economic causes) was offset, to a great extent, by another item with a minimum economic content, namely the statistical discrepancy (-4.5 percentage points).

As concerns the quarterly developments in external demand, both exports and imports of goods and services continued to post higher volumes (by 4.9 percent and 3.9 percent respectively), in line with the upturn in the industrial sector.

1.1. Demand

The economic decline was further put down on domestic demand (-12.4 percent), the influence of this component being again offset by the favourable contribution from net external demand (6.9 percentage points).

¹⁵ Unless otherwise indicated, the growth rates in this section are annual percentage changes, calculated based on the unadjusted series of national accounts.

¹⁶ Quarterly changes are calculated based on the seasonally-adjusted data series.

Compared to the previous quarter, domestic demand recorded a slower annual dynamics (by 3.2 percentage points). However, this was not due to its main components (the cumulative volume of final consumption and gross fixed capital formation posted an even sharper decrease to -17.9 percent) but, similarly to the quarterly performance, to the significant build-up of inventories, which contributed by almost 7 percentage points to GDP dynamics – the outcome can be attributed to some economic causes (the replenishing of agricultural product stocks), without overlooking the significant residual component of this position.

1.1.1. Consumer demand

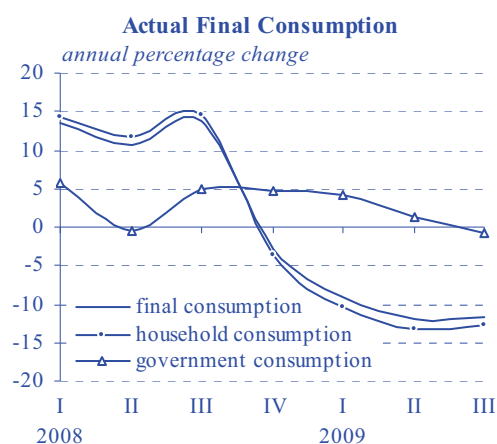
Final consumption continued to diminish at a pace similar to that seen in Q2 (-11.8 percent), with both the private consumption and government consumption contributing to this performance.

Household consumer demand

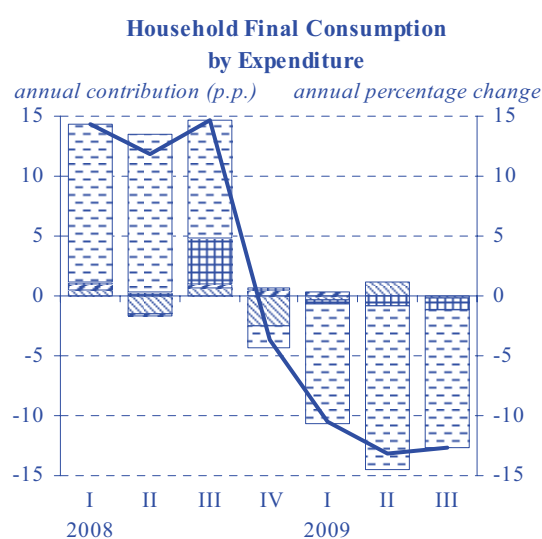
Household final consumption recorded a lower drop than in the previous period (12.7 percent), owing solely to the slowdown in the rate of decrease of “self-consumption and purchases on the agri-food market” (to -6.4 percent, i.e. half of the level seen in the previous period), as a result of the favourable performance in agriculture.

Purchases of goods and services maintained their swift pace of decline (-18.9 percent, a reading comparable to that reported in Q2) against the background of further contraction in financial resources and persistently pessimistic expectations of households on the economic and financial developments. The same as in the previous period, durables and fuels were the hardest hit by weaker demand (with the volume of sales going down by almost 30 percent and 20.6 percent respectively); purchases of non-durables, except for fuels, also saw a further decrease in terms of volume (by about 5 percent), particularly owing to purchases of foodstuffs and pharmaceuticals.

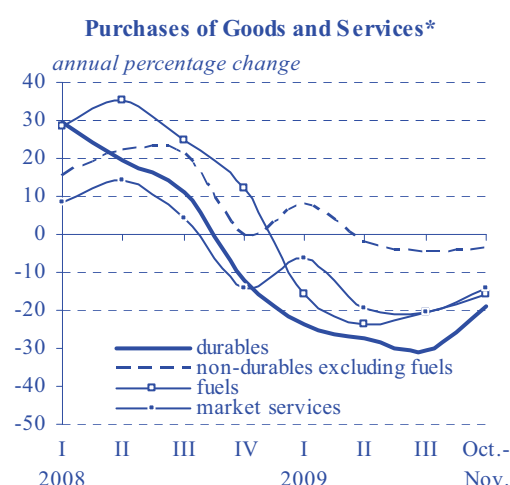
As concerns the influence of demand on consumer prices, the current developments in the volume of retail sales¹⁷ of products holding a large share in the CPI basket reported in 2009 Q3 and October through November 2009 suggest further an absence of pressures. This owes particularly to the foodstuff segment (-0.3 percent in Q3 and -6.6 percent in October-November) and to purchases of wearing apparel and footwear (-8 percent and -10.9 percent respectively).



Source: NIS



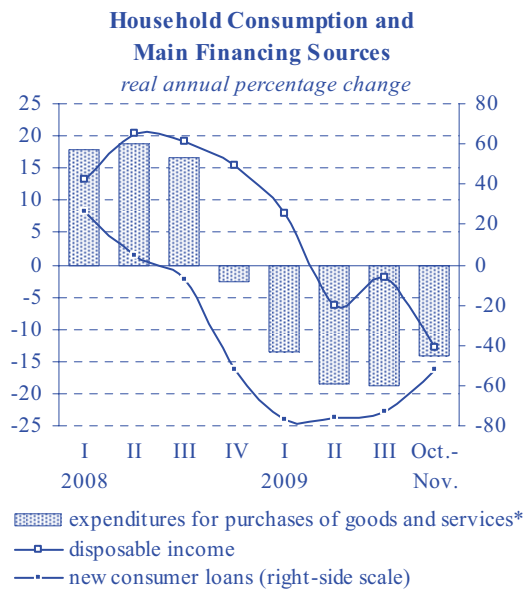
Source: NIS, NBR calculations



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

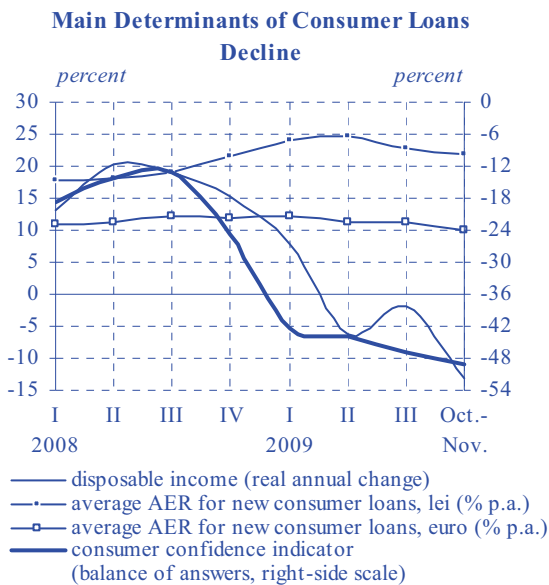
Source: NIS, NBR calculations

¹⁷ Working day and seasonally-adjusted data; changes calculated by comparison to the previous quarter's average.



*) for Oct.-Nov. 2009, the turnover volume in trade and market services was used

Source: NIS, MPF, NBR calculations



Source: NIS, EC - DG ECFIN, MPF, NBR calculations

In 2009 Q3, the financing channels of household consumption saw no trend changes:

- (i) the household disposable income¹⁸ contracted by 2 percent in real terms, and
- (ii) the volume of new consumer loans plunged by more than 70 percent, the easing signals sent by commercial banks (via cutting financing costs, particularly those related to leu-denominated loans) being offset by households' lack of confidence in the short-term improvement of their financial standing.

Furthermore, households' propensity for saving remained particularly strong, with the portfolio of investments posting, however, some structural changes. Thus, households showed a shift in their preference from time deposits (amid their becoming less attractive, as suggested by the drop, for the second straight quarter, in the average interest rates) to mutual fund investment, the net assets of which trebled versus the previous year, pushing the market to a record high.

By market of origin of consumer goods, 2009 Q3 saw no trend change against the previous quarter, with both purchases of consumer goods on the domestic market and imports of such products continuing to decline in real terms. "Non-durables" posted a rate of decrease similar to that in Q2, with sales of domestic industrial companies on the domestic market diminishing by about 23 percent and the physical volume of imports¹⁹ shrinking by approximately 11 percent. "Durables (except for motor vehicles)" remained on a downward trajectory as well, with the decline being further more pronounced on the domestic market, in spite of a visible moderation compared to the previous period (-29 percent). The 10 percent rise in the imports of "electrical machinery and apparatus" offset to a large extent the decreases by at least 30 percent reported by the other imported consumer goods. For the fourth quarter in a row, the demand for motor vehicles witnessed severe contractions for both domestically-produced and imported motor vehicles (-33.2 percent and -58.4 percent respectively).

¹⁸ 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, i.e. workers' remittances and current private transfers by non-residents.

¹⁹ 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.

Government consumption

The provisional data on the national accounts for Q3 show a slight contraction in final government consumption (by 0.9 percent in annual terms), in line with the discontinued upward trajectory posted by the number of employees in the general government sector.

Budgetary developments

However, in 2009 Q3, the consolidated general government deficit widened, reaching 2.2 percent of GDP, of which 2 percent represented the primary deficit, 0.9 percentage points and 1.1 percentage points respectively higher than the levels recorded in 2009 Q2, amid mixed developments in revenues and expenditures. Overall, the budgetary execution in the first three quarters of 2009 ended on a negative balance of lei 25,563 million, accounting for 5.1 percent of GDP, i.e. 70 percent of the programmed deficit for 2009²⁰, in line with the ceiling agreed upon by the multilateral external financing arrangement signed with the EU, IMF and other international financial institutions.

Total budget revenues decreased at a faster pace, the annual dynamics²¹ decelerating to -14 percent from -10.1 percent in Q2, chiefly on the back of the more significant compression in VAT receipts (the annual change of which dropped to -28.9 percent, 9.6 percentage points below the previous quarter level), weaker collection of profit tax (which posted an annual growth rate of -34.1 percent, compared with -10 percent in Q2), as well as the further downtrend in the annual dynamics of wage and income taxes. The negative contribution of these revenue categories was only partially offset by the relative alleviation of the decline in the annual change of social security contributions (from -7.0 percent to -6.6 percent) and of non-tax revenues (from -26.5 percent to -13.3 percent), as well as the increase in the growth rate of excise duties²² (to 14.3 percent, from 10.9 percent in Q2).

In contrast to the previous quarter, the growth rate of total expenditures reverted to positive territory, reaching 6.1 percent from -7.4 percent in Q2, due mainly to the increase in primary expenditures to 5.2 percent from -8.4 percent. Behind this development stood chiefly the heftier current expenditures, accompanied for the first time in 2009 by a faster increase in

²⁰ The second budget revision, providing for raising the deficit target for 2009 to 7.34 percent of GDP, was performed in August (see the November 2009 Inflation Report).

²¹ Unless otherwise indicated, percentage changes refer to the real annual growth rate.

²² Excise duties were raised on 1 April and 1 September, according to Government Emergency Ordinance No. 29 of 25 March 2009 amending Law No. 571/2003 - the Tax Code.

capital expenditures (8.1 percent). Social security outlays²³ further put the strongest pressure on the budget, with an annual growth rate of 19.6 percent against 16.3 percent in the previous quarter. Conversely, the period under review saw the possible inception of staff cost adjustment (-1.6 percent from 2.7 percent and 7.8 percent respectively in the first two quarters of 2009) which, along with the further contraction in goods and services expenditures (although at a slower pace compared with the prior quarter) made government consumption dynamics fall into negative territory.

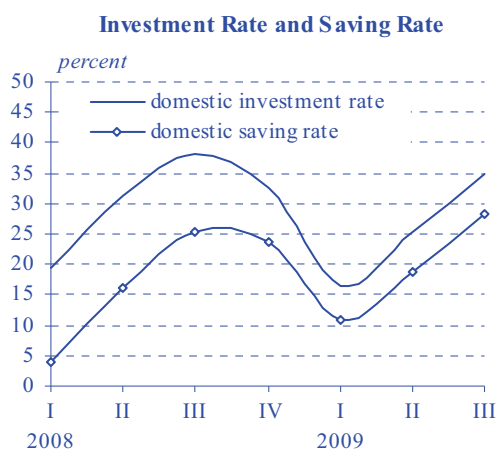
At the end of the first 11 months of 2009, the consolidated general government deficit widened to lei 29,750 million, accounting for 6.0 percent of GDP from 3.1 percent in the same year-earlier period. According to the latest monthly budgetary execution, total revenues recorded in November the fastest growth pace in 2009 (0.8 percent compared with an average monthly change of -11.4 percent for the first 10 months of 2009), due also to a base effect, while total expenditures contracted by 15.3 percent year on year.

1.1.2. Investment demand

In 2009 Q3, the annual rate of decline of gross fixed capital formation accelerated by 3 percentage points to -28.6 percent, owing to the severe reductions on all main segments: (i) equipment (including transport means purchased by companies and institutions), the decrease of which (by 43.5 percent) generated half of the contraction in capital spending; (ii) new construction works and capital repair works, whose cumulative volume narrowed by approximately 23 percent in annual terms.

As concerns the financing sources of investment projects, mention should be made that all channels reported further downward trajectories:

- (i) the drop in own sources earmarked for capital investment is suggested by the poor financial results in the corporate sector and the decline in household disposable income;
- (ii) the estimates on the volume of new loans granted in 2009 Q3²⁴ point to the maintenance of downward trajectories of both



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

²³ Among the causes for the year-on-year rise in social expenditures in 2009, besides the effect of automatic stabilisers, were the increase of the pension point in April (in compliance with Law No. 19 of 26 February 2009 – The 2009 State Social Security Budget), the introduction of the minimum guaranteed social pension starting April (according to Government Emergency Ordinance No. 6 of 18 February 2009 on establishing the minimum guaranteed social pension), as well as the rise in minimum guaranteed income starting July (consistent with Government Emergency Ordinance No. 57 of 27 May 2009 amending Law No. 416/2001 concerning the minimum guaranteed income).

²⁴ Calculations based on the data provided by the CCR; the quarterly flow is estimated as the difference between ending and beginning stocks for the reviewed period.

purchases of equipment (-26 percent in real terms), and real-estate investment (-60 percent); to this performance contributed medium- and long-term foreign borrowings by the non-bank non-government sector, whose net cumulative flow for the past four quarters saw a markedly faster annual pace of decrease (-78 percent)²⁵;

- (iii) lease financing, resorted to almost entirely by the corporate sector, did not show any recovery sign; when expressed in euro, the value of contracts concluded by local companies accounted further for roughly one quarter of the level reported in the same year-ago period amid the persistent decline in sales of new cars and equipment, as well as the freezing of real-estate projects;
- (iv) capital inflows of foreign direct investment declined almost three times faster, their annual dynamics in the past four quarters reaching about -27 percent²⁵.

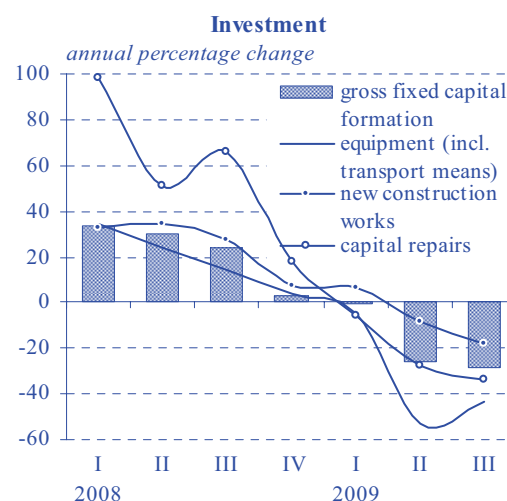
Financing via budget resources was the only exception, its upturn by +30 percent in real terms owing possibly to the thermal rehabilitation of blocks of flats.

The contraction in investment demand was felt on both markets of origin of capital goods, as illustrated by the severe contractions in the volume of sales of domestic industrial companies on the domestic market (by almost 40 percent) on the one hand, and in the physical volume of imports of machinery and mechanical devices (by more than 30 percent)¹⁹, on the other.

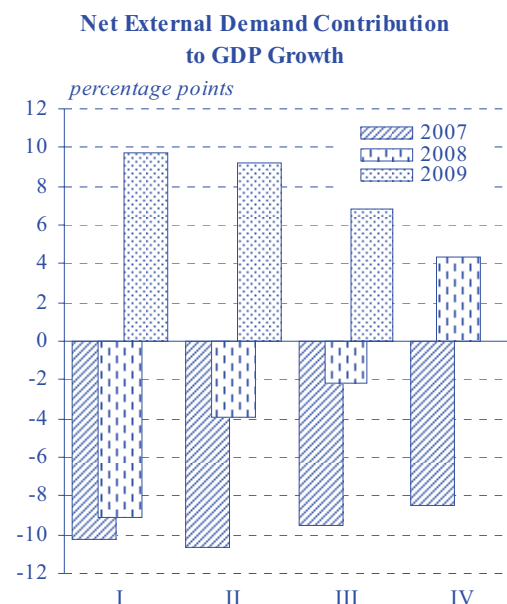
1.1.3. Net external demand

In the period under review, the rebounding demand from the major foreign partners had a favourable impact on the trade balance, reflected also by the national accounts estimates. Thus, the volume of exports of goods and services went up 1.6 percent year on year, while imports saw a significant slowdown in their dynamics, although they still declined at a fast pace of -15.3 percent, against the backdrop of an ongoing contraction in domestic absorption and a weaker domestic currency in annual terms.

The improvement in trade deficit against the previous quarter is however reflected to a lesser extent by the physical volume indices of both exports and imports of goods, computed by deflating the two trade balance components by the international trade-related unit value indices. In this respect, the only favourable outcome was a slower pace of decline year on year.

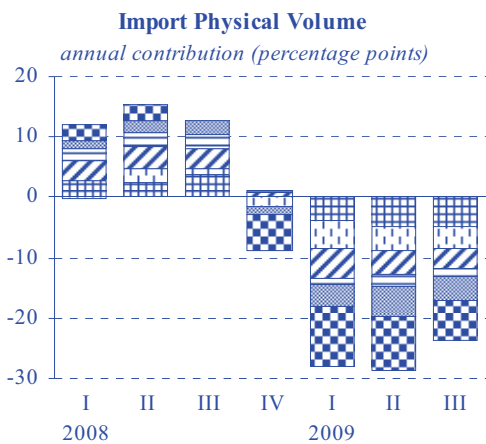
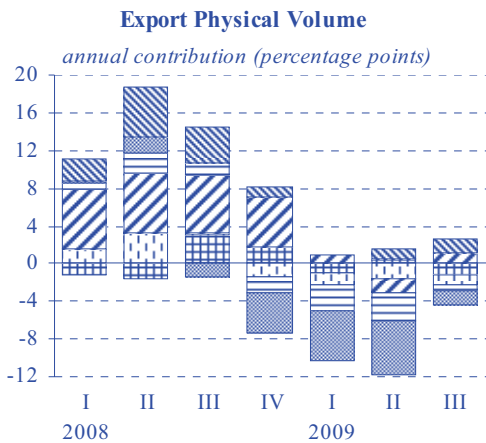


Source: NIS, NBR calculations



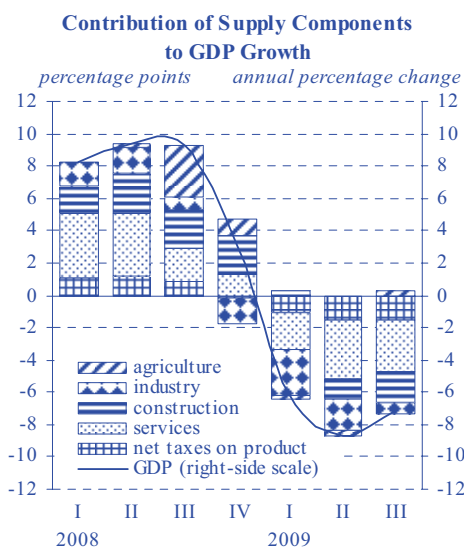
Source: NIS, NBR calculations

²⁵ Calculations based on balance-of-payments data.



- transport means
- base metals
- chemicals
- mechanical devices; electrical machinery and apparatus
- fuels
- other

Source: NIS, NBR calculations



Source: NIS, NBR calculations

Export composition reveals the positive contribution of “machinery and apparatus” and “transport means”, with positive growth rates of 5.4 percent and 11.2 percent respectively in annual terms, as well as a smaller negative contribution of “fuels”, “chemicals” and “base metals” following their slower annual rate of decline than in the previous quarter.

As for imports, except for electrical machinery and apparatus purchases, which remained on an uptrend, none of the groups holding a large share in total import value witnessed positive dynamics. Nevertheless, the downward path in the physical volume of each category was less steep than in the prior quarter.

1.2. Supply

The flattening out of the downward path of real GDP in Q3 was bolstered by most economic sectors, except construction where gross value added sped up its decline (to -17.4 percent in annual terms), particularly on the back of the residential and non-residential segments.

Favourable weather conditions contributed to the rise in vegetal production in Q3 (chiefly maize, sunflower, potatoes and grapes), thereby gross value added in agriculture posting a positive growth rate for the first time in 2009 (2.4 percent year on year).

The upturn in industrial output starting with March 2009, as illustrated by the quarterly rises in gross value added (4.5 percent and 3.6 percent respectively in the last two quarters²⁶), led to the slowdown of the annual pace of decrease in industrial gross value added (to -3.5 percent in Q3. This performance was further underpinned by the economic rebound in Romania’s main trade partners, the real turnover on the external market reporting a positive annual dynamics for the first time after three consecutive quarters of declines. In this context, the following sub-sectors stood out: woodworking, road transport means and, by association, electrical machinery and apparatus.

The negative contribution of the services sector to GDP growth contracted as well, but the annual pace of decline of gross value added decelerated by only 0.5 of a percentage point compared to Q2 (to -6.9 percent). Activity contracted in all sub-sectors (especially in trade, hotels and restaurants, transports and telecommunications where gross value added fell by 11.3 percent); “financial activities, real estate transactions and rentals” was the only segment reporting a flattening out of the downward path.

²⁶ Data adjusted by the number of working days and seasonality.

2. Labour market

2009 Q4 witnessed the further rise in the number of jobless, the drop in the number of vacancies and broader measures for tightening of wage policy for public sector employees. As a result, labour market saw an additional widening of the mismatch between the supply of and the demand for labour force, as well as the persistent slowdown in the annual growth rate of wages. Nevertheless, there were signs that the downsizing slowed down in response to the impact of the economic crisis on the background of the ULC in industry speeding up its decline in annual terms.

2.1. Labour force

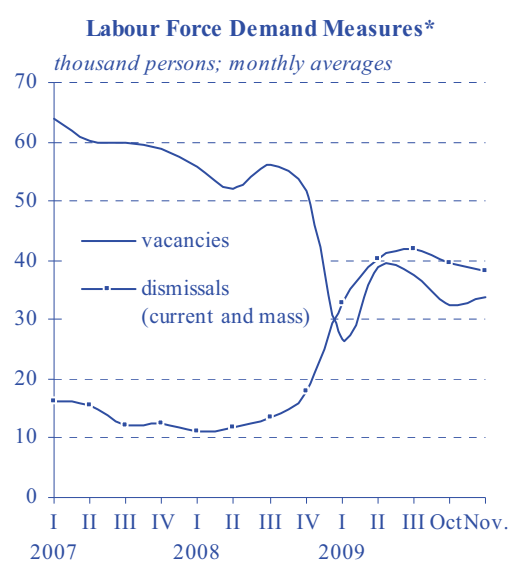
Recent developments on the number of lay-offs and vacancies²⁷ are indicative of the further contraction in labour demand, as well as of a slight relaxation of downsizing measures implemented by private companies with a view to enhancing efficiency. Thus, although in October-November 2009 the average number of redundancies rose by roughly 15 percent compared to Q2 and Q3²⁸, the increase was entirely due to seasonal factors (when eliminating this influence, a reversal in the upward trend of the number of dismissals can be noticed.) Nevertheless, the uncertainties surrounding the prospects for economic recovery are mirrored by (i) the drop in the average number of vacancies identified by the NEA (seasonally-adjusted data) and (ii) the larger weight of new temporary contracts in total hirings from the ranks of the jobless.

In these conditions, the staff numbers reported by employers kept contracting, to 4.36 million, the low level for the February 2004–November 2009 period. The annual change of this indicator economywide was -8.9 percent in November, while at sector/sub-sector level it posted declines even twice as high; the hardest hit (in relative terms) were several manufacturing sub-sectors (light industry, metallurgy, construction-related sub-sectors²⁹, oil processing, machinery and equipment, furniture), construction, real estate transactions. However, mention should be made of the discrepancy between the deceleration rate of the number of employees calculated based on employers' reports and that resulting from the AMIGO survey (across industry, 14.2 percent compared to only 9.4 percent in 2009 Q3) in line with

²⁷ NEA statistics.

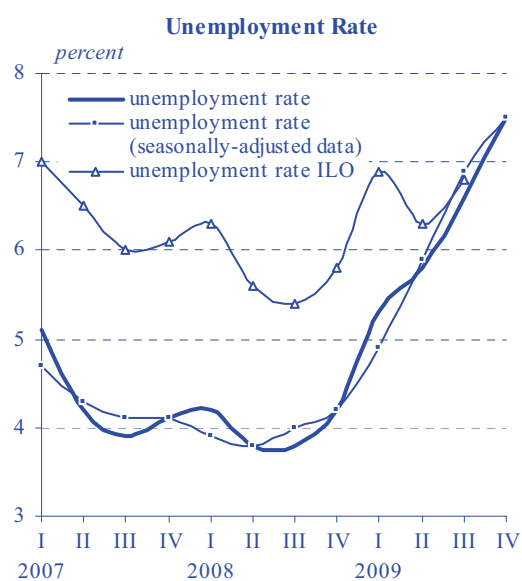
²⁸ The comparison against the prior periods was preferred to the annual growth rate analysis, which is affected by base effects particularly in Q3 (low number of lay-offs in 2008 Q3, prior to the onset of the economic crisis; this base effect diminishes in Q4, once companies have taken the first adjustment measures in response to lower demand).

²⁹ Woodworking, products from non-metal minerals, metallic construction and metal products, excluding machinery, equipment and engineering.



*) seasonally-adjusted data

Source: NEA, NBR calculations



Source: NIS, NBR calculations

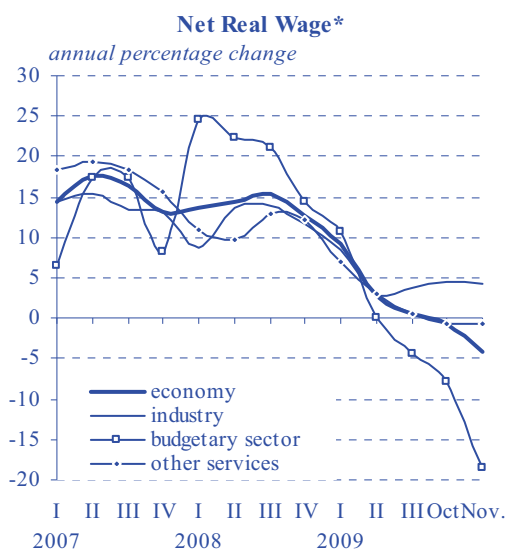
a more modest growth of ILO unemployment than the rise in registered unemployment; a likely explanation of differences observed lies in the expansion of the informal economy which suggests the overestimation of structural adjustments by monthly statistics used in calculating productivity and, implicitly, ULC.

The relaxation of downsizing measures, illustrated by the evolution of dismissals, led to the slower rise in excess labour supply, the monthly growth rate of unemployment declining to half compared to the previous quarters³⁰. Nevertheless, the difference between the number of jobless and that of vacancies³¹ widened considerably (from 69:1 in Q3 to 90:1 in October-November 2009), which is indicative of the further easing of labour market conditions and validates the assumption of low inflationary pressures coming from the wage policies applied by private companies in the first part of 2010, the more so as the unions' claims as regards bringing the minimum gross wage in the private sector (lei 600 at present) to the level of the minimum gross wage in the public sector (lei 705 as from 1 January 2010, in compliance with Law No. 330/2009) were rejected. Moreover, the authorities do not intend to approve any other wage hikes except those derived solely from the change in the minimum gross wage.

2.2. Incomes

The annual growth rate of net average wage economywide continued to decelerate, from 5.6 percent in Q3 to 2 percent in October-November and to a negative value anticipated for December 2009. In the last two months of 2009, the trend was accelerated by public sector employees taking turns in getting unpaid leave (a measure meant to reduce staff costs), as well as by the reduction/removal of end-of-year bonuses in both the private and public sectors.

Thus, at sector level, the annual dynamics of net average wage witnessed uneven developments in October-November 2009 compared to Q3, i.e. strong fall in negative territory (around 10 percentage points) in the public sector and stay in the positive territory in the case of the private sector³², with a slight acceleration in industry and renewed slowdown in construction and services. In industry, the annual growth rate of net wage remained relatively unchanged at around 9 percent during April-November, the increasingly pronounced positive deviation from the economywide average being accounted for by the differences between sectors in terms of companies' manner to cut



*) deflated by CPI

Source: NIS, NBR calculations

³⁰ Seasonally adjusted data.

³¹ Stock of end of the month.

³² About 6 percent, down by only 1 percentage point versus Q3, according to NBR estimates.

costs in the new economic environment – in industry, by the prevalent recourse to downsizing rather than to wage cuts.

The adjustment measures implemented in industry were further reflected by the reduction in ULC, whose drop in annual terms widened from 5 percent in 2009 Q3 to 10.3 percent in October-November 2009³³. The advance in regaining competitiveness was reported mainly in manufacturing (acceleration of the negative annual dynamics from -6.2 percent to -14.2 percent), chiefly in road transport means, metallurgy, metallic construction, electrical equipment, woodworking. The imbalances observed in the previous periods in several consumer goods producing sub-sectors continued to narrow (light industry, pharmaceuticals) or were eliminated altogether (chemicals), while, in some other sub-sectors, the imbalances worsened (oil processing, machinery and equipment, and electronic apparatus and appliances).

In the second part of 2009, the support lent to consumption by household real disposable income remained weaker than in the same year-earlier period, as the slight rebound reported in Q3³⁴ was short-lived. The annual dynamics of real disposable income fluctuated from -6.2 percent in Q2 to -2 percent in Q3 and about -13 percent in October-November 2009; thus, the prospects for 2009 Q4 are bleak given the annual drop in real terms of the three components (wage earnings, social transfers and remittances from abroad).

3. Import prices and producer prices

In 2009 Q3, both import prices and domestic (industrial and agricultural) producer prices saw negative annual changes, indicating the lack of pressures on consumer prices via these channels. Such developments could persist into Q4 in the case of import prices and agricultural producer prices, yet a trend reversal is expected for prices of industrial goods, the waning base effects that affected the annual dynamics of prices for energy products being associated with the re-emergence of tensions on world oil market.

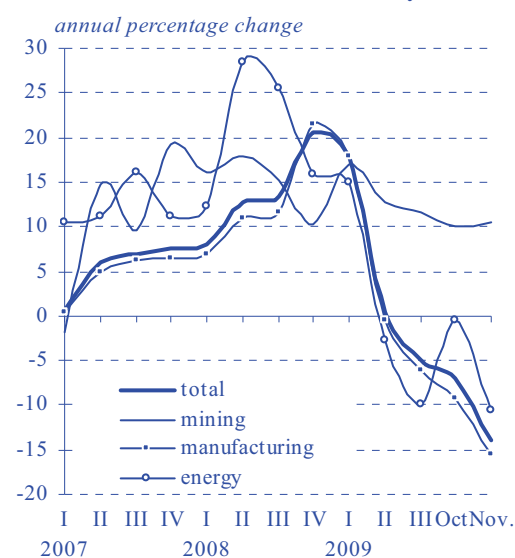
3.1. Import prices

In the reviewed quarter, the annual growth rate of import prices continued to decelerate, given that the annual unit value index of imports stayed considerably below par (84.8 percent as compared with 88.4 percent in 2009 Q2) and the domestic currency position

³³ This trend can also be noticed when using productivity indices obtained by reporting gross value added to employment, yet the annual growth rate of ULC still lied in positive territory in 2009 Q3 (3.6 percent as compared to 26.4 percent and 9.1 percent in Q1 and Q2).

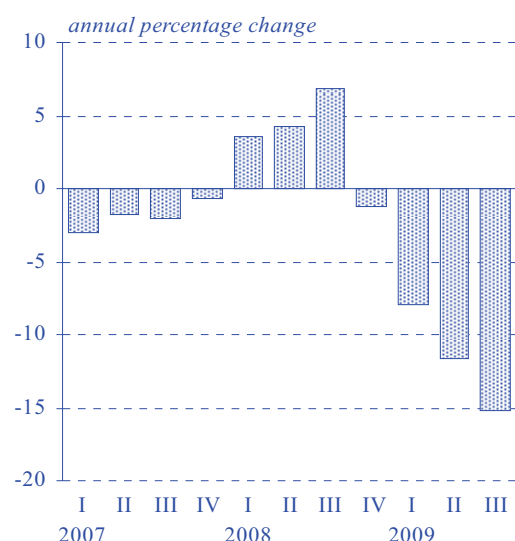
³⁴ A 2 percent growth from the prior quarter, bolstered by social transfers (especially those from the unemployment fund) and remittances from abroad.

Unit Labour Costs in Industry

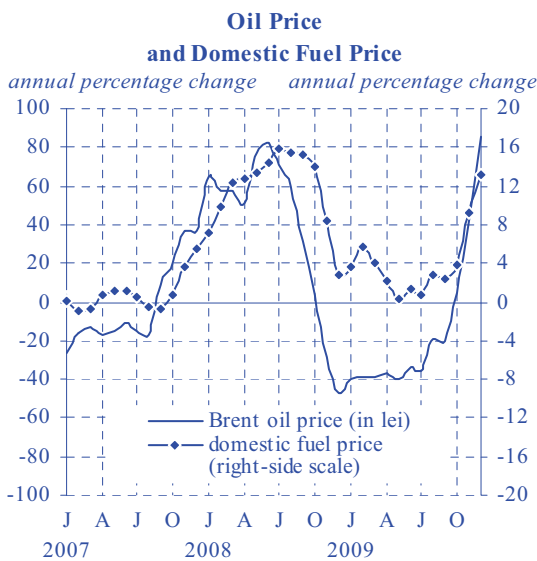


Source: NIS, NBR calculations

Unit Value of Imports



Source: NIS, NBR calculations



Source: NIS, EIA, NBR calculations

versus major currencies remained broadly unchanged from the previous quarter.

This trend was reported by most groups of goods, being more pronounced in the case of goods whose prices depended on the year’s agricultural output (fruit, fat, meat), where the negative annual dynamics of external prices fell to levels as low as -41.1 percent. Furthermore, similar developments were recorded by base metals, owing particularly to some base effects. Therefore, external prices for capital goods and transport equipment also posted negative annual changes.

By contrast, the unit value index of imports of clothing increased by 3.2 percentage points versus Q2 (up to 100 percent), on the back of costlier imports from non-EU countries. Additionally, the unit value index of imports of pharmaceuticals was further above par, yet its magnitude contracted considerably from 107.2 percent to 102.9 percent in 2009 Q3.

The same trends are expected to persist into 2009 Q4 in the case of both external prices and exchange rate movements, except mainly for energy products, whose current developments are indicative of mounting pressures.

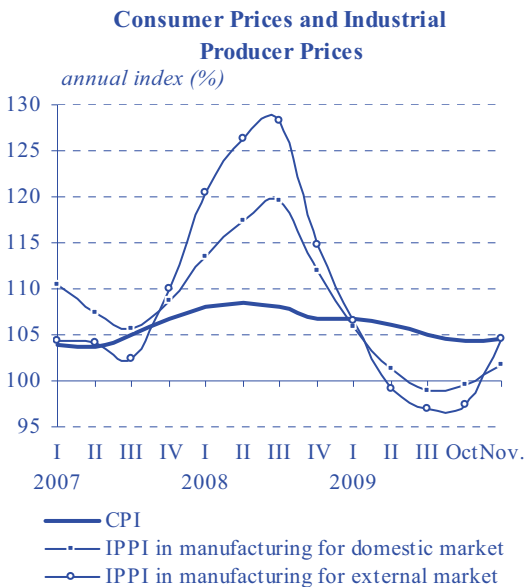
3.2. Producer prices

3.2.1. Industrial producer prices

In 2009 Q3, the annual growth rates of industrial producer prices for the domestic market entered negative territory (-0.6 percent versus 2.2 percent in Q2), against the background of developments in mining and manufacturing. The annual dynamics of producer prices in manufacturing decelerated to -1.3 percent. Unlike the previous quarters, prices on new orders in manufacturing posted a significantly slower growth pace (from 6.3 percent in Q2 to 1.3 percent in July-September), due possibly to the joint effect of lower input costs (commodities, labour force) and narrower profit margins of new orders, under the impact of the severe contraction in their volume.

Favourable base effects were further significant in certain sub-sectors (intermediate goods and energy products): despite producer price increases in the hydrocarbon processing sub-sector³⁵ in the reviewed period, the annual change in producer prices for energy products remained sharply negative (-6.1 percent). Similar developments were detectable in the case of intermediate goods, whose annual dynamics of producer prices decelerated to -5.1 percent.

³⁵ On the back of external market developments.



Source: NIS

The downtrend in the annual growth rates of producer prices for capital goods was much less abrupt (6 percent, 1.3 percentage points below the previous quarter's figure), in the context of substantial positive contributions from (road and non-road) transport means sub-sectors³⁶. In both cases, movements were associated with current developments, the quarterly changes being positive and higher than in the preceding quarter. In automotive industry, this dynamics may be attributed to the costs associated with the improvement of some motor vehicle models that had been already launched by the main domestic car producer (Dacia-Renault).

A high level of stickiness persists in the case of producer prices of consumer goods (8.2 percent in annual terms), particularly of non-food items. Hence, while the dynamics of producer prices for food items, beverages and tobacco slowed down 1.6 percentage points on average as compared with 2009 Q2 to 5.8 percent³⁷, the average growth rate of prices for other consumer goods further recorded a positive two-digit level (10.8 percent), the quarter-on-quarter adjustment being marginal (merely 0.3 percentage points). As concerns the latter sub-sector, the highest growth rates of producer prices were reported by pharmaceuticals and light industry.

After three months of negative annual changes, in October-November, the annual growth rate of producer prices returned to positive territory (1 percent on average), owing particularly to waning base effects associated with the annual dynamics of energy products (2.4 percent in November, the first positive figure recorded in 2009). The annual dynamics of producer prices for the other groups of goods slowed down further. The deceleration pace was faster in the case of capital goods and durables, owing possibly to exchange rate stabilisation.

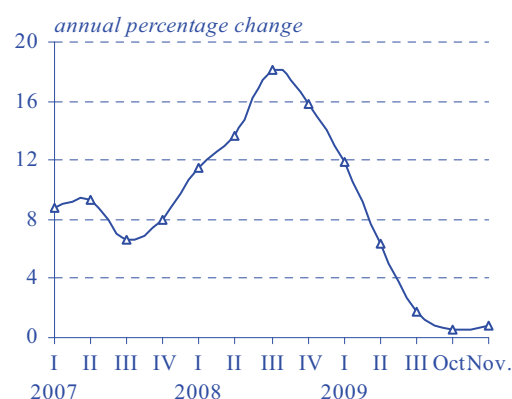
3.2.2. Agricultural producer prices

In 2009 Q3, the annual growth rates of agricultural producer prices remained in negative territory (-8.9 percent), on the back of developments in prices for vegetal products (down 13.8 percent). By contrast, prices for animal products further recorded strongly positive annual growth rates (10.7 percent), which decelerated swiftly as against Q2 (down 6.5 percentage points). Behind the movements reported by both categories of products stood current developments, the year's bumper crops contributing to the

³⁶ In 2009 Q3, the annual growth rates of producer prices stood at 12.1 percent in road transport means and 16.8 percent in other transport means.

³⁷ It is worth noting the significantly slower growth rate of producer prices in the food sector (2.3 percent in annual terms), underpinned by the satisfactory supply of agricultural products.

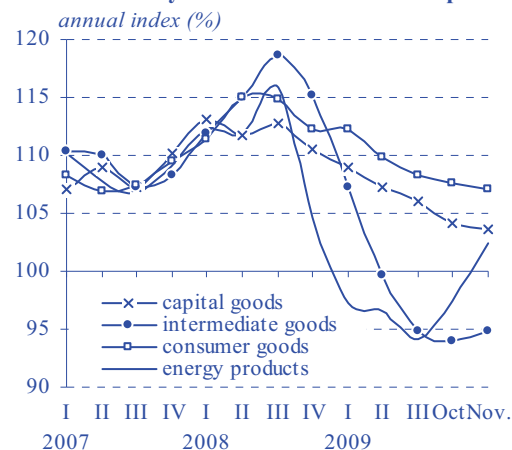
Industrial Producer Prices on Domestic Market* for New Orders



* in order-based manufacturing sector

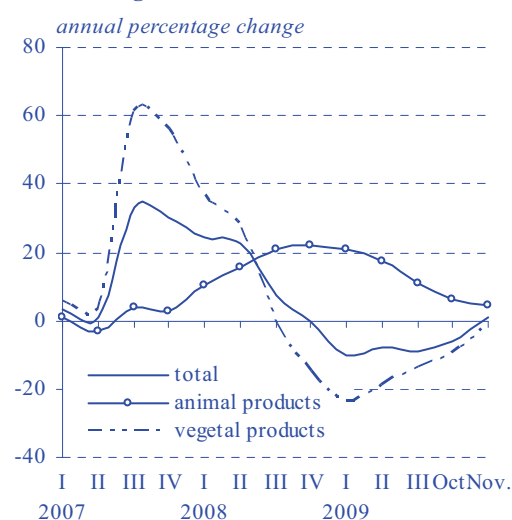
Source: Eurostat

Industrial Producer Prices for Domestic Market by Industrial Products Group



Source: NIS

Agricultural Producer Prices



Source: NIS

lowering of tensions in the case of agricultural product supply and the cost of fodder.

As concerns the vegetal component, prices for grains and technical crops further saw negative annual growth rates of down to -25.7 percent, whereas the annual dynamics of prices for vegetables stayed in positive territory, yet on a downtrend versus the previous quarter (15.7 percent for potatoes, nearly half of the figure recorded in 2009 Q2).

With regard to products of animal origin, only mutton prices increased at a faster pace (up to 66.1 percent) than in the preceding quarter, due possibly to the narrowing domestic supply in the context of the expansion in related exports. Consumers' shift towards cheaper meat types continued to be mirrored by the significantly slower dynamics of prices for pork and beef, although, in the latter case, the growth rate remained particularly high (30.4 percent).

In 2009 Q4, agricultural producer prices will not see considerable changes from prior quarters given that influencing factors have remained unchanged.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In 2009 Q4, the National Bank of Romania discontinued the downward trend in the monetary policy rate, which was left unchanged at 8.0 percent per annum. Also, the NBR Board reduced by another 5 percentage points the minimum reserve ratio on credit institutions' foreign currency-denominated liabilities with residual maturity of up to two years³⁸ down to 25 percent. The key interest rate was subsequently lowered by 50 basis points in January 2010, against the background of a relative improvement in foreign investors' sentiment towards the prospects of the Romanian economy and, implicitly, in the developments in the exchange rate of the leu, with broad monetary conditions remaining prudent throughout the period under review.

The decision to leave the monetary policy rate unchanged at 8.0 percent per annum, taken in the NBR Board meeting of 3 November 2009, was primarily motivated by the anticipated short-term emergence of the inflationary effects of excise duty hikes starting 1 January 2010 and mostly of the adverse impact on inflation expectations arising from heightened risks related to income and fiscal policies in the context of stronger tensions in domestic politics in the run-up to year-end. Against this backdrop, the balance of risks to the updated inflation forecast tilted slightly upwards, especially in the short run. The strongest risks to inflation rate deviating upwards from the projected baseline scenario trajectory were the following: (i) the risk of overshooting the budget deficit target and delaying the measures aimed at adjusting the public spending composition and fiscal consolidation envisaged for 2010-2011, implicitly that of a more challenging public deficit and public debt financing/refinancing, also as a result of a possible disruption in the implementation of the multilateral arrangement signed with international financial institutions and bodies – should some of these risks materialise, disinflation could be stymied even in the longer term, and (ii) the foreseeable deterioration, under the circumstances, of domestic and foreign economic and financial agents' perception of the outlook for the Romanian economy, that was likely to fuel domestic currency depreciation and, implicitly, inflation expectations.

The materialisation of the risk of a deviation from the external borrowing calendar for 2009 Q4 under Romania's multilateral arrangement with EU, IMF and other international financial

³⁸ Starting with the 24 November – 23 December 2009 maintenance period.

institutions prompted the NBR Board to lower, in a special meeting held on 16 November 2009, the minimum reserve ratio on credit institutions' foreign currency-denominated liabilities with residual maturity of up to two years to 25 percent, from 30 percent, starting with the 24 November – 23 December 2009 maintenance period. Given the delay in external inflows, the measure was aimed at ensuring adequate financing conditions in the local banking system, as required by the covering of the government sector's borrowing needs from domestic market resources in the last part of 2009, while preserving the macroeconomic equilibria. At the same time, this was another step in the process of gradual harmonisation of minimum reserve ratios in Romania with ECB standards.

Against the background of a projected abatement of the tensions associated with the domestic political environment and a lower risk for income and fiscal policies to deviate from the coordinates agreed with the EU and the IMF, the NBR Board resumed the rate cutting cycle, reducing the policy rate by 50 basis points to 7.5 percent on 5 January 2010. The chief driver behind this move was the outlook for consolidation of disinflation in the medium term, in line with the expected magnitude and duration of the negative output gap. The ongoing rise in the demand shortfall was confirmed by the persistence of a severe economic contraction in Q3, as reflected by the annual GDP dynamics that reached -7.1 percent; nevertheless, the magnitude of the economic downturn lagged behind that seen in 2009 Q2, which could have been the lowest ebb of the Romanian economy. Behind the turning point in the annual GDP growth in Q3 stood the slower decline in domestic demand³⁹ on the back of a slight improvement in household actual final consumption (-12.7 percent year on year compared with -13.2 percent in the prior quarter) and gross capital formation (due solely to the change in inventories).

In turn, incoming economic statistics and data during 2009 Q4 pointed to the high likelihood of a protracted negative GDP dynamics. This was however relatively mitigated by a potentially slower contraction in both major components of domestic demand. It was assumed that the decline of gross fixed capital formation would further outpace that of consumer demand⁴⁰, but there are still uncertainties surrounding the latter's magnitude because of the mixed developments in the leading indicators of such a behaviour. Thus, on the one hand, the negative annual dynamics of turnover volume in services and trade in motorcycles and motor vehicles slowed down, with the similar indicator on retail trade

³⁹ Net exports posted a lower positive contribution to GDP advance for the second successive quarter.

⁴⁰ Suggested especially by the developments in indicators on new construction works and equipment purchase, foreign direct investment, medium- and long-term corporate loans and public-sector's capital expenditures.

turnover volume staying flat on average compared with the previous quarter. On the other hand, the annual growth rate of the average real net wage slipped into negative territory (together with the sharper decrease in Romanian workers' remittances in October versus the same year-earlier period), budgetary personnel costs appeared likely to decline over the final two months of 2009 (due also to the unpaid leave imposed on public-sector employees) and the unemployment rate rose at a quicker tempo in October, along with the consumer confidence index recording an ongoing deterioration; these developments were accompanied by a further upturn in households' net savings with banks.

This was the result of the continued decline in the annual real growth rate of loans to households, which went down to 0.2 percent in October-November from an average of 3.7 percent 2009 Q3. The real annual dynamics of such loans re-entered negative territory in November after rebounding somewhat in October largely as a result of the year-on-year depreciation of the domestic currency. Both demand for and supply of loans to this sector remained feeble in October-November. Demand for loans was hurt by the absence of a significant improvement in developments in interest rates on new business, which stayed at very high levels, and the somewhat growing household fears regarding their jobs and incomes in the future; a relative recovery, falling short of expectations however, saw the demand for housing loans, which benefited from the implementation of the "First Home" programme. In turn, the loan supply was affected primarily by the banks' ongoing caution that was motivated, *inter alia*, by an increasingly challenging management of the size and/or structure of their balance sheets in the current economic and financial environment. The persistence of banks' relatively high wariness and risk perception relative to loans to households was also reflected in 2009 Q3 by the partly unexpected protraction of the tightening in lending terms and conditions⁴¹, the adjustment of which was nevertheless slower than in prior quarters and different in terms of borrowers⁴². Under the circumstances, in October and November the new loans to households⁴³ inched up from the

⁴¹ As reflected by the NBR's survey on lending to non-financial corporations and households conducted in November.

⁴² According to the cited survey, the change in households' lending conditions was motivated basically by: (i) expectations on their general economic standing and the risk associated with customers' creditworthiness; (ii) real-estate market outlook, including collateral risk and (iii) the widening share of non-performing housing loans in the loan portfolio. As for lending terms, collateral requirements and other contractual clauses were tightened and the spread between lending rates and 1M ROBOR was raised; nonetheless, the same requirement, together with that concerning the maximum share of the loan amount in the real-estate collateral value, was eased in the case of mortgage loans.

⁴³ Based on data available at the CCR, along with those included in credit institutions' reports submitted pursuant to Norms No. 14/2006 issued by the National Bank of Romania.

previous quarter, owing chiefly to the implementation of the “First Home” programme and, to some extent, the broadening of debt rescheduling practices. The combined effect of the above-mentioned determinants caused, in October and November, the persistence of a downward drift in average annual growth rates⁴⁴ of leu- and foreign currency-denominated loans granted to households to as low as -9.5 percent and -2.6 percent against -6.5 percent and 0.3 percent in 2009 Q3. The analysis of the household loans by borrower continues to illustrate the steepest fall in the annual dynamics of consumer loans, which touched -2.4 percent, down 4.2 percentage points against the preceding quarter. The average annual rate of increase of housing loans remained in positive territory (17.3 percent), although it decreased over the previous quarter; this owed much to the foreign currency-denominated component (expressed in euro), the annual change of which gathered momentum in October and November.

At the same time, in contrast to the previous periods, the real average annual dynamics of household deposits with banks rose to 16.1 percent in October-November, compared with 13.0 percent in Q3. The explanation for these developments lies, to some extent, with the base effect induced by the short-lived drop in those deposits in October 2008. Nevertheless, against the background of the ongoing portfolio shift towards term deposits, this move suggests a relative persistence of the propensity for saving given the worsening expectations on future incomes and the debt servicing capability. The ongoing rise in demand for money for precautionary reasons was underpinned also by the relative changes in yields on various monetary asset classes⁴⁵. Therefore, the real annual dynamics of households’ term deposits with a maturity of up to two years peaked at 61 percent, fostered both by leu- and foreign currency-denominated deposits. An upward trend was reported by the annual growth pace of term deposits with a maturity of over two years as well. The term structure of new deposits in October-November reveals, unlike the previous months, the shaping of a possible polarisation trend as far as households were concerned, as illustrated by the relatively larger volume (and weight) of deposits at the shorter end of the maturity spectrum (between one month and three months) and, to a smaller extent however, deposits with a maturity of over two years.

Another chief driver behind the NBR Board’s decision to lower the monetary policy rate was the recent improvement in the performance of the leu exchange rate and in the expectations on

⁴⁴ In real terms in case of leu-denominated loans and calculated in euro terms in case of foreign-currency-denominated loans.

⁴⁵ As far as households were concerned, the spread between interest rates on term deposits and those on overnight deposits in domestic currency increased in October and November.

future developments (see 2.2. *Exchange rate and capital flows*), also due to favourable prospects for reactivating the multilateral external borrowing arrangement signed with the EU, the IMF and other international financial institutions. This context strengthened the case for an ongoing sustainable decline in adjusted CORE2 inflation rate and for the resumption of the downward trend in headline inflation, whose interruption in November 2009 – foreseen to persist into early 2010 – was solely due to the impact of higher excise duties (especially on tobacco⁴⁶) and administered price adjustment; in addition, the risk of second-round effects of these excise and price increases was considerably mitigated by expectations of a deeper and persistent aggregate demand deficit.

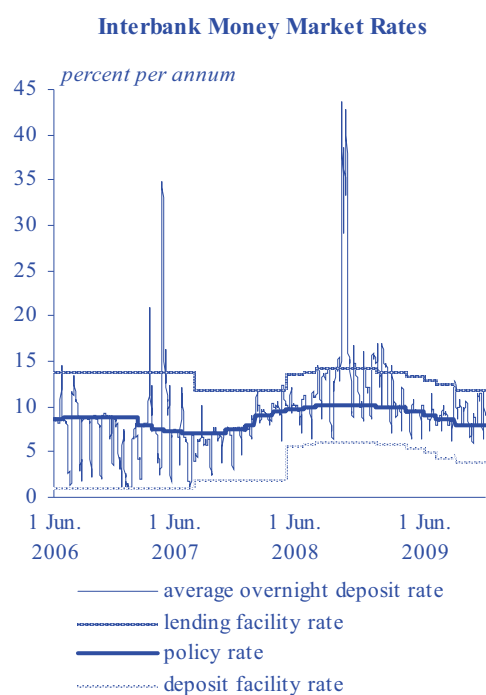
Monetary policy rate decisions were taken against the background of ensuring a firmer management of liquidity in the banking system. The central bank's creditor position vis-à-vis the banking system continued to shrink in 2009 Q4, due basically to larger liquidity injections performed by the State Treasury. The National Bank of Romania adjusted the volume and the frequency of repo transactions accordingly, their average reaching about one-third of the third-quarter figure. At the same time, the maturity associated with such operations was shortened temporarily, to between two and seven days. Against the backdrop of higher uncertainties surrounding liquidity conditions, fuelled *inter alia* by expectations of a hefty increase in public sector's financing requirements in the run-up to year-end, banks' resort to the lending facility picked up in October and December; in November however, credit institutions had a smaller recourse to this facility, concurrently with a stronger resort to the deposit facility and the central bank's organising a deposit auction. In 2009 Q4 as a whole, the average volume of liquidity-providing operations dropped to less than half of the level seen in the previous quarter, but remained well above that of liquidity-absorbing operations.

2. Financial markets and monetary developments

In 2009 Q4, interbank market rates stood higher than the monetary policy rate, in the context of the stronger impact that the substantial budget deficit financing needs exerted on the money market. In the latter part of the quarter under review, the exchange rate of the leu resumed a downward path, amid the improvement in global risk appetite and the outlook for stabilisation in the domestic political climate. The growth pace of broad money accelerated marginally, on the back of the expansion in net credit to the general government.

⁴⁶ The impact of higher excise duties for tobacco products on annual inflation rate in December 2009 was estimated at 1.8 percentage points.

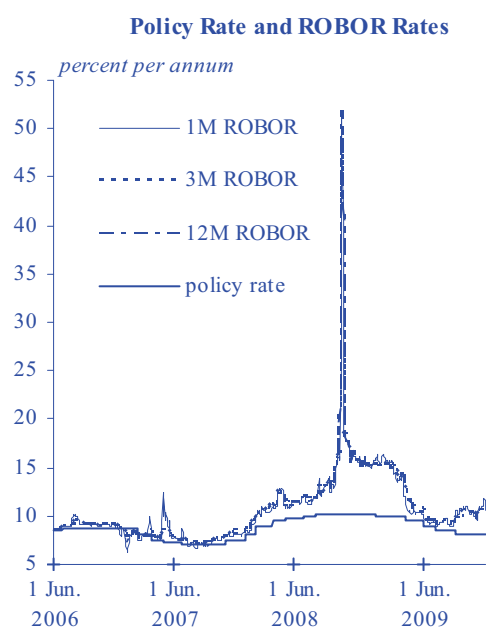
2.1. Interest rates



In the final quarter of 2009, the downtrend in interbank market rates came to a halt. For most of the period under review, these rates stood in the upper part of the corridor defined by the interest rates on central bank's lending and deposit facilities, and displayed higher volatility. In this context, the quarterly average of interbank market rates rose to 9.3 percent, up 0.4 percentage points from the figure recorded in the preceding quarter.

However, very short-term interbank rates posted uneven developments in the period under consideration. In October and the first ten-day period of November, these rates hovered around 10 percent, staying on the path they followed ever since the end of the preceding quarter, in the context of higher uncertainties surrounding the current and short-term developments in liquidity conditions. The central bank increased the firmness of management of liquidity in the banking system, credit institutions' reserve demand being covered, in October, by short-term (4- and subsequently 2-day) repo transactions, as well as by increased recourse to the lending facility.

Subsequently, very short-term interest rates fluctuated within narrower ranges, declining at levels close to the monetary policy rate, due to the relative easing of liquidity conditions. Hence, the temporary reserve surplus built up in the reserve maintenance period ended in November was partially mopped up by the central bank via a deposit-taking operation. However, in December, interbank deposit rates reverted to levels in a range of 11 percent, on the back of the increase in the share of credit institutions' resort to lending facility in total NBR's refinancing operations. Nevertheless, by year-end, a normalisation process of money market interest rate became apparent, under the impact of the rise in liquidity supply, including as a result of the central bank performing a 6-day repo transaction, with volumes traded by banks being entirely allotted.



Longer-term money market rates stayed on the upward path they followed since end-September, given the substantial rise in budget deficit financing needs in the last part of 2009, as well as the increase in credit institutions' uncertainties surrounding the future developments in liquidity conditions. The (1M-12M) ROBOR saw only a temporary uptrend reversal at mid-quarter and reached intra-quarter highs at end-December. Thus, average (1M-12M) ROBOR rates added 1.1 percentage points in December versus September, sharper increases being reported in the case of (1M-3M) rates.

Implicit forward rates posted similar developments. Therefore, the expected 3M ROBOR rates covering 3, 6 and 9 months (calculated

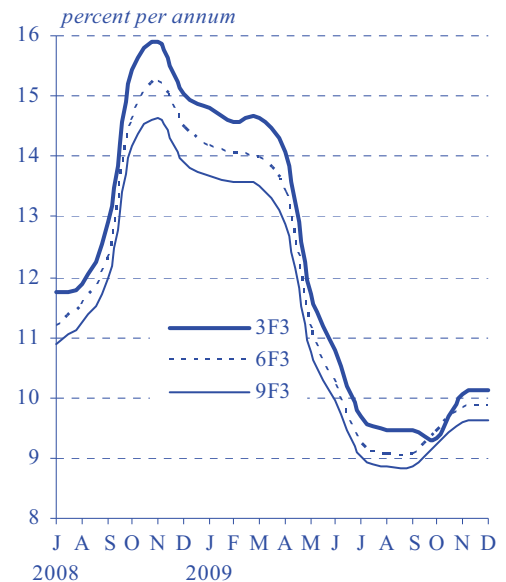
based on December average quotations) were of 10.1 percent, 9.9 percent and 9.6 percent respectively, standing nearly 0.8 of a percentage point higher than those recorded in September.

In 2009 Q4, interest rates on the primary market for government securities remained unchanged from the level recorded in September (10.0 percent). The volume of securities the MPF issued in the final three-month period of 2009 totalled RON 9.2 billion (about 55 percent of the announced figure), 64 percent of which being accounted for by 6-month and 1-year bills. Furthermore, in November, the MPF also raised foreign currency funds from the domestic market, via two government (1- and 3-year) securities issues, whereby EUR 1,423 million and EUR 794 million were borrowed at an average interest rate of 4.25 percent and 5.25 percent respectively.

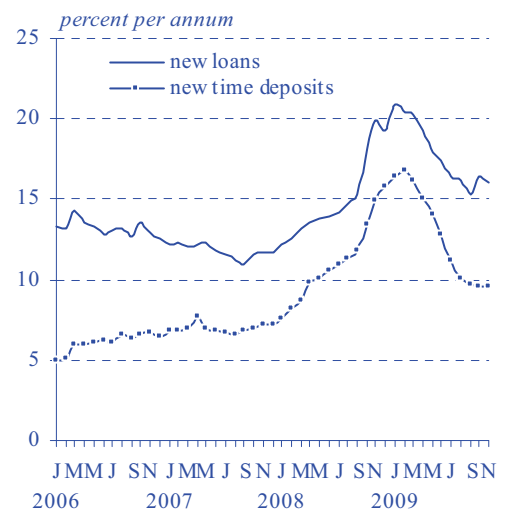
The average interest rate on outright operations performed on the secondary market for government securities decreased marginally from 2009 Q3, i.e. down 0.15 percentage points to 10.04 percent, given that the volume of transactions reached an all-time high (also due to the ongoing increase in non-residents' leu-denominated securities holdings). The quarterly turnover of the secondary market for government securities (excluding the NBR) ran at RON 23.1 billion, most being outright transactions (about 90 percent)⁴⁷. Securities with residual maturities of up to one year remained the most heavily traded.

Average lending and deposit rates on new business decreased at a slower pace in September-November 2009 (down 0.48 percentage points to 9.58 percent and 0.15 percentage points to 15.99 percent respectively). Interest rates on new time deposits recorded similar developments as regards both categories of customers, their downward adjustment being significantly lower (down 0.82 percentage points to 9.86 percent for households and 0.22 percentage points to 9.38 percent for non-financial corporations). However, in the quarter under review, average lending rates on new business followed a downward course only in the case of households, standing at 17.18 percent in November (down 0.77 percentage points versus August), as a result of the decline in the average interest costs associated with new consumer loans, as well as with loans for business development and other purposes. By contrast, average interest rate on new loans of non-financial corporations recorded monthly fluctuations in both directions, reaching 15.76 percent at the end of the reviewed period, a level slightly higher than that recorded in August.

Implicit Forward Rates



Bank Rates



⁴⁷ The volume of transactions in government securities performed via BSE also hit a record high, yet it remained relatively low as compared with that of transactions conducted in SaFIR; the average interest of BSE transactions stood at 9.72 percent (0.48 percentage point lower than the figure recorded in Q3).

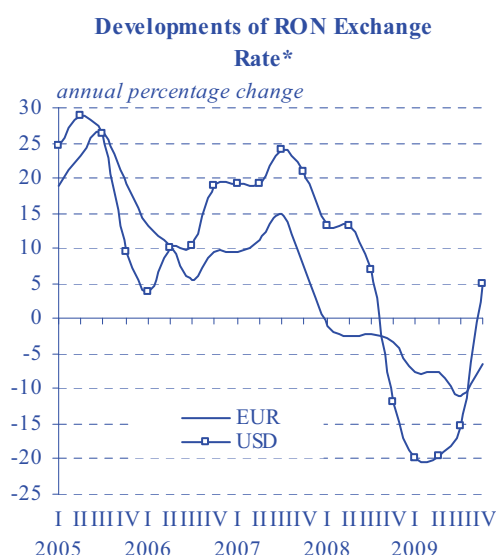
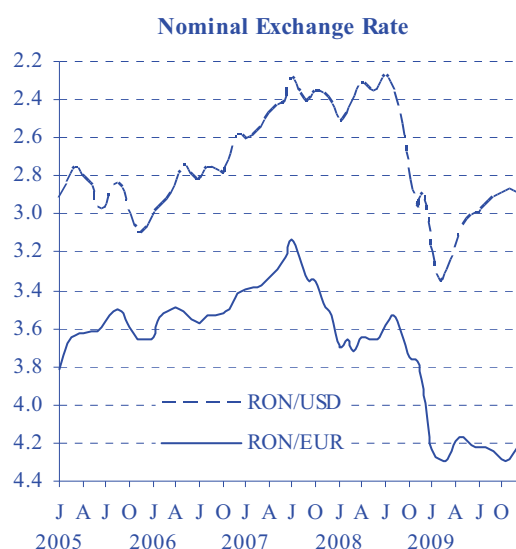
This development was mainly due to the rise in the average interest cost associated with small-value loans (the equivalent of less than EUR 1 million), amid the overall upward trend in ROBOR rates.

2.2. Exchange rate and capital flows

The RON/EUR exchange rate embarked on a steeper upward path in early 2009 Q4 amid worsening investor sentiment on economic and financial developments in the region and heightened domestic political tensions. Subsequently, the exchange rate reverted to a generally downward slope, reflecting the relative improvement in global risk appetite and, towards the end of the period under review, prospects of the domestic political environment stabilising. Such developments were accompanied by increased daily volatility in the RON/EUR exchange rate.

Consequently, October through December, the domestic currency strengthened against the euro by 0.3 percent in nominal terms and 1.7 percent in real terms, compared to a depreciation of 0.5 percent in both nominal and real terms in 2009 Q3. In relation to the US dollar, the leu strengthened 0.6 percent in nominal terms and 2.0 percent in real terms, given that the US currency weakened slightly against the euro. Calculated as an average annual change for 2009 Q4, the domestic currency posted a considerably slower nominal depreciation versus the euro (10.6 percent) and at the same time the first nominal appreciation against the US dollar in the past six quarters (0.2 percent).

Upward pressures on the RON/EUR exchange rate gained momentum in the first part of October, amid the worsening of investor sentiment towards the financial markets in the region, also as a result of: (i) statements by EBRD and IMF officials concerning the fragility of banking systems in major CEE countries and the possibly slower recovery of these economies; (ii) insufficient hints on the improvement in macroeconomic developments in these countries, as revealed by the statistical data published during the period under review. Such pressures were amplified by (i) heightened tensions in the domestic political field following the no-confidence vote given by Parliament to the incumbent government on 13 October and by (ii) the risk of a downgrade in Romania's sovereign rating in the event of threats to the smooth unfolding of the external financing arrangement with the EU, the IMF and other international financial institutions. Against this backdrop, banks' foreign liabilities witnessed a slight decline, mainly on account of long-term financial borrowings and deposits. Furthermore, the RON/EUR exchange rate followed an almost steady upward path – despite the sizeable month-on-month decline in resident corporations' net demand for foreign currency – and reached an 8-month high on 29 October. Thus, the leu



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

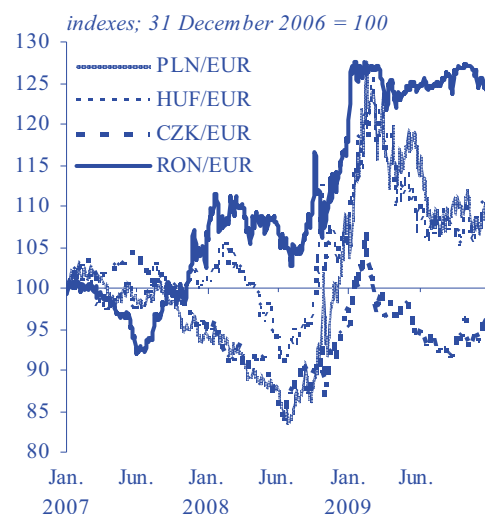
Source: NIS, NBR

posted a nominal depreciation of 1.1 percent versus the euro, but fared better than the Czech koruna and the Polish złoty (which weakened 1.9 percent and 1.3 percent respectively in nominal terms).

The RON/EUR exchange rate saw a trend reversal in November versus the previous month, primarily on account of a relative improvement in global risk appetite and in investor sentiment towards the economies in the region⁴⁸. Expectations of investors on the domestic market and hence exchange rate developments were also positively affected by: (i) the relatively better-than-anticipated developments in major indicators, such as GDP, industrial output and budget deficit, published during the reported period, (ii) the European Commission's brighter outlook concerning the Romanian economy during 2010 and 2011 (the autumn forecast), and (iii) foreign banks reaffirming their commitment to maintain their exposure to the local market. To this favourable impact added, to a certain extent, the monetary policy decisions taken by the NBR in early November⁴⁹ in response to heightened tensions in the domestic political field and, subsequently, to the deviation from the external borrowing calendar for 2009 Q4. Against this background, the foreign currency-denominated loans taken by the MPF on the domestic market during the period under review (amounting to EUR 2,217.1 million) did not feed through into exchange rate movements. Thus, the average RON/EUR exchange rate posted a marginal increase versus the previous month. The Hungarian forint weakened considerably against the euro (0.9 percent), while the Polish złoty and the Czech koruna strengthened in relation to the single currency.

Exchange rate volatility heightened in December within an external environment featuring opposite influences⁵⁰. Developments reflected mainly both-way effects exerted on investor sentiment by major economic indicators staying on favourable trajectories (the press release on third-quarter GDP, industrial output in October and the 10-month trade balance), on the one hand, and by the political instability and related uncertainties lingering on until the end of

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

Key Financial Account Items (balances)

	EUR million	
	2008 11 mos.	2009 11 mos.
Financial account	17,027	4,133
Direct investments	8,554	3,746
residents abroad	-87	-79
non-residents in Romania	8,642	3,826
Portfolio investments and financial derivatives	-216	112
residents abroad	-271	172
non-residents in Romania	55	-60
Other capital investments	8,797	2,217
credits and loans from the IMF	0	6,769
medium- and long-term investments	5,220	1,373
short-term investments	-1,293	-2,718
currency and short-term deposits	1,564	-4,358
other	3,306	1,151
NBR's reserve assets, net		
(—" increase/"+" decrease)	-109	-1,942

⁴⁸ Estimates on GDP dynamics in 2009 Q3 released during the period under review pointed to faster-than-expected growth in most Central and East-European countries and to the euro area economy emerging from recession.

⁴⁹ On 3 November, the NBR Board decided to leave the policy rate unchanged at 8 percent. Furthermore, on 16 November, the NBR Board decided to lower by 5 percent the minimum reserve requirements ratio on credit institutions' foreign currency-denominated liabilities with residual maturities of up to two years.

⁵⁰ The downgrading of Greece's and Spain's sovereign ratings and the ECB's warning on the high uncertainties surrounding the revival of the euro area economy, on the one hand, and the upgrading of Turkey's sovereign rating, more favourable prospects related to the situation in Dubai and encouraging developments in the US economy, on the other hand.

the second 10-day period of the month, on the other hand. However, the validation of the new cabinet by Parliament on 23 December, which paved the way for the reactivation of the multilateral external financing arrangement with the EU, the IMF and other IFIs, had a favourable impact on the RON/EUR exchange rate, which witnessed in December the largest decline in the past eight months, i.e. 1.5 percent.

2.3. Money and credit

Money

Annual Growth Rates of M3 and Its Components

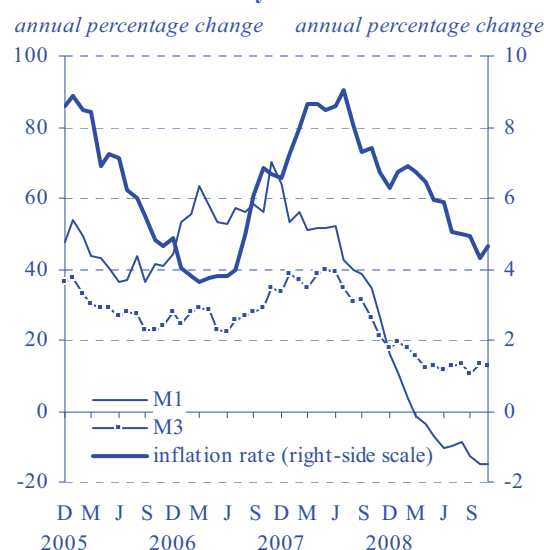
	real percentage change						
	2008	2009				Oct.	Nov.
		IV	I	II	III		
	quarterly average growth						
M3	13.8	10.0	5.7	6.8	8.5	7.6	
M1	17.7	-2.1	-12.4	-14.8	-18.2	-18.7	
Currency in circulation	18.2	8.9	-0.1	-2.9	-7.1	-10.0	
Overnight deposits	17.5	-6.0	-16.7	-19.0	-22.3	-21.9	
Time deposits (maturity of up to two years)	8.9	24.1	26.8	32.8	42.0	40.0	

Source: NIS, NBR

September through November 2009, the pace of increase⁵¹ of broad money (M3) picked up marginally (up 0.4 of a percentage point to 7.2 percent), although remaining at one of the lowest readings in past eight years. However, developments in this indicator were not uniform⁵² over the quarter under review, reflecting the impact of the persistent decline in economic activity, on the one hand, and the one-off decline in M3 in October 2008.

The analysis of M3 structure reveals the consolidation of the majority share of time deposits (56.3 percent on average, 2 percentage points higher quarter on quarter). This trend was manifest for both households and companies and reflected, similarly to the previous quarters, the keener demand for money for precautionary reasons, amid the worsening of both current and expected financial position of these non-bank sectors. Thus, while narrow money (M1) contracted more sharply than in the same year-ago period, the annual growth rate of time deposits with a maturity of up to two years hit a new all-time high.

Broad Money and Inflation Rate



Source: NIS, NBR

This portfolio shift was more obvious in case of households, with their overnight deposits posting the lowest dynamics and their time deposits with a maturity of up to two years the fastest pace of increase in the data series, irrespective of denomination. Overall, the growth rate of households' M3 deposits picked up only marginally, reflecting mainly the base effect induced by the retrenchment in the balance of these placements in October 2008. In addition, similarly to the previous period, certain amounts from budgetary sources were channelled to these deposits (such as those earmarked for agriculture⁵³).

The dynamics of total corporate deposits included in M3 gathered momentum more visibly during the reported quarter, most likely

⁵¹ Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2009.

⁵² M3 annual dynamics slowed to an 8-year low in September (5.5 percent, also seen in April 2009) and then edged up around 3 percentage points in October.

⁵³ In line with calculations based on APIA press releases (The Agency for Payment and Intervention for Agriculture).

boosted by (i) budget outlays destined, among others, to paying off arrears and to VAT refunds⁵⁴ and, to a certain extent, by (ii) the still high volume of foreign direct investment in the non-bank sector⁵⁵. The dynamics of corporate overnight deposits saw a less negative value, while the pace of increase of time deposits with a maturity of up to two years further posted an upward trajectory, both being ascribable to the foreign currency-denominated component. Households also displayed a keener interest in forex placements, although on a slightly lower scale. Hence, during the reported period, the average share of foreign currency-denominated deposits in broad money hit a 4½-year high of 33.6 percent.

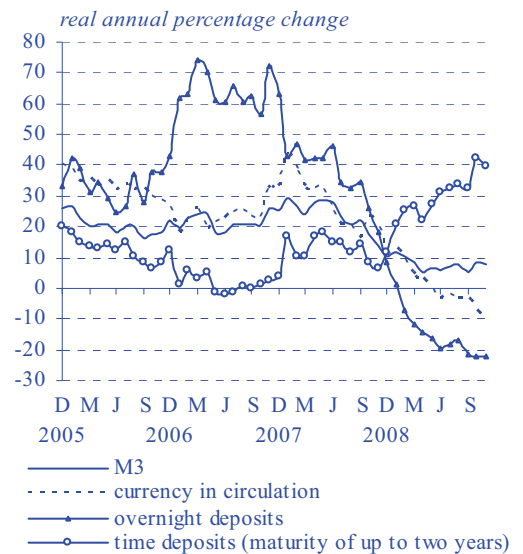
From the perspective of M3 counterparts, the slower dynamics of credit to the private sector further acted as the major deterrent to the growth of liquidity in the economy. An opposite influence came from the pick-up in the growth rate of central government net credit (particularly in November) and that of net foreign assets, as well as from the slower increase in long-term financial liabilities (capital accounts included).

Credit

September through November 2009, the growth rate⁵⁶ of credit to the private sector continued to decelerate and entered negative territory (-1.4 percent) for the first time in the past eight years and a half. The development was due both to the domestic currency component, whose dynamics slackened to an 8½-year low, and to foreign currency-denominated loans, whose percentage change turned negative for the first time over the last nine-and-a-half years. However, when expressed in lei, the pace of increase of forex credit remained in positive territory (albeit also on the wane), so that the average share of the foreign currency-denominated component in total credit to the private sector peaked at 60.1 percent, the highest reading since 2005 Q2.

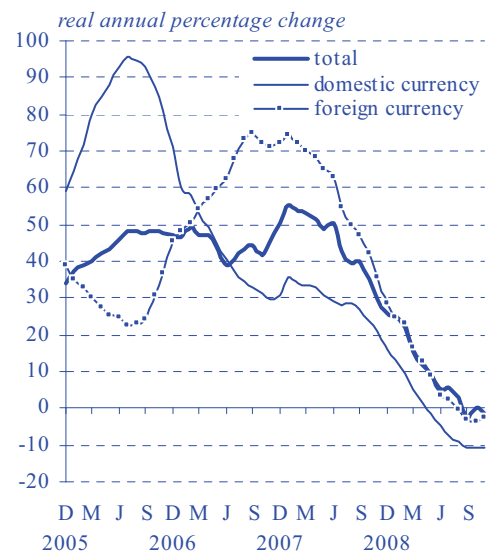
Both credit demand and credit supply in the private sector were further dampened mainly by: (i) the protracted decline in economic activity and its unfavourable prospects over the short term⁵⁷ and (ii) credit institutions’ increased wariness, as highlighted

Main Broad Money Components



Source: NIS, NBR

Credit to Private Sector by Currency



Source: NIS, NBR

⁵⁴ According to the MPF press release of 17 December 2009.

⁵⁵ According to balance-of-payments data, the average volume of non-residents’ investment in the non-bank sector during September-October 2009 exceeded the June-August 2009 reading.

⁵⁶ Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for September-November 2009.

⁵⁷ According to the NIS survey on economic activity trends, some major fields in the national economy are expected to see a decline in activity December 2009 through February 2010.

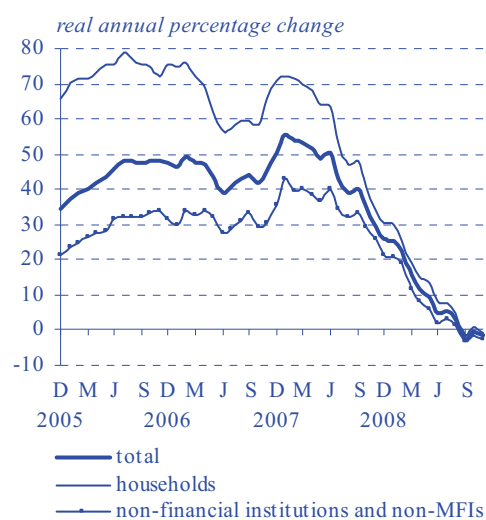
by tighter lending terms and standards⁵⁸ (although to a lesser extent than in the previous quarters) and still large holdings of government securities.

Against this backdrop, both the growth rate of loans to households and that of corporate borrowings entered negative territory for the first time in the past nine years and eight and a half years respectively. Developments in household loans reflected the year-on-year contraction in real terms in outstanding consumer loans, irrespective of denomination, as well as the slacker dynamics of housing loans, especially the leu-denominated component. Albeit also on the wane compared to the previous period, the pace of increase of foreign currency-denominated housing loans remained the fastest of all credit categories, i.e. 7.3 percent. It was bolstered by the “First Home” programme, as indicated by the considerable rise in the volume of new business in euro for real estate assets⁵⁹. The growth rate of corporate borrowings further posted a relatively steeper deceleration than that of household loans, mainly on account of the leu-denominated component and of forex loans with a maturity of up to five years. Conversely, the dynamics of long-term corporate loans in foreign currency picked up, possibly due also to the debt rescheduling, aiming to improve firms’ ability to service their debts to banks.

Nevertheless, corporate debt restructuring might have lost momentum against the previous periods, as CCR data⁶⁰ indicate that the flow of new business of companies contracted versus the previous quarter, when some sectors had seen historical highs in terms of credit flows. This could also be attributable to the impact of still high lending rates on new business to non-financial corporations and worsening expectations regarding short-term developments in the RON/EUR exchange rate.

Net credit to central government continued to exert an expansionary impact on M3, with its dynamics reaching a historical high on account of the growth rate of this sector’s deposits with credit institutions plunging deeper into negative territory. On the other hand, the dynamics of government securities held by credit institutions decelerated, albeit remaining at very elevated level, while the pace of increase of Treasury deposits gained momentum.

**Credit to Private Sector
by Institutional Sector**



Source: NIS, NBR

⁵⁸ According to the NBR survey on lending to non-financial corporations and households published in November 2009.

⁵⁹ According to CCR data referring to loans in excess of leu 20,000 approved during the period under review.

⁶⁰ Idem.

V. INFLATION OUTLOOK

The current projection indicates the continuation of disinflation, placing annual CPI inflation at 3.5 percent for end-2010 and 2.7 percent for end-2011. CPI inflation is expected to return inside the variation band around the central targets, i.e. 3.5 percent in 2010 and 3.0 percent in 2011, as early as the first part of the current year. The upward revision of the end-2010 CPI inflation forecast is largely attributed to reassessing as more unfavourable the projected effects of exogenous and supply-side factors, mainly due to estimates of a stronger-than-previously-forecasted inflationary impact of the hike in excise duties on tobacco products on 1 January 2010 and the projection of higher increases in administered prices. Similar, albeit less significant, influences are due to larger projected rises in fuel prices and some volatile food prices.

For 2010, the current projection envisages the path of CORE2 inflation rate running above that presented in the previous forecasting round, especially due to the additional first-quarter effect of the adjustment of excise duties on tobacco products, as well as a slightly lower negative output gap projected for the current year. Nevertheless, while being projected to gradually decline starting with 2010 Q2, the sizeable negative output gap is expected to continue to exert disinflationary pressures over the entire forecast horizon. Such pressures will induce a consolidation in the decrease of adjusted CORE2 inflation in 2010, which will benefit also from moderate import price dynamics in the absence of inflationary pressures similar in magnitude to those exerted in 2009 by the leu exchange rate.

It is anticipated that the projected decline in CORE2 inflation rate below that of headline inflation starting with 2010 Q2 will support the gradual anchoring of inflation expectations at levels compatible with the established targets and thus foster the disinflation process over the entire projection horizon.

For 2011, the current projection envisages a consumer price inflation trajectory largely in line with that presented in the previous Inflation Report. A marginally unfavourable contribution will be generated towards the end of the projection horizon by the incorporation of higher increases in administered prices into the current baseline scenario. The annual CORE2 inflation is foreseen to fall rapidly in early 2011, particularly as a result of a strong base effect expected in Q1. The downward trend will reverse towards the end of the period under review, in line with the gradual fading of disinflationary pressures from the negative

output gap and the influence of a relative acceleration of the euro area inflation rate on imported goods prices.

The monetary policy stance will remain prudent, aiming to alleviate potential second-round effects of adverse exogenous shocks such as those at end-2009 and those expected for 2010 Q1. Throughout the projection horizon, the central bank will pro-actively seek to ensure a balanced adjustment of real broad monetary conditions with a view to consolidating the prospects of both inflation returning in the vicinity of the established medium-term targets and sustainable revival of lending in the Romanian economy. The fulfilment of these objectives is strictly conditional upon the other elements of the macroeconomic policy mix complying with the updated coordinates of the multilateral external financing arrangement signed by Romania with the EU, the IMF and other international financial institutions, on the one hand, and the absence of any significant deviations from the forecast assumptions regarding the impact of exogenous factors and external developments, on the other hand.

Against the background of persistently high uncertainties surrounding the macroeconomic developments both domestically and internationally over the current projection horizon, the overall risks of inflation rate deviating from the baseline scenario trajectory appear to be relatively balanced. Compared with the assessment in the previous forecast, the current one foresees relatively lower risks posed by possible slippages in the coordination and implementation of the macroeconomic policy mix, although such risks have not yet dissipated altogether. The present revision relies on the stabilisation over the past months of the domestic political climate, in the absence of a deterioration of the macroeconomic environment, and the reactivation of the multilateral external financing arrangement in January. Although the risks of some macroeconomic policy components deviating from the coordinates in the programme due to domestic reasons cannot be overlooked, developments in the external economic environment appear to be the major potential source of uncertainties surrounding the current projection.

From the perspective of the risks posed by the external environment, particularly relevant is the extent to which the recent signals on the global economic recovery and the growing confidence on international financial markets will be sustainably confirmed in the future, absent the resurgence of any fallout from the global crisis. Over the medium term, a reversal in the optimistic developments that are manifest in the short run could adversely impact the Romanian economy, thereby amplifying the risks related to growth and public deficit financing and putting renewed pressure on the leu exchange rate. At the same time, such a scenario would imply lower commodity prices on foreign

markets inducing stronger disinflationary pressures on domestic prices. Under the circumstances, it is difficult to assess in which direction the inflation rate will deviate from the forecasted path, though downside deviations in the near run and upside deviations in the medium term are considered as being more likely to occur.

On the other hand, a more favourable scenario than that incorporated in the current forecast regarding the developments in the real sector and global financial markets could boost investor confidence in the prospects for the Romanian economy, with beneficial effects on the domestic currency and the financing of real economy. By contrast, world commodity prices might increase at a faster pace, fuelling domestic inflation. The short-term implications on the deviation of the inflation rate from the baseline trajectory are difficult to foresee, however, such a scenario is expected to relatively improve the outlook for disinflation in the medium and long term, amid the persistence, over this horizon, of the stability of the domestic macroeconomic environment.

The assumptions regarding future developments in administered prices and volatile food prices imply relatively high uncertainties. Hence, the risks for such prices to deviate from the baseline scenario coordinates are deemed as being relatively symmetrically distributed around the projected CPI inflation path for both price categories, with a slightly higher likelihood of upward deviations for food prices.

1. The baseline scenario of the forecast

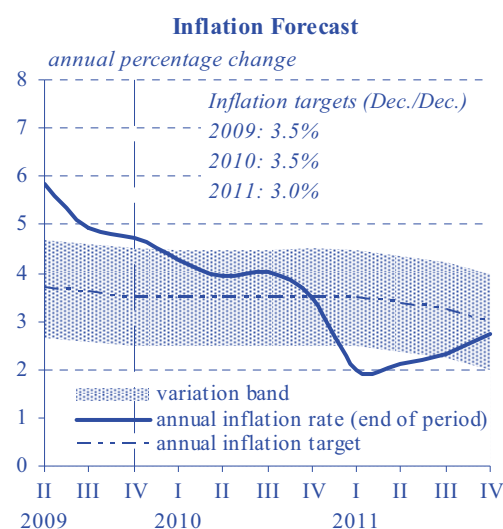
1.1. Inflation outlook

The current projection envisages the annual CPI inflation rate falling to 3.5 percent at the end of this year and 2.7 percent next year. The baseline scenario incorporates some favourable prerequisites for the consolidation of disinflation, thus strengthening the outlook for inflation staying within the targets set for the upcoming two years, i.e. 3.5 percent for end-2010 and 3.0 percent for end-2011, with a ± 1 percentage point variation band around the central target.

Table 5.1. The annual inflation rate in the baseline scenario

Period	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Target				3.5				3.0
Forecast	4.3	3.9	4.0	3.5	2.0	2.1	2.3	2.7

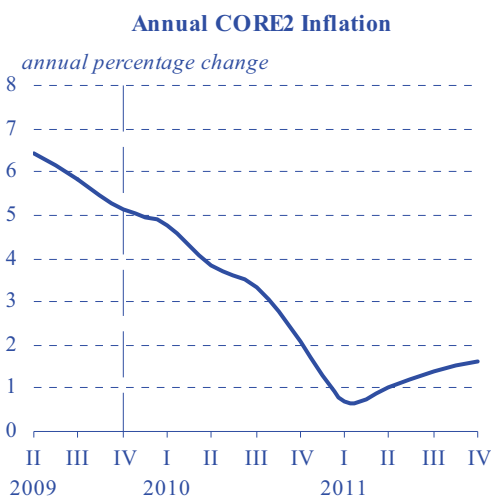
percent



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

Source: NIS, NBR calculations

Compared to the November 2009 Inflation Report, the annual CPI inflation forecast was revised upwards by 0.9 percentage points at the end of 2010, on the back of some unfavourable contributions arising particularly from administered prices and excise duties on tobacco products and cigarettes. Monetary policy will be aimed at alleviating potential second-round effects triggered by supply-side shocks that could fuel economic agents' inflation expectations. In 2010, disinflation will carry on, albeit at a somewhat slower pace than described in the previous projection. The largest contributor to disinflation will be the annual CORE2 inflation rate that is set to decline quickly in the first part of the projection horizon. Over the medium term, a significant favourable support from all CPI components is required in order to ensure the consolidation of inflation at levels that are compatible with the assumed targets.



Source: NIS, NBR calculations

In the current forecast, the projected inflation rate builds upon the following:

- (i) The annual CORE2 inflation rate is expected to decelerate noticeably over the projection horizon, though at a slower pace than envisaged in the previous forecast, from 5.1 percent in 2009 Q4 to 2.1 percent and 1.6 percent in 2010 Q4 and 2011 Q4 respectively. Compared with the previous projection, the effect induced by the recent hike in the excise duty on tobacco products and cigarettes was adjusted upwards, leading to a relatively slower disinflation of this CPI component. Insofar as the influence of adverse supply-side shocks on CORE2 inflation diminishes gradually, this component's dip below CPI⁶¹ inflation is expected to induce a stronger decline in inflation expectations.

The weakening inflationary pressures from the exchange rate against the background of abating risk aversion of foreign investors will have an additional favourable contribution to CORE2 dynamics via import price inflation, especially in 2010. In its turn, the persistence of marked pressures exerted by aggregate demand⁶², although slightly revised compared with the previous forecast, is expected to trigger downward pressures on CORE2 inflation this year. The magnitude and the persistence related to the negative deviation of real GDP throughout the projection horizon underpin the assumption of subdued competitive pressures on production factor markets. This is expected to result in lower production costs borne by companies, thus being conducive to final goods' price dynamics fostering disinflation.

⁶¹ Starting in 2010 Q2.

⁶² For further details, see Section 1.3. *Aggregate demand pressures*.

Summing up the impact of its own determinants and taking into account the strong base effect expected for 2011 Q1, the baseline scenario places the annual CORE2 inflation for 2011 at levels well below the announced inflation target of 3 percent. Nevertheless, the downward trend anticipated in CORE2 inflation for this year is expected to reverse in 2011. This would be largely due to the developments in import prices, on the back of euro area HICP inflation returning to more elevated levels. At the same time, the expected resumption of economic growth in 2011, bolstered by favourable dynamics of most domestic demand components, will strengthen the disinflation process in accordance with the medium-term targets.

- (ii) In the near term, we expect a substantial inflationary impact on fuel prices generated by the hike in the excise duty on fuels as from 1 January 2010. Relative to the previous forecasting round, such impact was subject to revision. Over the projection horizon, fuel prices stand out as the most dynamic component of the consumer basket, owing primarily to the assumption of a rising oil price on the global markets.
- (iii) For most of 2010 and during 2011, administered prices are foreseen to have a slightly unfavourable contribution to disinflation⁶³. The baseline scenario includes certain revisions⁶⁴ against the previous forecasting round, i.e. expectations of higher increases in administered prices.
- (iv) The scenario regarding volatile prices of vegetables, fruit and eggs saw insignificant changes compared to that presented in the November 2009 Inflation Report. It anticipates that the contribution of this variable to inflation will be slightly higher in 2010, but lower in 2011.

Over the medium term, the convergence of inflation expectations towards the announced targets is expected to help contain the effects of some exogenous factors.

1.2. Exogenous pressures on inflation

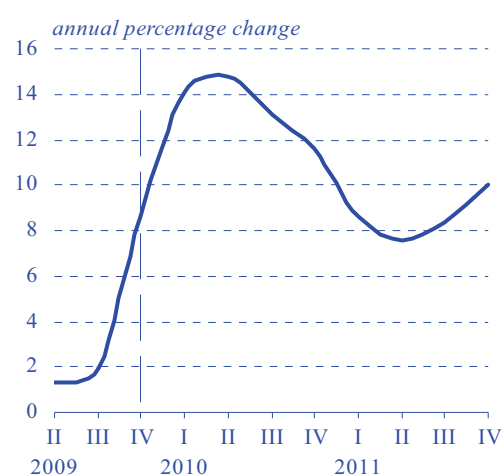
Compared to the previous projection, in the current scenario the cumulative effect of exogenous components⁶⁵ is seen as bringing about a larger contribution to CPI inflation both in 2010 and 2011, by 1 percentage point and 0.2 percentage points respectively. In

⁶³ The annual growth rate of administered prices is faster than those of all the other items included in the CPI basket.

⁶⁴ For further details, see Section 1.2. *Exogenous pressures on inflation*.

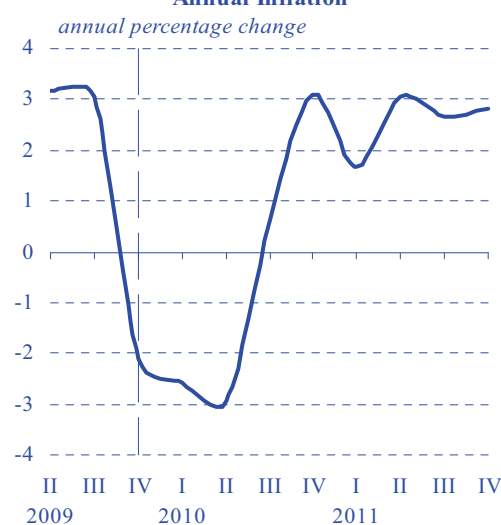
⁶⁵ The exogenous components of CPI inflation include administered prices, volatile prices of fruit, vegetables and eggs (VFE), excise duties on tobacco products and fuel prices.

Fuel Prices Annual Inflation



Source: NIS, NBR calculations

Vegetables, Fruit and Eggs Prices Annual Inflation



Source: NIS, NBR calculations

2010, additional inflationary pressures are expected from all exogenous components, whereas in 2011, such pressures are seen to be exerted solely by higher adjustments in administered prices⁶⁶. Thus, the annual rate of administered price inflation is projected to reach higher levels throughout the projection horizon, while volatile food inflation is anticipated to increase slightly during 2010 and decrease by end-2011.

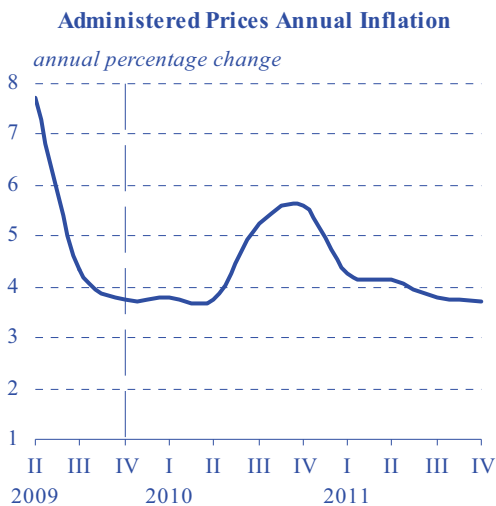
Excise duties on cigarettes are expected to make an additional contribution to CPI inflation in 2010, mainly as a result of a stronger-than-anticipated impact exerted by the hike in the excise duty on tobacco starting 1 January 2010.

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

percent

		Administered prices		Volatile food prices	
		2010	2011	2010	2011
Current projection	Annual change	5.6	3.7	3.1	2.8
	Contribution to annual CPI inflation (pp)	1.1	0.7	0.2	0.2
Previous projection	Annual change	2.7	2.0	2.2	4.6
	Contribution to annual CPI inflation (pp)	0.5	0.4	0.2	0.3

* Calculations for Q4 current year/Q4 previous year



Source: NIS, NBR calculations

The exogenous scenario for administered prices is built upon the usual assumptions regarding the adjustments in the prices of natural gas, electricity and heating – shown in Table 5.3. – but also incorporates the latest information relative to other categories of non-food items and services whose prices are likely to be subjected to significant adjustments over the projection horizon. As a result, compared to the previous projection, the baseline scenario of the current projection incorporates larger hikes in the prices of electricity and natural gas, as well as of medicines⁶⁷ for 2010; more significant adjustments in the prices of medicines, heating, water, sewerage and waste disposal, and transport services are expected for 2011.

⁶⁶ The Tax Code does not provide for any change in the excise duties on tobacco for 2011.

⁶⁷ In the case of medicines, such hikes will be generated by both the likely change in the methodology of calculating the reference prices of medicines for humans and the use by the authorities of a less favourable reference exchange rate for 2010 than for 2009.

Table 5.3. The scenario for the electricity, heating and natural gas prices growth rates*percent, annual change*

	Electricity		Heating		Natural gas	
	2010	2011	2010	2011	2010	2011
Current projection	4.0	0.0	5.2	4.6	5.0	0.0
Previous projection	0.2	0.0	5.2	1.5	0.0	0.0

The assumptions regarding the developments in external variables used in the current projection indicate the hypothesis of a gradual recovery of global economy from the severe recession. In light of the latest official statistical data⁶⁸, the assumption on the average annual increase in euro area GDP over the projection horizon was subject to an upward revision (by 0.3 percentage points in 2010 and by 0.1 percentage points in 2011). In line with the assumption on the economic pick-up in the member countries of the euro area, the annual HICP inflation rate is expected to remain, throughout the forecast horizon, on an upward trend⁶⁹, embarked upon in 2009 Q4. The 3-month EURIBOR interest rate is expected to decrease in 2010, while remaining relatively unchanged in 2011 compared to the previous projection. Considering the recent developments on the international financial markets⁷⁰, the current projection encompasses the scenario of a weaker USD against the EUR over the following eight quarters. The exogenous scenario for the oil price is similar to the one included in the previous report: it assumes a gradual increase in the price over the projection horizon⁷¹ under the impact of an expected upturn in the demand for commodities following the resumption of economic growth.

Table 5.4. Expectations on the developments in external variables*annual averages*

	2010	2011
WTI oil price (USD/barrel)	79.8	85.6
EUR/USD exchange rate	1.46	1.43
3-month EURIBOR interest rate (%)	1.17	2.24
Economic growth in the euro area (%)	1.4	1.4
Annual inflation rate in the euro area (%)*	1.3	2.1

* in Q4

⁶⁸ In 2009 Q3, the major world economies, i.e. the euro area, the United States of America and Japan, saw positive quarterly changes in real GDP.

⁶⁹ To reach a higher-than-previously-projected level (by 0.4 percentage points) in the final quarter of the projection horizon.

⁷⁰ In 2009 Q4, the US dollar depreciated by 3.2 percent quarter on quarter.

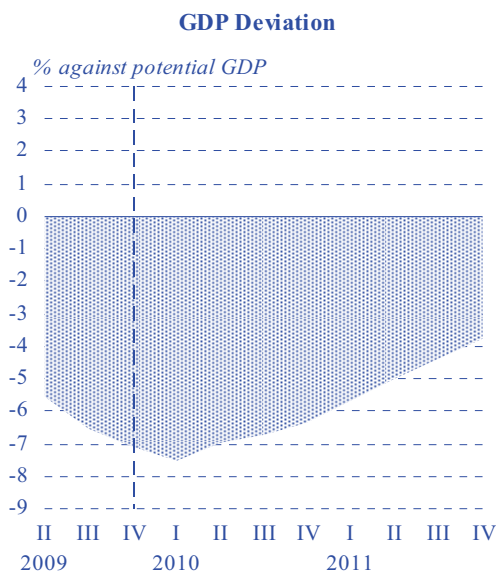
⁷¹ The international oil price is expected to go up gradually 2010 Q1 through 2011 Q4 by approximately 15 percent, the same as in the previous projection, starting however from a higher initial level than that estimated in the previous projection.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

In 2009 Q3, the magnitude of the quarter-on-quarter real GDP decline was lower than in the previous three quarters⁷², namely -0.6 percent, according to the seasonally-adjusted data released by the National Institute of Statistics. In the context of a lower-than-expected decline in real GDP, the current forecasting round incorporated a downward revaluation of the negative output gap for 2009 Q3. The analysis of a large set of statistical indicators points to a further moderation in the economic decline in 2009 Q4 as well, inducing *ceteris paribus* an upward evaluation of the negative output gap for the abovementioned period compared to the previous one.

The decrease in investment, the significant drop in foreign capital inflows (seen as a considerable source for company retooling), and the decline in the number of employees economy-wide, owing to a widening mismatch between demand and supply on the labour market, weighed heavily on the contraction of the real economy throughout 2009. Amid the persistent global crisis fallout on the Romanian economy, the growth rate of potential GDP is estimated to have decreased in 2009 as compared to 2008. Assuming an upturn in investment in 2010, the quarterly advance of potential GDP is expected to be higher than the similar measure in 2009.



Source: NIS, NBR calculations

In 2009 Q3, GDP posted a slower decline than in the previous quarter on the back of the marked deceleration of actual final consumption and gross fixed capital formation rates of decrease⁷³, given that the exports of goods and services continued to post faster growth rates than imports⁷⁴. Against the backdrop of a delayed resumption of lending and pessimistic expectations on future economic developments, domestic demand was almost entirely responsible for the magnitude of the economic contraction, being offset only to a small extent by the positive contribution of net exports (favourably influenced by the depreciation of the domestic currency in the first half of 2009).

⁷² According to the seasonally-adjusted data, GDP posted the following quarterly growth rates: -2.8 percent in 2008 Q4, -4.6 percent in 2009 Q1, -1.1 percent in 2009 Q2. Based on the non-seasonally adjusted data, real GDP posted the following annual dynamics: 2.9 percent in 2008 Q4, -6.2 percent in 2009 Q1, -8.7 percent in 2009 Q2 and -7.1 percent in 2009 Q3. Unless otherwise indicated, the quarterly growth rates of GDP components in this section are calculated based on the seasonally-adjusted data series released by the NIS.

⁷³ In 2009 Q3, actual final consumption dropped by 1.1 percent in quarter-on-quarter terms, after posting a 2.8 percent decline in 2009 Q2. Similarly, the quarterly rate of decrease of gross fixed capital formation slowed to 4.6 percent in 2009 Q3 from 13.5 percent in 2009 Q2.

⁷⁴ The exports of goods and services (seasonally-adjusted data series) recorded a quarterly pace of increase of 4.9 percent in 2009 Q3, compared to 5.0 percent in 2009 Q2, whereas the imports of goods and services reported a growth rate of 3.9 percent compared to 3.1 percent in 2009 Q2.

The quarterly rate of decrease of real GDP in 2009 Q3 was slower than anticipated in the previous forecasting round. Under the circumstances, the current projection incorporates a downward revaluation of the negative output gap across the economy for 2009 Q3. In view of expectations of further contraction in the economic activity in 2009 Q4, the negative output gap is seen widening as compared to the previous quarter. This implies, *ceteris paribus*, mounting disinflationary pressures coming from the aggregate demand.

The drop in actual final consumption in 2009 Q3 against the previous quarter was reflected by the decline in both household actual consumption and general government final consumption by 1.1 percent and 1.5 percent respectively. In 2009 Q4, household actual consumption is expected to post further a negative growth rate and stay below the medium term trend. A significant contribution to this evolution is anticipated to be made by the contraction in household disposable income earmarked for consumption as a result of the fall, in real terms, in the economy-wide net wage⁷⁵, the marked pick-up in the unemployment rate⁷⁶ and the persistently negative quarterly growth rates of consumer loans⁷⁷. Moreover, the positive dynamics of time deposits⁷⁸ suggests a persistent household propensity for saving at the expense of current consumption, amid the uncertainties surrounding future economic developments⁷⁹ and the relatively favourable deposit rates. The aggregate demand contraction is also reflected by the ongoing decline in the turnover

⁷⁵ The economy-wide average net real wage (seasonally-adjusted data, NBR calculations) deflated by the consumer price index for October and November went down by 1.8 percent against the average for 2009 Q3 compared to positive readings of 1.8 percent in 2009 Q2 and 0.1 percent in 2009 Q1. During 2009, the annual rate of increase of this indicator decelerated gradually from 9.3 percent in 2009 Q1; according to the data available for Q4, the change in the net real wage in October and November compared to the average for 2008 Q4 entered negative territory, reaching -5.6 percent.

⁷⁶ Unemployment rate (registered unemployment, non-seasonally adjusted data) reached 7.8 percent at end-2009, compared to 4.4 percent at end-2008.

⁷⁷ In 2009 Q4, the volume of consumer loans fell 1.5 percent in real terms versus the average for 2009 Q3. In 2009 Q3, consumer loans reported an average quarterly growth rate of -0.6 percent as compared to -2.9 percent in 2009 Q2. Thus, in 2009 Q4, the annual change of this component of non-government credit fell into negative territory, i.e. -3.5 percent, compared to 29.8 percent in 2008 Q4.

⁷⁸ In 2009 Q4, household time deposits in both RON and foreign currency expanded by 3.5 percent as compared with the average for Q3, when their growth rate stood at 5.8 percent (seasonally-adjusted data expressed in real terms, NBR calculations).

⁷⁹ According to the DG ECFIN survey, although consumer confidence indicators remained relatively unchanged in Q4 versus Q3, they point to an all-time low in consumer confidence.

of both retail trade (except motor vehicles and motorcycles) and market services to households⁸⁰.

In 2009 Q3, the quarterly growth rate of government final consumption followed a trend similar to that of private consumption, slowing down 1.5 percent quarter on quarter. In addition, it is also expected to stay below the trend level in the final quarter of the year. Public deficit was kept within limits in compliance with the parameters agreed upon with IFIs at end-2009, the preliminary available data at end-November indicating a 6 percent deficit-to-GDP ratio.

In July-September 2009, gross fixed capital formation decreased at a slower pace quarter on quarter⁸¹, posting however the sharpest fall as compared to the other real GDP components. In fact, gross fixed capital formation is the domestic demand component that saw the strongest adjustment throughout 2009, the annual rate of decline standing at 28.6 percent (gross data) in the period under review. The components of investment in the domestic economy posted significant year-on-year declines in 2009 Q3. Hence, new construction works decreased by 17.9 percent (their dynamics decelerated sharply versus the prior quarter's figure of only 8.6 percent), while equipment fell by 43.5 percent (its year-on-year decline standing below the previous quarter's figure of -52.8 percent). On the other hand, the quarterly dynamics of imports of capital goods (expressed in EUR) reverted to positive levels in 2009 Q3, whereas the annual growth rate remained in the negative territory⁸². Considering the drop in financing sources, the bias towards domestic bank credit is contained by the relatively high lending rates as well as by the further tightening of lending standards⁸³, as illustrated by the marginal rise in medium- and long-term loans to companies⁸⁴. In this context, investment is unlikely to experience an upturn in the final quarter of 2009, being expected to decline further, yet at a slower quarterly pace than in Q3.

⁸⁰ In October and November, average retail turnover (except for motor vehicles and motorcycles) went down 1.7 percent as against the 2009 Q3 average, whereas the turnover of market services to households fell by 3.0 percent in the same period (seasonally-adjusted data, NIS).

⁸¹ The quarterly change in gross fixed capital formation was of -7.1 percent in 2009 Q1, -13.5 percent in Q2 and -4.6 percent in Q3.

⁸² In 2009 Q3, the quarterly dynamics of imports of capital goods stood at 2.8 percent (seasonally-adjusted data, NBR calculations), whereas the growth rates recorded in Q1 and Q2 were of -35.4 percent and -6.0 percent respectively. In 2009 Q1-Q3, the annual growth rates were -53.7 percent, -55.8 percent and -49.5 percent respectively.

⁸³ According to the National Bank of Romania's survey on lending to non-financial corporations and households, released in November 2009.

⁸⁴ In 2009 Q4, medium- and long-term loans to companies advanced 1.2 percent in real terms as against the 2009 Q3 average. Throughout 2009, the annual dynamics of this indicator slowed down, from 16.4 percent in Q1 to 2.3 percent in Q4.

In 2009 Q3, the quarterly growth rate of exports was faster than that of imports, both of them being further below their medium-term figures. The depreciation of the leu in the first part of the year and the stabilisation of external demand⁸⁵ continued to foster exports, helping to maintain a positive growth rate in the considered period. The quarter-on-quarter increase in demand for exports may have contributed to the positive quarterly dynamics of imported production inputs, offsetting the negative impact of narrower domestic demand and a weaker domestic currency on imports. In 2009 Q4, imports and exports are expected to record similar developments as in Q3, their growth rates decelerating however, in line with the dynamics of the above-mentioned determinants.

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

In 2009 Q4 against the previous quarter, from the perspective of the effective exchange rate⁸⁶, the domestic currency strengthened in real terms, but weakened slightly in nominal terms.

Over the first part of the final quarter of 2009, the domestic currency was affected by increasing domestic political instability, with possible consequences on the unfolding of the financial arrangement concluded with IFIs. In the second part of Q4, a favourable impact on the developments in the leu exchange rate came from the alleviation of political tensions, foreign banks' reaffirming their commitment to maintain exposures to the local market, better than anticipated evolution of some economic indicators such as GDP and industrial output, as well as the cut in the minimum reserve requirements ratio for credit institutions' foreign exchange-denominated liabilities with maturities of up to two years⁸⁷.

In 2009 Q4, the impact of the real effective exchange rate of the domestic currency via the net export channel on the aggregate demand in the quarters ahead continues to be stimulative, albeit slightly weaker than in the prior quarter. Through the wealth and balance sheet effects, the impulse of the real exchange rate of the

⁸⁵ In 2009 Q3, the quarterly growth rate of real GDP in the euro area, whose Member States are Romania's major trading partners, returned to positive territory for the first time after 2008 Q1, reaching 0.4 percent. The quarterly dynamics of this indicator stood at -2.5 percent in Q1 and -0.1 percent in Q2 (seasonally-adjusted data, EUROSTAT).

⁸⁶ The effective exchange rate based on which the analysis is conducted implies RON/EUR and RON/USD exchange rates respectively, according to the weights of the two currencies in Romania's foreign trade.

⁸⁷ On 16 November 2009, the NBR Board decided to cut the minimum reserve requirements ratio on credit institutions' foreign exchange-denominated liabilities with maturities of up to two years from 30 percent to 25 percent starting with the 24 November - 23 December maintenance period.

leu on the aggregate demand in the future periods remains stimulative in 2009 Q4 as well. The cumulative effect of the exchange rate on future aggregate demand via the two aforementioned channels is estimated to be relatively more stimulative than in Q3, further mitigating, *ceteris paribus*, the demand shortage in the coming periods. The slight depreciation of the domestic currency in nominal terms in Q4 against the previous quarter leads to a small rise in import prices generating, *ceteris paribus*, an increase in CPI inflation.

Throughout 2009 Q4, 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), with volumes significantly lower versus the previous quarter. In the period under review, the evolution of overnight ROBOR shifted away from that of the monetary policy rate, against the backdrop of higher volatility of short-term yields, which resulted in a positive spread between their quarterly averages.

The pass-through of developments in interbank interest rates to nominal lending and deposit rates applied by credit institutions to their non-bank clients continued to be asymmetrical in 2009 Q4 as well. Thus, in the context of banks' persistently high prudence vis-à-vis non-bank clients and of households' and companies' caution in taking loans the reduction in lending rates was marginal. On the other hand, following the adjustment of banks' behaviour to the successive policy rate cuts, nominal deposit rates remained on a downward path in the fourth quarter of 2009. Nevertheless, the magnitude of lending rate cuts was significantly smaller than that of deposit rates.

Given that the assessment of inflation expectations is at a level similar to Q3, the adjustment in credit institutions' nominal deposit rates for non-bank clients was incorporated in the evolution of real rates. As for lending rates, the reduction of the restrictive impact of real interest rates was minor, taking into account the low fluctuations in nominal rates and the relative stability of inflation expectations. The decline in the cumulative restrictive impact of the aforementioned interest rates on the economic activity in the quarters ahead comes mainly from deposit rates.

Overall, for 2009 Q4, the cumulative effect of the leu exchange rate and of credit institutions' interest rates applied to non-bank clients on future economic activity is estimated to be stimulative and slightly stronger than in the previous quarter.

1.3.3. Demand pressures within the projection horizon

Compared with the previous round, the upward revision of the negative output gap in 2009 Q4 and its projected dynamics for the subsequent eight quarters (under the cumulative impact of its determinants) envisages a slight revision of inflationary pressures caused by the aggregate demand in the economy. However, these revisions are uneven, leading to the anticipation of some comparatively less ample disinflationary pressures in the current year and the first part of the following year, but more pronounced in the final quarters of 2011⁸⁸.

One of the essential assumptions of the current baseline scenario refers to the recovery, albeit at a slower pace, of the euro area economy (the annual GDP growth is projected to remain in positive territory throughout the forecasting horizon⁸⁹). Nevertheless, the gap between euro area GDP and its medium-run⁹⁰ trend is anticipated to remain negative until the end of the current year⁹¹, reducing the arguments in favour of a robust revival of Romania's exports in 2010. The trend is expected to reverse partly in 2011, the positive values of the external output gap triggering the projection of a slight improvement in the dynamics of exports versus that of imports.

Domestically, the baseline scenario of the current projection is built on the premise that the financing arrangement signed by Romania with the IFIs⁹² will be in place until 2011 as agreed upon, despite the delays accumulated in recent months from the initial calendar⁹³. According to the baseline scenario, the conduct of monetary policy during the projection horizon is calibrated having as objectives, on the one hand, the keeping in place of prospects for inflation rate to return in the vicinity of the

⁸⁸ Demand shortage will have a relatively lower contribution to the projected trajectory of the annual CPI inflation rate, compared to the November 2009 Inflation Report. For an account of the major determinants of the higher projected inflation rate, see Section 1.1. *Inflation outlook*.

⁸⁹ This scenario includes the official data available for the quarterly growth rate of euro area GDP in 2009 Q3 (positive figure) and is, at a same time, consistent with the expectation of a slight moderation, starting with 2010 Q4, in the favourable annual dynamics of this indicator as the fiscal and monetary stimuli in advanced economies are expected to be gradually exhausted.

⁹⁰ This measure of euro area GDP cyclical development is used in the macroeconomic forecasting model to approximate the evolution of external demand for Romanian products, given that the euro area is Romania's major trade partner.

⁹¹ Although, compared to the prior projection, it is revised slightly towards more favourable values for Romania's net exports.

⁹² The International Monetary Fund, the European Commission, the World Bank, the European Bank for Reconstruction and Development.

⁹³ They were manifest in 2009 Q4, amid the political crisis and the presidential elections.

established medium-term targets⁹⁴ and the sustainable revival of lending in the Romanian economy, on the other hand. The fulfilment of these objectives is however conditional upon the other elements in the macroeconomic policy mix complying with the co-ordinates in the financing arrangement signed by Romania with the IFIs. As an indicator summarising the transmission of monetary policy decisions to the economy, real broad monetary conditions are expected to reflect a prudent stance over the policy-relevant horizon.

Despite the uncertainties surrounding both domestic and external economic developments, the current baseline scenario is built on the assumption of a moderate revival of investors' risk appetite⁹⁵ worldwide, as compared to the prior projection. Consistent with this assumption, the positioning, in the following quarters, of the real effective exchange rate of the leu in relation to its medium run trend, anticipates a less stimulative impact transmitted via the net export channel to the output gap in the current baseline scenario.

Offsetting the reduction, compared to the prior projection, of the favourable influence of the real exchange rate on aggregate demand via net exports, the net impact of real interest rates applied by financial institutions on either deposits or loans is foreseen to be less constraining for the domestic economic activity during the projection. This is due to the anticipation of a further strong decline, compared to the recent periods, in lending and deposit rates set by the financial institutions⁹⁶, concurrently with the anticipated narrowing of the spread between these rates. Also, a less constraining impact of real interest rates set by the banks is expected to result from the upward revision of the projected CPI inflation rate compared to the prior projection.

Against the background of the gradual dissipation of financial institutions' balance sheet problems and of more appealing interest rates, the baseline scenario envisages the resumption, as early as

⁹⁴ Given incidental factors that are largely exogenous to monetary policy decisions and which determines the projected trajectory of inflation rate in the current baseline scenario, the calibration of the NBR interest rate trajectory during the projection horizon focuses mainly on offsetting the second round effects of adverse supply-side shocks on CPI developments.

⁹⁵ In the macroeconomic forecasting model, the indicator reflecting investor sentiment vis-à-vis the investments in local currency-denominated financial instruments is the level of the risk premium. Following its expected repositioning on a favourable trajectory for the most part of the projection horizon we envisage, particularly during the current year, a strong stimulus to aggregate demand, thus resulting in lower financing costs associated to foreign currency-denominated loans.

⁹⁶ Such an evolution is consistent with the anticipation of a gradual resumption of lending once the recession is over, illustrating, at the same time, the incorporation to a larger extent of the downward impulses to the monetary policy rate in recent periods, which is foreseen to continue conditional upon the validation of the assumptions in the baseline scenario in the subsequent quarters.

2010, of a favourable dynamics of gross fixed capital formation, strongly boosted, in the first part of the current year, by the positive effect of the expected turn in the inventory cycle. As regards private consumption, it is assumed that the favourable impact of interest rates will become manifest especially in 2011. In the current year, their stronger stimulative impact is expected to be more than offset by the adverse influence of the anticipated drop in households' disposable income, largely correlated with the outlook for the labour market⁹⁷.

The dynamics and the impact of fiscal policy during the projection horizon are based, similar to the previous forecast, on the coordinates agreed upon in the multilateral financing arrangement signed by Romania with the IFIs, to which the dynamics anticipated in the baseline scenario of the relevant macroeconomic variables are added. The values determined for the dynamics of the primary structural deficit anticipates a pro-cyclical fiscal policy stance throughout the projection horizon, the key determinants consisting in the size of the fiscal adjustment Romania committed to, corroborated with the forecasted position of the economy in the business cycle.

1.4. Risks associated with the projection

This section encompasses a qualitative assessment of the risk factors deemed to have a significant impact on the projection of macroeconomic variables in the baseline scenario and a relevant likelihood of materialising over the upcoming eight quarters. Compared to the November 2009 Inflation Report, the analysis of risks associated with the current forecast indicates a lower likelihood of inflation and economic activity deviating either way from the baseline scenario projections, given the relative stabilisation of the domestic political climate, the positive macroeconomic developments in 2009 Q4⁹⁸ and the reactivation of the external financing arrangement with IFIs. The overall risks of inflation rate and economic growth deviating from the baseline scenario trajectory are relatively balanced, provided an efficient coordination of the macroeconomic policy mix is maintained.

Since the previous Inflation Report, external economic conditions have witnessed a recovery, with the major economies reporting

⁹⁷ This arises from the labour market's tendency to react with a certain time lag to the aggregate dynamics of economic activity (GDP), leading to a stronger persistence of unfavourable effects associated to labour market developments. With the inevitable drop in economic agents' disposable income, the baseline scenario foresees, similar to the prior projection, the persistence of a keener propensity for saving of economic agents (households, companies) with a dampening impact on consumption dynamics in the current year.

⁹⁸ The reduction of the risk premium on domestic currency investments, the achievement of an end-2009 public deficit in line with the coordinates agreed under the financing arrangement with IFIs.

growth during 2009 Q3, while risk aversion on international markets has remained on a downtrend and financial and trade flows gained momentum. Against this background, the likelihood of the world economy recovering during 2010 at a faster pace than assumed in the baseline scenario cannot be ruled out and this may have a favourable impact in terms of risk appetite on global financial markets. Under these circumstances, stronger external demand would have an expected beneficial effect on Romania's net exports, while the lower risk premium might lead to diminished external financing costs and to renewed capital inflows, thus fostering the stability of the domestic currency and the financing of the real economy. Nonetheless, the optimism currently discernible on global markets might not be solely due to improved fundamentals and could thus result in an overestimation of the recovery potential of the world economy⁹⁹. In this case, its dynamics throughout 2010 might invalidate economic agents' expectations. Under such conditions, it is difficult to assess in which direction the inflation rate will deviate from the forecasted path, though downside deviations in the near run and upside deviations in the medium term are considered as being more likely to occur (given the related increase in risk aversion, the estimated dynamics of foreign capital flows and exchange rate movements).

The fiscal policy stance remains a source of uncertainty in the current scenario, with a potentially significant impact on the evolution of the domestic economy. The relative stabilisation of the domestic political climate over the past months has considerably diminished the risk of fiscal policy slippages in the first part of the forecast horizon. However, the failure to rigorously implement the corrective measures laid down in the financing arrangement signed with IFIs or any deviation of the macroeconomic scenario from the coordinates underlying the fiscal projection¹⁰⁰ might jeopardise the attainment of the forecasted budget deficit levels. Under these circumstances, correcting such imbalances would require the adoption of

⁹⁹ The recent renewed interest in emerging market investments was also based on several reversible factors, such as the excess liquidity which resulted from the stimulative economic policies, insufficient appealing investments on developed markets etc. The negative signals related to several countries' public debt servicing capacity (e.g. Greece, Ukraine or Latvia), in conjunction with a possible spill-over effect on other economies in the region, might entail a reversal in such flows and hence trigger sharp adjustments in asset prices. Given the likely progressive unwinding of the accommodating policies in advanced economies during 2010 (by the elimination of the fiscal and monetary stimuli), as well as the ongoing process of balance sheet adjustment in financial and non-financial sectors, excess liquidity might diminish and a capital flight could occur, even absent a deterioration in fundamental variables.

¹⁰⁰ A major risk stems from worse-than-anticipated labour market conditions, likely to respond with a certain lag to GDP aggregate dynamics. This will have an equally detrimental impact on aggregate demand (via economic agents' disposable income) and aggregate supply (by reducing the potential for economic growth) and hence on the government budget.

offsetting measures that are not included among the current assumptions underlying the fiscal projection and that might have a detrimental impact on economic growth and inflation rate. This would lead to a suboptimal coordination of the domestic macroeconomic policy mix, which would adversely affect investors' risk perception, thereby amplifying the challenges to the financing of the public deficit.

Another uncertainty with a direct impact on the pace of economic growth is the extent to which the revival in lending will take place in 2010. The volume of new loans will rely on factors whose evolution might exert mixed influences on lending, such as credit terms and standards¹⁰¹, the financial situation of economic agents, the measures aimed at fostering lending, the adjustment process of credit institutions' balance sheets, foreign capital flows (and hence the public deficit financing needs from domestic credit). Throughout the projection horizon, monetary policy measures are expected to act towards gradually fostering the lending activity provided however that the relevant signals are properly assimilated by credit institutions.

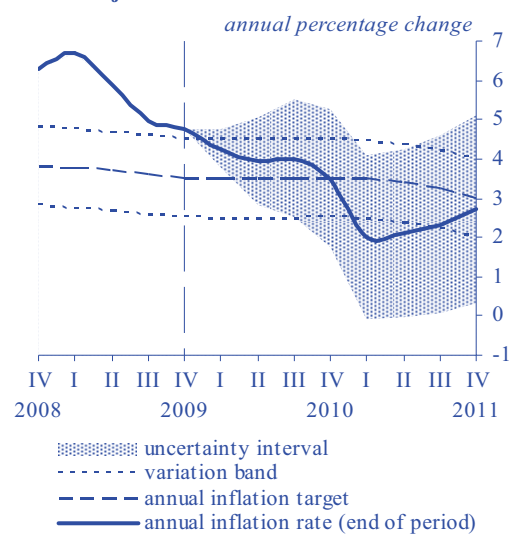
Similarly to the previous quarterly issues of the Inflation Report, relevant risks are related to developments in oil prices, administered prices and the volatile prices of some food items.

A larger-than-anticipated hike in oil prices is likely to occur particularly especially over the first part of the projection horizon, considering the recovery in global aggregate demand. This will have a detrimental impact on fuel price inflation and hence on CPI inflation. On the other hand, a slower-than-forecasted recovery of the world economy may lead to an opposite scenario in terms of oil price developments, i.e. fuel prices will rise at a slacker pace than that assumed in the baseline scenario.

As regards administered prices, their adjustment calendar to the levels agreed with the EU has not been clearly defined beforehand, being subject to repeated and sizeable changes over the past projection rounds. Given that changes may incorporate either upward or downward movements, assessments point to a balanced distribution of such risks in relation to the projected trajectory of CPI inflation in the baseline scenario.

The chart illustrates the risks of upward or downward deviations of CPI inflation from the forecasted values under the impact of general risk factors. The uncertainty interval around the central

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR calculations

¹⁰¹ It is uncertain when the tightening of lending terms and standards by financial institutions, which took place throughout 2009, might come to a halt or even reverse.

trajectory is symmetrical and is based on past CPI inflation forecasting errors¹⁰².

2. Policy assessment

The disinflation process which resumed in 2008 H2 broke off temporarily towards the end of 2009, with the annual inflation rate reaching 4.7 percent in December, slightly above the upper limit of the variation band around the central target set for year-end, but 1.6 percentage points below the year-earlier level of 6.3 percent. The 0.4 percentage point increase in the annual inflation rate during the past two months of 2009 (from 4.3 percent in October) was due to the substantial hike in cigarettes prices – as a result of *ex ante* incorporation into consumer prices of the upward adjustment in excise duties starting 1 January 2010 – and increase in fuel prices. The significant inflationary impact of such factors was only partly offset by the effects of persistent deflation of volatile food prices, the more pronounced deceleration in the annual dynamics of administered prices and the pick-up in disinflation related to the adjusted CORE2 measure, whose annual pace of growth fell to 2.8 percent in December 2009 from 6.3 percent in December 2008.

As a result of the temporary standstill in disinflation, due also to the sharper-than-expected increase in some administered prices and to raising other excise duties on 1 January 2010, the updated trajectory of the projected annual inflation rate will, over the next quarters, run above the path presented in the previous forecasting round. However, this variable is expected to stay on a downward drift and to converge towards the 3.5 percent central target at end-2010. In the latter half of the forecast horizon, the projected annual inflation rate will drop and remain, similarly to the previous projection, in the lower half of the variation band around the central target set for December 2011.

In addition, the anticipated consolidation of disinflation throughout the policy-relevant horizon relies mainly on the deceleration in adjusted CORE2 inflation. This owes much to the size of the aggregate demand shortage in 2009 and to the high levels of the magnitude and duration of this shortage anticipated for the period ahead. Thus, according to the updated forecast, the negative output gap is seen widening in early 2010, its width remaining sizeable until the end of the projection horizon, despite the gradual narrowing trend it will embark upon in 2010. Compared with the previous forecasting round, the negative GDP deviation from its potential level will decline somewhat throughout the projection horizon, basically as a result of the slight downward revision of the foreseen magnitude of the economic

¹⁰²For further details, see Box 3 in the November 2008 Inflation Report.

contraction in 2009. Accordingly, the updated forecast reiterates the expected return of annual GDP dynamics into positive territory during 2010 and implicitly a relative step-up in the annual pace of economic growth next year; nevertheless, the tempo of economic recovery, reflected by the projected annual rates, is slower than envisaged earlier.

The persistently negative annual GDP dynamics at end-2009 and in early 2010, hinting at a further deepening of the demand shortage, features the following main prerequisites and signs: (i) an ongoing negative annual dynamics of euro area GDP in 2009 Q4; (ii) the inertial nature of the contraction of the Romanian economy in the preceding quarters; (iii) pick-up/protraction of the negative annual dynamics of some leading indicators of consumer and investment demand during the first months of 2009 Q4; (iv) the recent fall into negative territory of the annual growth rate of average net real wages; (v) the persistence of financial deleveraging, but also of an improving trend in households' net saving with banks; and (vi) the ongoing rise in unemployment rate in 2009 Q4.

After assessing the current context and the forecast coordinates, the outlook for higher demand-side disinflationary pressures appears to be supported not only by a further deepening of the negative output gap, but also by the current and future relative increase in adjusted CORE2 inflation rate elasticity relative to the wider/protracted aggregate demand shortage, suggesting its lowering persistence. The explanation for the moderation in the persistent nature of core inflation may lie with the dissipation of adverse effects coming from the significant pass-through of the leu exchange rate, given the improvement in the recent and expected performance of this variable.

Adding to this are the signs of an incipient – albeit with a certain lag – adjustment in the retail price and wage setting behaviour, in response to the magnitude and persistence of the downturn in the Romanian economy and to the more pronounced evidence of a protracted deterioration in labour market conditions and a delay in economic recovery internationally and especially domestically. In this regard, illustrative are the downtrend/fall into negative territory of the annual growth rate of real net wages or even of nominal ULC in some consumer goods industries and services to households, as well as the gradual slowdown in the annual pace of increase of prices for several processed food, durables and services.

The ongoing adjustment of such behaviours over the period ahead is essential for ensuring a sustainable decline in core inflation persistence which, in turn, conditions the pace at which the monetary policy stance will be tailored to the projected downturn

in annual inflation in the medium term – a horizon within the scope of central bank’s monetary policy instruments – down to the lower half of the variation band around the central target. In the current juncture, an economic policy mix complying with the coordinates recently agreed with the EU and the IMF would give a considerable impetus to this adjustment. Apart from the pick-up in structural reforms, aimed to remove/mitigate some of the economy’s structural rigidities, this mix implies a relatively stronger pro-cyclical nature of fiscal¹⁰³ and income policies that could foster, including via the latter’s demonstration effect, an improvement in inflation expectations and an increase in disinflationary pressures both on demand side and supply side.

The adjustment of such behaviours could also be enhanced over the period ahead by the outlook of still feeble domestic demand, private consumption demand in particular. The possible maintenance of the latter’s negative annual dynamics, reflected also by the persistent worsening of the consumer confidence index, can be attributed to the prevalence of an expected further decrease in households’ real disposable income – amid the annual dynamics of real net wages falling deeper into negative territory – and to the lingering concerns over jobs in the future, and households’ capacity of servicing borrowings.

Consumer demand will also be dampened by the continued decline in consumer credit and the – possibly slightly weaker – balance sheet effect stemming from high interest rates and the exchange rate via households’ debt in both domestic and foreign currencies as well as by a potential compression in their real disposable income following the recent excise duty and administered price increases. In addition, against this background, the precautionary motive is expected to remain relevant in shaping the households’ consumption-saving balance; their sharp propensity for saving is therefore seen persisting or even becoming more marked – in this vein, a sign could be the ongoing improvement of households’ net savings with banks of late.

In this context, the risk of excise duty and administered price adjustments, effective 1 January 2010, generating second-round effects is considerably mitigated; however, it remains more relevant in case of the fuel price that might be raised substantially over the upcoming quarters due to costlier oil on world markets. Adding to this is the risk of a relative heightening of direct inflationary effects triggered by regulated price adjustment over the projection horizon assuming that the authorities resort to further corrections, which were hardly predictable when preparing the forecast. As a matter of fact, assuming that core inflation falls

¹⁰³The programmed public deficit target for 2010 was lowered to 5.9 percent of GDP versus 7.3 percent of GDP, the estimated figure for 2009.

to low annual rates, the unpredictable nature of the administered price and some indirect tax adjustment programme in terms of duration and magnitude tends to become an increasingly relevant risk both to disinflation and attaining the medium-term inflation target.

As for investment, the improving trend in business confidence indicators hints at the likelihood of a relatively faster upturn in their future evolution, although the contraction in this domestic demand component has deepened until recently, in construction at least. The precise moment of a turning point in this behaviour is however highly uncertain, given in principle the ongoing downturn in corporate profitability and sales outlook, the persistence and even the increase in spare capacities in some industrial sub-sectors, as well as the incomplete downward adjustment of the real estate market. Against this backdrop, companies in some sectors might still resort to cuts in working hours and wages, as well as to renewed layoffs. Nonetheless, investment could be spurred somewhat by the implementation of the “First Home” programme and the potential increase in public investment expenditures, particularly those financed via EU funds and resources taken from international financial institutions and bodies. Moreover, the turn in the inventory cycle in certain sectors could make a substantial contribution to the annual dynamics of gross capital formation returning to and remaining in positive territory.

Nevertheless, such evolution hinges widely on the improvement in financing conditions for companies that has failed to materialise as yet in the local banking sector, which still exhibits a pro-cyclical behaviour. Grim prospects also persist in regard to the future evolution of external financing allocated to the Romanian economy, fuelled *inter alia* by the downtrend in foreign direct investment becoming more pronounced of late and the delay in the improvement signs on external financial borrowings. Romanian credit institutions appear to become increasingly reluctant to grant new loans, a behaviour motivated among other things by their further deteriorating loan portfolios and the stronger concern for reducing the loans/deposits ratio in some cases, amid the balance-sheet adjustment and capitalisation plans put into motion by the parent undertakings. In this context, in the course of 2009 Q4, banks continued to tighten their lending standards and terms. A positive signal though could be the considerable growth of new loans¹⁰⁴ to companies in December 2009, along with the upward path in the housing loan stock that became manifest in 2009 H2, most likely as a result of implementing the “First Home” programme.

¹⁰⁴Data supplied by CCR.

The rebound in corporate lending is nevertheless seen as long in coming. This is contingent upon the decline in banks' mistrust in the economic outlook and in the risk perception towards the sub-sector the company is active in, on the one hand, and the restoration of demand for loans, on the other hand. As such, a sustainable resumption of lending is expected to materialise with a lag after the economy's embarking upon a growth path. In the period ahead, companies' resort to bank loans could however be fostered to some extent by the potential easing of credit institutions' lending conditions following the recent reduction in policy rate and interbank rates. The decline in lending rates – also beneficial in terms of the wealth and balance sheet effect and implicitly of credit institutions' loan portfolios – might however be slower and more modest than the reductions in bank deposit rates.

In this context, an upturn in external demand will most likely play a decisive role in the rebound of economic activity and in the annual economic growth rates returning to positive territory. The reinvigoration of advanced economies, particularly those in the euro zone – supported also by monetary and fiscal stimuli and the modest improvement in confidence – is set to continue over the following quarters, albeit at a moderate and uneven pace. The dynamics will be considerably influenced by the duration of the stimulus programmes put in place by the authorities, on the one hand, and the further rise in unemployment rate, the increase in public debt to unprecedented levels, and the balance-sheet adjustment in financial and non-financial sectors, on the other hand.

The euro area economic recovery has already had a favourable bearing on the Romanian exports to some extent and implicitly on the industrial production, as the annual growth rates of both indicators reverted to positive territory in November 2009, also due to a base effect. Against the backdrop of a gradual revival in external demand, the depreciation of the leu versus the euro could have a stimulative effect on exports as well. Although the ongoing pick-up in the growth rate of exports is likely to prompt an upturn in imports as well, the latter's dynamics is seen remaining tepid amid the weak domestic absorption. Thus, for 2010, the current account deficit as a percentage of GDP is expected to exceed only marginally the level recorded in 2009 when it was subject to a larger-than-expected correction.

Given the anticipated consolidation in the decline in the Romanian economy's external vulnerability, including as a result of the reactivation of the multilateral external financing arrangement signed with the EU, the IMF and other international financial institutions, the outlook for the leu exchange rate behaviour has improved markedly. Even in such a context, the risk of a renewed

pick-up in the depreciation pressures on the domestic currency and an ensuing worsening of inflation expectations should not be entirely ruled out. This risk could materialise if some of the major conditionalities in the agreements signed with the EU and the IMF – especially those relating to fiscal consolidation – are not complied with, as well as in the event of new episodes of growing risk aversion on global markets and worsening investor sentiment with regard to the national economy or other economies in the region.

Given the prospects of a gradual pick-up in demand-side disinflationary pressures, enhanced by the prerequisites of further consistent implementation of the economic programme agreed with the EU, the IMF and other international financial institutions, the Board of the National Bank of Romania has decided, in its meeting on 3 February 2010, to lower the monetary policy rate by 50 basis points to 7.0 percent per annum. Moreover, the Board decided to ensure an adequate management of liquidity in the banking system and to maintain the existing levels of minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities. In this context, the Board of the National Bank of Romania reiterated that keeping the macroeconomic policy mix – monetary, fiscal, income policies and structural reforms – in line with the coordinates agreed under the multilateral external financing arrangement signed with the EU, the IMF and other international financial institutions is essential for further achieving sustainable disinflation, maintaining financial stability and restarting a lasting economic recovery.