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N O T E

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. *Inflation Report* is the main means of communication.

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

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

Inflation Report was completed on 3 May 2010 and approved by the NBR Board in its meeting of 4 May 2010.

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

ABBREVIATIONS

AER	annual effective rate
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
ECB	European Central Bank
EIA	Energy Information Administration (within the U.S. Department of Energy)
Eurostat	Statistical Office of the European Communities
FED	Federal Reserve System
FOMC	Federal Open Market Committee
GFCF	Gross Fixed Capital Formation
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IFI	international financial 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
OPEC	Organisation of Petroleum Exporting Countries
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
ULC	unit labour cost
UVI	unit value index
1W	one week
12M	12 months

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I. SUMMARY

Developments in inflation and its determinants

In March 2010, the 12-month CPI inflation rate went down to 4.20 percent, 0.54 percentage points below the end-2009 reading of 4.74 percent. The inflation rate has thus returned within the variation band around the 3.5 percent central target, standing 0.3 percentage points below its upper limit. The slowdown in the annual growth rate of consumer prices is attributed mainly to the effects of the persistent demand shortfall that have prevailed over the impact of the hikes in excise duties on tobacco products.

In 2010 Q1, disinflationary pressures from the ongoing weak aggregate demand, the relatively low exchange rate volatility and the absence of tensions on agri-food commodity markets helped consolidate the downward trend in the annual adjusted CORE2 inflation rate[1]. External price dynamics, however, acted in the opposite direction.

Against the background of an emerging relative stabilisation between demand and supply on the labour market, the annual pace of increase of economy-wide average nominal gross wage picked up during January-February 2010, thereby alleviating the trend for lower wage-related inflationary pressures which was manifest during 2009. In the industrial sector however, unit labour cost dynamics continued to report significantly negative readings in annual terms, with labour productivity growth overtaking wage growth.

Among exogenous factors, the increase in EUR-denominated excise duties on tobacco products and in the reference leu exchange rate used in calculating these excises had a strong adverse impact on inflation in 2010 Q1. Therefore, more than half of the annual CPI inflation rate at end-March was due to the contribution of the hike in tobacco product prices. The faster rise in fuel prices also generated significant inflationary pressures. By contrast, the slower increase in administered prices and the sharper decline in volatile prices of some food items had a favourable contribution to the year-on-year dynamics of consumer prices.

In 2009 Q4, the annual pace of real GDP contraction slowed down to -6.5 percent from -7.1 percent in the previous quarter. The slowdown in the GDP decline was due to a relative deceleration in the contraction of final consumption, with another contribution also attributable to the annual dynamics of exports re-entering positive territory; however, the latter also contributed, through the import content of exports, to a slower reduction in import flows. These influences were nevertheless partly offset by a faster downturn in gross fixed capital formation. As a result, both the negative contribution of domestic absorption and the positive contribution of net exports to GDP dynamics decreased.

The protracted decline in domestic demand reflects the persistently stringent financial constraints facing households and corporations, as well as the still high risk perception in the private sector deterring consumption and investment spending. Uncertainties surrounding future income flows are fuelled by the recent swings in GDP growth on a quarterly basis. In contrast to the annual GDP dynamics, which improved slightly in 2009 Q4, the quarterly GDP advance over the same period

[1] This core inflation measure excludes from the total CPI a number of prices on which monetary policy (via aggregate demand management) has limited or no influence whatsoever: administered prices, volatile prices (of fruit, vegetables, eggs and fuels), tobacco product prices and alcoholic beverage prices.

fell again into negative territory, reaching -1.5 percent, after the decline had reversed in Q3 (+0.1 percent)[2].

Monetary policy since the release of the previous Inflation Report

On 3 February 2010, the Board of the National Bank of Romania decided to lower the monetary policy rate from 7.5 percent to 7.0 percent per annum. This decision was motivated by the prospects – as revealed by the updated macroeconomic projection and consolidated by the reactivation of the multilateral external financing arrangement signed with the European Union, the International Monetary Fund and other international financial institutions – of continued convergence of inflation rates towards medium-term targets, after the anticipated temporary pick-up in January, as a result of the exogenous shock of the adjustment of excise duties on tobacco.

Subsequent to the February monetary policy decision, statistical data have confirmed the central bank's projection of the aggregate consumer price index resuming disinflation. At the same time, the annual adjusted CORE2 inflation rate remained on a downward trend, owing to the pressures from the negative output gap and to the absence of opposite influences from the leu exchange rate volatility, and reached 1.63 percent in March 2010, according to NBR calculations.

Furthermore, following the release of fourth-quarter GDP data in March, along with the substantial revision of seasonally-adjusted historical figures on GDP dynamics and its components (starting in 2000), previous assessments were adjusted accordingly.

The analysis of data on revised GDP and other economic activity indicators revealed some signals of improvement in a number of sectors across the national economy, alongside continued uncertainties surrounding the timing of the recovery in other sectors. Relatively high uncertainties also persist over future developments in the external environment, capital flows and exogenous factors weighing upon the dynamics of consumer prices.

Against this background, while keeping in mind the projected disinflation gains, on 29 March 2010, the Board of the National Bank of Romania decided to cut the monetary policy rate from 7.0 percent to 6.5 percent per annum. It also reaffirmed the critical importance of the consistent implementation of the set of macroeconomic policies agreed under the external financing arrangement concluded with the European Union, the International Monetary Fund and other international financial institutions in order to achieve the NBR objectives related to both price stability and financial stability.

Inflation outlook

The baseline scenario of the current projection foresees the convergence of the annual consumer price inflation rate over the forecast horizon towards the central bank targets. The expected continuation of disinflation is underpinned by GDP remaining below its potential level over the entire forecast horizon. The projection anticipates a gradual reduction in the negative output gap as economic growth returns to positive territory during 2010 and gathers momentum in 2011. Over the projection horizon, the current account deficit is expected to remain at levels compatible with a sustainable rebound in economic activity, without the leu exchange rate generating inflationary pressures. Given the persistence of uncertainties associated, particularly over the short term, with

[2] Compared to the previous report, this issue specifies, in some cases, different values for the dynamics of GDP and its components over the same reference periods. The differences may relate not only to the magnitude, but also to the sign of these dynamics. This owes to the broad-based revisions to the seasonally-adjusted data series performed by the NIS in between the two reports.

domestic and global macroeconomic developments, the balance of risks surrounding the inflation forecast appears to be relatively tilted to the upside.

The baseline scenario of the current projection places the annual CPI inflation rate at 3.7 percent for end-2010, 0.2 percentage points higher than the level published in the February 2010 Inflation Report. For end-2011, the inflation rate is expected to fall below the central target of 3.0 percent and reach 2.8 percent, 0.1 percentage points above the previously projected figure.

The upward revision of the CPI inflation forecast is attributed to projecting a higher annual CORE2 inflation rate as well as to a larger share assigned to this component in the consumer price index. This unfavourable influence, which will be stronger in 2010, is foreseen to be only partly offset by a lower cumulative contribution, in terms of annual dynamics, from the other CPI components (administered prices, fuel prices and some volatile food prices).

The increase in the projected CORE2 inflation rate is largely the result of the negative output gap persisting throughout the projection horizon at relatively smaller levels than those forecasted previously. The negative output gap was reassessed following the substantial revision of seasonally-adjusted historical data series on the dynamics of GDP and its components by the NIS, in March 2010. Despite this reassessment, the persistence of a demand shortfall is seen remaining the main source of disinflationary pressures over the entire projection horizon.

Similarly to the previous forecast, the CORE2 inflation rate is foreseen to fall below CPI inflation starting 2010 Q2, as the impact from first-quarter hike in excise duties on tobacco products fades out and a favourable base effect becomes manifest. During 2010, moderate import price dynamics and the gradual mitigation of inflation expectations will also be supportive of disinflation. The latter is however strictly conditional upon the avoidance of any slippages in implementing the macroeconomic policy mix over the forecast horizon. The projection envisages annual CPI and core inflation rates to decline to record lows in early 2011, also as a result of a favourable base effect. Subsequently, the gradual narrowing of the *negative* output gap, in line with the consolidation of economic growth, and the influence of a progressive increase in euro area inflation on import prices will cause a moderate rise in CORE2 inflation rate, bringing the CPI inflation rate closer to the end-2011 target.

Throughout the projection horizon, the monetary policy stance will remain prudent, aiming to steadily ensure adequate real broad monetary conditions in order to consolidate the prospects of both the return of inflation in the vicinity of the established medium-term targets and of a sustainable revival of lending in the Romanian economy. The fulfilment of these objectives is again strictly conditional upon all elements of the macroeconomic policy mix complying with the coordinates of the economic programme under the external financing arrangement concluded with the European Union, the International Monetary Fund 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.

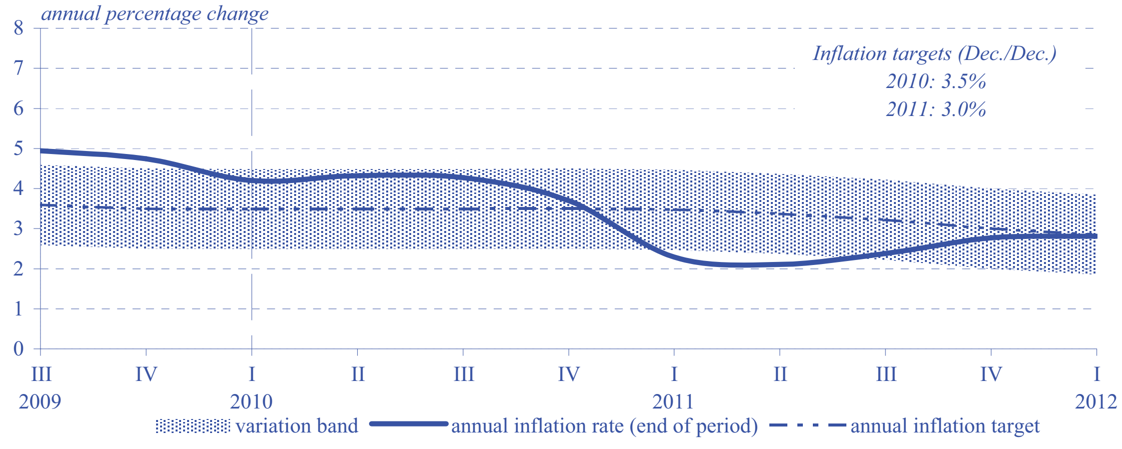
Recent macroeconomic developments, both domestically and internationally, point to persistently high uncertainties as to the time horizon when the fallout from the global crisis on the Romanian economy will actually dissipate. The overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to be relatively tilted to the upside. Risks associated with the domestic environment appear more likely to lie at the root of this asymmetry.

The major domestic risk factors are associated with fiscal and income policies in the public sector and with structural rigidities in the economy. The delayed emergence of clear signs of the economy sustainably returning to positive growth rates implies the likelihood of a fiscal policy slippage from the coordinates included in the baseline scenario of the projection. The adverse effects of such slippages on economic growth and inflation rate would be considerably stronger in the absence of corrective measures allowing the orderly carrying out of the external financing arrangement. The uncertainty perceived by economic agents with regard to their future income flows, along with the anticipated adverse fiscal effects that may weigh further on them, generate the risk of maintaining or even strengthening rigidities in price formation. The relatively high uncertainty surrounding the current projection horizon justifies a somewhat higher likelihood to be ascribed to upside deviations from the projected trajectory.

Risks related to external developments are generated by the so far fragile revival of euro area real economy. At the same time, the escalating issues plaguing the sustainability of public finances in Greece or even their potential spill-over, through contagion, to other euro area countries facing similar vulnerabilities might result in a shift in investor sentiment to the detriment of emerging economies, likely to impact the risk perception towards Romania as well. The delayed consolidation of economic growth and the resurfacing of global financial market turmoil could send ripple effects to the domestic economy via the foreign trade, financial and exchange rate channels. On the other hand, a stronger economic recovery along with the timely exit from the fiscal and monetary stimulus packages to fiscal consolidation measures taken by the authorities in euro area Member States, including the configuration of an adjustment and assistance programme for Greece which would consolidate financial market confidence, may yield favourable effects on the Romanian economy. Hence, risks associated with external economic developments appear to be symmetrically distributed around the trajectories of the macroeconomic variables in the baseline scenario.

For the current forecasting round, the risks of fuel prices, administered prices and some volatile food prices deviating either way from the baseline scenario trajectories appear to be relatively balanced.

Inflation Forecast



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

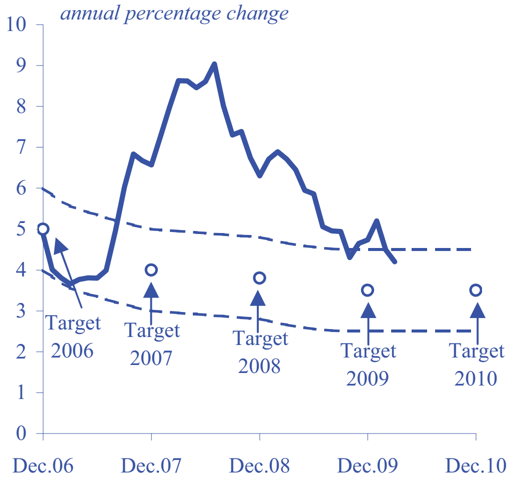
Source: NIS, NBR calculations

Monetary policy decision

Given the prospects of disinflation to continue, albeit at a relatively slower pace than previously projected, and of somewhat higher risks to its consolidation, the Board of the National Bank of Romania has decided, in its meeting on 4 May 2010, to lower the monetary policy rate by 25 basis points to 6.25 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 NBR Board reiterated that further compliance with the commitments set under the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions would ensure a consistent implementation of the macroeconomic policy mix, which is essential for achieving sustainable disinflation, maintaining financial stability and restarting a lasting economic recovery.

II. INFLATION DEVELOPMENTS[3]

Inflation Developments



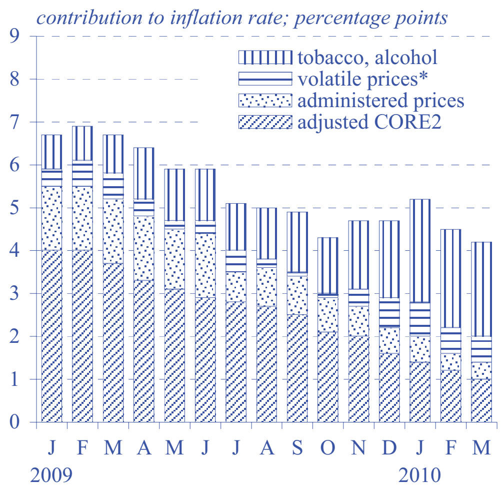
Note: Variation band is ±1 percentage point around the central target

Source: NIS, NBR calculations

In 2010 Q1, the 12-month inflation rate declined by 0.54 percentage points to 4.20 percent, falling within the variation band of ±1 percentage point around the annual target (3.5 percent for 2010), for the first time in eleven quarters. The downward trend in inflation rate, which had come to a temporary halt in November 2009, resumed in February 2010, after the excise hike passed entirely through into the prices of excisable products[4]. Amid the persistent decline in consumer demand, the satisfactory supply of agri-food items and the appreciation of the domestic currency against the euro, disinflation was visible in both volatile food prices and adjusted CORE2 measure. Furthermore, lower adjustments in administered prices, in annual terms, acted in the same direction, whereas prices of tobacco products and fuels remained the only factors putting pressure on inflation.

Administered prices further saw a slower annual change (down another 1.3 percentage points to 2.2 percent[5] in March 2010), despite the rise in prices of electricity, heating, medicines and some public good services. The deceleration in the group's annual dynamics is attributed to the fading of the unfavourable base effect induced by more expensive fixed telephony services at the beginning of 2009, irrespective of the fact that such services are no longer included in the category of products with administered prices as of January 2010.

Annual Inflation Rate



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

Source: NIS, NBR calculations

Unlike 2009 Q4, when it followed an upward trend, the annual growth rate of volatile prices decelerated by 0.6 percentage points in the period under review to 4.7 percent, against the background of higher deflation in food items[6] (-2.8 percent). This was due mainly to (i) favourable developments in import prices of vegetables and fruit[7] supported by both the nominal appreciation of the domestic currency against the euro and the drop in external prices and (ii) the change in households' consumer behaviour, reflected by the contraction of the volume of purchases and the higher sensitivity to prices. By contrast, prices of fuels continued to increase at a fast pace (12.9 percent), with the hike in the excise duties on petrol and diesel oil and, subsequently, the resurgence of pressures on the international crude oil market[8] being mirrored by successive rises in fuel prices.

[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] Driving up the 12-month inflation rate to a 5.2 percent peak in January 2010.

[5] This increase was fully reported in the period under review, after a relative stability of administered prices in 2009 Q2-Q4.

[6] Vegetables, fruit, eggs.

[7] Fruit and vegetables are primarily imported at this time of the year.

[8] The Brent crude oil price posted daily readings higher than USD 80/barrel in January and March, while its average for March hit an 18-month peak of USD 78.8/barrel.

In January 2010, the prices of tobacco products reported the highest monthly increase in ten years (+13.9 percent) following the hike in excise duties (by EUR 10/1,000 cigarettes) and the change in the exchange rate used for converting euro into lei (from RON/EUR 3.7364 in 2009 to RON/EUR 4.2688), although part of the shock was already absorbed in the last two months of the previous year. Under the circumstances, the annual pace of increase of such prices reached 48.5 percent at the end of the reviewed quarter (up 9.9 percentage points from that recorded in December 2009), while the contribution to the 12-month inflation rate rose to about 2.5 percentage points.

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, which continued to follow a steady downward trend in annual terms. The same as in the previous quarter, the exchange rate movement[9] was an important explanatory factor, its influence being further particularly visible in services at market-determined prices, all the more so as the share of services with prices directly linked to the euro picked up after including the fixed-telephony services provided by Romtelecom in this group. In this context, the adverse impact of more expensive compulsory car insurances and that of higher fuel prices on road transport prices were fully offset.

Despite the fast-paced deceleration in the annual dynamics of market prices of services and the slower disinflation in prices of food items (excluding volatile food prices), the latter remained the category posting the lowest annual inflation among the adjusted CORE2 components. Except for edible oil prices, whose monthly change moved back to positive territory in the period under review after five quarters of ongoing negative readings, the current developments were, overall, favourable, due to both the absence of tensions on the domestic and international agri-food commodity markets (grains, meat, sugar) and the flagging demand[10].

As concerns non-food items included in adjusted CORE2, the easing of the annual growth rate of their prices resembled that in 2009 Q4, being relatively slow, except for those components which are highly sensitive to exchange rate movements (mainly motorcars and electronic products). While in the latter half of 2009 the downward adjustment trend was rather triggered by imports and a more flexible marketing policy pursued by large retail chains, in the period under review, domestic industrial producers

Administered Prices versus Market Prices

annual percentage change; end of period

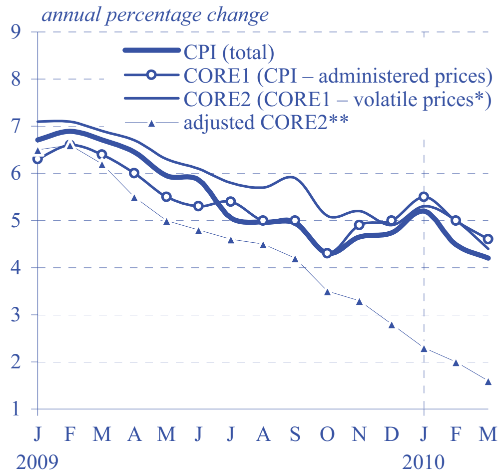
	2009				2010
	I	II	III	IV	I
Inflation rate	**6.71**	**5.86**	**4.94**	**4.74**	**4.20**
Administered prices*	**7.8**	**7.7**	**4.7**	**3.4**	**2.2**
1. Non-food items*:	**7.6**	**7.0**	**0.9**	**0.6**	**0.4**
electricity	4.8	4.8	0.2	0.2	4.2
heating	12.0	11.8	11.8	4.2	2.8
natural gas	12.5	8.6	–8.4	–8.4	–8.4
medicines	4.6	5.6	5.7	8.2	2.4
2. Services*, *of which:*	**7.9**	**9.1**	**13.5**	**9.9**	**6.0**
water, sewerage, waste disposal	12.8	14.7	16.3	15.0	11.3
fixed telephony	5.7	5.9	16.6	7.9	x
passenger railway transport	0.0	0.0	0.0	0.0	0.0
(passenger) city transport	8.0	8.8	7.6	7.4	5.3
Market prices (CORE1)	**6.4**	**5.3**	**5.0**	**5.0**	**4.6**
CORE2**	**6.9**	**6.1**	**5.9**	**4.9**	**4.4**
CORE2 less tobacco, alcohol	6.2	4.8	4.2	2.8	1.6
tobacco, alcohol	14.9	20.1	24.2	29.3	36.7

*) NBR calculations

**) CORE1 - volatile prices

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation



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

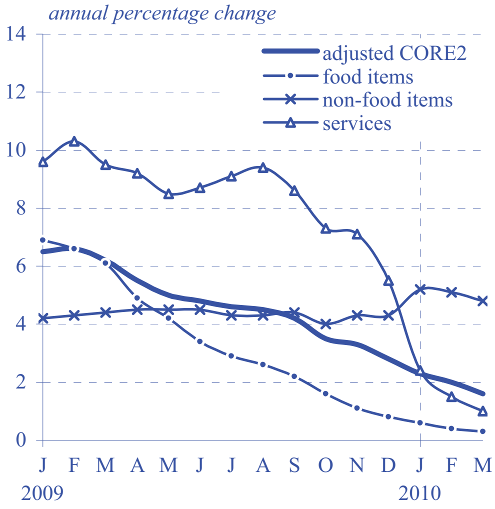
**) excluding tobacco and alcohol

Source: NIS, NBR calculations

[9] After an annual depreciation of 7.3 percent against the euro in December 2009, the national currency appreciated by 4.8 percent in March 2010, reflecting partly a base effect.

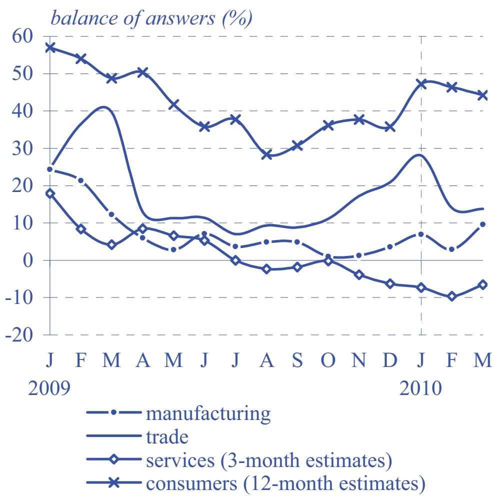
[10] January through February 2010, the volume of retail sales of foodstuffs stood 9.2 percent lower than in the same year-ago period, the change versus the previous quarter (-1 percent, seasonally-adjusted data) pinpointing however a slower decline in the demand for such items.

Adjusted CORE2 Components



Source: NIS, NBR calculations

Inflation Expectations of Economic Agents



Source: EC - DG ECFIN

started also to show a different behaviour (quarterly changes in producer prices of durables edged down after 14 consecutive quarters of positive growth rates[11]). Moreover, some of the factors identified in the previous quarter (the favourable developments in the exchange rate and the sluggish demand) continued to support disinflation. By contrast, external prices seem to have been less supportive of disinflation, as, in EU15, the annual growth rate of prices of consumer goods exports moved back to slightly positive readings in the first two months of 2010.

Inflation expectations of economic agents (consumer goods industry companies, trading companies, services companies, consumers) were generally volatile, with the overall influence for the entire period being, however, rather negative – the durables industry and services were the only segments on which a favourable climate for disinflation was anticipated.

The same as in the previous quarter, 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 by the strength of competitive pressures. Thus, the acceleration in the annual growth rate of tradables prices was associated with the higher excise duties, whereas the slower pace of increase of non-tradables prices was mainly the result of a number of base effects (manifest across components whose prices depend on the exchange rate movements).

Disinflation was further visible in the 12-month average HICP, which fell to 5 percent in 2010 Q1 (down by another 0.5 percentage points). Albeit less wide than at the end of the previous quarter, the gap between the 12-month average HICP in Romania and the 12-month average HICP in EU27 continued to be significant (4 percentage points), given that, throughout 2009, a number of rigidities on the product and labour markets delayed the adjustment of prices in the context of the global economic and financial crisis and that the inflationary effect exerted by the hike in some indirect taxes was significant. It is difficult to assess the gap between the 12-month average HICP in Romania and the corresponding Maastricht criterion, in view of the ambiguity relative to the definition of the reference value in the absence of a clear rule for interpreting the negative growth rates of inflation.

At the end of 2010 Q1, the actual annual inflation rate was 0.1 percentage points lower than the projection presented in the February Inflation Report, amid more favourable than anticipated developments in the exchange rate.

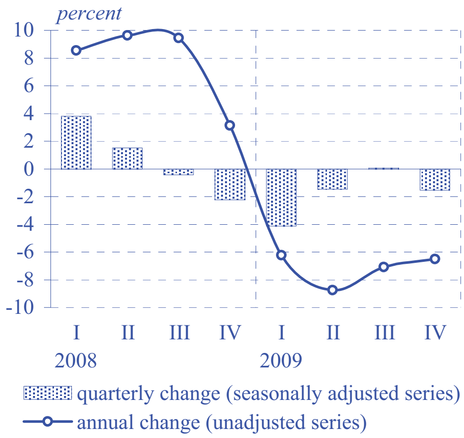
[11] Seasonally-adjusted data.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2009 Q4, real GDP saw further a slower annual rate of decline than in the previous quarter (by 0.6 percentage points to -6.5 percent[12]). The difference between the actual figure and that projected in December was marginal (-0.2 percentage points) despite the disparity between the actual quarterly pace of decrease (-1.5 percent) and that forecasted (-0.1 percent). This can be explained by the NIS significantly revising the seasonally adjusted data series.

Real Gross Domestic Product

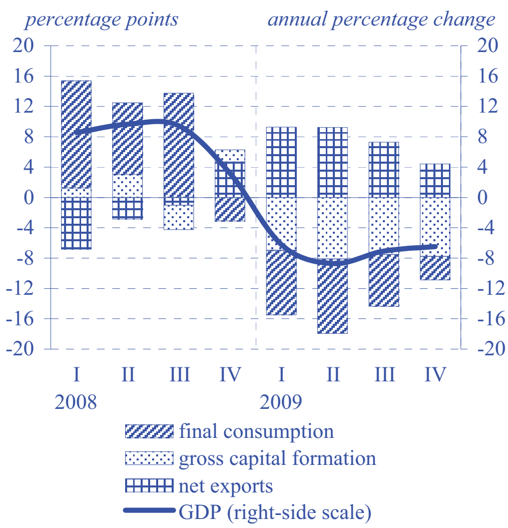


Source: NIS

On the demand side, the economic decline moderated due to domestic absorption (the rate of decline of which slowed by 2.8 percentage points), whereas the contribution of net exports, albeit still positive, decreased. On the supply side, the moderation was attributed to the upturn in industry, the other economic sectors posting lower performances than in the previous period.

The quarter-on-quarter analysis[13] of real GDP shows that the slight revival reported July through September 2009 (0.1 percent) was short-lived, as 2009 Q4 saw a 1.5 percent contraction in the economic activity. Behind this was mainly the drop in investment demand (-2.7 percent against +5 percent in Q3). Furthermore, the positive contribution of net external demand to GDP dynamics diminished to 1.3 percentage points, particularly as a result of the slower growth rate of exports of goods and services. However, the quarterly advance in consumer demand sped up by 1 percentage point. On the supply side, all economic sectors fared worse in 2009 Q4, with the steepest decline being further reported by gross value added in construction (-6.3 percent).

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

1.1. Demand

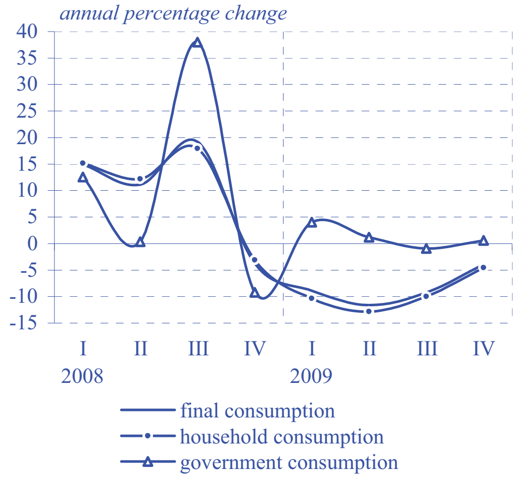
In 2009 Q4, domestic absorption shrank by 9.9 percent (compared to -12.7 percent in the previous quarter), with its two main segments following divergent trajectories:

– final consumption showed a smaller annual decline, as a result of both the developments posted in the current period (acceleration in the quarterly growth rate to 1.1 percent) and the favourable base effect associated with the 5 percent contraction recorded in 2008 Q4;

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

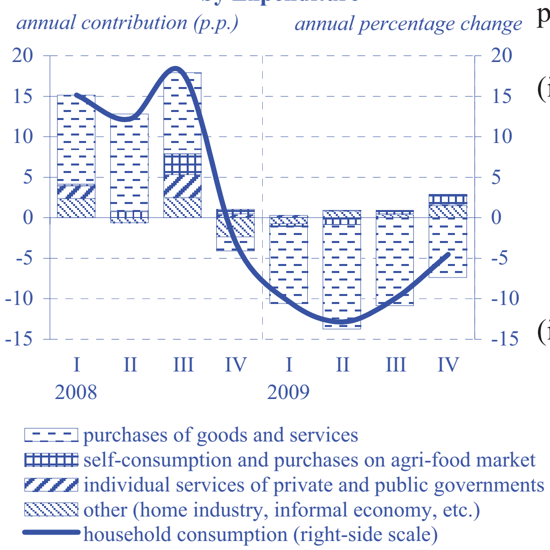
13 Quarter-on-quarter changes in GDP and its components are calculated based on the seasonally adjusted data series.

Actual Final Consumption



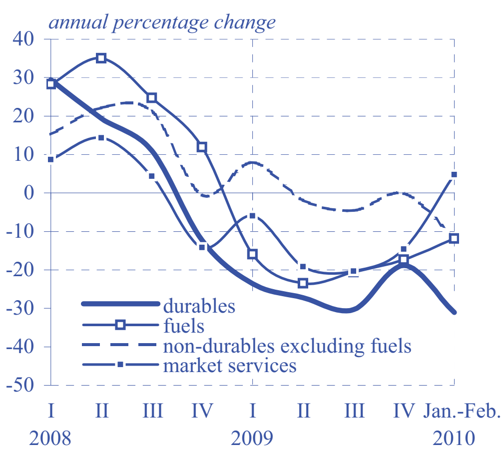
Source: NIS

Household Final Consumption by Expenditure



Source: NIS, NBR calculations

Purchases of Goods and Services*



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

Source: NIS, NBR calculations

– investment reported a steeper fall, as a consequence of the quarterly decrease in the current period (by 2.7 percent).

The revival of exports of goods and services was accompanied by a sharp slowdown in the import decline, so that the contribution of net external demand to the annual GDP dynamics fell to +4.4 percentage points in 2009 Q4.

1.1.1. Consumer demand

The downward trend of final consumption eased due to a similar evolution of the private component to which added the sign reversal posted by the annual dynamics of the public component.

Household consumer demand

In 2009 Q4, household final consumption recorded a slower annual decrease, i.e. -4.5 percent, less than half of the fall seen in the previous quarter. This evolution was mainly underpinned by:

(i) higher positive contributions made by "self-consumption and purchases on the agri-food market" and by "other consumption" (with home industry having a significant contribution in the latter case), as their annual growth rates accelerated by almost 4 times to roughly 13 percent in either case, amid bumper crops in agriculture;

(ii) the slowdown in the annual decline of purchases of goods and services (by 6 percentage points to -12.2 percent). Most trade segments saw lower annual decreases than in the previous quarter; durables and fuels remained the hardest hit by the drop in demand, whereas purchases of non-durables (except for fuels) posted a level similar to that in 2008 Q4.

From the standpoint of the influence on consumer prices, the developments in the volume of retail sales of products holding a large share in the CPI basket reported in 2009 Q4 suggest further the absence of demand-side inflationary pressures. This owes to the steeper decline in purchases of non-durables (-2.4 percent compared to -0.6 percent in Q3, quarter-on-quarter changes). The downward trajectory is even steeper if fuels are left apart: from +0.2 percent in Q3 to -2.6 percent in the quarter under review.

The analysis of financing sources shows a markedly faster decline in household disposable income[14], in annual terms (from -1.4 percent to -13.9 percent). As a result, the slower contraction in private consumption could be associated with the evolution of banking channels:

[14] 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 nonresidents.

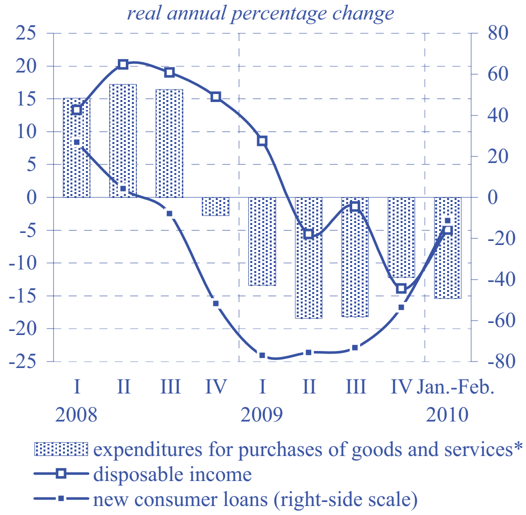
(i) the volume of new consumer loans decreased at a slower pace (by about 50 percent in annual terms, after a plunge by more than 70 percent in Q3) – however, one should not overlook that this was entirely the result of the base effect associated with the strong sign reversal posted by the quarterly dynamics of consumer loans October through December 2008, while the current change and households' expectations on the overall economic outlook and their financial standing were negative, despite the new cuts in the costs related to loans.

(ii) the propensity for saving moderated, as suggested by the slower pace of increase of new time deposits in Q4 – households' interest in such deposits lowered on the back of the average interest rates on both lei- and foreign currency-denominated deposits remaining on a downward trend.

As concerns the markets of origin of consumer goods (except for motor vehicles), 2009 Q4 saw no improvements in developments in annual terms – on the non-durables segment, both the volume of sales of domestically-produced goods and that of imports continued to shrink (by 17 percent[15] and 13 percent[16] respectively); on the durables segment, domestic products seem to have lost market share, given that the turnover volume of producers in this line of business declined at an even faster pace (to -37 percent), whereas imports either went up (by 2.5 percent, on the "electrical machinery and apparatus" segment) or saw a slower contraction (on the segment of other categories of goods). By contrast, the drop in the auto market was significantly alleviated, particularly on the domestic segment where the volume of sales posted an almost 13 times slower annual pace of decline (to -2.5 percent), with a considerable contribution coming from the third stage of the car-scrapping incentive scheme unfolding in late 2009.

Household Consumption and Main Financing Sources

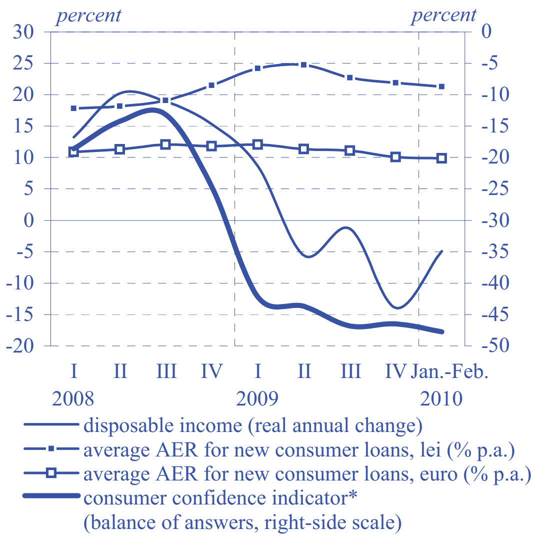
real annual percentage change



*) for Jan.-Feb.2010, the turnover volume in trade and market services was used

Source: NIS, MPF, NBR calculations

Main Determinants of Consumer Demand



*) seasonally adjusted data; the latest data refer to 2010 Q1.

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

Government consumption

The provisional data on the national accounts for 2009 Q4 show a slight pick-up in final government consumption (by 0.6 percent in annual terms), in line with the rise in the number of employees in the general government sector.

Budgetary developments

At end-2009, the consolidated general budget deficit stood at lei 36,401 million (accounting for 7.4 percent of GDP[17], of which the

[15] The analysis of developments in the demand for domestic products is based on the calculations concerning the change in the volume of retail sales of domestic industrial companies on the domestic market.

[16] 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.

[17] The latest GDP figure released by the NIS was used for calculations.

primary balance was 6.2 percent), marginally below the nominal benchmark lei 36,500 million agreed upon with the EU, the IMF and other international financial institutions and assumed by the Romanian authorities in the last budget revision for 2009. The lei 24,794 million budget deficit (accounting for 4.8 percent of GDP, of which the primary balance was 4.1 percent) exceeded that recorded in 2008[18], owing mainly to the far more severe contraction in revenues than in expenditures (-10.4 percent[19] and -4 percent respectively).

In 2009 Q4, the execution of the consolidated general budget resulted in a deficit of lei 10,838 million (2.2 percent of GDP, of which the primary deficit was 1.8 percent), 41 percent below the deficit recorded in the previous year (lei 17,463 million, i.e. 3.4 percent of GDP, of which the primary deficit was 3.2 percent). As for the pattern of budget spending, 2009 saw an improvement compared to 2008, with the fourth-quarter primary deficit accounting for 30 percent of the total deficit (against 78 percent in 2008 Q4).

The pace of decline in revenues slackened in the last three months of 2009 to -5.9 percent, from -14 percent in the previous quarter, mainly as a result of the dynamics of profit tax collection reverting to positive territory (9.5 percent against -34.1 percent in the previous quarter) and of the ongoing high growth rate of excise duty collection (9.2 percent, albeit lower than in the prior quarter). Against the backdrop of a protracted negative annual dynamics of economic activity, budget receipts were hit by the steeper annual contraction in social security contribution (-10.7 percent from -6.6 percent in 2009 Q3), as well as in wage and income tax (-13 percent against -8.8 percent). In turn, the annual change in VAT collection remained in negative territory at -10.1 percent, yet improving from the extremely low level recorded in 2009 Q3 (-28.9 percent).

Oddly enough, the positive dynamics of actual final government consumption recorded in 2009 Q4 was associated with a substantial decrease in total public spending (-16.2 percent, following a 6.1 percent increase in 2009 Q3) and primary spending (-17.7 percent, compared to a 5.2 percent rise in July-September), due largely to the adjustment measures implemented by the authorities. These measures materialised in the reduction of capital expenditures (-28.1 percent, versus an 8.1 percent increase in the prior quarter) and current expenditures (-9.6 percent compared to

[18] Data on the 2008 budget execution were recalculated by the MPF to ensure compatibility with those for 2009.

[19] Unless otherwise indicated, percentage changes refer to the real annual growth rates.

6 percent in Q3)[20]. The latter occurred mainly on the back of a larger decline in goods and services expenditures (-34.5 percent, against -6 percent in the previous quarter), as well as in staff costs (-18.9 percent, from -1.6 percent in the previous quarter)[21]. By contrast, social security expenditures increased slightly (0.7 percent, following a 19.6 percent rise in the preceding quarter), against the backdrop of a 2 percent indexation of the pension point and the rise to lei 350 in the minimum pension starting with October[22].

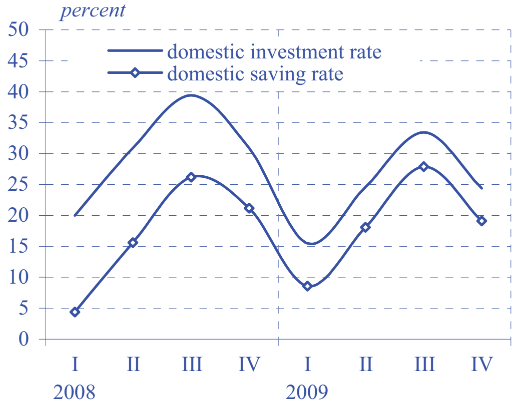
The consolidated general budget for 2010[23] includes the adjustment of the deficit down to 5.9 percent of GDP[24], the nominal target set by the multilateral external financing agreement being lei 31,900 million. Given the projected 0.6 percentage points decline in the share of total revenues in GDP (to 31.3 percent), the expected fiscal consolidation will be achieved via the reduction in primary expenditures, whose share in GDP is projected to shrink by 2.5 percentage points (to 35.5 percent), due primarily to the decrease in the share of social security expenses and staff costs in GDP (by 1 percentage points each, to 12 percent and 8.5 percent respectively), as well as in the share of the amounts allotted to goods and services procurement (down 0.7 percentage points to 5.2 percent of GDP).

In February 2010, the EU Council issued a new recommendation for Romania on the measures to be taken in order to bring the budget deficit (calculated in compliance with ESA95 methodology) below the reference value of 3 percent of GDP[25]. The deadline for achieving this objective was extended by one year to 2012. This implies an annual fiscal consolidation effort averaging around 1.75 percent of GDP over the next three years.

1.1.2. Investment demand

The annual rate of decline of gross fixed capital formation accelerated by 3.8 percentage points to -31.4 percent, severe contractions being further recorded on all main segments – the

Investment Rate and Saving Rate



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

Source: NIS, NBR calculations

[20] The cut in expenditures was due also to a temporary measure accounting for 0.4 percent of GDP (whereby the total volume of expenditures was lowered by lei 1,806 million, representing the balance of the funds managed by EXIMBANK joint-stock company as of 31 December 2008, in compliance with Article 35 of Government Ordinance No. 19 of 29 August 2009 on the budget revision for 2009).

[21] Including the savings from the unpaid furlough for public-sector employees.

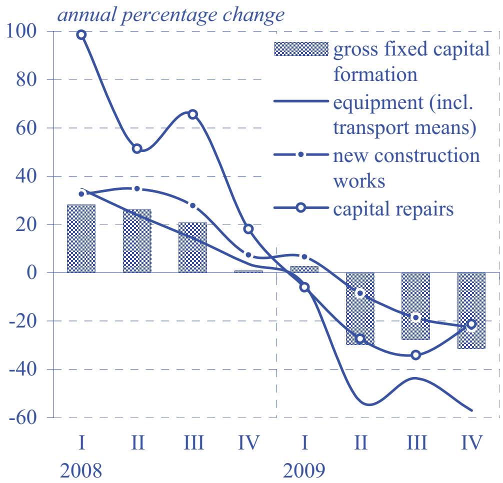
[22] The impact of these increases was somewhat offset by the base effect generated by the 20 percent indexation of the pension point in October 2008.

[23] Approved by Law No. 11 and Law No. 12 of 26 January 2010 on the state budget for 2010 and the state social security budget for 2010 respectively.

[24] The level of nominal GDP taken into account for 2010 is lei 538,917 million, according to the budget execution released by the MPF in February.

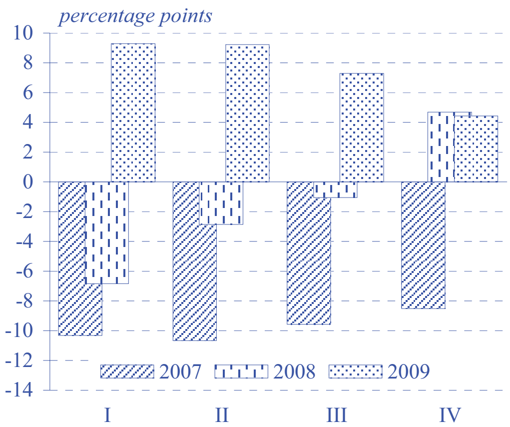
[25] Romania is among the EU Member States subject to the excessive deficit procedure.

Investment



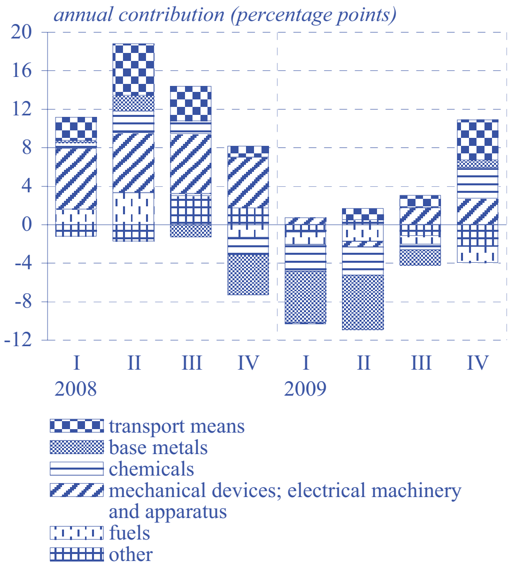
Source: NIS, NBR calculations

Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

Export Physical Volume



Source: NIS, NBR calculations

volume of investment in equipment (including transport means purchased by companies and institutions) made up less than one-half of the level recorded in 2008 Q4, while the volume of new construction works and capital repair works shrank by approximately 22 percent in annual terms.

As for the financing sources of capital increases in 2009 Q4, mention should be made that most of the channels reported weaker results against the previous quarter:

(i) signs regarding own sources are negative both for the corporate sector (taking into account the generally dismal performance of the main sectors), and households, whose disposable income posted a downward drift;

(ii) the estimated volume of new bank loans[26] for real estate investment further shrank (by about 30 percent in Q4); as concerns equipment purchase loans, although a recovery in annual terms can be noted, this is attributable solely to the substantial adjustment seen in the reference period, when the volume of new loans was almost zero;

(iii) lease financing, resorted to by 90 percent of the corporate sector, further posted the steep downward path seen in the first three quarters of 2009, the EUR- expressed value of the contracts concluded in 2009 Q4 being 60 percent lower than in the same year-earlier period;

(iv) the pace of decline of foreign direct investment accelerated, with total inflows in 2009 falling to almost one-half of the year-earlier level[27];

(v) the volume of investment made from budget sources contracted by roughly 4 percent in annual terms.

In 2009 Q4, further declines in the volume of capital goods purchases, both on the domestic markets and in terms of imports, were recorded, with the annual pace of decrease exceeding again 20 percent.

1.1.3. Net external demand

In 2009 Q4, the rebounding demand from the major foreign partners had a favourable impact on the trade balance, reflected also by the national accounts estimates:

(i) the volume of exports of goods and services increased for the second consecutive time on a quarterly basis, the annual dynamics turning positive (2.9 percent);

[26] Calculations based on data provided by the CCR, the flow related to one quarter being approximated as the difference between the balance at the end of period and that at the beginning of period.

[27] Calculations based on balance-of-payments data.

(ii) the volume of imports saw a significant slowdown in its decline, although the annual dynamics (-11.1 percent) was further affected by the fall in domestic absorption and the ongoing depreciation of the domestic currency. Nevertheless, both developments unfolded at a slower pace.

It is worth mentioning that the base effects associated with the significant quarterly contractions posted by exports and imports of goods and services in 2008 Q4 (-7.2 percent and -11 percent respectively, seasonally-adjusted data) had a large contribution to the improvement of annual volume indices).

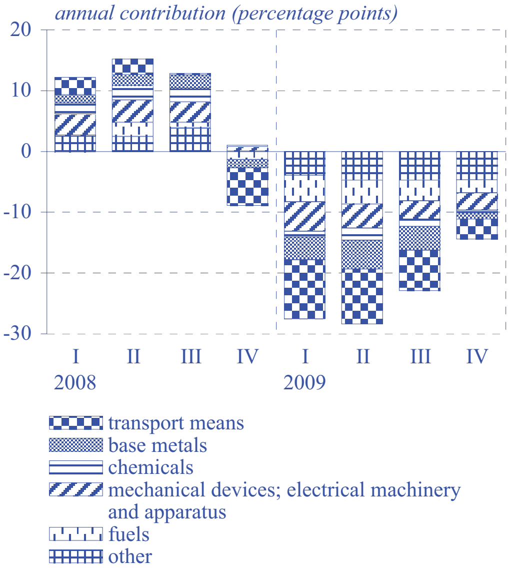
Similar trajectories saw the physical volume indices of both exports and imports, computed by deflating the two trade balance components by the corresponding unit value indices.

The structural analysis shows that the recovery of exports was driven mainly by: (i) the reversal in the downward trend of exports of chemicals and (ii) the faster growth rate of "transport means" and "machinery and equipment", which contributed to the increase up to 46.1 percent in the share of high value added goods in total exports.

As for imports, more than one-third of the slowdown in rate of decline of the physical volume was the result of the substantially lower decrease in purchases of "transport means" (from roughly -57 percent in 2009 Q3 to -36 percent, annual change); "base metals" and "fuels" had similar contributions, but of a lesser magnitude.

Import Physical Volume

annual contribution (percentage points)



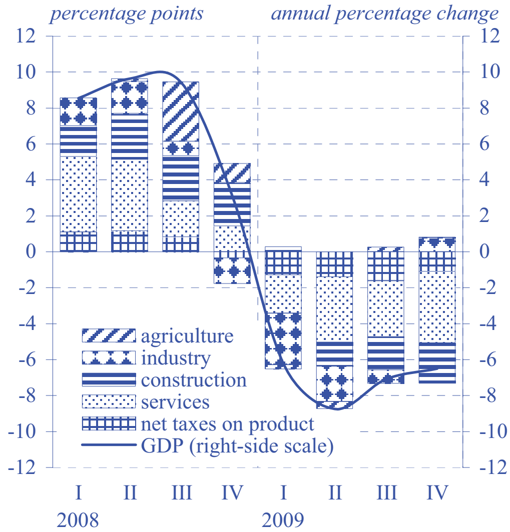
Source: NIS, NBR calculations

1.2. Supply

The slowdown in the annual decline in real GDP in 2009 Q4 was bolstered by the rebound of industry, where gross value added rose by 4 percent (from -3.5 percent in the prior period). Structural analysis of industrial activity indicates the large contribution of stronger demand for metallurgical and chemical products as well as the thriving activity in the sub-sector producing road transport means and, by association, in the sub-sector producing electrical equipment. Even though the fast-paced annual dynamics seen in these sub-sectors incorporates a substantial base effect, account shall be taken of the positive quarterly changes generated largely by the signs of recovery in the economies of Romania's main trading partners as well as by higher domestic sales of certain products, particularly motor vehicles (in light of the resumption of the car park renewal programme in February 2010) and metallurgical products (the step-up in engineering works is a possible explanation).

Contribution of Supply Components to GDP Growth

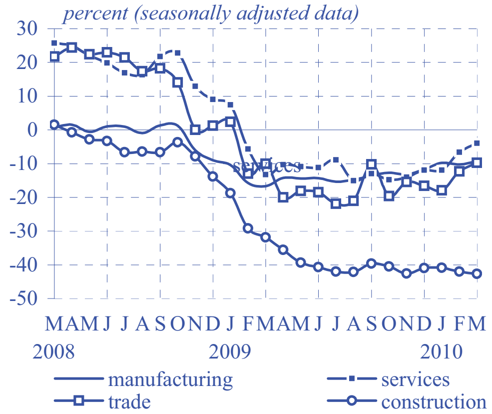
percentage points *annual percentage change*



Source: NIS, NBR calculations

Construction activity was further on a steep downward path (gross value added fell 15.9 percent in annual terms), residential works

Corporate Sector: Confidence Indicators for the Next 3 Months



Source: EC - DG ECFIN

displaying again the most severe contraction (almost 39 percent). As regards non-residential and infrastructure works, the annual paces of decline slowed down due to the upturn seen in Q4 (compared with 2009 Q3, the volumes of output rose by 6 percent and 11 percent respectively, adjusted series).

The positive contribution of the agricultural sector to GDP dynamics decreased in Q4, with the annual growth in gross value added decelerating to less than one third compared to the prior period (to 0.7 percent).

Services remained on a downward trend, which grew even steeper (annual dynamics of gross value added stood at -8 percent). Decreases in the output volume were seen in all sub-sectors, especially in "trade, hotels and restaurants, transports and telecommunications" and "financial activities, real estate transactions and rentals" (to -12.5 percent and -9.3 percent respectively).

2. Labour market

In January-February 2010, signs of the labour demand/supply ratio stabilising emerged amid a flattening out of the upward path of registered unemployment. However, the small capacity of the private sector to absorb excess workforce is still seen as a deterrent for potential wage increases unmatched by productivity gains so that the higher annual dynamics of wages in the period under review are likely to have been only temporary. In fact, ULC in industry remained significantly lower compared to the year-earlier period despite the fast-paced annual dynamics of wage earnings. The measures aimed at cutting staff costs in the public sector materialised in a slight reduction in both staff numbers and average wages.

2.1. Labour force[28]

Statistical data provided by the NEA for the first two months of 2010 indicate that the private sector has surpassed the peak of staff retrenchments required by adverse economic conditions, the removal of seasonal influences illustrating a lower average number of lay-offs compared to 2009 Q4.

Nevertheless, the analysis of staff numbers reported by employers show a persistent downward path in the number of employees (-2.2 percent in January-February 2010 compared to 2009 Q4), at a pace only marginally slower than in the prior periods; the

[28] Data in this section are seasonally-adjusted. The comparison against the prior quarter was preferred to the annual growth rate analysis, which is affected by base effects (adverse in 2009, by comparison to the period prior to the onset of the domestic crisis, favourable in January-February 2010, amid the severe drop in workforce demand at the beginning of 2009).

possible explanations behind the mismatch with the evolution of lay-offs include the delayed registration of the jobless due to cumbersome, time-consuming formalities, the expansion of informal economy, as well as the statistical records discrepancies. In this case too, the private sector[29] was in the lead as regards staff adjustments while in the public sector the speed of implementing staff-cutting measures remained modest, similar to the average for 2009 Q2 - Q4 and lower compared to 2009 Q4.

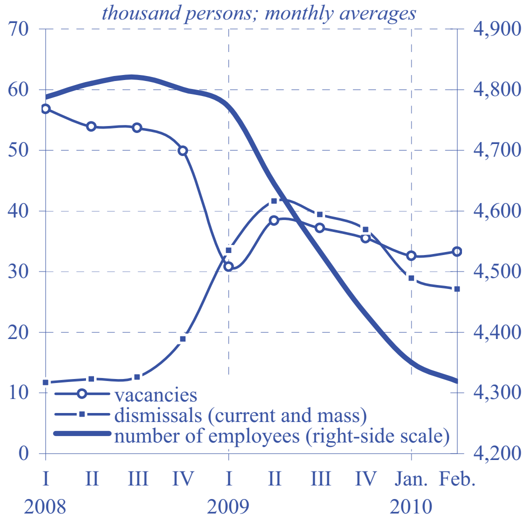
Therefore, demand for workforce further displayed low levels as the slow pace of economic activity was not supportive of job creation. The number of vacancies remained on a downward path (-7.2 percent from 2009 Q4), a slight rebound being reported by recruitment agencies no sooner than March.

The slowdown in the monthly rate of increase of excess workforce manifest starting with 2009 Q4 persisted into 2010 Q1, with registered unemployment rate going up only 0.2 percentage points in March 2010 from end-2009. This development was essential in containing the gap between the number of unemployed and the number of vacancies[30] at roughly 97:1 (in 2009 Q4 and January-February 2010). The size of this gap suggests that wage hikes in the private sector[31] at the beginning of 2010 were not the result of staff pressures, as the bargaining power of employees was dramatically compressed by the unfavourable economic conditions, but the result of employers' decision to reward their staff for the additional effort made after the redistribution of tasks following the reorganisation of companies that had resorted to redundancies. Given the persistent uncertainty regarding the economic rebound and the employers' refusal to increase the gross minimum wage for private sector employees since the start of 2010, these wage hikes may have been granted on an occasional basis, not on a permanent one.

2.2. Incomes

In January-February 2010, the net average nominal wage economy-wide rose by 4.6 percent in annual terms, due solely to private sector developments (around +7 percent[32]); the explanations reside, on the one hand, in the higher wages/incentives granted to employees and, on the other hand, in the statistical effect of average wage increase following the laying-off of lower wage

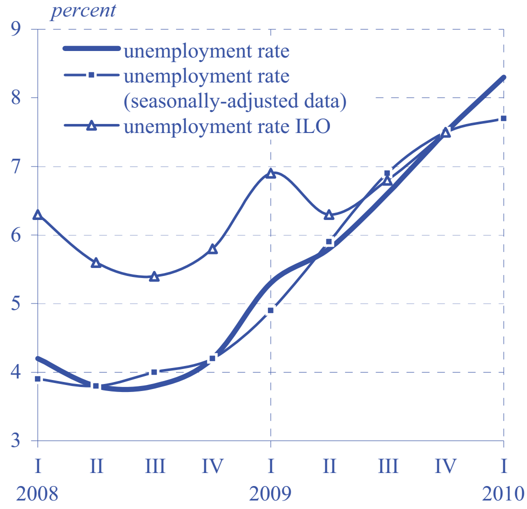
Labour Force Demand Measures*



*) seasonally-adjusted data

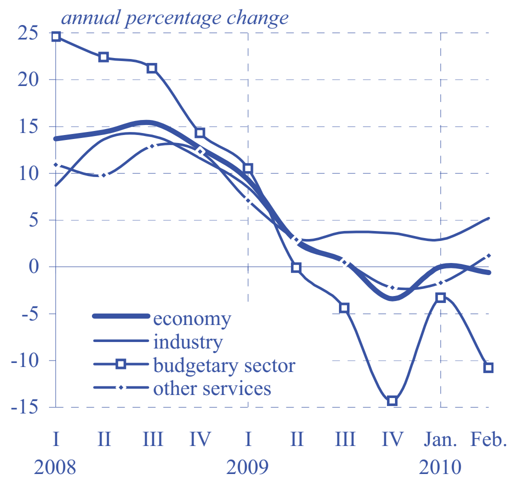
Source: NEA, NIS, NBR calculations

Unemployment Rate



Source: NIS, NBR calculations

Net Real Wage*



*) deflated by CPI

Source: NIS, NBR calculations

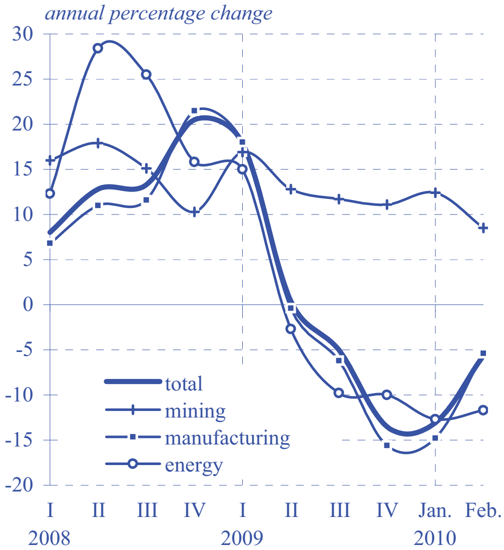
29 Contractions above the economy-wide average were observed in industry, construction, transports and warehousing.

30 Stock at end of month.

31 See Subsection *2.2 Incomes*.

32 NBR calculations.

Unit Labour Costs in Industry



Source: NIS, NBR calculations

earners[33]. Net average wage of public sector employees dropped by 2.6 percent in annual terms following the coming into force of Law No. 330/2009 on the unitary wage for public sector employees (by limiting bonuses and incentives granted to employees, which counteracted the opposite effect associated with the setting of the gross minimum wage at lei 705).

The annual dynamics of economy-wide net average wage ran at 3.6 percentage points higher compared to 2009 Q4, when its level contracted to 1 percent due to the following temporary factors: (i) the granting of fewer and lower end-of-year bonuses in the private sector compared to 2008 and (ii) the measures aimed at cutting staff costs in the public sector (unpaid furlough imposed on public sector employees, removal of occasional bonuses).

In the period under review, industry was the sector further displaying the highest annual dynamics of wage earnings (twice as much as the economy-wide average), which however were fully covered by productivity gains mainly as a result of substantial staff cuts. Thus, ULC still posted negative annual dynamics (9.3 percent), the performance being yet lower (by 4.2 percentage points) compared to 2009 Q4 amid the slowdown in labour productivity growth[34]. The drop in ULC in manufacturing moderated to 10 percent from 15.6 percent in 2009 Q4, chiefly as a result of the up to 25 percentage point acceleration in the annual dynamics of chemicals, rubber and plastic products, segments related to the construction sector[35]. Conversely, the industry-wide average was favourably impacted by several sectors that account for a large share in the industrial production value (oil processing, metallurgy, electrical equipment, transport means), where ULC cuts ranged between roughly 15 percent and 30 percent.

In line with estimates, household real disposable income fell deeper in 2009 Q4 (-13.9 percent in annual terms) as a result of the further drop in the wage bill and transfers from abroad, as well as of the sign reversal in the annual dynamics of social benefits. Even though, in January-February 2010, the annual rate of decline of household real disposable income moderated to 4.9 percent, its evolution starting with 2009 Q2 provides an explanation for the fading pressure from household consumption on the prices included in core inflation adjusted by the impact of higher excise duties.

[33] Based on the NIS Press release No. 68/7 April 2010.

[34] The annual growth rate was 21.7 percent in January-February 2010 compared with 26.6 percent in 2009 Q4.

[35] Metallic construction, processing of other non-metal products.

3. Import prices and producer prices

In 2009 Q4, import prices and agricultural producer prices continued to make a favourable contribution to consumer price developments, at a lower extent, however, compared with previous quarters. In addition, the annual changes in prices for domestically-produced industrial goods re-entered positive territory, yet pressures were limited to the energy sector. Prospects indicate the persistence of current developments: slower annual pace of decline in import prices and agricultural producer prices as well as positive annual growth rates of prices for industrial goods.

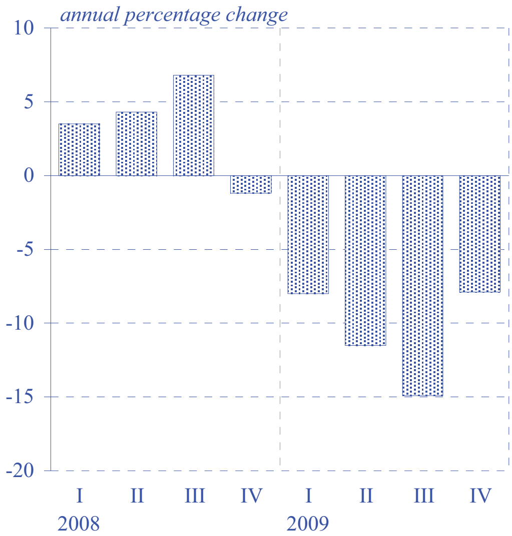
3.1. Import prices

Import prices further made a favourable contribution to inflation developments in 2009 Q4, albeit to a lower extent than in prior quarters, given that the annual unit value index of imports remained below par (92.08 percent) and the domestic currency position versus major currencies improved from the preceding quarters (lower depreciation versus the euro and relative stabilisation in US dollar terms).

The 6.9 percentage point slowdown in the annual pace of decline of external prices as compared with 2009 Q3 was mainly attributable to fuels, despite contributions made by other groups of goods (vegetal products, fruit, fats, base metals, electrical machinery and apparatus). However, mention should be made that unit value indices for all those groups of goods stayed considerably below par.

In late 2009 and the first months of 2010, external prices of commodities (oil and metals in particular) followed an ever sharper uptrend, on the back of signs of world demand recovery, which could also entail trend reversals of import prices for manufactured industrial goods.

Unit Value of Imports



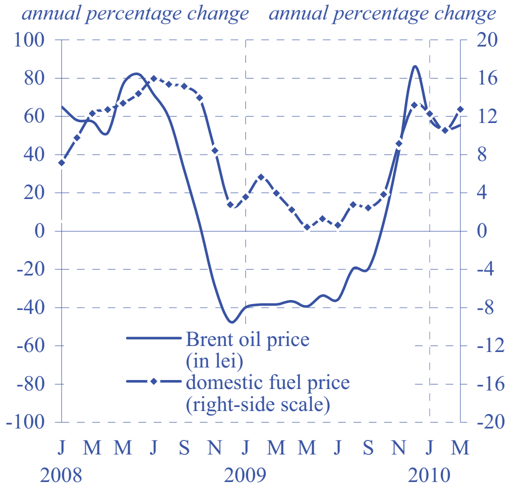
Source: NIS, NBR calculations

3.2. Producer prices

3.2.1. Industrial producer prices

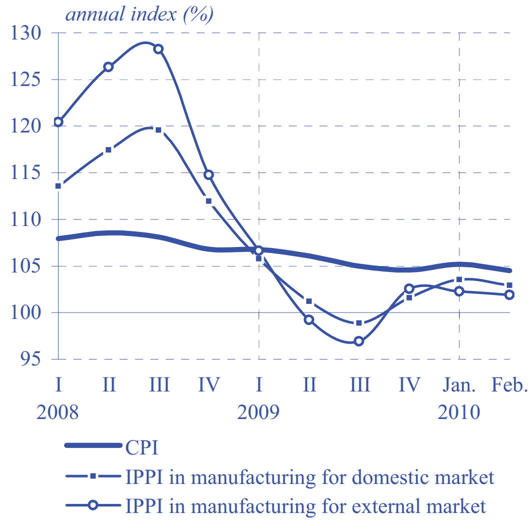
In 2009 Q4, industrial producer prices for the domestic market reverted to positive annual growth rates (1.8 percent), due solely to the trend reversal in energy prices. The base effect associated with the downtrend in external prices of oil products in 2008 Q4, as well as the currently build-up pressures on world specialised markets caused the annual growth rate of producer prices for energy to stand at 1.9 percent as against -5.8 percent in 2009 Q3. A trend reversal was also reported by intermediate goods, whose quarter-on-quarter price changes slowed down to -0.3 percent versus -2.4 percent in 2009 Q2.

Oil Price and Domestic Fuel Price



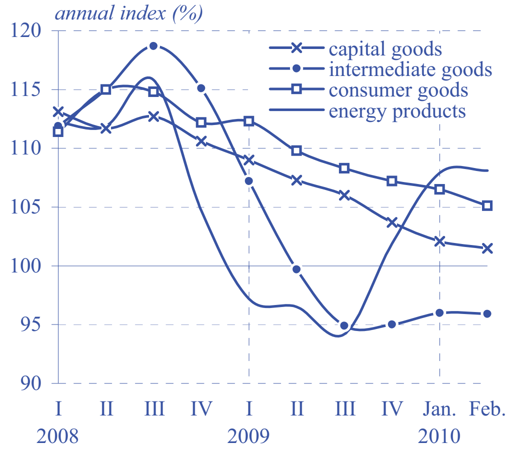
Source: NIS, EIA, NBR calculations

Consumer Prices and Industrial Producer Prices



Source: NIS

Industrial Producer Prices for Domestic Market by Industrial Products Group



Source: NIS

The annual dynamics of producer prices for the other groups of industrial goods stayed on a downward path. In the absence of pressures on input costs and given the sharp contraction of domestic demand[36] for capital goods, in 2009 Q4, producer prices on this segment saw the sharpest pace of decline in the past year (down 2.3 percentage points to 3.7 percent).

Prices for consumer goods recorded much less pronounced changes (-1.1 percentage points), their annual growth rate remaining particularly high at 7.2 percent, reaching even 7.8 percent in the case of durables. Current price developments of durables hint at a deceleration in their dynamics in the period ahead – relative stability of quarterly changes in producer prices following 13 consecutive quarters of growth[37] – which might point to the shift in producers' behaviour, possibly under the pressure exerted by the steep fall in the sales volume on the domestic market[38]. The delayed response of local producers to demand developments may be largely attributed to promoting a price policy based on preserving revenues, in a period when producers perceived demand for durables as insufficiently sensitive to price cuts.

Price changes reported by key segments of non-durables were generally favourable, yet the annual growth rates of producer prices (7.1 percent) were merely 1 percentage point below the average for the prior quarter, due to the further uptrend in tobacco processing and pharmaceuticals. In the latter case, the annual dynamics of producer prices accelerated to 19.5 percent and 28.3 percent respectively in January and February 2010, the price increases applied by domestic producers (with the approval of the Ministry of Health) being accounted for by the need to cover input costs.

In January-March 2010, the annual rates of increase of industrial producer prices for the domestic market will consolidate their upward trend, with a major contribution from energy and consumer goods, even though, in the latter case, pressures build up further on the same two segments (tobacco processing and pharmaceuticals).

3.2.2. Agricultural producer prices

In October-December 2009, the sharply negative annual growth rates of agricultural producer prices recorded in the past three quarters slowed down considerably to -1.1 percent as compared

[36] Real turnover of capital goods for the domestic market (seasonally adjusted series, deflated by industrial producer prices for the domestic market) posted a quarterly decline for the fifth quarter in a row, the 2009 Q4 figure standing nearly 37 percent lower than that recorded in 2008 Q3.

[37] Seasonally-adjusted data.

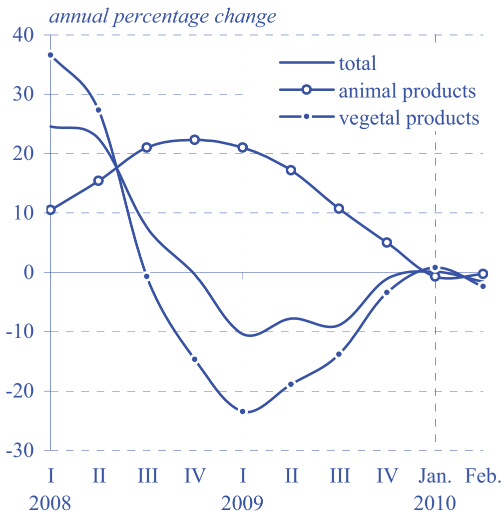
[38] In 2009 Q4, real turnover of durables on the domestic market (seasonally adjusted series, deflated by industrial producer prices for the domestic market) stood over 40 percent lower than in 2008 Q3.

with -8.9 percent in the prior quarter, owing solely to developments in prices for vegetal products. As the negative annual growth rates of producer prices for main grain types were slower than in the preceding quarters (over two times lower for wheat) and the annual dynamics of prices for vegetables saw a trend reversal, producer prices for vegetable products saw a year-on-year decline of 3.4 percent as compared with 13.8 percent in 2009 Q3. However, mention should be made that the trend for the entire quarter was generated by fruit and vegetable prices changes recorded in December (up 14.9 percent month on month), due possibly to mounting seasonal demand during winter holidays, given that domestic supply is contained by the lack of appropriate storage facilities.

A similar development was detectable in the case of animal products, yet price movements were much slower (1.7 percent month on month). In 2009 Q4, the annual growth rate of producer prices decelerated to 5 percent, i.e. half of the prior quarter's figure, on the back of developments in prices for most types of meat.

In the first three months of 2010, the annual growth rates of agricultural producer prices might stay on an uptrend, even revert to positive annual changes, owing solely to developments in the vegetal component, whereas the annual dynamics of prices for animal products is likely to decelerate further.

Agricultural Producer Prices



Source: NIS

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

The National Bank of Romania lowered the monetary policy rate further in February and March 2010, each time by half of a percentage point. As a result, the key interest rate was brought down to 6.5 percent per annum. At the same time, the central bank pursued an adequate management of liquidity in the banking system, thereby underpinning the normalisation of interbank money market rates. These measures – taken against the background of a stronger leu against the euro and a protracted economic contraction – were aimed at calibrating broad monetary conditions in terms of consolidating inflation rate convergence towards medium-term targets and creating favourable conditions for a sustainable revival of lending and the achievement of a solid economic recovery.

The decision to lower the monetary policy rate by half of a percentage point to 7.0 percent per annum, taken in the NBR Board meeting of 3 February 2010, was primarily motivated by prospects of a gradual pick-up in disinflationary pressures on the demand side, which were underpinned by pre-requisites of a further consistent implementation of the economic programme agreed with the EU, the IMF and other international financial institutions. Behind the anticipated slowdown in adjusted CORE2 inflation stood the size of the negative output gap in 2009 and the outlook for its deepening and extending over the period ahead as well as the recent (and expected) relative decline in the persistent nature of this inflation component. The annual GDP dynamics remained in negative territory at the turn of the year, hinting at an increase in the negative output gap, due to the following major indications and pre-requisites: (i) the still negative year-on-year dynamics of euro area GDP in 2009 Q4; (ii) the inertial nature of the Romanian economy's downturn in the previous quarters; (iii) the faster/protracted negative annual dynamics of a number of relevant indicators on consumer and investment demand over the first months of 2009 Q4; (iv) the recent fall into negative territory of the annual growth rate of the real net average wage; (v) the ongoing financial deleveraging and further improvement in households' net savings with banks; and (vi) the rising unemployment rate during 2009 Q4. Under these conditions, the forecasted[39] annual inflation rate remained headed downwards, although in 2010 it ran a course higher than that foreseen in the previous forecasting round, owing largely to higher-than-expected

[39] February 2010 Inflation Report.

increase in some administered prices and excise duties. Thus, the 12-month inflation rate appeared set to near the midpoint of the 3.5 percent inflation target at end-2010 and thereafter to remain, similarly to the previous forecasting round, in the lower half of the variation band around the central target set for December 2011. Moreover, the balance of risks to the updated inflation forecast had reached equilibrium, reflecting the lower likelihood of slippages in coordinating and implementing the macroeconomic policy mix. The evolution of the external environment was seen as the major potential source of uncertainties surrounding the current projection.

In March, the NBR Board opted for cutting the monetary policy rate by another 0.50 of a percentage point, down to 6.5 percent per annum. This decision was substantiated mainly by the resumption of disinflation in February amid the quasi-fading of the effects triggered by the hike in several excise duties on 1 January 2010 and the prospects of this process to carry on, as the annual GDP dynamics was expected to remain in negative territory over the first part of 2010. The magnitude of GDP decline was however foreseen to shrink progressively given the improvement in the annual economic contraction in 2009 Q4 (-6.5 percent as against -7 percent in Q3) and especially the signs of a brighter picture in a number of sectors across the national economy. Nonetheless, the pace of economic recovery was expected to be slower than projected previously, since certain economic indicators relevant for consumer demand and investment[40] dynamics continued to fare badly, or even worse, in January 2010. Thus, the annual rate of increase of both consumer demand and especially gross fixed capital formation appeared to remain in negative territory in 2010 H1. The major indications concerning the developments in consumption were the following: (i) a more negative annual change in the turnover volume of retail trade (non-food items in particular) and motor vehicles and motorcycles trade (against the previous quarter's average), (ii) a substantial year-on-year decline in VAT receipts in January, (iii) a decrease in workers' remittances in the same month, and (iv) the upward trend in unemployment rate during January – February 2010. Adding to these were the still robust money demand for saving and the steeper decline in the annual dynamics of loans to households[41].

The average annual growth rate of loans to households became more negative in January – February 2010 (-9.0 percent against an average of -1.1 percent in 2009 Q4). Both demand for and supply of loans to this sector failed to show a clear improvement over the aforesaid period, the signs of a marginal recovery being most

[40] Particularly the indicators on construction works and equipment purchase, the balance on medium- and long-term corporate loans as well as external financial borrowings.

[41] Unless stated otherwise, growth rates are annual rates of increase in real terms.

likely due to the implementation of the "First Home" programme[42]. Demand for loans was adversely affected by the still elevated interest rates on new business (primarily borrowings in domestic currency) and the worsening of the current and expected developments in unemployment and incomes (from wages and workers' remittances). In turn, loan supply was further depressed by the banks' ongoing caution that was motivated, inter alia, by the protracted uptrend in households' overdue loans[43]. Also relevant for credit institutions' caution in 2009 Q4 was the continued, albeit partial, tightening of household lending terms and conditions, whose change was yet again slower quarter on quarter and different in terms of credit destination[44]. Against this background, the average volume of new loans to households[45] declined in January – February 2010 versus 2009 Q4, although it increased year on year on account of a sizeable base effect. Reflecting not only these influences, but also the relatively strong statistical impact from domestic currency appreciation, the average annual rate of increase of consumer loans to households slipped to -10.7 percent, i.e. 7.3 percentage points below the fourth-quarter average; by eliminating the exchange-rate effect, the persistence of this trend owed largely to leu-denominated credit (-9.7 percent on average year on year, down 0.5 percentage points over 2009 Q4). The dynamics of housing loans also lost momentum against the same year-ago period, but remained in positive territory at 3.7 percent against 15.1 percent in 2009 Q4. The foreign currency-denominated component of loans to households saw its annual growth rate picking up to 13.6 percent over 8.7 percent in 2009 Q4, chiefly on the back of the impact of implementing the "First Home" programme.

At the same time, money demand for saving was still relatively robust, as the upward trend in the average weight of term deposits (up to and over two years) in total household deposits persisted into January – February 2010 to reach a three-and-a-half-year high of 74.8 percent. Money demand for precautionary motives was

[42] The launch/progress of the "First Home" programme had a direct impact on the participating banks' demand for and supply of loans. Moreover, it contributed to less tight lending conditions associated with housing loans extended by the other credit institutions.

[43] According to Credit Bureau figures.

[44] According to the NBR's February 2010 survey on lending to non-financial corporations and households, the latter's lending conditions were further subject to (a relatively slower) tightening in the case of consumer loans during Q4 due largely to the following factors: (i) the risk associated with customers' creditworthiness, (ii) collateral risk, (iii) expectations on households' financial standing and (iv) the central bank's monetary policy and prudential supervision decisions. To some extent, lending terms were also tightened: the maximum share of the debt service in disposable income was reduced, while the average level of the loan-to-value ratio was slightly lowered in respect of mortgage loans.

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

underpinned by households' lingering pessimism as a result of a worsening in their current and expected financial standing and, to some extent, of the relative changes in yields on various monetary asset classes[46]. It should be noted that the term structure of new deposits over January – February 2010 highlights the renewed interest of households in longer-term deposits (over three months) thanks to their attractive interest rates. The balance of term deposits (up to and over two years) saw its average annual dynamics halving in the period under review (25.2 percent compared with 55.3 percent in 2009 Q4), due largely to the fading of a base effect, and thus returned close to the levels recorded in 2009 Q1. Moreover, the annual rate of increase of overnight deposits remained in negative territory, but rebounded somewhat from the previous three months' level. Reflecting all these moves – which emerged also following the reduction in incomes of households, along with the ongoing repayment of their bank debt service –, household savings with credit institutions (including deposits with a maturity of over two years) posted a markedly slower year-on-year growth rate, averaging 5.8 percent in January-February 2010 against 14.7 percent in 2009 Q4.

The drop in the risk premium related to investments on the Romanian financial market also paved the way for a monetary policy rate cut. Due account was taken of the stronger leu against the euro amid the improvement of global risk appetite and in particular the shift in foreign investor perception as concerns profit opportunities on financial markets in Central and Easters Europe. On the domestic front, this trend was bolstered by the sustainable levels of the current account deficit as well as the implementation, in line with the established coordinates, of the multilateral external borrowing arrangement signed with the IMF, the EU and other international financial institutions, both of them being reflected by the upgrade of the outlook on the sovereign rating (see Subsection *2.2. Exchange rate and capital flows*).

Throughout 2010 Q1, the central bank pursued an adequate management of liquidity in the banking system seeking to support the normalisation of longer-term money market rates, along with spurring a faster downward adjustment in deposit/lending rates, which had remained high in relation to the monetary policy rate.

Thus, in January-February and early March 2010, the central bank continued to conduct repo transactions with a maturity ranging from 5 to 7 days via fixed-rate auctions with full allotment. Such operations enhanced the easing of liquidity conditions on the money market following the money injections performed by the

[46] As far as households were concerned, the spread between interest rates on new term deposits and those on overnight deposits in domestic currency edged up in January, but narrowed in February, staying however above the levels seen until November 2009.

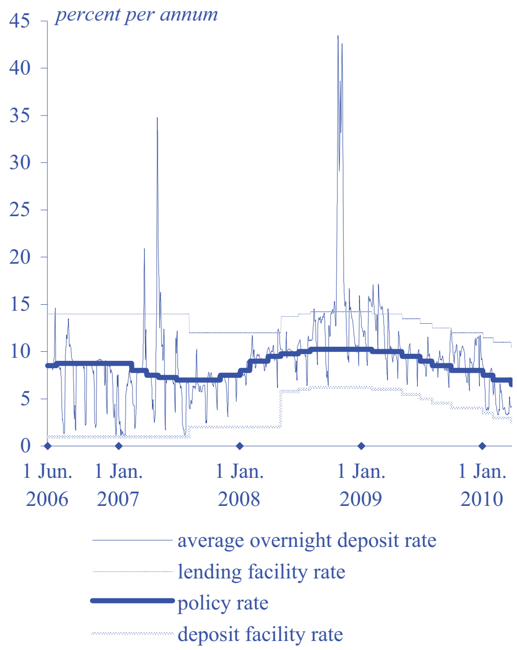
State Treasury[47] in the run-up to the end of 2009 and during 2010 Q1. The latter resulted in the central bank resuming its net debtor position vis-à-vis the banking system towards the end of the period under review. The ensuing liquidity surplus was mopped up solely via banks' resort to the deposit facility, with average daily volume of such deposits recorded in January-March 2010 rising well above the levels seen in 2009 Q4. Against this background, interest rates on overnight deposits in the interbank market posted a sharper downtrend, thereby nearing the central bank's interest rate on the deposit facility.

2. Financial markets and monetary developments

In 2010 Q1, interest rates on all financial market segments decreased at a faster pace, while the RON/EUR exchange rate also followed a downward course. The annual growth pace of broad money decelerated, amid the persistent downtrend in the annual dynamics of credit to the private sector.

2.1. Interest rates

Interbank Money Market Rates



In the first quarter of 2010, interbank market rates dropped markedly, reflecting the easing of liquidity conditions in the banking system and the cut in the monetary policy rate. Throughout most of the quarter, very short-term interbank rates fluctuated within the lower part of the corridor defined by the interest rates on the central bank's lending and deposit facilities, while their volatility increased. As a result, average interbank deposit rates went down 3.5 percentage points as compared with the prior quarter to 5.8 percent.

The rise in the liquidity supply on the interbank market was mainly accounted for by the Treasury's reserve injections. In the first part of the quarter, the effect of such injections on interbank rates was enhanced by the impact of significant liquidity volumes borrowed by banks via 1W repo operations conducted by the central bank following tender procedures at fixed rate (monetary policy rate) and with full allotment. In this context, ever since the first part of January, overnight rates followed a sharp downtrend, declining at levels close to the interest rate on the deposit facility. Thereafter, they further recorded levels significantly below the monetary policy rate for most of the period under review, given that excess liquidity was mopped up solely via the deposit facility.

Longer-term interbank money market rates also followed a downward path, which was manifest soon after the NBR decision to cut policy rate in January and reflected the successive declines in the latter, the easing of liquidity conditions on money market, as

[47] By resorting to part of its resources in the foreign-currency-denominated account at the central bank.

well as market participants' expectations on the future developments of the central bank's key interest rate and liquidity in the banking system. Towards the end of the quarter, the fall in 1M and 3M rates was relatively sharper. As a result, average (1M-12M) ROBOR rates went down 4.0 percentage points in March as compared with the end of the preceding quarter.

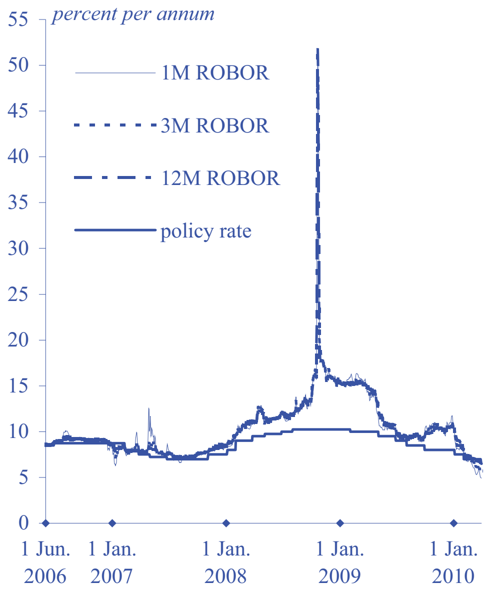
Implicit forward rates also followed a significant downward course. Accordingly, the expected 3M ROBOR rates covering 3, 6 and 9 months (calculated based on March average quotations) stood at 7.3 percent, 6.6 percent and 6.5 percent respectively. These levels stood, on average, 3.1 percentage point lower than those recorded in December 2009.

In turn, interest rates on the primary market for government securities declined throughout the quarter for all categories of securities, the average quarterly yield standing at 7.77 percent (down 2.23 percentage points as against 2009 Q4). The volume of securities issued totalled lei 12.7 billion, up 15 percent from the announced figure, 78 percent of which being accounted for by 6-month and 1-year bills. Investors showed a relatively equal interest in short- and long-term government securities, as reflected by the required/announced volume. In 2010 Q1, the average yield on outright operations performed on the secondary market for government securities decreased as well (down 2.5 percentage points to 7.6 percent). The quarterly turnover of the secondary market for government securities (excluding the NBR) rose quarter on quarter (owing also to the rise in securities purchases by non-residents) to reach about lei 28 billion, most being outright transactions (about 93 percent)[48]. Securities with residual maturities of up to 1 year and 3 years, whose average interest rates went down to 7.7 percent and 7.6 percent respectively, were the most heavily traded.

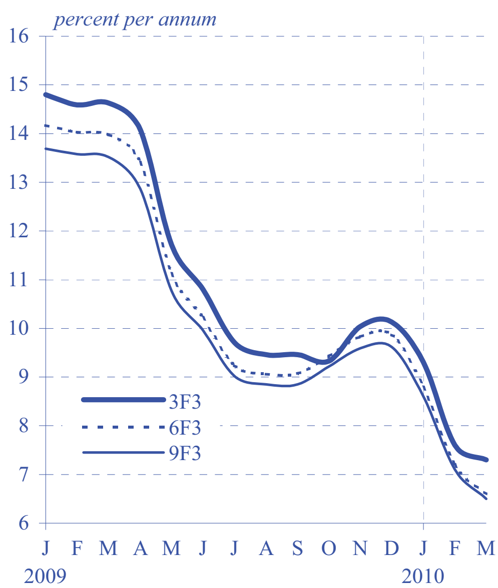
In December 2009 - February 2010, average time deposit and lending rates on new business decreased at a faster pace (-1.46 percentage points to 8.13 percent and -2.22 percentage points to 13.75 percent respectively), amid the declines in the monetary policy rate and interbank rates and the significant improvement in the liquidity in the banking system. Developments were similar for both categories of customers, yet different in terms of magnitude. Thus, the most significant downward adjustments in interest rates were recorded in the case of non-financial corporations: average interest rates on new time deposits dropped 1.93 percentage points to 7.45 percent, whereas average

[48] The volume of transactions in government securities performed via BSE hit a record high (lei 1.38 billion), yet it remained relatively low as compared with that of transactions conducted in SaFIR; the average interest of BSE transactions decreased quarter on quarter by 2.27 percentage points to 7.45 percent; securities with residual maturity of 4 years were the most heavily traded.

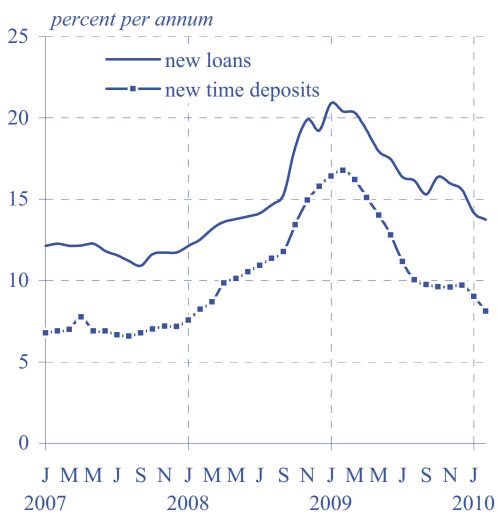
Policy Rate and ROBOR Rates



Implicit Forward Rates



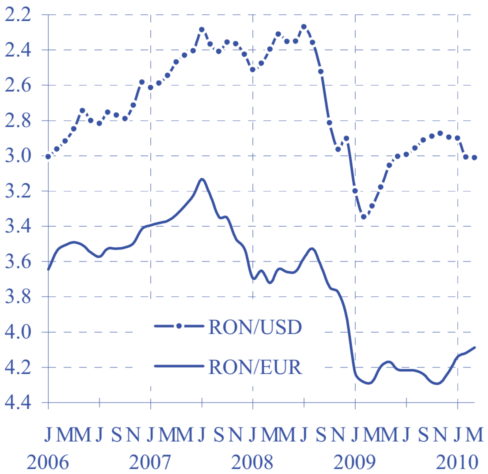
Bank Rates



lending rates on new business – which are closely linked to changes in interbank ROBOR rates – declined markedly by 2.51 percentage points to 13.23 percent in February. Average interest rates on large-value loans of companies saw the sharpest adjustment (down 3.23 percentage points to 11.08 percent). Average interest rates on new time deposits of households fell by 0.93 percentage points to 8.93 percent in the period under review, while average lending rates on new business dropped 1.19 percentage points (standing at 15.99 percent in February).

2.2. Exchange rate and capital flows

Nominal Exchange Rate

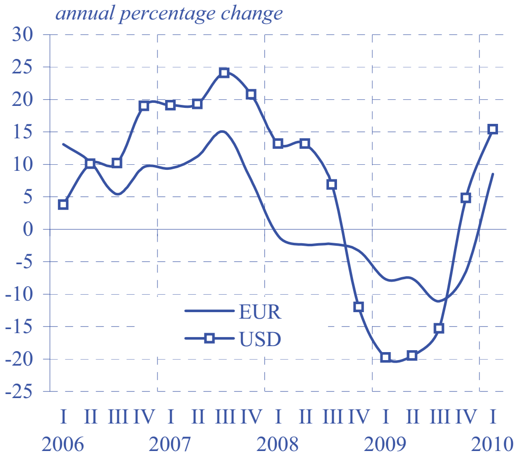


The appreciation trend of the domestic currency vis-à-vis the euro became more visible during 2010 Q1, the short-lived depreciation episodes notwithstanding. The generally downward slope of the RON/EUR exchange rate reflected mainly the relatively rekindled global risk appetite, along with improved investor sentiment towards financial markets in the region, also as a result of the somewhat worse outlook concerning developments in the euro area. The daily volatility of the RON/EUR exchange rate diminished towards the end of the quarter under review to levels below those posted by the major currencies in the region.

Consequently, January through March, the domestic currency strengthened against the euro by 3.3 percent in nominal terms and 5.5 percent in real terms, well beyond the appreciation of 0.3 percent in nominal terms and 1.7 percent in real terms seen in 2009 Q4. In relation to the US dollar, however, the leu shed 3.9 percent in nominal terms and 1.8 percent in real terms (compared to an appreciation of 0.6 percent in nominal terms and 2.0 percent in real terms in 2009 Q4), given that the US currency strengthened abruptly against the euro. Calculated as an average annual change for 2010 Q1, the domestic currency posted the first nominal appreciation versus the euro in the past nine quarters (3.6 percent), while strengthening further against the US dollar (10.3 percent).

Developments of RON Exchange Rate*

annual percentage change



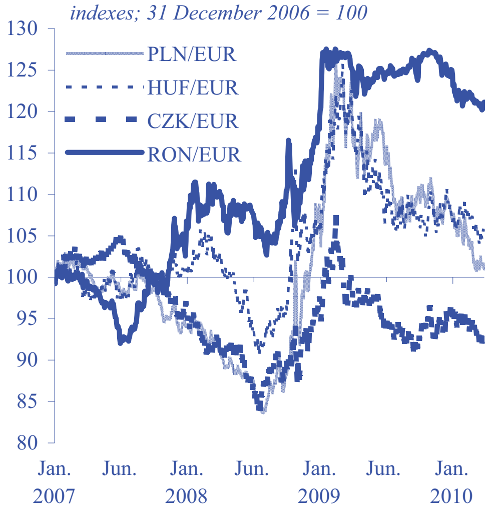
*) appreciation (+), depreciation (-) in real terms; deflated by CPI

Source: NIS, NBR

The RON/EUR exchange rate embarked on a steeper downward path amid a slight upturn in the global economic environment and particularly the improved sentiment on the regional market following comments by IMF and ECB officials on the potentially faster recovery of these economies compared to euro area countries. Moreover, exchange rate movements were boosted by brighter investor outlook concerning developments in the Romanian economy, mainly as a result of: (i) approval by Parliament, on 14 January, of the 2010 State Budget Law and subsequently (ii) the reactivation of the multilateral external financing arrangement with international financial institutions, as well as (iii) improved IMF and Moody's economic growth projections for 2010. Against this backdrop, the turnover of non-residents' transactions increased in January, while the interbank forex market deficit narrowed to a 20-month low. The RON/EUR exchange rate hit the lowest reading in the past year on 18 January, with its average value posting in January the sharpest drop in nine months (2.0 percent). At the same time, developments in the RON/EUR exchange rate became increasingly correlated with those of the Polish złoty and the Hungarian forint, while exchange rate volatility went up slightly, albeit below the values recorded by similar parameters of the major currencies in the region.

Rising concerns surrounding Greece's fiscal standing and the risks of ripple effects being sent over to European economies, to which added the weaker-than-expected GDP in 2009 Q4, triggered short-lived depreciation episodes of the leu in late January and early February. Thereafter, the leu re-embarked upon an appreciation trend versus the euro, similarly to its peers in the region. This evolution reflected a relative increase in the attractiveness of the Central and East European financial market, brought about by the worsening sentiment on the risk associated with the euro area[49], which was deemed to be primarily impaired by the Greek debt crisis. The interest rate differential and possibly the abundant liquidity on the global financial market, on its quest for attractive yields, added to the upward pressures on the currencies in the region. The RON/EUR exchange rate movements were also influenced, to a certain extent, by: (i) Fitch Ratings revising Romania's outlook to stable in February, followed by a similar decision announced by Standard & Poor's in March; (ii) the relatively better-than-anticipated developments in the current account deficit in January; (iii) the rising foreign currency reserve of the central bank, as a result of further disbursements from the IMF and EC loans and of the successful unfolding of the MPF Eurobond issue. Against this background, the turnover of non-residents' transactions on the interbank forex market increased further in March, also on account of their keener interest in leu-denominated government securities issued by the MPF, peaking at a 17-month high, while the interbank forex market balance reentered positive territory for the first time since August 2007. Furthermore, on 25 March the RON/EUR exchange rate posted the lowest reading since January 2009. Despite an end-of-month temporary trend reversal, February through March the domestic currency strengthened 1.3 percent versus the euro in nominal terms (the Polish złoty, the Czech koruna and the Hungarian forint posted nominal appreciations of 4.6 percent, 2.3 percent and 1.5 percent respectively in relation to the single currency), while the daily volatility of the RON/EUR exchange rate diminished.

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

Key Financial Account Items (balances)

EUR million

	2009 2 mos.	2010 2 mos.
Financial account	**474**	**852**
Direct investments	**1,336**	**445**
- residents abroad	10	-21
- non-residents in Romania	1,326	466
Portfolio investments and financial derivatives	**-160**	**58**
- residents abroad	-26	86
- non-residents in Romania	-134	-28
Other capital investments	**-2,041**	**1,274**
- credits and loans from the IMF	0	2,453
- medium- and long-term investments	534	-1,007
- short-term investments	-1,175	-309
- currency and short-term deposits	-1,350	316
- other	-50	-179
NBR's reserve assets, net ("–" increase/"+" decrease)	**1,339**	**-925**

[49] Reflected also by the lower EUR/USD exchange rate.

2.3. Money and credit

Money

Annual Growth Rates of M3 and Its Components

real percentage change

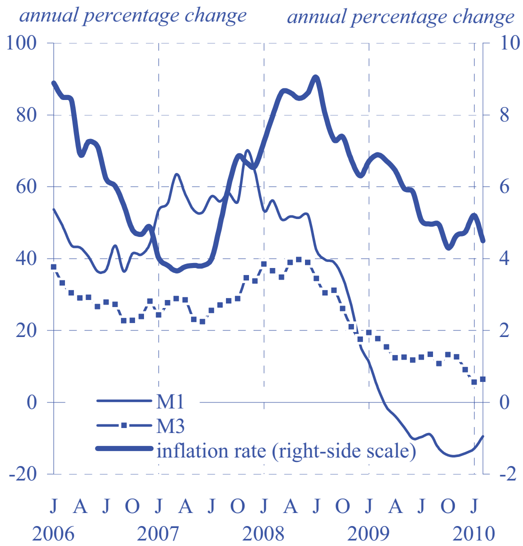
	2009				2010	
	I	II	III	IV	Jan.	Feb.
	quarterly average growth					
M3	10.0	5.7	6.8	6.7	0.4	1.9
M1	-2.1	-12.4	-14.8	-18.3	-17.2	-13.3
Currency in circulation	8.9	-0.1	-2.9	-8.9	-9.2	-5.1
Overnight deposits	-6.0	-16.7	-19.0	-21.9	-20.3	-16.8
Time deposits (maturity of up to two years)	24.1	26.8	49.9	36.7	16.5	14.5

Source: NIS, NBR

December 2009 through February 2010, the pace of increase[50] of broad money (M3) witnessed a steep slowdown to the lowest reading since 2001 Q2, i.e. down 5.1 percentage points to 2.1 percent, reflecting the impact of the persistent decline in economic activity as well as the statistical effect of a stronger domestic currency[51]. However, developments in this indicator were not uniform over the period under review, as the fast decline in M3 annual dynamics in December and January (nearing zero for the first time in the past nine years) was followed by a relative rebound in February, amid higher public spending[52].

The dynamics of the main components of M3 posted trend reversals, with the annual growth rate of narrow money (M1) recording less negative readings and the uptrend in the pace of increase of time deposits with a maturity of up to two years coming to a halt. In turn, the growth rate of the other financial instruments included in M3[53] remained robust, as such placements further provided attractive yields. The latter two components strengthened their majority share in M3 (adding 1.6 percentage points to 58.7 percent as period average), reflecting the still keen demand for money for precautionary reasons, i.e. for savings/ investment purposes.

Broad Money and Inflation Rate



Source: NIS, NBR

The breakdown of monetary developments by institutional sector reveals that the slacker M3 dynamics is attributed to developments in currency in circulation, household deposits and especially corporate deposits. Thus, after three quarters of relative stability, the growth rate of total M3 deposits of households halved, reflecting – aside from the aforementioned statistical effect – the decline in income[54] and the impact of households repaying their current bank debts. The pace of increase of M3 household deposits in foreign currency[55] doubled, seemingly in contrast with the strengthening trend of the leu, whereas the dynamics of leu-denominated deposits halved. However, this portfolio shift was manifest almost entirely in December 2009 when, amid

50 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2009 – February 2010.

51 January through February 2010, the RON/EUR exchange rate (end-of-period) posted a drop in annual terms for the first time since October 2007.

52 The real annual growth rate of public spending re-entered positive territory in February 2010 after five months of negative readings.

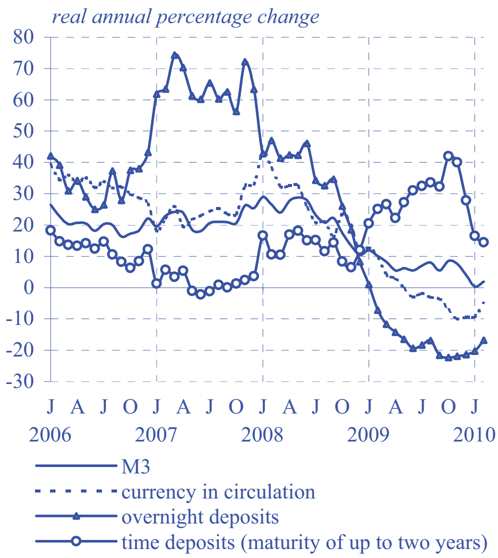
53 Money market fund shares/units, repurchase agreements and debt securities with a maturity of up to and including two years.

54 Over the quarter under review, the net average wage economy-wide continued to drop in real terms versus the same year-earlier period (-1.9 percent against -1.6 percent).

55 Expressed in euro.

expectations of a weaker domestic currency, natural persons resorted to larger net purchases of foreign currency on the interbank forex market. The pace of increase of corporate deposits included in M3 returned into negative territory during the period under review, after two quarters of increasingly positive readings. The trend reversal was due to the more sluggish dynamics of corporate deposits in foreign currency, amid this sector's shift towards purchasing forex-denominated government securities and keener appetite for foreign currency-denominated deposits with a maturity of more than two years, as well as amid larger external debt payments and signs of a faster growth rate of imports. Conversely, leu-denominated corporate deposits included in M3 posted a less steep negative dynamics, on the back of certain amounts from budgetary sources[56] being channelled to this segment. Under the joint impact of the aforementioned factors, the average share of foreign currency-denominated deposits in broad money remained at a 5-year high of 33.6 percent.

Main Broad Money Components



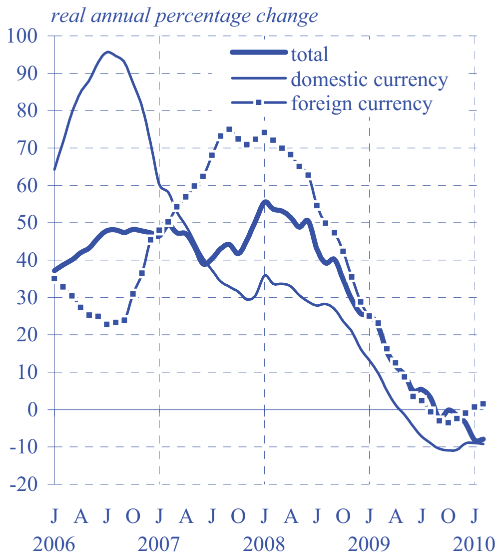
Source: NIS, NBR

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, to which added the slight deceleration in the expansion of net foreign assets. An opposite influence came from the pick-up in the growth rate of central government net credit and from the slower increase in long-term financial liabilities (capital accounts included).

Credit

December 2009 through February 2010, the growth rate[57] of credit to the private sector plunged deeper into negative territory and hit a 9-year low of -6.6 percent. Aside from the unfavourable economic environment, which further dampened both credit demand and credit supply, these developments were largely influenced by the statistical effect of a stronger leu. Thus, albeit still at very low levels, both the dynamics of leu-denominated credit to the private sector and that of the forex component seem to have overcome the trough in their downward trajectories (on which they had embarked around two years earlier), with the former posting less negative readings and the latter (calculated by expressing the balance in euro) re-entering positive territory[58]. The relative rebound could be ascribed not only to the fading of the effect exerted by the incipient contraction in the balance of

Credit to Private Sector by Currency



Source: NIS, NBR

[56] January through February 2010, payments were effected for agriculture (according to press releases of the Agency for Payment and Intervention for Agriculture) and for medical goods and services (according to MPF press releases).

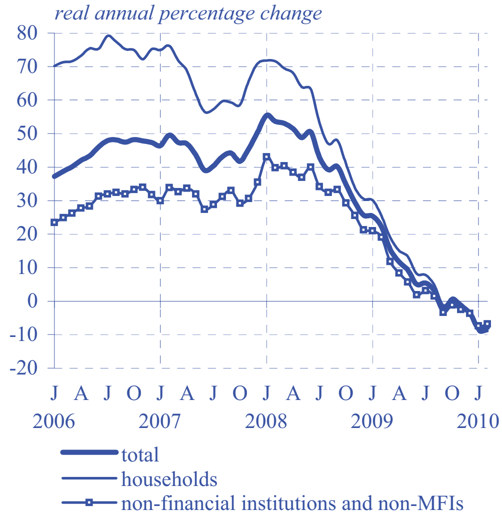
[57] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2009 – February 2010.

[58] Under the circumstances, the average share of the foreign currency-denominated component in total credit to the private sector remained relatively stable at a high of 60.0 percent.

these loan categories, but also to a potential slight improvement in credit supply, as hinted by developments in lending terms and standards[59] in 2009 Q4 and especially banks' expectations on their short-term prospects.

Credit to Private Sector by Institutional Sector

real annual percentage change



Source: NIS, NBR

The structural breakdown by major customer category reveals that both the annual growth rate of loans to households and that of corporate borrowings posted negative readings for the first time since 2000 even in nominal terms. Moreover, unlike the developments seen over the past year, household loans witnessed a faster decline than corporate borrowings, so that households became once again a net creditor of the banking sector[60] in February 2010, for the first time in two years and a half. The chief drivers behind the faster negative dynamics of household loans were: the worsening financial standing of households and bleaker prospects in this respect, the still tight lending terms and standards on consumer loans and high, albeit declining, lending rates on new business to households, to which added a major statistical effect related to the stronger domestic currency. Against this backdrop, the balance of consumer loans contracted further, with a steeper drop in the leu-denominated component and a less sharp retrenchment in the forex component compared to the previous three-month period. In turn, housing loan dynamics were further on the wane, exclusively on account of the leu-denominated component, whose growth rate entered negative territory for the first time in the past four years and a half. Conversely, the pace of increase of foreign currency-denominated housing loans (expressed in euro) regained momentum, primarily on the back of the "First Home" government programme.

The contraction in the balance of corporate borrowings was however due almost exclusively to the statistical effect of the exchange rate, with the pace of increase of leu-denominated loans posting less negative readings and that of the forex component (expressed in euro) re-entering positive territory. A breakdown by maturity reveals that the upturn in the dynamics of the domestic currency component was largely ascribable to loans with a maturity of up to five years. The growth rates of loans in foreign currency posted a rebound across the maturity spectrum, although only long-term loans also witnessed an increase in balance versus the same year-earlier period. These developments were correlated to a larger volume of new business[61] to companies (mainly in December 2009) and were attributed both to (i) the step-up in

[59] According to the NBR survey on lending to non-financial corporations and households published in February 2010.

[60] The balance of total household deposits (including those outside M3) exceeded the balance of total household loans.

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

renegotiation procedures related to ongoing contracts (spurred by a further increase in overdue loans) and to (ii) the possible provision of new credit lines, fostered by lower costs attached to new business to non-financial corporations and by potentially less tight lending standards applicable to companies.

Net credit to central government continued to exert an expansionary impact on M3, with its dynamics intensifying on account of the larger portfolio of foreign currency-denominated government securities held by credit institutions. On the other hand, the growth rate of leu-denominated government securities held by banks decelerated, also on the back of transactions with non-residents, while the pace of increase of central government deposits gained momentum.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the annual CPI inflation rate at 3.7 percent for end-2010, 0.2 percentage points higher than the level published in the February 2010 Inflation Report. For end-2011, the inflation rate is expected to fall below the central target of 3.0 percent and reach 2.8 percent, 0.1 percentage points above the previously projected figure.

The upward revision of the CPI inflation forecast is attributed to projecting a higher annual CORE2 inflation rate as well as to a larger share assigned to this component in the consumer price index. This unfavourable influence, which will be stronger in 2010, is foreseen to be only partly offset by a lower cumulative contribution, in terms of annual dynamics, from the other CPI components (administered prices, fuel prices and volatile food prices).

The increase in the projected CORE2 inflation rate is largely the result of the negative output gap persisting throughout the projection horizon at relatively smaller levels than those forecasted previously. The negative output gap was reassessed following the substantial revision of seasonally-adjusted historical data series on the dynamics of GDP and its components by the NIS in March 2010. Despite this reassessment, the persistence of the demand shortfall is seen remaining the main source of disinflationary pressures over the entire projection horizon.

Similarly to the previous forecast, the CORE2 inflation rate is foreseen to fall below CPI inflation starting 2010 Q2, as the impact of the first-quarter hike in excise duties on tobacco products fades out and a favourable base effect becomes manifest. During 2010, moderate import price dynamics and the gradual mitigation of inflation expectations will also be supportive of disinflation. The latter is however strictly conditional upon the avoidance of any slippages in implementing the macroeconomic policy mix over the forecast horizon. The projection envisages annual CPI and core inflation rates to decline to record lows in early 2011, also as a result of a favourable base effect. Subsequently, the gradual narrowing of the negative output gap, in line with the consolidation of economic growth, and the influence of a progressive increase in euro area inflation on import prices will cause a moderate rise in CORE2 inflation rate, bringing the CPI inflation rate closer to the end-2011 target.

Throughout the projection horizon, the monetary policy stance will remain prudent, aiming to steadily ensure adequate real broad monetary conditions in order to consolidate the prospects of both the return of inflation in the vicinity of the established medium-

term targets and of a sustainable revival of lending in the Romanian economy. The fulfilment of these objectives is again strictly conditional upon all elements of the macroeconomic policy mix complying with the coordinates of the economic programme under the external financing arrangement concluded with the European Union, the International Monetary Fund 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.

Recent macroeconomic developments both domestically and internationally point to persistently high uncertainties as to the time horizon when the fallout from the global crisis on the Romanian economy will actually dissipate. The overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to be relatively tilted to the upside. Risks associated with the domestic environment appear more likely to lie at the root of this asymmetry.

The major domestic risk factors are associated with fiscal and income policies in the public sector and with structural rigidities in the economy. The delayed emergence of clear signs of a sustainable return of the economy to positive growth rates implies the likelihood of a fiscal policy slippage from the coordinates included in the baseline scenario of the projection. The adverse effects of such slippages on economic growth and inflation rate would be considerably stronger in the absence of corrective measures allowing the orderly carrying out of the external financing arrangement. The uncertainties perceived by economic agents with regard to their future income flows, along with the anticipated adverse fiscal effects that may weigh further on them, generate the risk of maintaining or even strengthening rigidities in price formation. The relatively high uncertainty surrounding the current projection horizon justifies a somewhat higher likelihood to be ascribed to upside deviations from the projected trajectory.

Risks related to external developments are generated by the so far fragile revival of euro area real economy. At the same time, the escalating issues plaguing the sustainability of public finances in Greece or even their potential spill-over, through contagion, to other euro area countries facing similar vulnerabilities might result in a shift in investor sentiment to the detriment of emerging economies, likely to impact the risk perception towards Romania as well. The delayed consolidation of economic growth and the resurfacing of global financial market turmoil could send ripple effects to the domestic economy via the foreign trade, financial and exchange rate channels. On the other hand, a stronger economic recovery along with the timely exit from the fiscal and monetary stimulus packages to fiscal consolidation measures *taken by the authorities in euro area Member States, including the configuration of an adjustment and assistance programme for Greece which would consolidate financial market confidence, may yield favourable effects on the Romanian economy. Hence, risks associated with external economic developments appear to be symmetrically distributed around the trajectories of the macroeconomic variables in the baseline scenario.*

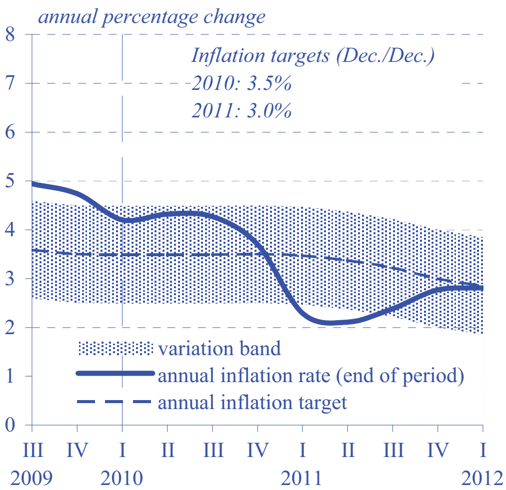
For the current forecasting round, the risks of fuel prices, administered prices and some volatile food prices deviating either way from the baseline scenario trajectories appear to be relatively balanced.

1. The baseline scenario of the forecast

1.1. Inflation outlook

According to the baseline scenario of the current projection, the annual CPI inflation rate is seen standing at 3.7 percent at the end of 2010, i.e. 0.2 percentage points higher than the level published in February, and at 2.8 percent at the end of 2011, i.e. 0.1 percentage points above the previously projected figure. Thus, the projected annual CPI inflation rate will stay within the ±1 percentage point variation band around the central target which has been set at 3.5 percent for end-2010 and 3.0 percent for end-2011.

Inflation Forecast



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

Source: NIS, NBR calculations

Table 5.1. The annual inflation rate in the baseline scenario

percent

Period	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1
Target			3.5				3.0	
Forecast	4.3	4.3	3.7	2.3	2.1	2.4	2.8	2.8

Compared to the February 2010 Inflation Report, the marginal upward revision of the annual CPI inflation over the entire projection horizon is due to a larger contribution from the annual CORE2 inflation rate, with the other components[62] having lower contributions to headline inflation. The current inflation rate forecast builds upon the following:

(i) The annual CORE2 inflation rate is expected to decelerate markedly over the projection horizon, albeit at a slower pace than envisaged in the previous forecast, from 4.9 percent in 2010 Q1[63] to 2.8 percent and 1.7 percent in 2010 Q4 and 2011 Q4 respectively. The significant decline in the annual CORE2

[62] Administered prices, fuel prices and volatile prices of vegetables, fruit and eggs.

[63] The figure was calculated using quarterly price indices (Q/Q-4). The annual CORE2 inflation rate for the end of this quarter (March 2010/March 2009) stood at 4.4 percent.

inflation rate over the upcoming quarters[64] is expected to materialise given the fading of the shocks induced by the previous successive hikes in excise duties on tobacco products[65], as well as due to a likely future increase in core inflation elasticity to the protracted negative output gap[66]. Moreover, the recent persistence of unemployment at high levels is expected to prevail throughout 2010, which will contribute to keeping subdued inflationary pressures related to labour costs.

Compared to the February 2010 forecast, the upside revision of the core inflation forecast is the result of several factors acting jointly, as follows:

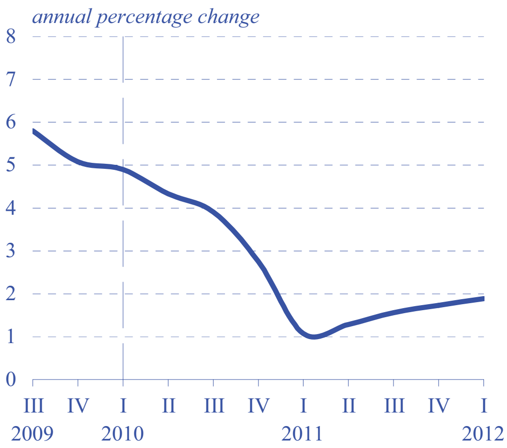
– higher projected levels of this component in the forecast's starting point (2010 Q2), mainly due to a higher-than-expected CORE2 inflation rate in the previous quarter;

– a larger share assigned by the NIS from January 2010 (up by about 2 percentage points) to this component in the CPI basket; and

– the reassessment of the cyclical positioning of aggregate demand towards levels less favourable to disinflation[67].

In this context, such effects are partly countered this year by the opposite impact of developments in the leu exchange rate on import prices, especially amid decreasing risk aversion of foreign investors and the still high yields on investments in domestic currency compared to those made in the euro area. Import price dynamics are lower than those previously anticipated for 2010 and only marginally higher for 2011. Thus, market price inflation is seen re-entering a slight uptrend starting 2011 Q2 towards levels compatible with the end-2011 target. This is attributable both to import price dynamics, as the euro area HICP inflation returns to more elevated readings, and to the gradual reduction in the negative output gap in line

Annual CORE2 Inflation*



*) quarterly average

Source: NIS, NBR calculations

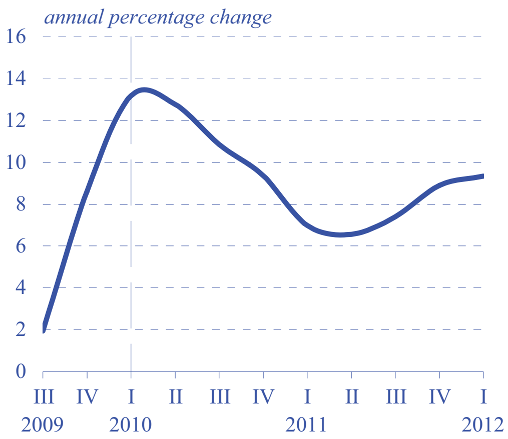
[64] Starting with 2010 Q2, in terms of annual inflation calculated based on quarterly price indices (Q/Q-4), it is estimated to fall below the projected CPI inflation trajectory.

[65] The last increase in excise duties on tobacco products set out in the current Tax Code was the one implemented on 1 January 2010. Hence, the inflationary impact from this group of products is anticipated to decrease markedly throughout the projection horizon: from a 1.8 percentage points contribution at end-2009 to an expected contribution at the end of 2010 and 2011 of 0.7 percentage points and 0 percentage points respectively.

[66] In the context of assuming lower unit labour cost economy-wide as redundancies carry on, along with a significant slowdown of public-sector wage dynamics in the future, impacting private-sector wage setting favourably, as well as the fading of recent adverse supply-side shocks, which could result in economic agents' inflation expectations being more firmly anchored. At the same time, it is expected that the gradual revival in lending to the private sector, as economic activity recovers, will considerably reduce the structural rigidities seen recently on the product markets, thereby enhancing price responsiveness to stronger competition pressures.

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

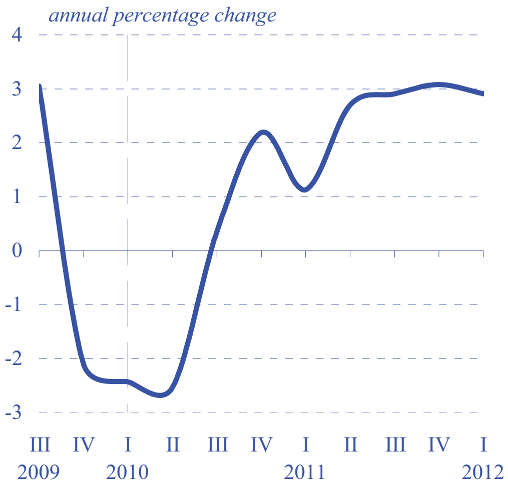
Fuel Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR calculations

Vegetables, Fruit and Eggs Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR calculations

with the consolidation of economic growth at sustainable levels over this horizon[68].

(ii) Against the backdrop of weaker-than-expected inflationary pressures generated in 2010 Q1 by fuel prices and of an oil price scenario similar to the previous forecasting round[69], the annual inflation trajectory of this component was revised downwards for nearly the entire projection horizon. As such, the inflationary contribution of fuels is projected to narrow for almost the entire period[70].

(iii) The cumulated contribution from administered prices and volatile prices of vegetables, fruit and eggs to the annual CPI inflation rate will be smaller than in the previous forecast[71] in both 2010 and 2011, by 0.2 percentage points and 0.1 percentage points respectively.

Over the medium term, the convergence of economic agents' inflation expectations towards the announced targets is expected to help consolidate disinflation.

1.2. Exogenous pressures on inflation

Compared to the previous projection, the exogenous components[72] of CPI inflation have a smaller cumulative contribution in both 2010 and 2011 (by 0.1 percentage points). At the end of the two-year projection horizon, administered price inflation is anticipated to reach levels slightly higher than those projected in the February 2010 *Inflation Report,* while volatile food inflation is expected to be with 0.9 percentage points smaller at end-2010 and 0.3 percentage points larger at end-2011. Although the scenario for the administered prices growth rates was subject to upward revision almost throughout the projection horizon, the downward revision by the NIS of the share of goods with administered prices in the CPI basket[73] led to a drop in the contribution of this category of products to consumer price inflation.

[68] For 2011, the current projection envisages significantly positive growth rates for all domestic demand components (private consumption, public consumption and investment).

[69] See Subsection *1.2. Exogenous pressures on inflation*.

[70] Although the share of fuels in households' CPI basket rose by almost 0.7 percentage points as from January 2010.

[71] For a more in-depth analysis of these CPI inflation components, see Subsection *1.2. Exogenous pressures on inflation.*

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

[73] Starting with January 2010, the NIS announced a decrease in the share in the consumer basket of both goods with administered prices (from 19.1 percent to 16.7 percent) and food products with volatile prices (from 7.1 percent to 6.7 percent).

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

		Administered prices		Volatile food prices	
		2010	2011	2010	2011
Current projection	Annual change (%)	5.7	3.8	2.2	3.1
	Contribution to annual CPI inflation (pp)	*0.9*	*0.6*	*0.1*	*0.2*
Previous 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*

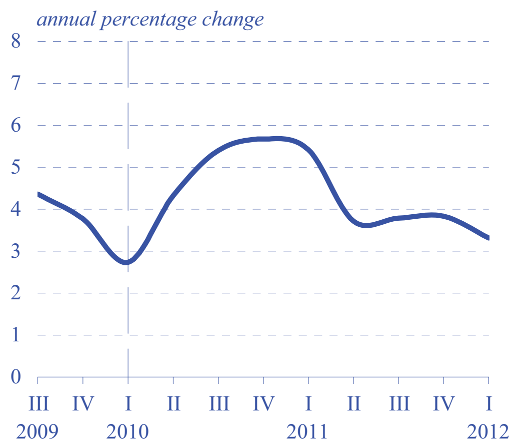
* Calculations for Q4 current year / Q4 previous year

The scenario on the developments in administered prices in 2010 encompasses the changes pointed out by the specialised authorities (for instance, the hike in medicine prices as of 1 April) and is built on the assumption of an increase in the international oil price during the year[74]. In view of the high level of uncertainty surrounding the projection of administered prices in the absence of an official schedule for their adjustment, the scenario on the developments in administered prices in 2011 is based on the adoption of an expert assumption, starting from the analysis of historical data on the average annual change in such prices[75] along with the scenario of an increasing oil price during this year.

In 2010 Q1, the impact exerted by the hike in the excise duty on tobacco products as of 1 January 2010 on the inflation related to the prices of such products was stronger than previously expected. Considering also the marginal upward revision of the share of tobacco products in the CPI basket[76], the current projection incorporates a larger contribution of the excise duty on tobacco to consumer price inflation during 2010[77] (0.1 percentage points).

The scenario on the developments in euro area economy foresees its recovery from the severe recession, albeit at a slow pace induced by the need to continue balance sheet adjustments in various economic sectors and by the anticipation of a sluggish rate

Administered Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR calculations

[74] A hike in the international oil price may be expected to lead to higher transport prices.

[75] The analysis of historical data shows that during 2000-2009, the average annual growth rate of administered prices exceeded almost without exception the consumer price inflation. 2009 saw the lowest average annual administered price inflation amid rises in some prices being postponed for the following year. As a result, the expert assumption adopted for 2011 anticipates the annual hike in administered prices to outpace the consumer good inflation forecasted for end-2011, and to equal the historical record low seen in 2009.

[76] The share of tobacco products in the CPI basket advanced to 4.7 percent from 4.6 percent.

[77] The Tax Code does not mention any change in the excise duty on tobacco products for 2011.

of increase of consumption and investment[78]. The economic growth expected for the euro area was subject to a downward revision for 2010 (by 0.3 percentage points) and to an upward revision for 2011 (by 0.1 percentage points). The scenario on the developments in the average annual inflation rate in the euro area was subject to a downward revision for both 2010 (by 1 percentage points) and 2011 (by 0.3 percentage points). Against the background of a less favourable economic outlook, the anticipated trajectory of the 3-month EURIBOR interest rate was revised throughout the projection horizon to lower-than-previously-expected levels. Given the recent significant depreciation of the euro versus the US dollar and the uncertainty surrounding the EUR/USD exchange rate developments, the current forecast comprises the assumption of the EUR/USD ratio remaining steadily at 1.37 throughout the projection horizon. The scenario on the developments in the international oil price assumes its gradual increase during the projection horizon[79], under the impact exerted by an anticipated gradual revival of demand for commodities, in line with the upturn in the world economy and by a relatively low oil supply from OPEC.

Table 5.3. Expected developments of external variables

annual averages

	2010	2011
WTI oil price (USD/barrel)	80.3	85.6
EUR/USD exchange rate	1.37	1.37
3-month EURIBOR interest rate (% p.a.)	0.84	1.62
Economic growth in the euro area (%)	1.1	1.5
Annual inflation rate in the euro area (%)*	1.2	1.5

* in Q4

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

Concurrently with the release of data on the developments in real GDP and its components for 2009 Q4, the NIS revised also the seasonally-adjusted series for the entire horizon for which these data were provided, namely 2000 Q1-2009 Q3. Thus, according to the data released, in 2009 Q4, real GDP contracted by 1.5 percent quarter on quarter, after a slightly positive quarterly change in the

[78] According to the European Central Bank's projection of March 2010 (*ECB Staff Macroeconomic Projections for the Euro Area*), during the current year, consumption is expected to remain at a low level in the euro area owing to further high unemployment and saving rates. Investment is seen to expand at a slow pace as a result of the high level of spare capacity and the low aggregate demand.

[79] Compared to the previous projection, the scenario on the oil price developments for the period spanning 2010 Q2-2011 Q4 was left unchanged. Furthermore, this scenario was extended to 2012 Q1 as well, by using the steady quarterly growth rate assumed for 2011.

previous quarter, i.e. 0.1 percent[80]. In 2009 as a whole, the economic activity shrank by 7.1 percent according to the unadjusted series and by 6.9 percent according to the seasonally-adjusted series. In 2010 Q1, the assessment carried out based on the data released by the NIS and the analysis of a set of relevant economic indicators shows a wider negative output gap than in the previous quarter, entailing *ceteris paribus* mounting disinflationary pressures from aggregate demand.

According to the data released in March 2010, the cumulative volume of quarterly flows of gross fixed capital formation starting 2001 Q1 is lower than that calculated based on the previously released data. In light of the data released in March, the volume of capital is also smaller, while potential GDP for the period under review stands slightly below the previous forecasting round assessment. In addition, financial crises are generally followed by relatively long periods displaying persistently slower growth rates and lower readings of GDP than those reported in no-crisis times[81]. Adding to this the drop in the investment activity and companies' retooling during 2009, the assessment of potential GDP and its growth rates reveals a marked decrease starting 2008 Q4 compared to the previous quarters. In the assumption of a revival in investment in the period ahead, quarterly growth rates of potential GDP are seen accelerating compared to those in 2009. During the current forecasting round, based on the data provided by the NIS and the reappraisal of potential GDP, implicitly the output gap was also subject to reassessment and attained higher values than in the previous forecasting exercise (i.e. wider positive output gaps and narrower negative output gaps). In the context of a halt in the easing trend displayed by quarterly developments in real GDP in 2009 Q4 and in line with the new assessments, the negative output gap is expected to widen during this period compared to that in the previous quarter while disinflationary pressures from aggregate demand are anticipated to intensify.

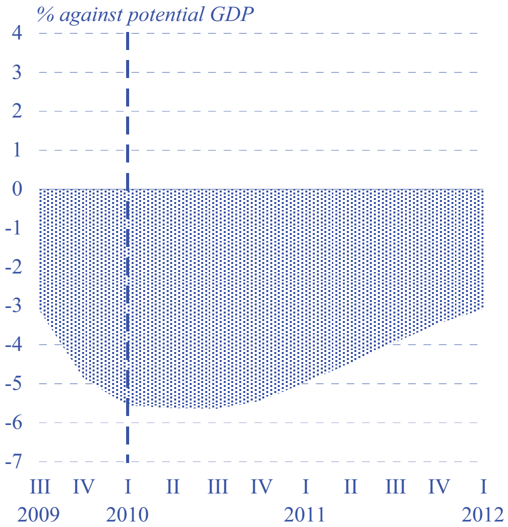
The quarterly dynamics of real GDP in 2009 Q4 can be ascribed to developments in gross capital formation[82] and to the statistical

[80] According to the new seasonally-adjusted data, GDP posted the following quarterly growth rates: -2.2 percent in 2008 Q4, -4.1 percent in 2009 Q1, -1.5 percent in 2009 Q2. Based on non-seasonally-adjusted data, real GDP posted the following annual dynamics: 3.1 percent in 2008 Q4, -6.2 percent in 2009 Q1, -8.7 percent in 2009 Q2, -7.1 percent in 2009 Q3 and -6.5 percent in 2009 Q4. 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.

[81] For further details, see IMF, *World Economic Outlook*, Chapter IV, "What's the damage? Medium-term output dynamics after financial crises", October 2009.

[82] Gross capital formation continued to report wide changes in 2009 Q4 as well, shrinking by 24.5 percent in quarter-on-quarter terms after a 24.4 percent increase in the previous quarter. The adjustment in 2009 Q4 shows both the downward evolution of gross fixed capital formation (-2.7 percent quarter on quarter) and the significant adjustment in the changes in inventories.

GDP Deviation



Source: NIS, NBR calculations

discrepancy, with the positive growth rate of the other components[83] suggesting an upward quarterly evolution.

The increase in actual final consumption in 2009 Q4 against the previous quarter indicates the positive dynamics of both household actual final consumption (0.9 percent) and general government actual final consumption (4.4 percent). After the 9.2 percent decline in 2009 versus 2008 (non-seasonally-adjusted data), in 2010 Q1, household actual consumption is expected to stay below the medium-term trend, amid diverging developments in household disposable income earmarked for consumption. Hence, budget transfers[84] (state social security and unemployment fund expenditures) and economy-wide net real wage[85] are seen recording positive quarterly growth rates, whereas net foreign transfers[86], unemployment rate[87] and consumer loans[88] are estimated to reflect the ongoing decline in household disposable income earmarked for consumption throughout January-March 2010. As compared with the preceding quarter, in 2010 Q1, household propensity for saving was lower, with household

[83] After resuming a positive quarterly growth rate in 2009 Q3, actual final consumption accelerated (by 1.1 percent in 2009 Q4 and by 0.1 percent in 2009 Q3 respectively), while exports reported further a positive pace of increase, albeit slower than in the previous quarter (0.7 percent in 2009 Q4 and 4.0 percent in 2009 Q4 respectively), which outpaced the still negative growth rate posted by imports in 2009 Q4 (-1.4 percent in 2009 Q4 and -1.9 percent in Q3 respectively).

[84] Budget transfers rose 4.6 percent in real terms in January-February 2010 as compared with the average for the previous quarter, non-seasonally-adjusted data.

[85] After recording negative annual and quarterly growth rates in 2009 Q4, economy-wide average net real wage (seasonally-adjusted data, NBR calculations) deflated by consumer price index for January and February 2010 increased slightly by 0.4 percent as compared with the average for 2009 Q4. The annual change in the first two months of 2010 as compared with the average for 2009 Q1 was negative, i.e. -1.0 percent (non-seasonally-adjusted data).

[86] In January-February 2010, leu-denominated net foreign transfers dropped 44.9 percent in real terms as compared with the average for the previous quarter, non-seasonally-adjusted data.

[87] In March 2010, unemployment rate (registered unemployment, non-seasonally-adjusted data) stood at 8.4 percent, on a rise from 7.8 percent at end-2009. In fact, unemployment rate continued to increase from the 3.7 percent reading recorded at the end of 2008 Q2.

[88] According to the National Bank of Romania's quarterly survey on lending to non-financial corporations and households, released in February 2010, household lending standards were tightened in 2009 Q4, except for those related to mortgage loans (which remained unchanged). However, lending standards are expected to be no longer tightened in 2010 Q1. Nevertheless, the aforementioned expectations do not seem to be confirmed in the first part of 2010 Q1, as in the first two months of Q1 new loans to households dropped 23.4 percent in nominal terms (leu-denominated loans) and 28 percent (EUR-denominated loans) as compared with the average for 2009 Q4 (non-seasonally-adjusted data), whereas consumer loans fell by 5.6 percent in real terms in 2010 Q1 against the average for 2009 Q4.

deposits decreasing in real terms[89]. A heterogeneous picture on aggregate demand developments is also revealed by the dynamics of market services to households which followed a sharp upward trend in Q1, whereas the turnover of retail trade (except motor vehicles and motorcycles) stayed on a downward path quarter on quarter[90].

After declining for two consecutive quarters, general government final consumption saw a positive quarterly growth rate of 4.4 percent in 2009 Q4, yet it is expected to remain below the medium-term trend in 2010 Q1 as well. Public deficit was kept in the vicinity of the parameters agreed upon with IFIs at end-2009, i.e. 7.4 percent, the preliminary data available at end-March indicating a 1.5 percent deficit-to-GDP ratio.

In 2009 Q4, the quarter-on-quarter dynamics of gross fixed capital formation re-entered negative territory, standing at -2.7 percent as compared with the quarterly growth rate of 5.0 percent[91] recorded in Q3. Gross fixed capital formation is the GDP component that saw the strongest adjustment throughout 2009, dropping 25.3 percent, as compared with the figure recorded in the previous year (gross data). Investment in equipment posted further sharply negative annual growth rates in 2009 Q4 (-57.1 percent), as companies adopted a prudent stance with regard to continuing retooling due to uncertainties generated by economic crisis, which also had a negative impact on the growth rate of potential GDP. The sharp year-on-year decline in investment in equipment is also reflected by imports of capital goods whose annual rate of increase remained negative in 2009 Q4, the quarterly change being nevertheless positive[92]. The other component of investment in the domestic economy, namely new construction works, continued to decrease year on year in 2009 Q4 (-22.6 percent), reflecting the substantial adjustment in the construction sector. The resumption of investment is also limited by the tight real lending rates, given the significant drop in external financing sources, so that medium-

[89] In 2010 Q1, household deposits in both leu and foreign currency declined by 2.8 percent against the preceding quarter, reflecting real decreases in both components: leu-denominated deposits went down -2.1 percent, while foreign currency deposits dropped -3.9 percent when expressed in lei (seasonally-adjusted data, NBR calculations).

[90] In January and February, the average retail trade (except for motor vehicles and motorcycles) went down 1.5 percent as compared with the average for 2009 Q4, while the turnover for market services to households rose by 13.1 percent over the same period (seasonally-adjusted data, NIS).

[91] According to the data released by the NIS in March 2010, the quarterly change in gross fixed capital formation stood at -0.1 percent in 2009 Q1 and at -32.3 percent in 2009 Q2.

[92] The annual growth rate was of -29.9 percent, whereas the quarterly growth rate remained in positive territory for the second quarter in a row, i.e. 8.7 percent (seasonally-adjusted data, expressed in EUR).

and long-term loans to legal entities post negative annual and quarterly growth rates[93].

The positive albeit slower quarterly dynamics of exports in Q4 than in 2009 Q3[94] was influenced by exchange rate developments of the domestic currency, as well as by external demand which stayed flat in 2009 Q4, following the advance seen in the preceding quarter[95]. The persistent downtrend in imports[96] starting with 2008 Q4 reflects the fall in household aggregate income as well as companies' low propensity for investment. In addition, the slowdown in import adjustment in the latter half of the previous year is in line with the positive dynamics of exports. In 2010 Q1, the positive dynamics of exports and the slower pace of decline of imports are expected to continue, both components remaining below the medium-term trend.

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

Over the first quarter of 2010, the domestic currency strengthened in nominal terms against the euro, its dynamics remaining on the path initiated in the second part of the previous quarter. By contrast, the leu weakened against the US dollar, reflecting the appreciation of the latter against the euro in 2010 Q1. In the period under review, the domestic currency saw a quarterly appreciation in terms of the nominal effective exchange rate[97]. As a result of the increase in domestic prices exceeding that recorded by Romania's trade partners, the appreciation of the national currency in real terms was even higher.

In the period under review, the pressures towards the appreciation of the leu on the foreign exchange market were based on some positive developments in the domestic economy, within an overall

[93] Medium- and long-term loans to corporations declined by 2.1 percent in real terms in 2010 Q1 versus 2009 Q4. The annual change of this indicator entered negative territory (-4.4 percent) for the first time in Q1.

[94] In 2009 Q4, the quarterly growth rate of exports of goods and services stood at 0.7 percent, on a downtrend as compared with that recorded in the preceding quarter, i.e. 4.0 percent.

[95] In 2009 Q4, the quarterly growth rate of real GDP in the euro area, whose Member States are Romania's major trading partners, stayed flat at 0 percent, after the quarter-on-quarter expansion seen in Q3 for the first time since 2008 Q1 (0.4 percent). The quarterly dynamics of imports of euro area countries, which may be seen as an alternative measure of external demand, slowed down as well. Thus, after a quarterly increase of 2.9 percent in 2009 Q3, the quarterly growth rate, although further positive, decelerated to 1.3 percent in Q4.

[96] In 2009 Q4, the quarterly dynamics of imports posted further a negative reading, i.e. -1.4 percent, declining at a slower pace than in the prior quarter (1.9 percent).

[97] 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.

positive trend seen in Central and Eastern European countries. Except for the arrears criteria, Romania has complied with the terms of the loan agreement concluded with the IMF, the EU and other international financial institutions, so that two new disbursements were made. Furthermore, favourable effects on the strengthening of the leu resulted from the relative political stabilisation, the improvement of the country's outlook from "negative" to "stable" by Fitch credit rating agency, the further adjustment of the current account deficit and, last but not least, the rate of GDP contraction in 2009 posting less unfavourable levels than those forecasted by some institutions (e.g. -8.0 percent projected by the European Commission against the actual level of -7.1 percent).

The issues related to the financing of Greece's public debt that were discussed during 2010 Q1 had an adverse impact on global investors' sentiment towards the euro area, which improved slightly towards the end of this period, against the backdrop of euro area participants assuming, at declarative level, a financial assistance package to this Member State. The assessment of the sustainability of the public debt incurred by some euro area countries contributed to the investors' decision to channel their money towards countries in the region with lower deficits and levels of public debt and higher growth potential, Romania being one of the recipients.

The appreciation in real (effective exchange rate) terms of the domestic currency offset the past stimulative impact on the aggregate demand via the net export channel. Moreover, through the wealth and balance sheet effects, the impulse of the stronger leu on foreign currency lending and implicitly on aggregate demand is stimulative, due to lower cost for foreign currency loans and higher foreign currency value of the collateral. The cumulative effect of the exchange rate on future aggregate demand via the two aforementioned channels was significantly less stimulative in 2009 Q4. The leu appreciation in nominal terms exerts a direct impact, *ceteris paribus*, on the lower CPI inflation rate through the favourable effect on import prices.

Over the first two months of 2010 Q1, the NBR was still a creditor vis-à-vis the banking system, whereas in March the net liquidity position of the banking system returned to a surplus. Against this background, in 2010 Q1, the average overnight ROBOR rates on the interbank market fell by 4.4 percentage points as compared with the previous quarter, being positioned below the monetary policy rate.

The evolution of interbank interest rates, influenced also by the successive cuts in the monetary policy rate over the last quarters, fed through into decreases in nominal lending and deposit rates applied by credit institutions to their clients. Thus, these rates dropped approximately 1 percentage point against the previous quarter. In 2010 Q1, the interest rate spread widened marginally compared with 2009 Q4, suggesting the persistence of banks' prudence at elevated levels.

For 2010 Q1, inflation expectations show a slightly lower level than that recorded in 2009 Q4, the decline in lending and deposit rates in real terms being thus determined mainly by the change in nominal rates. Therefore, the restrictive impact of real (lending and deposit) rates on the future economic activity is estimated to be weaker.

For 2010 Q1, the cumulative effect of the leu exchange rate and of credit institutions' interest rates applied to non-bank clients on the future economic activity became neutral (compared with the previous quarter when it was assessed to have been stimulative).

1.3.3. Demand pressures within the projection horizon

The latest data on the real GDP growth rate for the euro area[98] called for the downward revision of the assumption regarding external demand dynamics. Moreover, the recent problems regarding the sustainability of the public finances in certain Member States as well as the fiscal consolidation efforts made by government authorities associate a high level of uncertainties related to the external economic environment. The current projection maintains a significant positive contribution of real exports to domestic economic growth, albeit slightly lower compared to the previous round. The revival of economic activity in the euro area is the key determinant for export dynamics. In contrast to the sizeable current account deficit adjustment made in 2009[99], the current projection shows a slight worsening of this deficit in the latter half of the projection horizon generated by the rebound of import dynamics following the foreseen revival of domestic demand.

Private consumption is expected to remain at relatively low levels at least for the upcoming period, but it will benefit from the favourable impact of certain factors starting with the second half of the projection horizon. The unemployment rate stabilisation in the latter half of the current year and the favourable prospects for its evolution throughout 2011 will contribute to the relative improvement of labour market conditions. In such an environment, an increase in labour productivity will create favourable conditions

[98] See Subsection *1.2. Exogenous pressures on inflation* for the assumptions regarding the economic growth rates in the euro area, Romania's main trading partner.

[99] According to revised statistics, the share of the current account deficit in GDP narrowed from an estimated 11.6 percent in 2008 to only 4.5 percent in 2009.

for the real wage growth rate to return to positive territory in the latter half of the projection horizon. Private consumption dynamics will also benefit from gradually less tight lending standards and the progressive cut in the interest rates applied by commercial banks to their clients.

So far, the companies' excess production capacity and the uncertainties surrounding the future demand dynamics have acted as a deterrent to gross fixed capital formation. The downward revision of the potential GDP[100] growth rate for both the previous period and the period ahead was also due to the reduction in the level of fixed capital stock. The baseline scenario envisages the persistence of a negative GDP deviation from its potential level throughout the projection horizon. In this context, companies are expected to choose to defer new investment until capacity utilisation rate rises to a sufficiently high level. Moreover, the size of the estimated demand shortfall allows persistently high disinflation pressures, the companies opting for accommodating any pressures coming from a prospective rebound in demand by boosting supply and production to an optimal level rather than by increasing retail prices. In the light of stronger consumer demand, the change in inventories will make, by contrast, a positive contribution to economic growth throughout the projection horizon. Starting with the latter part of the projection horizon, the upturn in investment is anticipated to help boost real imports, particularly imports of capital and intermediate goods.

The baseline scenario of the forecast is conditional upon the carrying through of the multilateral external financing arrangement signed by Romania in April 2009 and updated in January 2010. Foreign investor sentiment regarding the vulnerabilities, along with the favourable prospects for the Romanian economy, depends on the 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 IFIs[101]. Under such circumstances, the baseline scenario foresees the exchange rate dynamics being in line with the developments in macroeconomic fundamentals, which will create the conditions for a relatively neutral real effective exchange rate in relation to the economic activity.

Regarding the monetary policy, the favourable prospects for disinflation to continue throughout the projection horizon imply the keeping in place of a monetary policy stance adequate to the rebound in economic activity. In this respect, real interest rates

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

[101] For an assessment of the implications of a potential worsening of the domestic macroeconomic environment, reflected in the adjustment of the conditionalities attached to this arrangement, see Subsection *1.4. Risks associated with the projection.*

applied by financial institutions to non-bank clients will play a key role. Moreover, the downward adjustment of nominal interest rates will depend on a number of factors, among which: (i) the manner in which financial institutions will choose to respond to monetary policy signals; (ii) the risk perception associated with the economic environment as regards lending; (iii) the constraints on each financial institution in terms of prudential regulations and requirements pertaining to the banking sector.

Fiscal policy coordinates remained in line with the obligations assumed under the external financing arrangement signed by Romania with IFIs[102]. The reassessment of the estimated negative output gap towards less ample levels in the current round led to the revision of the ratio between the impact of cyclical factors and structural factors on the projected budget deficit, thus contributing, *ceteris paribus*, to the outline of a slightly more pronounced pro-cyclical fiscal policy stance compared to the previous projection.

1.4. Risks associated with the projection

For the current projection round, the analysis of the specific risk factors with a relevant likelihood of materialising over the upcoming eight quarters points to a slightly asymmetrical distribution, implying a relatively higher likelihood of upside deviations of inflation from the baseline scenario trajectory, especially over the first part of the horizon. The relevant risks to economic activity appear to be relatively symmetrically distributed around the baseline scenario levels.

Some of the risks identified in the previous Inflation Report materialised during February-April 2010, albeit still in an early stage. The risk associated with external economic developments especially deserves to be mentioned as it has materialised in a slowdown of the quarter-on-quarter growth rate of euro area GDP in 2009 Q4 and in the downward revision of its dynamics forecasted for 2010[103].

Amid the still fragile recovery, the possible upcoming heightening of the tensions that have recently built up on certain segments of the European financial market[104] might contribute to investors' increased risk aversion towards several euro area economies with similar vulnerabilities[105] and could thus generate spill-over effects

[102] Described, for instance, in the Technical Memorandum of Understanding concluded between the Romanian authorities and the IMF and published on IMF's website on 5 February 2010.

[103] For further details, see Subsection 1.2. Exogenous pressures on inflation.

[104] Relating mainly to the fiscal sustainability challenges faced by Greece and the likelihood of contagion in the financial sector amid worsening sovereign credit risk.

[105] Refers to fiscal sustainability in economies such as those of Portugal, Spain or Italy.

with a likely detrimental impact on future developments in the euro area's real and financial sectors. In the event of such a risk materialising, the effects on the Romanian economy conveyed via the external demand and financial channels would entail a downward revision of economic growth outlook compared to the baseline scenario coordinates, while the effects propagated via the exchange rate channel[106] would lead to an upside deviation of the inflation rate from the coordinates.

Against this background, a risk scenario might relate to a more persistent depreciation of the euro versus the US dollar during 2010 if the resort by Greece to the financial assistance package proposed by euro area countries in cooperation with the IMF does not solve the issue, be it in terms of the actual size of the package or the effectiveness of the attached conditionalities. As far as the Romanian economy is concerned, the depreciation of the euro against the US dollar would entail a weaker leu versus the latter, resulting in higher domestic fuel prices[107]. At the same time, further downward pressure on the domestic currency could become manifest, at least over the short run, if the likely rekindling of global risk aversion were to be accompanied by capital outflows. This would have a detrimental impact on domestic economic growth, amid the marked deterioration of the net wealth of economic agents indebted in foreign currency (the wealth effect channel), not offset by a stronger stimulative effect of the effective exchange rate on net exports, given the heightened uncertainties surrounding the companies' outlook for the duration of this state of affairs.

Amid the high uncertainties regarding the short-term developments of the euro area economy, the materialisation of more visible favourable trends than those assumed in the baseline scenario of the projection is also possible. This might occur as a result of stronger-than-anticipated effects of the monetary and fiscal stimulus packages implemented by euro area countries, the consolidation at a faster pace of euro area financial institutions' balance sheets – entailing the sooner-than-expected unwinding of government support schemes – and the faster recovery in international trade. Under such conditions, the risks described by the entire possible range of the dynamics of the external economic environment are perceived as symmetrically distributed around the trajectories of macroeconomic variables in the baseline scenario.

[106] The impact exerted via this channel could be considerably magnified if the risk of a slippage in domestic fiscal policy coordinates materialises at the same time. This risk is described in more detail further on in this section.

[107] The oil price used in the baseline scenario projection, i.e. West Texas Intermediate, is expressed in US dollars.

Looking at the components of the domestic macroeconomic policy mix, the fiscal policy stance is deemed to be ridden with the highest uncertainties over the current forecasting round. The baseline scenario of the projection incorporates the assumption of keeping fiscal policy coordinates in line with the commitments made under the multilateral external financing arrangement signed with the EU, the IMF and other IFIs. Based on past experience[108] and given the latest information on GDP historical data[109], as well as the likelihood of the macroeconomic scenario deviating from the levels underlying the fiscal projection[110], a possible risk scenario regarding fiscal policy developments will most likely be one of the following: (i) upward revision of the budget deficit, provided that the EU-IMF-IFIs give their approval; or (ii) upward revision of the budget deficit, non-acceptance of the upward revision of the budget deficit and hence termination of the IMF-EU-IFI-led multilateral financing arrangement.

In the event of the former scenario materialising, the need to finance the additional deficit, which will possibly be partly covered from funds released by the international consortium, would probably feed through eventually into heightened pressures on the domestic financial markets[111]. This would result, to a certain extent, in the crowding-out of the private sector in relation to available financing sources and would thus generate delays in the sustainable revival of lending to the productive sector of the economy and in the recovery of domestic economic activity. The latter scenario would bring about a critical disruption in the coordination of the domestic macroeconomic policy mix, with negative consequences in terms of investor risk aversion towards leu-denominated assets and fuelling inflation via depreciation pressures on the domestic currency. Moreover, correcting the deficit under such a scenario could not rule out the resort to *ad-hoc* measures aimed at increasing budget revenues, with potentially unfavourable effects on domestic economic growth.

[108] The fiscal policy coordinates agreed under the IMF-EU-IFI-led multilateral financing arrangement have changed during 2009 and in early 2010, largely on account of projected GDP dynamics or, as applicable, of actual GDP dynamics (especially as regards budget revenues) and of the measures taken to curb current expenditures (particularly staff costs, but also expenditures for purchases of goods and services). Thus, the budget deficit criteria (cash) agreed in June 2009 set forth a 3.6 percent level for 2010 and 2.7 percent for 2011. Subsequently, as Romania's economic performance deteriorated, the new budget deficit targets were adjusted in October 2009 to 5.9 percent for 2010 and 4.2 percent for 2011. The targets remained generally unchanged in February 2010.

[109] See Chapter III, *Economic developments*.

[110] Against this background, a major risk stems from the more severe deterioration of labour market conditions and their possibly lagged response to GDP aggregate dynamics, which would have an equally detrimental impact on aggregate demand (via economic agents' disposable income) and aggregate supply (by limiting the economic growth potential) and hence on the government budget balance.

[111] Given that a wider budget deficit might convey a message of increased wariness on international financial markets, most likely reflected in a larger risk premium for holdings of leu-denominated government bonds.

Box. Quantitative assessment of the influence exerted by some unfavourable exogenous shocks

In the current approach, the influence of *general risk factors* on the inflation projection in the baseline scenario is illustrated in quantitative terms, by associating an uncertainty interval to it (see the chart *Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario*). This methodology relies primarily upon the use of past forecast errors in approximating future uncertainty, plus a certain correction factor due to the involvement of monetary policy makers*.

Each issue of the Inflation Report regularly provides a qualitative description of the influence exerted by *specific risk factors* deemed to be particularly relevant over the projection horizon. The quantitative assessment of one or several specific risk factors implies explicitly-quantified assumptions.

This box aims to provide indications regarding the impact on the annual CPI inflation rate projection (calculated through the NBR's forecasting model) in the hypothetical event that several *specific risk factors* materialise at the same time. In order to facilitate the interpretation of results, the scenario assumes a monetary policy stance identical to that in the baseline scenario. The specific assumptions differ significantly from those incorporated in the baseline scenario and refer to:

(i) a weak agricultural output over the upcoming two years on account of adverse weather conditions (e.g. drought, flooding, etc.), as a result of which volatile food prices (of vegetables, fruit and eggs) would increase faster than assumed in the baseline scenario. Moreover, there might be an additional impact in this case: since domestic demand for food products could be satisfied through imports, cumulated with the effects of assumption (iii), the inflationary impact in terms of the annual CORE2 inflation rate would be even higher;

(ii) a significant adjustment of administered prices for a broad category of goods and services amid the occurrence of events not included in the baseline scenario assumptions: (a) a larger increase in the costs incurred by distributors/producers in the energy sector amid the worsening of their financial situation, as a result of the contraction in domestic economic activity, (b) the unfavourable influence exerted by higher international oil price [see assumption (iii)] on the domestic natural gas price**, (c) the need to bring public utilities (water, sewerage, sanitation) in line with European quality standards through additional investment;

(iii) a larger-than-forecasted hike in oil and other commodity prices (agricultural produce included) on international markets on the back of stronger global demand.

N.B.: (1) The scenario described herein serves an illustrative purpose only; although the underlying assumptions are deemed to have a reasonable degree of plausibility, the specific values associated with the shocks in the risk scenarios are randomly chosen (i.e. they do not represent forecasts). (2) Depicting an upside deviation of the inflation rate from the baseline scenario trajectory does not necessarily imply a higher likelihood attached to such slippages (compared to opposite movements); Section 1.4 dwells further on the relevant considerations for the reference period regarding the symmetrical/asymmetrical nature of the risk factors depicted in this box. (3) Results may not be used in calculating average elasticities. The magnitude of the estimated impact hinges explicitly on the current macroeconomic environment, while the same shocks may lead to different results in other circumstances. Moreover, applying shocks of an equal magnitude, but of an opposite direction, under the same initial conditions will not yield numerically-symmetric results.

	Baseline scenario		Risk scenario		Change (p.p.)	
	2010	2011	2010	2011	2010	2011
Assumptions						
Annual inflation rate of volatile food prices (%, Q4 current year/Q4 previous year)	2.2	3.1	8.6	10.0	+6.4	+6.9
Annual inflation rate of administered prices (%, Q4 current year/Q4 previous year)	5.7	3.8	7.0	5.1	+1.3	+1.3
International oil price (annual average, USD per barrel)	80.3	85.6	85.9	100.2	+5.6 USD per barrel	+14.6 USD per barrel
Results						
Annual CPI inflation rate (%, end of period)	3.7	2.8	4.7	3.7	+1.0	+0.9
Annual CORE2 inflation rate (%, Q4 current year/Q4 previous year)	2.8	1.7	2.9	2.0	+0.1	+0.3
Annual fuel price inflation (%, Q4 current year/Q4 previous year)	9.4	8.9	12.3	10.7	+2.9	+1.8

* For further details, see Box 3 - *Building the uncertainty interval associated with the baseline scenario inflation forecast* in the November 2008 Inflation Report.

** According to the Romanian Energy Regulatory Authority (ANRE), any change in the international oil price feeds through into natural gas import prices with a lag of around 6-9 months.

One of the risks reiterated over the previous projection rounds – and primarily since knock-on effects from the global crisis became manifest on the domestic economy – relates to CORE2 inflation dynamics in connection with developments in economic activity (approximated through the dynamics of GDP deviation from its potential level). Although demand shortfall was revised to less negative readings, the distribution of risks associated with the persistence of core inflation points to slightly asymmetrical risks over the current projection horizon, with a higher likelihood ascribed to upside deviations from the projected trajectory of CORE2 inflation in the baseline scenario. On the one hand, given the considerable share of economic agents facing financial constraints, any delays in the sustainable revival of lending to the private sector[112] might further deter any cutback in retail prices or could lead to a gradual reduction in such prices, at a pace not matching the decline in solvent demand in the economy[113]. Such behaviour could not be entirely ruled out even assuming a significant decrease in nominal unit labour cost incurred by them[114]. In addition, the anticipation of possible future steps taken by the authorities with a view to correcting macroeconomic imbalances[115] could generate heightened uncertainties, likely to translate into persistently high inflation expectations (CORE2 inflation included), not necessarily substantiated by fundamentals. On the other hand, the faster rebound in consumers' solvent demand compared to the baseline scenario assumptions, amid the recovery of economic activity and the sustainable revival of lending for productive activities, might entail a drop in market prices below the baseline scenario levels, given the keener competition among economic agents.

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

A larger-than-anticipated hike in international oil prices could occur particularly 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. An alternative scenario is also likely at this juncture,

[112] According to the latest survey conducted by the National Bank of Romania on lending to non-financial corporations and households (February 2010), the risks perceived by banks in relation to companies increased economy-wide during 2009 Q4, thus marking the first significant upswing in risks associated with corporations.

[113] Preserving a certain profit margin, even at the cost of a lower market share, might safeguard the self-financing of economic agents to a certain extent.

[114] See Chapter III, Section *2. Labour market*.

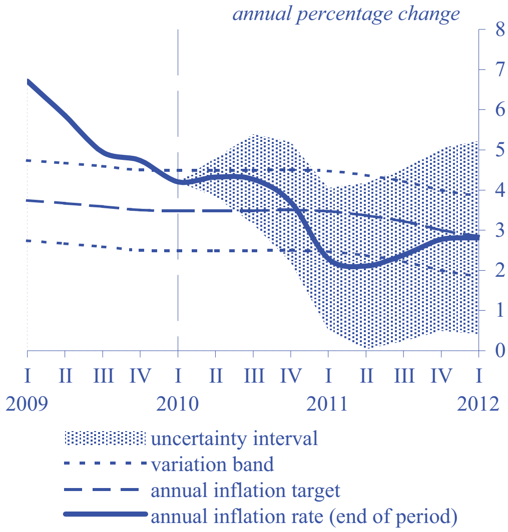
[115] For example, possible decisions by fiscal authorities might not exclude *à priori* additional hikes in administered prices or even further upward adjustments of taxes levied on certain categories of excisable goods. In either case, the CPI inflation rate would witness upward deviations from the baseline scenario trajectory.

namely a lower oil price over the projection horizon, especially assuming a more sluggish rebound in aggregate demand across advanced economies, which would offset the recovery of economic activity in emerging economies. In this case, domestic fuel prices would drop below the baseline scenario reading.

As regards administered prices, their adjustment calendar set by the authorities is fraught with uncertainties, as reflected by the 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. In this case, the uncertainty interval around the central trajectory is symmetrical in relation to the projected trajectory of CPI inflation in the baseline scenario and is based on past CPI inflation forecast errors.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR calculations

2. Policy assessment

The performance of inflation in 2010 Q1 was largely in line with expectations. The disinflation process which broke off temporarily in November 2009 due to the significant impact of the hike in some excise duties resumed in February 2010, with the annual inflation rate returning within the variation band around the central target. In March, the 12-month inflation rate fell to 4.20 percent, markedly below the level recorded at end-2009. The one percentage point drop in the annual inflation rate over the two final months of 2009 was attributed to the stronger impact of the pick-up in demand-side disinflationary pressures[116] (adjusted CORE2 inflation) and administered price adjustments as well as to the more pronounced disinflation of volatile food prices. In turn, the developments in these CPI components benefited from the stronger leu in annual terms.

Disinflation will continue over the coming quarters, as the updated forecast of macroeconomic developments in the medium term reconfirms the outlook for a further downtrend in the annual inflation rate, albeit more slowly, over most of the projection horizon. Moreover, similarly to the previous forecast, the projected annual inflation rate decreases and remains over the first quarters of 2011 in the lower half of the variation band around the central target set for December 2011; subsequently, it will resume a slowly upward trend. However, the current forecast places the trajectory

[116] Over the period, both the annual adjusted CORE2 inflation and the annual growth rate of administered prices hit historical lows.

of the anticipated annual inflation rate slightly higher than that described in the previous forecasting round, but the annual inflation rate expected for December 2011 is still below the central target.

The major determinant of this trajectory is the foreseen performance of the annual adjusted CORE2 inflation rate, whose impact on headline inflation was recently enhanced by the slightly upward revision of its share in the CPI basket. Thus, adjusted CORE2 disinflation is anticipated to consolidate over the coming quarters, albeit at a slower pace than previously projected; its relative slowdown is ascribable almost entirely to the downward revision in the magnitude of the negative output gap given that the potential GDP growth rate, both backward- and forward-looking, was reconsidered in the current forecasting round. Anticipations of a relative pick-up in demand-side disinflationary pressures over the period ahead are based on the high likelihood of a widening negative output gap in 2010 Q1, but especially on the prospects of the aggregate demand shortfall remaining at its highest level over most of 2010 amid expectations of a delay in annual GDP dynamics returning to positive territory; implicitly, the rebound in economic activity is expected to be slower than previously projected over the entire projection horizon, as the uncertainties surrounding the current forecast remain however at very elevated levels.

The annual GDP dynamics remaining in negative territory in 2010 H1, which is indicative of a further deepening of the demand shortfall, features the following major prerequisites and signs: (i) the halt in euro zone economic recovery in 2009 Q4 and the outlook for its fragile resumption in 2010 Q1; (ii) the adverse effect of the significant quarterly decline in GDP in 2009 Q4 on current year's GDP evolution; (iii) faster/protracted negative annual dynamics of some leading indicators of consumer and investment demand during the first months of 2010 Q1; (iv) the persistence of financial deleveraging, but also of an improving trend in households' net saving with banks; and (v) the ongoing deterioration, albeit at a slower pace, of labour market conditions in early 2010.

After assessing the recently available data and the forecast coordinates, the outlook for higher demand-side disinflationary pressures appears to be further supported not only by the persistent economic decline, but also by the relative rise in core inflation elasticity of late in regard to the wider/protracted aggregate demand shortage, suggesting its lowering persistence. Apart from the dissipation of adverse effects coming from the significant pass-through of the leu exchange rate, another explanation for the moderation in the persistent nature of core inflation may lie with the unfolding adjustment in the retail price and wage setting behaviour in response to the magnitude and persistence of the economic downturn in Romania.

Given the maintenance of uncertainties surrounding the outlook for domestic economic recovery, this adjustment is expected to continue in the period ahead. A possible sign is the freezing in 2010 of the private-sector minimum wage, while additional future evidence may come from the outcome of renewed collective bargaining in this sector. From this perspective, less encouraging is the halt, during January-February 2010, in the downward course of the annual growth rate of real gross wage, but especially in the year-on-year reduction in ULC across industry, most notably in some consumer goods industries. By contrast, industrial producer prices for the domestic market further saw their annual dynamics declining in certain sectors producing goods included in the CPI basket, thereby suggesting a squeeze in manufacturers' profit margins. At the same time, the annual rate of increase of prices of some processed food items and durables as well as of some services rates remained on a gradual downtrend.

To continue adjusting these behaviours over the period ahead is essential for curbing the persistence of core inflation in a sustainable manner, implicitly for attaining inflation targets in the medium term without incurring additional economic costs, as well as for the monetary policy stance to be tailored accordingly. From this point of view, inflation expectations play a major role and their necessary re-anchoring is conditional upon the firm implementation of structural and macroeconomic policy measures pursued by the authorities, which are also conditionalities of the financing arrangement agreed with the EU and the IMF. This implies both a pick-up in implementing structural reforms, including in the public sector, and a stronger pro-cyclical nature of fiscal and income policies that could fuel, including via the latter's demonstration effect, an increase in disinflationary pressures both on demand side and supply side.

The adjustment of these behaviours could also be spurred by an anticipated delay in the recovery of domestic demand. As for private consumption demand, anticipations of such an evolution are driven by the persistence of serious concerns regarding households' job prospects and their capability to honour the bank debt service, as well as by the highly likely further contraction in consumer credit. The annual negative dynamics of private consumption is however expected to decelerate gradually, also in view of the recent halt in the worsening of the consumer confidence indicator, and the developments in households' real disposable income, as well as due to the gradual improvement in the balance sheet effect from interest rates and the exchange rate related to households' domestic and foreign currency-denominated debts with credit institutions. Nevertheless, private consumption demand will most likely see a gradual restoration, given that the relevance of caution in shaping households' consumption-saving balance is expected to prevail, at least until signs of the completion of adjustment in private and public sector employees start emerging.

Against this background, the risk of possible administered price adjustments due for implementation over the next quarters to generate second-round effects has diminished significantly. However, it remains high in the case of fuel price, which is expected to be further subject to large upward adjustments following higher oil prices on world markets and a possibly faster pace of appreciation of the US dollar against the euro. Another relevant risk appears to be that to sustainable disinflation and to the achievement of the inflation target in the medium term, owing to high likelihood of steeper prices of some commodities on world markets in the context of a gradual rebound in global demand. From the same point of view, worrying are both the magnitude of direct inflationary effects of any adjustments in regulated prices/ indirect taxes decided and implemented by the authorities throughout the forecast horizon and the unpredictable nature of such adjustments in terms of duration and scale.

Over the period ahead, the recovery of investment demand is expected to be stymied, in turn, by the companies' continued profitability and sales outlook weakening, the maintenance or even increase in overcapacity in some industrial sectors, as well as the delay in real-estate market stabilisation. The protracted trend of a slight improvement in business confidence indicators, which had become manifest at end-2009, fuels however expectations of a possible slowdown in the negative annual dynamics of investment, although during 2009 Q4 the year-on-year decline of this domestic demand component fell further into negative territory in terms of both new construction works and equipment purchase.

Under these conditions, the revival of the dynamics of gross capital formation could be slower than that of private consumption. Nonetheless, this outlook could be invalidated by stronger favourable effects of the implementation of the "First Home 2" government programme and the potential increase in public investment expenditures, chiefly those financed via EU funds and resources taken from international financial institutions and bodies; the latter assumption materialising is however contingent upon the relative cut in current budgetary expenditures. Moreover, the turn in the inventory cycle in certain sectors could help slow down the decline in gross capital formation at a relatively faster pace.

Nevertheless, such evolution hinges largely on the improvement in financing conditions for companies. So far, this has been still hardly reflected by domestic bank loans and has been confined to lower lending rates, following, partially and with a certain lag, the past downward adjustments in interbank market rates. The future evolution of external financing for companies is also surrounded by uncertainties, as a halt in the current downward course of foreign direct investment and external financial borrowings is not yet visible. In addition, Romanian credit institutions appear to become increasingly reluctant to granting new loans, a behaviour motivated, among other things, by fears over their further deteriorating loan portfolios and their concern for reducing the loans/deposits ratio, including amid the balance-sheet adjustment and capitalisation plans put into motion by their parent undertakings. Another reason for banks' behaviour is the ongoing deterioration in perceived risk associated with economic sectors and types of debtors. In these conditions, a possible resort by credit institutions to the protraction of the tightening in some lending terms and conditions should not be ruled out. Also from this perspective, demand for loans might stay weak or even keep weakening in certain economic sectors despite the slim recovery signals sent by companies.

Against this background, similar to other countries' experience, the revival of lending is expected to follow the recovery in economic activity with a certain lag; this is conditional on banks' increased confidence in the economic outlook and the improved risk perception regarding borrowers, on the one hand, and the rebound in demand for loans, on the other hand. A faster rebound in demand for loans might however be fostered by the potential pick-up of the current downtrend in lending rates; this would be the result of successive policy rate cuts and particularly of the recent reduction in interbank rates on longer terms amid the substantial improvement in liquidity in the banking system. Although the possible decline in interest rates on loans in progress might not entail an earlier recovery in lending, it could alleviate considerably the restrictiveness of the related balance sheet effect and mitigate the risks to the credit institutions' loan portfolio quality.

A relatively early recovery in economic activity is however not to be ruled out assuming the rebound in external demand exerts ripple effects on domestic demand components which have so far barely or not at all felt these effects. Even in the absence of such an effect, the previous forecasts indicating the rebounding external demand as the chief driver of domestic economy recovery remain valid, with developments in Romanian exports and implicitly industrial output in recent months being fostered by the reinvigoration of euro zone economy. Although a further pick-up in export dynamics will most likely push imports higher, the growth rate of imports is expected to remain at moderate levels and the current account deficit appears set to stay at sustainable readings.

The recovery of advanced economies, particularly those in the euro zone – supported also by monetary and fiscal stimuli and the relative improvement in confidence –, appears however to be characterised by a higher level of moderation and inconsistency than currently projected. Thus, the euro zone perspectives are fraught with serious uncertainties associated particularly with the duration of the economic stimulus programmes implemented by governments and the effects of their unwinding, as well as with the impact of the increase in public debt to unprecedented levels and the balance-sheet adjustment in financial and non-financial sectors. Adding to these threats are the upside risks to restoring confidence and returning to normality on financial markets induced by heightening investor concerns regarding Greece's debt crisis and its possible contagion effect on other European economies.

In this context, preserving the credibility of the authorities' economic programme by complying with the conditionalities in the agreement signed with the IMF, the EU and other IFIs is crucial for a sustainable consolidation of disinflation, along with restoring confidence and ensuring a lasting revival of both lending and economy in Romania. From this perspective, the major risk looming at the current juncture is a possible deviation of fiscal policy from the current programme coordinates assuming the revenue collection rate fails to improve and the necessary adjustment of public sector's current spending is delayed, thereby entailing the impending postponement of fiscal consolidation. In the event of this risk materialising, the short-term performance of the leu exchange rate and, in turn, the inflation rate might be adversely affected. Such an impact could be magnified by the possibility of a severe deterioration of the risk perception attached to the domestic financial market amid the recent worsening of global financial market sentiment in view of Greece's mounting debt crisis. Furthermore, the tempo of economic recovery and the growth potential in the medium term could be hurt as well.

Given the prospects of disinflation to continue, albeit at a relatively slower pace than previously projected, and of somewhat higher risks to its consolidation, the Board of the National Bank of Romania has decided, in its meeting on 4 May 2010, to lower the monetary policy rate by 25 basis points to 6.25 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 NBR Board reiterated that further compliance with the commitments set under the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions would ensure a consistent implementation of the macroeconomic policy mix, which is essential for achieving sustainable disinflation, maintaining financial stability and restarting a lasting economic recovery.